



The Fifteenth Dubrovnik Economic Conference

Organized by the Croatian National Bank



Patrick Honohan

Euro Membership and Bank Stability Friends or Foes? Lessons from Ireland

Hotel "Grand Villa Argentina",
Dubrovnik
June 24 - June 27, 2009

Draft version

Please do not quote



CROATIAN NATIONAL BANK

DRAFT

EURO MEMBERSHIP AND BANK STABILITY FRIENDS OR FOES? LESSONS FROM IRELAND

Patrick Honohan¹

Department of Economics and IIS, Trinity College Dublin and CEPR

Prepared for the Bank of Croatia's 15th Dubrovnik Conference, 26-27 June, 2009

Abstract

Ireland's world-beating property bubble took off on the eve of Euro membership. It swelled, based on huge capital inflows especially after 2003 – more than 50 per cent of GDP in about 4 years – largely sucked in by locally-controlled banks. International wage competitiveness deteriorated as the boom spilled-over into the rest of the economy. The collapse in the construction and real estate business, the fall in property prices and the severe knock-on effects on the banking system have all undermined employment and the public finances, and left the economy in a weakened condition to face the global recession. The peak-to-trough fall in output is likely to exceed 15 per cent.

This paper examines the conjecture that the collapse can be traced to the effects of EMU membership. We find that this change in exchange rate regime certainly entailed a strong trigger in the form of a sharp and apparently permanent fall in real and nominal interest rates. Furthermore the removal of exchange risk facilitated import of capital. And the financial markets seem to have become less sensitive to emerging disequilibria whether in the public finances or in wage competitiveness.

But the contrasting cases of some other small economies on the European periphery – in and out of the eurozone – show that EMU membership is neither necessary nor sufficient for a banking crisis. And the euro provided an anchor for Ireland as the crisis broke.

¹This is part of the IRCHSS-sponsored project: "Turning Globalization to National Advantage: Economic Policy Lessons from Ireland's Experience." Author's email: phonohan@tcd.ie. Useful suggestions were received from Philip Lane, Colm McCarthy and Brendan Walsh. Karen Mayor and Gavin Murphy provided helpful research assistance.

EURO MEMBERSHIP AND BANK STABILITY FRIENDS OR FOES? LESSONS FROM IRELAND

1. Introduction

With the third largest bank having been nationalized, and the remaining locally-controlled banks wholly dependent on a government guarantee for their access to liquidity, the Irish banking system is among the most severely affected in the global downturn. Yet the Irish banks did not indulge in the financing of US securitized mortgages, nor were they involved in aggressive international acquisitions – flaws that characterized weakened banks in Iceland, the Netherlands, Switzerland, the UK and elsewhere.

Instead, the Irish banks had been fatally weakened by their involvement in a local property bubble. Ireland's world-beating property bubble took off on the eve of Euro membership. It swelled, based on huge capital inflows especially after 2003 – more than 50 per cent of GDP in about 4 years – largely sucked in by locally-controlled banks.

As Shiller (2005) has convincingly argued, boom-and-bust cycles are normally based on the propagation of a misplaced optimism built on a half-truth or myth which seems to foretell an unprecedented stream of prosperity. In Ireland's case the scene was set by the seeming effortlessness of the "Celtic Tiger" boom which, starting in the late 1980s and especially after 1993 had soaked-up unemployment, attracted a huge increase in female participation and even caused a reversal in the traditional pattern of outmigration.

Then, on top of this sustained growth in employment, income and household formation, Ireland became a founder member of the eurozone. The euro brought a dramatic and sustained fall in nominal and real² interest rates. The higher capitalization rates warranted higher equilibrium asset valuations by a hard-to-pinpoint multiple. In addition, the inflow of funds through the banks was not

² Real rates dipped strongly into negative territory in the early years of the Euro as the initial weakness of the euro against sterling and the US dollar added disproportionately to Irish inflation (Honohan and Lane, 2003).

restrained by any exchange rate risk. All the ingredients, then, to sustain a belief that equilibrium house prices would soar and that the demand for housing units would continue to grow for the foreseeable future.

The economic consequences of the crash have been severe. The collapse in the construction and real estate business, the fall in property prices and the severe knock-on effects on the banking system have all undermined employment and the public finances, and left the economy in a weakened condition to face the global recession. Given this background, it is no wonder that Ireland is experiencing one of the most severe downturns anywhere in the world. The peak-to-trough fall in output is likely to exceed 15 per cent.

So was euro membership to blame? The answer to this question is one that must be exercising other potential eurozone members. Our conclusion is that, despite being clearly implicated in the Irish experience, euro membership was neither necessary nor sufficient for a crisis. It did help trigger the low interest rates that launched the property bubble and eased its financing, weakening some traditional automatic restraints on the emergence of imbalances. But the Irish authorities did retain sufficient policy instruments to have combated the emergence of imbalances; they simply did not use them effectively.³

Furthermore, the other most adversely affected economies with weak banking systems such as Iceland and Latvia, are outside the eurozone, so membership was in no way a prerequisite of policy failure. Indeed, it seems that the hazards of financial globalization were transmitted across currency-zone boundaries, and that Ireland's failure to cope with its new situation does not mean that it would have succeeded better outside the eurozone.

After the crash, eurozone membership helped ease financial market conditions, though the lack of a domestic currency means that restoring competitiveness is requiring nominal wage reductions.

³ Indeed, monetary policy errors have been frequent and severe in Ireland in previous exchange rate regimes, including the Sterling Link (Honohan and Ó Gráda, 1998) and the ERM (Honohan and Conroy, 1994).

The remainder of the paper is organized as follows. Section 2 briefly reviews the Celtic Tiger period. Section 3 describes the emergence of the property bubble. Section 4 examines the evolution of the banking crisis. Section 5 discusses the potential role of EMU membership in precipitating the fall in interest rates and muffling the warning signs of imbalances, while moderating the consequences of the crash for the financial markets. Section 6 places the Irish experience in context with an overview of the experience of a handful of other small countries within and outside of the eurozone. Section 7 draws conclusions.

2. The Celtic Tiger

During the 1990s, Ireland emerged from a lengthy period of economic stagnation marked by high unemployment, emigration, and crippling public debt despite high tax levels (Ó Gráda and O'Rourke, 1996, Honohan and Walsh, 2002). From 1988 to 2007 real GDP expanded by 6 per cent per annum on average (reaching double digits on average during 1995-2000). Even more astonishing, the unemployment rate shrank from 16 per cent (on the ILO basis) in 1994 to 4 per cent in 2000 – essentially full employment for the first time in modern history. Non-agricultural employment jumped from 33 per cent of the population in 1993 to 41 per cent in 2000 and 46 per cent by 2007. With Ireland at the frontier of economic prosperity, surely this was an economic miracle to be studied and replicated.

To understand what went wrong it is essential to distinguish between two different growth phases. Up to 2000 there was the true “Celtic Tiger” period of exceptional export-led growth with moderate wage and price inflation and healthy public finances. This began back in the late 1980s when, after several false starts, Government finally tackled its over-indebtedness with tough spending restraint, and managed to negotiate a series of centralized social partnership agreements which seem to have bought wage rate moderation (and peaceful industrial relations) in return for income tax concessions. This confidence-restoring policy package, given a competitiveness boost by the successful devaluation of 1986, launched the economy on a belated convergence in living standards towards the highest in Europe. An expanded flow of European Union structural funds amounting to as much as 3 per

cent of GDP per annum also helped fund sufficient public infrastructure in those years. The historic pattern of net emigration was dramatically reversed.

3. The emergence of a property price construction bubble

Although international pressures contributed to the timing, intensity and depth of the Irish banking crisis, the underlying cause of the problem was domestic and classic: too much mortgage lending (financed by heavy foreign borrowing by the banks) into an unsustainable housing price and construction boom.

The banks got into trouble because they got caught up in the mass psychology of an unprecedented property bubble – the steepest and longest of the several national property bubbles of the late 1990s and early 2000s around the world.

The boom seemed credible to enough borrowers given sharply lower interest rates with adoption of the euro on top of the protracted expansion in output, employment and population especially from the mid-1990s.

