The Economic Crisis in Ireland, Iceland and Latvia

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INTRODUCTION AND SUMMARY

Ireland, Iceland and Latvia have encountered momentous economic problems in recent years. There has been a striking resemblance between the factors that triggered the crisis in the three countries. Ahead of the crisis, all three countries saw strong economic growth, driven by the banks' aggressive credit policies and booming property markets. This led to worsening economic imbalances. The banking sectors grew to a size many times larger than the annual gross domestic product, GDP, making these countries very vulnerable when investors lost confidence in them.

The three countries have requested help from the international community to solve urgent liquidity problems and get their economies back on track. Thus, loan programmes have been launched with contributions from the International Monetary Fund, IMF, the EU and the Nordic countries, including Denmark. All three countries are implementing massive fiscal consolidation plans – with direct austerity measures by close to or more than 10 per cent of GDP. Moreover, a significant improvement of competitiveness is needed in the three countries. In Ireland and Latvia, this is obtained via lower prices and wages and a prolonged period of very modest wage increases. Latvia, among others, has also seen very substantial growth in productivity, which is helpful to the recovery process. The Icelandic krona fell sharply by about 50 per cent in the autumn of 2008. To prevent further depreciation and capital flight, this was met by very extensive capital controls, which have prevented international investors from withdrawing their capital and prevented Icelanders from investing abroad. The decline in the exchange rate eroded purchasing power, resulting in a decline by 20-25 per cent in private consumption in Iceland, while the decline in real GDP was curbed by the impact on competitiveness. Due to the inflationary effect of the currency depreciation, wages and prices have not declined in Iceland.

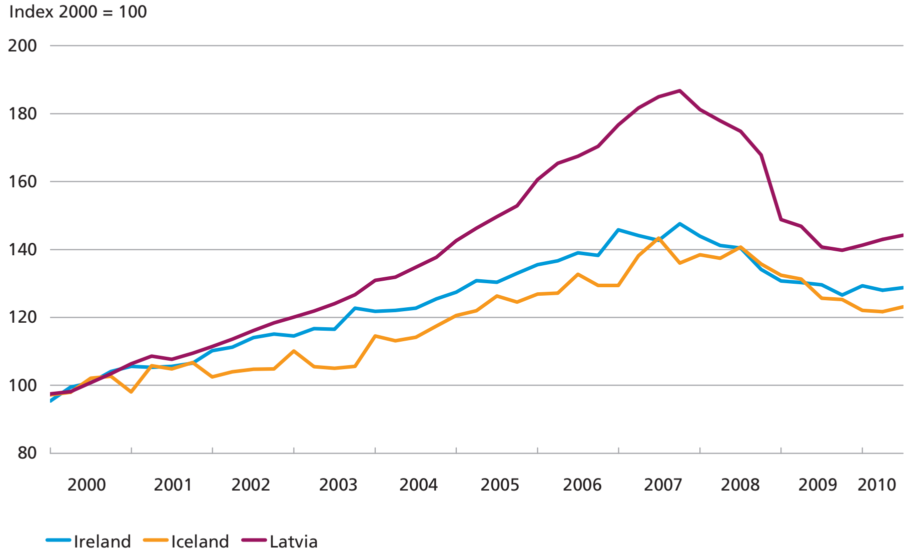
In spite of the severe economic adjustment, there are tentative signs of recovery in the three countries. The macroeconomic situation has stabilised, and the economies experience export-driven growth. However, it is too soon to declare the crisis over, and it will be a great challenge, particularly for Ireland, to complete the extensive adjustment programme and restore investor confidence.

A DEBT-FINANCED ECONOMIC UPSWING

Ireland, Iceland and Latvia posted strong economic growth from early 2000 until the economic slowdown at end-2007, cf. Chart 1. The upswing was largely driven by a huge boom in the housing market, cf. Chart 2. In the period 2001-06, annual increases in nominal house prices averaged 11, 14 and 32 per cent. Investment in construction rose by 5-8 per cent of GDP from 2000 to 2007 and thus accounted for 20 per cent of GDP in 2007, cf. Chart 2. In comparison, investment in construction in Denmark totalled 11.5 per cent of GDP in 2007.

