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Experiences of fast adjustment: a snapshot comparison of Iceland, Ireland, Latvia and Estonia

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The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.

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Contents

1 Rationale 3
2 Starting point 4
3 Output 5
4 External and financial balances 8
5 Public finances 11
6 Labor market 14
7 Lessons 16

List of charts

Chart 1. Real output 6
Chart 2. Domestic demand 7
Chart 3. Exports of goods and services 8
Chart 4. Current transfers and income balance 9
Chart 5. Goods and services balance 10
Chart 6. Bank lending 11
Chart 7. General government debt 12
Chart 8. General government expenditure 13
Chart 9. Government revenues 14
Chart 10. Employment 15
Chart 11. Unemployment 16

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1 Rationale[1]

Following the escalation of the global financial crisis in 2008, a number of new experiences of external and internal adjustment motivated by sizable imbalances have appeared. Iceland, Ireland, Latvia and Estonia provide examples of countries that have carried out relatively swiftly and, by any comparison, large turnarounds by rebalancing their pre-crisis excesses in domestic absorption and losses of competitiveness.

Such selection of countries is unavoidably arbitrary[2], but three specific features argue in favor of the choice. Firstly, all four countries commenced with adjustment fairly early on in the global crisis – in 2007 or early 2008. Secondly, the speed and extent of policy actions and market adjustment have been considerable by international standards, and all four countries have by now at least stabilized output levels or even experienced a fairly strong rebound. Thirdly, as Estonia carried out the adjustment without direct external assistance, it provides a valuable double-check for the usual approach, which is to study only countries that had to resort to formal international financial assistance programs.

The snapshot comparison is organized as follows. Firstly, a small detour is made to list a few similarities and differences between the countries, in order to formulate the overall framework. Secondly, a brief review of some key macroeconomic indicators is carried out. The focus is on core indicators that should depict an overall picture in terms of real outcomes, with less attention being paid to adjustment mechanisms. Finally, some general cross-country conclusions are provided, which may serve as lessons for other adjusting countries as well.

[1] The author benefited greatly from valuable comments from Arnór Sighvatsson, Jarmo Kontulainen, Samu Kurri amd Andres Saarniit. The cutoff date for statistics was 19/06/2012.

[2] In particular, Lithuania could be a natural addition to the group of countries; but it was left out for purely practical reasons, to limit the weight of Baltic countries in the sample.

2 Starting point

The four countries under scrutiny share a number of general similarities. Most fundamentally, all countries are very small and open economies. Furthermore, there were a number of similarities in the run-up to the crisis episode. All of them experienced very high growth rates in output, employment and wages as well as extensive enlargement of the banking sector balance sheet. While exporting sectors continued to perform reasonably well prior to the crisis and gross savings did not collapse, large domestic absorption manifested itself in both large capital inflows to the banking sector and deteriorating external balances.

While the above arguments provide a logical setting for bundling the countries together, one should keep in mind that there were and are a number of differences.

Firstly, the countries vary greatly in terms of pre-crisis income and price level. While Iceland and Ireland were among the richest nations, as measured by per capita GDP, Estonia and Latvia had just reached middle-income status in the mid-2000s. Similarly, while Icelandic and Irish price and wage levels were high, even by European standards, the other countries had some upside room for real and nominal catch-up. This is reflected, among other things, in their different absolute growth levels during the boom-phase.

Secondly, while all four countries experienced large expansions in banking liabilities, the structure of bank ownership and the nature of international integration were very different. In Ireland and Iceland the banks were primarily domestically owned and capital inflows to the sector comprised mainly direct market funding by these institutions. At the same time the Estonian banking sector was almost fully controlled by Nordic-Baltic banking groups, whose non-retail financing was by mid-2000 almost entirely managed outside the country from their headquarters. Latvian banking was also mostly arranged along the same lines, except for a few domestic banking institutions comprising about a quarter of the market. While this difference was not fundamental in many respects, it was important enough to alter the government's liquidity position during the crisis.

Thirdly, both before and after the crisis there were some important differences in economic policies. Iceland was the only one of the countries to follow a flexible exchange rate policy, which led to a sizable depreciation of the external value of the currency in 2008, and the only one to introduce capital controls during the crisis. At the same time Ireland was the only member of the European currency union, and therefore its banks had direct access to a lender-of-last-resort facility with an international reserve currency. Both Estonia and

Latvia kept their exchange rates fixed against the euro throughout the period. Estonia joined the euro area later in 2011 and was therefore in an active preparatory phase already by end-2009. Furthermore, while in Ireland bank restructuring (including some wind-downs) did not cause losses to creditors, Icelandic banks' foreign creditors faced large asset write-downs, and Latvia introduced temporary limits to creditor payouts in connection with the biggest problem bank.

One should also recall that due to the small size of the economies very few specific or one-off factors could explain the important differences in outcomes, even on the aggregate level. For example, while the role of construction in overall output was broadly similar in the four countries during the boom, Icelandic investments were more dominated by a few large export-oriented industrial investments in the metal processing and energy-producing industries. They were thus less dominated by the housing construction, even though the latter expanded markedly during the boom-phase. Similarly, Estonian post-crisis export developments were disproportionately influenced by the stellar performance of a single international electronics company and therefore the rebound in exports in 2011 should be somewhat "discounted". All in all, this should caution one about reading too much into the short-term volatile indicators for these countries.

Based on these starting positions the following will concentrate on the adjustment outcomes.

