A Tale of Two Debtors
Iceland and Ireland – and their banks

BY THORVALDUR GYLFASON
Iceland and Ireland go back a long way together.

While Iceland’s roots largely lie in Scandinavia, there’s evidence that about a third of the Viking settlers from the ninth century onward made the journey from Ireland. This may help to explain why in modern times Iceland has charted a course in economic, political and social affairs that has often been closer to Ireland’s than to that of its Nordic neighbors. And even if it really doesn’t, it’s a nice conceit for introducing this tale of two national banking crises with similar roots – and strikingly different denouements.

There’s more here, of course, than a little history. While Iceland and Ireland both dug themselves deep, deep holes in the 2008 global crash, Iceland has emerged battered but on its feet, while Ireland is still mired in austerity-induced recession and flattened by public debt. Not surprisingly, a lot of people would like to know what Iceland did right to escape the trap – and what Ireland did wrong.
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BEGINNING AT THE BEGINNING
Since the 1930s, Iceland and the Republic of Ireland have been among the most inertia-driven and inward-looking Western European societies. To take one example, the Irish required all flights from the United States to land at Shannon Airport on the island’s west coast long after expanded aircraft range made it unnecessary. This added several hours to the journey for a majority of passengers, who were headed for Dublin on the east coast—but pleased numerous interests in the Shannon area. In the same spirit, Iceland virtually bars the importation of dairy products and meat, a policy that remains in place today because the votes of Iceland’s rural minority are vastly overrepresented in the parliament.

Nonetheless, both countries were sufficiently flexible to take advantage of changing economic circumstances. When Iceland was effectively freed from Danish rule in 1904, living standards were about half the level of its quasi-colonial parent. But the island’s socially cohesive people proved surprisingly well-prepared for growth. Natural resources, in the form of rich fishing grounds and abundant geothermal and hydropower energy, played a part. Probably more important, Iceland adopted political and economic institutions that encouraged capital accumulation and innovation, driving productivity growth. On the eve of the financial crisis, GDP per capita in terms of purchasing power was about $35,000—the same as Germany’s. Moreover, Iceland used the income responsibly, creating an egalitarian society that ensured economic

THOR GYLFAISON is a professor of economics at the University of Iceland and was elected to Iceland’s Constitutional Assembly in 2010.
mobility and virtually wiped out poverty.

Iceland chose to remain apart from the European Union and the Economic and Monetary Union – choices that reflected the inward-looking nature of the culture. Thus, like Norway, it only dipped a toe in Europe: Iceland belongs to the European Economic Area (comprising the European Union plus the European Free Trade Association), giving it full access to European markets but allowing the country to go its own way in the regulation of agriculture and fisheries.

Ireland has been even more successful in parlaying modest assets into true affluence. Ireland’s economy remained poor and largely agrarian after winning its independence from Britain in 1922, deriving almost a fifth of its GDP from farming as late as the 1970s. But things began to change rapidly once Ireland joined the European Union in 1973.

Buoyed by new markets and subsidies from the European Union through the Common Agricultural Policy, the Celtic tiger took off. GDP per capita increased seven fold in terms of purchasing power from 1980 to 2006, even surpassing that of Britain in 2006-7. Irish exports (which long consisted, as the saying went, of dead sheep and live people) increased sharply, making Ireland one of the world’s top ten in terms of exports relative to GDP.

IRRATIONAL EXUBERANCE

When strictly regulated financial institutions are freed from their shackles, they are prone to kick up their heels like cows let out in spring. This exuberance helps explain why the 2008 financial crashes in the conservative economic cultures of Iceland and Ireland proved more traumatic than the banking crises experienced in Finland, Norway and Sweden two decades earlier.

Iceland privatized its banks only in the 1998-2003 period. Earlier, the banks were run by political operatives who paid scant attention to their profitability or efficiency as financial intermediaries, allocating credit and foreign currency at preferred rates to preferred customers. But when privatization became
all the rage across Europe and Asia, Icelandic politicians could no longer resist demands for privatization. They chose to keep the windfalls in the family, eschewing sales to experienced foreign banks in favor of well-connected locals inclined to preserve the unsavory alliances between politicians and the financial system.