Preconditions for the bubble

The preconditions for growing housing demand thus gradually emerged with the sustained export-led real economic expansion from 1988 and especially from 1994. Jobs were plentiful, net immigration sizable and there was a growing sense of economic security. But it was the fall in interest rates in the months running-up⁴ to EMU entry that really triggered the housing price surge by sharply lowering nominal and real interest rates, thereby lifting equilibrium asset prices (Figure 2). The combination of higher population, higher income and lower actual and prospective mortgage interest rates clearly provided a straightforward upward shift in the willingness and ability to pay for housing – an upward shift in the demand.⁵ The problem is that property prices developed their own momentum and overshot equilibrium levels as calculated by all models. In effect, purchasers increasingly built in an expected continuation in the increase of the relative price of housing.

⁴ Fearing excessively rapid economic growth, the Central Bank worked to maintain interest rates high for as long as possible before the euro came in; but from September 1998 Irish short-term rates began to converge quickly towards DM levels.

⁵ Supply response should, of course, in time fully offset this capitalization effect for standard houses built on marginal land – e.g. far from a city centre.

This was not just a price bubble (Figure 3). Importantly, it also involved a sharp increase in construction. House completions soared and, overall, the share of the growing workforce engaged in construction jumped from about 7 per cent in the early and mid-1990s to over 13 per cent by 2007 (Figures 4,5). And residential construction soared well beyond population. According to the 2006 census of population, some 15 per cent of the housing stock was vacant at census date, mostly reflecting speculative purchasing of additional housing by prosperous households (less than 3 percentage points of that being holiday homes). Of course this speculative element quickly vanished as a positive contribution to demand as soon as prices started to drop and revealed to investors – or confirmed them in their suspicions, that relying on continued house-price inflation was unwise.

Even if the lower real and nominal interest rates from 1998 meant that any given income could support the servicing of much higher loans, the three-fold increase in average real property prices from 1994 to 2006 was the highest boom in any advanced economy in recent times. Long before it peaked, it looked unsustainable to most commentary.

Role of the banks in the bubble

Banks had not been central to the financing of the export-led Celtic Tiger period of the Irish Economy which ended about 2000 (Honohan, 2006). Nor do they seem to have led the early phase of the property bubble before 2002. Timing relationships between credit expansion and house price increases suggest that bank behaviour may have begun to drive the inflation only from about 2003 on (Figure 7).

In contrast to the United States, where much of the growth in property-related lending was driven by the technology of automated credit appraisal for subprime borrowers and the securitization of mortgages, Irish property lending technology was traditional. Only the scale was new.

From 2003 the banks leveraged their local resources with enormous borrowings from abroad (easily available due to the global savings glut, and also to the lack of exchange rate risk for euro borrowing). At the end of 2003, net indebtedness of Irish

banks to the rest of the world was just 10 per cent of GDP. By early 2008 that had jumped to over 60 per cent (Figure 1). And the borrowing was mainly for property. The share of bank assets in property-related lending grew from less than 40 per cent before 2002 to over 60 per cent by 2006. Without this large-scale foreign borrowing by the banks, the property boom could not have grown as it did.

Furthermore, although demand factors were certainly important throughout—and a renewed acceleration of house prices from 2003 was also fuelled by a reversal of earlier tax tightening, reinforcing Ireland’s tax bias towards construction (cf. Barham, 2004; Rae and Van den Noord, 2006)—this lending was not just demand-driven. The banks were certainly not tightening credit conditions as the prices rose (Figure 6). Indeed, from 2003 on, banks continued to ease loan conditions such as maximum loan-to-value ratios. These continued to fall right through 2006 despite the increasingly evident vulnerability of the bubble.

Competitive pressure on the leading banks to protect market share came especially from reckless expansion by one bank, Anglo-Irish (whose market share among Irish-controlled retail banks jumped from 3 per cent to 18 per cent in a decade, as it grew its total portfolio by an average of 36 per cent real). Foreign controlled banks, especially the local subsidiary of HBOS also contributed. (Irish-controlled banks, long active in the retail market in Northern Ireland and in Britain, were also lending in these and other property markets in Europe and North America during these years.)

Why the complacency?

Although most economists foresaw – and many publicly forecast – a severe correction in the price of housing, few confidently predicted bank solvency problems because public information about loan-to-value ratios and additional securities taken by lenders was sketchy: published results of official stress tests were also relatively uninformative.

Besides, how could traditionally conservative banks – some of them with a 200-year history – have been so careless as to leave themselves exposed in such a conspicuous and obvious property bubble?

Given how comfortably the Irish banks had survived severe recessions in the mid-1950s, the 1970s and the 1980s – the last of which especially involving a sharp fall in real house prices – it is surprising that these traditionally conservative institutions succumbed to financing such an extravagant price and construction bubble.

One factor that might have encouraged complacency is that the previous house price bubble of the 1970s took place in an environment of rapid general inflation. Real repayment of mortgage loans was in such circumstances front-loaded so that, by the time the bubble burst and house prices were falling in real terms, the real value of the remaining debt for most borrowers was low.

There is also the fact that banks had not been the main players in the residential mortgage market until the late 1980s: before then, fiscal privileges ensured that building societies held the lion's share of that business. Thus the banks were not steeped in the deeply ingrained suspicion of the mortgage market as a source of systemic difficulties that now prevails in Japanese banks, for example.

4. The bubble bursts

More or less simultaneously with Britain and the US, real residential property prices in Ireland peaked in late 2006. Loan demand slowed and construction – which had employed over 13 per cent of the workforce – began to contract.

At first, the banks were relatively unconcerned, their share prices peaked in February 2007, but remained high through the remainder of that year. Despite their dependence (noted above) on property-related lending, the perception was that most household mortgages would continue to be serviced even if house prices fell back by 20-30 per cent. The growing international banking crisis cast doubt on such complacency, and especially after the rescue of Bear Stearns, the liquidity of some Irish banks came under repeated pressure. After the collapse of Lehman Brothers in mid-September 2008, the third largest bank in Ireland, Anglo Irish – widely understood to be heavily exposed to troubled property developer loans – found itself unable to rollover borrowings.

Fearing a contagious reaction on confidence in the other banks, the authorities decided not to put Anglo into a government-controlled winding-up, but instead, extended a systemwide bank guarantee with effect from 30 September 2008. This extended even to Tier 2 subordinated debt and to the foreign liabilities of the main Irish-controlled banks.⁶

The guarantee and subsequent events did little for the shareholders of Irish banks: by end-year (December 2008) the share price of three of the four listed banks was between 5 and 7 per cent of their peak value reached in early 2007 ; the other one was trading at less than 1 per cent, and was nationalized within days. According to their published accounts, the book value of equity in the main banks was then a multiple of almost eight times the market price. Indeed, the market was capitalizing the banks at less – in two cases much less – than their last reported full year’s profit. The share prices of the two main banks subsequently dipped even lower – falling in early March 2009 to 1 per cent of their peak value before subsequently recovering somewhat. By April it was generally expected that the State would soon take a large majority equity stake in both.

The prospective budgetary cost if this guarantee should have to be called, together with the dramatic collapse in tax revenue which was becoming increasingly evident, began to put upward pressure on the secondary market yields of Irish Government securities. The spread over German Federal Government bonds at 10 years maturity jumped from about 30 basis points in September reaching 284 basis points in March 2009 before falling back.

Anglo Irish Bank’s aggressiveness was not restricted to loan growth. It turned out that for years this bank had been concealing the existence of loans to Directors by the simple means of transferring these loans for a few days around the end-year reporting date to a small unlisted and complaisant bank, Irish Nationwide (itself currently thought to be also in a very weak capital position). Astonishingly this ruse was not uncovered by the auditors, and only came to the regulator’s notice in early 2008. The scale of the Directors’ loans were well within regulatory thresholds, but the

⁶ After some international pressure, the guarantee was also offered to the main non-Irish controlled retail banks in respect of their Irish business, but not to others, such as DepFa.

concealing of them was a clear evasion, and may have been illegal. Further window-dressing of Anglo-Irish bank's balance sheet occurred at end-September 2008, when it requested and was granted a loan for 24 hours from a non-bank (insurance) subsidiary of yet another Irish bank, ILP. The delay in regulatory response to the Directors' loans issue and the fact that the 24-hour nonbank deposit occurred against a background in which the Irish Financial Regulator had been encouraging Irish banks to help one another with liquidity loans where possible has shaken market confidence – already weakened by its ineffective steps against prior credit expansion – in the competence and effectiveness of the Regulator. On January 15, Anglo-Irish was nationalized, and within days the old board of directors had been replaced.