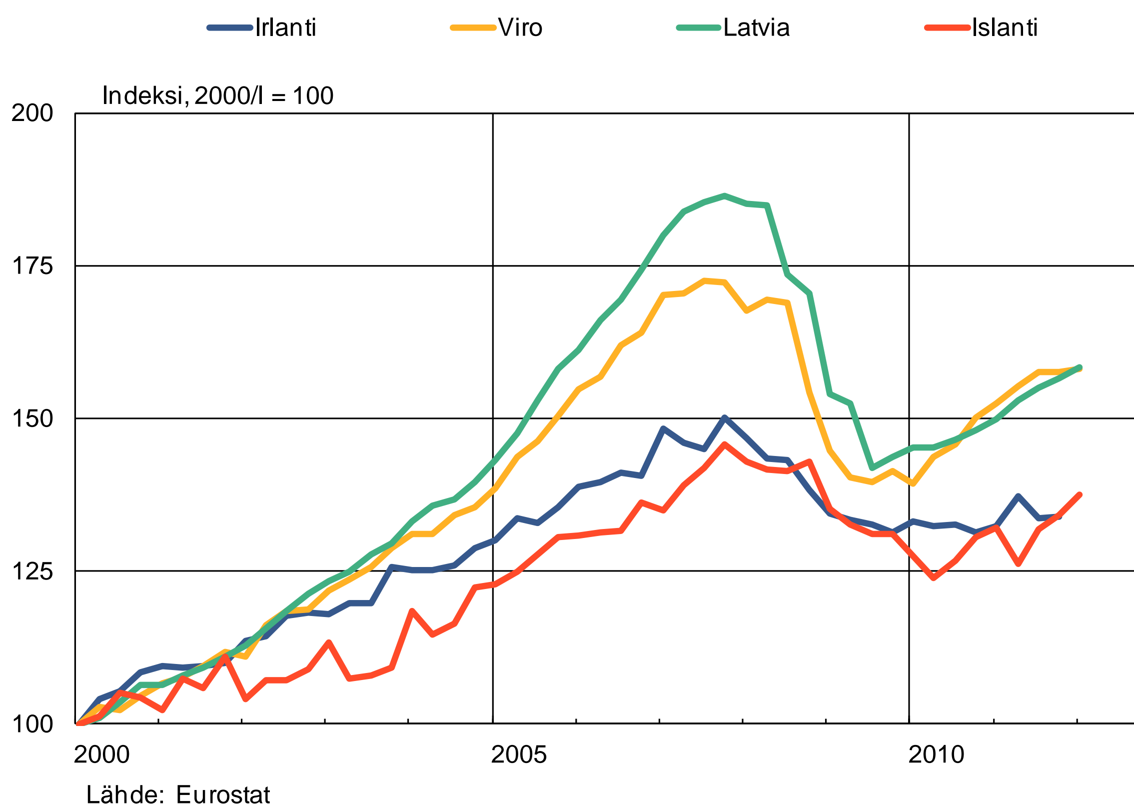
3 Output

After excessively fast growth in 2005–2007 all the economies started to cool down in the latter part of 2007 (Chart 1). The first country to start the adjustment of aggregate output was probably Estonia, while Latvia was the last to turn the corner in the beginning of 2008. However, a more notable decline in activity followed in the latter half of 2009. In Ireland and Iceland this was more closely related to post-Lehman intensification of the global financial market panic. In Estonia and Latvia the decline was highly accentuated by the collapse of global trade.

The activity slowdowns that ensued were very pronounced in all four countries. Reaching the lowest quarterly output level in the third quarter of 2009, the cumulative decline in GDP was almost 20% in Estonia and close to 24% in Latvia. In Ireland the corresponding figure was about 14.5% one quarter later, and two quarters later the contraction apparently

bottomed out in Iceland after a 15% cumulative decline. However, despite the differences in cumulative output contractions, all four countries recorded almost identical results in terms of timing: the trough in GDP was in every case similar to that recorded in the first two quarters of 2005.

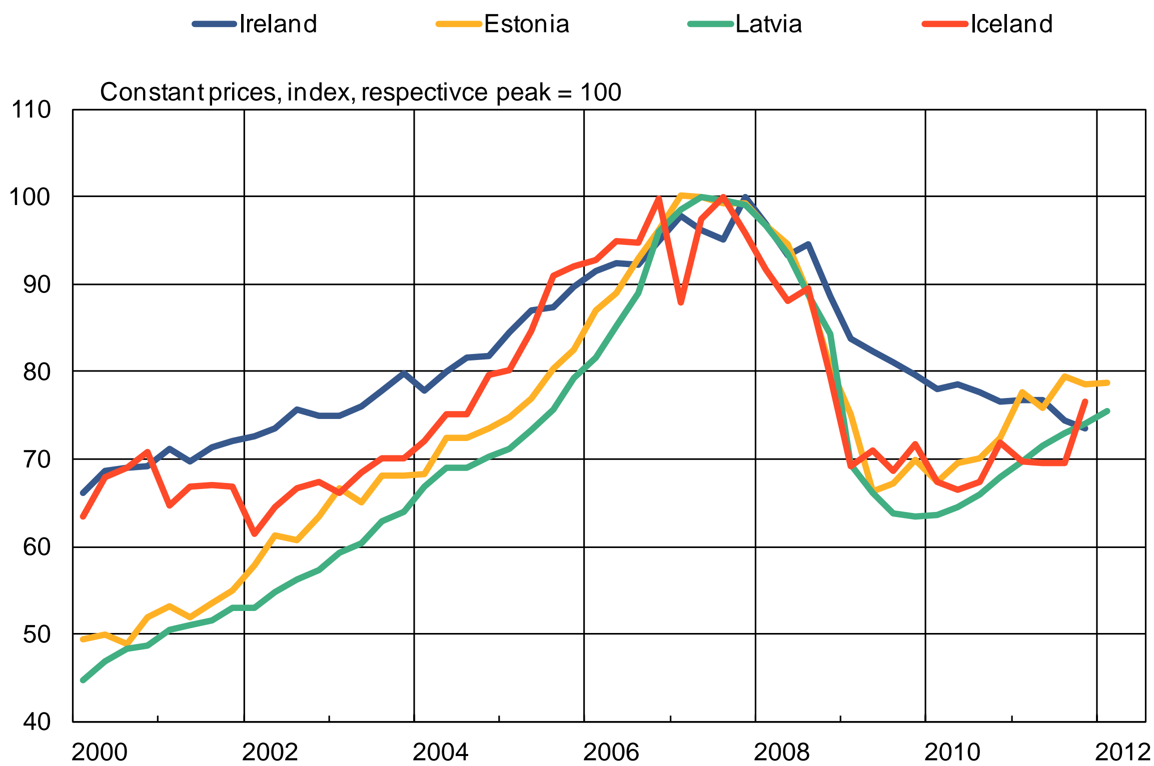
Chart 1. Real output



Stabilisation of output thus occurred roughly 2–2.5 years after the onset of decline. Subsequent recovery has been fairly fast in Latvia and Estonia as well as in Iceland while remaining almost flat in Ireland.

