



Munich Personal RePEc Archive

Separating the Wheat from the Chaff: Icelandic and Irish Policy Responses to the Banking Crisis

Howden, David

2013

Online at <https://mpra.ub.uni-muenchen.de/79600/>
MPRA Paper No. 79600, posted 09 Jun 2017 04:52 UTC

Separating the Wheat from the Chaff of the Icelandic and Irish Policy Responses to the Banking Crisis¹

This article can be cited as: Howden, David. 2013. “Separating the Wheat from the Chaff of the Icelandic and Irish Policy Responses to the Banking Crisis.” *Economic Affairs* 33(3): 348-60.

It can be found at: <http://onlinelibrary.wiley.com/doi/10.1111/ecaf.12044/abstract>

David Howden
St. Louis University – Madrid Campus
Department of Business and Economics
Avenida del Valle, 34
Madrid, 28003, Spain
dhowden@slu.edu

Abstract: When the tales of the Icelandic and Irish crises are told, they are framed as if one country did everything right to exit recession. In this paper I assess their recovery policies and find that the truth lies somewhere in the middle. By allowing its banking system to suffer substantial losses, Iceland shielded its citizens from the costly debt overhand apparent in Ireland. Ireland’s commitment to open capital markets and price deflation has allowed trade flows to remain robust, and relative prices to realign to signal sustainable production plans to entrepreneurs. These lessons provide a roadmap for other countries entering similar crises in the future.

¹ This paper builds off and extends arguments made in Howden (2012). Research funding was generously provided by the Mercatus Center. I would like to thank Devin Bowen for excellent research assistance, and two anonymous referees for helpful comments.

1 Introduction

In the fall of 2008, the Icelandic banking system collapsed, giving rise to a general economic recession and currency crisis. The size of the banking system and the severity of the events rendered both the Icelandic government and its central bank unable to save the insolvent financial system. The dire situation was mirrored 1,000 miles to the southeast, as Ireland entered into a similar banking crisis. Without a concerted effort to bail out its banking system, it would be brought to its knees like its Nordic neighbour's. The sentiment of the time was captured in a common joke:

“What’s the difference between Ireland and Iceland? Six months and one letter.”

Today each country is slowly exiting its recession, though not without considerable hardship along the way. In general, output has recovered stronger in Ireland while employment growth is more robust in Iceland. In many ways each country pursued an opposite policy response to their recessions: whether it be concerning monetary policy, banking guarantees, nationalizations of the financial sector, or capital controls on the economy.² In this article, I assess the distinct responses and separate the wheat from the chaff. Neither country was able to construct an optimal policy response, though pieces of each response have merit. I conclude with some lessons for countries in similar situations – small open economies with large financial sectors.

2 Nationalizing the Financial Sector

The comparison between Iceland’s and Ireland’s crisis responses typically centres on the idea

² The different responses stem, in part, from the different instigators of the crisis in each country (Howden forthcoming). In this paper I ignore the causes of each country’s crisis and focus exclusively on the policy responses that resulted.

that Ireland bailed out its banking sector, while Iceland allowed its to default. Although this is true in some ways, it understates the role of the Icelandic government in saving its own banks.

2.1 The Liquidation of the Icelandic Financial Sector

The size of the Icelandic banking system, and more importantly the extent of its foreign-denominated liabilities, exceeded the ability of the government or the Central Bank of Iceland (CBI) to bail out. The big three Icelandic banks—Kaupthing, Glitnir, and Landsbanki—dominated the Icelandic banking sector, holding almost 80 percent of its banking assets. More strikingly, these assets amounted to 1,100 percent of Icelandic GDP in 2007 (Buiter and Sibert 2008). By comparison, the U.S. banking sector's total assets in 2007 were less than the size of the whole economy and were spread over a much less concentrated banking industry.

In the initial stages of the crisis of 2008 the Icelandic government did attempt to nationalize the financial system in an attempt to save it. Most notable was the September 29 announcement that Glitnir, the third largest of its banks, was to become effectively nationalized via a €600 million purchase of its assets by the government. This, and subsequent attempts to nationalize the banks, failed to materialize and the country's Financial Supervisory Authority (FME) took over the banks to place them into receivership. The scope of the debts incurred was beyond the ability of the government to secure, and their denomination in foreign currency made the CBI unable to guarantee them. By October 8, all three of the large Icelandic banks had been similarly placed into receivership. Not strictly bailing out the Icelandic banks and placing them into receivership allowed the sovereign of Iceland to remain solvent due to its unwillingness (and inability) to guarantee the banking sector's debts.

