The Way Out

A COMPARATIVE ANALYSIS OF
THREE EUROPEAN RECOVERIES
FROM THE GREAT RECESSION

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JOSEF FILIPOWICZ

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The Way Out:

A Comparative Analysis of Three European Recoveries From the Great Recession

Abstract: The wake of the Great Recession, as well as revived economic worries in several European countries, provides an ideal setting for the review of how it manifested itself in various national contexts, as well as how recovering nations were able to pull themselves out from often devastating economic shocks. The following study aims to assess such recoveries in order to elucidate the impact of European integration upon them –an important analysis to undertake, given the rise of euroscepticism. First it will outline the *research question* (are nations less integrated in the European framework better equipped to respond to exogenous economic shocks?), as well as its *significance* to the overall ongoing process of closer integration. These, as well as the methodological approach are outlined in an *Analytical Framework* chapter. Second, it will navigate through three case studies of recovering European countries –Iceland, Latvia, and Ireland- and identify the factors leading to recovery, as well as their point of origin (domestic, EU, or other/international). Third, a comparative analysis is carried out based on these factors in an attempt to rank the success of recovery. It concludes that the Icelandic recovery was most successful in mitigating direct impacts of the shock upon its population, and Ireland was the least successful in this regard, suggesting a generally negative relationship between degree of integration and economic recovery from the 2008 financial crisis. Additional analysis of the types of recovery instruments selected furthers that the damage caused by the EU's role in addressing the crisis was likely worse than the good it generated.

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"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises."

-Jean Monnet

Introduction

The receding yet persisting global financial 'downturn' has not only strained all levels of government in Europe, but has exposed a number of weaknesses in the institutional structures of the European Union (EU) and member states alike. Originating in the United States, the 2008 'credit crunch' resulting from the collapse of the real estate market did not take long to spread across the Atlantic. A number of European countries soon followed the United States into deep recession, fuelling the phenomenon now often referred to as the Great Recession, which peaked in 2009 when global GDP shrank at a scale unseen since the Great Depression.[1] A number of subsequent policy responses followed, aiming to return national economies to growth and employment, which generated mixed results. In Europe in particular, there has been increased rhetoric surrounding the combination, or 'communitization' of debt as a means of tackling the sovereign debt issues faced by the worst-hit crisis states in the EU. Measures falling under the umbrella of 'fiscal union' such as issuing common government bonds ('euro-bonds') and the recent steps towards a banking union have become the source of increasing debate between rich northern countries and crisis-stricken southern or 'periphery' countries. Essentially, the debate between more and less European integration has accelerated, as have the powers transferred to the EU in recent years. This causes for fundamental questions to arise concerning the ability of communitization to solve issues faced by member states, as is suggested by former Vice-President of the European Commission Viviane Reding, who stated in 2013 that:

> The on-going crisis has triggered a very necessary public debate about where Europe is heading. To make Economic and Monetary Union truly irreversible and to regain trust and confidence, it is important to give citizens and companies a perspective on what Europe will look like in 2020. For [me], strengthening Europe and strengthening Europe's legitimacy can be best done by turning our Union into a United States of Europe.[2]

In its analysis of the gradual sovereignty transfer from several member states to the EU, this study aims to explore the relationship between the level, or 'degree', of integration of European countries (how integrated they are in the EU or pan-European institutions such as the European Economic Area) and the success of their responses to the 2008 financial crisis. Otherwise posed, are nations less integrated in the EU framework better equipped to respond to exogenous economic shocks[3], worse equipped, or does integration play no substantial role in the success of their responses? The key variable here is state 'equipment', which may be defined as the toolkit available to national (state or non-state), supranational, and international actors to respond to the impacts of the crisis in a particular national context. For example, the options available to Cyprus in its ongoing recovery efforts are domestic (bank restructuring, capital controls) as well as EU and IMF-based (bailout funding) in nature. It is important to specify the multi-jurisdictional nature of equipment (national, supranational, and international), as a focus on purely national equipment would point to its obvious reduction as further competencies are transferred upwards. Hence, this study's focus on the entirety of the 'response-packages' applied to national crises is central to answering the research question.

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1 International Monetary Fund, *World Economic Outlook: Crisis and Recovery*, (Washington: IMF, 2009), 9.

2 Reding, Viviane. *Towards a United States of Europe*. Brussels: European Commission, 2013.

3 The term 'exogenous' refers to the crisis' origin, or 'spark' in the United States, although domestic factors have largely contributed to the vulnerability of the affected European countries.

The **significance** of answering this question is that, should a generally negative relationship be suggested between level of integration and state 'equipment' in addressing exogenous economic shocks, perhaps ideas of further economic integration (such as joining the euro, banking union, or euro-bonds) would no longer be necessarily as attractive. Of course, there are many non-economic motivations for the process of European integration, but the European Project's origins and the continent's gradual convergence have often been led by economic reasoning (e.g. trade openness leading to political convergence[4]), including its inception as the European Coal and Steel Community. Such a relationship would also challenge the very notion of 'ever-closer union'[5] as desirable (at least in economic terms), as has already been expressed by the rise in euroscepticism in recent years.[6] Similarly, no substantial relationship between the two may dispel notions of further integration as a panacea for economic ills (as suggested by Viviane Reding's statement). A generally positive relationship (further integration within the EU likely improves a nation's ability to respond to exogenous economic shocks) would reinforce the rhetoric of communitization, and validate political efforts towards further power transfers.

This study seeks to shed light on this question in several steps. After laying out the methodological approach deemed appropriate in assessing the impact of integration on state equipment in recovering from the Great Recession, a brief note will be made on institutionalism –a key explanatory theory that will frame some of the language used in this study to establish the contextual factors shaping each national experience of the crisis, as well as the theoretical framing used throughout. Three case studies will then be conducted, tracing the booms, busts, and recoveries of Iceland, Latvia, and Ireland –all small recovering European states differently placed along the spectrum of continental integration. The study will conclude with a comparative analysis of all three cases based on a number of qualitative and quantitative indicators. Although each have distinct advantages and disadvantages in their approaches, the overall success of the Icelandic recovery –especially in its minimization of public exposure to private sector losses- hints at a broadly negative relationship between degree of integration and the ability of states to recover from the 2008 financial crisis. Another important finding is that the framework of European integration was instrumental in causing some of the factors leading each case state into crisis, even adding barriers to recovery in some cases. This said, many domestic and international factors also contributed to each manifestation of the crisis, leading to further questions about shared causality and the complex, interwoven nature of the origins and mitigation of economic shocks.

[4]This notion is the heart of the neofunctionalist explanation for postwar European integration.
[5] This terminology is from the 1957 Rome Treaty
[6]The results of the 2014 European Parliamentary Election in France, the UK, Denmark, and Greece –all of which saw eurosceptic parties take the largest share of the vote- confirm this trend.

Previous Studies

Before delving into the methodological approach adopted in this study, recognition should first be given to previous work in this field. Much has been written on the financial crisis since it began, spanning numerous disciplines. Relating to the crisis' manifestation in the countries of Europe is an equally broad literature. Among the best known (and broadly published) criticisms in this field are the now landmark arguments of Paul Krugman and Andrew Moravcsik, who criticise the monetary union's lack of corresponding fiscal union. These comments, as well as literature on 'europeanization'[7] and European 'disintegration'[8] navigate the process of European convergence, outline its various threats, and often propose predictions or solutions to these.[9] Many empirical reports (including those referred to in each case study) also delve into the potential causes of the crisis, as well as the solutions administered. Two of these studies in particular take a similar case-based approach at determining whether the extent to which countries are integrated in the European framework impacts their recoveries –a similarity they share in spite of not belonging to a similar definable subcategory or canon of literature within the umbrella of the 2008 financial crisis. First is Darvas' 2011 working *paper A tale of three countries: Recovery after banking crises*, in which the same three case countries' recoveries (as of the year of publication) are examined based on numerous macro-economic indicators. Although it was published during the early stages of recovery, clear indications had already emerged that the Icelandic response had "the right policy mix" due largely to its focus on minimizing public exposure to the collapse of its oversized banking sector. This policy mix will be elaborated on in Case 1.

Second is Thorhallsson and Kirby's 2012 article *Financial Crises in Iceland and Ireland: Does European Union and Euro Membership Matter?*, in which the authors borrow from small state literature to assess whether the 'shelter' from exogenous economic shocks supposedly provided by joining communities such as the EU is a valid concept when applied to recovery from the Great Recession. This notion of 'shelter' is important in its similarity to the idea that further integration leads to better 'equipment' afforded to states in their recoveries from exogenous shocks. In this study as well, Iceland is identified as the most convincing recovery. Where the two studies differ is that Darvas' piece calls for the creation of a 'European Banking Federation' (further integration), while Thorhallsson and Kirby argue that the basic definition of 'shelter' as protection from external economic shocks is not applicable to Ireland's EU membership. The former is important in voicing a common criticism of the EU –that monetary union without fiscal union is impossible (like Krugman and Moravcsik)- while the latter posits the argument that EU membership is not tantamount to protection from exogenous shocks. Some of the core conclusions argued in these two publications are therefore echoed in the chapters that follow (e.g. that the Icelandic recovery was the most successful in minimizing public exposure to private losses). However, the study conducted here differs from these in several ways.

7 Featherstone, Kevin, and Claudio M. Radaelli, eds. *The Politics of Europeanization*. Oxford: Oxford University Press, 2003.

8 Webber, Douglas. "How Likely Is It That the European Union Will Disintegrate? A Critical Analysis of Competing Theoretical Perspectives." *European Journal of International Relations* 20, no. 2 (2012): 341-65.;Vollaard, Hans. "Explaining European Disintegration." *Journal of Common Market Studies*52, no. 5 (2014): 1142-159.

9 Kapoor, Sony. *The Financial Crisis – Causes & Cures*. Brussels: Friedrich-Ebert-Siftung, 2010.

Although the root question, case and criteria selection used here resemble those of the Darvas and Thorhallsson and Kirby studies, the key difference (and therefore contribution) of this study is its conceptual mapping of the options available to each case in response to the crisis, as well as those factors which narrowed the eventual selection of options deployed to generate recovery –an aspect missing in previous analyses. It is through this conceptual lens that the following study seeks to explain why Latvia, though institutionally permitted to devalue its currency (a successful policy used in Iceland), did not. A combination of historical and ideational factors are drawn upon to explain why some cases were constrained to a narrower selection of solutions than were available to them. This is done through an emphasis on the historical narratives underlying individual cases in order to better illustrate the unique nature of each, rather than imply their complete comparability as units of analysis beyond their status as small, recovering European states.

Analytical Framework

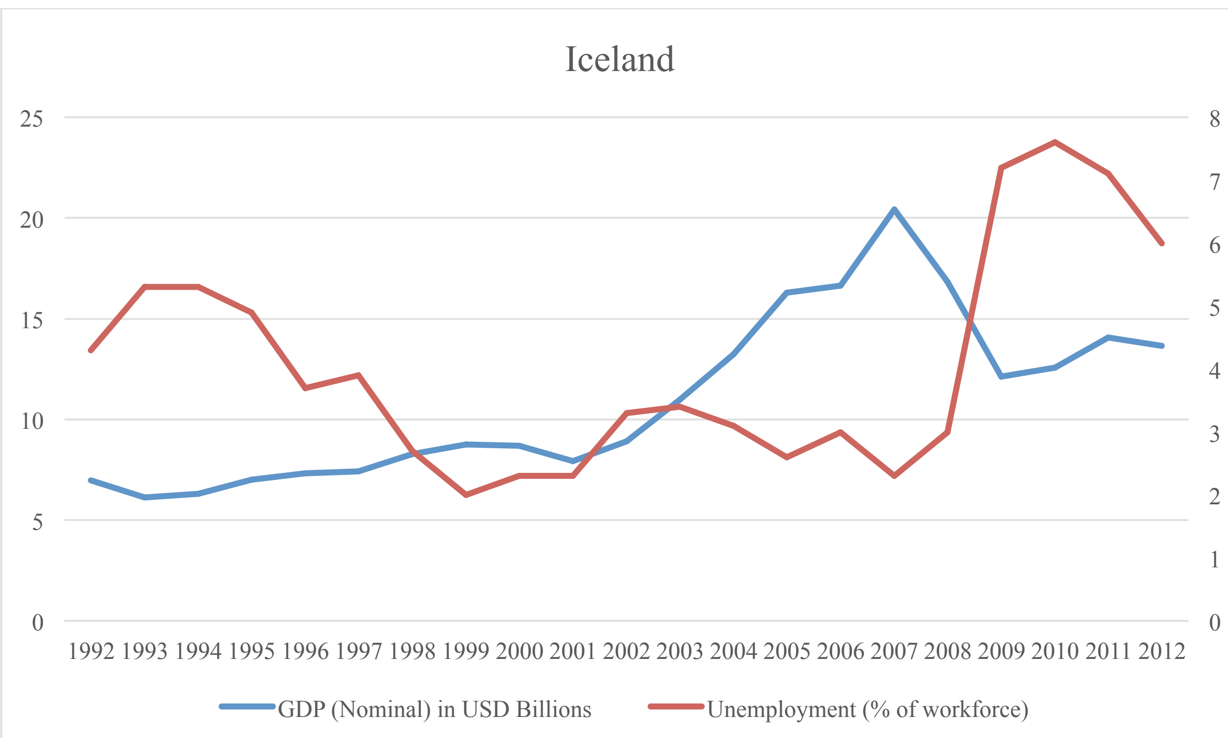
Methodology

In order to infer a potential relationship (broadly positive, broadly negative, or non-existent) between level, or 'degree', of European integration and recovery from the Great Recession, a definitional basis for the overall analysis must be established. This allows for clarity and purpose in the study, but also helps reduce an otherwise broad topic. Firstly, the definition of crisis and recovery to be used in selecting cases is based on two variables: gross domestic product (GDP) and unemployment levels. Recession being generally defined in economics as two consecutive quarters of negative growth in GDP, it will be used to narrow the number of European nations that have gone into recession following the 2008 origin of the crisis in the United States, as well as gauge those that have begun to recover. For the purposes of this paper, recovery will be defined as a return to positive growth, following a recession. This is due to the fact that a number of purportedly 'recovering' states have not yet surpassed their pre-recession GDP and employment levels. Unemployment, as another crisis and recovery indicator, will follow along the same lines. This is because of its direct impact on the population -who arguably feel its effects in a more direct way than a collapse in GDP. In this paper, states with lowering levels of unemployment following recession-related peaks are seen to be 'recovering', even if unemployment remains high in comparison to pre-recession conditions, due to the more gradual nature of employment rebounds.

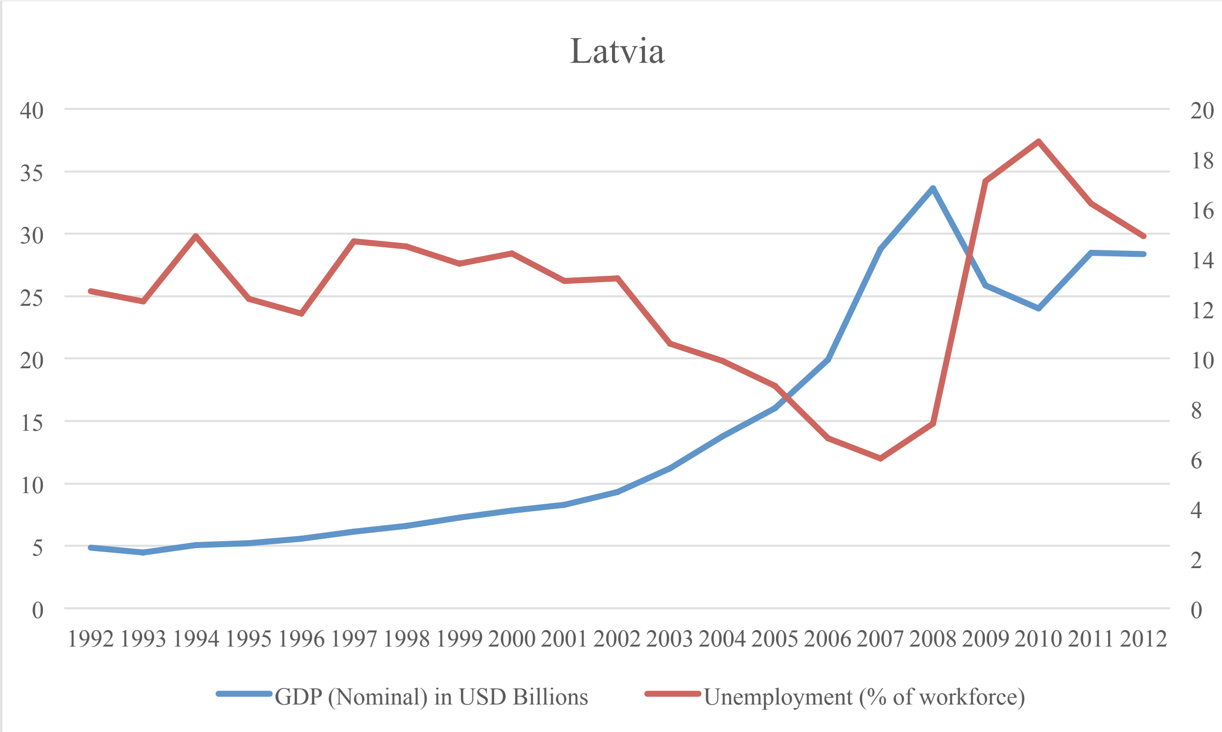
Having established the definitional parameters for crisis/recovery states, the methodological approach deemed most appropriate here to analyse and compare the extent to which these recoveries were impacted by degree of European integration is an *outcome-based* *comparative analysis* between three case countries that are recovering (as per the definition above) from the crisis. This form of analysis is useful in "unravel[ling] causal complexity by applying set-theoretic methods to cross-case evidence ... [which] researchers in comparative politics and related fields often seek to identify commonalities across cases, focusing on a relatively small number of purposefully selected cases."[10] The three cases selected are Iceland, Latvia and Ireland, all three being small, recovering European states (recovery being the key *outcome*), as shown in Chart 1. Where they differ (crucially), is in their degree of integration within the EU (see Image 1). Iceland, though geographically and culturally a part of the European continent and free trade area, is neither in the EU nor the Eurozone; Latvia, though in the EU, retained its monetary independence throughout the crisis (and adopted the euro afterwards); Ireland is both in the EU and the Eurozone. This key difference in situation along the spectrum of European integration will facilitate the comparison of the levels of 'equipment' available to each case state in responding to the 2008 financial crisis.

