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Financial crises in Iceland and Ireland: Does EU and Euro membership matter?

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Baldur Thorhallsson and Peadar Kirby[1]

Introduction

The collapse of the banking systems in Iceland and Ireland in 2008, the impacts on economy and society of this collapse, and the measures taken by the political authorities in each country to deal with the crises, have all been the subject of extensive commentary (see for example, Krugman (2009, 2010) and O'Brien (2011c)). Yet little attention has been devoted to the role that membership of the European Union (EU) and of the Euro played in the case of Ireland, contrasted with Iceland which is a member of neither. This is the purpose of this report. It begins by situating the study in the political science literature on small states, framing it as testing the claim in this literature that small states prosper better by being members of multilateral organizations that provide them with a shelter, particularly valuable at a time of economic and political crisis. The report then examines the Irish and Icelandic cases under three headings – their respective economic booms before the crises, the trajectory of the crisis in each country, and the role of EU membership and of the Euro in the Irish case compared with its absence in the case of Iceland. The report ends by using conclusions from these crises to re-assess the relevant claims in the small states literature.

1. Small states and shelters

Katzenstein (1997) argues that alliance formation is of particular importance for small states since they are more vulnerable to international economic fluctuations. Multinational organizations are said to provide small states with a stronger ability to deal with unanticipated risks than do bilateral relations (Neumann and Gstöhl, 2004).

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Accordingly, small states can use these devices to help compensate for their greater vulnerability, in terms of their small economic, administration and defence capacities, compared to larger states (Keohane, 1969; Handel, 1981). Moreover, Katzenstein (1997) argues that membership of supranational organizations limits the international economic and political constraints that small states, like others, are bound to experience in the neo-liberal global economy. The EU can be taken as a good example in this context of a supranational organization that provides small states with economic and political shelter.

On the other hand, Vital (1967) also argues that a state's most fundamental objective is to withstand stress and pursue a policy of its own devising. The viability of any state needs to be assessed through its ability to protect itself from being attacked, bullied or heavily pressurised by international or domestic actors. This is of prime importance in order for states to provide their citizens with economic growth and social stability (Vital, 1967). Also, importantly, Katzenstein (1984 and 1985) argues that small countries need two things: fast-paced change and flexible adaption (based on short decision-making chains and corporatist decision-making structures); and a capacity to socialize risk by developing a comprehensive welfare state and active labour market policies.

This leads us to the question as to whether small European states badly hit by the financial crisis of 2008 are better off with or without membership of the EU, and/or participation in Economic Monetary Union (EMU) which entails adopting the Euro. This is of particular importance since small economies may be hit more swiftly by local or global crises than large economies and their downturns may become deeper (Handel, 1981; Ólafsson, 1998).

Our two test cases will be examine by placing them within a framework of the small state literature, which argues that the importance of economic and political shelter for small states is related to three interrelated features: reduction of risk before the crisis event; assistance in absorbing shocks when severe risks eventuate; and help in recovering after the event. A distinction is needed here between economic and political shelter. The former may be in the form of direct economic assistance, a currency union,

help from an external Central Bank, beneficial loans, favourable market access, a common market, and other general or specific benefits provided by a more powerful country or an international organization. Political shelter refers to direct and visible diplomatic or military backing in any given need by another state or an international organization (which can include the impact of organizational rules and norms) (Thorhallsson, 2011). Ireland and Iceland's latest experiences provide an excellent case to test whether the supranational multilateral arrangements of the EU and the use of the Euro in Ireland (alliance formation), or the greater economic flexibility provided by a state's own currency and an independent central bank, as in the case of Iceland, provides a better framework for small states to reduce risk before the crisis event; to get assistance in absorbing shocks when risk goes bad; and to secure help in cleaning up after the crisis.

2. Economic success before the crisis

From the late 1990s up until 2008 both Iceland and Ireland were widely perceived as states that had managed to turn globalisation to their advantage. Both had high and sustained growth rates, had living standards among the highest in the world, and had governments in power whose policies stimulated free market activity.

2.1 The rise of the Celtic Tiger

Since independence in 1922, the Irish economy had gone through a series of boom-bust cycles. It avoided much of the Great Depression by introducing a policy of state-led industrialisation behind high tariff barriers; but by staying neutral in the Second World War, it isolated itself from the post-War boom and entered the 1950s with a severe balance of payments crisis. The liberalisation of the economy in the early 1960s, a Free Trade Agreement with Britain in the mid-1960s and membership of the then European Economic Community (EEC) in 1973 helped stimulate economic growth and the modernisation of Irish society. However, high levels of foreign borrowing in an attempt to stimulate the economy in the 1970s resulted in a heavy debt burden that again

plunged the country in a severe recession for most of the 1980s, with high unemployment and outward migration of many young people.

The long boom which began in 1993 and continued until 2007 was a novel experience for Ireland both for its length and its high growth rates, averaging 7.3 per cent per annum over the period and surpassing 10 per cent in some years in the late 1990s. Employment grew from just 51 per cent of the labour force of 1.38 million in 1993 to almost 64 per cent of a labour force of 2.2 million in 2007 with unemployment over this period falling from 15.6 per cent to 4.4 per cent of the labour force. Living standards, when measured in GDP per capita, had risen from around 60 per cent of the EU average – which was where they stood for the first 20 years of Ireland's membership of the EU since 1973 – to 145 per cent by 2007, making it the second richest country in the Union after Luxembourg (Kirby, 2010). Ireland was being hailed as *'a showpiece of globalisation'* (Smith, 2005: 2) for its ability to capture global flows of investment and trade as a basis for transforming its economy and society.

In large part the Irish boom resulted from the state's success in winning high levels of foreign investment in targeted sectors such as information and communications technology, biotechnology, pharmaceuticals, medical devices and financial services. Yet, this success depended on key features of the Irish state and its policies. Of primary importance was the role of the semi-state Industrial Development Authority (IDA), described as the *'hunter and gatherer'* of foreign investment (Ó Riain and O'Connell, 2000: 315). However, two features of significance for the concerns of this report need to be highlighted: firstly, the role of the European Union in the Irish boom and, secondly, the coordinative mechanism of social partnership, generating a consensus among the key social partners within the economy. Membership of the EU was an important constitutive feature of the Irish boom in two ways. Firstly, it offered companies from outside the Union who established in Ireland access to the lucrative European market, something that Irish policy makers turned greatly to the advantage of Ireland's development. Secondly, Ireland was very successful at winning high levels of EU grant aid through the regional and structural funds, enabling the upgrading of infrastructure and human resources so as to gain maximum benefit from the high levels

of foreign investment arriving in the country. It is estimated that receipts from the structural funds were equivalent to 2.6 per cent of GNP over the decade 1989-1999 and that they increased the level of Ireland's GNP by two percentage points (Laffan and O'Mahony, 2008: 43). The impact was most evident in transforming Ireland's trade performance. Not only did trade come to represent a far larger share of Ireland's GDP so that by 2002 exports and imports constituted 176 per cent of GDP (Sweeney, 2003: 210), but both the composition of what was traded and its destinations also changed fundamentally. When Ireland joined the EEC most of its exports were of agricultural goods, whereas by the early 2000s its trade profile was that of a modern high-tech manufacturing and services economy: pharmaceuticals and chemicals accounted for around 30 per cent of exports, computer services and business services around 15 per cent each, electronics five per cent and food and beverages five per cent. Furthermore, Ireland had diversified its markets away from its traditional dependence on Britain, with over half of all exports going to EU states other than Britain, though indigenous Irish firms still remained significantly dependent on the latter. In these ways EU membership was seen as being central to Ireland's success.

Social partnership was introduced by the incoming Fianna Fáil government in 1987 as a way of generating a consensus among employers and trade union leaders on a recovery plan for the country. The co-ordination of key elements of economic policy among the social partners, unwritten by a national wage agreement under which wage increases were moderated through a trade-off which involved the lowering of income taxes, came to be seen as a key element of Ireland's success and became a generalised feature of policy-making at national, regional and local levels through numerous social partnership bodies. In this way, Ireland's success seemed more consistent with Katzenstein's views than was the case at the same time in Iceland.

What interested policy makers and observers abroad in the Irish model – particularly in regions like central and Eastern Europe and Latin America which had shared many of Ireland's development problems – was that it seemed to contradict key tenets of the dominant neo-liberal development prescriptions actively promoted by the World Bank at the time. Viewed from a distance, they saw the Irish state as having

played an active role in winning high levels of foreign investment in cutting-edge high-tech sectors, thereby upgrading the industrial and services economy; while at the same time co-ordinating policy making between the main stakeholders through social partnership, resulting in a spectacular increase in living standards and employment. This appeared to offer a new form of state-led road to successful development, one able to manoeuvre deftly amid the pressures and threats of globalisation. Observers wanted to learn more about this seemingly successful 'Irish model' and Irish policy makers and academics were much in demand to explain what constituted it. As Casey has written: *"When Ireland was booming we had a more important voice in international fora. At meetings in the EU whenever structural reform was being discussed, the Irish delegation would usually be asked to explain the flexibility of our labour market or the beneficial effects of low taxation. How had we done what the rest of Europe – still in the throes of Eurosclerosis – could not do? … It was heady stuff. Instead of being ignored as we were in the 1970s and 1980s, we were now the talking point and an oracle to be consulted"* (Casey, 2009: 13).