Placing the banks into receivership has oftentimes been misconstrued as allowing them to

fail. In fact, the FME ring-fenced the domestic operations of these banks using a modification of the good bank–bad bank model employed in Sweden in 1992. Instead of just isolating toxic from clean assets, however, they opted to split the banks along geographic lines in an effort to protect Iceland from international default (Danielsson 2011a). Unfortunately few assets of suitable quality existed for either the good or the bad bank, effectively rendering the new, albeit smaller banks in trouble and the government on the hook for domestic deposit insurance payouts. “New” (*nýi*) banks were formed to provide for the continued banking operations of “Icelandic families and businesses” (Financial Supervisory Authority 2008a; b; c). Emergency legislation passed on October 7 by the Icelandic parliament gave depositors and the country’s deposit insurance plan priority over other claims to banks. Domestic assets and liabilities were transferred to the new banks. Deposits in foreign branches were given priority status to the assets held in the old banks. Bondholders of the banks—both new and old—were left with claims to the assets that remained in the old banks. In this way much of the banking debt was “repudiated,” though it is clear that depositors (especially domestic depositors) were given priority (Baldursson 2011).

The Icelandic government lent these three new banks €7.96 billion in a bid to recapitalize them, pushing the public debt to more than 70 percent of the country’s 2008 gross national income. This action placed Icelandic public finances on an unsustainable trajectory (Danielsson 2011b) and created what some may call a “dysfunctional” banking system, more interested in recovering its assets from the old banks than in providing core banking activities (Danielsson 2011a). While this has reduced the risk of a sovereign default by ensuring banks put solvency issues at the forefront, it has limited banks’ abilities to fund investment activities essential to growth.

2.2 *The Nationalization of the Irish Financial Sector*

Faced with the real possibility of having its banking system collapse, in September 2008 the Irish Ministry of Finance guaranteed all senior bondholders and extended its deposit insurance guarantee to an unlimited amount. The latter policy had the beneficial effect of generating additional capital, which flowed from other troubled European countries to the perceived safety of the Irish banking system. It also created a contingent liability for the Irish government of about 200 percent of GDP (Connor *et al.* 2010: 5). Political tensions grew because Ireland's European neighbours were unhappy about its unilateral guarantee, which pushed them to follow suit with their own deposit guarantees in an attempt to stifle deposit outflows.

By December of that year, the Irish government had spent €5.5 billion to take controlling stakes in the country's three main banks—Allied Irish Bank (AIB), Bank of Ireland (BoI), and Anglo Irish Bank. In an emergency legislative session, Anglo Irish Bank was nationalized in January 2009, with AIB and BoI each receiving €3.5 billion recapitalizations.

Although these costs of nationalizing Ireland's three main banks seem fairly insignificant—barely €3,000 per Irish citizen—a more extensive if controversial measure was the government's purchase of their bad assets. The National Asset Management Agency (NAMA) was created in late 2009 to take on nonperforming property development loans in exchange for government bonds. While this measure was undertaken to stabilize the banking system, it also ultimately raised the taxpayer cost of resolving the banking crisis (Honohan 2010; Lane 2011).

NAMA purchased loans estimated to be worth €72 billion for €30 billion, making payment partly in cash, and partly by issuing government bonds. This amounted to nearly €7,000 in additional public debt per Irish citizen. It was soon apparent that the Irish government could not afford to finance a deficit during the crisis and support NAMA simultaneously, and Irish

bond prices began deteriorating. By November 2010, the Irish government was obliged by the EU and the IMF to accept an €85 billion bailout, with another €150 billion being provided by the ECB to meet the liquidity needs of the banking system through secondary market bond purchases. Including this additional ECB liquidity directed to the banking sector, the Irish government increased its indebtedness by nearly €25,000 per citizen. These bank bailouts alone amounted to over 14 percent of Ireland's GDP in 2009, and 32 percent of GDP in 2010 (Kinsella and Lyons 2011). Despite these efforts, by April 2011 all six of the major Irish banks had been reduced to junk bond status. By the time the nationalizations were complete the total cost of the bank bailout was 50 to 60 percent of 2010 GDP (O'Callaghan 2011).