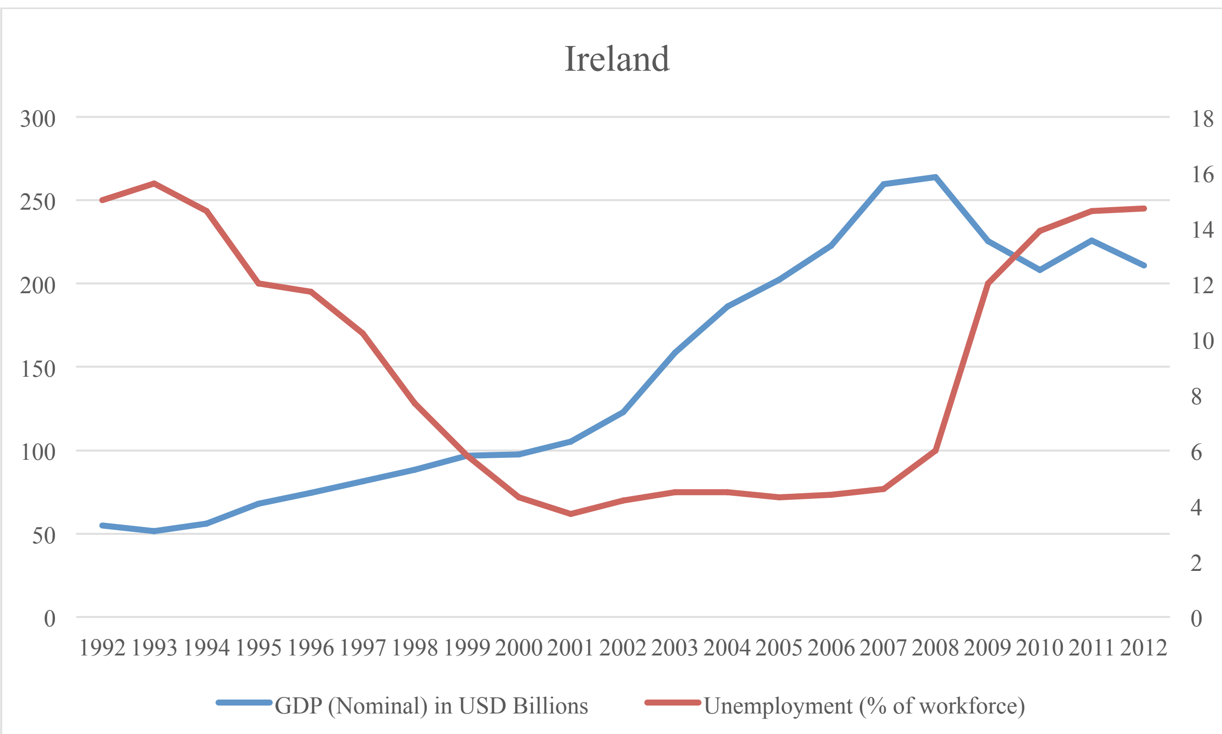
Chart 1: GDP and unemployment in Iceland, Latvia and Ireland.

In all three cases GDP fell drastically following the 2008 crash, unemployment rose, and then both either reversed or stabilized by 2011/12.



[10]BenoîtRihoux, "Qualitative Comparative Analysis (QCA), Fuzzy Sets, and Related Techniques," chap. 31 in *The Oxford Handbook of Political Methodology*, ed. Janet M. Box-Steffensmeier, Henry E. Brady, and David Collier (Oxford: Oxford University Press, 2008), 723-725.

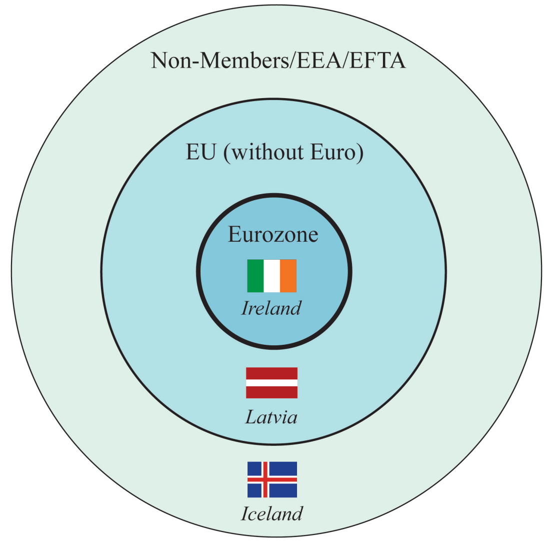




Source for chart data:

The World Bank. 2014. *GDP (current US$)*. Washington D.C.: The World Bank (producer and distributor of dataset). http://data.worldbank.org/indicator/NY.GDP.MKTP.CD

Image 1: Degrees of Integration



This diagram depicts the conceptual framework underlying the case selection. Each case state is recovering (see Chart 1), and each was situated differently along the spectrum of European integration when the crisis struck. A potential fourth category may be added for European states outside of any pan-European frameworks, like Belarus.

As a conceptual aid, this paper borrows from Benz and Broschek, who in their study of ongoing change in federal political systems provide a visual framework outlining a general pattern of evolution. This model provides an apt aid in carrying out this study, as the process of European integration is comparable to that of federal dynamics (as suggested by Viviane Reding's quote above). The approach (depicted in Chart 2a) involves three steps in explaining how change comes about. First are exogenous and endogenous sources of change, which generate the need to challenge the status quo. Second are the channels offered by that system for change to occur ('mechanisms' of change). These then translate the demands for change into the patterns of evolution in federal systems.[11]When applied to the change (responses) generated by states as a result of the financial crisis, this model provides a useful conceptual tool (see Chart 2b). The sources of change are the credit crunch spreading from the US (exogenous), as well as the domestic vulnerabilities specific to each case country (endogenous). These generate pressure on the channels of change ('equipment') available to each country, be they internal (e.g. austerity) or external (e.g. bailouts). The 'equipment' is therefore the toolkit that may be applied to a country in crisis, and in the case of Europe is highly dependent upon the degree to which a nation is integrated into the European framework (e.g. EU membership allowing for bailout funds, but being in the eurozone eliminates the option to devalue the national currency). These channels in turn shape the responses that are ultimately implemented, as well as the trajectory of the state towards further or less integration

[11]Arthur Benz, and JörgBroschek, *Federal Dynamics: Continuity, Change, and the Varieties of Federalism*, (Oxford: Oxford University Press, 2013).

Chart 2a: The Benz and Broschek model for change in federal systems.

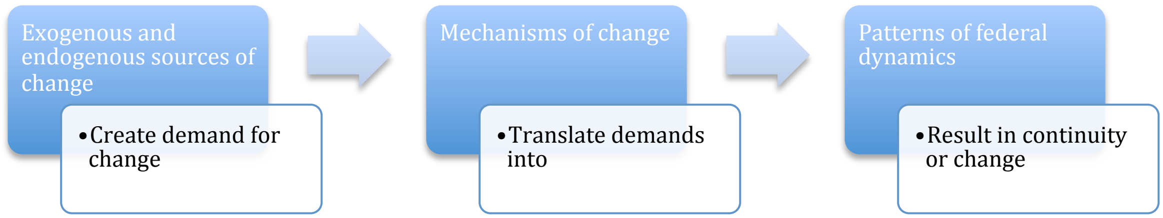
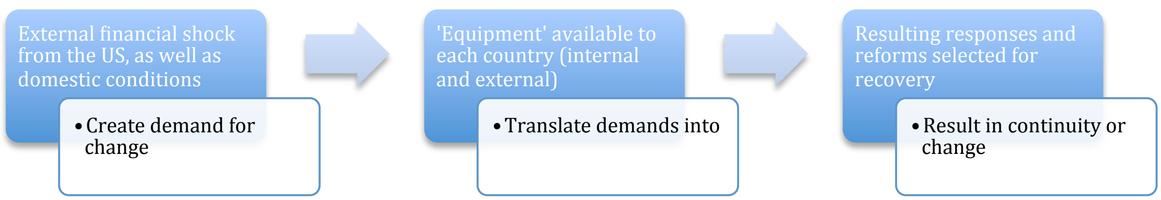


Chart 2b: The Benz and Broschek model applied to state responses to the 2008 financial crisis.



The two most important variables in this model for the purposes of this study are the ‘mechanisms of change’, or ‘equipment’ variable, as well as the ‘patterns of federal dynamics’ or ‘resulting responses’ variable. These elements are where a potential relationship is found, as their constituting factors (e.g. the decision to devalue the national currency, or to purchase poorly performing bank assets with EU funds) are what contribute to recovery (according to the myriad studies on this subject). They are also the decisions that result in a state’s continued path towards integration, or a reversal of this centripetal tendency in favour of further independence. As such, it will be the equipment deployed by state, non-state, supranational, and international actors in response to the crisis in each case country that will be studied and listed, so as to ascertain the extent to which degree of integration influences recovery.

The importance of the ‘equipment’ variable as a key dependent variable in defining the margins within which responses may be selected (and placement along the spectrum in Image 1) is because it is largely determined based on degree of integration within the EU framework. For example, Latvia’s situation as an EU member state but not within the eurozone granted it a broad toolkit of crisis-mitigation measures at its disposal, including EU bailout funding and the ability to devalue its currency. Though critical in establishing the toolkit, this ‘equipment’ variable does not explain *why* certain ‘tools’ are selected over others. To continue with the Latvian example, devaluation was never selected, in spite of the fact that it was as available as bailout funding from the EU (which was one of the responses selected). It is here that the second dependent variable is introduced –the ‘resulting responses’, or ‘tools’ that are ultimately selected. In order to explain this response-selection by the various actors involved in staving the 2008 financial crisis and to determine the impacts of integration, a theoretical approach grounded in historical and ideational experience will be drawn upon.

History Matters, Ideas Matter

In order for this study to assess the impact of degree of European integration upon the recoveries of European states, it first needs to determine the equipment available to each case state, as mentioned in the previous section. This helps establish rudimentary relationship between where a state is situated along the spectrum of integration, and its ability to recover. Where the study seeks to deepen its analysis into this relationship is in its parsing of the responses selected by actors from their respective toolkits. If currency devaluation –an option selected by Iceland (and widely argued to be successful) - was available to Latvia, why was it not implemented? It is this '*why?'* element that must be established through a review of the contextual factors –often rooted in history and culture- that came to influence the response packages deployed to combat the Great Recession (see Image 2).

For the purpose of exploring how each state ended up with their respective toolkits of available responses, and why they each narrowed their tool selection in the way they did, this study will draw from the language of *historical institutionalism*. As argued by Parsons, "Institutionalist claims are those that explain action by pointing to someone's position in a man-made but intersubjectively present obstacle course. Their man-made quality creates a logic of 'path dependence', in which earlier choices shape later ones in unintended ways."[12] The notion of path dependence is evident in the degree to which countries are integrated in the European framework, as each state's situation along this spectrum is the result of historical circumstances or choices. For example, the Common Travel Area (CTA) between the United Kingdom and the Republic of Ireland is a nine-decade-old agreement permitting the free movement of persons between the two countries, neither of which joined the Schengen Area of free movement between European countries (although they have bilateral agreements with it). The UK's continued preference for an independent immigration policy, ostensibly due to its insular geography[13], has led to its non-participation in the Schengen Area. Ireland, in spite of being an otherwise fully-integrated EU member state, and in agreement with the free movement of persons within the EU, has maintained the CTA in order to keep open its land border with Northern Ireland.[14] This unique arrangement is certainly path-dependent, as it falls into the category of "those historical sequences in which contingent events set into motion institutional patterns or event chains that have deterministic properties."[15] Had the UK ceded the entire island of Ireland to the newly independent Irish Free State in 1922, perhaps the Republic of Ireland (its successor) would now be a member of the Schengen Area. Further examples of path-dependence are displayed in the cases covered in this study, such as the feudal arrangement of Icelandic society, which persisted into the 20th century and contributed in setting the stage for the banking bubble that collapsed during the 2008 financial crisis.

Path dependence, as a notion, goes a certain distance in clarifying institutional outcomes –such as Ireland's non-membership in the Schengen Area. However, equally essential to

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12Parsons, Craig. "Institutional Explanation."In *How to Map Arguments in Political Science*. Oxford: Oxford University Press, 2007: 39.

13"House of Commons Hansard Debates for 12 December 1996 (pt 13)." www.parliament.uk. December 12, 1996. Accessed August 14, 2014. http://www.publications.parliament.uk/pa/cm199697/cmhansrd/vo961212/debtext/61212-13.htm.

14"DáilÉireann - Volume 450 - 14 March, 1995 Written Answers. - EU Border Controls."Historical Debates Website -Parliament of Ireland. March 14, 1995. Accessed August 14, 2014. http://historical-debates.oireachtas.ie/D/0450/D.0450.199503140014.html.

15James Mahoney, "Path Dependence in Historical Sociology," *Theory and Society*, 29, no. 4 (2000): 507.

institutional constraints in explaining the choices of actors are the *ideas* which drive them. Parsons defines "ideational elements" as "practices, symbols, norms, grammars, models, beliefs, ideas, and/or identities that carry meanings about the world."[16] These are crucial in enriching the perception and study of institutional change and continuity.[17] In short, ideas provide the *why* necessary to explain the choices and constraints of actors. In the CTA example, although the convenience and cost advantages of free movement of persons are clear motivating factors (no border stops, less personnel required to enforce border controls), there is something to be said about the contentious notion of the Irish border itself. Traditionally, there have been no road signs on either side of the border welcoming travellers to the UK or the Republic. Only recently has signage been erected in Northern Ireland stating "Welcome to Northern Ireland", a move that has been accused of "antagonising nationalists", who believe in a united Ireland.[18] The importance of free movement, therefore, is enriched when it is understood as a significant symbol of Irish unity, as are the island's single national rugby team and joint Gaelic sports leagues. Similar ideational factors are considered in each of the three cases which follow, such as Latvia's pursuit of westward integration after almost four decades of Soviet occupation, which in turn influenced the decision not to devalue the national currency, as had been the case in Iceland.

In short, the set of options available to all actors involved in the recovery of states from financial crises are largely path-dependent. This helps explain why Ireland could not devalue its currency, Iceland could not access EU bailout funding, and Latvia had relatively few barriers to drastic reductions in public sector wages. The choices ultimately selected in crisis mitigation, however (including why certain responses available were *not* deployed) are largely explained by the ideational influences motivating these actors. Among the most potent include the goal of integration into the EU framework (especially for Latvia), as well as austerity as an antidote to economic ills.[19] The 'European Idea' is in itself a driver of integration, and informs –explicitly or implicitly- the very conceptualization of the continent as more than a collection of states. This goes a certain way in explaining how €225 billion in taxpayer money[20] was disbursed between nations during the EUs sovereign debt crisis, and underlies many of the responses analyzed in the cases that follow.

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[16]Parsons, Craig. "Ideational Explanation."In *How to Map Arguments in Political Science*. Oxford: Oxford University Press, 2007: 96.