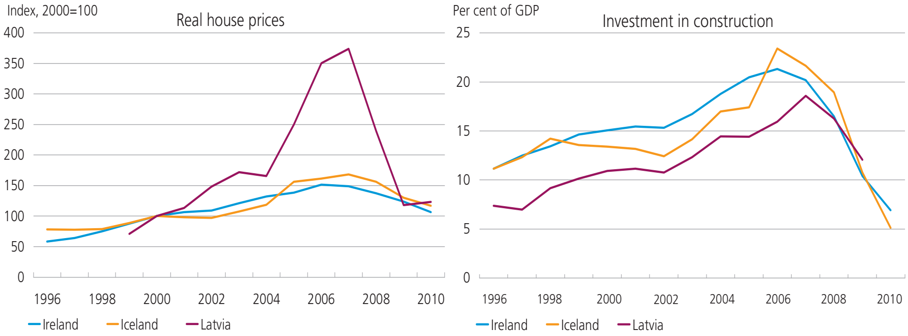
The strong growth was stimulated by aggressive expansion of bank lending. The banks benefited from the ample international liquidity, and credit demand was underpinned by low (or negative) real interest rates. In Iceland and Latvia, many of the loans were issued or index-linked in foreign currency. Irish and Latvian banks primarily granted loans to the housing and construction sectors. The proportion of home loans in the Irish banks' portfolios rose from 40 to 60 per cent during the period 2002-06. In Latvia, home loans also constituted an important

DEVELOPMENT IN REAL GDP Chart 1



Source: The European Commission's Ameco database.

HOUSE PRICES AND INVESTMENT IN CONSTRUCTION, 1996-2010 Chart 2



Note: House prices have been deflated by the GDP deflator. House prices for Latvia are based on prices of a standard flat in Riga. As prices were stated in dollar terms until 2005, the price fluctuations were to some extent affected by exchange rate movements between dollar and euro, to which the Latvian currency was pegged. The sharp price increases in 2004 were, according to the Latvian central bank, due to price hikes by estate agents in connection with the transition to quotation in Latvian lats.

Source: National statistical agencies and the European Commission's Ameco database.

element in the banks' loan portfolios, while the Icelandic banks primarily granted loans to holding companies. This loan type represented half of the Icelandic bank lending in March 2008.

The rapid increase in lending meant that the banks grew very large relative to the size of the economies. This was particularly the case in Ireland and Iceland where the banking sector's assets accounted for 791 and 681 per cent of GDP, respectively, in 2008. Growth in the Latvian banking sector was more subdued, as the sector's assets reached 144 per cent of GDP.

The banks funded much of their lending growth through loans from international capital markets. In this process, they built up large customer funding gaps, which rose to 280, 250 and 220 per cent of deposits in Icelandic, Latvian and Irish banks, respectively, in 2008.

Not until late in the period did the authorities step in with macro-prudential instruments to dampen the rapid lending growth. In both Latvia and Iceland, the reserve requirements for banks were reduced during the upswing. In Iceland, the reserve requirements applying to deposits in the banks' international branches were removed, cf. Iceland's Special Investigation Commission (2010). When the authorities finally tightened the reins on banks, it was too late, and the measures were too inadequate for effective reversal, cf. Honohan et al. (2010).