Somewhat bigger differences appear in more disaggregated data. While it is not surprising that the pre-crisis disequilibria had to be cured in all four economies primarily via a contraction in domestic demand, Ireland stands out by following a notably more gradual path of demand downsizing (Chart 2). In the other cases, the contraction in domestic demand was faster and more extensive. Almost ironically, however, by the second half of 2011 the relative level of domestic absorption was essentially the same in all the countries compared to peak levels.

Chart 2. Domestic demand



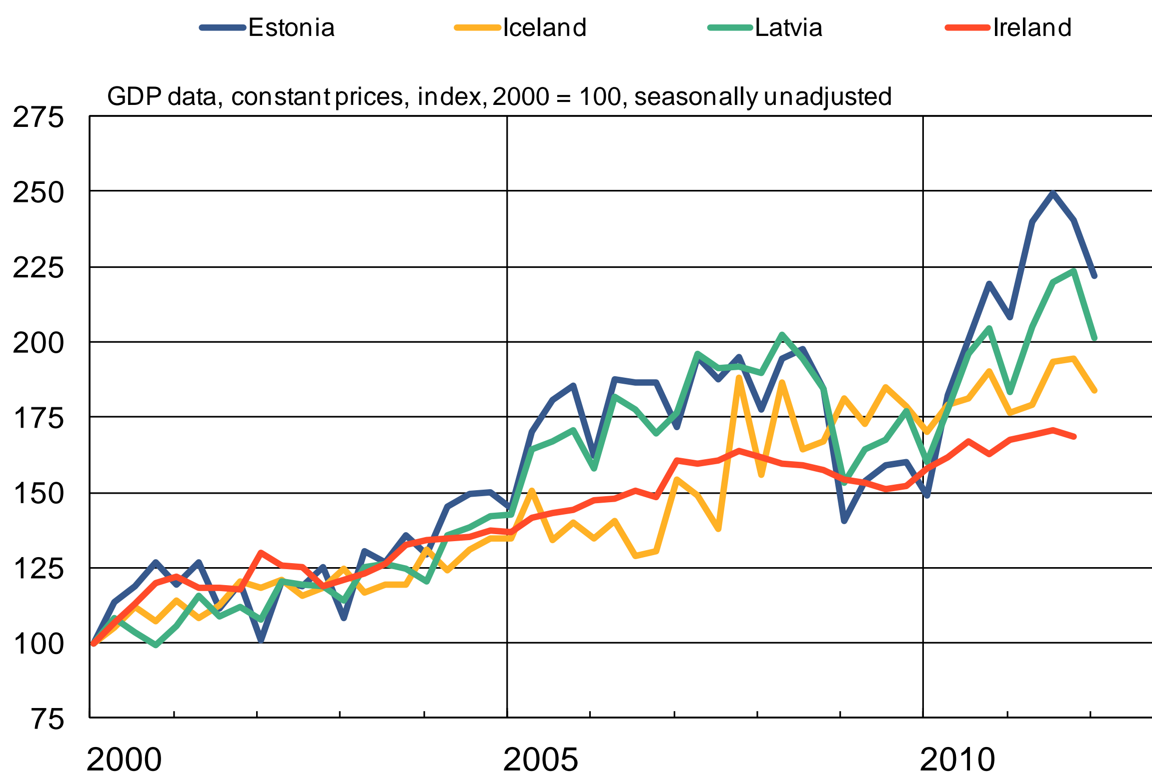
Source: Eurostat

On the export side, the performance has been more diverse, although by end-2011 the cumulative differences were again fairly small. Iceland, the only country experiencing nominal exchange rate depreciation during the adjustment process, performed best in the immediate post-crisis period. However, the supportive role of the exchange rate was probably limited to service exports where the decline in relative price levels (albeit from very high levels by international standards) supported activity. As regards goods exports, the primary jump is actually observable before the exchange rate depreciation, as extensive investment in the metal processing industry began then to bear fruit; the subsequent devaluation had little or no effect on the sector's export supply capacity. Other manufacturing, meanwhile, followed quite closely the rollercoaster in global trade.

Ireland showed remarkable resilience to the global trade collapse in 2009, whereas Estonia and Latvia followed the trends more closely. The latter development was actually quite similar to that of the whole Nordic-Baltic region, probably reflecting the high level of

integration of manufacturing sectors. However, by end-2010 all the countries were performing relatively well in global trade.