In 2006, the banks made political contributions that were the equivalent of $8 per Ice-lander—an order of magnitude greater than financial industry contributions in the United States. Other ties between banks and politicians were arguably even more ethically problematic. On the eve of the financial crisis, 10 (out of 63) members of parliament owed the banks more than a million euros each. (Parliament’s Special Investigations Committee, which unearthed that figure, chose not to reveal how many more MPs owed the banks merely hundreds of thousands of euros.) Iceland’s banks thus had ample reason to believe that when they effectively bet the island’s future on the staying power of the global real estate bubble, regulators would look the other way.

Ireland’s financial services market, by contrast, was open, with both Irish and foreign banks avidly competing for local customers. Yet, as in Iceland, regulators with less-than-arms-length relationships to the banks chose to ignore their massive run-up in debt secured by real estate.

**DIVERGENT RESPONSES**

Iceland’s banks lost the equivalent of seven times the country’s pre-crash GDP—a world record. Ironically, the sheer magnitude of the loss effectively guaranteed that the government would walk away from those private liabilities, even though the banks’ foreign creditors had been led to believe that the government stood behind them. Had the scale of the problem been smaller, it is quite conceivable that Iceland would have done “the right thing” by the banks’ creditors. In this case, the right
thing was, quite simply, not an option.

To be sure, Iceland’s choice would have been far more problematic if the International Monetary Fund had refused to lend the country the hard currency (all told, $2.1 billion) needed to pay its bills for basic imports and foreign-currency-denominated government obligations. And at the time (2008), there was some muttering that the IMF, which has been accused of taking on the role of private debt collector in previous financial crises, was giving Iceland a preferential deal.

That’s a misreading of the historical record, however. The IMF is inclined to play hard ball only on sovereign debts. And through the crisis, Iceland never missed a payment on its government debt – as opposed to the debts of the Icelandic banks.

None of this means, though, that Iceland got off scot-free in the crisis. GDP fell by 10 percent and households lost significant chunks of the equity in their homes. Unemployment spiked to 6 percent – a modest rate by European standards, but a very high rate for the homogeneous workforce of this pint-sized economy with a population just over 300,000.

Note, moreover, that Iceland’s expeditious return to growth was possible only because its currency was allowed to depreciate, making Icelandic goods and services more competitive in export and tourism markets. As a result, imports have become far more expensive in this small, open economy, where almost all manufactures must be imported. Accordingly, living standards will remain lower than the precrisis peak long after GDP has fully recovered.

All that said, Iceland has escaped the worst of the global crisis in spite of the fact that its banking system dug the deepest debt hole ever recorded, relative to the size of the economy. And the contrast with Ireland is startling.

The Irish government chose to socialize the banks’ losses, at least in part because it initially judged the liabilities of the banks to be manageable. It even committed Irish tax-
payers to covering claims on their banks that were not insured.

That judgment proved to be catastrophically wrong— for reasons captured perfectly in the title of Fintan O’Toole’s book Ship of Fools: How Stupidity and Corruption Sank the Celtic Tiger. O’Toole describes a first-world country with a third-world political culture marred by deep-seated cronyism and other forms of soft corruption not measured in incidents of bribery or outright flouting of the law.

It shouldn’t be very surprising, then, that one big bank, the Anglo Irish Bank, had to be nationalized in early 2009 after it emerged that the chairman personally owed €84 million to his employer. Meanwhile, Ireland’s two largest banks— Allied Irish Bank and Bank of Ireland— were found to have taken bizarre risks with their depositors’ and other creditors’ money. They required cash injections of €3.5 billion each in late 2009 to cover their losses in the tanking real estate market. All told, the Irish banking crisis is expected to cost the taxpayers an astonishing €60 billion— over €14,000 per Irish citizen. And this loss comes on top of the decline in personal wealth from the property crash: in 2012, roughly a half of Irish households had negative equity in their houses— twice the proportion in Iceland.

Accepting the burden of the bank liabilities triggered a chain reaction in which the Irish government ran huge budget deficits and was largely shut out of the global bond market. It was bailed out in 2010 by the European Financial Stability Facility, but on terms that locked the government budget into austerity mode at a time when the Irish economy desperately needed stimulus. The economy has begun to grow again, but at a pace that has left GDP about 7 percent smaller than the peak
and kept unemployment above 14 percent.