Yet, amid the euphoria of Ireland's success, some warning signals of growing dependence on the construction sector as the motor of economic growth were overlooked by political leaders and the elites in the banking and construction sectors, both of them with close personal ties to the ruling Fianna Fáil party. Manufacturing employment, which had been growing over the decades since the 1930s reached its peak in 2000 and began to decline afterwards. The largest increase in employment took place in the construction sector which greatly increased its employment over the intervening years and in 2006 employed about one eighth of the national labour force stimulated by state subsidies and tax breaks. Furthermore, membership of the Euro from 1999 onwards had two effects in stimulating the construction boom. The first was that the interest rates set by the European Central Bank (ECB) were too low for a booming economy like Ireland and so added fuel to the housing market. The second effect was that Irish banks, as Ireland was a member of the currency union, were able to access liquidity easily on the international market, allowing them lend recklessly to property developers which further drove up prices.

The first signs that Ireland's growth economy was faltering came in 2007 as prices in the booming housing market began to contract; but it was mid-2008 before the alarm bells began to sound that the economy was entering into a deep recession as domestic demand contracted and unemployment began to rise. Even then, however, most forecasters were predicting a return to growth in 2009 as an upswing in the global economy would increase demand for Irish exports.

2.2 The Icelandic 'outvasion'

The Icelandic financial sector, after its privatization in 2003, made full use of liberalisation and the free movement of capital within the European Economic Area (EEA). Iceland implemented the EU's four freedoms by virtue of the EEA Agreement which came into force in 1994. That said, protectionist policies have continued to prevail in the agrarian and fisheries sectors which are not part of the EEA package. All Icelandic governments, expect for the present one, have hesitated to take full part in the European project in view not least of the economic and political constraints that EU membership would impose on the country. The EEA Agreement by contrast was seen highly beneficial to the country, giving it nearly tariff-free access to the Common Market, without posing any constraints on the country's agriculture, fisheries and monetary and economic policy.

Historically, Iceland was slow in adopting the liberal economic and trade policies of its neighbouring Western European states. The economy was characterized by economic and trade restrictions and high tariffs until the 1960s. In the early 1960s, the government did not consider Iceland capable of joining EFTA and the European Economic Community (EEC) because of how far it lagged behind other states in Western European in terms of economic development and free trade (Thorhallsson and Vignisson, 2004). Economic liberalization took place in order to prepare the country for EFTA membership in 1970 and a free trade agreement with the EEC two years later.

The centre-right government which took office in 1995 (and lasted until 2007), consisting of the conservative Independence Party and the centre-agrarian Progressive Party, continued the new liberalization of the economy which began in 1991 and further

intensified with the EEA Agreement three years later. The parties managed simultaneously to implement their *laissez-faire* agenda and to keep the protected fiefs of their long-term supporters, the fisheries moguls and farmers, intact. Historically, Icelandic governments were always willing to sacrifice manufacturing interests for the fishing industry. The latter generates most of the country's export of goods and, in 2009 the share of marine products was around 42 per cent of the total value of exported goods (Statistics Iceland, 2010a). Governments regularly devalued the króna for the benefit of marine exports, making it impossible for manufacturing firms – which relied on imports of raw material or other goods – to become competitive internationally.

The Independence Party's *laissez-faire* policies were portrayed as an alternative to the European model. Accordingly, Icelandic governments, from 1991 to 2009, under the party's leadership, gradually moved away from Katzenstein's European small-states model, which had taken shape in the country from the mid-1980s. Particularly from 2003 onwards, they side-lined social partnership, consensus-building and democratic corporatism – all of which are of prime importance under that model. The emphasis was placed on rapid economic gains, private handling (ownership) of fish stocks and privatising the state-run financial sector. The government did not seek and was not expected to interfere in the market economy through regulations and strict supervision. This led to rapid economic growth and the rise of a gigantic new financial sector but, at the same time, undermined economic and social stability and efficient economic management (Thorhallsson, 2010; Althingi, 2010a).

The Conservatives pointed to Iceland's economic success since the mid-1990s and argued that the country's living standards had risen enormously, partly or mainly owing to the country's status as a non-member of the EU (Oddsson, 2004). Iceland's growth rate rose to an annual average of 6.3 per cent over the four years to 2007. This was well above the rates recorded in previous economic booms, namely an average of 5 per cent from 1995-99 and 3.7 per cent from 1985-89 (OECD, 2009). In 2007 the banking sector, for the first time, contributed more to GDP than the fishing industry (Statistics Iceland, 2009), and in autumn 2008 it had assets valued at over ten times Iceland's GDP (Central Bank of Iceland, 2010a). Also, the Conservatives stressed that the government

and the Central Bank had been able to form their own economic policy without EU interference, including a reduction of corporate taxes (Oddsson, 2002 and 2004). The EU project was portrayed as putting constraints on businesses, restricting world trade, threatening the authority of domestic institutions, diminishing sovereignty, and undermining the uniqueness of the nation and its identity (Thorhallsson, 2010).

An investment boom led the economic boom. The most noticeable investments were the large-scale projects in aluminium smelting and the associated expansion in electricity generation capacity. Also, residential construction investment grew strongly. The housing market boom reached a peak when the sector provided seven per cent of GDP – still well below, however, the 13 per cent share of GDP reached in Ireland (Carey, 2009).

Interest rates were kept high in an attempt to control inflation. This resulted in a massive influx of capital and a high exchange rate for the Icelandic króna – which in turn created an enormous trade deficit. The overheating of the economy resulted in labour shortage which was met with large inflows of immigrants. Average real wage growth picked up markedly during the boom and reached a peak of around ten per cent from the previous year in late 2006-early 2007 (Carey, 2009).

In February 2008, the OECD concluded that Iceland's economy was prosperous and flexible. The country had the fifth-highest per capita income in the OECD member countries and it had been growing at double the OECD rate since the mid 1990s. According to the OECD report this impressive performance was due to extensive structural reforms that deregulated and opened up the economy. This unleashed entrepreneurial dynamism that was manifested by an aggressive expansion of Icelandic companies abroad.

At the same time, Iceland was top out of 177 countries on the 2007/2008 Human Development Index (UN Development Programme, 2007/2008). The Icelandic economic miracle or 'outvasion', as the Icelandic media liked to label it, was hailed as a great success. It was attributed mainly to the new entrepreneurs of the Viking race who knew how to explore and take over the world. They were constantly praised by the President of Iceland, among others, for taking business risks that proved they knew how to play

the game, and succeeding due to their natural talent and the informal and flexible decision-making culture of the country (President of Iceland, 2006; Althingi, 2010a). The Icelandic Chamber of Commerce and the British–Icelandic Chamber of Commerce (2005) described the 'outvasion' as *"the tsunami-like investment wave by Icelandic companies into London and the UK"* and pointed out that *The Economist* had *"cited the 'courage' and 'resilience' shown by Icelandic companies in their invasion of Britain"* (Icelandic Chamber of Commerce, 2005: 6). The Icelandic 'outvasion', in fact, did not kick off until after the privatization of the state-run banks was finalized in 2003. It only took it five years to bring the country to its knees.

Iceland's general economic management during this period was to be severely criticised by the Special Investigation Commission later appointed by the national parliament, the Althingi, to investigate the fall of the banks: *"neither the state's budget policy nor its monetary policy adequately addressed economic fluctuations, overexpansion and growing imbalance in the economy. Unfortunately, it seems to be unavoidable to conclude that the state's budget policy increased in fact the imbalance. The policy of the CBI [the Icelandic Central Bank] was not sufficiently restrictive and its actions too limited to render the desired results in the fight against increased leverage and underlying inflation"* (Althingi 2010b: 5).

3. Trajectories of the two crises

Table 1. Macroeconomic data for Ireland and Iceland

	2007	2008	2009	2010
GDP growth (%)				
Ireland	5.6	-3.5	-7.6	-0.2
Iceland	6.0	1.0	-6.8	-3.0
General government balance (% of GDP)				
Ireland	0.1	-7.3	-14.4	-31.7
Iceland	5.3	-0.5	-8.9	-5.8
General government gross debt (% of GDP)				
Ireland	25.0	44.4	65.6	94.5
Iceland	28.0	69.3	92.6	96.3
CPI inflation (%)				
Ireland	1.1	-1.5	-4.0	-1.7
Iceland	5.0	12.4	12.0	5.4
Effective exchange rates*				
Ireland	120.0	125.6	121.9	
Iceland	5.1	-20.7	-18.4	4.5
Nominal ISK/EUR Exchange rate		127.0	172.0	166.2

Source: IMF, 2011, February; IMF, 2011, January; IMF, 2010, December.
Note: * IRL: 1999:Q1=100, annual average, real CPI based.

Table 2. Social indicators for Ireland and Iceland

	2007	2008	2009	2010
GDP per capita				
Ireland ($)	59,821	59,902	49,863	45,642
Iceland ($)	65,181	53,107	37,991	39,563
Unemployment (%)				
Ireland	4.6	6.3	11.8	13.3
Iceland	1.0	1.6	8.0	8.3
Gross fixed investment (%)				
Ireland	2.8	-14.3	-31.0	-20.6
Iceland	-11.1	-20.9	-50.9	-4.0
Real wages (%)				
Ireland	5.2	3.5	-1.0	-1.7
Iceland	4.1	-8.1	-10.1	-1.0
Private consumption (%)				
Ireland	6.4	-1.5	-7.0	-1.3
Iceland	5.6	-7.9	-16.0	-0.3
Consumer price index (%)				
Ireland	2.9	3.1	-1.7	-1.6
Iceland	5.0	12.4	12.0	5.4
House prices (%)				
Ireland	-6.9	-8.8	-18.5	-10.8
Iceland	20.1	14.6	-24.2	-6.8

Source: IMF, 2011, February; IMF, 2011, January; IMF, 2010, December.