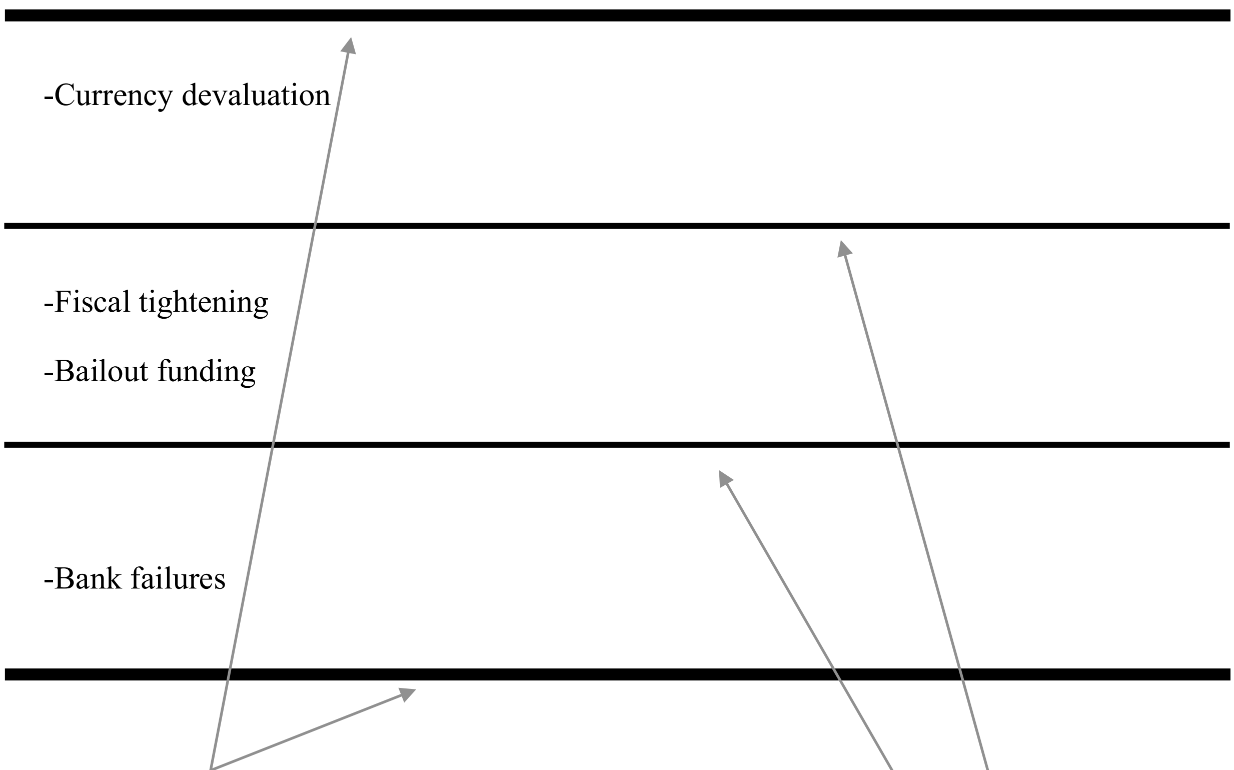
[17] Vivien A. Schmidt, "Discursive Institutionalism: The Explanatory Power of Ideas and Discourse," Annual Review of Political Science, 11, no. January (2008).

[18]"Welcome to Northern Ireland Signs 'for Information'" *BBC*, August 7, 2012. Accessed August 14, 2014. http://www.bbc.com/news/uk-northern-ireland-19169469.

[19] The notion of austerity as an idea is discussed in depth by Mark Blyth, of Brown University, in his 2013 book *Austerity: The History of a Dangerous Idea.*

[20]Ewing, Jack. "The Euro Zone Crisis: A Primer." *The New York Times*, May 22, 2012. Accessed August 15, 2014. http://economix.blogs.nytimes.com/2012/05/22/the-euro-zone-crisis-a-primer/?_php=true&_type=blogs&_r=0.

Image 2: The impact of history and ideas on response selection



The **'Corridor'** of action available to mitigate crisis in a state (responses that may be deployed). This range is set largely by the historical path that shaped the institutional reality of a state (e.g. its monetary independence or membership in the IMF).

The **reduced corridor** of available responses shaped by the ideational context (responses ultimately deployed). This smaller range is set by the various narratives that predominate at any given point in time (e.g. the notion of austerity as the only plausible solution to the 2008 financial crisis).

Case 1: The Icelandic Saga

"A free man can live on fish. Independence is better than meat."

–Halldór Laxness, *Independent People*

In September of 2008 the entire financial world watched in horror as Lehman Brothers –a large American investment bank- declared bankruptcy, causing a freeze in global credit flows. The contagion caused by this 'spark' spread rapidly throughout the highly interdependent global banking network, leaving no national economy unscathed, no matter how robust. The first, and definitely one of the hardest hit, dominoes to fall was Iceland, a mid-Atlantic island nation with the population of Cardiff, Wales. Having radically liberalized its banking sector, Iceland became very prosperous very quickly throughout the 1990s and early 2000s, earning the label 'Nordic Tiger', after Ireland's 'Celtic Tiger' boom economy of the same period. However, the highly underregulated banking sector leading the 'miracle' accrued enormous debt, amounting to several times the national gross domestic product (GDP). As such, when the Lehman shockwave reached Iceland's shores only a few short weeks after the bankruptcy, the island-state found itself ill-prepared to offset the damages caused when lenders began to demand repayment from its banks.

What ensued, in early October of 2008, was the near-complete collapse of the Icelandic banking sector, the largest of its kind in history.[21] In addition to the economic collapse was the disintegration of the party system that had dominated national politics since independence following the Second World War, as well as the powerful elite behind it. Far-reaching reforms and democratic procedures followed the economic crash, which would change the economic, political/partisan, and societal landscapes that had defined the nation for the better part of its millennial history. It is by employing this broader view of the crash as part of a national historical trajectory that this chapter seeks to assess the causes of and responses to the financial crisis as it manifested itself in Iceland. It will first draw from historical and discursive institutionalism to frame the national trajectory that led to the crisis. It will then gather the primary responses mobilized to lead to the spectacular (if ongoing) recovery that Iceland has witnessed following its worst recession since independence. These permissive and responsive factors will then be tabulated to contribute to this study's final comparative analysis.

[21]"Cracks in the crust." The Economist, December 11, 2008. http://www.economist.com/node/12762027

Background and the Boom

In order to delve into this paper's purpose regarding the extent to which degree of European integration helps or hinders the ability of crisis states to recover from the Great Recession, and the application of this purpose to the Icelandic case, the contextual backdrop against which this event occurred must first be established. Indeed, the roots of the country's economic collapse run deep into its thousand-plus-year history. As such, this story –a saga in itself- is best explained through an institutionalist lens. Identified here are the path-dependent and ideational influences that led to the dire situation and the significant measures undertaken by the island nation in the wake of its economic and political collapse.

First Phase: Feudal Residue and Path Dependence

Though recent archaeological discoveries reveal otherwise, the generally accepted story of Iceland's settlement begins in the year 874. Generations of Norsemen settled the mid-Atlantic island thereafter, leading to its feudal ties (as a vassal territory) to Norway and Denmark. This hierarchical system incubated for a millennium, remaining very present during Iceland's move toward home rule, and eventual independence from Denmark in 1944. Structures of land ownership have endured, which, as argued by Wade and Sigurgeirsdottir, have contributed to

> a path-dependent line of ascent from the quasi-feudal power structures of the nineteenth century to the modernised Icelandic capitalism of the later twentieth century, when a bloc of 14 families, popularly known as The Octopus, constituted the economic and political ruling elite, living like chieftains.[22]

The Octopus controlled all of the most important industries, including fishing, banking, media outlets and the supply of the US-NATO base –a non-negligible contributor to the small nation's 200,000-strong workforce. By extension, these 14 families anchored the party system that governed the country for the better part of six decades, centered on the right-leaning Independence Party (IP) and the Centre Party (CP). As such, they also controlled civil service, police, and judiciary appointments, furthering their grip on Icelandic domestic power levers.[23]The Octopus' origins being rooted in the nation's feudal history, as well as the nepotistic nature of the elite –many of whom knew each other from childhood, due to the country's small population[24]- points to continuity rooted in Iceland's past as a crucial element in the build-up to the crisis.

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[22] Robert H. Wade, and SillaSigurgeirsdottir, "Iceland's rise, fall, stabilisation and beyond," *Cambridge Journal of Economics*, 36 (2012): 131–32.
[23]Wade &Sigurgeirsdottir, *Iceland's rise, fall, stabilisation and beyond,* 132.
[24] Roger Boyes, *Meltdown Iceland: Lessons on the World Financial Crisis from a Small Bankrupt Island* , (London: Bloomsbury USA, 2009).

Second Phase: The Power of Ideas

The Octopus' grip on Icelandic politics and the national economy stood effectively unopposed (other than by trade unions) until well into the 1980s. However, the seeds of change of the clique's nature were sown from *within*. As early as the 1970s, a number of law and business administration students (many having informal or familial ties with the Octopus) took over one of the University of Iceland's journals, *The Locomotive*. Many of them being frustrated with the slow cronyism of the Octopus, as well as influenced by neoliberal economic ideas, used the journal "not just to promote free-market policies but also to open career opportunities for themselves, rather than wait for Octopus patronage."[25]

This budding network, known as the Locomotive Group, rose to prominence within the Icelandic business and political elite. Most notably, Davíð Oddsson, who would later become a long-serving IP prime minister, rose quickly through the party ranks, becoming a Reykjavik city councillor at age 26 and then mayor six years later in 1982. Within this role he applied much of the Locomotive's free-market ideology through privatisations (often to the benefit of fellow group members), including that of the local fishing industry.[26] Elected as prime minister in 1991, Oddsson immediately set about continuing his campaign to further privatize state assets and liberalize the Icelandic economy. Among the most important reforms under his government were the privatization of the national fish industry, with little opposition from the rest of the Octopus (which stood to gain the most from the move), as well as a drastic reduction in the corporate tax rate from 48% to 18%. The reforms which would prove to be the most significant in the long term, however, were the privatizations of public banks. The three largest state-owned banks were the FBA investment bank, Landsbanki, and Bunadarbanki, all of which were sold by the Oddsson administration in the late 1990s and early 2000s. In return, the emerging bank ownership –often tied to the Octopus and Locomotive- made significant political donations to the IP, and took in many party members as new hires, with the understanding of reduced regulatory oversight.[27]

What followed was the dramatic increase of bank assets, based largely on cheap credit and loose regulation of capital flows in and out of the country. These assets rose from just under two times the Icelandic gross domestic product (GDP) in 2003 to ten times national output right before the crash, in June 2008 –a ratio second only to Switzerland.[28] Due to the sudden flux of cheap credit, Icelanders incurred an unprecedented amount of debt, seeing their average wealth increase by 300% between 2003 and 2006[29], causing the rapid rise of a credit bubble. What is most significant from the period between the mid-1970s until the eve of the crash is the transformation that occurred. The stage was set by the cronyism that survived after the feudal era, but the power of neoliberal economics as an *idea,* and its interpretation by key figures had an enormous impact on the politics and economy of Iceland.

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[25]Wade &Sigurgeirsdottir, *Iceland's rise, fall, stabilisation and beyond,* 132-33.
[26]Wade &Sigurgeirsdottir, *Iceland's rise, fall, stabilisation and beyond,* 133.
[27]Boyes, *Meltdown Iceland.*
[28]Wade &Sigurgeirsdottir, *Iceland's rise, fall, stabilisation and beyond,* 134-35.
[29]Boyes, *Meltdown Iceland.*

Third phase: The Bubble

As mentioned above, enormous debts were accrued by Icelandic banks and households alike in the period following the privatization of the three major state banks. In his chapter from *The First Global Financial Crisis of the 21st Century*, a 2009 anthology on the global economic downturn, Jon Danielsson of the London School of Economics points to three factors influencing Iceland's vulnerability to economic trends abroad. The first is inflation targeting, one of the key roles of central banks, aimed at pinpointing the desired rate of currency inflation and deploying monetary policy tools (such as interest rate changes) to accomplish it. In Iceland's case, unusually high interest rates (sometimes reaching 15%) in the period leading up to the crash, aimed to curb inflation. However, they had the unintended effect of spurring Icelanders to trade or borrow in foreign currencies, as well as encouraging foreign speculators to move capital into the country, leading to large foreign currency inflows. This boosted the Icelandic currency –the króna- while simultaneously causing inflation, leading to the formation of a currency bubble.[30]

Danielsson's second factor stems from the first. In order for the currency bubble to form, the governance of the central bank had to have missed several opportunities to adjust its policy. The unique structure of Iceland's central bank has three governors, at least one of which is usually a former politician –often from the Octopus. As such, the independence of the central bank is questionable, as it may reflect the will of the political and banking milieu. Moreover, the former politicians serving as governors do not always have the technical expertise required to be central bankers. After serving for thirteen years as prime minister, and one year as foreign minister, Davíð Oddsson became a central bank governor, serving from 2005-2009 – when the crisis hit the hardest. Additionally, his appointment was questionable, due to his lack of explicit experience within the world of central banking, which has led some to believe that he furthered Iceland's vulnerability by not reacting in an optimal or timely manner to the credit bubble.[31]

The third factor is the aforementioned bloated banking sector. With bank assets totalling ten times the national GDP in the months leading into the crisis, there was no possibility for the state to adopt a US-style recapitalization program. As such, the high risks being taken by Icelandic banks –both domestically and abroad- could not be guaranteed by state coffers, unlike most other European countries (and without the aforementioned 'shelter' of EU membership). These three factors combined created a perfect storm of economic vulnerability that left Iceland heavily exposed to the shock that would come following the Lehman Brothers collapse of 2008.

The Crash

With over €50 billion in debt, compared to a national GDP of €8.5 billion, when Icelandic banks had to face lenders amid the emerging global credit crunch they could not count on the central bank as a lender of last resort. Moreover, their international bank branches were not independent subsidiaries, meaning they were directly dependent upon the Central Bank of Iceland for liquidity. The result was the re-nationalization of the three major banks in September 2008, following their inability to incur further debt to repay loans, and the IMF's involvement in a bailout –the first for a

[30] Jon Danielsson, "The first casualty of the crisis: Iceland," chap. 1 in *The First Global Financial Crisis of the 21st Century Part ll June-December 2008*, 9-10.
[31] Danielsson, *The first casualty of the crisis: Iceland*, 10.

developed country since the UK in 1976. Due to significant deposits in foreign branches, most notably in the UK and the Netherlands, the Icelandic government was now under pressure to guarantee them, in spite of these deposits representing several times the national output. Simultaneously, there was heavy capital flight from the island, causing the króna's value to plummet, and further hindering the government's ability to cover any deposits other than those held by Icelanders –a fraction of total holdings.

Regarding how this impacted the population, the complete collapse of the economic bubble that had been growing since the 1990s provided a rapid and brutal shock to the Icelandic people. The economy dove into recession, contracting by 15% internally (within the króna) and 65% externally (when adjusted for devaluation compared to the euro).[32] Unemployment had tripled by late November 2008, less than two months after the banking collapse[33], causing the downturn to be felt by many ordinary Icelanders, rather than solely the banking class. Wade & Sigurgeirsdottir describe the tension:

> Iceland's normally placid population erupted in an angry protest movement, principally targeted at Haarde [the prime minister], Oddsson and the IP … Thousands of people assembled in Reykjavik's main square on freezing Saturday afternoons between October 2008 and January 2009, banged saucepans, linked arms around the parliament building to demand the government's resignation and pelted the building with food.[34]

Their efforts were answered with the eventual breakup of the government coalition in January 2009. Within a few short months, Iceland had gone from one of the wealthiest nations per capita in the world, run by a historically-rooted elite, to an effectively bankrupt state that had ousted its political power structure. Where a general path consisting of incremental historical steps had predominated in Iceland's pre and post-independence periods, the timeframe roughly from the collapse of Lehman Brothers in September 2008 to the resignation of the Icelandic government in January 2009 represented a significant branching point in the nation's trajectory.

The Response

Though the roughly four-month period referred to above comprises the epicentre of the Icelandic crisis, the denouement resulting from these critical events is as important –if not more- to the development of the different Iceland that emerged. The way in which the country responded to the crisis was unique both in its political ramifications as well as its economic responses. This is largely due to the broad range of responses available to Iceland, as well as the singular set of actions ultimately selected by the government and people.

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[32]Danielsson, *The first casualty of the crisis: Iceland*, 12.
[33]IceNews, "Interest in jobs abroad." *IceNews*, November 22, 2008. http://www.icenews.is/2008/11/22/interest-in-jobs-abroad/
[34]Wade &Sigurgeirsdottir, *Iceland's rise, fall, stabilisation and beyond,* 138-39.

Political Response

Following the government resignation in the wake of the 'Kitchenware Revolution', a new government was formed from the opposition parties leading up to fresh elections in April of 2009. The new government, which won the eventual election, was the first left-leaning government (a coalition between the Social Democratic Alliance and the Left-Green Movement) since independence following the Second World War.