2.3 *Discretionary Costs of the Bailouts?*

As a consequence of this one-time payment to the banking system, Iceland's public deficit has not swelled today due to payments to sustain its banking sector—the cost has already been incurred. In Ireland this is decidedly not the case. Additional public sector payments to sustain its zombie banking system—one which is insolvent but sustained by government transfers—have become the norm. Iceland continues to run a public deficit, but not to sustain its banking sector. Instead, strained public finances are the result of decreases in tax revenue from the crisis coupled with an increased drain on its services due to plush unemployment insurance payments and other transfer schemes. Indeed, in 2009 government transfers to households increased to 8.2 percent of GDP, up from 6.1 percent the previous year. Likewise, “public social protection expenditures” increased to 11.3 percent of GDP, up from 8.9 percent in 2009 (Ólafsson 2011: 12). While it could get its deficit under control today by cutting other discretionary spending, Ireland cannot do the same until it allows its banking sector to fail because continual transfers have become

necessary to its continued functioning. Indeed, as illustrated in table 1, Iceland has largely reigned in its public deficit while Ireland still grapples with double digit expansions to its public debt level.

	Iceland		Ireland	
	Public Debt	Deficit/Surplus	Public Debt	Deficit/Surplus
2005	26.0	4.9	27.3	1.7
2006	27.9	6.3	24.6	2.9
2007	28.5	5.4	25.1	0.1
2008	70.4	-13.5	44.5	-7.4
2009	87.9	-10.0	64.8	-13.9
2010	93.0	-10.1	92.1	-30.8
2011	101.0	-5.4	106.4	-13.4
2012	n.a.	n.a.	117.6	-7.6

Table 1: Public debt and deficits (percent of GDP)

Source: Eurostat

The current unsustainable path of Iceland’s public finances is only possible through the \$2.1 billion IMF-supported program enacted in 2008. The ability of the government to continue running large deficits has allowed the country to set itself on a path that must be corrected before insolvency fears re-emerge.

3 Internal or External Depreciations?

Perhaps the greatest distinction in the aftermaths of the two countries’ crises is found in their exchange rate regimes. With its independent currency, Iceland’s króna depreciated quickly as banks sold off domestic assets to fund foreign liabilities. Ireland succumbed to an exchange rate determined in large part by the eurozone’s economic strength, as well as by policies enacted in Frankfurt by the ECB with little regard for the country’s fundamentals (Sharkah and Pawela

2010).

3.1 Was Iceland's Ability to Depreciate Beneficial?

In response to increased foreign claims on Icelandic banks, the sale of domestic assets depreciated the króna. Throughout 2008 the currency lost about half of its value against both the U.S. dollar and the euro. While this sharp depreciation hampered banks as they attempted to meet their foreign claims, it did have the beneficial effect of allowing export-oriented industries to regain international competitiveness quickly. A trade deficit of 30 percent of GDP at the end of 2006 began to reverse in response to increased affordability of domestically sourced Icelandic goods. Entrepreneurs eager to put their newly competitively priced currency to good use came up with creative solutions to profit from the collapse. HEKLA, a 74-year-old car importer in Iceland, constructed a database to clear the excess supply of cars. Buyers from the Faroe Islands, Norway, Denmark, Sweden, and Germany rushed to purchase these cars, and allowed the island to become an exporter of automobiles for the first time in its history (Bagus and Howden 2011a: 107). The fact that Iceland is much more open than other economies made it especially important to seek recovery through its trade account. The openness index – the ratio of total exports and imports to GDP – is a common way to proxy an economy's degree of openness. In 2009 this index stood at 48.6 percent for Iceland, versus 41.3 for the broader OECD and 29.1 for the United Kingdom.

This króna depreciation has benefited Iceland, but only with a lag. The reason is not in the effectiveness of the depreciation to stimulate exports, but rather in the lack of domestic productive capacity to produce goods to export (Bagus and Howden 2011a: 112). In one sense, by saving the defunct banks in the form of their new versions with government money, parts of

an unsustainable banking model have been sustained artificially, and resources have not been redirected to sustainable paths. The fishing industry, for example, can export to help the island in its recovery, but its output has been slow to respond to its price advantage due to a relative lack of labour. This is partly because it is time-consuming for workers to learn skills for a new job. Given that the seafood industry directly and indirectly accounts for 26 percent of Iceland's GDP, and up to 8 percent of its labor force (Sigfusson and Arnason 2011), inhibiting this key sector from growing will prolong the crisis.

Icelandic inflation totalled approximately 28 percent from 2008-09, as the CBI moved to paper over banking and deposit insurance losses (table 3). Iceland's ability to inflate some of its debt away solved one apparent problem but may exacerbate a larger one. The swift depreciation allowed the CBI to honour some of its pledges made to domestic residents though it did nothing to help those who had their debts denominated in a foreign currency, nor did it aid exporters as much as might at first blush be assumed. As the financial sector had some of its debts inflated away, losses were not as great as would otherwise have been the case. While this had the immediate effect of softening the blow, it hindered the exit of workers from this area to more sustainable sectors. As a result, export sectors that can generate capital through exports—such as the seafood industry—have been unable to expand as quickly as would otherwise be the case.