Currency depreciation as a means of stimulating foreign demand is off the table, of course, because Ireland shares a currency with the rest of the Eurozone. And with households reeling under housing debt accumulated during the bubble, there is little hope of a boost in consumption demand anytime soon.

The only bright side to the Irish economy is export growth. But if current Irish policy is a model for post-crash recovery as some suggest, it’s not one likely to appeal to those trapped without savings or jobs. Hard times have shocked Ireland into adopting some needed regulatory reforms and may shake up the country’s self-satisfied elite. However, the “internal devaluation” on which Ireland’s recovery now depends has largely come at the expense of Ireland’s labor force.

ASSIGNING BLAME

Figuring out who brought down these two economies and punishing them appropriately is surely less important than repairing the damage. It is, nonetheless, a test of the quality of governance in a crisis and offers clues to the likelihood that the mistakes will be repeated.

Iceland’s Financial Supervisory Authority has referred some 80 cases of legal violations to a special prosecutor. But the wheels of Icelandic justice grind slowly. Pressure to bury the past culminated in the removal of the reform-minded director of the authority in early 2012. Even so, those who thought from the outset that no one would be held responsible for breaking the law have been proved wrong. The chief executive of one of the three failed banks was recently handed a nine-month prison sentence for breach of trust. And a general amnesty now appears to be off the table.

The unanswered question is whether enthusiasm for regulatory reform now will translate into enduring change. There’s reason to hope it will: revisions to Iceland’s constitution, which would reduce politicians’ incentives to bow to special interest pressure,
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passed by a margin of two-to-one in a national referendum. The only remaining barrier to its adoption is the requirement that it be ratified by two successive parliaments.

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While Ireland has done less than Iceland to go after bankers suspected of having broken the law, the nation’s voters have meted out much harsher punishment to the politicians who fiddled while Dublin burned. Fianna Fáil, Ireland’s dominant political party for 61 of the last 80 years, was virtually wiped out in the general election of 2011. By contrast, Iceland’s majority Independence Party lost 9 of its 25 parliamentary seats in the general election of 2009, but remains a force in Iceland’s political scene.

Some observers worry that the Independence Party will be returned to power in the election of April 2013, and will thereafter close the investigation into what the party’s leaders have taken to calling the “so-called crash.” Such amnesia would be understandable: of the seven cabinet ministers and civil servants singled out by the special prosecutor for gross dereliction of duty before the fall, four were ranking members of the Independence Party. But the constitution’s revision, if ratified by parliament, may at least serve to keep whoever is elected on a narrow path going forward.

HINDSIGHT

After the fact, it’s pretty clear why Iceland and Ireland adopted very different approaches to managing their financial crises that led to very different results: they had little choice in the matter. Iceland simply couldn’t socialize bank liabilities equal to seven times its GDP. And the international lender of last resort that came to its rescue never insisted that Iceland pay penance for private bank failures in the form of depression-inducing austerity. What’s more, currency depreciation was possible (indeed, inevitable), giving the economy an overnight boost in competitiveness in global markets.

For its part, Ireland faced net liabilities equal to “only” one-third of its GDP – a monstrous sum in absolute terms, but one that could (and probably will) be extracted from Irish taxpayers. Moreover, Ireland, in contrast to Iceland, had the bad luck to be rescued by the European Union, which demanded fiscal austerity as the price of access to sovereign loans. And, it goes without saying, the option of depreciating the currency was not on the table.

Austerity hasn’t worked in Europe. But for reasons that are unclear, the European Union is still dominated by policymakers who are convinced that the only proper medicine for financial indiscretion is fiscal pain – that the right way to manage the economic dislocation created by the crisis is to squeeze every bit of fat out of public and private spending. Iceland’s economy was spared the consequences of this Dickensian view of macroeconomics because it wasn’t a member of the Eurozone and was small enough to fly under the radar of the deficit hawks in Europe who might nonetheless have insisted that the IMF play hardball. Ireland wasn’t as lucky.