Although the other banks are currently reporting a healthy capital position, bolstered in the case of the two biggest ones by the Government's injection in the form of preference shares of a total of €7 billion (or over 2 per cent of their aggregate balance sheet), there is evidently a large discrepancy between these reported figures and the market's assessment of the true value of equity shares in the banks, considering the likely scale of future loan losses beyond those currently acknowledged by the banks. Since neither the regulator nor bank management have been able to convince the market that losses will not be high, it is clear that further financial restructuring will be necessary.

The Government announced in April 2009 that a National Asset Management Agency would be created to acquire the development property portfolio of the banks at a written-down value. The book value of the loans to be purchased was put at €80-90 billion, or about 50 per cent of GDP. If (as seemed likely) the valuation process for the loans resulted in write-downs bringing capital below regulatory levels, the Government will inject common equity, likely taking a substantial majority stake in the banks, though they have indicated reluctance to become outright owners,

At present continued funding of the banks' operations is therefore wholly dependent on the State's guarantee. The banking sums covered by this guarantee have approached 300 per cent of GDP, but of course this figure greatly exceeds the net figure that will ultimately fall on the taxpayer. According to the most pessimistic projections offered by the banks, the banks' own capital would be sufficient to cover

future losses, and there would be no net call on the guarantee. However, the deteriorating economic situation, with rising unemployment, combined with the continued falls in house prices and the unprecedented difficulties in projecting loan delinquencies in such circumstances mean that this optimistic scenario cannot be relied upon. No serious commentator would now be surprised to if the net cost of the guarantee proved to be as high as 10 per cent of GDP, and it could be higher.⁷ (This figure, combined with the prospective Government borrowing requirement for 2009 at 11 per cent of GDP, serves to highlight the fact that the bank losses represent only a part, and likely the smaller part, of the additional borrowing that will have to be undertaken by government in the years ahead.)

5. How did euro membership change relevant conditions in Ireland, potentially contributing to the crash?

Shiller (2005) presents the most convincing account of how boom-and-bust bubbles emerge and evolve. He emphasizes what he calls “new era” economic thinking as a precipitating factor, whereby a pulse of optimism, built on faulty analysis of the potential from some new technological or institutional development, starts a wave of optimism, reinforced by processes of collective psychology that builds a myth on this half-truth.⁸

In explaining the global financial meltdown, the most plausible encompassing explanation has it that the exaggerated belief in financial risk management systems was the key element triggering – and indeed sustaining – the extravagant expansion in leverage of capital and liquidity worldwide (Honohan, 2008). It was, in effect, the relevant “new era” myth. Although this thinking was limited to specialists in banking, it did underpin misplaced confidence in risky credit-related derivatives and other

⁷ Basing their analysis on CDS spreads, IMF (2009) presented an estimate of financial restructuring costs for Ireland of 13.9 per cent of GDP. In March 2009, based on projections of loan losses, Standard and Poors provided an estimate of “gross fiscal costs” of about 11 per cent of GDP. Analyst forecasts of prospective loan losses for the banking system range from €20 billion up. The book value of the equity capital of the guaranteed banks at end-2008 stood at less than €25 billion.

⁸ As examples, Shiller points to the exaggerated belief in the potential of internet technology to generate growth and profits on a sustained basis as an important example of “new era” thinking which fuelled the dot.com bubble of the late 1990s. He also notes the role of the radio and other electrical inventions around the turn of the 19th Century, resulting in the stock market bubble that peaked in June 1901, and the role of the motor car and related technologies as the basis of the “new era” myth driving the US bubble of the late 1920s.

investments, shrinking risk premia and generating unsupportable degrees of leverage, ultimately collapsing into the widespread losses and general credit revulsion that is the global financial collapse.

But in addition to the main crisis affecting the major global US and European banks, the credit boom also spawned a number of country-specific booms and busts, of which Ireland's was one. And each of these country-specific booms and busts was built on its specific myth.

For the new era thinking behind the Irish myth, the lower interest rate environment assured by euro membership was a key underpinning element. Furthermore, euro membership facilitated the propagation and expansion of the bubble built on the myth. Fortunately, euro membership has helped to insulate the financial sector in the containment and resolution phase.

5.1 The euro as a precipitating factor

So far, the analysis suggests that the seeds of the crisis were sown around the time the single currency began at the beginning of 1999. That this was more than a coincidence is suggested by the role of interest rates in triggering the bubble, and of easy foreign borrowing in amplifying it.

Specifically, real interest rates 1998-2007 averaged *minus* 1 per cent, compared with over 7 per cent in the ERM period (even excluding the crisis of 1992-3) and 3¾ per cent in the floating rate period from between the two. The fall in nominal interest rates was even steeper. Eurozone membership certainly lowered interest rates in Ireland (and not just for a transitory interval such as the 2002-4 Taylor rule undershoot in the US). No wonder long-lived assets like residential property, capitalized at permanently lower discount factors, seemed and were appropriately valued more highly than before. The problem was to determine just how much higher. EMU introduced that element of uncertainty.

5.2 The euro eases propagation of the bubble in Ireland

Up to 2003, the property boom was financed without significant recourse to foreign borrowing, but then the banks started to borrow heavily from abroad. This was an

effortless undertaking thanks to the removal of currency risk. That the funds the banks were borrowing from abroad were in local currency and thus could be lent locally without exchange risk was a consequence of euro membership.

Financial markets failed to provide the warning signals that they had been only too quick to do in earlier periods (especially the 1980s). Astonishingly, the scale of this borrowing seems to have gone almost un-remarked by analysts before 2006, the focus of policy attention having shifted away entirely from balance of payments concerns. Although the current account balance of payments ballooned out in the period 2005-8 (4.4, 6 and 5% of GDP), financing was not a problem. The consequence was not only the easy access of individual banks to foreign borrowing. In addition, the insensitivity of the exchange rate and of interest rates to domestic developments removed a traditional warning sign for policy.^{9,10} Only when credit risk became an issue after September 2008 did the financial markets belatedly sound a warning sign.¹¹

5.3 The euro's role in Ireland after the crisis

The increase in general interest rates in Ireland following the market's loss of confidence in the banks was rather muted. This can be attributed to the lack of an exchange rate risk premium, and to the extensive access of the banks to the ECB.

To be sure, the banks' own access to bond markets after September 2008 was dependent on the Government's guarantee, and the banks were of course not immune from the virtual closure of the short-term interbank market in the fourth quarter of 2008. Furthermore, the market's realization that large contingent liabilities related to banking were now weighing down the Government's finances contributed to the widening of spreads on Irish Government bonds described above. The broader

⁹ This parallels the removal of a warning sign on wage competitiveness, which deteriorated sharply in the 2000s. As shown by Honohan and Leddin (2006), the former tendency for deviations in wage competitiveness to correct themselves (error correction model), detectable in previous data, was no longer evident after EMU began. The regime once again tolerated a larger movement away from equilibrium before warning signals sounded.

¹⁰ The enlargement of the EU also meant that the boom could continue longer than otherwise, fuelled as it was by strong inward migration.

¹¹ That the banks were headquartered in the eurozone—and thus had access to the ECB for liquidity—may also have eased access to international financing on a huge scale. However, the explosion in international capital flows in the mid-2000s suggests that bank access to foreign borrowing might not have been too difficult even absent this factor.

deterioration of the Government's finances contributed also to these spreads and indeed the banking element of prospective future borrowing is smaller than that coming from the excess of ordinary spending over revenue.