Some relevant prices in the country *have* fallen over the past four years. In particular, securities' prices have collapsed as the general Icelandic stock index fell 93 percent, and housing prices have fallen throughout the country. These price declines, though painful in a financial sense, have sent entrepreneurs a necessary signal as to relative costs and profits in the economy in an attempt to attract their attention to the necessary restructuring. Instead of relying on financial profits from investment portfolios, Icelanders have worked to generate real income-

generating businesses. The fall in stock prices has also increased the cost of capital, which, although making some business ventures unprofitable, allows this unprofitability to be easily seen. When equity prices soared during the boom, the cost of capital in Iceland fell below what was necessary given the supply of real savings to sustain investment projects. As prices have fallen, international competitiveness has been regained, and signalled to investors in the form of higher profits.

	2006	2007	2008	2009	2010	2011	2012
Euro area	6.6	4.5	4.3	-2.3	-0.6	1.2	3.4
Germany	-1.2	-3.8	3.6	-1.2	1.4	1.4	2.1
Iceland	16.8	9.4	6.2	-9.7	-3.0	4.6	5.9
Ireland	14.2	1.7	-12.4	-18.6	-10.5	-16.7	4.3
USA	11.5	-2.0	-13.8	-18.9	2.3	-4.8	1.6

Table 2: House Prices (percent change, year-on-year)

Source: Eurostat experimental house price index, S&P/Case-Shiller national index, Statistics Iceland, Ireland Central Statistics Office

3.2 *The Euro as Ireland's Quasi Gold Standard*

By being locked into the eurozone, Ireland sacrificed one important policy tool. Lacking an independent central bank, the country could not inflate its obligations away. This has come to be seen as a major detriment to Ireland as it tries to regain its footing, though there are important caveats to remember.

First, in a bid to regain international competitiveness the relevant price is the real exchange rate. Decreasing the cost for others to import your goods is a function of your domestic selling price and the nominal exchange rate. The Irish price level declined for two consecutive years, and the country has experienced deflation relative to its continental European neighbours, as can be seen in table 3. As a consequence, despite having the same nominal exchange rate as

other eurozone members, Ireland has been able to regain relative competitiveness through a depreciating real exchange rate.

	Iceland	Ireland	Eurozone
2005	1.4	2.2	2.2
2006	4.6	2.7	2.2
2007	3.6	2.9	2.1
2008	12.8	3.1	3.3
2009	16.3	-1.7	0.3
2010	7.5	-1.6	1.6
2011	4.2	1.2	2.7
2012	5.1	1.7	2.2
Total change	69.7%	10.1%	17.8%

Table 3: Irish, Icelandic and eurozone inflation

Source: Eurostat

Second, one problem in the boom was not one of all prices inflating to the same degree. As credit was injected into the economy asymmetric affects resulted, sending erroneous price signals to investors. As an example, cheap credit engendered a housing boom, leading property prices to rise faster than other prices. As a consequence, many Irish resources were directed to the real estate market, at the expense of other productive activities. At the peak of the boom, 13 percent of Irish employment was in the construction industry, and it produced 24 percent of the Irish gross national product, as opposed to an average of 12 percent for the rest of Western Europe (Kinsella 2012). The false price signals sent to entrepreneurs needed to be corrected: housing prices needed to fall relative to other prices. Depreciation in the nominal exchange rate would have resulted in an equivalent decline in all prices. What is necessary at some point in time is an alteration of the constellation of prices.

In Ireland domestic disinflation and more recently deflation have guided prices back to

their correct relative levels, allowing entrepreneurs to regain focus on the profitable areas of the economy. While Ireland’s other peripheral European counterparts—Greece, Italy, Portugal, and Spain—have had more trouble reaching the bottom of their busts, the common reason provided is that they cannot regain competitiveness with the currently strong euro. This neglects the importance of domestic price deflation (or at least disinflation) and begs the question why this has not occurred. One significant reason can be found in the relative size of each country’s public sector, as shown in table 4. Despite running large public deficits, Ireland’s public sector is smaller than that of most of its peripheral eurozone counterparts, with the second lowest tax burden. Even when factoring the large ongoing cost of bailing out the Irish banking sector, Irish public expenditure is still not higher than the majority of its counterparts, and remains below that of the larger eurozone.