Nor was fiscal policy sufficiently tight to offset the overheating of the three economies. Even though public finances improved, and government debt was reduced, the underlying fiscal balance was weak. Ireland's structural budget deficit rose from 2.8 to 7.3 per cent of potential GDP from 2004 to 2007 according to the most recent assessment by the IMF (2010). This assessment reflects a sharp downward revision of the estimate of the structural balance relative to the IMF's 2007 forecast of a surplus on the structural balance of 0.7 per cent of GDP in 2007. The erroneous assessment of the underlying fiscal position has presumably contributed to the overly accommodative fiscal policy before the crisis. In Iceland, taxes were cut, cf. Iceland's Special Investigation Commission (2010). In both Ireland and Latvia, the authorities raised public-sector wages and transfer payments, cf. Purfield and Rosenberg (2010) as well as Regling and Watson (2010). In Ireland, government revenue became increasingly dependent on taxation related to property transactions. This made public finances vulnerable to the slowdown in the housing market, cf. Kanda (2010).

The strong economic growth led to overheating. Ireland and Iceland were close to full employment, and unemployment fell sharply in Latvia. The low unemployment triggered higher wages, with annual wage inflation reaching 8 per cent in Ireland, 11 per cent in Iceland and 27 per cent in Latvia in 2004-2008. The strong growth in both domestic demand and wages caused inflation to rise, exceeding 10 per cent in both Iceland and Latvia. Business competitiveness was eroded in tandem with the appreciation of the real exchange rate, particularly in Ireland and Latvia. The Icelandic krona weakened from early 2006. The weaker currency to some extent prevented appreciation of the real exchange rate. However, the weakening of the nominal exchange rate contributed to heightening any inflation pressures in the economy.

The overheating caused increasing external imbalances. In both Iceland and Latvia, the current-account deficit rose to more than 20 per cent of GDP before the outbreak of the crisis. The widening of the Irish deficit to 6 per cent of GDP was more moderate. As the deficits were increasingly funded via short-term foreign loans, the countries became more vulnerable to sudden drops in capital inflows.

STRONG MEDICINE AND LEAN YEARS

The three countries were already hit by an economic slowdown in late 2007, before the global crisis broke out in the wake of the collapse of Lehman Brothers. International funding conditions for the countries' banks tightened. At the same time, the banks tightened their credit standards, particularly regarding loans to the housing sector. Moreover, underlying fiscal problems surfaced during the economic downturn.

The banks' liquidity problems worsened after the collapse of Lehman Brothers, and Iceland and Latvia soon had to turn to the international community for help in October and December 2008. Ireland for long tried to avoid an external rescue package, but had to apply for assistance from the IMF and the EU in December 2010, as the pressure had become too strong after new write-downs in the banking sector. The loans under the rescue packages were substantial, totalling 54 per cent of GDP for Ireland, 40 per cent for Iceland and 33 per cent for Latvia. Denmark contributes bilateral government loans to all three rescue packages.

A basic focal point in the countries' economic stabilisation programmes has been to address the considerable internal and external economic imbalances and at the same time address the serious problems in the financial sectors. Three focus areas were defined: 1. Fiscal consolidation to get government debt under control. 2. Improvement of competitiveness and strengthening of the basis for export-driven growth. 3. Cleanup of the financial sectors.

In spite of the common goals, the actual implementation in economic policy has varied across the countries. Ireland and Latvia, which have fixed exchange rates, follow an internal devaluation programme based on tight fiscal and wage policies combined with structural reforms and support for ailing banks. Iceland, however, pursues a strategy based on depreciation of the exchange rate, capital controls and a serious slimming down of the banking sector. The two types of programmes are outlined below, with special focus on differences and similarities.

Fiscal consolidation and reduction of debt burdens

The three countries recorded burgeoning budget deficits and government debt after the outbreak of the crisis.[1] The main reasons included transfer of social payments to the ever-increasing unemployment queue and expenditure for bank rescue packages. Furthermore, their budgets were burdened by the strong growth in public expenditure before the crisis, cf. Chart 3. Also, tax revenue fell almost as rapidly as it had risen up to the crisis.

The governments therefore had to prescribe a drastic fiscal cure. Since end-2008, Ireland, Iceland and Latvia have tightened their fiscal policies by 6, 7 and 13 per cent of GDP, respectively. Most of the adjustment has been on the expenditure side, partly by reducing public-sector wages, the number of public-sector employees and state pensions. In Latvia, public-sector wages have been reduced by 25 per cent on average. However, all programmes have included room for targeted stimuli, particularly to mitigate the effect of the cutbacks on the most vulnerable groups.