Progressively, though, as their short-term capital market borrowings from abroad matured, the Irish banks turned more and more to the European Central Bank to make up the shortfall. Indeed, by March 2009, the total central bank lending to Irish credit institutions had reached the astonishing figure of €130 billion – or about 95 per cent of expected 2009 GNP.¹² This has allowed Irish banks' prime lending rates to stay within shouting distance of the ECB's main intervention rate throughout the crisis (Figure 10). Without some such support, short term financial market conditions in the containment phase would doubtless have been much more severe than they are.

At the same time, the lack of an independent currency means that adjustment of the real exchange rate is having to be done through nominal wage adjustments.

6. And in other countries...

6.1 Source and propagation of the crisis in other countries

Although the main story of the global financial crisis relates to the large international banks, it is well-accepted that banking problems in the Baltic States, Iceland, the United Kingdom and Ireland and some others were largely home-grown (IMF, 2009b), although sustained and concealed by the global bubble and eventually exposed and burst by the global downturn.

Although the euro provided both an important precipitating factor and eased the propagation of the Irish crisis, it is evident from the experience of other small European economies that in neither of these roles was it indispensable. Mention of three¹³ other cases is sufficient to establish this point.

¹² Some of this lending was to banks in the offshore financial centre IFSC which have little domestic business.

¹³ Almost every country has its story to tell in the current crisis, and some are still hard to assign robustly to crisis or non-crisis categories.

Portugal is a euro country which, despite experiencing a sharp fall in interest rates on euro membership, did not see anything like the Irish boom. Non-euro EU members such as Latvia had a very similar boom despite not joining the euro. And a bubble of quite a different character emerged in Iceland, without the help of the euro or even of the prospect of euro membership.

In short, the experience of other small countries on the periphery of Europe confirms that eurozone membership was neither necessary nor sufficient for countries to get sucked into an idiosyncratic credit-fuelled boom.¹⁴

Latvia

Latvia seems at the time of writing to be the worst affected country in the current crisis. It too had experienced a dramatic property price and construction boom, especially in 2005-7, when GDP growth averaged almost 11 per cent. House price inflation reached 60 per cent per annum in 2005 and 2006, before stalling in 2007. Bank credit had expanded rapidly to reach 70 per cent of GDP, and almost two-thirds of bank credit was for property.¹⁵

The “new era” myth underlying the Latvian boom was subtly different from the Irish story. Here was a small country which had—at last—found its post-transition feet and was rapidly converging to the frontier. No reason why it should not get there faster with the help of credit. Property prices at Western European levels would soon be justified by the income convergence. The double-digit inflation – despite the 15-year currency peg, at first to the SDR and then, from 2004, to the euro – could be justified by a Balassa-Samuelson story.

This flawed analysis of Latvian prospects became the “new era” myth that generated both the demand and supply of credit. Less-dominated than its Baltic neighbours by foreign banks, Latvia nevertheless depended on foreign-owned banks, especially from

¹⁴ Indeed, many other famous foreign-borrowing-financed booms from Chile early 1980s through Thailand 1998 could be taken as examples.

¹⁵ As in Ireland, procyclical fiscal policy also fuelled the boom. For this and other key descriptive facts about the Latvian boom, see IMF (2009c).

Scandinavia, for 60 per cent of its loans.¹⁶ The locally-owned banks also borrowed heavily from abroad. Almost 90 per cent of bank credit was denominated in foreign currency, mainly the euro. Bank lending rates thus reflected euro interest rates and not those on Latvian currency (which were higher, despite the long-standing peg).

Access to low-interest sources of funds was not a constraining factor for the Latvian boom, despite the exchange risk being assumed by the final borrowers. Misplaced confidence in the Latvian “new era” myth, and a desire to establish market share in a region with promising medium-term income convergence prospects, were enough to overcome whatever misgivings the resulting credit risk might have generated for the banks.

Quite similar stories can be told of the booms in Estonia and Lithuania, both of which also have euro-pegs. But property booms fuelled by low interest foreign-currency credit flows occurred even in Transition countries without currency pegs, of which the largest are Hungary and Poland. In the latter two countries, the Swiss franc was – somewhat surprisingly – the currency of denomination of much bank lending. Use of the Swiss clearly reflected the familiar borrower preference for low initial servicing charges, but also built on the common practice of Austrian banks to offer lending in the low-interest currencies. The Austrian banks had developed this as a speciality in their domestic market from the mid-1990s, when the Austrian banking system was privatized and liberalized. Indeed the Austrian banks made substantial loans in their local market in Japanese yen, before switching largely to Swiss francs. They extended the practice of Swiss franc lending to their very large operations in Central and Eastern European Countries.¹⁷

¹⁶ The largest bank in Latvia at present is Sweden’s Swedbank, which in early 2009 was reporting 14 per cent loss rate on its loan book in Latvia. The second largest bank, Parex, is locally controlled; it suffered a crippling run in the period September to November 2008 and was nationalized. A partial freeze on deposit withdrawals was imposed in early December 2008. Latvia had a previous severe banking crisis in 1994, involving the loss of about 40 per cent of the system’s assets (Fleming and Talley, 1996)

¹⁷ Despite the regressions of Haiss et al. (2009) – which show no tendency of Transition countries with a higher share of foreign bank ownership to rely more on foreign currency lending – it is clear that the origin of denominating lending in lowest-interest currencies was an innovation of Austrian banks (Tzanninis, 2005, IMF, 2008, Brown et al., 2009)

Thus banks in Central and Eastern Europe, including numerous foreign-owned banks from Austria, Sweden and other EU15 countries, assumed sizable credit risks by, in effect, involving their customers in a carry-trade. This was clearly an aspect of the overall increase in risk appetite in worldwide finance. And it was essential for the amplification of the bubble in these countries. The full denouement of this risk remains for the future. This kind of risk was not, however, assumed for their Irish lending by the Irish banks: euro membership made it unnecessary.

Iceland

The Transition-based “new era” myth was not, of course, relevant to the complex and dramatic case of the Iceland banking crash (for a macro-oriented account, see Buiter and Sibert, 2008; for background colour, see Lewis, 2009). For our purposes, the key dimensions of the Iceland case relate to how little it had to do with the euro. The three Icelandic banks that expanded so recklessly from the mid-2000s both fuelled a domestic bubble, and assumed credit risk abroad (between ½ and ⅔ of their balance sheets was outside Iceland).

The Icelandic banks’ financing of foreign industrial and commercial mergers and acquisitions by Icelandic entrepreneurs abroad was mainly in Europe, but not mainly in the eurozone. For example, three-quarters of the largest bank Kaupthing’s loans outside Iceland were to the UK and Scandinavia. That Iceland’s banks were allowed to grow so quickly to the point where their total assets amounted to about ten times the home country GDP could possibly be attributed in part to the single license principle of the European Second Banking Coordination Directive. This had the effect that regulatory failure in one small jurisdiction allowed these unsound banks access to the whole European Economic Area market. But the eurozone *per se* was not central in helping to amplify the Icelandic boom.¹⁸

Portugal

In contrast to the countries already discussed, which built idiosyncratic booms based on foreign credit despite not being members of the eurozone, Portugal seems to have

¹⁸ Use of consumer price index-linked mortgages in Iceland, by lowering current servicing charges, may also have helped fuel the boom – this a form of financial innovation which had nothing to do with the euro.

avoided the boom despite being a founder user of the euro. Absent the kind of euphoria-promoting myth that drove Ireland, the Transition economies and Iceland into boom, the easy money seemingly offered by the euro had relatively little effect in Portugal. Before and immediately after the start of EMU, there was a brief surge in Portuguese economic activity, promoted by euro-entry optimism and the lower interest rates. Following the recession of 2002-3, though, growth has been sluggish. The Portuguese story is not altogether a benign one. Indeed, its failure to close the per capita output gap with the leading EU countries in the last decade is a notable disappointment. The point here though is to draw attention to the fact that euro-membership of a small peripheral country need not trigger the kind of boom we saw in Ireland.

Even though it did play an essential part in the neo-myth underlying the Irish fiasco, the euro was thus neither necessary nor sufficient for a boom-and-bust cycle in the European periphery. Alternative myths have driven non-euro countries into equally devastating bubbles. Had the EMU not been created, it is quite possible that a slightly different narrative could have formed the basis for a slightly different type of boom, perhaps based – as in the Baltics and Iceland – on foreign currency lending.