	Total government revenue	Total government expenditure
Italy	46.1	49.9
Eurozone	45.3	49.4
Portugal	44.7	48.9
Iceland	41.7	46.1
Greece	40.9	50.1
Ireland	35.3	48.1
Spain	35.1	43.6

Table 4: Government size (2011, percent of GDP)

Source: The Heritage Foundation

The public sector typically experiences more rigid labor costs than its private alternatives (Hutt 1977, Bagus and Howden 2011b: 392-93). Public unions, especially in Europe’s south, enjoy engrained positions due to their numbers and potential to sway politics. In addition, fewer Irish firms are subject to union agreements obstructing wage declines than the eurozone average. (72

percent of Irish firms are subject to union agreements, accounting for 42 percent of all employees while the eurozone figures are 94 and 84 percent (Du Caju *et al.* 2013: 12.) Furthermore, only 39 percent of surveyed Irish firms cite regulations or union agreements as a reason to avoid wage cuts versus 85 percent of eurozone firms (*ibid.*: 17). Austerity measures aimed at reducing public sector expenditures were implemented in Ireland with minimal public sector backlash. As a consequence, important prices such as wages fell more quickly in Ireland than in other European countries, allowing it to regain competitiveness while remaining in the eurozone.

Third, while a currency depreciation will aid exporters to some degree, it has two significant drawbacks. The first of these is that an expansion of the money supply is necessary to depreciate a currency, and such a policy places upward pressure on prices (as was the case in Iceland). The result is potentially nil, as the two effects may counter each other. The second drawback is a consequence of the first—any depreciation of the currency aids one group while harming another. In this case, exporters *may* be aided, while domestic consumers and producers will see their costs increase, and their real savings dwindle, so that a decline in savings through an inflationary policy will hinder recovery.

The preceding discussion is not to imply that price deflation has been costless or easy in Ireland. It is rather a question of when the costs will be incurred. Although prices were quick to adjust downwards, there was a short-run decrease in output until this happened. While this could have been somewhat mitigated by an inflationary policy, as in Iceland, it would have prohibited important relative price adjustments from taking place. Deflation has allowed relative prices to realign themselves in a bid to better signal to entrepreneurs those avenues of investment more conducive to growth. Thus, even though Ireland was locked into a currency union and unable to unilaterally allow its currency to adjust to regain competitiveness, it was able to make the

necessary price adjustments domestically.

Not only do these adjusting prices allow entrepreneurs to better see what avenues of investment are more valued, they also allow important costs to readjust. The decline in housing prices has reverberated backward to adjust downward input costs, including labour costs for construction workers. While declining incomes for these workers may seem like a negative result, it allows workers to realize where they are most valued and readjust their employment accordingly. In many ways we can sympathize with Huerta de Soto (2012) as he refers to the euro positively as a type of quasi “gold standard.” By not being able to inflate its problems away, Ireland along with other periphery eurozone countries are facing the reality that their fiscal paths are unsustainable and that prices, including wages, will need to adjust accordingly. These price adjustments permit the relative price structure to realign to signal entrepreneurs and investors what production and investment plans are sustainable.

4 Two Types of IMF Bailouts

Though both countries eventually succumbed to IMF-led bailouts, important differences in their implementations abound. Ireland’s bailout by the ECB and IMF came with some high costs, although capital controls aimed at inhibiting the outflow of funds were absent. As a result, trade flows continued largely as usual, with exports increasing due to its increased competitiveness through price deflation.

4.1 Icelandic Capital Controls

Iceland became the first developed country in over 30 years to request aid from the IMF (Gylfason 2011). When accepting emergency loans, the IMF imposed strict capital controls as

part of the package (International Monetary Fund 2010; Yeyati 2011). The aim of the controls was to: 1) limit foreign currency outflows, 2) stop the exchange rate from depreciating further, and, 3) keep foreign exchange available for vital transactions. While the controls were originally temporary in nature, they persist to this day with no plans to taper them off until 2015 at the earliest.

These controls resulted in some unintended consequences, and in many ways differed from the conventional or more modern use of capital controls. In particular, as part of the IMF's standby agreement of November 2008, residents and non-residents were obliged to report all foreign exchange transactions to the Central Bank of Iceland. Residents were forced to surrender all foreign exchange to the central bank within two weeks of obtaining it by depositing the proceeds in a domestic bank. Divestments of foreign direct investments in Iceland were not permitted. Finally, only financial products denominated in króna were allowed under the controls.

Some have called a return to such harsh capital controls draconian, and their use marks a strict departure from how the IMF has more recently implemented emergency relief (Arnason and Danielsson 2011). While capital controls are increasingly seen as a way to prevent excess foreign investment from overheating an economy, these controls have marked a shift backward to controlling all transactions, even those that are potentially beneficial. By placing blanket controls over the whole economy, currency flows that would have been beneficial (e.g., purchasing imports necessary for the sustainability of a small, isolated island) have been placed in the same category as those deemed troublesome (e.g., carry traders liquidating króna holdings and depreciating the currency further).