Chart 3. Exports of goods and services



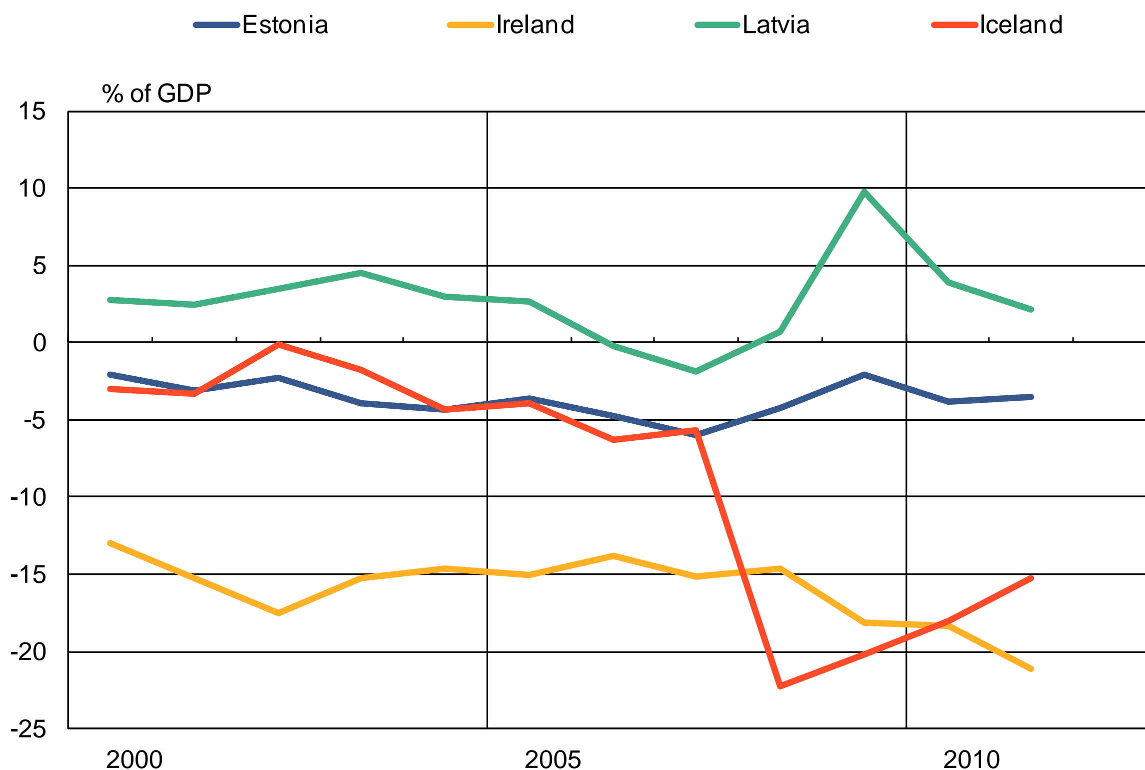
4 External and financial balances

There were some notable differences in external imbalances before the crisis (Chart 4). As expected, because of its high level of income, Ireland's current account had remained in balance until 2004. The deficit surged thereafter to comparatively high levels, but the peak remained at around 5% of GDP. In country comparisons, however, this masks the structural difference of a large trade surplus prior to the crisis. That was mirrored in the extensive profit accumulation and outflows of earnings and transfers by foreign direct investors, so that Ireland's income balance remained at a deficit level of 15% of GDP throughout the decade.

After the crisis, an enlarged foreign debt added further pressure on the debit side of the income account (Chart 5). Moreover, for Iceland high levels of income balance deficits

reported in the statistics, due to large swings in external net debt positions, were combined with still-large accrued interest payments.

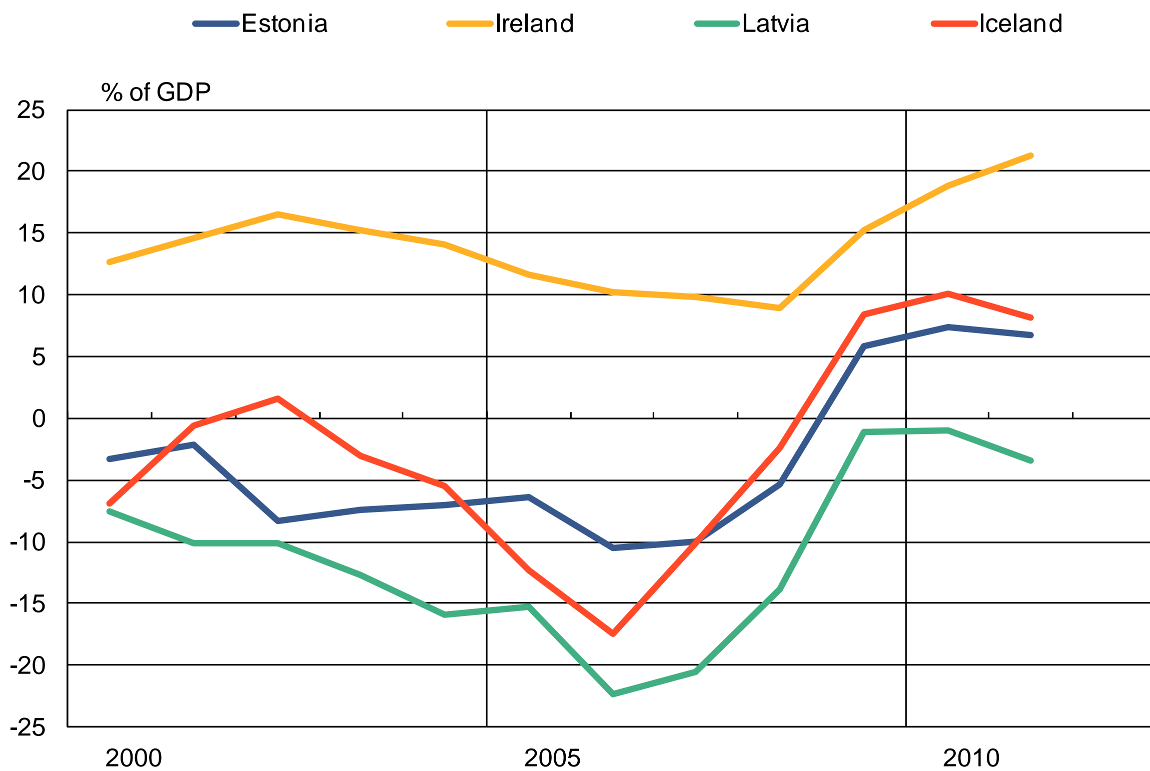
Chart 4. Current transfers and income balance



Beyond Ireland, the external imbalances were manifested in much bigger headline current account deficits and reached more than 15% of GDP, at least for two years. The imbalance in Iceland's goods balance improved notably in 2007, which lent support to the thesis that a large part of the 2006 imbalance problem in Iceland was due to one-off large-scale export oriented investments. However, the underlying imbalances were still large.