6.2 Crisis management in other countries

How about the role of the euro in crisis containment and the macroeconomic workout?

Although eurozone membership does not constrain Latvia's exchange rate policy, it has opted (up to the time of writing) to maintain the euro peg, thereby turning its back on the use of devaluation to accelerate the recovery of wage competitiveness, which had been lost over the past several years. Like Ireland, then, it has opted for the slower and potentially more politically and socially fraught route of nominal wage reductions. At the time of writing, the jump in unemployment envisaged for Latvia in 2009 is comparable to that expected in Ireland. Both have jumped from 5-6% in 2007 to 13-17% in 2009. Of course these figures are affected, not only by the bursting of the domestic spending bubble, but by the differential exposure of both countries to the global downturn. So far Latvia's exports (especially wood and metal products) have slumped further than Ireland (whose chemicals exports have held up quite well).

Given how much of internal debt in Latvia is denominated in foreign currency, avoiding devaluation does have the advantage of avoiding balance sheet problems. To that extent, reliance on foreign currency denomination of the bulk of one's financial system has much the same effect as adoption of the euro. But the deteriorating real economy will further knock-on to credit losses as the banks

Iceland has gone through a period of many months of severe exchange controls during which, when foreign currency could be obtained, it was only at a deeply discounted value of the Icelandic krona. Whether this effective devaluation will speed the recovery of Iceland's economic activity and reverse the surge in unemployment remains to be seen. Current GDP growth forecasts suggest that peak-to-trough annual GDP declines will be comparable in Ireland and Iceland, and rather worse in Latvia, consistent with the idea that a currency peg outside the eurozone may be inferior both to eurozone membership and to the alternative of a float.

Iceland and Latvia both successfully applied to the IMF and other international lenders for official assistance. This has come at the price of strict policy conditionality, which has led to especially difficult negotiations and compliance issues in Latvia. As mentioned earlier, Ireland's euro membership has indeed given its banks access to liquidity from the ECB without apparent conditionality (though of course requiring appropriate collateral) on a larger scale than the corresponding IMF loans to Iceland and Latvia.¹⁹

7. Concluding remarks

Any account of the Irish crisis must include the causal role of euro membership as a precipitating factor in producing the lower interest rates that clearly ignited the property price boom. Eurozone membership was the context in which the Irish banks lavishly—and almost without it being noticed²⁰—expanded credit from 2003 on the

¹⁹ The total Latvian package from multilaterals and bilaterals comes to about €7 billion or about one-third of GDP; the Iceland package came to over 100 per cent of GDP (IMF 2008b, 2009c).

²⁰ Perhaps reflecting the ECB's preference for consolidating data for the zone as a whole

basis of foreign borrowing in euros. Indeed the stability of the financial platform provided by the eurozone was part of the illusion that sustained the Irish boom for as long as it did. And the zone did not back up this stability with tougher centralized prudential supervision.

Yet as we have seen, all of this expansion occurred against the background of a global credit bubble, generated and sustained by a wider illusion, the myth of the sophisticated risk management model. By legitimizing expansive credit from the World's leading banks, this deeper illusion lulled supervisors into a sense of false security and allowed reckless banking behaviour in several peripheral European states, even though this recklessness was of a sort that did not make any call on modern risk management techniques.

Although implicated in the actual myth that sustained the Irish boom, and in fuelling its progress, the euro was not essential in either role. Its place was taken by other factors in Latvia and Iceland among others. And, as Portugal shows, a massive bubble was not inherent or entailed for a peripheral state by membership of the eurozone.

Any major change in economic conditions can heighten financial market risks (Honohan, 1997), ironically including especially a change which, like the euro, seems to offer the promise of greater stability.

Irish policy antennae were not re-tuned to take account of the fact that, following euro membership, financial markets (hitherto so sensitive to currency risk) were no longer offering an early warning system. Corrective action that could and should have been taken (fiscal policy, bank regulation, centralized wage negotiations) were neglected as a result. This was a costly error that will not be repeated in Ireland and should not be repeated elsewhere.

References

- Brown, Martin, Marcel Peter, and Simon Wehrmüller. 2009. "Swiss Franc Lending in Europe." Swiss National Bank, mimeo.
- Buiter, Willem H. and Anne Sibert. 2008. "The Icelandic Banking Crisis and What To Do about It: The Lender of Last Resort Theory of Optimal Currency Areas". CEPR Policy Insight No. 26. London
- Duffy, David, John Fitz Gerald and Ide Kearney. 2005 "Rising House Prices in an Open Labour Market" *Economic and Social Review*, 36(3): 251-72.
- Fleming, Alex and Samuel Talley. 1996. "The Latvian Banking Crisis: Lessons Learned." World Bank Policy Research Working Paper 1590.
- Haiss, Peter R., Paulhart, Andreas and Rainer, Wolfgang. 2009. "Do Foreign Banks Drive Foreign Currency Lending in Central and Eastern Europe?" <http://ssrn.com/abstract=1343557>
- Honohan, Patrick. 1997. "Banking System Failures in Developing and Transition Countries: Diagnosis and Prediction" Bank for International Settlements Working Paper 39. <http://www.bis.org/publ/work39.htm>
- Honohan, Patrick. 2006. "To What Extent Has Finance Been a Driver of Ireland's Economic Success?" *ESRI Quarterly Economic Commentary* December: 59-72.
- Honohan, Patrick. 2008. "Risk Management and the Costs of the Banking Crisis." *National Institute Economic Review* 205: 15-24.
- Honohan, Patrick. 2009. "Resolving Ireland's Banking Crisis." *Economic and Social Review* 40(2).
- Honohan, Patrick and Philip R. Lane. 2003. "Divergent Inflation Rates in EMU" *Economic Policy* 18(37): 357-394.
- Honohan, Patrick and Anthony J. Leddin. 2006. "Ireland in EMU: More Shocks, Less Insulation?" *Economic and Social Review* 37(2): 263-294.
- Honohan, Patrick and Cormac Ó Gráda. 1998. "The Irish Macroeconomic Crisis of 1955-56: How Much Was Due to Monetary Policy?" *Irish Economic and Social History* 25: 52-80.
- Honohan, Patrick and Brendan Walsh. 2002. "Catching-up with the Leaders: The Irish Hare." *Brookings Papers on Economic Activity* 2002(1): 1-79.
- International Monetary Fund, 2008a. *Austria: Financial Sector Stability Assessment Update*. Washington DC. <http://www.imf.org/external/pubs/ft/scr/2008/cr08190.pdf>
- International Monetary Fund. 2008b. "Iceland: Request for Stand-by Arrangement". IMF Country Report No. 08/362. Washington DC.

International Monetary Fund. 2009a. “Companion Paper—The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis.” Mimeo. Washington DC <http://www.imf.org/external/np/pp/eng/2009/030609a.pdf>

International Monetary Fund. 2009b. *European Regional Economic Outlook: Addressing the Crisis*. May 2009. Washington DC

International Monetary Fund. 2009c. “Latvia: Request for Stand-by Arrangement”. IMF Country Report No. 09/3. Washington DC.

Lewis, Michael. 2009. “Wall Street on the Tundra”, *Vanity Fair* April. <http://www.vanityfair.com/politics/features/2009/04/iceland200904>

Ó Gráda, Cormac and Kevin H. O’Rourke. 1996. “Irish Economic Growth since 1945.” in N.F.R. Crafts and G. Toniolo, eds. *European Economic Growth* (Cambridge: Cambridge University Press), pp. 388-426.

Rae, David and Paul Van Den Noord. 2006. “Ireland’s Housing Boom: What Has Driven It and Have Prices Overshot?” Working Paper 492, OECD Economic Department.

Tzanninis, D., 2005, “What Explains the Surge of Foreign Currency Loans to Austrian Households?,” IMF Country Report 05/249 (Washington: International Monetary Fund).