Furthering this significant shift, the new government was quick to acknowledge public momentum towards radical change in the nation's governance structure by recognising the creation of a citizens' assembly with the purpose of discussing the drafting of a new constitution. From late 2009 to mid-2011, a highly inclusive process was conducted, which eventually led to the tabling of arguably the first 'grassroots' constitution in modern history, which currently awaits final ratification[35]. In addition, a number of critical referenda and parliamentary votes were held on a range of important and pressing issues. First the Icelandic electorate was consulted on two occasions regarding the repayment of deposit insurance from Icelandic bank branches in the UK and the Netherlands –both times a resounding 'no' (an option not given to taxpayers in other crisis or bailout states). Second, the continuation of accession talks with the EU was also rejected –a significant path selection in favour of continued independence by the Icelandic electorate. Third, a parliamentary vote on whether to indict the prime minister at the time of the crisis, GeirHaarde, was held in 2010, and resulted in the calling of the Landsdómur, a special court for the trial of government members never convened since its creation in 1905. A last important shift was the election of the Best Party –a satirical party- to the municipal government of Reykjavik, Iceland's capital, in reaction to the traditional dominion of the Octopus establishment.[36] All of these radical changes following in the wake of the crisis are indicative of a largely new national context and path for Iceland's economic and political spheres. This political shift was critical in informing the economic responses that would follow, as it became clear that the solutions selected would have to place the interests of Icelanders above those of creditors.

Economic Response

From its trough of -6.6% growth in GDP for 2009, Iceland was able to return to positive growth by 2011 (at 2.9%)[37], a feat that few other nations affected by the Great Recession were able to replicate. This spectacular –albeit ongoing- recovery has been attributed to a wide variety of factors, five of which stand out most prominently. They are (in no particular order): the devaluation of the króna; the ring-fencing of domestic payment systems and subsequent refusal by the government (and electorate) to shoulder guarantees of the foreign accounts of Icelandic banks;

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[35] The Constitution has been stalled in Parliament since the 2013 parliamentary election. Although current prospects of its ratification are low, its very existence as a crowdsourced draft is significant, and future governments may incorporate it in their platforms.

[36] Casey, Michael. "Iceland's Ire Helps Comic's Campaign Take Fire." *The Wall Street Journal*, May 28, 2010. http://online.wsj.com/news/articles/SB10001424052748703630304575270382689239888.

[37] World Bank, "GDP growth (annual %) ."Last modified 2014.Accessed March 30, 2014. http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG.

the imposition of capital controls; emergency funding, both bilateral and from the IMF; and a broad-based reform program, consisting of renewed regulatory oversight of the financial sector, and fiscal consolidation at the government level. Each of these factors contributing to the Icelandic recovery warrant (and have generated) extensive literature, which describes them in more depth. For the purposes of this paper they are only briefly illustrated, their greater extent having been better identified by the authors sourced.

1. Currency Devaluation

One of the most significant, yet paradoxical elements of the Icelandic recovery is the devaluation of the króna (ISK). Trading at approximately ISK 90 per EUR 1 prior to the crisis, the collapse of the banking sector led to the rapid drop of assets denominated in the Icelandic currency, ing its drastic devaluation (it stabilized two years later at approximately ISK 180 per EUR 1). Thorhallsson and Kirby echo OECD Economic Department representative David Carey's diagnosis that this devaluation, though inflationary, propelled exports and mitigated immediate impacts on Icelandic competitiveness.[38] This argument that devaluation caused an important shift away from imports towards domestic products, leading to a trade surplus, is maintained by several economists, including Ólafsson and Pétursson of the Central Bank of Iceland.[39] Many also concede, however, that the unstable króna was partly responsible for the circumstances leading up to the crash, due to its vulnerability to capital flows in and out of the country. It is also seen as a source of potential issues in coming years, due to stubbornly high prices to consumers, whose real wages have decreased.[40]

2. Ring-Fencing Icelandic Debt

As mentioned in the previous section, the most visible vulnerability in the Icelandic banking sector prior to the crash was the size of total bank assets relative to the nation's GDP. Ballooning to ten times national output, the combined holdings of the three largest banks, FBA investment bank, Landsbanki, and Bunadarbanki, made any kind of US-style bailout via public funds impossible. An important factor in mitigating the devastating effects of the bankruptcy of these three main financial institutions was the division, or 'ring-fencing' of domestic banking from foreign activity, which was accomplished in several ways. Central Bank of Iceland Governor *Már Guðmundsson points to pre and post-crash efforts towards the "carving out [of] domestic assets and liabilities out of the old, failing banks" as the key which permitted the continued functioning of the payment system of Icelanders, while letting their international operations go into default. This effectively minimized the "socialization of private sector losses, and [created] the conditions for the reconstruction of a domestic banking system" at a more manageable scale vis*-à-*vis the Icelandic economy.*[41]

More visibly, if less financially significant, was the controversial decision by the Icelandic president, Ólafur Ragnar Grímsson, to call a referendum on the ratification of the Icesave bill, an act which would make the Icelandic government shoulder the responsibility of

[38] Baldur Thorhallsson, and Kirby Peadar, "Financial Crises in Iceland and Ireland: Does European Union and Euro Membership Matter?," *JCMS: Journal of Common Market Studies*, 50, no. 5 (2012): 812.
[39]ThorvardurTjörviÓlafsson , and Thórarinn G. Pétursson, "Weathering the financial storm: The importance of fundamentals and flexibility," *Central Bank of Iceland* , 51 (2010): 1-46,
[40]Thorhallsson& Kirby, *Financial Crises in Iceland and Ireland*, 812.
[41]Guðmundsson, Már. Central Bank of Iceland, "Opening Address: The financial crisis in Iceland and Ireland: What are the lessons five years later?." Last modified November 28, 2013.Accessed April 5, 2014. http://www.sedlabanki.is/library/Skráarsafn/Ræður--erindi-og-greinar/Ræða MG Harpa Nov 2013.pdf..

*guaranteeing the deposits of British and Dutch account-holders in Icelandic bank branches abroad (who outnumbered the entire population of Iceland). This decision, as well as the subsequent 'no' vote by the Icelandic electorate caused a row with the governments of the UK and the Netherlands, the former using controversial legislation to freeze all assets belonging to the bank concerned (*Landsbanki*'s Icesave product). This dispute, however, is of decreasing significance, as it appears that the asset recovery of the failed bank may cover upwards of 90% of the funds owed.*[42] *As such, it is arguably more significant symbolically, representing the popular refusal to bail out failed private institutions with public funds.*

3. Capital Controls

Prior to the crash, Iceland (and the króna*) was a favoured destination for carry trade, due to a very high benchmark rate (reaching 18% in 2009) set by the Central Bank of Iceland. Consequently, significant holdings in ISK belonged to non-residents drawn to the potential for high returns on their investments. With the credit bubble collapse in 2008 came the threat of capital flight from the island, which would cause further drops in the value of the* króna. The Central Bank decided to breach the European Economic Area (EEA) Agreement, which obligated Iceland to maintain the free movement of capital with other member states, by imposing capital controls. This restriction on the outflow of capital is cited as one of the most significant protective measures in mitigating domestic impacts, as it was crucial in preventing a complete collapse of the currency.[43] Conversely, it should be mentioned that there are projections that these controls will have a negative effect on the Icelandic economy in the medium-to-long terms if maintained. These are largely attributed to restrictions on investment abroad by large institutions such as pension funds, which are increasingly exposed to risks related to domestic overinvestment, and lack of portfolio diversity. As such, increasing pressure has been mounted on policymakers to further relax or remove the controls in spite of their positive immediate effect.[44]

4. Bailout Program

In order to respond to the banking and currency crises while keeping its own finances afloat, the Icelandic government sought bailout funds from a wide variety of actors, including fellow Nordic countries, Russia, and the International Monetary Fund (IMF). After some stalling by Britain and the Netherlands due to the Icesave dispute, the IMF consented in November 2008 to a Stand-By Arrangement, involving a €2 billion loan from the Fund and another €2 billion loan from the Nordic countries and Poland. This funding permitted the country to continue functioning in spite of heavy losses in productivity and employment, and undoubtedly played a role in allowing Iceland to recover. Access to this type of emergency funding, however, was far more difficult for Iceland to acquire than its EU member-state counterparts.[45]

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[42]Wade &Sigurgeirsdottir, *Iceland's rise, fall, stabilisation and beyond,* 139.

[43] International Monetary Fund, "Iceland: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-by Arrangement," *IMF Country Report*, 12, no. 91 (2012): 20.

[44]M. Baldursson, and Richard Portes, "Capital controls and the resolution of failed cross-border banks: the case of Iceland," *Capital Markets Law Journal*, 9, no. 1 (2014): 40-54.

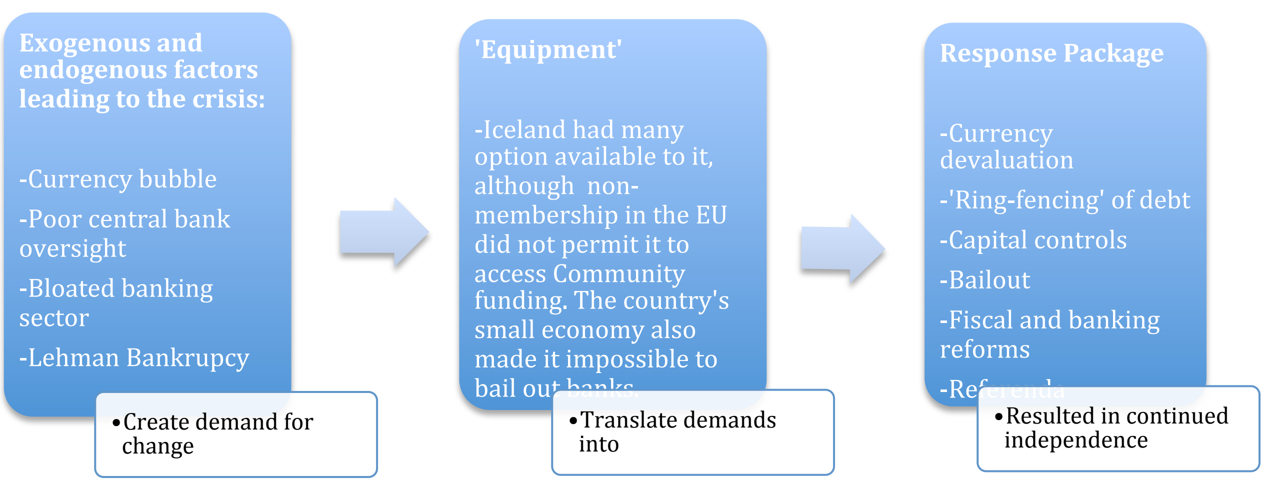
[45]Thorhallsson& Kirby, *Financial Crises in Iceland and Ireland*, 815.

5. Reforms

As a combination of the conditions attached to the bailout funding by the IMF, and independent initiative by the Icelandic government, a series of regulatory and fiscal reforms were undertaken in order to radically transform the banking sector and rein in public spending. These were conducted in conjunction with the "new/old" bank split, or ring-fencing, and aimed at avoiding the same bubble from re-emerging, as well as consolidating government expenses while minimizing impact on the wider Icelandic public.[46] Key among these reforms were heightened capital requirements for banks (16%); a transferral of shares in the "new" (consolidated) banks to creditors of the "old" banks (called a *debt-to-equity swap*) so as to avoid complete loss, while not necessitating a compensatory reimbursement; a shift away from 'catch-all' deposit insurance (which led to the row with British and Dutch depositors); and strengthened supervision of the banking sector.[47] Alongside these reforms was the significant fiscal consolidation of the government, amounting to approximately 9% of GDP over two years. This consisted of a balance between civil service wage-cuts, fixed-capital expenditure reductions, and broad-based tax-hikes (as opposed to targeting key increases), while preserving the core elements of the welfare state, as expressed by the government in its talks with the IMF, which remained remarkably flexible throughout the operation.[48]

Results

Based on the above analysis of Iceland's experience of the Great Recession, a number of root causes and responses to it have been identified. The following chart adapts the Benz and Broschek model for change in federal systems to this case by incorporating the key inputs outlined in this chapter:



[46] International Monetary Fund, *Iceland: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-by Arrangement,* 12.
[47] International Monetary Fund, *Iceland: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-by Arrangement,* 13-17.
[48] International Monetary Fund, *Iceland: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-by Arrangement,* 17-18.

The key mechanisms outlined in the Response/Equipment section being the elements to be used in the concluding comparative analysis, it is important to outline their points of origin (national, EU, or international). As Iceland is not an EU member state, it may seem obvious that no response would originate in the EU. However, even non-member states may experience pull-factors from the EU that shape responses, as is discussed below. The following table outlines these points of origin:

Factor	***EU Origin***	***National Origin***	***International Origin***
Currency Devaluation		X	
'Ring-fencing' debt		X	
Capital Controls		X	
Bailout			X
Reforms		X	X
Referenda		X	

As mentioned above, it may seem obvious that Iceland's factors of recovery were primarily endogenous. However, there are several reasons why this is not entirely the case. First, there is the possibility of pull factors generated by the EU that shape Icelandic policy. A good example of this is Latvia's decision not to devalue the national currency (the centerpiece of their recovery policy). Although the decision was made internally, it was the prospect of euro accession that motivated Latvian decision-makers not to break from the peg to the euro – implying a shared origin in the response. Second, when the British and Dutch governments demanded that Icesave accounts in their countries be guaranteed by the Icelandic government, the path towards EU membership that was established in July 2009 could have been maintained, but instead there were the referenda held to consult Icelanders on their appetite for shouldering $5.5 billion more in debt to guarantee foreign accounts. Had EU accession been a priority among the Icelandic public this would likely have been ratified in parliament without any consultation. However, the two 'no' votes, as well as the subsequent election of an anti-accession government in 2013 indicates the lack of an EU pull-factor in the eyes of the public.[49]

Of equal importance is the fact that European Economic Area (EEA) membership is at the root of the Icesave dispute. The 'European Passport' is the term utilized for EEA credit institutions and investment firms opening branches in other EEA countries without creating subsidiary entities.[50] In the Icelandic case, Landsbanki introduced the Icesave high interest savings product to the Dutch and British publics as though they were the Icelandic public, as was permitted under Community law. The result was that when the 'ring-fencing' of international banking activities from domestic banking activities occurred, several hundred thousand British and Dutch account holders were not protected under the Icelandic deposit guarantee scheme, nor were they protected by their own governments as Icesave was not a British or Dutch entity. The resulting dispute is therefore attributable in large part to the lax regulatory landscape –originating at the European level- which permitted this high-risk maneuver.

[49]"The Icesave Bill." *The Economist*, August 13, 2009. Accessed August 7, 2014. http://www.economist.com/node/14214986.
[50]*The European Passport*. Bonn and Frankfurt Am Main: BaFin, 2013.

The Icelandic experience of the 2008 global financial crisis, as well as its unique recovery, may be summarized in the title of Nobel laureate Halldór Laxness' 1930s epic novel *Independent People*. The repeated refusal by Icelanders of the terms set by outside actors are what most distinguish this case from others. Recovery, though partial (Iceland is only now working towards lifting capital controls, and retains relatively high borrowing costs on international capital markets) is a reality, and was largely crafted domestically. This is no small feat for a nation of just over 300,000, and presents an interesting set of responses to compare with the remaining two cases.

Case 2: The Latvian Tragicomedy

"The last student out at the airport, please turn off the lights!"

-Latvian student protest placard

Introduction

The second case considered for this study is Latvia. This small state experienced one of the worst economic declines in the world in 2008, its GDP contracting by 25% from its peak in late 2007 to its trough just under two years later. Equally drastic was its rise in unemployment from 7% to 22.8% over roughly the same period. From this abyss the country recovered almost as quickly –GDP rose 18% and unemployment fell to 11.4% by early 2013. A fascinating story in itself, this economic rebound is ideal for the study of the extent to which degree of integration in the EU framework impacts on the ability of states to recover from economic shocks. Though it is a member state of the EU, it maintained its own currency throughout the crisis, eventually joining the Economic and Monetary Union (EMU) on 1st January 2014. As such, it is ideally placed between Iceland and Ireland on the spectrum of European Integration (see page 13).

This chapter will first outline the short history of the modern Latvian state following the collapse of the Soviet Union, including its rapid economic rise. Second, it will describe the factors that caused the severe economic downturn the country experienced, and is still feeling the effects of. Third, it will identify the key factors leading to recovery. It will conclude by comparing the origin of each of these factors (EU, domestic, or international) in order to infer the extent to which EU membership played a role in the recovery. The key finding is that though further EU integration was a motivating factor, it was primarily internally-generated efforts unique to the Latvian context that led to its recovery.

Background and the Boom

Due to its history as a territorial shuttlecock between Russia and Germany throughout the centuries succeeding the Teutonic crusades of the 13th Century, the small Baltic state of Latvia immediately sought to align itself with the West following its most recent independence in 1991, during the Soviet collapse. Membership in the United Nations and the International Monetary Fund were rapidly acquired, as well partnership agreements with NATO and the EU, both of which Latvia wished to join, and eventually did. Seen as "a tool for strengthening independence, security and sustainable development of Latvia"[51], membership in international organizations represents a kind of insurance policy for the country of 2 million, which neighboured the Soviet behemoth that occupied it most recently for almost four decades.