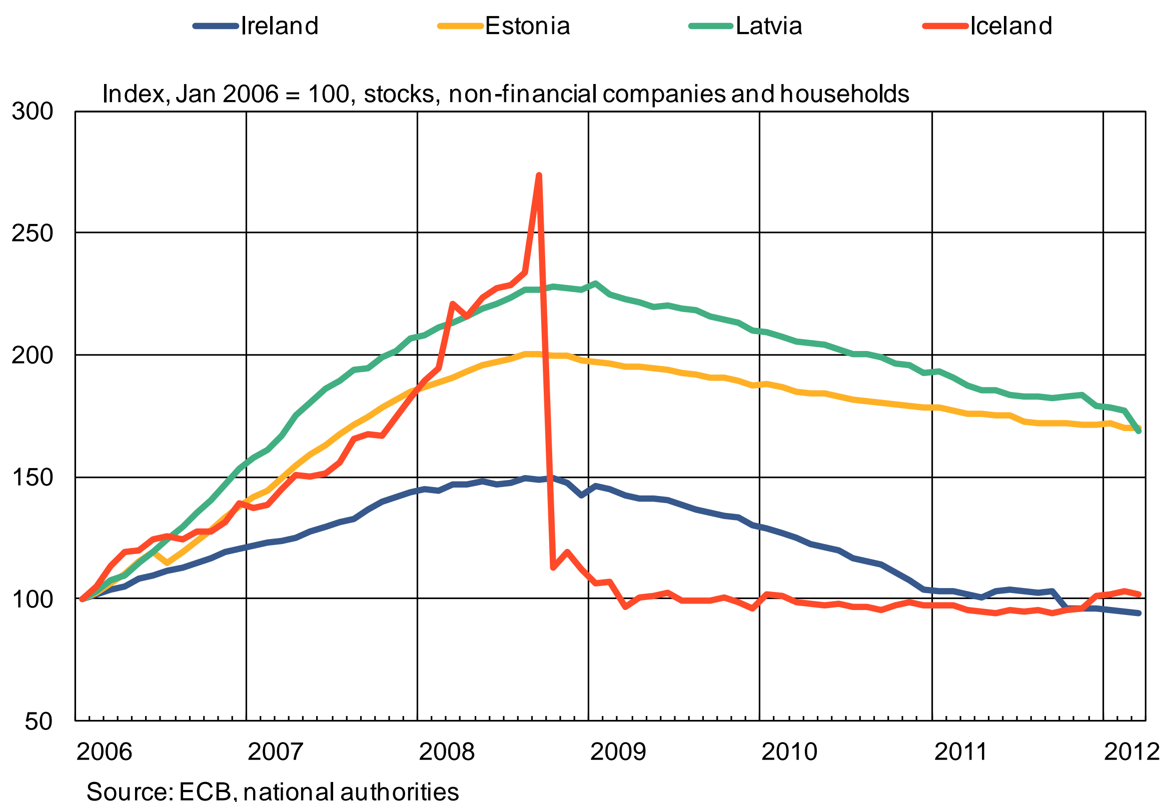
In Estonia and Latvia improvements in external flow imbalances began to go hand in hand with domestic demand contraction at the end of 2007. Over the next two years the goods and services balance improved in all three countries, by more than 15% of GDP. Ireland's surplus started to increase in 2009 and its swings remained smaller in magnitude.

Chart 5. Goods and services balance



In both the building up and winding down of external imbalances, an important role was played by the bank lending channel, financed largely by capital inflows. Comparing adjustments across national banking sectors is complicated by the differences in the handling of “old banks” in Iceland, which led to large bank closures and moved only a part of the assets and liabilities to the “new banks”. However, what is common to all four countries is a clear decline in loan stock during the adjustment phase, which was still in progress in most cases during the first half of 2012 (Chart 6). In Latvia the debt stock had fallen from its peak by more than a fifth, and in Estonia by about 15%. The fall in resident debt stock has been sizeable also in Ireland, even though the extent of it is somewhat exaggerated by the transfer of bad assets to separate institutions.

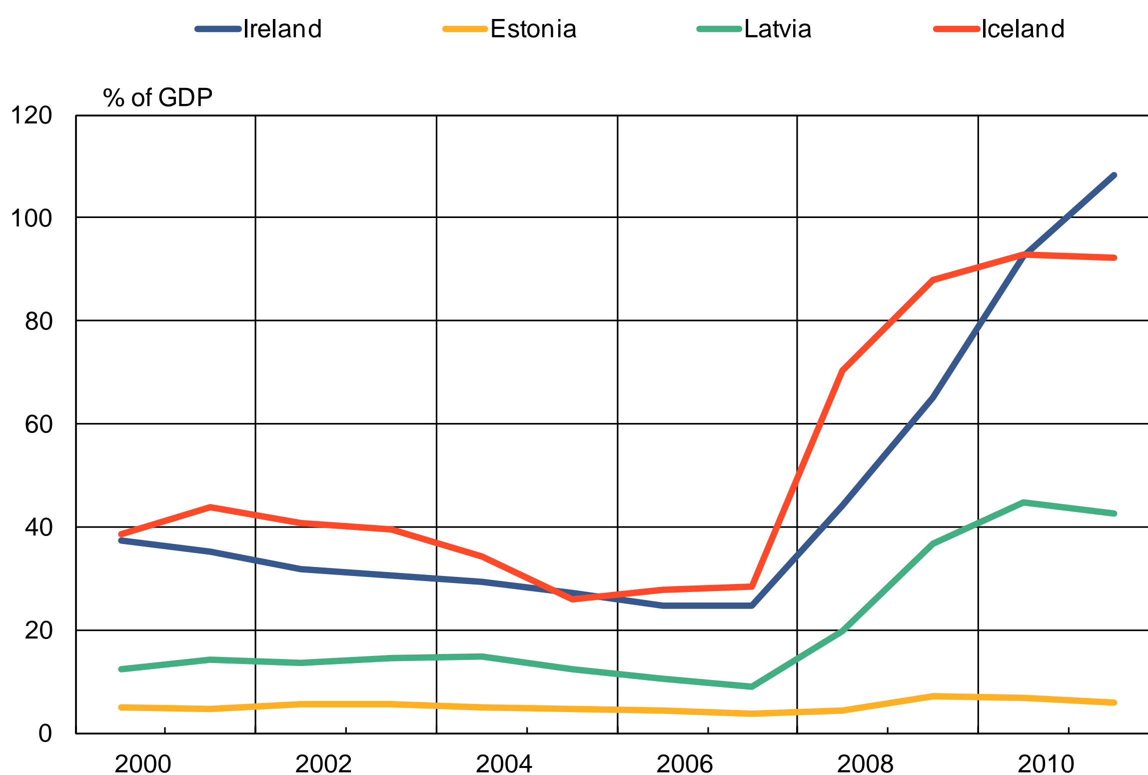
Chart 6. Bank lending



5 Public finances

Bigger differences can be observed also in the outcomes for public debt (Chart 7). Estonian public debt saw no notable change throughout the crisis, despite the fact that in comparison to Latvia and Ireland the pre-crisis period public expenditures were cut least in Estonia, as compared to pre-crisis levels (Chart 8).