These controls have inhibited the Icelandic recovery by removing several options from

citizens trying to recover lost economic activity. Entrepreneurs must seek permission from the CBI to procure foreign funds to invest abroad. Emigration from the country is limited, as individuals have no guarantee that they can take their financial capital with them. Domestically the controls could also be depreciating the króna, thus harming sectors reliant on imports (such as the food industry). Since Icelandic exporters have limited confidence in their future ability to access their earnings, they do not bring home all their foreign earnings. This has the effect of keeping the currency weaker than would otherwise be the case (Gylfason 2011).

Unable to easily get króna out of the country, foreign investors find themselves with limited options for any currency held in Iceland. Much of it is today being funnelled into real estate—thus propagating a new bubble in the housing sector (Valdimarsson 2012). International investors wary of channelling their savings into the current outlets, and lacking investment opportunities in avenues they deem sustainable, are at a loss for options. Thus investing in a real asset like real estate, even if it creates a new bubble, is less risky than remaining invested in Icelandic financial assets that might lose value if the recession renews itself.

More detrimental, perhaps, is the fact that the controls reduce foreign trust in the economy. By blocking divestments on projects funded by incoming foreign direct investment (FDI), the CBI has created a clear disincentive for foreigners to invest in Iceland. Coupled with this is the fact that Iceland has the highest number of restrictions on foreign direct investment of all member countries of the Organisation for Economic Co-operation and Development (Kalinova *et al.* 2010), contributing to a collapse in domestic investment.³

Arnason and Danielsson (2011) estimate the deadweight loss of the capital controls to be 1 percent of Icelandic GDP per year. Such a drain on a crisis-stricken economy is large, and

³ Icelandic investment had declined to 10 percent of GDP by 2010, compared to a decline to only 17 percent in the EU (Danielsson 2011b).

delays full recovery. Additionally, the controls delay one important price adjustment from occurring. Although a depreciation of the króna by itself is not a panacea for the economy—relative price adjustments must also occur—it is true that the króna was artificially overvalued leading up to the crisis, mostly due to ample government guarantees on the banking sector (Howden forthcoming). (*The Economist's* Big Max Index ranked the króna as the most overvalued currency in the world on 1 February 2007.) The capital controls have the effect of partially propping up the currency, making this currency adjustment more difficult to obtain. It is also difficult to ascertain whether the controls have any meaningful effect today. The exchange rate has already fallen by more than half over the past four years. Much capital had already left the country before the controls were established, and there may be little incentive for divestments to occur now. In fact, given the partially recovered state of the Icelandic economy, it is more likely that the controls are inhibiting capital inflows by removing an exit option from investments than keeping existing investments within the country.

4.2 *Ireland's Maintained Trade and Financial Flows*

Despite also being the recipient of funding through the IMF, Ireland was not subject to capital controls. The reasons are twofold. First, since Ireland is a part of the eurozone, there is no possibility of managing its exchange rate by such a policy. Second, barriers to trade would have conflicted with existing EU treaties. Consequently, the country has not been impaired by such policies, and capital flows have aided Ireland's return to normalcy—unlike that of its northern neighbour.

The distinction in the treatment of two countries making use of an IMF emergency loan is stark. Ireland was spared the curtailment of FDI in light of the fact that capital could still flow

freely into, and more importantly out of, the country. Investors could make liberal use of the country's unemployed citizens and lower wages without fear that they would not be able to exit with their funds if the project failed to meet their expectations.

The results are evident in Ireland's trade balance. Net exports have increased from less than 10 percent of GDP to almost 20 percent since the crisis began. While domestic demand for Irish goods has been falling, foreigners willing to take advantage of its newfound competitiveness have taken up the slack, and exports now lead the recovery. Foreign direct investment has also remained strong, reaching 11.9 and 8.6 percent of GDP in 2009 and 2010, higher than it has been for over a decade.

5 Conclusion

This comparison has shed light on several key differences between Iceland's and Ireland's policies in the wake of their financial collapses. In implementing policies to ease the effects of these two crises, three aspects stand out.

The first is the role of the countries' currencies in returning them to competitiveness. Ireland was unable to depreciate its currency, but the domestic price level was able to fall, thus compensating by depreciating the real value of its euro and lowering export costs. In Iceland the quick depreciation of the króna served to give the country a quick cost-based advantage. These across-the-board cost decreases from the depreciation did little to rectify the price maladjustments that the boom bred. In this way, Ireland suffered in the short run through an output decline, but by allowing the array of relative prices to adjust Irish entrepreneurs are now able to see the areas of the economy most conducive to growth.