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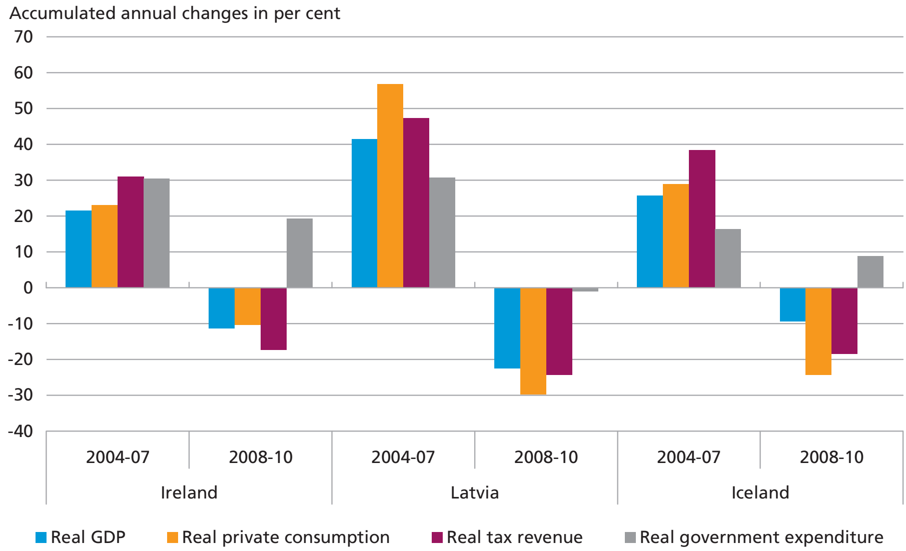
[1] The IMF estimated that the budget deficit would have increased to 13.5 per cent of GDP in Iceland and 20 per cent in Latvia in 2009 if the governments had not implemented fiscal tightening measures.

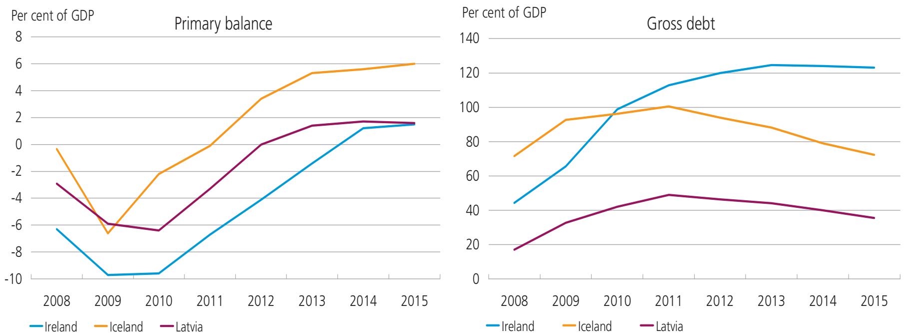
GOVERNMENT EXPENDITURE AND REVENUE DURING THE UPSWING AND RECESSION — Chart 3



Source: The European Commission's Ameco database.

However, public finances remain adversely affected by sizeable structural deficits, support for ailing banks and high unemployment. Ireland is hardest hit, with debt expected to rise above 120 per cent of GDP in 2012 despite substantial fiscal tightening, cf. Chart 4. Therefore, the country is also forced to introduce further considerable fiscal tightening of 9 per cent of GDP over the next four years. This is intended to reduce the deficit to 3 per cent of GDP in 2013. However, the other two countries still have to implement substantial consolidation to reduce debt.

PRIMARY GOVERNMENT BUDGET BALANCE AND GROSS DEBT, 2008-15 — Chart 4



Note: The primary balance of Ireland excludes support for the banking sector of 2.6 per cent of GDP in 2009 and 19.4 per cent in 2010.

