A Comparison Of Financial Crisis Policy Responses By Ireland And Iceland

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In this paper, James Green, John Kavanagh and Conor Leen focus on the recent economic crises experienced by Ireland and Iceland. They provide background for these crises and explore the different responses of the two. They emphasise Ireland's comparatively limited monetary powers and question whether this was an advantage or disadvantage in the path to recovery in the long run.

Abstract

This paper compares the effectiveness of the policies implemented by Iceland and Ireland in returning growth and stability to their respective economies. It begins by drawing parallels of the laxed management of their respective financial sectors and moves on to argue that Iceland's initial responses vis-à-vis capital controls and its currency depreciation allowed it to realise short term gains and benefits thus returning to moderate growth very quickly. Conversely, the paper argues that the policies implemented in Ireland were a lot more forward looking and the benefits had a longer time horizon. Whereas today Ireland has a stronger business environment and much higher investment levels, Iceland is finally coming out the other side and we see it now reverse some of the policies it implemented.

Introduction

A letter is not the only difference between Ireland and Iceland; this adage holds true no more so than when looking through the lens of the financial crisis. For the most part, there were stark differences in the genesis of the two crises. This paper looks at the respective causes of the each country's crisis and draws conclusions on the similarities between the evolutions of both crises, whether it be the faults and foibles of Ireland's property boom or Iceland's chronic mismanagement of its banks. The paper discusses both policy responses, be it bailout or default and discusses the immediate implications of both. Iceland's banks defaulted on their foreign obligations so the economy could stay afloat, while the Irish bailout was characterised by the recapitalization of Irish banks through

cash injections and the guaranteeing of banks liabilities. Fast forwarding to the present day, the paper analyses the effectiveness of both policy responses in restoring both financial and economic stability to their respective countries.

Background to Both Crises

Starting around the turn of the century, the Irish economy underwent a paradigm shift from export-led growth and became fuelled by rising property prices and a construction bubble (Honohan, 2009). At the same time, in a country of similar size but with less than a tenth of the population further north, banks were privatized for the first time, bringing about their rapid growth (Benediktsdottir *et al.*, 2011).

The boom in Ireland stemmed from a demand for houses, championed by membership of the EU and EMU, which increased net immigration and decreased interest rates (Honohan, 2009). The EMU made over borrowing quasi-safe by veiling the penalty of an interest rate increase if it occurred, which was amplified by the removal of currency risk and thus enabled foreign borrowing. The change in Iceland came from the view that banks should be separated from the government to avoid crony capitalism (Special Investigation Commission, 2010). This ultimately did not happen and the mismanagement of both countries' banks would prove to be a constant in what is otherwise two very different tales.

It would be idealist to say that fiscal policy had not been mismanaged in Ireland. The restructuring of the tax base reduced income tax while increasing the 'windfall revenues' of corporation tax, stamp duties and capital gains tax (Honohan, 2009). This was a fair weather policy that did not consider a downturn. The boom masked the volatility of such sources of revenue which was only revealed when it was too late to prevent what could only be called a fiscal crisis in Ireland. Looking at mismanagement in Iceland's case, IceSave accounts yielding high interest rates were used to attract foreign depositors, proceeds here were put into risky loans (Benediktsdottir *et al.*, 2011). Iceland's banks became key international financial intermediaries and the bank's foreign denominated debt grew to 8 times the size of Iceland's GDP (Brogger and Kristin Einarsdotti, 2008). Ireland's foreign borrowings from the boom, while still large in absolute terms at 60 per cent of GDP, were only a microcosm of Iceland's, showing the degree of mismanagement that manifested itself in the Nordic state.

Delving into the minutia of the Irish property boom, the threefold increase in average house prices from 1994 to 2006 should have been a warning signal to banks. Anglo-Irish Bank's reckless expansion put pressure on others to throw caution to the wind to maintain market share (Mody and Sandri, 2012). The bank's role in fuelling the boom exposed them to solvency and funding pressures. Credit risk was ignored, and bank regulators were complacent in letting lending standards relax (Mody and Sandri, 2012).

Looking at Pillar One and Two of the Basel framework, too much attention was paid to the latter while the former was ignored (Whelan, 2014). This mismanagement set the scene for Anglo-Irish to fail after the Lehman Brothers collapse, and put further pressure on secondary market yields of Irish government securities (Mody and Sandri, 2012). With this, Ireland had unwittingly plunged itself into a financial crisis.