Second, Ireland's use of the euro protected it from some worse fates. In particular it made

the country immune to calls for capital controls. When Iceland received its standby agreement from the IMF as part of its 2008 aid package, it included controls aimed at reducing the outflow of foreign reserves. This had the unintended consequence of also limiting the amount of incoming foreign investment that foreign investors were willing to risk in Iceland. Ireland enjoys a high degree of foreign investment today, as creditors are not worried about accessing their funds in the future. No such assurance can be offered in Iceland, and the capital controls are now slated to stay in effect until 2015.

Third, the nationalization of the financial sector in Ireland has left taxpayers on the hook for billions of euros. By allowing a large part of its financial sector to fail, Icelandic authorities have saved its taxpayers from funding a risky project. This has made funds available for social programs that have aided the unemployed throughout the crisis. Furthermore, allowing an insolvent banking sector to fail has allowed resources to be redirected, unlike in Ireland.

Iceland and Ireland provide two case studies for challenges facing an economy facing a modern banking crisis. Other countries, notably the United States and United Kingdom, have banking situations that feature similar weaknesses, including 1) poorly collateralized loans, 2) a reliance on continued credit expansion to roll over short-term funding, and 3) heavy exposure to the real estate market. There are three lessons to take from these two countries.

First, any losses in the banking sector are only the previous mistakes and malinvestments made visible. Covering up losses via bank bailouts does little to fix mistakes that were made in the past, and may delay recovery moving forward. The collapse of the banking system only exposed an insolvent system for what it was. *The Icelandic approach of allowing unambiguously insolvent institutions to default allows losses to be realized sooner, and a strong foundation for recovery to be built upon.*

Second, currency depreciation allows some types of adjustments to be made, but others can only be achieved by domestic price adjustments. In Ireland this happened quickly, allowing entrepreneurs to receive signals concerning how to reallocate resources to escape the recession. Iceland's swift depreciation increased the country's international competitiveness, but may now inhibit relative prices from realigning quickly to sustain the recovery. Iceland's approach inhibited the constellation of relative prices from quickly realigning in a sustainable manner and will jeopardize future growth, something that Ireland is increasingly well-positioned to take advantage of. *By not inflating its problem away and thus allowing for price deflation, Ireland has realigned relative prices to a more sustainable array that allows entrepreneurs to see what areas of the economy are profitable.*

Finally, some policies aimed at controlling capital flows have detrimental results. In Iceland's case, IMF-imposed capital controls have cost the country 1 percent of GDP for three years, and are estimated to stay in effect for at least another three years. While stopping the outflow of foreign reserves, the controls have also limited inflows. While the lack of capital controls in Ireland could have resulted in an outflow of capital, the evidence suggests that just the opposite happened. Taking advantage of lower costs and unused resources, capital has flowed into Ireland in recent years. The Icelandic approach has discouraged foreign entrepreneurs from investing domestically due to uncertainty about whether they will be able to access their capital in the future. *In this way, Ireland's continued commitment to open markets and trade has allowed foreign participation to shift the weight of recovery away from only domestic producers.*

When the tale of these two crises is told, the conclusion is typically that one set of policies was more beneficial than the other. In this paper I have shown that the truth lies somewhere in the middle. Icelanders have benefited by evading a debt overhang through an

undue bank bailout that shielded investors from losses. The Irish commitment to open capital markets and a willingness to reduce domestic prices to regain competitiveness has allowed prices to return to levels necessary for entrepreneurs to use as signals to invest. Countries facing similar crises—be they currency, banking, or generally economic—would be well-advised to heed these lessons when drafting recovery plans of their own.