Source: IMF (2010b), IMF (2010c) and IMF, *World Economic Outlook*, autumn 2010.

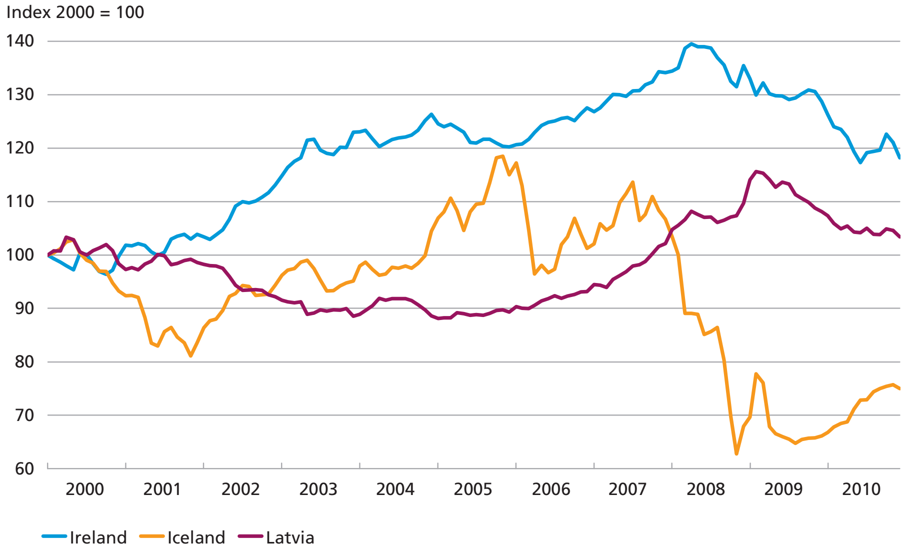
Improvement of competitiveness and export-driven growth

Ireland and Latvia have sought to strengthen competitiveness via a reduction of nominal labour costs. Their labour markets are dominated by a very high degree of flexibility in wage formation. The economic downturn has contributed to putting pressure on private-sector wages, meaning that unit labour costs in Ireland and Latvia have been reduced by 6 and 15 per cent, respectively, in 2009-10. The wage adjustment has caused the real effective exchange rate to depreciate by 15 and 10 per cent in the two countries since the peak in April 2008 and February 2009, respectively, cf. Chart 5.

As a euro area member state, Ireland was, by definition, not exposed to exchange-rate pressure during the crisis, and the wide yield spread after the crisis is not due to exchange-rate risk, but rather to market-related fears of credit risk. It could be argued that the markets practically ignored credit risk during the first 8-10 years after the introduction of the euro and almost exclusively noted that there was no longer any exchange-rate risk related to investment in government securities from euro area member states. Thus, yield spreads to Germany were extraordinarily low for all euro area member states in this period.

Latvia wishes to join the euro area as soon as possible, but has not yet had the opportunity. Instead, Latvia pursues a fixed-exchange-rate policy, in line with Denmark. This situation led to a stronger pressure from the markets as well as much international discussion and disagreement

DEVELOPMENT IN REAL EXCHANGE RATES 2000-10 Chart 5



Source: Reuters EcoWin.

on whether this was the right crisis strategy for Latvia, and some observers recommended devaluation. However, it was of crucial importance to Latvia to maintain the fixed exchange rate vis-à-vis the euro. For more than 15 years, the fixed-exchange-rate regime has provided the basis for stabilising the economy. The authorities feared a string of negative consequences if the exchange rate was allowed to weaken. Firstly, confidence in the country's exchange-rate policy would be eroded. One case of devaluation justifiably causes markets to expect further devaluation in future, resulting in wider yield spreads. Secondly, devaluation would lead to considerable imported inflation, which would make efforts towards wage restraint unrealistic and thus not complement, but replace the other elements of the strategy. Moreover, given the private net debt in foreign exchange of 70 per cent of GDP, devaluation would lead to massive and immediate declines in the net worth of the private sector, which would have a strong contractive effect. Thirdly, Latvia, as a small country, would have problems managing its exchange rate and become strongly exposed to international capital movements with unpredictable effects on the exchange rate and interest rates. Maintenance of the fixed-exchange-rate regime was the most important precondition for euro area membership and hence for obtaining protection against destabilising capital movements.