3.1 The collapse of the Icelandic 'outvasion'

In March 2008, the króna depreciated significantly after the market lost trust in the Icelandic state's ability to defend it and the financial system. In the following months, the króna depreciated more than most states' currencies. By late September, Glitnir Bank was the first to face default and the government paid for a 75 per cent stake in the bank in order to prevent it from collapsing. The Icelandic Central Bank (CBI) declined a loan request from Landsbankinn but lent to Kaupthing Bank as it was thought to have better chance of survival (Carey, 2009). After the announced nationalization of three-quarters of the shares of Glitnir, a significant outflow of deposits started at the other two banks (Althingi, 2010b). On 6 October the Althingi approved an Emergency Act allowing the Icelandic Financial Supervisory Authority (FME) to intervene in the banks' operations. The day after, the state took Glitnir and Landsbankinn over. The hope was

that Kaupthing Bank would survive the international economic turmoil; but the British government used its anti-terrorist financing legislation to prevent it from accepting further deposits and placed it into administration. This took Kaupthing out of business and the FME took control of it as well (Carey, 2009).

Out of all states affected severely by the financial crisis, Iceland is probably the only one not to have rescued its largest banks, but to have placed them effectively in receivership. Rescuing the banks and guaranteeing all their liabilities to foreign creditors was out of the question for the Icelandic government since (as noted) the Icelandic banks' loans and assets totalled more than ten times the country's GDP (Central Bank of Iceland, 2010a). The FME divided the assets and liabilities of the banks based on whether they were originated at home or abroad (Onaran, 2011). It created three new banks (Arion Banki, Íslandsbanki and Landsbankinn) and transferred to them the domestic assets previously held by the old banks, thus separating domestic from foreign operations. Resolution committees were set up to manage and liquidate the assets of the old banks consisting of the overseas borrowing and lending. Thus, the FME succeeded in enabling the domestic payments system to continue functioning, while foreign liabilities remained within the failed lenders. As the new banks had no capital, their equity was supplied by the government. The total cost of trying to save the banks and re-establishing them was around 346 billion ISK (Sigfússon, 2011), i.e. 1,1 million ISK per capita (Statistics Iceland, 2011a) or 22.5 per cent of GDP (Statistics Iceland, 2011b). Two of the banks have since been privatized while Landsbankinn remains state owned. Looked at the other way, the fact that the Icelandic state only guaranteed domestic liabilities and not foreign liabilities of its largest banks ensured that it was largely the creditors of those banks that had to shoulder their losses, and not the Icelandic taxpayer.

In this first week of October, during the near entire collapse of the Icelandic financial system (of which the three banks represented 85 per cent), the offshore rate of the ISK depreciated to ISK 305 to the Euro (European Central Bank, 2008; Thomas, 2008). In early 2008, the exchange rate had been ISK 90 to the Euro. In the first weeks after the crisis, the Icelandic Central Bank took an extraordinary decision to provide

foreign currency only for the import of food, medicine and fuel. Icelanders rushed to buy food and withdraw cash. In January, the króna had climbed back to ISK 167 to the Euro under strict capital controls (Central Bank of Iceland, 2009a). In total, the króna depreciated by around 48 per cent between 2007 and 2009 (Ólafsson and Petursson, 2010) (also, see Table 1 for the effective exchange rate).

The price of imported goods rose enormously, as indicated by the consumer price index in Table 2. For instance, food prices rose by nearly 40 per cent in a two year period from early 2009 (RÚV, 2010). The depreciation had substantial inflationary effects, with inflation peaking at 18.6 per cent in January 2009 and an annual average of 12 per cent, for the second year in a row (Table 1).

The depreciation substantially increased the debt burden borne by those households and firms that had borrowed in foreign currency. Household debts created predominantly through mortgages (and also foreign currency car credits) reached 103 per cent of the GDP in 2007 – a number higher than in the EU or in the United States (IMF, 2008a). Foreign exchange indexation clauses in loan contracts were declared illegal by the Supreme Court in Iceland in June 2010. Though the consequences of this ruling are still uncertain, it is clear that the ruling has benefited most of those who borrowed in foreign currency. The burden on households and firms that had borrowed in the Icelandic króna has also increased enormously due to the price indexation of all loans. To make things worse house prices have decreased considerably in 2009 and 2010, as indicated in the last row in Table 2. The number of bankruptcies reached a new peak in 2010 (Statistics Iceland, 2011c).

In 2009, Iceland's GDP decreased by 6.8 per cent, which was the largest drop in GDP ever recorded since measurements started in 1945 (see Table 1). General government debt increased from 28 per cent of GDP in 2007 to 96 per cent of GDP in 2010 (Table 1). While Iceland’s government had a budget surplus in 2007 of over 5 per cent of GDP, the financial crisis forced the state into several huge budget deficits in a row as seen in Table 1. The financial crisis also resulted in a collapse in tax revenue in 2009. The Icelandic government has subsequently raised taxes in order to deal with the

budget deficit. The first nine months of 2010 show an increase in tax revenue by 7.2 per cent, when compared to the first nine months in 2009 (Statistics Iceland, 2010b).

The financial crisis resulted in an immediate and unprecedented upswing of unemployment from a situation that previously came close to full employment. It rose to a historical peak annual average of 8.0 per cent in 2009 (Table 2). Simultaneously, the working hours of employees were reduced significantly (Statistics Iceland, 2010c). Real wages collapsed during the height of the crisis and fell by 8 per cent in 2008 and 10 per cent in 2009, as indicated by Table 2. For comparison, the International Labour Organization (ILO) claims that the average real wage growth was 2.7 per cent in several industrialized countries in this two year period (ILO, 2010).

In November 2008, the International Monetary Fund (IMF) approved a SDR 1.4 billion (1.6 billion euros) stand-by arrangement for Iceland to support the country's program to restore confidence and stabilize the economy - see Table 3 (IMF, 2008b). The arrangement had three main objectives: a) to stabilize the exchange rate, (b) to develop a comprehensive and collaborative strategy for bank restructuring and (c) to ensure medium-term fiscal sustainability. The approval made SDR 560 million (640 million euros) immediately available and the remainder in four instalments of SDR 105 million (about 120 million euros), followed by three instalments of SDR 140 million (about 160 million euros), subject to quarterly reviews. This sum amounted to 1,190 per cent of Iceland's IMF quota and was approved under the IMF's Emergency Financing Mechanism procedures. At the request of the Icelandic government, the stand-by agreement was extended to August 31, 2011 to compensate for long delays in completing the first two reviews (IMF, October 2010). The fourth and latest review of Iceland's economic performance was completed in January 2011 and enabled another immediate disbursement of the SDR 105 million (IMF, 11 January 2011).

Table 3. Rescue packages for Ireland and Iceland

	Ireland			Iceland		
Creditors	**Billion €**	**Per cent of GDP***	**Cost per capita €****	**Billion €**	**Per cent of GDP*****	**Cost per capita €******
IMF	22.5	14.4	5032.8	1.6	16.8	5033.2
EFSM#	22.5	14.4	5032.8			
EFSF##	17.7	11.3	3959.1			
Bilateral loans	4.8	3.1	1073.7	2.0	21.0	6291.5
National resources	17.5	11.2	3914.4			
TOTAL	**85.0**	**54.4**	**19012.8**	**3.6**	**37.8**	**11324.7**

Source: EFSF, 2011, January and April; IMF, 2011, January.
Notes: Due to its structure of 120 % over guarantee and cash buffer, EFSF's lending capacity does not correspond to the funding volume which is expected to be around €27 billion in total. Additionally, Irish banks have used Euro-system liquidity in total of 94 billion euros in December 2010 and Emergency liquidity assistance (ELA) from the Central Bank of Ireland of 51 billion euros (Danske Research, 2011).
#European Financial Stabilization Mechanism.
##European Financial Stability Facility.
*:Ireland's GDP: €155.992m ~ €156 billion (at Current Prices, 23 June 2011) (CSO, 2011a).
** Irish Population April 2010: 4.470.700 (CSO, 2011b).
*** Iceland's GDP 2010: ISK 1537.1 billion = € 9.5 billion (Statistics Iceland, 2011b); 1€ = 161.44 ISK (average exchange rate 2010 (Central Bank of Iceland, 2010c).
**** Icelandic population 2nd quarter of 2010: 317.890 (Statistics Iceland, e.d.).

Iceland received supplementary loans from the other four Nordic states, Poland and the Faroese government. The Nordic loans (which totalled 1.775 billion euros), to Icelanders' dismay, were tied to the first four reviews of Iceland's IMF programme with the payment of each tranche conditional on the approval of the relevant review. Poland lent Iceland about 150 million euros (Ministry of Finance, 2009) which was disbursed in three equal tranches tied to the second, third and fourth review of Iceland's IMF program. Originally, Poland had stepped in and offered Iceland a loan after a hint by the Russian government that it might be willing to bail Iceland out. The Faroese loan (about 40 million euros) was a highly symbolic expression of solidarity.