A saving grace for Ireland became a problem for Iceland: membership of the euro (or lack thereof). The Krona already had carry trade problems due to its overvaluation and Iceland broke the Giudotti-Greenspan rule in 2006 leading to an attack on the Krona by speculators (Gylfason *et al.*, 2010). Currency problems meant banks were unable to renew maturing short term obligations. The Central Bank couldn't fulfil its lender of last resort duties as Iceland's foreign debt was too large (Benediktsdottir *et al.*, 2011). The currency crisis made matters worse, foreign denominated debt meant the depreciation increased Iceland's debt burden. Banks tried to draw money from overseas subsidiaries but the UK froze Icelandic assets to protect Briton's Icesave account deposits (Special Investigation Commission, 2010). With credit markets dried up, the banks capitulated, they proved too big to save.

On 29 September 2008, the Irish banks made an overnight decision to guarantee the banking system, borrowing a total of €440 billion (Kauppinen, 2012). On the same day in Iceland, the government announced plans to nationalise Glitnir, the third largest bank (Benediktsdottir *et al.*, 2011). This set in motion the chain of events that would see Iceland default on its foreign debt, and become the first industrialised country in 30 years to get a loan from the IMF (Danielsson, 2011). With this, two crises were well and truly under way.

The Icelandic Default

Iceland adopted a heterodox policy when responding to the collapse of their banks, the inability to use a more orthodox policy cast a die for their future as we will see in the conclusions. They allowed the 3 largest banks, Kaupthing, Glitner and Lansbanki to capitulate, and founded new banks in their stead to take over the domestic operations of these banks. The new banks were bereft of foreign operations, which accounted for two-thirds of the old banks' liabilities, much to the detriment of shareholders and foreign creditors (Special Investigation Commission, 2010). This was by no means a silver bullet solution, but along with strict capital controls, which stabilised the value of the Krona and stopped creditors leaving in tandem with some of the country's GDP, and a debt package to finance the budget deficit, steps were taken in the right direction (Gylfason *et al.*, 2010).

Regarding the logistics of the default, Iceland claimed that since they did not offer a guarantee to foreign debtors, that it should not be them who bore the cost of its

fulfilment, which was a colossal 45 per cent of Iceland's GDP. This would have caused the economy to spiral out of control. Here Iceland's brinkmanship worked as they were not held fully liable where perhaps they would have been under a different system. To cushion the economy's freefall and keep their currency from crashing any more than it already had, Iceland got a loan of $4.6 billion in total (Brogger and Kristin Einarsdotti, 2008). Essentially, Iceland let their banks fail for foreigners, while shielding its people from the brunt of the crisis. Iceland's initial reason for not honouring the guarantee was due to insolvency arising from the credit markets drying up, further down the line when they had the means to repay debts, the people of Iceland voted against doing so in two referenda (Gylfason *et al.*, 2010).

Irish Bailout

With the fall of Lehman Brothers in mid-September 2008, huge pressure was exerted on the wholesale funding of banks, this included Ireland (Mody and Sandri, 2012) As a result, two weeks later, the Irish government introduced the blanket guarantee scheme covering almost all Irish bank liabilities.

This guarantee scheme was expected to cover liquidity problems at banks however it sharply contrasted with the majority of other European countries and the US where they only provide guarantees for new borrowings (Schoenmaker, 2015). However, due to maturing bank paper and non-renewal of deposits, ELA had to be introduced by the Central Bank of Ireland. Therefore the backing up of Irish banks changed hands from the government to the Central Bank. The increasing ELA and the dependence of banks on Eurosystem funding could not be sustained and the guarantee eventually expired (Schoenmaker, 2015).

The recapitalization of Irish banks took place in 2 phases. Both the Bank of Ireland and AIB received €3.5 billion of injections as part of phase one, in the meantime Anglo-Irish was nationalized in early 2009 and received an injection of €4 billion (Schoenmaker, 2015). Phase 2 witnessed the establishment of NAMA, to look after the large loans taken out by property developers. As a result of these large property loans being bought at 'long-term economic value', banks had to incur prospective losses. The Prudential Capital Adequacy Review estimate for the losses on these NAMA and non-NAMA loans of the Irish banks amount to €32 billion (Schoenmaker, 2015).