In their landmark study of the Latvian experience of the 2008 financial crisis, Blanchard, Griffiths and Gruss of the IMF point to a number of key factors underlying the economic boom in Latvia following independence. In the immediate aftermath of the split from the USSR, relatively low incomes, fairly strong institutions, and an educated workforce all contributed to what the authors label a 'catching-up' period with the rest of the West. Lasting until approximately 2000, this decade saw the Latvian currency –the lat- pegged to the SDR (the IMF's basket currency unit), and steady GDP growth (in PPP terms) of approximately 6.5% annually. From 2000 to 2004, growth accelerated to an average annual rate of 9%, which could no longer be attributed to 'catching up' alone. Following Latvian accession to the EU in 2004, as well as the re-peg of the lat to the euro, an average annual growth rate of 11.6% and a change in unemployment from 14% in 2000 to 6% in 2007 were indicative of "cyclical…unhealthy" growth.[52] By this point the Latvian boom was showing clear signs of overheating.

Underlying this incredible acceleration in growth were a number of factors. First and foremost was an increase in domestic consumption, led by a real estate boom. A cycle of high inflation (in spite of the peg) minimized or eliminated the interest costs of mortgages. In addition, the "prospects of catch-up growth, prospects of joining the EU, and later joining the euro" boosted additional demand and fueled the construction boom which generated 40% of the increase in employment between 2000 and 2007. This furthered the inflation cycle, which reached 10.1% in 2007 and 15.3% in 2008 –the highest in the EU.[53]

Funding this phenomenon were banks from other Nordic countries –especially Sweden- with Latvian subsidiaries. Aiming to benefit from the Latvian boom, these foreign creditors fueled it further through lending patterns that former Latvian prime minister Valdis Dombrovskis qualified as "irresponsible"cx.[54] Liabilities to foreign banks on the books of Latvian banks stood at 30% of GDP in 2000, rising to approximately 90% in 2007.[55] Moreover, the growth generated during this period fed demand for imports rather than domestic goods and services. This consumption pattern led to a current account deficit peak of 25% in 2007. The combination of

[51]Ministry of Foreign Affairs of the Republic of Latvia."International Organizations."2014. http://www.mfa.gov.lv/en/policy/InternationalOrganizations/

[52]Blanchard, Olivier, Mark Griffiths, and BertandGruss. "Boom, Bust, Recovery Forensics of the Latvia Crisis", Brookings, 2013, 4-5.

[53]Blanchard, Olivier, Mark Griffiths, and BertandGruss."Boom, Bust, Recovery Forensics of the Latvia Crisis", 5.

[54]Ward, Andrew. "Latvia issues warning to Swedish banks." *Financial Times*, December 22, 2009, sec. World.

[55]Blanchard, Olivier, Mark Griffiths, and BertandGruss."Boom, Bust, Recovery Forensics of the Latvia Crisis", 6.

these domestic factors contributed to the overall vulnerability of the Latvian economy to a significant correction, as did the Lehman collapse in 2008.

The Crash

Where the Latvian scenario turns from economic miracle to the tragicomedy of deep recession and eventual recovery is in the period from 2006 to 2008. The ‘catching-up’ of the Latvian economy with its western European counterparts had transformed into an overheated bubble economy. In their 2011 book *How Latvia Came Through the Financial Crisis*, Swedish economist Anders Åslund and former Latvian Prime Minister Valdis Dombrovskis explore the causes of and responses to the crisis. They point to a combination of five key blows to the Latvian economy, which had become vulnerable for the reasons mentioned above. These included:

> “a tightening of the regulatory policies of the central bank in the area of real estate lending; as well as a nearly total withdrawal of credit by the largest Swedish banks; the Lehman Brothers bankruptcy with a brief total freeze of global liquidity; the Parex Bank fiasco (Parex was the largest and most successful domestically owned commercial bank); and the inaction by the European Central Bank (ECB).”[56]

The overheating real estate boom fueled by easy credit from domestic and foreign lenders had already been identified as a substantial risk to the Latvian economy. Between 2005Q1 and 2007Q1, the Latvian house price index (HPI) increased by 134.3%[57], generating warnings from a number of commentators, including the minister of finance Oskars Spurdzins, whose ministry implemented an anti-inflation plan in 2007 outlining “measures to implement a deficit-free budget and prevent a "hard-landing".”[58] These included mortgage-lending restrictions and increased reserve ratios for banks. Although the desired effect of reduced lending was achieved, it would also amplify the eventual credit freeze that would cross the Atlantic a few months later.[59]

The second factor contributing to Latvia’s economic collapse was the withdrawal of investment and credit from foreign (especially Swedish) banks. SEB and Swedbank started this trend in 2007 by reining in their credit policies in the Baltic nation. This hit the construction and real estate sectors, upon which Latvia’s rapid growth largely depended, leading to a 35% per annum fall in housing prices and a drop in consumption. When combined with record inflation of 17.9% in May of 2008, Latvia was already in a highly precarious state.[60]

By the time the third factor –the Lehman bankruptcy- hit Latvia in the autumn of 2008, the country was already in a state of crisis. What little credit was available came to a complete

[56]Vīksniņš, George J. "How Latvia Came through the Financial Crisis." *Journal of Baltic Studies* 43: 309.

[57]Eurostat. "House Price Index." . http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=prc_hpi_q&lang=en (accessed June 30, 2014).

[58]Saule Archdeacon, Talis . "Finance minister defends anti-inflation plan." *Baltic Times*, April 4, 2007.

[59]Åslund, Anders, and ValdisDombrovskis. *How Latvia Came Through the Financial Crisis*. Washington: Peterson Institute, 2011: 34.

[60]Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 35.

standstill. Highly affected by the ensuing global credit freeze was Latvia's largest domestically-owned bank, Parex Bank, which held 20% of all bank assets in the country. The fourth factor was Parex Bank's collapse, due to a loss of confidence by (primarily Russian) account holders, who withdrew 25% of deposits between August and November of 2008. At this point the Latvian government had to intervene by purchasing 51% of the bank's ownership for a symbolic 2 lats, and proceeded to partially freeze withdrawals, while recapitalizing it at a cost of 4.9% of GDP.[61]

Highly needed liquidity following the credit freeze and costly bank recapitalizations was unavailable in the immediate term to Latvia from the European Central Bank (ECB), as the country had not yet joined the Eurozone, and the stability of member states without the euro is not explicitly included in the Bank's mandate.[62] According to Åslund and Dombrovskis, this inability to secure stable liquidity immediately (eventual loans were obtained from the EU, the IMF, and other Nordic Countries) prevented the government from effectively dealing with the multiple shocks that were being felt.[63]

In their report on Latvia, Blanchard, Griffiths and Gruss point to similar factors as Åslund and Dombrovskis, but divide them into two phases: first the natural downward trend of a boom cycle –labelled "fatigue"- from 2006-2007; second the "sudden stop" caused by the global credit crunch in 2008 exacerbated the existing contraction.[64] As such, largely *endogenous* factors such as easy credit facilitated by relaxed banking regulation commenced the recession, while *exogenous* factors such as the global credit freeze turned the situation into a full-blown crisis.

The Response

As a result of the factors described in the previous section, Latvia's GDP decreased by 25% from the fourth quarter of 2007 to the third quarter of 2009, mirrored by a rise in unemployment from 6% to 21% over virtually the same period.[65] It is in this setting that drastic action was taken by the Latvian government to recover from deep recession. The following section outlines the factors leading to Latvia's often lauded recovery, which includes 18% growth in GDP from late 2009 to the first quarter of 2013, and reduction of unemployment to 11.4% by mid-2013.

As previously mentioned by Blanchard *et al.* the dual nature of the Latvian crisis (endogenous and exogenous) meant that a portion of the recovery would result from adjustment efforts at the national level, but full recovery also depended on the global recovery.[66] Very early on in the crisis, suggestions of devaluation by unpegging the lat were floated by several economists, notably from the IMF. However, this option was quickly dismissed by the Bank of Latvia, the government, and even the Latvian people, who remained determined in their goal of

[61]Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 35.
[62]Pisani-Ferry, Jean, and Adam S. Posen. *The Euro at Ten: The Next Global Currency*. Washington: The Peterson Institute For International Economics, 2009: 5.
[63]Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 35.
[64]Blanchard, Olivier, Mark Griffiths, and BertandGruss. "Boom, Bust, Recovery Forensics of the Latvia Crisis", 11-12.
[65]Blanchard, Olivier, Mark Griffiths, and BertandGruss. "Boom, Bust, Recovery Forensics of the Latvia Crisis", 1-2.
[66]Blanchard, Olivier, Mark Griffiths, and BertandGruss."Boom, Bust, Recovery Forensics of the Latvia Crisis", 17.

euro accession. Åslund described this situation in his October 2009 presentation to the Annual Conference of the Bank of Latvia:

> As late as August 2009, an opinion poll reported that almost two-thirds of the Latvians wanted the lat peg to the euro to remain unchanged. They seemed prepared to take substantial social costs, including large wage cuts, and the Latvian labor market is very flexible. An early euro adoption remains their goal, with the government committed to reaching the Maastricht criteria and adopting the euro by 2014.[67]

In order to achieve these goals, the Latvian government opted for *internal* rather than *external* devaluation. By this is meant that, rather than devaluing the lat vis-à-vis foreign currencies so as to boost Latvian competitiveness, the peg with the euro was maintained, and the competitiveness would come from drastically reduced labour costs combined with significant fiscal consolidation by the government. It is this approach that has earned Latvia its reputation as a poster child for the pro-cyclical crisis management endorsed and prescribed by the European Commission, whose president at the time, José Manuel Barroso, presented Latvia as a "shining example" to other crisis-stricken member states.[68] Although many initial observations surrounding the Latvian recovery attributed the return to growth to drastic measures of fiscal consolidation and steadfast monetary policy, numerous commentators have since challenged this notion as the sole cause of recovery. Although there is much evidence suggesting budgetary discipline has helped in the timely management of the country's bailout package debt (the first of six factors identified here) and rapid return to the bond market[69], these commentators also point to strong productivity gains, a burst of inflation in 2010/2011, and the return to a positive trade balance –all of which were facilitated by Latvia's unique cultural cadre.

1. *The Bailout*

Although the Latvian budget had remained fairly balanced in the years leading up to the crisis, the sudden drop in government revenue caused by the depletion of economic activity led to a deficit of 3.4% of GDP, not including the capital required to restructure Parex.[70] This, as well as the aforementioned run on the banks increased the need for immediate liquidity. Following negotiations in December 2008 with the IMF, EU, and Nordic partners, a €7.5 billion bailout program was deployed, permitting the Latvian government to receive the first tranche by Christmas time. It is worth noting that Latvia only used €4.4 billion of the available funding, which furthered its image as the poster child of recovery through fiscal austerity rather than expansionism. The funding made available to Latvia by non-EU creditors amounted to €3.9 billion (89% of the total used) –an important consideration for the purpose of assessing the extent to which degree of integration in the EU framework (including its bailout funding) impacts the ability of states to recover from financial crises.

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[67] Åslund, Anders. "How Latvia Can Escape from the Financial Crisis." Lecture, Presentation to the Annual Conference of the Bank of Latvia, Riga, October 1, 2009. from Peterson Institute for International Economics, Riga, October 1, 2009.

[68] *New Europe*, "Barroso: Latvia a "shining example" for other member states," January 10, 2014.

[69] Blanchard, Olivier, Mark Griffiths, and BertandGruss."Boom, Bust, Recovery Forensics of the Latvia Crisis", 3.

[70] Blanchard, Olivier, Mark Griffiths, and BertandGruss."Boom, Bust, Recovery Forensics of the Latvia Crisis", 18.

2. Fiscal Consolidation

In parallel to Latvia's bailout negotiations with international creditors in December 2008, the government passed a budget for 2009 which drastically reduced spending, amounting to 7% of GDP in cuts. This approach survived the February 2009 change of government, and was expanded through additional measures including a 20% cut in government wages, and a less progressive income tax. In all, Blanchard *et al.* estimate a decrease in government spending of 8% of GDP in 2009, 5.4% in 2010, and 2.3% in 2011[71] –all representing impressive sacrifice by Latvians, who offered little resistance or organized protest in comparison to other crisis-stricken EU member states. When combined with the maintenance of the peg, these measures sent a clear message to credit rating agencies and investors that the Latvian government would go to great lengths to balance its books and avoid inflation. Indeed, long-term interest rates on government bonds dropped from 13.8% at the end of 2009 to 5.6% in the summer of 2011.[72]

3. Productivity Gains

Although the fiscal consolidation likely sent the right signal to investors, Blanchard *et al.* point to the gains in labour productivity achieved in the wake of the crash as one of the strongest drivers of the recovery. They maintain that the internal devaluation "worked, but in ways different from the textbook adjustment. Public wages decreased sharply, but with limited effects on private wages. Much of the improvement in unit labor costs, especially in the tradable sector, came from increases in productivity."[73] A strong decrease in Latvian unit labour costs (ULCs – the cost of labour relative to national output) may be attributed to wage cuts and labour shedding until mid-2009 (when unemployment peaked), but low ULCs persist even today, indicating productivity improvements in Latvian businesses, thanks to any number of efficiency efforts developed by individual firms. Latvian ULCs remain 20-25% lower than in the lead-up to the crisis, which has boosted the country's competitiveness enormously.[74]

4. Burst of Inflation

An unintended factor influencing Latvia's recovery from the crisis is a burst of inflation that occurred in 2011. In their account of Latvia's internal devaluation, Weisbrot and Ray point to the stagnation, and eventual deflation of the lat during the crisis (inflation reaching -4.2% in the first quarter of 2010) as a result of the rigid peg and fiscal contraction. They argue that these key policies linked to the internal devaluation were in fact detrimental to the recovery, and that it was not until fiscal policy shifted from a reductionist approach to a more neutral one, coupled with an increasingly expansionary monetary policy in 2010 that Latvia's recovery began in earnest.[75]The subsequent burst of inflation, reaching 5.6% in the summer of 2011, "lowered the country's debt burden … increased investor and consumer confidence (including confidence that the peg would hold, which facilitated the maintenance of more expansionary monetary policy)."[76] This aspect of the recovery is perhaps more controversial, as it challenges the government-IMF-EU prescription of austerity (internal devaluation) as a driver for competitiveness, rather than external (currency) devaluation.

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[71]Blanchard, Olivier, Mark Griffiths, and BertandGruss."Boom, Bust, Recovery Forensics of the Latvia Crisis", 18.
[72]Weisbrot , Mark, and Rebecca Ray. "Latvia's Internal Devaluation: A Success Story? ."*Center for Economic and Policy Research*, 2011, 12.
[73]Blanchard, Olivier, Mark Griffiths, and BertandGruss."Boom, Bust, Recovery Forensics of the Latvia Crisis", 3.
[74]Blanchard, Olivier, Mark Griffiths, and BertandGruss. "Boom, Bust, Recovery Forensics of the Latvia Crisis",21-22.
[75]Weisbrot , Mark, and Rebecca Ray. "Latvia's Internal Devaluation: A Success Story?", 12-14.
[76]Weisbrot , Mark, and Rebecca Ray. "Latvia's Internal Devaluation: A Success Story?", 13.

5. Trade Balance

As previously mentioned, Latvia's trade deficit leading up to the crisis was substantial, reaching 25% in 2007. As the bubble burst, domestic appetite for imported goods and services (or anything for that matter) dropped substantially. Consequently, Latvia reached a current account surplus by 2009 –a first for the Baltic state since independence. Additionally, the recovery was led by a surge in exports, rising by 29.5% in 2010. Åslund and Dombrovskis attribute this unprecedented rise to exports coming from manufacturing –a more sustainable source than the pre-crisis real estate and construction sectors. Wood and metal products played a particularly strong role, leading the manufacturing sector's 14% expansion in 2010.[77] Though imports also rose as consumer confidence rebounded, a healthier trade balance has become an integral part of the new Latvian economy.

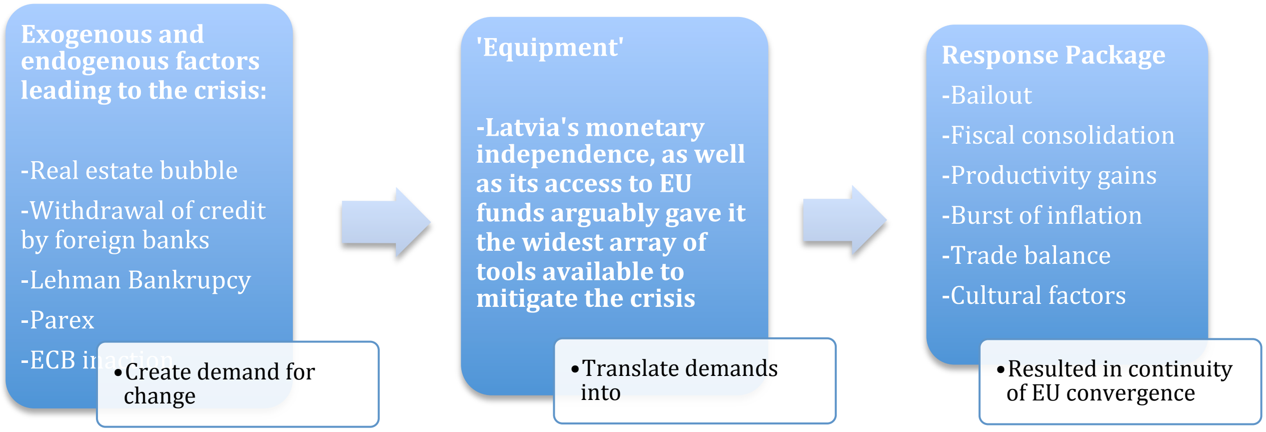
6. Cultural Factors

Less quantifiable, but of critical importance to the Latvian recovery are the culturally unique attributes that impacted the national response to the crisis. The country's recent USSR occupation left the somewhat ironic legacy of weak labour unions (independent unions being banned in the Soviet Union). A number of commentators, including Anders Åslund, point to this as a factor facilitating the drastic wage reduction –especially in the public sector- that was central to the internal devaluation.[78] This approach would arguably not be possible in other crisis states with stronger organized labour traditions, such as Greece. A second cultural factor that had a strong impact on the rebound in employment statistics was the mass exodus of (especially young) Latvians seeking work abroad. Between 2009 and 2011, an estimated 120,000 Latvians (roughly 10% of the workforce) emigrated to other, primarily EU countries. Were it not for this movement, unemployment may have reached 29% in late 2011 (rather than 21.1%).[79] Third, it was largely understood by Latvians that the boom was a temporary peak, not a new norm.[80] As such, it may be argued that the internal devaluation was perceived as an inevitability, especially as euro membership remained a priority of the Latvian people throughout much of the crisis. These factors unique to the Latvian context were not as present in other crisis-stricken European states, and are important in explaining how the austerity doctrine was so easily applied in comparison.