References

- Árnason, Árni Páll. 2011. “Iceland’s Recovery,” opening remarks at the IMF conference *Iceland’s Recovery—Lessons and Challenges*. Reykjavik, Oct. 27.
- Arnason, Ragnar, and Jon Danielsson. 2011. Capital controls are exactly wrong for Iceland. *VoxEU.com*, Nov. 14.
- Bagus, Philipp, and David Howden. 2011a. *Deep Freeze: Iceland’s Economic Collapse*. Auburn, AL: Ludwig von Mises Institute.
- Bagus, Philipp, and David Howden. 2011b. Monetary Equilibrium and Price Stickiness: Causes, Consequences, and Remedies. *Review of Austrian Economics* 24(4): 383-402
- Baldursson, Friðrik Már. 2011. Iceland’s programme with the IMF 2008–11. *VoxEU*, Nov. 8. <http://www.voxeu.org/index.php?q=node/7235>
- Buiter, Willem H., and Anne Sibert. 2008. The Iceland banking crisis and what to do about it: The lender of last resort theory of optimal currency areas. *CEPR Policy Insight*, 26.
- Connor, Gregory, Thomas Flavin, and Brian O’Kelly. 2010. The U.S. and Irish Credit Crises: Their Distinctive Differences and Common Features. *Working paper*.
- Danielsson, Jon. 2011a. How Not to resolve a banking crisis: Learning from Iceland’s mistakes. *VoxEU*, Oct. 26. <http://www.voxeu.org/index.php?q=node/7157>
- Danielsson, Jon. 2011b. Was the IMF programme in Iceland successful? *VoxEU*, Oct. 27. <http://www.voxeu.org/index.php?q=node/7162>
- Du Caju, Philip, Theodora Kosma, Martina Lawless, Julián Messina and Tairi Rðöðm. 2013. Why Firms Avoid Cutting Wages: Survey Evidence from European Firms. Central Bank of Ireland, Research Technical Paper 3/RT/13.
- Financial Supervisory Authority. 2008a. New Glitnir Bank Takes Over Domestic Operations of

Glitnir banki hf. Oct. 15. [Available] <http://en.fme.is/published-material/news--announcements/news/nr/1399>.

Financial Supervisory Authority. 2008b. New Kaupthing Bank Takes Over Domestic Operations of Kaupthing banki hf. Oct. 22. [Available] <http://en.fme.is/published-material/news--announcements/news/nr/1398>.

Financial Supervisory Authority. 2008c. New Landsbanki Takes Over Domestic Operations of Landsbanki Islands hf. Oct. 9. [Available] <http://en.fme.is/published-material/news--announcements/news/nr/1400>.

Gylfason, Thorvaldur. 2011. Houston, we have a problem: Iceland's capital controls. *VoxEU*, Jun. 1. <http://www.voxeu.org/index.php?q=node/6597>

Honohan, Patrick. 2010. The Irish Banking Crisis—Regulatory and Financial Stability Policy 2003–2008.

Howden, David. forthcoming. The Icelandic and Irish Banking Crises: Alternative Paths to a Credit-Induced Collapse. *The Independent Review*.

Howden, David. 2012. The Iceland and Ireland Banking Crisis: Lessons for the Future. *Mercatus Center* working paper no. 12-22.

Huerta de Soto, Jesús. 2012. *An Austrian Defense of the Euro*. Ludwig von Mises Institute Daily Article, June 22. [Available] <http://mises.org/daily/6069/An-Austrian-Defense-of-the-Euro>

Hutt, William H. 1977. *The Theory of Idle Resources*, 2nd ed. Indianapolis: Liberty Fund.

International Monetary Fund. 2010. Capital Inflows: The role of controls. IMF Staff Position Note SPN/10/04.

Kalinova, Blanka, Angel Palerm, and Stephen Thomsen. 2010. OECD's FDI Restrictiveness Index: 2010 Update. *OECD Working Papers on International Investment*, no. 2010/3.

Kinsella, Stephen. 2012. Is Ireland really the role model for austerity? *Cambridge Journal of Economics* 36(1): 223–35.

Kinsella, Stephen, and R. Lyons. 2011. "A return to managing the Irish Economy" in (eds.) Burke and Lyons, *Next Generation Ireland*, pp. 65–90. Dublin: Blackhall Press.

Lane, Philip R. 2011. The Irish Crisis. *Centre for Economic Policy Research*, Discussion paper no. 8287.

O'Callaghan, Gary. 2011. Did the ECB Cause a Run on Irish Banks? Evidence from Disaggregated Data. *Irish Economy Note* no. 13.

Ólafsson, Stefán. 2011. Iceland's Financial Crisis and level of Living Consequences. Þjóðmálastofnun Social Research Centre, University of Iceland, working paper no. 3.

Sharkah, Francis, and Oliver Pawela. 2010. Was the Euro Interest Rate Too Low for Ireland? A Time Series Analysis of the pre-EMU Period in Light of the Taylor Rule. *University of Stockholm*, working paper.

Sigfusson, Thor, and Ragnar Arnason. 2011. The Importance of the Ocean Cluster to the Icelandic Economy. Islandsbanki. <http://www.islandsbanki.is/english/products-and-services/seafood-industry/publications/>

Valdimarsson, Omar R. 2012. Iceland property bubble grows with currency controls: Mortgages. *Bloomberg*, May 30.

Yeyati, Eduardo Levy. 2011. Are capital controls effective? *VoxEU*, Jan. 20. <http://www.voxeu.org/index.php?q=node/6031>