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The Ongoing Economic Crisis- Series 5

What Precipitated the Economic Bubble in Europe, and How Did It Collapse? *(First published on May 25,2012)*

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Contents

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About the institutes

The collapse of the Soviet Union in the late 1980s opened up a new economic frontier in Europe. Western European financial institutions invest and loan money to central and eastern European countries that once belonged to the communist economic zone, and the region provides western European firms with cheap labor, opportunities to invest in areas like factory construction, and new markets for their products. Germany's entry into those markets was slightly delayed because of vexing issues related to reunification, but since the 1990s other countries have been plucking the fruits of the communist bloc's collapse. To prepare for the Y2K issue (or Millennium bug issue), central banks provided an unusual level of liquidity that created a small-scale bubble (the so-called IT bubble) from the end of 1999 to the summer of 2000. The world economy contracted for two years after the bubble's collapse, but the launch of the EU and the introduction of the euro as its common currency resulted in an unprecedented boom for Europe after 2002.

As for the financial industry, Austrian banks were the first to enter central and eastern Europe, which had become a financial vacuum after the collapse of the Soviet Union. Austria has close historical ties to the region. Competitive small- and medium-sized companies in Italy, unable to take advantage of cheap labor in China because of their small size, invested in Romania, which has a low cost of labor, is only a short distance from Italy, and shares a similar language. Italian financial institutions followed suit. During the Soviet period there were no local banks in the three Baltic countries, just Russian banks. So after the collapse of the Soviet regime, subsidiaries and branches of Western banks, led primarily by Swedish banks, came to be the only financial institutions in the region.

Entering the twenty-first century after a difficult unification, German banks could now afford to move into foreign markets, and they began expanding into central and eastern Europe in earnest. The bubble years between 2002 and 2006 witnessed competition among Western financial institutions who, while making inroads into central and eastern Europe, engaged in the same kind of race that took place in Japan in the late 1980s: namely, trying to boost loans to this area. As a result, outstanding loans from Western financial institutions to the region skyrocketed during this period.

Furthermore, the establishment of the EU and the introduction of the euro opened up a new economic frontier in Europe. As you may know, the EU and euro were established as a compromise by Germany's Chancellor Kohl in response to demands by France and the United Kingdom, which were concerned that a unified Germany would begin to turn towards eastern Europe. That backstory notwithstanding, a massive amount of foreign capital, including direct investment from western European countries, poured into central and eastern Europe beginning in 2000 in anticipation of bright prospects for the region in the event that it joined the EU and euro zone in the future. Such capital inflows resulted in the appreciation of currencies in central and eastern European countries, whose central banks increased interest rates to fight inflation triggered by surplus liquidity caused by such foreign capital inflows. This policy of high interest rates then attracted further inflows of foreign capital. As their currencies appreciated, financial institutions and enterprises in central and eastern Europe increased their borrowings from abroad.

Who benefited most from the introduction of the euro and the start of the EU? Germany. First, Germany suddenly became more competitive as the introduction of the euro led to a substantial decline in the cost of German labor, which had been relatively expensive. German companies dominated the EU market, while Germany recorded a larger trade surplus than China due to a significant surplus in intraregional trade. In contrast, countries with relatively weak currencies like Spain became much less competitive as their labor costs rose after the introduction of the euro, but their purchasing power was dramatically bolstered, turning them into promising export markets for German products. It goes without saying that the newly-developed central and eastern Europe represented significant new markets for German producers. It should be noted as well that the German mass media did not raise sufficient awareness among the German people of these economic benefits during the bubble. The absence of such recognition had deep implications following the Lehman crisis when European countries had to address the economic crisis in Europe.

The Lehman shock of September 2008 changed everything. The loss of market confidence all over the world triggered large-scale deleveraging and destroyed the economy of countries that had been benefiting from the bubble for several years. The first country that suffered was Iceland, followed by Latvia.

Consequences of the Lehman Shock, Part 1: Iceland

First I would like to consider the crisis in Iceland. Iceland is a small country, with a population of 350,000, half the population of Tottori, the smallest prefecture in Japan. Its territory is no more than the islands of Hokkaido and Shikoku combined. It is a volcanic country: the eruption of Iceland's Mt. Laki and Japan's Mt. Asama in 1783 famously released volcanic ash that lowered temperatures around the world and caused famines that helped bring about the French Revolution.

Until the 1980s Iceland was a poor country whose economy was dominated by fishery and tourism. The extensive use of hydropower and thermal power to generate electricity gave the country low electricity costs, which the first foreign investors tried to exploit in the late 1990s by building an aluminum smelting complex. The success of the complex led to the construction of similar plants, which led in turn to an inflow of foreign capital in general. Following the examples of Luxembourg, Switzerland, and Ireland, Iceland also facilitated liberalization of capital flows, privatization of banks, and flexible exchange rates. Under those circumstances, foreign investors launched major investments into Icelandic financial institutions, and Icelandic financial institutions started to raise money by issuing debentures in foreign countries, taking advantage of financial liberalization. The dependency on debentures as the source of funds reached fifty percent of the total fundraising of Icelandic banks. Capital inflow was first directed toward investments in domestic real estate, which led to a hike in prices. Rising real estate prices in turn attracted further investment from overseas. The high demand for krónur among foreigners seeking to invest in Icelandic real estate resulted in a sharp appreciation of the króna. Banks in Iceland took advantage of the strong króna and started investing in real estate and companies in the United Kingdom. Individual Icelanders also took advantage and borrowed low-interest currency such as Japanese yen to finance purchases of homes and luxury cars. As interest rates were raised to prevent the economy from overheating, foreign investors further increased investments into Iceland with the aim of enjoying high interest rates. Banks in Iceland also took advantage of the situation and opened up their branches or internet banking in Europe, mainly in the United Kingdom and the Netherlands, to attract foreign depositors with their high deposit rates.