Net international position of Irish credit institutions
1999q1-2009q1

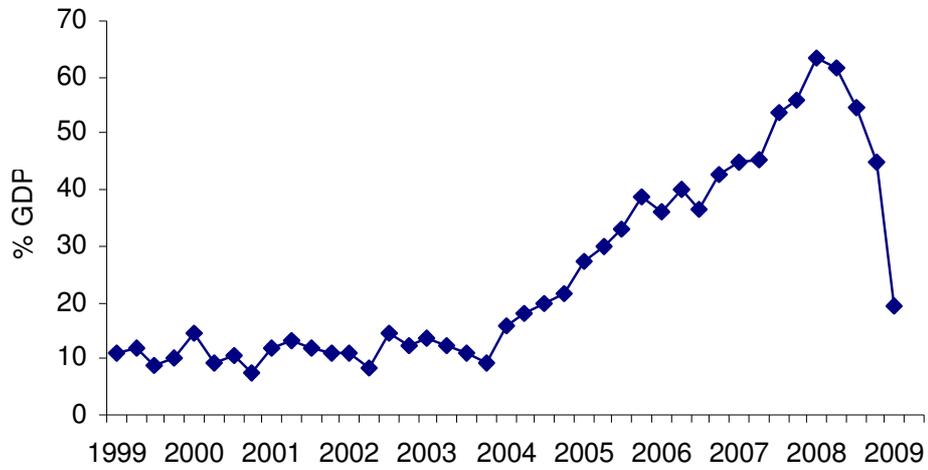


Figure 1: *Net borrowing of Irish banks from abroad (stock) 1999Q1-2009Q1*
Source: Central Bank quarterly bulletin, Table C3

Real interest rates 1983-2007
deflated by 4-quarter future inflation

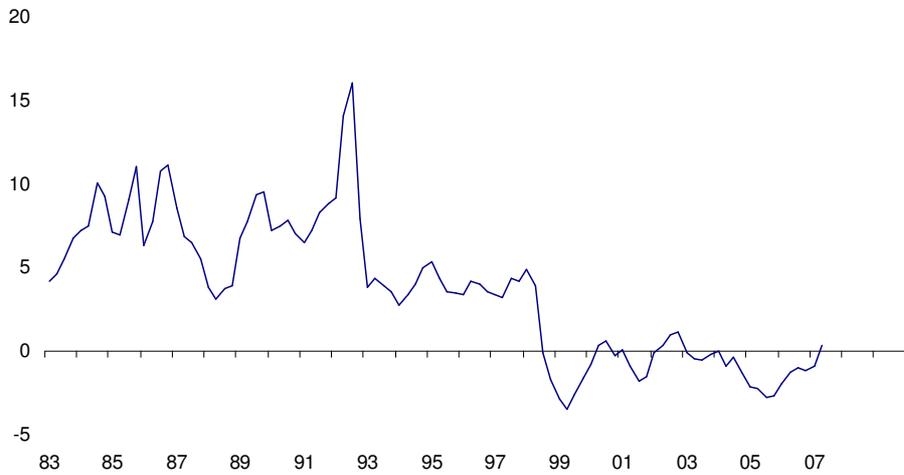


Figure 2: *Real interest rates 1983-2007*

Irish Real New House Prices 1970-2008

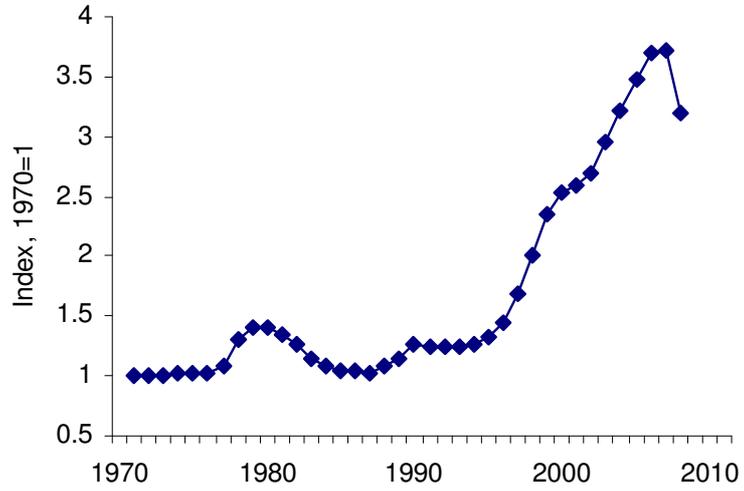


Figure 3: *Irish House Prices (deflated by CPI), 1970-2008*
Source: Department of Environment, Heritage and Local Government

Employment in construction
as % of total employment, 1990-2008 (April)

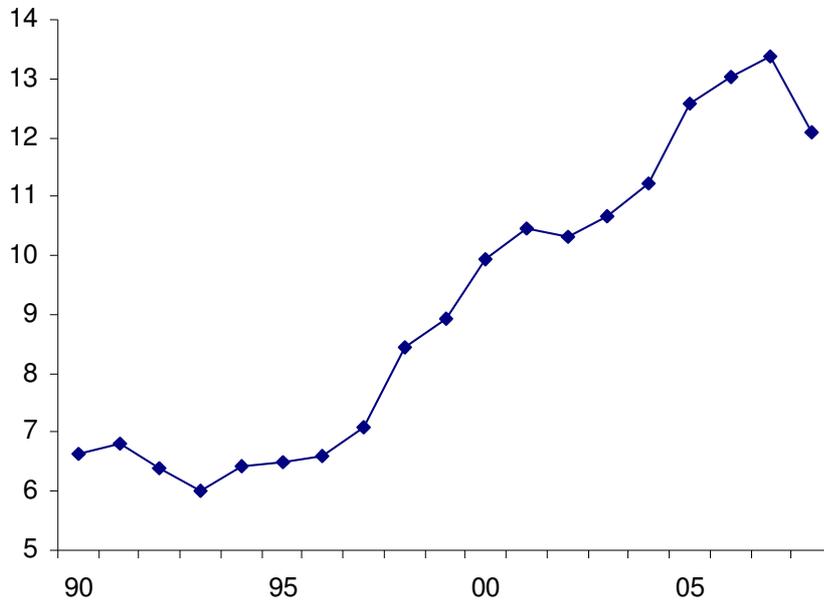


Figure 4: *Employment in Construction 1990-2008*

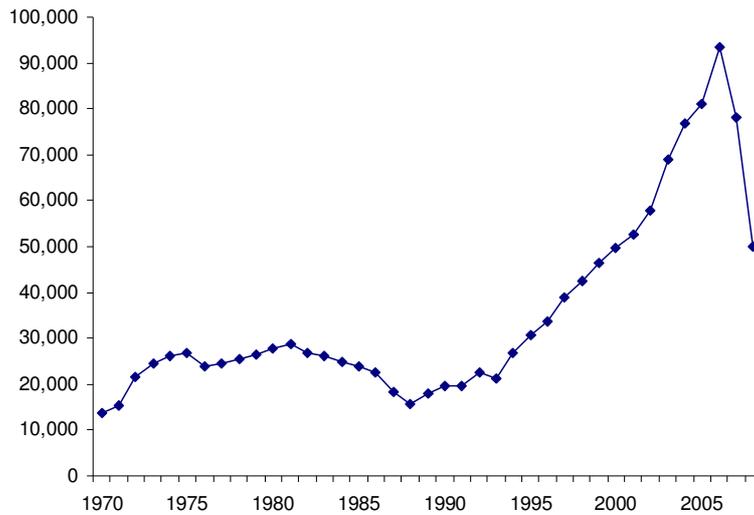
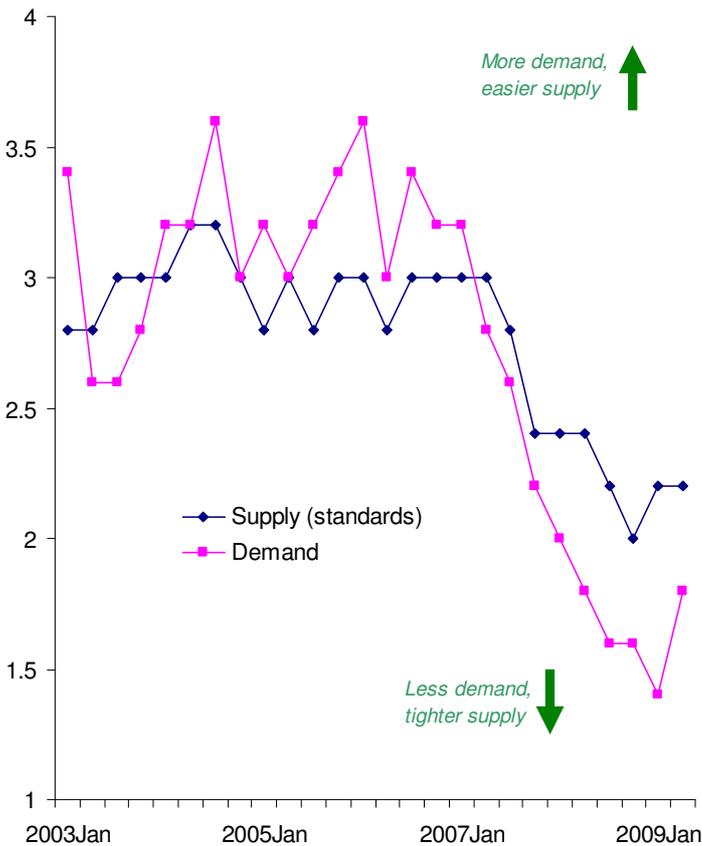