3.2 Collapse of the Celtic Tiger

Examining the Irish economy in April 2009, the IMF concluded that Ireland 'was perhaps the most overheated of all advanced economies' (IMF, 2009: 5) and said the Irish crisis 'matches episodes of the most severe economic distress in post-World War II history' (IMF, 2009: 28). It predicted a GDP decline of about 13.5 per cent for Ireland between 2008 and 2010 with unemployment set to reach 15.5 per cent in 2010. It predicted a return to 2 per cent growth as late as 2014. In the event, GDP declined by 3.5 per cent in 2008, by a further 7.6 per cent in 2009 and by 1.0 per cent in 2010, the most severe economic decline in the state's history. Unemployment in mid-2011 stood at 14.6 per cent but it was the return of high levels of emigration that ensured it was not higher. GNP, regarded as a more accurate measure of Irish growth since it excludes the profits of multinational companies taken out of the economy, contracted by 3.5 per cent in 2008, by a further 10.7 per cent in 2009, and by 2.1 per cent in 2010 (Central Statistics Office).

It was the collapse of Lehman Brothers in mid-September 2008 that exposed the vulnerability of the Irish banking sector as a gap of around €200 billion between what the banks had lent (largely to property developers) and deposits taken in. This gap had hitherto been bridged by borrowing in international markets but access to these markets now began to dry up. The bank most exposed to the property market, Anglo Irish Bank, began to lose deposits of around €1 billion a day as international depositors withdrew their money, and within days it became clear that most other Irish banks were also in difficulties. At an all-night crisis meeting between the government and the heads of the largest Irish banks on 29 September, it was decided that a blanket guarantee of the banks' liabilities was the best option to avoid what was feared would be the imminent collapse of at least Anglo Irish Bank. The then Minister for Finance, the late Brian Lenihan, boasted that it would be 'the cheapest bailout in the world so far', contrasting it to the billions of taxpayers' money being poured into banking institutions in the US and the UK and predicting that it would 'guarantee to the wider economy the necessary lifeblood that the system requires' (quoted in O'Toole, 2010: 7).

While the guarantee avoided the collapse of any Irish bank, neither did it resolve the banking crisis. Indeed, it has been described as a 'malignant colossus over the entire scene' which 'served to prop up the banks but it aligned the fortunes of the State with their fate' (Beesley, 2010a: 10). This had two main effects: firstly, it made the banks more and more dependent on state support to survive and, secondly, it made the Irish state's fiscal crisis severely worse. The period since September 2008 has witnessed a slow and painful revelation of just how deep is the crisis of the Irish banks: a realization that eventually sent the alarm bells ringing in Brussels, and finally forced the Irish government to accept at the end of November 2010 what is widely seen as a humiliating bailout package from the EU, the ECB and the IMF. Throughout 2009 and 2010, the government was forced to inject more and more capital into the Irish banks; but the more it did so the more did international markets lose confidence in Ireland, as reflected in the steady reduction by the main rating agencies of both the country's credit rating and that of the main Irish banks. Exactly two years after the September 2008 guarantee, the then Minister for Finance, Brian Lenihan, tried to calm markets by announcing a final figure for what it would cost to save the Irish banks: the estimate was €45 billion and in a worst case scenario this could rise to €50 billion. This, it was hoped, would inject some certainty into the situation and calm markets. However, comments by the German chancellor, Angela Merkel, that bondholders would have to carry some of the costs of bank bailouts in future further scared the markets, and the costs of Irish borrowing continued to rise on the international markets over October and November. Irish officials and some politicians did not hide their anger at the German move.

The EC/ECB/IMF package for Ireland, agreed in late November 2010 as the costs of the country's borrowing on international markets touched 10 per cent, provided a total fund of €85 billion over a period of seven and a half years at an estimated average interest rate of 5.85 per cent. This is made up of €10 billion for recapitalisation of Ireland's banks, a €25 billion bank contingency fund to meet on-going liabilities in the banking sector which the Irish state has guaranteed, and a €50 billion sum to support the state's borrowing requirements for the following three years. Of this, €22.5 billion comes from the IMF (see Table 3), €22.5 billion from the EU Commission, €17.5 billion

from the European Financial Stability Fund and a total of €5 billion in bilateral loans from the UK, Sweden and Denmark. Controversially the Irish state also agreed to contribute €17.5 billion, €12.5 billion of it from the National Pension Reserve Fund.

By this stage, the state had been forced to nationalise three Irish banking institutions. By late November, the flight of deposits from the two largest Irish banks, Bank of Ireland and AIB, and their inability to access capital through international financial markets, forced the state substantially to increase its share-holding in both. Only one Irish banking institution, Irish Life and Permanent, remained a viable commercial entity at this point. The government had been forced to inject €33 billion into the banking sector, most of it in promissory notes spreading the payments over 10 to 15 years. Shares in the two largest Irish banks dropped, in the case of AIB, from a peak of €23.95 in January 2007 to a low of 34 cents in November 2010 and for the Bank of Ireland, from a peak of €18.65 in February 2007 to a low of 27 cents. The three largest Irish banks lost €35 billion in deposits in 2010, most of which flowed out after June. AIB lost €13 billion in 2010, amounting to 17 per cent of its deposits. Its reliance on central bank funding tripled between June 2010 and the end of the year. Anglo-Irish Bank, whose reckless lending to property developers had placed it at the centre of the banking crisis, saw its deposits fall from €51 billion at the time of the bank guarantee in 2008 to around €16 billion by late 2010, and its reliance on Irish central bank funding was estimated to have grown to more than €43 billion. In late November 2010, the government finally decided to close it, transferring its deposits into a viable bank.

Meanwhile, to provide some solution to the banks' over-reliance on the property sector, in April 2009 the state established the National Asset Management Agency (NAMA) to manage the sector's non-performing loans. Altogether it expects to buy €73 billion worth of non-performing loans from the five banking institutions and for these to pay around half the original value of the debts. For example, in the first six months of 2010, it paid €8.4 billion for property loans with a nominal value of €16.4 billion, paying the banks in bonds which they can exchange for cash with the European Central Bank. Through relieving the banks of their bad debts, it had been hoped that they could raise fresh capital and so begin lending again. However, the extent of the 'haircut' - as the

discount on the loans' value is called - further damaged the balance sheets of the banks, especially Anglo Irish Bank, and some critics accuse NAMA of making the banking crisis worse.

Alongside the banking crisis, a severe budgetary crisis developed in the Irish state's finances. The state's income through tax revenue deteriorated sharply in 2008, due in part to the collapse in property prices since stamp duty, a tax on the purchase of property, had become a major source of state income during the boom. By the end of 2009 the budget deficit had widened to 14.6 per cent of GDP, but various measures to cut spending (including two cuts in the income of public servants) and some modest tax increases had reduced it to 11.9 per cent by late 2010. When, however, the full cost of supporting the banks is factored in, the deficit rises to 32 per cent of GDP in 2010 - widely regarded as the highest ever recorded in a developed country in peacetime. As international markets increasingly lost confidence in Ireland's ability to meet its huge debts, the government announced a four-year strategy to detail how it planned to return the budget deficit to three per cent of GDP by 2014 as demanded by the EU Commission (this was changed to 2015 as part of the terms of the EU/ECB/IMF rescue package). The austerity plan, entitled *The National Recovery Plan 2011-2014* and announced in late November 2010, details cuts in public spending totalling €10 billion and tax rises of €5 billion which, in the absence of a stimulus plan, many fear will only further deepen Ireland's recession.

4. EU membership and the Euro

We now turn to examine more precisely the role of EU and Euro membership in the Irish case and the absence of these in the Icelandic case. The comparison is structured around three questions:

- What role did membership of the EU and the Euro play in causing the Irish crisis, either as contributing factors or as ameliorating factors? How might membership of the EU and the Euro have helped Iceland avoid its crisis?

- Once the crisis struck, how did EU membership help the Irish authorities to address the crisis? What impact did membership of the Euro have, both in helping financial stability and in contributing to overcoming the crisis? By contrast, how did Iceland's lack of a 'shelter' impact on the development of the crisis and on the steps taken to find a way out of it? How might membership of the EU and of the Euro have helped?
- Membership of the EU and of the Euro, both provide a 'shelter' but also rule out national resort to certain mechanisms, most especially devaluation. This raises the need to identify the advantages and disadvantages of having a 'shelter' based on the prospects for recovery of Iceland and Ireland.

a. Causing the crisis

Ireland

While Irish government Ministers have tended to ascribe the causes of the Irish banking collapse to the international financial crisis, a report commissioned by the Minister for Finance into the causes of the Irish crisis was unequivocal in clarifying where the principal blame lay: *"Ireland's banking crisis bears the clear imprint of global influences, yet it was in crucial ways 'home-made'"* (Regling and Watson, 2010: 5). The report, written by two leading European banking experts, uncovers in forensic fashion the multiple governance and policy failures that led to the crisis. Interestingly, however, they pose the question: *"Was it a coincidence that Ireland's economic fundamentals began to deteriorate when Ireland joined the Euro area?"* (ibid.: 24). They argue that certain aspects of EMU membership *"certainly reinforced vulnerabilities in the economy. Short-term interest rates fell by two thirds from the early and mid-1990s to the period 2002-07. Long-term interest rates halved and real interest rates were negative from 1999 to 2005 after having been strongly positive"* (ibid.: 24). This situation contributed to the credit boom in Ireland since low interest rates encouraged borrowing and the removal of exchange rate risk facilitated the banks in accessing foreign funding, ensuring the flow of credit could continue. In this situation, official policies and banking practices

faced key challenges with *"scope to mitigate the risks of a boom/bust cycle through prudent fiscal and supervisory policies, as well as strong bank governance – thus raising the chances of a 'soft landing' for the property market and for society at large"* (ibid.: 5). However, the authors conclude that possible policy instruments such as fiscal policy, bank regulation and income policy *"were not used to offset the well-known expansionary effects of EMU membership on the macroeconomic environment or even fuelled the fire, in particular tax policies"* (ibid.: 24-5).