Results

The above narrative serves to provide the inputs necessary in assessing the extent to which Latvia's degree of integration impacted the equipment that was deployed in response to the Great Recession. When applied to the Latvian experience, the Benz and Broschek model tracing change in federal systems resembles the following:

[77]Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 103.
[78]Åslund, Anders. "How Latvia Can Escape from the Financial Crisis."
[79]Weisbrot , Mark, and Rebecca Ray. "Latvia's Internal Devaluation: A Success Story?", 1.
[80]Blanchard, Olivier, Mark Griffiths, and BertandGruss."Boom, Bust, Recovery Forensics of the Latvia Crisis", 23.



The key variable being the response package ultimately selected, it is important to identify the extent to which each factor in it was related to membership in the EU. The following table identifies whether each factor originated at the national, EU, or international (e.g. IMF) level:

Factor	*EU Origin*	*National Origin*	*International Origin*
Bailout	X		X
Fiscal Consolidation	X	X	X
Productivity Gains		X	
Burst of Inflation		X	
Trade Balance		X	
Cultural Factors	X[81]	X	

What becomes evident is that the majority of the factors driving Latvia's recovery originated domestically. Moreover, the fiscal consolidation (and the internal devaluation strategy as a whole) was primarily driven by domestic actors, and facilitated by Latvia's flexible labour culture. The IMF was initially clement to the devaluation of the lat, which Latvian policymakers rejected in favour of maintaining their goal of euro-adoption. The prospect of 'full' EU membership, therefore, is of critical importance to the country's approach. As for the bailout's multi-jurisdictional origin, the EU not only provided the largest portion of available funds, but did so in a fairly rapid way (most was available by early 2009). However, the IMF provided funding within days of their entente with Latvian officials, and all non-EU funding combined amounted to 89% of what was ultimately utilized by the Latvian government. As such, the EU's portion of the bailout, though important, was arguably unnecessary. It should also be noted that although free movement within the Schengen zone (facilitating the exodus) is an EU-generated factor in Latvia's decrease in unemployment, this is not beneficial to the nation's recovery in the long term due to ongoing demographic decline (inspiring the protest placard quoted at the beginning of this chapter).

[81] The inclusion of the EU as a point of origin for cultural factors leading to recovery is twofold: first is the prospect of adopting the euro –a key driver of Latvia's diligence in maintaining the internal devaluation; second is the facility with which Latvians may leave Latvia in search of work in other EU countries –a short term advantage with long term negative implications.

The Latvian recovery from the Great Recession is marked by an important paradox: although the majority of responses leading the nation's impressive rise from depression-worthy conditions were generated domestically, the motivation of euro-adoption was the key in determining Latvia's steadfast maintenance of its currency peg. This external prospect generated the response selection leading to the internal efforts that drove recovery, reflecting the Baltic nation's determination to maintain its path of convergence in the EU framework rather than pursue a completely different path, as was the case in Iceland. This considered, the answer to the question of the extent to which Latvia's degree of integration in the EU impacted its ability to recover in the crisis is that it was largely internally generated and implemented solutions (albeit motivated by external prospects) that caused Latvia's recovery.

Case 3: The Irish Lament

"Being Irish, he had an abiding sense of tragedy, which sustained him through temporary periods of joy."

-William Butler Yeats

Introduction

The selection of the Republic of Ireland for this comparative analysis was a natural one, as it was the first of the 'PIGS' countries (Portugal, Ireland, Greece, Spain) to begin recovering from the Great Recession. As such, it is the best example of recovery in a crisis stricken state both within the EU, and with the euro as its currency. As with the other two cases, this chapter will trace the historical path leading to the Irish boom years, labelled the "Celtic Tiger" after the Asian Tigers that were booming during the same period. This spectacular growth in the Irish economy then soured, causing a bubble to form around the real estate industry. When this bubble inevitably burst, the Republic was simultaneously hit by the global credit crunch and the Lehman collapse, causing for a sudden, drastic drop in GDP and employment. This chapter describes this crash, as well as the solutions brought by the Irish government, the EU and the IMF to stave further damage and eventually start recovering. Having exited its international bailout program in 2013, the signs of recovery in Ireland are clear, although other indicators such as government debt and employment are more lukewarm. Nevertheless, the unique response package assembled here led to recovery, and is reflective Ireland's own flavour of path dependence.

Background and the Boom

In a similar fashion to the other two case countries, the Republic of Ireland's economic story starts with occupation by a foreign power. The Norman Invasion of the 12th century ushered in seven centuries of direct or indirect Anglo-British rule. Throughout this period, as well as during industrialization, Ireland remained a highly agrarian society, depending greatly on the rest of the British Isles for manufactured goods in exchange for Irish foodstuffs. Even following the creation of the Irish Free State (the predecessor to the Republic) in 1922, the new Irish government encountered difficulty in establishing a sustainable industrial base through direct intervention –such as the state-owned Irish Sugar Company.

This penchant towards protectionism, import-substitution, and self-sufficiency through state intervention and funding –in vogue in many parts of the world during the mid-20th Century- endured throughout the de Valera and Lemass administrations (roughly the 1930s-1960s). These two key figures in the Republic's early decades "sought to both create jobs quickly and to build more gradually a large indigenous industrial sector, producing primarily for the home market."[82] This approach did not work in the Irish context however, as the small domestic market, lack of natural resources tied to industrialization, and the dissuasion (through tariffs) of the foreign capital and expertise necessary to establish a modern economy –to name a few[83]- impeded development.[84]

In her study of Ireland's transition from an agrarian society to an information economy, Eileen Trauth traces the change in economic policies that catalyzed what would become the 'Celtic Tiger' economy decades later. During the 1950s and 1960s, and especially under the guidance of finance secretary T.K. Whitaker (who is now revered), the barriers erected to trade were dismantled, and the Industrial Development Authority (IDA) played a central role in attracting foreign industry –especially 'clean' or non-polluting industries such as pharmaceuticals- to Ireland. Incentives such as tax exemptions, an English-speaking workforce, low operating costs, and, eventually, access to the European Community (which Ireland joined with the UK in 1973) were all leveraged by Irish policymakers to attract international (especially American) exporting firms. This was paralleled with unprecedented state investment in education, including public secondary schooling and a number of tertiary education institutions focusing on up-and-coming sectors, such as information technology (IT).[85]

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[82]Neary, J. Peter, and Cormac Ó Gráda. "Protection, Economic War and Structural Change: The 1930s in Ireland." *Irish Historical Studies* 27 (1991): 250.

[83] Additional reasons for Ireland's economic stagnation during this period have included the Catholic Church's influence and a broad cultural mistrust of entrepreneurship –a vestige of colonialism and the Great Famine.

[84]Trauth, Eileen M.. *The Culture of an Information Economy: Influences and Impacts in the Republic of Ireland*. Dordrecht, Netherlands: Kluwer Academic Publishers, 2000.

[85]Trauth, Eileen M.. *The Culture of an Information Economy: Influences and Impacts in the Republic of Ireland*,29-31.

The 1970s and 1980s were marred by inflation (linked to the oil shocks), as well as bank strikes, high government turnover and political scandals (linked to then Taoiseach –the Irish prime minister's official title- Charles Haughey), and the ongoing 'Troubles' spilling over from Northern Ireland all contributed to a period of slow growth and persistent outward migration. It was not until 1987 that a cross-party agreement arose to establish a "pro-business" entente (known as the "Tallaght Strategy"), coupled with a "social partnership" consensus reached between unions, business, and the political class. This more inclusive, cooperative and responsive change in governance, combined with the sharp increase in tertiary-educated workers able to fill high value-added positions (resulting from education reform mentioned above) all combined to launch a new phase in the Irish economy, the Celtic Tiger.[86]

Although the Irish economy hiccoughed with the European currency crisis of 1992 and its ensuing recession, the Tiger roared from approximately 1994 to 2000, averaging 8.6% annual growth in real GDP.[87] This boom was in large part due to the factors mentioned above, which, along with demonstration effects caused by the first wave of foreign firms establishing themselves in Ireland, generated a significant amount of foreign direct investment (FDI -largely in the pharmaceutical and tech sectors).[88] Wages also remained steady during this period due to the pre-existing unemployment gap, the return of expatriates, and increasing numbers of women joining the workforce.[89] These impressive gains in output, therefore, represented *real* gains in the economy. Although the Celtic Tiger period is often described as lasting until the crash in 2008, renowned Irish political economist Philip Lane is among those who identify the Tiger years as ending with the onset early 2000s recession, due to the unhealthy shift in the nature of Irish growth that would define the years leading up to the crash..[90]

Where symptoms of a souring in the Irish boom first became evident was in the shift in sectors generating GDP growth, which still averaged an impressive 5% annually between 2001 and 2007.[91]Lane points to the stabilization of FDI for manufacturing and IT due to diminishing marginal gains (as is natural following sector-specific growth), and the shift in investment towards less sustainable sectors. This boom was different:

> In particular, it was dominated by a surge in construction activity, with the economy driven by a boom in investment in housing and commercial property. In turn, the positive wealth effect from rising property prices fed into strong growth in private consumption. With tax revenues from asset-related sources very strong, the government was also able to fund a strong pace of public expenditure growth, while maintaining a budget surplus and enjoying a rapid decline in the debt/GDP ratio.[92]

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[86]Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 3-4.
[87]Donovan, Donal, and Antoin E. Murphy. *The Fall of the Celtic Tiger: Ireland and the Euro Debt Crisis*. Oxford: Oxford University Press, 2013, 16.
[88]According to Bielenberg and Ryan (2013), "Between 1990 and 1994, the Republic of Ireland consequently attracted 40 percent of US electronic investment in Europe.", 30.
[89]Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 4.
[90]Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 5.
[91]Donovan, Donal, and Antoin E. Murphy. *The Fall of the Celtic Tiger: Ireland and the Euro Debt Crisis*, 16.
[92]Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 6.

As such, the Irish government's seemingly robust fiscal management was increasingly dependent on the real estate and construction industries, which were in turn dependent upon household debt, which spiked to 2.3 times national GDP by 2008.[93]

Funding this rapid expansion in credit were Irish banks, which enjoyed far lower costs of borrowing since Ireland's euro accession in 1999 and were eager to lend. As Irish households developed a matching appetite for debt, these banks increasingly sought funding from international lenders (especially German banks, which held US$208.3 billion in exposure to Ireland by 2010[94]). Competition between Irish banks as well as foreign subsidiaries further fuelled the construction boom, which was already boosted by Ireland's young and growing population with rapidly increasing disposable income.[95] Easy loans available to potential buyers were largely responsible for the peak of 93,000 new housing units built in 2006 –up drastically from the pre-Tiger annual average of 23,000.[96] With housing prices almost tripling between 1995 and 2006, near full employment, high inflation combined with low borrowing rates, and the illusion of stability in government finance (due to its overdependence on the value of real estate), the Irish economy was clearly overheated, and by 2007 a correction was long overdue.

The Crash

The Republic's economy had, through a number of factors such as immigration, low rates of borrowing since joining the currency union, and positive feedback mechanisms in the real estate and construction sectors, prolonged its boom period from the healthier Tiger years to an economic bubble of immense vulnerability. Even on the eve of the crash in 2006, when the property sector peaked, there were hopes for a 'soft landing', and the assumption that the continued growth of 2007 signalled an offsetting of dependence on this sector through growth in others.[97] The luxury of hindsight exposes how unrealistically optimistic these predictions were. In his assessment of the crisis and its management, Lane points to the three ways in which the crash manifested itself in the Republic of Ireland in 2008, ushering in its own flavour of the Great Recession: economic recession; banking collapse; and fiscal deterioration.[98]

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93 Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 7.

94 *Wall Street Journal*, "Ireland Needs Relief," January 24, 2013, http://online.wsj.com/news/articles/SB10001424127887324624404578255103590739948?mod=ITP_opinion_0&mg=reno64wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424127887324624404578255103590739948.html%3Fmod%3DITP_opinion_0 edition, sec. Review & Outlook.

95 Malzubris, Jānis . "Ireland's housing market: bubble trouble." *ECFIN Country Focus -Economic analysis from the European Commission's Directorate-General for Economic and Financial Affairs* 5. http://ec.europa.eu/economy_finance/publications/publication13187_en.pdf (accessed July 20, 2014): 3.

96 Malzubris, Jānis . "Ireland's housing market: bubble trouble.", 2.

97 Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 10.

98 Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 11.

Decline in Economic Activity

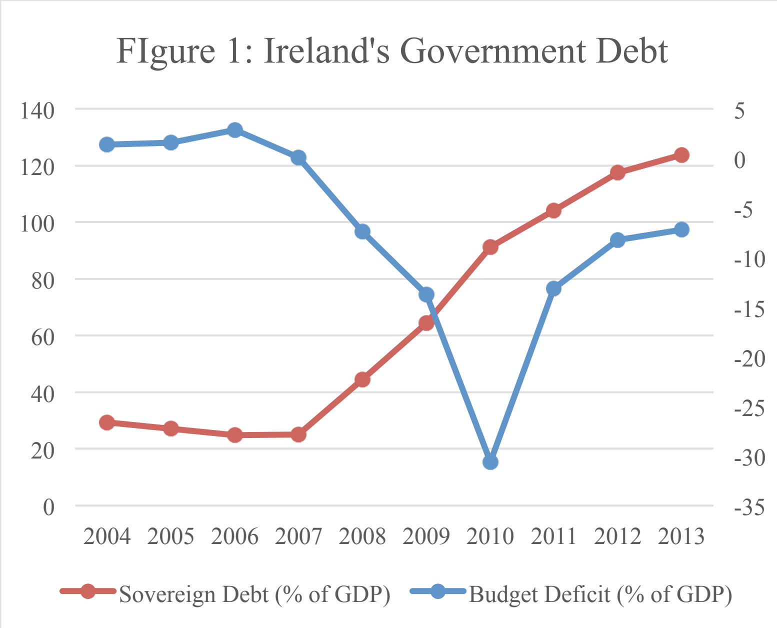
The first manifestation of the crisis was felt in the real economy. As Ireland's post-Tiger economic structure had become overly dependent upon the real estate and construction sectors, the inevitable correction (matching supply with actual demand, and the subsequent land value adjustment) that began in 2007 spilled over into the entire national economy. In addition, the slowdown and eventual freeze in lending caused by bad loans and the post-Lehman global credit crunch were instrumental in reversing the positive feedback mechanisms that had boosted all indicators of Irish economic health during the boom, mirroring them with negative feedback mechanisms (reduced lending slowing economic activity, in turn driving down employment, property values, and asset-based government revenue).[99] The result of this halt in activity was a steep rise in unemployment (which peaked at 15.1% in February 2012, and remains stubbornly high at 11.6% in June 2014[100]) and a significant drop in domestic consumption. This drop, combined with the devaluation of the sterling vis-à-vis the euro (the UK being Ireland's largest trading partner) drove deflation, further reducing government tax revenue and increasing real household debt.[101]

Banking Crisis

As the real estate industry collapsed, so did the balance sheets of its creditors. Irish banks were faced with increasing numbers of unpaid loans tied to real estate assets which had plummeted in value, further feeding the negative feedback cycle. The easy credit that had flowed into Ireland, largely from UK, US, and European banks, had contributed in propping the value of real estate assets –reinforcing the perceived health of Irish banks. When this loosely supervised cycle began to backfire during the interbank credit freeze of 2007-2008, it was initially thought that Irish banks were lacking in immediate liquidity alone, which the government sought to address through the guarantee of a large portion of bank liabilities for a two-year period. However, it soon became clear that the issue went far deeper, affecting the fundamental solvency of Irish banks.[102] Between May 2007 and February 2009, the Irish Stock Exchange (ISEQ), which includes all major Irish banks, dropped from a high of 9854.86 to a trough of 2074.32, its worst drop ever recorded.[103] By the fall of 2008, it became clear that immediate action would be required if the government wished to salvage the Irish banking sector.