Chart 7. General government debt



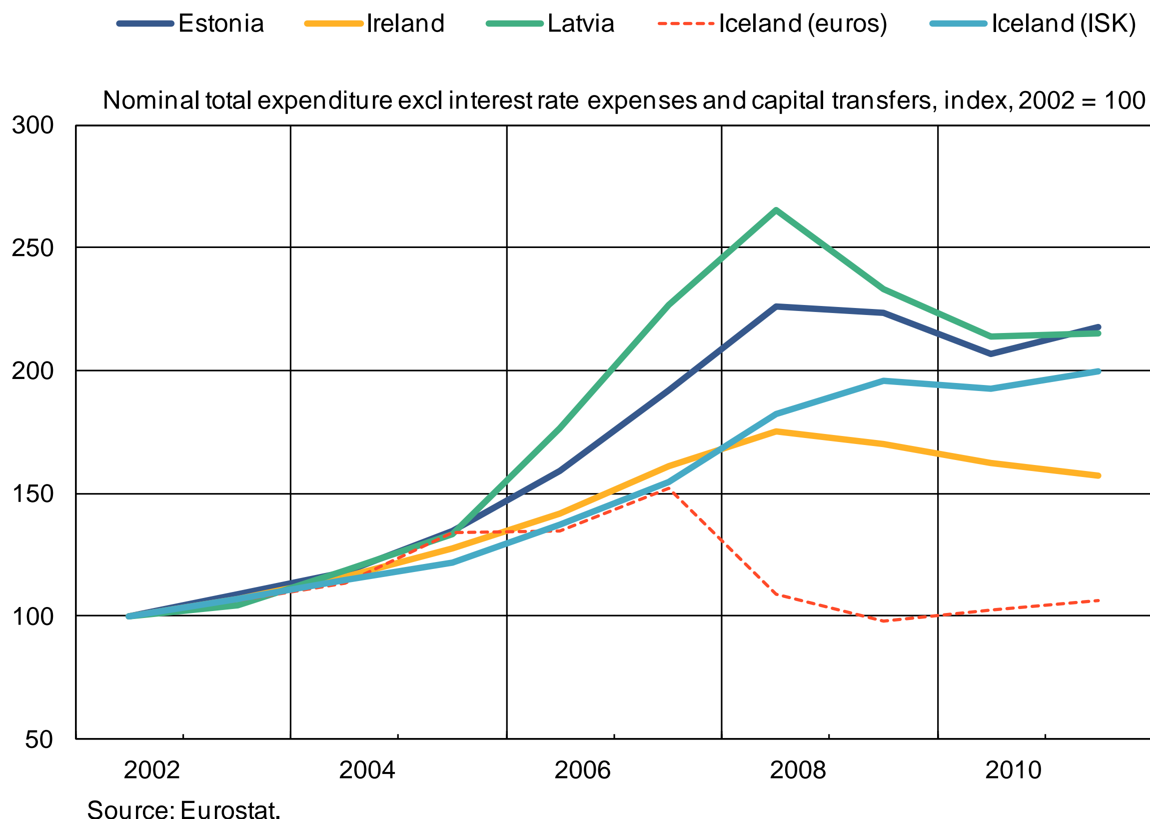
Source: Eurostat.

To a large extent these variations reflect differences in the build-up of imbalances in the banking sector and in the approaches to the crisis management. Ireland socialized the direct burden of preserving the functionality of the banking system. Iceland, where the size of the banking sector relative to the rest of the economy was even more inflated, limited the burden via large scale closure of the "old banking system", although part of the burden was carried by the public sector. Overall, the additions to public debt levels have thus remained closer to 15% of GDP in Iceland, whereas in Ireland additional government debt due to banking sector restructuring was over a quarter of GDP. In Latvia, public sector transfers in support of the banking sector remained slightly above 5% of annual output and were limited to a few domestic banks. Estonia did not carry any cost in this context.[3]

[3] Although financial stability in Estonia as well as in Latvia indirectly derived from banking sector liquidity and guarantee programs of the home countries of the biggest banking groups – ie Sweden and Denmark -- these programs did not ultimately burden those governments' finances as regards the joint banking groups.

However, banking sector costs alone do not explain fully the different paths in public debt. Somewhat more gradual expenditure cutting could explain part of the debt dynamics in Ireland and Iceland.