If membership of the Euro increased vulnerabilities for Ireland, Regling and Watson argue that being a member of a large monetary union *"helped Ireland to survive better the global financial crisis"* since without it funding problems for the banking sector would have become bigger, firms and households would have borrowed more in foreign currency and so would have been exposed to greater risks (as happened in Iceland), and coordination problems for national central banks would have been significant. They add that *"none of the interlocutors in Ireland and abroad, with whom the authors of this report talked, questioned that EMU membership for Ireland has been, on balance, highly beneficial"* (ibid.: 25). However, it needs to be recognized that Ireland's route to crisis was facilitated by membership of the Euro. If Ireland had kept its own currency the crisis could not have happened for two reasons: first, had Irish banks not had access to the levels of liquidity that allowed them to lend so extravagantly, such an inflated housing bubble would not have been possible and the banks could not have taken on such high levels of indebtedness; secondly, based on historical precedent, interest rates would have been set at a higher level by the Central Bank of Ireland thus curbing the extravagance in property development.

Iceland

The Icelandic crisis started with the fall of the króna in March 2008, as already stated. 'Hot' money had been flowing into the country due to very elevated interest rates, which the government kept high in an attempt to keep inflation under control. The result was an overvalued króna which paved the way for further investments by Icelandic companies abroad. Hence, an extremely high net foreign debt ratio added to

Iceland's vulnerability (Gros, 2008). In 2007, FDI flows were 61.5 per cent of GDP inward and 127.3 per cent of GDP outward. The rise had been striking. In 1990, as a percentage of Island's GDP, inward FDI flows were only 2.3 per cent of GDP and outward flows 1.2 per cent of GDP (Statistics Iceland, 2008a and 2008b).

Ólafsson and Pétursson (2010) point out that Iceland and South Korea were the only states among 46 medium-to-high income countries affected by the latest crisis (including all the OECD countries) to experience a currency crisis as such. They conclude an impressive analysis of the small European states that were hit particularly hard *"in terms of the real economy impact and the banking and currency crisis incidences"* by stating that *"we are able to predict quite accurately … that the main reasons for the large and persistent contraction in output and consumption"* in Iceland and Ireland *"were in addition to the inflationary-effect, the greater-than-average financial exposure of these two countries (larger capital inflows and higher private sector leverage in the case of Iceland, larger financial openness and limited exchange rate flexibility in the case of Ireland, and the very large banking systems in both countries)"* (Ólafsson and Pétursson, 2010: 24-25).

After pointing to findings that output losses tend to be much higher in currency crisis episodes (Cecchetti et al., 2009), Ólafsson and Pétursson conclude their comparison between the consequences of exchange rate flexibility and of EMU membership by remarking: *"Furthermore, it seems obvious that EMU membership protected countries against a currency crisis and may thus have helped in mitigating the real impact of the crisis through that channel … It could for example be argued that the large banking collapse in Iceland could have been contained to some extent had Iceland been a member of EMU, with stronger institutional support, for example through the greater ability of the ECB to provide liquidity support"* (Ólafsson and Pétursson, 2010: 24).

David Carey (2011), head of the Iceland Desk in the Economic Department of the OECD, agrees - in his independent analysis – about the importance of size in explaining the inability of the small Icelandic government and its central bank to save the banks. The banks' domestic operation and foreign branches lacked lender of last resort facilities

for their foreign lending. Also, Carey claims that the banks' negative equity positions were accentuated by currency depreciation as the crisis developed and it became increasingly difficult to find counterparts willing to buy króna in exchange for foreign currencies. According to Guðmundsson (2009), now the director of the Icelandic Central Bank, the risk of foreign currency shortage was underestimated and the subsequent lack of access to foreign currency significantly contributed to the financial crisis in Iceland.

On the other hand, Carey argues that the main problem was that the banks were suffering from liquidity problems because they were suspected of being insolvent. In fact, their wholesale funding had been very difficult from late 2006 and their funding dried up entirely in mid-2007. No lender of last resort facilities could have saved banks in such a position. Carey rejects the thesis that the króna had acted as the main bulwark against their collapse and argues that the banks would have been in great trouble even if Iceland had been within the Euro zone. He claims that the banks had access to liquidity facilities from foreign banks, notably the ECB, through their foreign subsidiaries. The ECB was, in fact, holding 4.5 billion Euros of collateralised loans to them (the Icelandic Central Bank was holding 2 billion Euros of collateralised loans to the banks).

It is clear at any rate that Iceland's small size in terms of the state's bureaucracy and its lack of expertise, coupled with a blind belief in the neo-liberal agenda and political favouritism, played a part in the collapse. The first mistake was to hand over the state-run banks at the time of privatisation to political favourites who did not have any experience to run financial institutions but already had major expansion plans. Furthermore, though the relevant financial regulations were mostly transposed from the EEA, *"Iceland's supervisors were unable to keep up with the complexity and size of the system as it grew rapidly and applied rules in an excessively legalistic manner"* (OECD, 2009).

In the summer 2007, warning signals started to pile up concerning the Icelandic banks because of their high exposure to global equity markets. Also, there were serious doubts about the Icelandic government's capacity to back them up if they got into difficulties. The banks were also thought to be less closely supervised than other banks in the EU/EEA (OECD, 2009). The banks turned to the CBI and ECB discount windows for

funding on a large scale. In the first half of 2008, despite the banks' 'near-death experience' and the Althingi's approval of legislation empowering the government to borrow up to ISK 500 billion to bolster the reserves of the CBI, the government did not act since it was unable to borrow at reasonable rates.

In the spring of 2008, the three Scandinavian Central Banks made currency swap agreements with the Central Bank of Iceland with the preconditions that the Icelandic Prime Minister, the CBI and the FMF would put pressure on the Icelandic banks to reduce their size of their balance sheets according to proposals made by the IMF. The Icelandic authorities did not act on these promises. It was clear that currency swap agreements with other central banks were not on offer for the Icelandic Central Bank. The Bank of England had instead offered that foreign central banks could help the CBI find an effective way to reduce the size of the Icelandic banking system. The CBI did not take up this offer (Althingi, 2010b). Foreign actors had lost faith in the Icelandic financial system which was on the verge of collapsing.

In the summer of 2008, *"the Icelandic authorities had become very isolated in the international community. Therefore, they had few to turn to when the Icelandic banks collapsed in October 2008"* (Althingi, 2010b: 13). It appears that both the parliament and the government lacked both the power and the courage to set reasonable limits to the financial system. All the energy seems to have been directed at keeping the financial system going. It had grown so large that it was impossible to take the risk that even one part of it would collapse (Althingi, 2010b: 17).

b. Addressing the crisis:

Ireland

In the immediate aftermath of the crisis, membership of the ECB was an advantage to the Irish authorities as they were able to draw on the Bank's support. For example, in the first six months of 2010 the National Asset Management Agency (NAMA) was paying Irish banks for property loans with bonds which the banks could exchange for cash with the ECB. However, by September 2010 when the Minister for Finance revealed a far higher estimate for the amount of capital needed to save the Irish banking system, the

ECB began to grow alarmed. Central to its fears was the growing dependence of the Irish banking sector on its support. Irish banks shed €109 billion in overseas deposits in the two years to September 2010 (this figure includes the subsidiaries of foreign banks in Ireland). According to the Irish central bank, this figure was made up of overseas deposits of €64 billion and €45 billion in debt securities held by overseas bondholders. This lost funding was replaced by the ECB from which Irish banks had borrowed €130 billion by the end of October 2010, as well as a further €34 billion from the Irish central bank. By mid-2011, the Irish banking system had accessed some €150 billion in liquidity from the ECB. In September 2010 the gap between their deposits and loans stood at €175 billion. During that month, €55 billion of bank bonds held mainly by UK, German and French banks matured and were repaid, mostly by borrowing from the ECB. The ECB's growing awareness that Ireland, a country with about one per cent of the EU's GDP, had ended up with more than 20 per cent of the ECB's lending caused a major shift in its policy. Economics professor Antoin Murphy has argued that the ECB's desire for a new mechanism to relieve it of some of the burden of its lender of last resort function to the Irish banking system prompted this change in its monetary policy in mid-November. As he wrote: *"As a result the Irish crisis, which has been initially a fiscal/funding crisis as highlighted by the bond markets, shifted to a full-scale crisis about the liquidity and solvency of the Irish banking system"* (Murphy, 2010: 3). It was the ECB's decision to discontinue lending to Irish banks, and seek a new arrangement from the European Commission and the IMF to provide an alternative bailout strategy, that forced the Irish government to negotiate an €85 billion package of financial assistance announced firstly in Brussels and then in Dublin on Sunday, November 28th before the Asian markets opened.