Policy Implications and Today's Environment

Fast forwarding to today, we are in a very different economic climate to the one witnessed at the time of the crisis. Both policies, either default or bailout, had considerably different effects on their respective countries. This paper now looks at some immediate and lasting effects of the policy responses, comparing how both countries have recovered and what

sort of condition both their financial sectors and economies are in today. It shows how the countries have performed relative to each other and if any lasting effects of the policies are still visible through looking at various figures, while drawing conclusions.

Currency Effects

Iceland's ability to depreciate their currency allowed them to return to moderate growth quite quickly in the form of a boost to exports (Howden, 2013). But this initial growth never developed into sustained long term growth (Howden, 2013). The paper will compare this to Ireland's situation where it was initially worse because of the euro but subsequently developed long term policies to help sustained growth into the future.

As a knock-on effect from the default in Iceland, the sale of domestic assets to fund foreign liabilities led to a huge depreciation in the value of the Krona which saw it surrender roughly half of its value to both the Euro and the Dollar (Howden, 2013). This rapid depreciation led to huge inflation in Iceland and it reached highs of 20 per cent in 2009 (Trading Economics, 2015). This depreciation allowed Iceland to inflate away some of their debts. Ireland on the other hand had to bear the brunt of their debts via the taxpayer as it lacks control over its own exchange rate (Whelan, 2014). Today, Ireland's Debt/GDP levels currently stand at 110 per cent and Iceland's at 86 per cent (Trading Economics, 2015). This points to the extra tax burden which was put on the Irish taxpayer because of the IMF bailout. For Ireland currency depreciation was not an option as it was a member of the EU and the EMU. This paper argues that while it initially hindered Ireland's recovery and proved to be an obstacle, it provided long term benefits for the economy as a whole.

Iceland's depreciation aided some groups, mainly exporters, but did not help domestic producers and consumers. (Howden, 2013) This drastic fall in prices helped them regain international competitiveness and their exports boomed. This also meant that imports became very expensive which, as a small isolated island, the Icelandic consumer relies on. There was a drastic shift of Iceland's balance of trade in 2008 with its increased exports. But it never managed to capitalise on this initial growth and its balance of trade has since been declining. (Trading Economics, 2015) A conclusion from this is that while beneficial in the short run, this depreciation harmed the long term sustained growth prospects of Iceland.

Today we see inflation levels of 2.5 per cent in Iceland which are definitely a lasting effect of crisis (Trading Economics, 2015). In a recent attempt to keep a lid on inflation rates, we have seen the Icelandic government raise interest rates (Hafstad, 2015). Recent developments in wage contracts have led to an increase in expected inflation rates and also indicators have pointed to large increases in household spending (Hafstad, 2015). This shows definite signs of an improving economy but with inflation set to reach 4 per

cent in 2016, the Central Bank of Iceland are taking necessary corrective measures.

Comparing the Irish situation to the depreciation which occurred in Iceland, Ireland witnessed a natural price deflation that allowed relative prices to realign themselves, pointing entrepreneurs in the direction of the profitable areas of the economy (Howden, 2013). Between 2008 and 2010 Ireland suffered deflationary pressures relative to other EU members. This change was a gradual process but there is evidence to suggest that long term benefits of deflation outweigh the short term benefit of a nominal depreciation.

Investment levels today in Ireland are much higher than Iceland's and an analysis of the countries respective current accounts points towards higher investment in Ireland (Trading Economics, 2015). The current account level is a very good indicator regarding the health of an economy (Chen *et al.*, 2013). Ireland's inflation rate, which was around the 4% mark pre crisis, drastically decreased and deflation of 6 per cent occurred in 2009. Today there are inflation levels of 2.5 per cent in Iceland while Ireland's is at a -0.2 per cent level (Trading Economics, 2015). While Ireland initially suffered a lot worse as it couldn't depreciate its currency, it has since surpassed Iceland in growth levels and is seeing the long term benefits of natural price realignment (Gylfason *et al.*, 2010). This return to competitiveness has seen Ireland's annual GDP growth rate be above 4 per cent since January 2014 (Trading Economics, 2015). This year it is set to reach 7 per cent, which is over three times above EU average and 2 per cent bigger than Iceland's. Ireland's policies were for the long term and this is where it reaped the benefits. Iceland performed better in the short run but the effectiveness of the Irish policy response surpassed Iceland's in the long run.