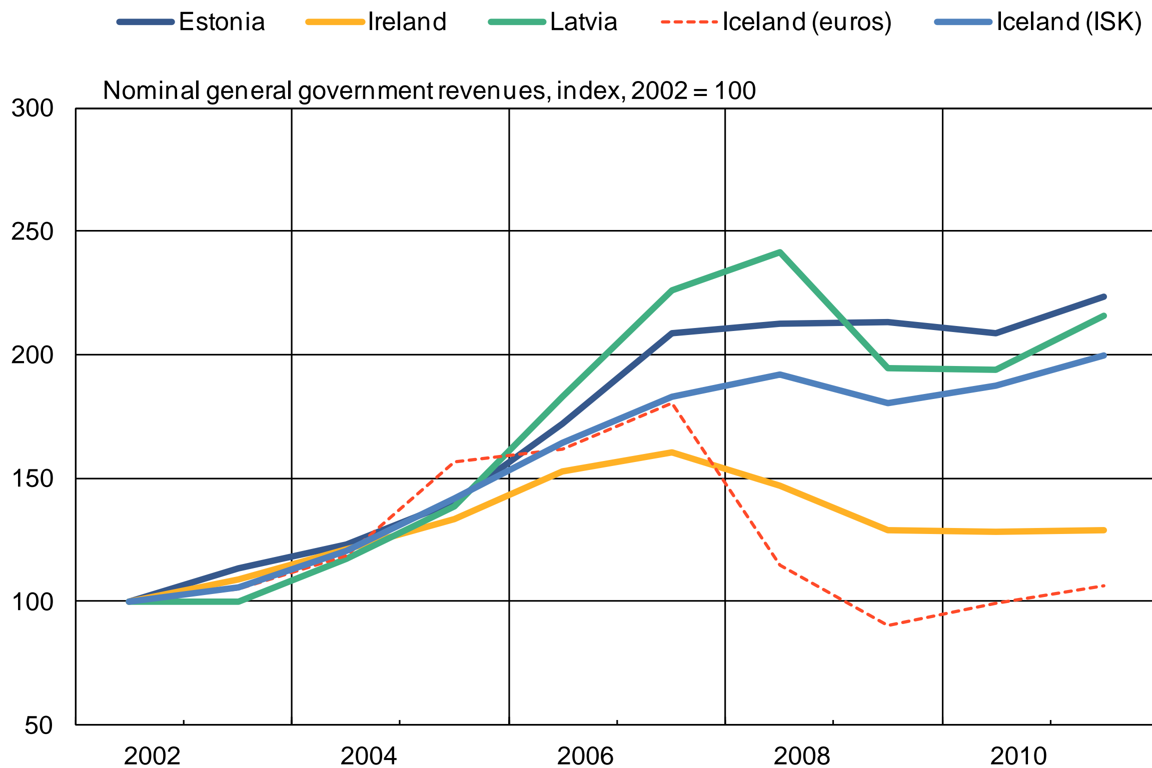
Chart 8. General government expenditure



Source: Eurostat.

But notable differences were recorded also in government revenue developments (chart 9). The Baltic countries continued to record high government income levels all the way into 2008, while Ireland and Iceland faced notable declines already by then. With the combination of higher taxes, a number of one-off revenue measures and better use of EU funding, Estonia actually managed to totally avoid a major decline in government tax and other revenues. The difference in results in tax collection might also reflect a somewhat smaller relative pre-crisis construction boom and therefore a more sustainable tax base in Estonia compared to Ireland and Latvia.

Chart 9. Government revenues



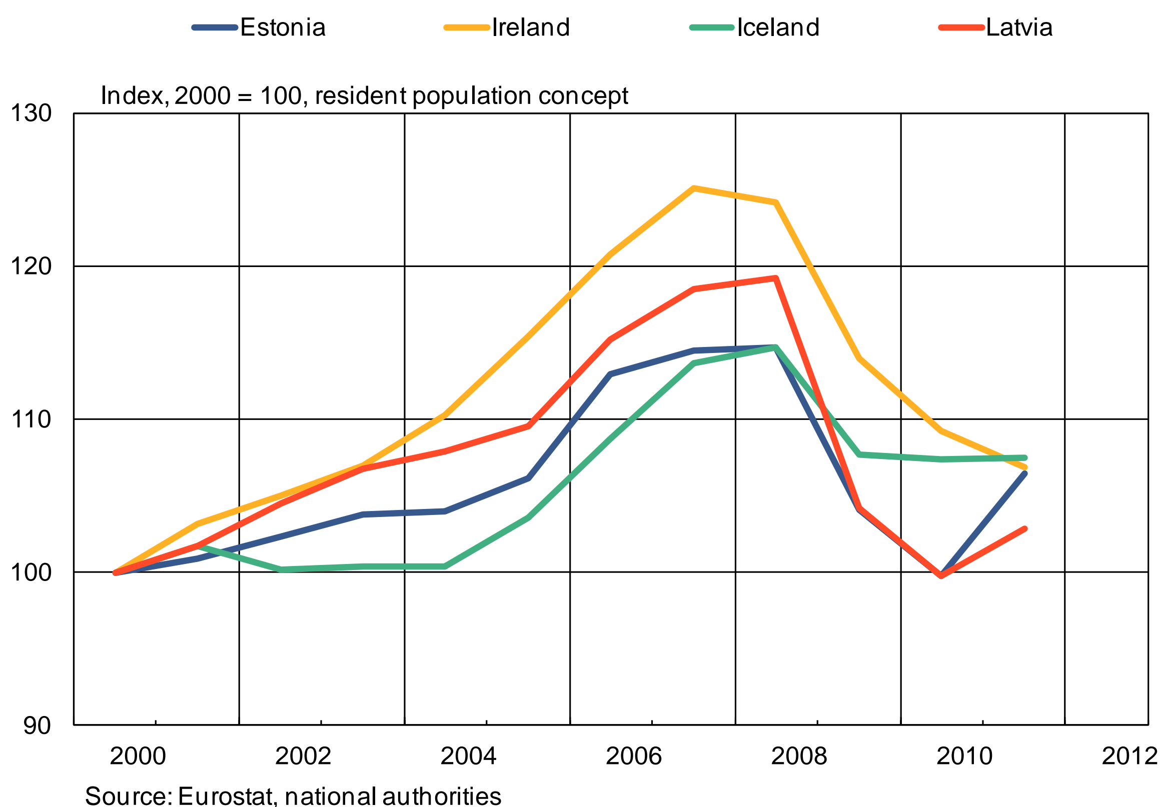
Source: Eurostat.

6 Labor market

The labor market has been greatly affected by the adjustment and was still in the ‘post-crisis workout’ stage in 2011. Although labor market regulations were regarded, at least in regional comparison, to be relatively flexible in all four countries, the pre-crisis disequilibria were too big not to be reflected in notable deteriorations in unemployment after the crisis. All the countries have also faced net emigration since the crisis.

All four countries saw large declines in employment in 2009 and, with the exception of Iceland, also in 2010 (Chart 10). But with domestic demand and exports recovering Latvia and Estonia saw notable improvements in job creation in 2011. Therefore, compared to the arbitrarily chosen longer term reference point of 2000, the unemployment rates remained in the surprisingly narrow range of 6–7% above the starting point in three of the countries, with Latvia recording the slightly smaller (3%) shift.