Latvia's strategy was supported and appreciated, not least by the EU and the Nordic countries. In addition to the assessment of what was best for Latvia, the risk of spreading the exchange-rate pressure to the other Baltic states should also be avoided.

The Icelandic krona weakened already from late 2007 when the economic setback began. The financial crisis in autumn 2008 resulted in further erosion of the exchange rate, and the nominal exchange rate bottomed out in November 2008, having declined by more than 50 per cent compared with the level at the outbreak of the crisis. To offset the weakening of the currency, monetary policy was tightened, and extensive capital controls of cross-border capital movements were introduced.[1] Unit labour costs in domestic currency rose slightly in 2008-10, so overall competitiveness, measured on the basis of the real exchange rate, has improved by 34 per cent from July 2007, cf. Chart 5.

Improvement of competitiveness has limited the decline in Iceland's real GDP to some 10 per cent as from 2008. In spite of the much bigger challenge in the financial sector, this loss of output does not exceed the output losses in hard-hit countries in the rest of Europe. However, the

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1 Restrictions on outgoing investments meant, *inter alia*, that international investors had been forced to maintain their exposure to Iceland. Moreover, the Icelanders have had to invest their savings in Icelandic assets, including government bonds.

standard of living has been clearly reduced by a contraction in private consumption of more than 20 per cent, cf. Chart 3. The reason is that a sharp decline in the exchange rate through deterioration in the terms of trade erodes domestic purchasing power, but through the effect on competitiveness, it affects export and import volumes and strengthens net exports.

Cleanup of the financial sectors

In light of the very large banking sectors in Ireland and Iceland, it is not surprising that the extent of the banking crisis and the price of cleaning up after the collapse have been higher there than in Latvia. Box 1 outlines the main features of the three countries' handling of the banking crisis. In Iceland, the three largest banks – with a combined market share

THE BANKING CRISIS APPROACHES OF IRELAND, ICELAND AND LATVIA Box 1

The three countries have handled the banking crises differently. The differences are to some extent due to the extent of the banking crisis, the banks' exposure and the degree of foreign ownership. In Latvia, most banks were on foreign hands, so they received liquidity injections from their parent banks and maintained their exposure, partly by agreement with the government according to the European Bank Coordination Initiative.

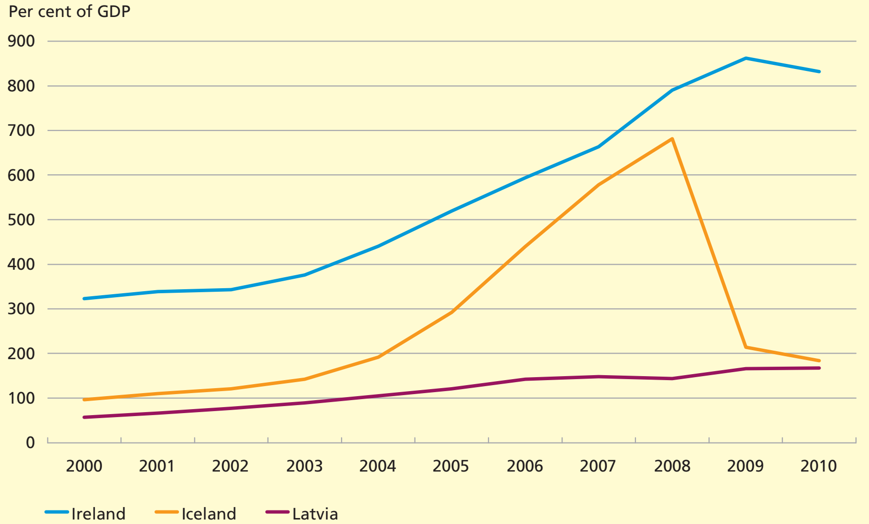
In Iceland, it was not possible to continue operation of the banks due to their size and substantial foreign exposure. To slim down the banking sector, the government split up the banks into "new" and "old" banks. The new state-owned banks took over domestic deposits and assets, and the government subsequently injected capital into these banks. Thus, the domestic banking activities could continue without any significant problems. The "old" banks maintained their foreign exposure. The banks' resolution committees are now responsible for the administration of the bankruptcy estates. Kaupthing and Glitnir were privatised under new names in 2009 and 2010. Landsbanki is still owned by the state. The discontinuation of foreign exposure has reduced the size of the banking sector (in terms of total assets) from 700 to 200 per cent of GDP, cf. Chart 6. The discontinuation of foreign exposure has reduced the Icelandic foreign debt accordingly.