However, two dimensions of the ECB's role have merited extensive criticism in Ireland. The first is the refusal to shoulder any of the burdens of adjustment after having, as is widely believed, advised the Irish authorities to introduce the blanket guarantee of bondholders in September 2008 that has been so criticised since. As banking analyst Peter Mathews put it, when negotiating the bailout package with the EU, ECB and IMF, Irish officials *"had a duty to clearly demonstrate … that the ECB had*

been 50 per cent culpable in its failure in regulation and supervision of Irish banks for four years up to 2007-2008" and by knowingly advancing loans to the Irish banks when it was obvious that they were heading for insolvency. He concluded that the ECB should have given a write-down of €60 billion on the €130 billion they lent to Irish banks (Mathews, 2010: 13). The second is a more general sentiment of resentment that the ECB pushed the Irish government into negotiating a financial assistance package in mid-November 2010; even while ECB officials were briefing key international media outlets that this was happening, government ministers in Dublin were staunchly denying it and it took a radio interview by the Central Bank governor to force the government to admit publicly it was happening. As a leading Irish correspondent in Brussels wrote a month later referring to officials in Dublin, *"it still rankles that the European Central Bank let it be known … it wanted the Government to take aid"* (Beesley, 2010b: 18). The lack of European solidarity at a time of national crisis has been well noted in Ireland.

Iceland

Iceland's struggle to get external financial assistance in order to deal with the crisis is in sharp contrast with the case of Ireland and other member states of the EU. The latter all received immediate assistance from the EU and the ECB and many of them have received a joint EU-IMF rescue package. In the case of Iceland, the British government used its anti-terrorist rules to take control of assets held in Britain by the beleaguered Icelandic banks and demanded full payback from the Icelandic government to British account holders. Tense relations followed between the two countries. To Iceland's dismay all member states of the EU, including the Nordic states, stood by Britain, delaying much-needed external assistance (Morgunblaðið, 2008). Iceland faced challenges on all fronts since the governments of Germany, the Netherlands and Luxembourg also demanded full guarantees from the Icelandic government of their citizens' savings, lost in the branches of the Icelandic banks in these states.

Iceland was faced with difficult bilateral negotiations with these states since the EU declined to step in and provide a framework for solving the disputes. Whether or not membership of the EU would have made any difference in this respect is difficult to

judge. That said, it would at least have meant that these talks would have taken place within the EU institutional framework where Iceland would have had a stronger foundation to defend itself. Also, it is difficult to imagine the scenario of one of the EU member state using measures drafted for anti-terrorist purposes against another member state, under highly disputable circumstances, and using its power to block IMF assistance to the country in question.

Moreover, to Icelandic decision-makers' surprise, the US government and its Central Bank were not willing to help out – despite providing the other Nordic states with swap facility arrangements that they could draw upon if necessary (Central Bank of Iceland, 2008), and despite the fact that the US ambassador in Reykjavik strongly recommend the US authorities to bail out Iceland (Watson, 2010). Hence, for the first time since the Second World War, Iceland could no longer rely on the US for economic shelter. Decision-makers in Washington simply expressed relief when the Russian government hinted that it was willing to bail Iceland out with a substantial loan after the crisis hit (Embassy of the USA in Reykjavik, 2009).[2]

In November 2008, the IMF finally came to the rescue – after Iceland had accepted preconditions for settling the dispute with Britain and the Netherlands, i.e. given in to their demands. The Icelandic government promised full reimbursement to the British and Dutch governments, which had meanwhile compensated their citizens who had lost their investments in savings schemes operated by the Icelandic banks, to a total value of 3.8 billion euros (Jóhannesson, 2009).

However, this so-called Ice-save dispute[3] dragged on and the IMF did not initiate the two-year Stand-By Arrangement until a year after the crisis hit – that is, until Iceland had finalized a deal with Britain and the Netherlands. According to the IMF, its member states, including the long term friends and closest neighbours of Iceland - the Nordic states - refused to lend Iceland money until the dispute had been settled (Strauss-Kahn,

[2] On the other hand, a number of European states formally made their concerns about the potential Russian influence in Iceland known to the Icelandic government. This was at least the case of France, Poland and all the other Nordic states.

[3] The dispute is centered on the retail creditors of the Icelandic bank, Landsbanki which offered online savings accounts under the Ice-save brand in Britain and the Netherlands. Landsbanki was placed into receivership by the Icelandic government early in October 2008. As a result, more than 400,000 depositors with Icesave accounts were unable to access their money for at least 6-8 weeks, i.e. until the governments of Britain and the Netherlands guaranteed them access to their money. On the other hand, deposits in Iceland were guaranteed by the Icelandic government from the beginning and were generally accessible.

2009). Hence, the IMF could not initiate its assistance plan since these national loans were to be part of the IMF's rescue package. Moreover, in January 2010, Britain, the Netherlands and the Nordic states yet again blocked the IMF assistance after the President of Iceland referred the Ice-save deal - which the government had struck with Britain and the Netherlands and the Althingi had narrowly approved – to a popular referendum. The deal was rejected by 93 per cent of voters (Landskjörsstjórn, 2010). Later, a new Ice-save deal, which was more beneficial to Iceland than the previous one and approved by an increased parliamentary majority, was rejected by 6 out of every 10 electors in a second referendum (Landskjörsstjórn, 2011).

At the same time, there has been a contrast in the short-term political aftermath of the crash in our two cases, which according to Krugman helps explain the current greater confidence in Iceland compared with Ireland (Onaran, 2011). A new government took over in Iceland soon after the crash while a change of government took place only on 2011 in Ireland. The Icelandic government now claims a major success in restoring the economy and in its other crisis response objectives, though the parliamentary opposition fundamentally disagrees. Bloomberg's assessment of the government's achievements two years after it took office, in a piece called 'the Icelandic Miracle' (Onaran, 2011), may be an overestimation but several important missions have been accomplished.

In January 2009, the most violent protest on the streets of Reykjavik in the country's history contributed to the fall of the government. The Independence Party was thrown out of office and the Social Democratic Alliance, its coalition partner in government since 2007, formed a minority government with the Left Green Movement with the tacit consent of the Progressive Party. It immediately scheduled a general election in the spring. The previous government had been deeply divided on how to tackle the crisis, with the Social Democrats demanding a revised European policy, a firmer handling of responses to the crisis by the conservative Prime Minister, and the removal of the director of the Icelandic Central Bank (a former leader of the Independence Party and long serving Prime Minister (1991-2004)). The Independence Party had not met these demands and the Left Greens had hinted that they would not

hinder a move towards an EU application. Thus, the Social Democrats were able to justify breaking up the coalition and shifting partners.

In the April 2009 election, the resulting interim government got a renewed mandate and gained a majority in the Althingi. Hence, it formed the first majority Left majority government in Iceland's history. By contrast, the Irish government stayed in office until February 2011, i.e. until the devastating election defeat of Fianna Fáil which declined from 78 seats to 20 in the Dáil (its popular vote fell from 41 per cent in 2007 to 17.4 per cent in 2011, the lowest in the party's history). The Icelandic Independence Party had experienced a similar defeat in the April 2009 elections – also the worst result in its history.

Immediately, the new Icelandic majority government announced a list of measures to be adapted within its first 100 days (Prime Minister's Office, 2009) and a more detailed Policy Declaration for the parliamentary term. The initial work of the government included restoration of the failed banks, restructuring of the Central Bank, implementation of the IMF programme, preventing further down-valuing of the currency, beginning the accession process for membership of the European Union, budget cuts and taxe increases to limit the budget deficit, adapting rescue measures for households and companies which had borrowed in foreign currency, completing the negotiation concerning Ice-save, tackling unemployment and, in general, stabilizing the economy (lower inflation and interest rates). Also, the government started a process to amend the constitution, restructure the government and the public administration, and adopt several measures intended to rebuild trust in the government and the administration. More recently the government adopted 'The Iceland 2020 Policy Statement' which includes proposals and accompanying processes concerning the development of economic and employment activities for immediate and future implementation (Prime Minister's Office, 2010).

c. Resolving the crisis: Ireland

Table 4. Comparable predictions for Ireland and Iceland

	2011	2012	2013	2014	2015
GDP growth (%)					
Ireland	0.9	1.9	2.4	3.0	3.4
Iceland	2.0	3.0	2.5	3.0	3.0
General government balance (% of GDP)					
Ireland	-10.5	-8.6	-7.5	-5.1	-4.8
Iceland	-5.3	-1.7	0.8	1.8	2.5
General government gross debt (% of GDP)					
Ireland	112.8	120.0	124.5	124.1	123.0
Iceland	100.5	93.9	88.1	79.0	72.4
CPI inflation					
Ireland	0.4	0.8	1.4	1.6	1.6
Iceland	2.5	2.4	2.5	2.5	2.5
Effective exchange rates*					
Ireland					
Iceland	2.0	1.0	1.0	1.0	0.0
Nominal ISK/EUR exchange rate	165.2	165.1	165.0	163.9	163.9
Unemployment					
Ireland	13.5	12.8	12.3	11.5	10.7
Iceland	7.5	5.8	4.1	3.4	3.4
Gross fixed investment					
Ireland	-10.4	3.5	5.0	8.0	9.0
Iceland	15.5	23.2	13.6	3.5	2.1
Real wages					
Ireland	-1.1	0.4	1.1	1.7	1.8
Iceland	1.0	2.0	2.4	2.4	2.4
Private consumption					
Ireland	-1.0	0.5	1.2	1.5	2.2
Iceland	3.0	3.3	3.5	3.0	3.0

Source: IMF, 2011, February; IMF, 2011, January; IMF, 2010, December.
Note: *(1999:Q1=100, annual average), real (CPI based)

The third issue to be examined concerns the cost of Ireland's EU and Euro shelter. The relevant debate within Ireland focuses on the role the ECB in influencing the Irish government's response to the crisis. For example, it has been claimed that it was the ECB that recommended the former government on the fateful evening of 29 September

2008 to give a blanket guarantee to the Irish banking system, including to bondholders; however, no evidence has emerged to substantiate this claim. During the campaign for the general election on 25 February 2011, the outgoing government was criticised for not achieving an element of burden-sharing by the ECB as part of the rescue package; and in an April 2011 interview, the former Finance Minister Brian Lenihan stated that the government sought to impose losses on the banks' senior bondholders but that the option was ruled out by the troika (the Commission, the Bank and the IMF): *"I discussed the matter with Dominique Strauss-Kahn [IMF managing director] himself and Monsieur Trichet [ECB president], but it was clear to me there was no budge on this whatsoever in the discussions"* (O'Brien, 2011b: 1). In the same interview, Lenihan said that it was the ECB rather than the European Commission that precipitated the Irish rescue package and that the Bank did so as Irish banks grew more dependent on its short-term liquidity funding. Prior to November 2010, the ECB had been *"rather disinterested in Ireland"*, Lenihan said.