[99]Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 11-12.
[100]Central Statistics Office of Ireland. "Seasonally Adjusted Standardised Unemployment Rates (SUR)". http://www.cso.ie/multiquicktables/quickTables.aspx?id=lrm03_lra03 (accessed July 28, 2014).
[101]Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 11.
[102]Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 14-15.
[103]Yahoo News Network. "ISEQ-OVERALL PRICE." . http://finance.yahoo.com/echarts?s=%5Eiseq+Interactive (accessed July 29, 2014).

Fiscal Crisis



Sources:

Eurostat. 2014. *General government gross debt - annual data*: Eurostat (producer and distributor of dataset). http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&language=en&pcode=teina225

Eurostat. 2014. *General government deficit (-) and surplus (+) - annual data*: Eurostat (producer and distributor of dataset). http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=teina200

Faced with the collapse of real estate, construction and banking –the three symbiotic sectors that had driven the post-Tiger boom- the Republic of Ireland's government was hard-pressed to react. Having enjoyed balanced budgets –including occasional surpluses- in the years leading up to the crisis, the government was suddenly faced with enormous deficits due to a combination of a significant drop in GDP (-7.1% in 2009), and increasing pressure to keep the country's banks afloat. Although taxes were eventually raised and public sector wage reductions carried out, government deficits remained very high in 2009 and 2010. Lane attributes this to the gradual replacement of stable tax sources to more asset-related tax sources during the boom years, such as corporation tax, stamp duties and capital gains taxes[104], in addition to the already low-to-inexistent property or municipal taxes.[105] Added to this were the eventual costs of bank restructuring and bailouts (see the next section), which greatly deepened the Irish government's debt burden in a very short period of time, as is shown in Figure 1. In under five years, Ireland went from having one of the EU's lowest debt-to-GDP ratios to one of the highest, surpassing France and Portugal (and nearing Italy and Greece) by 2010.[106] Heavy sovereign debt persists in Ireland in 2014, although the government successfully returned to the bond market in 2013, and has begun refinancing.

[104]Honohan, Patrick. *What Went Wrong in Ireland?*. Dublin: The World Bank, 2009: 3.
[105]Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011): 13.
[106]Lane, Philip R.."The European Sovereign Debt Crisis." *The Journal of Economic Perspectives* 26 (2012): 51.

The Response

The fact that Ireland's recovery indicators (especially GDP and unemployment) are generally tepid in comparison to the other two case countries is attributable in part to the fact that an international bailout was requested later, but also because the measures taken were arguably less effective. The following is a list of the most important responses to tackling the crisis in the Republic of Ireland. Although recovery is a reality, these measures may also have gone a certain way in hindering recovery to the extent experienced elsewhere. As such, their role in generating improvements is not absolute.

1. *Fiscal Consolidation*

In the weeks leading up to the Lehman bankruptcy, the Irish government was already feeling the impact of the credit freeze in the banking sector, due to reduced asset-related tax revenue (which the government was overly dependent upon). As such, the minister for finance Brian Lenihan and the four-month-old FiannaFáil-Green Party coalition government made the unusual decision of bringing forward the 2009 budget from its usual December slot to October 14th, 2008. Included in the original budget proposal were a number of cost-cutting and revenue-increasing measures, including an income levy, an increased value-added tax, wage reductions for ministers, and a voluntary early retirement scheme for health workers.[107]

This budget was followed by a second emergency budget in April 2009, which called for further hikes in the income levy, consumption taxes (notably on cigarettes, gasoline, and stamp duty), as well as deeper cuts, including welfare freezes, childcare supplement reductions, and a smaller jobseeker's allowance. Combined, these budgets (as well as further cuts in later budgets) were met with vehement opposition from unions, university students, and pensioners (to name a few). These were intensified with the 2010 budget, which called for additional 5-10% pay cuts on the civil service. The resulting negotiations between government and labour representatives (known as the "Croke Park Agreement") has led to further cost reductions through productivity increases and gradual headcount cutbacks resulting in a 17.7% decrease in the government pay bill between 2009 and 2012[108] -a non-negligible contribution to a return to budget balance. In spite of continued austerity measures, however, the government deficit hit a low point in 2010 (see Figure 1) due largely to expenses tied to bailing out the banking system.

2. *Bank Guarantee*

As discussed in the previous section, Irish banks had become tremendously dependent on positive feedback mechanisms with the real estate sector, which accounted for 60% of their lending in 2007.[109] When combined with the government's overreliance on unstable tax revenue (such as stamp duties and capital gains taxes) tied to those sectors, a failure of Irish banks could not be fathomed. As such, in the immediate wake of the Lehman crash, the Irish government,

[107]*The Irish Independent*, "Budget Main points," October 14, 2008, sec. Business Newsletter.
[108]*Public Service Agreement: Third Progress Report*. Dublin: Implementation Body for the Public Service Agreement 2010-2014, 2013: ii.
[109]Honohan, Patrick. *What Went Wrong in Ireland?* The World Bank (2009): 5.

afraid of the effects of a loss in investor confidence, placed a virtually unlimited guarantee on domestic banks over a two-year period, effective as of late September 2008. By late 2008, the government had already injected €7 billion. This would be the first of many more injections (including the nationalisation of Anglo-Irish Bank –a lender particularly exposed to development loans), which outspoken Irish economist and professor Morgan Kelly would later qualify as the "costliest mistake ever made by an Irish person" (in reference to Central Bank Governor Patrick Honohan), estimating the long-term cost of the guarantee at a quarter-of-a-trillion euro[110] (current estimates stand at approximately €64 billion). Although this move has drawn much criticism, it also avoided widespread bank defaults, the effects of which are incalculable. This determination by the government may also have led to the return in investor confidence that would come several years later. Indeed, Irish government 5-year borrowing costs dropped to record lows in early 2014, falling below UK bonds and US Treasuries.[111]

3. *NAMA*

Included in the second emergency budget in April of 2009 was the creation of the National Asset Management Agency (NAMA), a 'bad bank' mandated to absorb all of the underperforming loans from six major Irish banks in the hope of maintaining favourable credit (one of the factors upon which the feedback cycle depended). As an extension of the bank guarantee, NAMA's purpose was to prop up the Republic's banking sector through the purchase of €77 billion worth of property development-related loans with a 30% 'haircut'. As such, banks would (ideally) have a newfound flexibility to resume activity. The purchase of these loans was carried out through government bonds, as well as state part-ownership in return for recapitalisation. NAMA's mixed public-private ownership structure, as well as the fact that the government did not allow for certain banks to default (as had been the case in the United States or other crisis-stricken countries) drew criticism from economists including Joseph Stiglitz and Nouriel Roubini, who portrayed the Agency as a public subsidy for private bank and property development failures. Nevertheless, NAMA's role in reducing the (incalculable) risk of bank defaults, as well as its continued profitability (estimated at €1.2 billion in 2013) undeniably played a role in spurring the Irish recovery.[112]

4. *Troika Bailout*

As a result of the spiralling budget deficits caused by loss of government revenue and increasing bank bailout costs (including the extension of the bank guarantee for a third year), the government of Ireland began talks with the European Central Bank (ECB) and the IMF. By November 21, 2010, the Republic of Ireland had formally requested bailout funding, and an agreement was reached on the 28th. The bailout package, totalling €85 billion at an average 5.8% interest per annum, was provided by the IMF, the European Commission, and the ECB (known as the *Toika*), as well as an Irish pension fund and bilateral arrangements with other member

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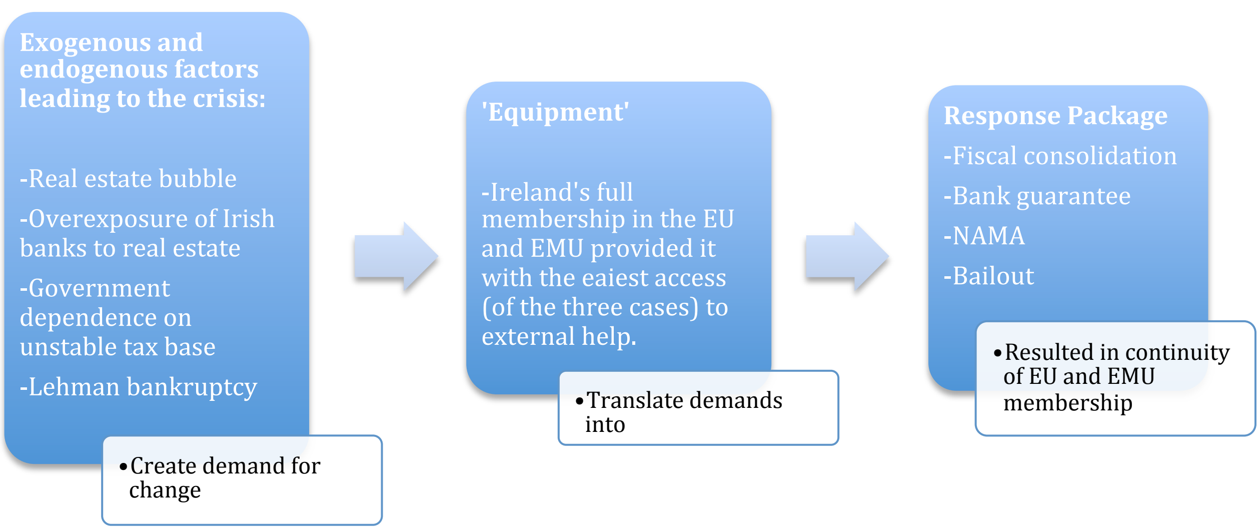
[110] O'Connell, Hugh. "Honohan defends actions in face of criticism over bailout and banking guarantee." *TheJournal.ie*, May 8, 2011.
[111] *The Telegraph*, "Irish five-year bond yields fall below UK," January 20, 2014, sec. Economics.
[112] *Annual Report and Financial Statements for the year ended 31 December 2013*. Dublin: National Asset Management Agency, 2014.

states (most notably the UK). Of note is that a €10 billion tranche was immediately disbursed in order prop up the banking sector –a move some commentators have qualified as indicative that the "bailout was really about saving the banking system."[113] This said, Ireland officially exited the bailout program in December 2013 –the first eurozone country to do so. About a month later, the Republic reached the aforementioned all-time-low in borrowing costs.

Results

Although less convincing, perhaps, than the Icelandic or Latvian recoveries, the Irish scenario is the most promising of the eurozone recoveries thus far. It also sent a clear message to investors and the EU that it intends to remain a member state, and in the currency union –no matter the cost. When studying the extent to which full integration into the EU framework (as a member of the eurozone) has impacted Ireland's ability to recover, the question is not whether membership has affected the recovery –it undoubtedly has. Of more importance is whether membership has *positively* impacted recovery. Otherwise posed, was the EUs involvement in the Irish recovery beneficial, not beneficial, or of no significant impact? Below is the Benz and Broschek model, as applied to the Irish scenario:

As with the other two cases, the response package variable is key in determining the point



of origin for each measure applied. Ireland's membership in both the EU and the eurozone inevitably hazes these points of origin, so some measures will be split between jurisdictions, as is shown in the following table:

[113] O'Carroll, Lisa. "Ireland bailout: full Irish government statement." *The Guardian*, November 28, 2010, sec. Business.

Factor	*EU Origin*	*National Origin*	*International Origin*
Fiscal Consolidation		X	
Bank Guarantee		X	
NAMA		X	
Bailout	X		X

Although the European Commission approved of measures such as the bank guarantee and NAMA, these originated in Ireland. This point of origin is plausible, due to the government's reliance on positive feedback from banking and real estate development for much of its revenue. Where the EU comes front-and-centre is in its insistence on a bailout, which Ireland had gone to great lengths to avoid. Revelations from a former economic adviser to European Commission President Barroso allege that "It was a mistake by the previous [Irish] government to guarantee all Irish bank debts but it was outrageous to effectively threaten to force Ireland out of the euro unless the government went through with that foolish pledge", regarding the Commission and ECB's involvement in the bailout.[114]

Similarly to the Latvian scenario, Ireland's crash and recovery is marked by paradox. On one hand, EU –and especially euro- membership exacerbated the factors leading into the crisis. Although a correction was inevitable, the cheap interest rates available to Irish banks coincided with the launch of the euro in 1999. Moreover, the addition of ten new countries into the Union in 2004 led to unprecedented inward-migration from Eastern Europe –maintaining the downward pressure on wages necessary for the continued construction boom.[115] On the other hand, EU membership allowed Ireland to access direly-needed funding (about half of the bailout) in order to pursue its policy of guaranteeing its domestic banks.

Though some seeds of the crash were sown in Ireland's post-colonial past, including the staunch resistance towards any form of property tax –an impediment to land ownership reminiscent of the landed aristocracy that ruled the Island for centuries- the country's history may also serve to explain its maintained path within the EU, rather than through juncture (such as a default or exit from the eurozone). Having been isolated from the European continent for centuries, as well as the protectionist years of early independence, the conscious move towards a more open economy at the heart of the European Project started in the 1960s, and the country has become a stalwart of a highly integrated continental economy (being home to many corporate headquarters serving the entire EU). Degree of integration, therefore, played an important, though mixed, role in impacting the ongoing Irish recovery from the Great Recession.

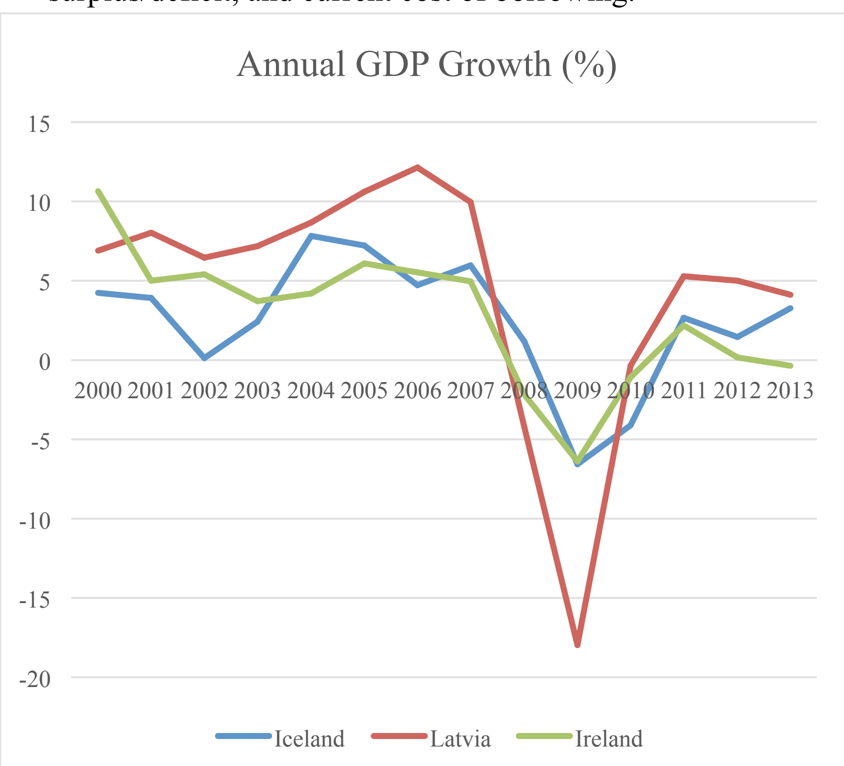
114Fox, Benjamin. "EU 'bullied' Ireland into bailout, former Barroso aide says." *EUobserver*, May 8, 2014.
115Honohan, Patrick. *What Went Wrong in Ireland?* The World Bank (2009). ; Lane, PhlipR.."The Irish Crisis." *IIIS Discussion Papers* 356 (2011).

Conclusion: Comparative Analysis

The assessment of how Iceland, Latvia, and Ireland entered and exited (or are exiting) the Great Recession provides three very similar, yet very different approaches to economic crisis management. When comparing the response packages deployed by each (see the tables near the end of each case), it is interesting to note that the majority of responses were developed internally, no matter the level of integration. These responses, however, were still shaped by EU membership in that the maneuverability available to each state in responding was dependent upon the importance placed on continued participation in the EU and EMU. The staunch rejection of allowing any kind of bank default in Ireland and Latvia was undoubtedly shaped by EU membership and/or the prospect of EMU accession. This pull-factor was not as present in Iceland, which in turn provided a very different set of policy options. This concluding chapter seeks to compare all three cases based on a number of quantitative and qualitative criteria so as to gauge the relative ranking of each.