However, the discontinuation of foreign exposure has not been a smooth process. Firstly, the Icelandic authorities passed emergency legislation, changing the priority of depositors, so that depositors took priority over foreign investors in the administration of the bankruptcy estates. Secondly, depositors in international branches of Icelandic branches, most importantly in the UK and the Netherlands, are covered by the 20,000 euro deposit guarantee according to the EU Directive on deposit guarantee that Iceland has joined via the agreement within the EEA (European Economic Association, which, in addition to the EU, comprises Iceland, Liechtenstein, Norway and Switzerland). After a lengthy negotiation process – the Icesave dispute – Iceland, the UK and the Netherlands have agreed on the conditions for refunding the UK and Dutch outlays for the guarantee in autumn 2008. A referendum is scheduled on the issue in Iceland.

CONTINUED Box 1

The problems of the Irish banks were primarily ascribable to their strong exposure to the housing market and a wide customer funding gap, which made them vulnerable if they could not refinance their loans in the international capital markets. The government has kept the banks afloat via capital injections of 45 billion euro in 2009-10. Moreover, the government has set up an agency for managing the banks' bad assets (National Assets Management Agency, NAMA). At end-2010, the agency had taken over bad assets from the banks equivalent of 71.2 billion euro with average write-downs of 58 per cent, cf. National Assets Management Agency (2010). The liquidity problems have been mitigated by government guarantees for the banks' liabilities, access to the ECB's liquidity facilities and emergency liquidity assistance from the Central Bank of Ireland. So far, the strategy has failed to reduce the Irish banking sector notably. The consolidation of the banking sector is expected to take off as part of the IMF/EU programme of support, including via divestment of the banks' international assets.

DEVELOPMENT IN THE BANKS' ASSETS, 2000-10 Chart 6



Note: GDP for 2010 is based on IMF estimates, *World Economic Outlook*, autumn 2010.
Source: Reuters EcoWin, IMF, *World Economic Outlook*, autumn 2010, and national supervisory authorities.

of 85 per cent – collapsed. In Ireland, ailing banks that have received a bailout from the government account for just over three quarters of the banking sector, cf. Laeven and Valencia (2010). In Latvia, only two domestically owned banks collapsed. One of them was the second largest bank in the country. Overall, these banks had a market share of less than 20 per cent. The large foreign-owned banks were supported by their parent banks.

The banking crisis has had a strong negative impact on government budgets in Ireland and Iceland. In Ireland, government capital injections into the banking sector amounted to 45 billion euro in 2009-10, corresponding to just over 22 per cent of GDP, cf. IMF (2010b). For Iceland, the crisis has so far cost an amount corresponding to 22 per cent of GDP in government capital injections and payment of state guarantees under the deposit guarantee scheme, cf. IMF (2010c).[1] In Latvia, the bill was significantly lower at 10 per cent of GDP in 2008-11, cf. IMF (2010a).