Figure 5 : Ireland: Housing Completions 1970-2008
 source : Department of Environment Heritage and Local Government

Ireland: Credit Supply and Demand -- Enterprises
 (Change from previous quarter)



Ireland: Credit demand & Supply -- House purchase
 (change from previous quarter)

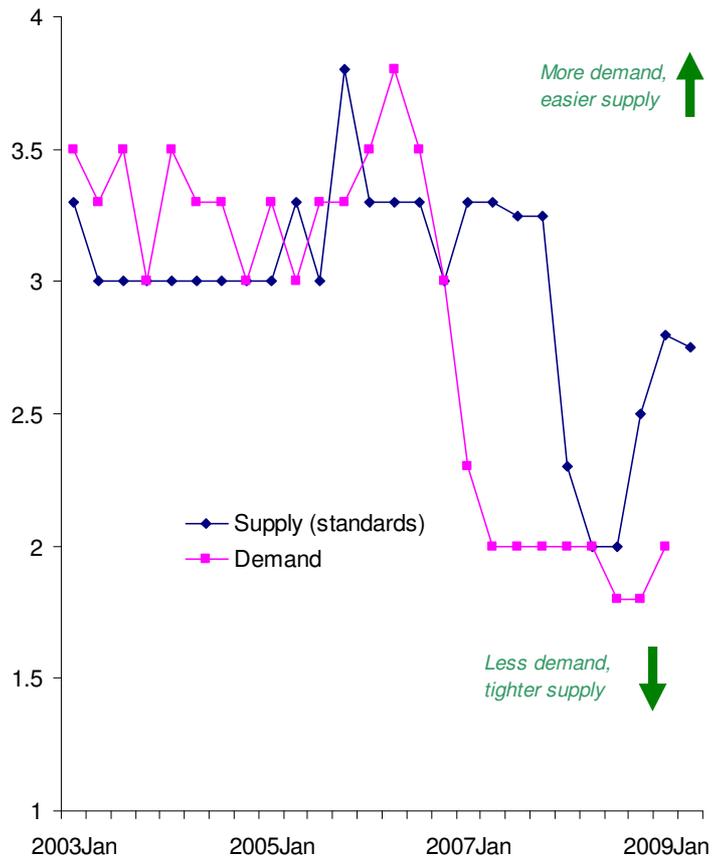


Figure 6 : Credit supply and demand conditions as reported by Irish banks 2003-2009

Source: CBFSAI: ECB Lending Survey, various dates.

“3” represents no change from previous survey. Higher numbers imply easing supply conditions and greater demand; lower numbers imply the opposite.

Real domestic credit & house prices
rolling 3-month growth rate 1997-2008

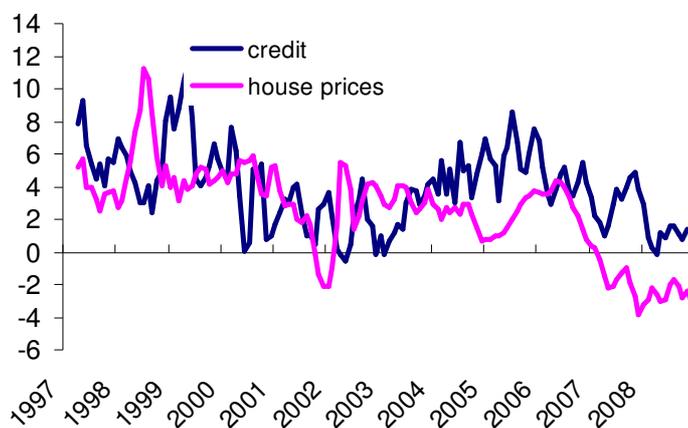


Figure 7: Ireland: Credit and house prices – rolling 3-month growth rate
Source: CBFSAI for credit; ILP-ESRI for house prices

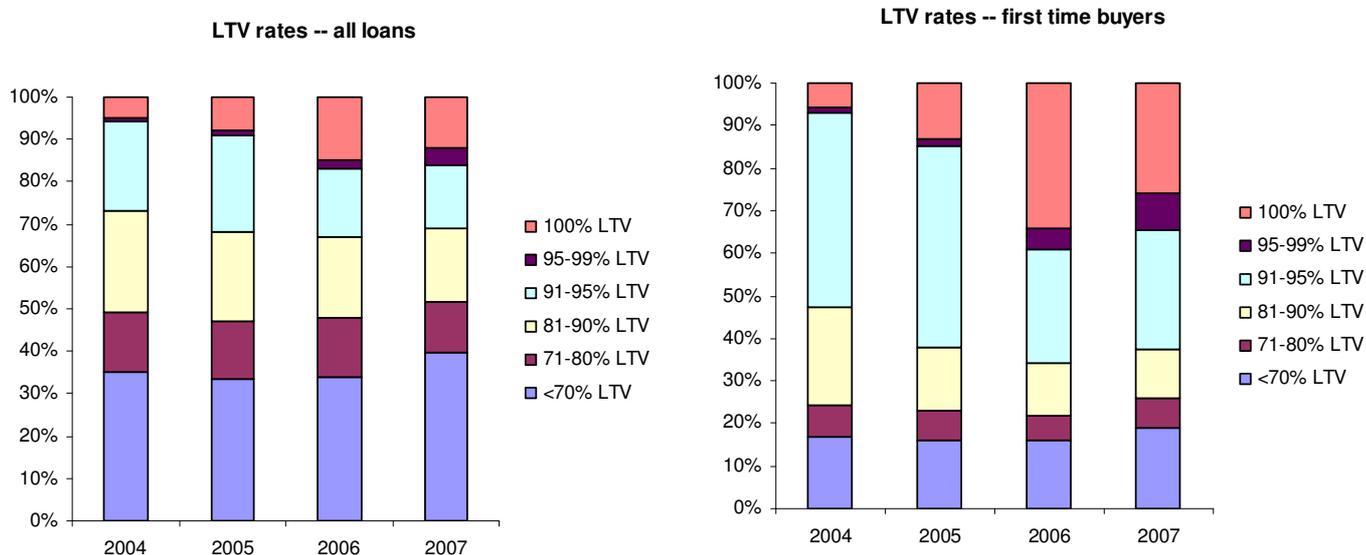
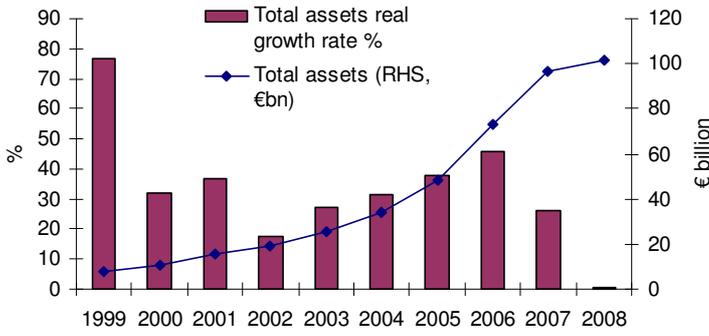
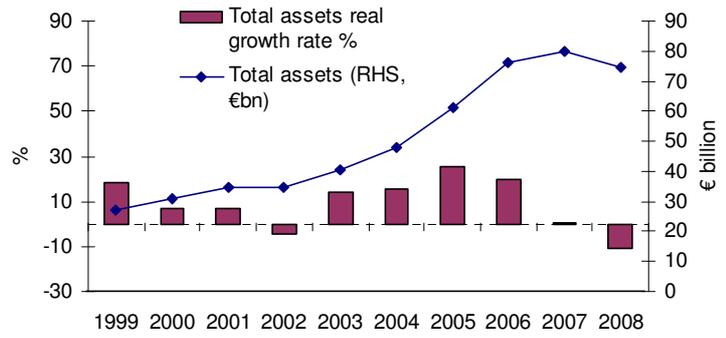