Consequently the size of the balance sheets of Icelandic banks reached more than ten times the size of the country's GNP (about 2 trillion JPY). As a result of this bubble, Iceland became the third wealthiest nation in the world after Norway shortly before the financial crisis broke out in 2008. This was a very risky situation. We might compare the country to someone with a limited income who borrows money from others and stays afloat by investing that loaned money or loaning it others. Since his own income is so small, as soon as the funds stop flowing he is hard-pressed to repay his loans.

The Lehman shock of September 2008 changed everything in Iceland. As confidence dropped out of global markets, the corporate bond market literally closed. Icelandic banks completely lost their ability to raise funds and the market began to indicate a clear lack of faith in Iceland's ability to repay. In early October of 2008, less than one month after the Lehman shock, Iceland had to approve a bill to nationalize Icelandic banks that found themselves unable to pay. Its currency plummeted and the value of debts denominated in foreign currencies ballooned. On October 24, one month after the Lehman shock, the IMF board approved USD 2.1 billion in emergency credit for Iceland.

Subsequently, an international dispute developed over the protection of depositors in the United Kingdom and the Netherlands, who had deposited their money in branches and internet banks of Icelandic banks that attracted them with high interest rates. The United Kingdom applied an anti-terrorism law to freeze assets of Icelandic banks inside its territory. Consequently a compromise was reached whereby Icelandic taxpayers would shoulder the burden of protecting British and Dutch depositors. A bill to this effect was approved by the parliament of Iceland in late 2010, only to find the president reluctant to sign the bill because of taxpayer resentment. The bill was rejected in two referendums. Currently the issue is under deliberation in the EFTA Court.

The "Finance Nation" Delusion

What the tragedy in Iceland made clear is the true nature of the "Finance Nation" concept, which was once loudly trumpeted in our country too. In the "Finance Nation" model, a country builds its foundation by attracting foreign capital and financial institutions through such measures as the liberalization of its financial market and favorable tax policies such as reduced corporate taxes. In addition to Iceland, the United Kingdom, Switzerland, Portugal, Ireland and Singapore have all attempted to adopt this model. Even in Japan several economists argued that it was necessary to become a "Finance Nation." These countries maintained a high value for their currency in order to remain competitive in the financial sector. But maintaining a high-value currency puts manufacturers in a difficult position and makes it hard to develop the national economy by producing goods. The United Kingdom is the best example.

"Finance Nation" policies work well as long as the financial sector operates normally, but once a financial crisis like the current one occurs those policies become disastrous. Ultimately the only prescription for treating a financial crisis is the injection of public money with a view to protecting the financial system. This is well evidenced in the experience in Japan. Japan or the United States, which have the luxury of large-scale economies, can manage problems in their financial systems by shifting the burden to their taxpayers. However, countries like Iceland whose financial sectors are too large relative to the scale of their economies cannot protect their financial institutions with huge injections of taxpayer money, for the simple reason that the liabilities of the financial institutions are several times larger than the country's GNP. As mentioned above, Icelandic banks' balance sheets were more than ten times larger than the country's GNP before the sharp drop in the value of the króna, while those of Switzerland are nearly five times the size of the Swiss GNP. In 2009 the United Kingdom nationalized major banks by injecting huge amounts of public funds. That injection amounted to more than 3% of GNP. The government guarantee on banks amounts to 10 times the injected public funds, accounting for nearly 40% of GNP. If the repayment of such public funds cannot be assured, the prudence of British public finance will naturally come under suspicion. Thus, the dark side of the "Finance Nation" model has been revealed through the ongoing economic crisis.

The Success (?) of Iceland

Recently the Icelandic economy has made a rapid recovery. The depreciation of the króna has contributed to a marked recovery of tourism, resulting in increased foreign currency payments. Assisted by a flourishing fishing industry, GNP growth in 2011 turned positive for the first time since 2008, and for 2012 growth is expected to be 2.5%. The burden of large amount of debts mainly owed by private financial institutions has been mitigated by debt reduction, and the financial system, which was the major source of concern, now operates more smoothly than envisaged. As a result, Iceland made a prepayment to the IMF in 2012. While there are lingering issues such as the outcome of the court case brought against it by the governments of the United Kingdom and the Netherlands, which might result in substantial amounts of additional liabilities for the government of Iceland, at least it is not in the desperate situation envisaged at the onset of the crisis.

This situation in Iceland could teach a lesson to Greece and other European countries that are suffering from debts and economic crisis. In short it could point the way to a successful recovery: restore competitiveness by depreciating the exchange rate and reducing debt in order to restore public finances and the financial sector. Nevertheless, it should be noted that Iceland has the following unique circumstances:

1. A major part of Icelandic debts was privately denominated in the local currency, the króna. This is different from the debt of Greece, which is mostly public and denominated in euro.

2. The Icelandic economy is so small that trimming back Iceland's private liability has only a limited effect on other European countries, particularly on their bank balance sheets. That is not the case when European countries with large economies like Spain cut liabilities, which has a substantial effect on those countries' creditors--the financial institutions of their European neighbors.

3. It was relatively easy for Iceland to reach consensus thanks to its small population.

4. Depreciation of its currency was possible because Iceland is not a member of the EU.