The countries' banking sectors are still struggling with non-performing loans. In Ireland, they accounted for 13 per cent of the banks' total loan portfolio in August 2010 and in Latvia for 19 per cent in December 2010. In Iceland, 40 per cent of corporate loans were non-performing in August 2010.

Thus, the private sector is still faced with serious debt problems in all three countries. Therefore, restructuring private debt is a key issue. In Iceland, the government, banks and pension funds entered into an agreement last autumn, aimed at easing homeowners' debt burden. Accordingly, the most heavily indebted homeowners can reduce their loans to 110 per cent of the property value. Other selected borrowers may voluntarily have their loans reduced to 100 per cent of the property value. Moreover, the banks have agreed to reduce the interest rate for selected homeowners for the text two years. IMF (2010c) estimates that the banks' earnings will decline by 10 per cent as a consequence of lower interest income, but it will not affect their solvency notably. In Ireland and Latvia, the restructuring of debt is effected on a more voluntary basis.

Economic outlook 2011-15

There are signs that two years of harsh reforms are beginning to bear fruit in Iceland and Latvia. Confidence in the economies is returning, as reflected in declining risk premiums and yield spreads. For Iceland, however, it remains uncertain how private investors will react when the restrictions on capital movements are lifted. Confidence in the Irish economy is weakened by worries about further losses in the financial sector and mounting debt problems. The rescue package from the IMF and the EU member states has not yet convinced investors that Ireland can break the vicious spiral between the financial sector and public finances.

Though the countries experience an incipient upswing, the crisis is expected to cast long shadows over their economies for many years. The international organisations expect growth to remain moderate until

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1 Though this is a large amount, it is significantly lower than the initial estimates, according to which gross costs of rescuing the banks would have been 83 per cent of GDP, cf. IMF (2008).

2015. The growth outlook is brightest for Latvia, following by Iceland and then Ireland. Domestic demand will be negatively affected by heavy debt burdens and the need for fiscal consolidation.[1] There is a basis for export-driven growth, though. The economies have already succeeded in regaining some of the lost competitiveness, but continued wage restraint and structural reforms are needed to improve the export potential, cf. IMF (2010).

THE LESSON FROM THE ECONOMIC CRISIS

The financial and economic crisis has had a very high price for the three countries under review. They have lost five years of economic growth. In other words, GDP is back at the 2005 level. A record-high number of people have lost their jobs. The bank rescue packages have cost taxpayers dearly. At the same time, the countries have had to accept harsh adjustment programmes, often dictated by foreign institutions.

Obviously, the crisis has led to self-scrutiny in the countries to find out why it went so wrong, and how a similar situation can be avoided in future. The countries have set up commissions to examine these issues (the Regling Watson report on Ireland and the Special Investigation Commission in Iceland). The lesson is largely the same for the three countries. Firstly, significant overheating of the economy results in severe economic crises and a tough adjustment process. There is no easy way out of such a crisis, which – regardless of the crisis management approach – has negative implications for the standard of living and entails a need for prolonged fiscal consolidation programmes. The international community can contribute to preventing the economies from collapsing completely, but the fundamental restoration can only be handled nationally. Against this backdrop, authorities should display stronger vigilance towards macroeconomic warning signals, including awareness as to whether growth is based on unsustainable indebtedness. There is no doubt that fiscal and macroprudential tools should have been used more actively to curtail overheating and the strong credit growth.

Secondly, there are considerable risks associated with allowing the financial sector to grow significantly out of proportion to the size of economy. Experience from Ireland and Iceland shows that the price can become very high in terms of public finances, but also for the economy overall, if the banks face problems.

[1] Herzberg (2010) has estimated that Latvian households' debt overhang has so far reduced private consumption and GDP by 3 per cent. The high corporate indebtedness has reduced investments and caused a decline in GDP of 4 per cent.

Thirdly, it is important to create appropriate incentive structures in the banking sector and at the same time strengthen banking supervision. This will require adequate resources and competencies as well as better and closer cooperation between the various institutions responsible for supervising the banks.

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