In the same interview, the former Minister was very critical both of the high interest rates included in the rescue package and of ECB plans for the Irish banking system, which he described as *'un-implementable'*. As he said: *"It became clear to us that the European solution was to stuff the banks with capital and see would that generate confidence in them"* (O'Brien, 2011a: 11). Apart from the pressure from the ECB, an influential Irish economist, Morgan Kelly, claimed that during negotiations of the Irish rescue package with the IMF, the latter *"presented the Irish with a plan to haircut €30 billion of unguaranteed bonds by two-thirds on average. Lenihan was overjoyed, according to a source who was there, telling the IMF team: 'You are Ireland's salvation'."* However, Kelly claims this offer was vetoed by the US Treasury Secretary, Timothy Geithner, during a conference call with G7 finance ministers on the rescue package. Kelly adds that *"the IMF were scathing of the Irish performance [during the negotiations of the package], with one staffer describing the eagerness of some Irish negotiators to side with the ECB as displaying strong elements of Stockholm Syndrome"* [when kidnap victims take the side of their captors] (Kelly, 2011: 13).

These claims give a flavour of the tensions that characterise Irish perspectives on the role of the ECB in particular. Another example of these is the letter written by the former Taoiseach [prime minister] and former EU ambassador to Washington, John Bruton, to the president of the European Commission president, José Manuel Barroso, in January 2011. This followed upon comments in the European Parliament by the Socialist MEP for Dublin, Joe Higgins, who attacked the EC/ECB/IMF rescue package for Ireland, calling it a mechanism to turn Irish taxpayers into vassals for European banks and questioning the morality of transferring to taxpayers the responsibility for banks' bad debts. The package, Higgins said, was no more than a tool to cushion banks from the consequences of reckless speculation. Clearly angry, Barroso replied that *"the problems of Ireland were created by the irresponsible financial behaviour of some Irish institutions and by the lack of supervision in the Irish market"* (Beesley, 2011: 1). In his letter a few days later, Bruton told Barroso that his criticisms of Irish institutions were fully justified, but that he was only telling one part of the story: British, German, Belgian, American, French banks and the banks of other EU countries *"lent irresponsibly to the Irish banks in the hope that they too could profit from the Irish construction bubble"*, and therefore *"must take some share of responsibility for the mistakes that were made."* Furthermore, referring to the responsibility of the European Commission for supervising the Irish economy, Bruton wrote: *"You ought to have acknowledged that responsibility of your own institution, which the Commission shares with ECOFIN".* He added that the ECB kept interest rates low *"pursuing interest rate policies that were unsuitable for Ireland"* (Bruton, 2011). This letter, from a strongly pro-European senior Irish politician, accurately reflects the widespread view in Ireland that the country has been unfairly treated by both the Commission and the ECB.

These views have been accepted by the new Fine Gael-Labour coalition government that took office on March 6th 2011. The new government promised to negotiate a reduction of the interest rate and less onerous conditions; but European leaders have continued to insist that Ireland offer something in return, with French President Sarkozy and German Chancellor Merkel mentioning the need for Ireland to increase its 12.5 per cent corporation tax. This is completely rejected by Irish politicians

and has caused something of a standoff in the first months of the new administration. The new government also hoped it had finally got to the bottom of the banking crisis when it announced the results of severe stress tests on the Irish banks within a month of taking office. This put the cost of rescuing the banks at €70 billion and represents the fifth and highest estimate since the beginning of the crisis: the estimated cost has grown from €5.5 billion in December 2008, to €11 billion in February-March 2009, to €35 billion in March 2010, and €46 billion in September 2010 to €70 billion in March 2011. This last announcement was coupled with a plan to restructure the banking system, now entirely in the hands of the state, on two pillars with the banks most damaged by the collapse - Anglo Irish Bank and the Irish Nationwide Building Society - being closed down (though after most of their bondholders had been paid). The government thereby hoped that, 30 months after the crisis first revealed itself, a final line would be drawn under it and badly needed credibility in financial markets could be won back.

A final point to be considered concerns whether membership of the Euro has closed off policy mechanisms, particularly devaluation, that could assist Ireland's recovery in comparison to Iceland. Since neither country has yet recovered from the crisis, what can be said is necessarily speculative. However, it is to be noted that Nobel economics prize-winner Paul Krugman wrote in late November 2010 in reference to Ireland and Iceland that *"at this point Iceland seems, if anything, to be doing better than its near-namesake. Its economic slump was no deeper than Ireland's, its job losses were less severe and it seems better positioned for recovery. In fact, investors now appear to consider Iceland's debt safer than Ireland's".* Asking how this is possible, Krugman points to a number of factors some of which are policy tools not available to Ireland. Firstly, he says part of the answer is that Iceland let foreign lenders to its banks pay the price of their poor judgement rather than putting its own taxpayers on the line. Ireland did not do likewise partly, it is believed, because of contrary advice from the ECB. Secondly Iceland imposed temporary capital controls, something not available in the currency union of which Ireland is a member. Thirdly, devaluation of the krona made Iceland's exports more competitive, an important factor in limiting the depth of the slump. As Krugman concludes: *"None of these heterodox options are available to Ireland, say the*

wise heads. Ireland, they say, must continue to inflict pain on its citizens – because to do anything else would fatally undermine confidence" (Krugman, 2010). It remains to be seen how accurate an analysis this proves to be, though it should be noted that the absence of the possibility of a currency devaluation has not hampered Ireland's exports. Paradoxically, the value of Irish exports, mostly constituted by goods and services produced by multinationals, was in February 2011 higher than at any time since 2002 and had risen by 11 per cent over the previous 12 months (CSO, 2011c), illustrating the extent of the disconnect between the domestic and foreign sectors of the economy.

Iceland

Ólafsson and Pétursson's (2010) findings indicate that exchange rate flexibility seems to have facilitated the real adjustment to the crisis in the case of Iceland. This boosted exports and redirected demand from imports to domestic production. Also, the currency depreciation quickly more than reversed the losses in competitiveness during the economic surge (Carey, 1011).

On the other hand, the surplus on external trade has not provided the króna with the expected support, which has made it more difficult for monetary policy to facilitate the reconstruction of private sector balance sheets (Central Bank of Iceland, 2009b). In March 2011, the króna was being held at 161 to the Euro (Central Bank of Iceland, 2011) with help from the Central Bank's strict capital movement controls (Sighvatsson, 2010). Even so, it is not surprising that many Icelanders now doubt the relevance of the króna. It has depreciated by 99.95 per cent against the Danish Krona since 1920, having previously been tightly pegged to the DKK (Central Bank of Iceland, 2010b). This is mainly due to inflation, which the Icelandic government and the Icelandic Central Bank have a bad reputation for controlling. The most important factor explaining much higher inflation volatility in Iceland is high exchange rate pass-through (Pétursson, 2008, August). The consequences for Icelanders have been clear: price indexation of all loans (which is unique in Europe), much higher interest rates than in the neighbouring states and a fall in real wages in times of recessions, largely due to higher prices of imported goods and high inflation.

The January 2011 IMF report argues that Iceland has made impressive progress by implementing capital controls, introducing automatic fiscal stabilizers in the immediate wake of the crisis and successfully implementing the IMF's program policies. The IMF positive outlook is based on the following: The Icelandic economy is gradually recovering. Growth turned positive in the second half of 2010 and the economy is set to expand on an annual basis in 2011 (see Table 4), for the first time in two years. The still-wide output gap and króna appreciation have further reduced inflation pressures (Table 4), and the underlying current account remains in surplus. Financial markets have remained stable, despite turbulence in European sovereign debt markets. Significant fiscal adjustment has already take place, and is set to continue in 2011. With sustained adjustment in line with the program, the public debt ratio should begin to decline in 2012. The general government account is projected to show only a small primary deficit (see Table 4), *"which is a significant achievement only two years after the crisis".* The financial system is gradually being restored, and the recapitalization of key institutions marks an important milestone in this area (IMF, 2011). On the other hand, unemployment is expected to remain high throughout 2011 (7.5 per cent as indicated by Table 4).

Despite claiming that the depreciation of the króna has helped economic recovery and that membership of the Euro area would not have prevented the collapse, Carey argues that joining the Euro area in future is likely to be advantageous for Iceland. Membership of the Euro area would deepen trade with other Euro zone members, increase the economic gains from trade, reduce domestic interest rates, and increase the capital intensity of production and labour productivity. Iceland's flexible labour market *"augurs well for it being able to make the necessary real exchange rate adjustment within the Euro area at reasonable cost despite being subject to supply shocks that are uncorrelated with those in the Euro area"* (Carey, 2011, 6) Carey concludes: *"All of these gains would likely be greater for Iceland than they have been for most other countries that have joined the Euro area. The króna exchange rate historically has exhibited high volatility, increasing the potential for trade gains and reductions in interest rates from eliminating this source of risk. Moreover, the CBI as not yet*

established a good track record for delivering price stability, the scope for a reduction in the inflation premium in interest rate is relatively large" (Carey, 2011: 5).