Figure 8: Ireland: Mortgage loans by initial loan-to-value ratio 2004-7.
Source: Department of Environment, Heritage and Local Government

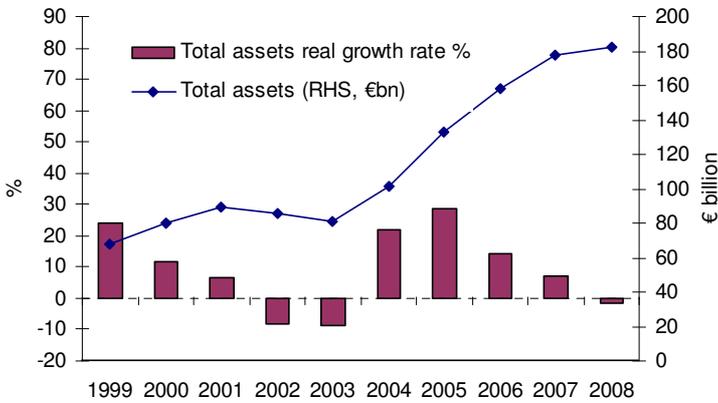
Anglo Irish Bank Growth 1999-2008



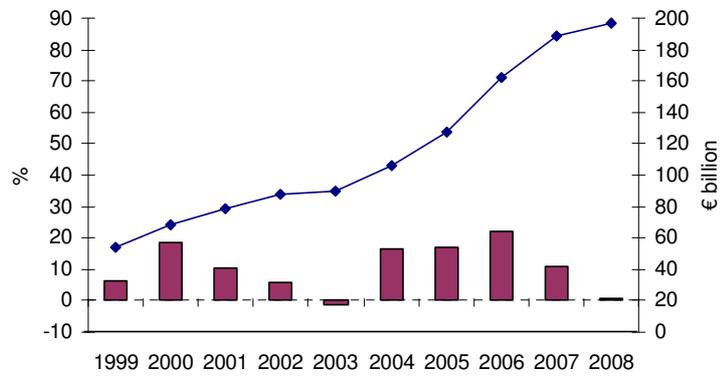
Irish Life and Permanent Growth 1999-2008



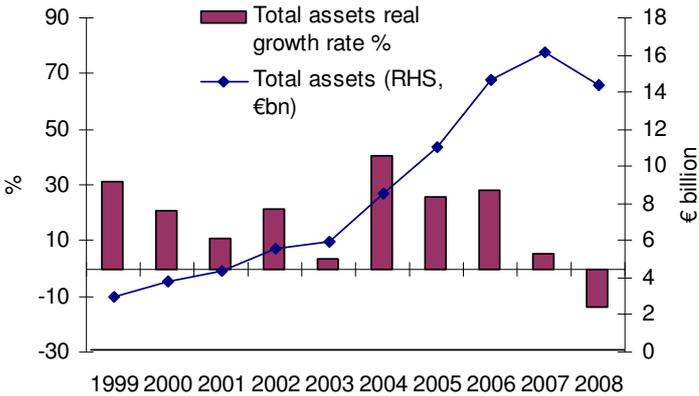
Allied Irish Banks AIB Growth 1999-2008



Bank of Ireland Growth 1999-2008



Irish Nationwide BS Growth 1999-2008



Educational BS Growth 2001-2008

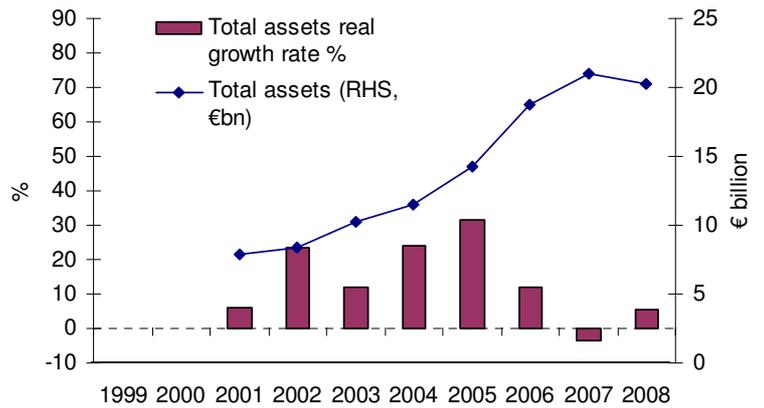


Figure 9: *Growth rates of six Irish banks, 1999-2008*
 Line: Total assets at end of each accounting year € billion (RHS)
 Bar: % real growth rate (LHS)
 Source: Bank Annual Reports

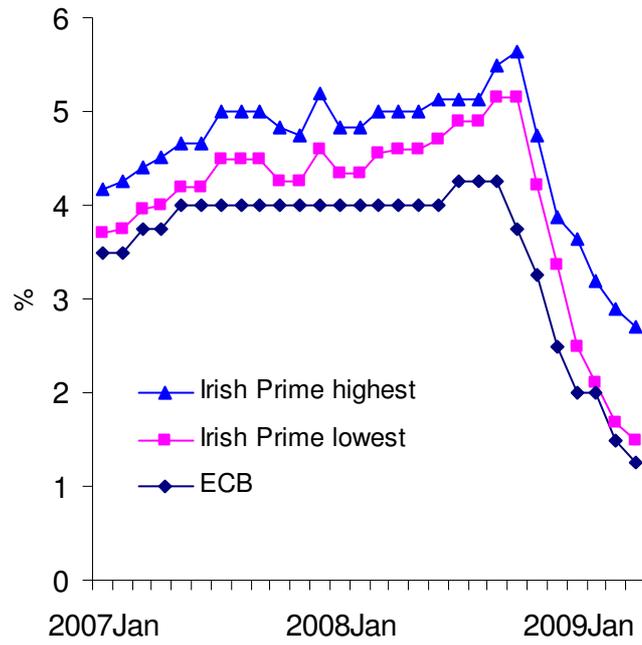


Figure 10: *Irish bank prime lending rates 2007-2009*
 Source: Central Bank of Ireland.

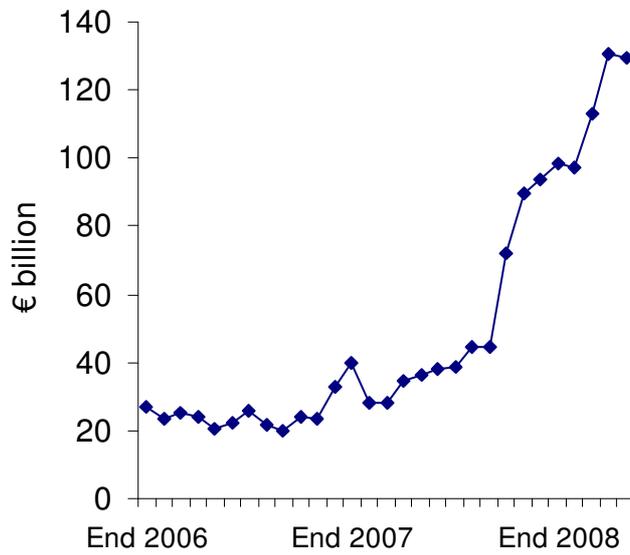


Figure 11: *Irish Credit Institutions Borrowing from Central Bank*
 December 2006-April 2009
 Source: Central Bank of Ireland