Effects of Capital Controls and the Bank Guarantee

As another impact of the default, the IMF implemented strict capital controls on Iceland (Howden, 2013). The aims of these capital controls focused on three mains areas including limiting foreign currency outflows, putting a stop to the Krona depreciating any further and finally maintaining a desirable level of foreign currency for vital transactions (Howden, 2013). This paper finds that these controls greatly affected Iceland and the lasting effects of these can still be seen today through low levels of foreign direct investment, capital flows, trade balances and the damage done to the legitimacy of its business environment.

The effect of capital controls imposed by the IMF on Iceland have drastically harmed its FDI and have greatly inhibited recovery (Danielsson, 2011). Under the capital controls, entrepreneurs were forced to seek permission from the Central Bank of Iceland to procure foreign funds to invest abroad which made it very difficult for organic growth post crisis. Emigration was also limited as individuals had no guarantee that they could bring their financial capital with them (Howden, 2013). However, more detrimental is the fact that the controls have reduced foreign confidence in the economy and harmed

the nature of their business environment. By blocking investment in projects funded by incoming FDI, Iceland's Central Bank has created a clear disincentive for foreigners to invest in Iceland, effectively reducing its level of openness as an economy (Danielsson, 2011).

Looking at the current figures we see that Iceland's FDI went from extreme highs of 200 billion ISK in 2007 to negative levels in the depths of the crisis (Trading Economics, 2015). Capital controls also meant a lack of access to foreign capital and loans. Investors have had to borrow at the Icelandic interest rate which for the last 3 years has been at highs of 6 per cent. This has made any sort of borrowing very expensive in Iceland and inhibited recovery and real economic growth. In a recent announcement, these capital controls are not set to last much longer as the Icelandic government plans to remove them in January 2016 (The Economist, 2015). It has now reached a stage where the government is in a strong enough financial and economic position to remove these capital controls. Since announcement of this in June 2015, capital flows have skyrocketed and are double what they were at the start of 2015 now (Trading Economics, 2015). Iceland must be cautious in exiting these controls however as it could lead to a huge outflow of assets, thereby destabilising its currency.

In contrast to the harming effect of capital controls on the business environment of Iceland, the Irish bank guarantee gave a boost of confidence to foreign investors as Ireland solidified the stability and longevity of its financial sector (Schoenmaker, 2015). It solidified the government's commitment to an open economy and today we see levels of foreign direct investment have only been increasing in Ireland (Trading Economics, 2015). Unlike Iceland, Ireland's balance of trade has only increased and this is generally due to its export led nature. Due to the free movement of capital, Ireland had access to financing options all over Europe. It has been able to benefit from extremely low interest rates of late and this has greatly aided the economic recovery through cheap loans and increased investment. The figures show that Ireland has had interest rates of approximately 1 per cent since 2010. Compare this to Iceland's current level of 5.6 per cent and it's easy to see why Ireland has recovered so well compared to Iceland.

Conclusion

Bond yields in both countries spiked hugely around the time of the crisis with both Ireland and Iceland's reaching record levels. These are key signs of the stability of a country's financial sector and with banks being so closely linked to the sovereign before the crisis, it points to quite a high level of systemic risk (Battistini *et al.*, 2014). Looking at bond yields today, we have seen Ireland's return from a 12 per cent high in 2009 to a healthy 1 per cent on ten-year sovereign bonds (Trading Economics, 2015). Similarly Iceland's ten-year sovereign reached highs in 2009 of 12.5 per cent (Trading Economics, 2015). We have

since seen Iceland's lower to 6 per cent but this is still quite high for a developed nation. This can be argued to point to an overall better recovery in Ireland because ,as mentioned, bond yields are an indicator of financial and economic stability (Battistini *et al.*, 2014).

The paper set out to compare the performance of each country's economy in response to the implemented policy, be it bailout or default. From both researching the extensive literature and gathering indicators, we were able to draw conclusions on the effectiveness of both respective policies. The paper found that while Iceland initially returned to moderate growth, the lasting effects of the default proved to be detrimental for long term sustained growth. We are finally seeing Iceland come out the other side as it lifts its capital controls. Ireland, on the other hand, implemented long term policies and has reaped the benefits of enduring an initially tougher policy stance.

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