Quantitative Indicators

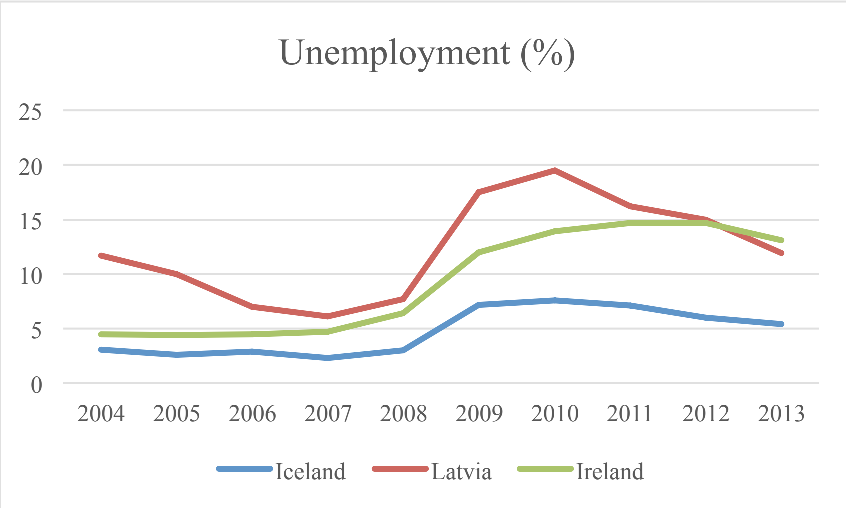
In order to determine the extent to which degree of integration within the EU framework helps, hinders, or has no significant effect upon the ability of states to recover, it is helpful, first, to directly compare the three cases based on a number of indicators. In addition to the two primary benchmarks of GDP (this time measured in annual growth) and unemployment are three more sources of comparative insight: the national debt-to-GDP ratio, government budget surplus/deficit, and current cost of borrowing.



1. Annual GDP Growth

As mentioned in the introductory chapter, annual growth in gross domestic product presents the clearest picture of economic recovery, as the term 'recession' hinges on two consecutive quarters of negative growth in GDP. To complement the total nominal GDP displayed in the first chapter, the chart here illustrates the very clear drop in annual GDP growth all three countries experienced during the financial meltdown. Both the clearest drop and clearest gain are in Latvia, which suffered a Great

Depression-level contraction. Iceland proved the most resilient of the three, however, contracting for two years compared to Ireland's four and Latvia's three. As Iceland and Latvia now share comparable levels of growth, Iceland has been selected as the best recovery in nominal GDP, followed by Latvia then Ireland.



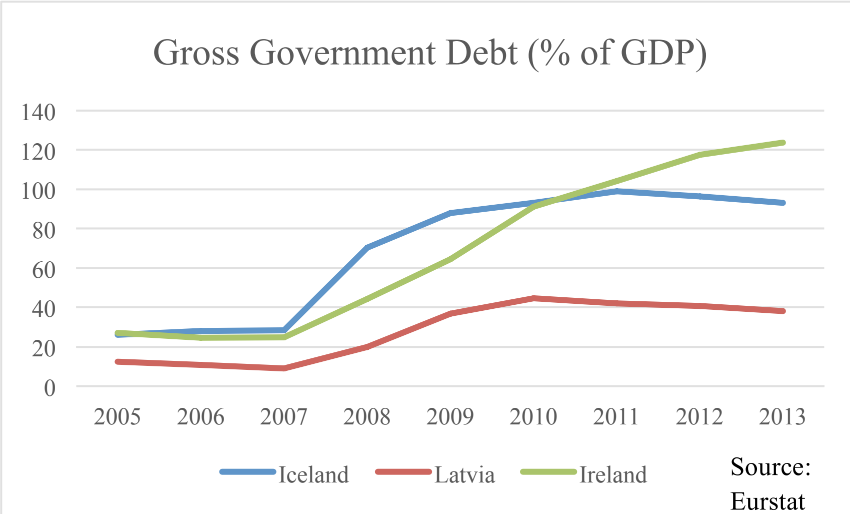
Source: Eurostat. 2014. *Unemployment rate by sex and age groups - annual average, %*: Eurostat (producer and distributor of dataset). http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=une_rt_a&lang=en

2. Unemployment

In terms of the popular experience of the crisis, likely the best indicator is the national rate of unemployment. In this this case as well, Iceland proved the most resilient of the three, never surpassing the 10% mark. Ireland, and especially Latvia are still experiencing significant unemployment in spite of outward migration. Although other indicators may be improving, the employment prospects of everyday Latvians are far worse than their Icelandic counterparts.

Employment often trails GDP growth by several years, however, and it remains to be seen whether Irish and Latvian growth will generate new employment to better retain their workforces. Iceland easily ranks first in this case, followed by Ireland and Latvia –whose unemployment would be higher had it not been for the mass emigration of –especially young-workers.

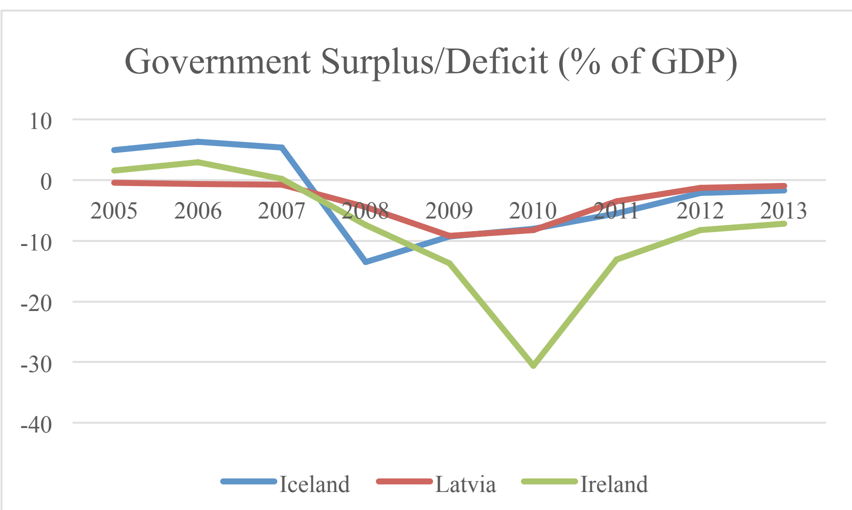
3. Government Debt



Source: Eurostat. 2014. *General government gross debt - annual data*: Eurostat (producer and distributor of dataset). http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&language=en&pcode=teina225

The Great Recession's impact not only affected the current generation, but will have ripple effects over several decades, especially in the cases where national governments accrued significant sovereign debt – to be paid off by future generations. The most fiscally stringent of the three case countries is Latvia, which never reached the 45% mark for government debt-to-GDP(and this *in spite* of its 18% GDP contraction in 2009). This approach is reflected in the enormous cuts administered by the Latvian government, as well as the incomplete use of available bailout funds. The particular brand of fiscal austerity applied in Latvia may arguably not be applicable to other crisis countries. Even Ireland's demonstration-generating civil service cuts were approximately half as severe as those in Latvia, which lacked in organized labour movements. The rankings for government debt, therefore are Latvia, Iceland, and then Ireland in third.

4. Government Budget

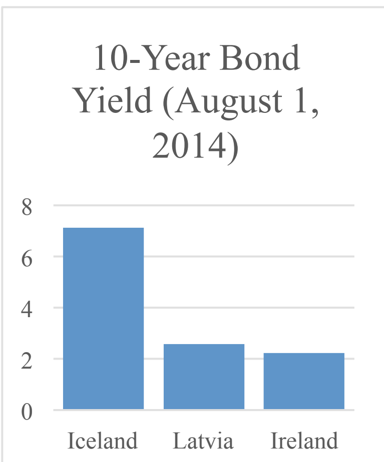


Source: Eurostat. 2014. *General government deficit (-) and surplus (+) - annual data*: Eurostat (producer and distributor of dataset). http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=teina200

Closely linked to sovereign debt are the annual budgets that aggravate or eliminate it. In all three cases, government budgets were either balanced or in surplus during the boom years preceding the crash. The sudden drop in economic activity drastically lowered tax revenues, causing the need for fiscal consolidation. Ireland's overdependence on asset-related tax revenue such as capital gains tax and stamp duty on new property rendered it more vulnerable to cyclical changes than was the case in the other two countries. Without the incredible wage flexibility of Latvia, or the ring-fencing of non-domestic liabilities from the public purse in Iceland, Ireland remains in deficit –albeit decreasing year-on-year. Latvia ranks first in this case as well, followed by Iceland and Ireland.

5. *Costs of Borrowing*

Another important indicator of current economic health is the cost at which governments may borrow. This reflects market perceptions of a country's recovery. Indeed, the purpose of the international bailout packages was largely to compensate for a loss of market confidence. The



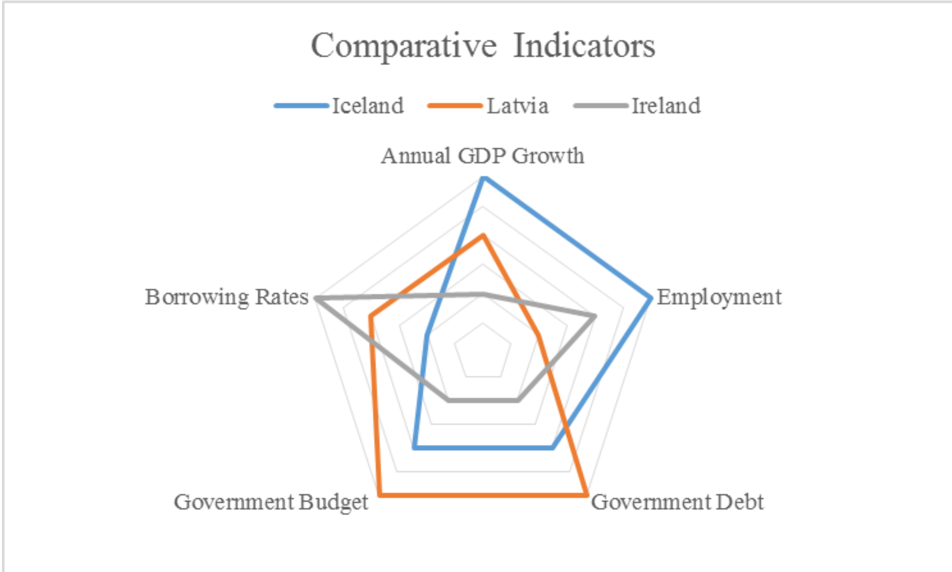
ability for countries to successfully return to the bond markets also implies a certain degree of financial independence. Shown here are the current yields on 10-year government bonds for each of the three case states (a common indicator for investor confiedence). The fiscal diligence of Ireland and Latvia in pursuing investor-friendly repayment policies have paid off. Conversely, Iceland must borrow at over twice the rate of the other two –likely the result of the complete severance from the Icelandic banking sector's international creditors, as well as the small size of its economy (implying an inability to guarantee debt). Ireland ranks a close first place here, followed by Latvia, then Iceland a distant third.

Source: Trading Economics. 2014. *Government Bond 10y - Countries - List*: Trading Economics (producer and distributor of dataset). http://www.tradingeconomics.com/bonds

Cross-Indicator Comparison

Having established a ranking for each of these indicators, the following radar chart projects the relative success of each case state's recovery (the greater area covered implying greater success in recovery). Of course this visualization implies both the equal weight of each indicator to the recovery, as well as the equal weight of each ranking (e.g. Ireland's third place in GDP growth is equal to Iceland's third place in borrowing costs), which is not the case.

Nevertheless, it provides a useful a visualization of recovery rankings that is helpful in answering the key question of how/if degree of integration relates to recovery from the 2008 financial crisis.



Assuming the equality in importance of all five indicators, as well as the ranking positions, it appears that Latvia and Iceland are tied for most successful recovery. Before delving into the differences between the two, it is important to note that Ireland is easily the weakest recovery of the three. It is also the state most integrated in the EU framework, and arguably the most influenced by the EU, due to its monetary dependence (versus Latvia's *voluntary* peg, in spite of international suggestions to devalue), as well as its 'forced' acceptance of the bailout terms set by the European Commission. As such, there is already a tentative basis for the argument that degree of integration in the EU *negatively* impacts success of recovery from the Great Recession.

Overall Comparison and Findings

Regarding which of the Latvian and Icelandic recoveries was most successful, relative weight must be allotted to each of the indicators, based on perceived importance. If sovereign debt load and budget restraint are considered paramount, Latvia is clearly the ideal recovery. Conversely, if employment retention and minimization of GDP contraction are perceived as the most important benchmarks, Iceland presents the most convincing and exemplary recovery. For the purposes of this study, the greatest weight is placed on the impact felt by the majority of the citizenry, as opposed to select creditors. Within this conceptualization, the clear leader of the three case countries is Iceland, which never passed the 10% mark of unemployment, and protected the public from private bank losses. Moreover, the Latvian scenario's significant side-effects make it far from ideal. The mass exodus of especially young Latvians is reflective of the recovery's inability (so far) to trickle down to the average citizen. Moreover, this loss of young talent will likely cause larger issues in years to come –especially for pension schemes- due to an uneven population pyramid. Similarly, Ireland's significant debt burden will weigh down upon future generations, preventing the government from allocating funding more productively.

Although correlation in answering whether degree of European integration impacts (positively, negatively, or not at all) the ability of states to recover from the 2008 financial crisis is impossible to obtain in this study (due to small sample size availability) the suggestion drawn from the evidence provided above is that states at the heart of the European project (the eurozone) are worse equipped, in spite of EU 'shelter', to recover from these shocks –as argued by Thorhallsson and Kirby.

With the above in mind, the evidence brought forth in this study contains strong implications. The fact that Ireland's degree of integration in no way protected it from the crisis, and that most of the responses in all three cases originated domestically is important. However, what also emerges from these case studies is that Europeanization had an undeniable influence in some of the factors leading to each state's vulnerability to the global crisis. In Iceland, the EEA "European Passport" available to its banks allowed them to offer accounts in other European countries without setting up subsidiaries. In Latvia, EU membership and the prospect of euro accession exacerbated the bubble. In Ireland, the low cost of borrowing, due to euro membership, did not reflect the true state of the economy (as was the case in the other PIGS countries).

Europeanization was also influential in hampering recovery. Though it may be argued that just as many young Latvians would have emigrated had Latvia not belonged to the Schengen Area, the fact that the vast majority emigrated to other EU states (especially the UK) due to freedom of movement is important, as the short term gains of losing a large portion of the workforce (less unemployment, less pressure on the welfare state) outweigh the long-term costs (shrinking tax-base, brain drain). Similarly, the European Commission's pressure on Ireland to maintain the bank guarantee at all costs was also influential in its deepening of Irish government debt. The Irish government may have resorted to any number of solutions (e.g. further bank debt 'haircuts' or additional bank nationalisations) had this not been the case. The very assumption by the Commission and ECB that fiscal 'austerity' is an inevitability, as no other possibilities exist[116], is an ideational force that has compelled crisis-stricken EU states to adopt its prescribed responses, rather than explore other possibilities permitted by all of the potential 'equipment' available to them (see Image 2 in the *Analytical Framework* chapter). Iceland retained the broadest control over its equipment of the three cases, and its subsequent selection reflected a completely different approach. Ireland's full integration into the EU framework exposed it to these ideational prescriptions to a greater extent than the other two case states. As such, the less convincing nature of the Irish recovery is in large part attributable to its full EU membership, although domestic factors such as the asset-based tax structure are also responsible (and grounded in Irish culture and history).

Where this study differs from Darvas, as well as the myriad other authors who point to various forms of fiscal union as the solution to further crises, is in its assertion that fewer constraints on state 'equipment' (including constraints set by historical and ideational influences), rather than more constraints, afford the actors involved in recovery a wider range of tools they may use in response to future exogenous shocks –potentially increasing the likelihood and speed of recovery. Fiscal union, as a form of communitization is simply the institutionalization of an ideational current, or "instruction sheet" (e.g. austerity) which does not

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[116]Deen, Mark. "Noyer Rules Out Greek Debt Restructuring, Says Austerity Is Only Solution."*Bloomberg*, May 24, 2011. Accessed August 17, 2014. http://www.bloomberg.com/news/2011-05-24/noyer-rules-out-greek-debt-restructuring-says-austerity-is-only-solution.html.

apply across all contexts (if any).[117] Therefore, the broader toolkit available to Iceland, as well as the lack of external constraints on its tool-selection were central in generating the (more successful) response package it ultimately deployed. This conclusion has strong implications for other recovering European states, such as Spain, Greece, Cyprus and Portugal, all of which have followed similar paths to the Irish one, and whose populations will be paying for the mistakes of the crisis for generations to come.

[117] In his 2013 book *Austerity: The History of a Dangerous Idea*, Mark Blyth points to the political power of financial ideas (like austerity) when he writes the following:

"We tend to think of economic theory as the instruction sheet for running the economy. Like the instructions that come with an IKEA dining table, the theory says that the box marked "the economy" contains X items that fit together in Y order. Ignore the instruction sheet and your economic IKEA dining table will not come out too well. This view sees economic theory as what philosophers call a "correspondence theory" of the world. Whatever the instruction sheet (theory) says about the table (reality) is true about all tables (states of the world) regardless of where and when the information is applied. But what if economic theories are less than these perfect correspondences of the world? What if our knowledge of the economy becomes less relevant over time as the worldchanges while the theory stays the same? Our theory would then correspond less over time, becoming in the process a less reliable instruction sheet."p.38

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