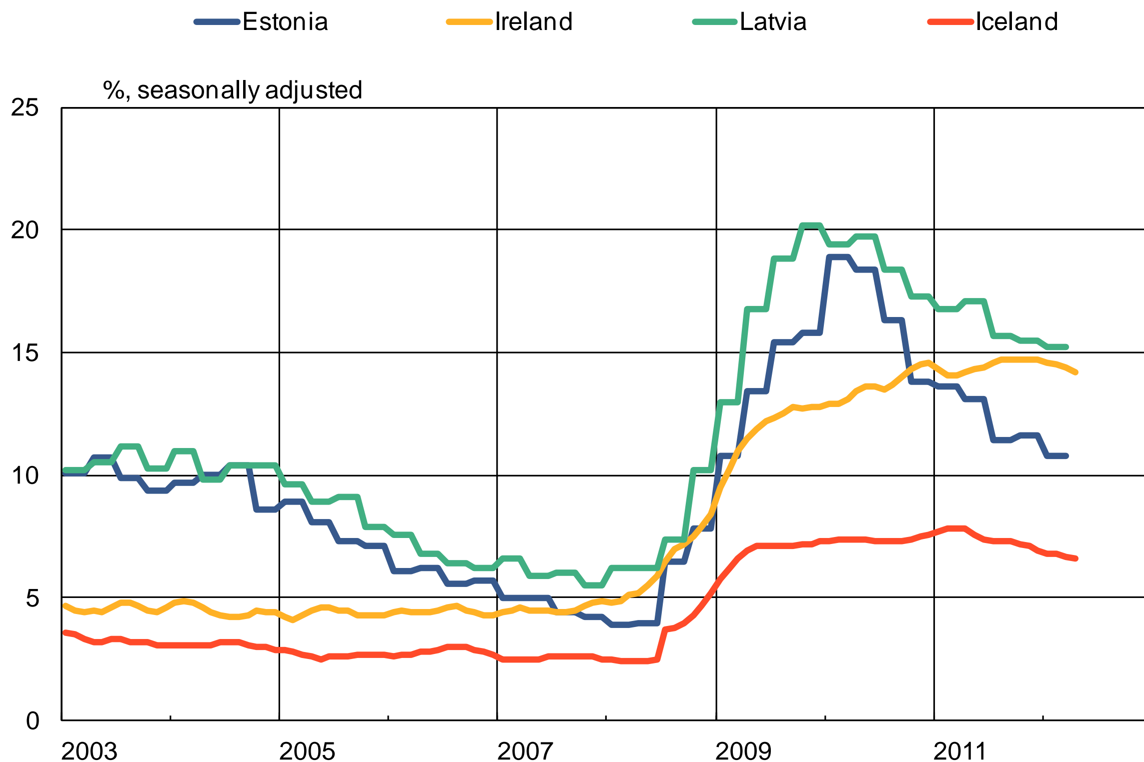
Chart 10. Employment



However, despite broadly similar outcomes in employment, assessing the relative performances in detail is complicated by the differences in pre-crisis situations. While Iceland and Ireland had experienced very low unemployment levels throughout the decade prior to the crisis, it was not until the mid-2000s that Latvia and Estonia enjoyed a more broad-based decline in the unemployment rate from peaks reached during the transformation to a market-economy. There were also some differences in the share of construction in overall employment: in Iceland it stood at a more or less “ordinary” 8–10% level, compared the high levels of 11–14% elsewhere.

Although employment remained similar in Ireland and Iceland, larger net immigration flows during the construction boom kept Irish unemployment above 14% in 2011, while in Iceland it had not risen above 8% even at the peak of the crisis. The highest peak of unemployment was registered in Latvia, followed by Estonia. But subsequent declines during 2011 were also fairly swift. Thus, while Iceland and Ireland had lower peak levels, their unemployment rates remained at 10 to 15-year highs whereas in Estonia the rate was not much different from the earlier peaks of 2000–2001 (chart 11).

Chart 11. Unemployment



Source: Eurostat.

7 Lessons

A natural question arising from these comparative case studies is whether there are lessons for other countries in need of adjustment from internal and external imbalances. While country-specific circumstances matter and one should not therefore overdo the lessons from fast adjustments, some general conclusions do emerge from these examples.

Firstly, the most important lesson is that, contrary to the expectations of many skeptics, large and relatively fast adjustments necessitated by imbalances are possible without major disruptions. While the crisis hit many sectors hard and it would be wrong to propose that all necessary structural changes have already been achieved; the sufficient reestablishment of a basis for sustainable growth was achieved within 2–3 years from the start of adjustment.

Secondly, these case studies seem to confirm that marked improvement in the economy is easier to achieve once boom-time excesses have been thoroughly worked out. Delay or

even excessive smoothing of the process does not necessarily ease the adjustment or make it ‘cheaper’. Whether the experiences of these countries provide a good benchmark for the required magnitude of adjustment in domestic absorption and wages is certainly questionable. But it seems clear that these changes are necessarily sizable.

Thirdly, these case studies seem to confirm the need for external financial assistance to smooth the adjustment process. However, the assistance could take different forms. For example, Estonia did not apply for the formal IMF/EU programs but was indirectly assisted by deep banking sector integration into the Nordic-Baltic banking groups, whose liquidity was supported on the group level.

Fourthly, however, combining the second and third lessons, one may conclude that the design and extent of international assistance should not protect economies even from short-term pronounced swings in activity and therefore from the pressure to make necessary changes in either domestic demand, relative prices or even in the nominal debt level. This is probably also the main lesson for the functioning of a currency union, i.e. that the monetary framework should not unduly delay the necessary changes in private sector leverage.

Finally, while country-specific circumstances probably play an important role in the exact policy design, for example vis-à-vis exchange rate or capital controls, these case studies suggest that large readjustments are possible in widely differing policy setups. More important than the specific choice of policy is the overall coherence of the whole package.