5. Conclusions

The difference in our two test cases lies in Ireland's membership of the EU and EMU, and Iceland's non-EU membership and possession of its own currency. In the terms of the theoretical literature on small states, Ireland is part of an alliance (the EU) that provides it with economic and political shelter. Iceland is not sheltered by the EU institutions though it is obliged as an EEA member to implement the four freedoms, including relevant rules of finance. What difference did this diversity mean for the two countries in question in terms of reducing the risk before the crisis event, getting assistance in absorbing the shock and receiving help in cleaning up after the event? We can isolate two elements of the shelter concept to illuminate our cases, i.e. Ireland's shelter provided by the currency union and its general support from the EU institutions.

First, Ireland was as badly hit by the crisis as Iceland despite its Euro currency shelter. A common currency shelter does not save the day if domestic economic policies are not solid. As has been made clear, the primary responsibility for the Irish collapse rests with the reckless activities of the banks, abetted by pro-cyclical government policy and weak regulation. In the absence of appropriate policy responses by domestic policymakers, Ireland's membership of the Euro exacerbated Ireland's property bubble and fuelled the lending of Irish banks. It is paradoxical that the Irish property bubble could not have grown to the extent it did had the country maintained its own currency and therefore its independent interest rate policy, since interest rates would have been used to dampen demand and banks could not access liquidity as readily. Following the collapse, the Euro did act as a financial shelter for Irish households: inflation remained very low (indeed, Ireland experienced deflation for a period), there was no increase in the costs of imports, and the cost of borrowing remained low (though the Irish banks grew very adverse to lending). The main benefit of the Euro, therefore, was to shelter the living standards of Irish people from the high levels of inflation and the increase in costs of imported goods that is revealed in Table 2.

Ólafsson and Pétursson's (2010) findings indicate that variations between the impact of economic crisis in individual states have mainly to do with their macro-economic policies. States *"that, in the run up to the crisis, had higher inflation, larger current account deficits, a more leveraged private sector, greater output volatility, or a poorer fiscal position tended to experience some combination of a deeper or more protracted contraction in output or consumption, and were more likely to experience a systemic banking or currency crisis"* (Ólafsson and Pétursson, 2010: 25). Also, the size of the financial sectors and lack of effective supervision played a part in such countries' downfalls. The failure of the Icelandic government to curb the rapid expansion of the banking sector magnified the scale of the Icelandic crash. The banks' balance sheets and lending portfolios expanded beyond both the capacity of their own infrastructure and the government. The massive growth in lending by the banks caused their asset portfolio to develop into a very high-risk one. The state's management and supervision did not keep pace with the rapid expansion of lending (Althingi, 2010b).

From the Irish perspective, the governor of the Central Bank of Ireland, Prof. Patrick Honohan - in a report to the Minister for Finance on the collapse of the banks – has stated that while the crisis in both Ireland and Iceland derived from a nationally-generated bubble, the parallels between the two countries' experiences *"are not all that close"* (Honohan, 2010: 133). He differentiates on three grounds:

- Firstly, the rate of expansion of the Icelandic banking system was far higher than the growth of even the fastest growing Irish bank, Anglo Irish bank. Furthermore, the losses incurred by the Icelandic banking system were almost ten times those of Ireland when measured relative to each country's GDP. The average write-down for the assets of the three Icelandic banks is estimated at 62 per cent compared to an average of around 50 per cent in the Irish case.
- Secondly, the pattern of bank behaviour was different, with property lending not being so central in Iceland. Instead, an extraordinary amount of self-lending has been exposed in the Icelandic banks; where this happened in Ireland it was on a far smaller scale. Other differences relate to the growth in investment funds managed by the Icelandic banks, and their late expansion into retail

franchises in other countries as they attempted to substitute wholesale funds with retail deposits.

- Thirdly, in contrast to the Icelandic authorities, the Irish financial regulator did increase capital requirements in an attempt to slow risky lending, though by too little (Honohan, 2010).

However, the cases of Ireland and Iceland both clearly demonstrate that *"countries with relatively large banking systems or stronger global financial linkages tended to experience a deeper or longer contraction in output or consumption"* (Ólafsson and Pétursson 2010: 25).

The story of the Icelandic króna provides a mixed picture for Icelanders. Firstly, it may have contributed to the collapse of the financial sector. The over valuation of the króna coupled with very high interest rates made Icelandic banks very appealing. After the market lost trust in the króna, the banks and the ability of the state to defend them, a large outflow of capital exacerbated the crisis further. Secondly, the crisis became deeper because of the slump in value of the króna – particularly for those who had borrowed in foreign currency and for households and employees. Thirdly, the country was not sheltered by the EMU system's institutional framework and did not have access to its rescue packages. Finally, Iceland still faces a currency crisis. The consequences of lifting the capital controls are unknown and create great uncertainty for the economic recovery.

That said, in the aftermath of the crisis Icelandic entrepreneurs and the state generally benefitted from the currency depreciation, contributing to a quicker overall recovery than in Ireland. Ólafsson and Pétursson (2010) argue that *"greater exchange rate flexibility coincided with a smaller and shorter contraction"*. On the other hand, greater exchange rate flexibility *"increases the probability of a currency crisis or a combination of a systemic banking and currency crisis"* (Ólafsson and Pétursson 2010: 25-26). They conclude: *"countries with unilateral exchange rate pegs had a particularly large and protracted consumption contraction, while no comparable evidence is found for the EMU countries. This suggests that countries with exchange rate pegs outside a*

monetary union were particularly vulnerable in the current financial crisis" (Ólafsson and Pétursson 2010: 25-26).

Iceland's independent currency continues to impose a high risk to the country's economic recovery and future prosperity. It may have led to a smaller and sharper contraction than in Ireland but at the cost of a large and protracted consumption contraction and on-going vulnerability. In the terms of our shelter discourse, the króna increased the risk before the crisis event; it did help the economy to recover; but at the same time, it makes it more difficult for the country to resolve the long-term effect of the crisis.

Second**,** to what extent did membership of the European Union provide shelter for Ireland? There is not a straightforward answer in the Irish case since the European Commission has in general terms been seen to be less flexible in dealing with Ireland than has the IMF. As already stated, Irish politicians have been very critical of the interest rate charged by the European Commission for the rescue package and have been pressing for a reduction. Furthermore, the failure of the Commission and of the ECB to countenance some burden sharing continues to rankle deeply in Ireland. However, Ireland did not face the difficulties in accessing rescue funds that Iceland faced and to this extent membership of the Union has provided a shelter, though on rather onerous terms. There is widespread concern that these terms, which require a continuation of severe austerity at least until 2015, are hampering economic recovery and may contribute to a continuation of the already very deep recession that the country is undergoing. As economist Morgan Kelly put it in his article in May 2011: *"With the Irish Government on track to owe a quarter of a trillion Euro by 2014, a prolonged and chaotic national bankruptcy is becoming inevitable"* (Kelly, 2011: 13). Therefore, while Ireland does not face a currency crisis, it does face a sustained economic crisis, even if it is able to put in place a functioning banking system. It is widely seen that the EU Commission and particularly the ECB are imposing too severe a burden.

Iceland's lack of political and economic shelter caused international isolation and prolonged the economic crisis. Iceland was, at times, faced with its closest neighbours' blockage of the IMF assistance instead of solidarity and rescue packages. Membership of

the European Union might have prevented political isolation and mitigated the economic effects. Also, it is highly likely to have provided Iceland, like other member states, with assistance in cleaning up after the event. While an EU shelter is unlikely to have prevented the crisis in Iceland - given the scale of the banks' jeopardy due to their massive expansion - it might have calmed down the market's fair assumption that the Icelandic state, on its own, was not able to defend the banks. Finally, it will take Icelandic politicians and entrepreneurs a long time to gain trust and respect from the international business community and countries around the globe after they let foreign creditors of the banks shoulder their losses. Membership of the European Union and the EMU's institutions might have helped (or might help in future) in this rehabilitation process.

In conclusion, therefore, the experiences of Iceland and Ireland during the banking crisis do to some extent confirm the claims of the small state literature on the importance of an economic and political shelter. On the other hand, our cases also indicate the limits of such axioms and underline the importance of domestic arrangements. The case of Iceland indicates that a lack of economic and political shelter escalated the crisis itself, though the government's control of its national currency, in the immediate term, helps the economic recovery. The Irish case confirms that such a shelter is beneficial but only in specific and limited respects, and may also entail severe costs. Importantly, eurozone membership did not prevent the crisis and may, in fact, have paved the way for it due to insufficient domestic policy actions. In addition, it is paradoxical that Iceland, the country without this shelter, is recovering more successfully than is Ireland. This is related *inter alia* to the early change of government in Reykjavik and the success of domestic policy in restructuring the banking sector. More generally, our analysis confirms that good national economic management and supervision of the financial sector is a precondition for states' ability to limit external risks. For these reasons, we conclude that the notion of shelter needs to take more account of domestic arrangements and of the shelter's own potential risks and costs: a finding that in turn highlights the importance of national choices and domestic arrangements for understanding and minimizing such effects.

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