



International burden-sharing during a financial crisis: We will all go together when we go

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Accepted: 26 March 2021

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Abstract

During the financial crisis of 2008–2010, governments have had varying success in containing the fiscal costs of stabilizing their financial sectors. This article challenges the existing literature that attributes these differences purely to national factors and contends that the international dimension affects a government's capacity to share the costs across borders. Specifically, if a country shares a leveraged creditor with other countries, concerns about regional contagion will drive decisions by outside actors to participate in or prevent external burden sharing. A comparison of the role of the Swedish government during the financial crisis in Latvia and the ECB's influence on Ireland shows that these decisions can both facilitate or prevent international burden-sharing. While Latvia benefited both from maintained exposure by Swedish banks and an internationally coordinated response to its crisis, the Irish government accumulated losses because foreign banks reduced their exposure and the European Central Bank vetoed "bailing in" bondholders of bankrupt banks. Future research on financial stabilization should therefore more explicitly consider possible contagion effects from bailing in foreign creditors.

Keywords Financial crisis · Financial integration · Bank bailouts · Ireland · Latvia · Contagion

Introduction

Financial crises can be costly experiences for taxpayers. During the financial crisis of 2008 governments stepped up considerable resources to rein in panic in the banking sector and restore stability. They ensured the provision of liquidity to their financial sector when the interbank market froze and almost invariably set up support schemes for recapitalizing banks and relieving them of toxic assets. But some governments could limit fiscal outlays on financial stabilization, whereas others incurred

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considerable government debt in the process of rescuing their banks (Grossman and Woll 2014). In Europe, several countries ended up requesting international assistance to cope with the fiscal costs of stabilizing their financial sectors.

Most analyses of financial crises focus on national bailout schemes to explain why some countries have incurred higher losses than others. Often these studies concentrate on the precise design of bank bailout schemes and try to understand why governments accept more losses or prefer to uphold market outcomes (Honohan and Klingebiel 2003). The main question is thus often how decisions by the government and the cooperation of the financial sector affected the fiscal costs of restoring financial stability (Culpepper and Reinke 2014; Woll 2014).

Less attention has been paid to the fact that financial instability in 2008 was an international phenomenon. After all, many governments were spurred to intervene in financial markets because the failure of Lehman brothers in the United States had spread panic in European markets. And while the failure of the US government to set up a rescue scheme for Lehman unleashed the global crisis, this article argues that in Europe concerns about international financial fragility could play an important role in the politics of financial stabilization.

In short, the article argues that international actors sometimes intervened to ensure governments did not take actions that could spark international financial contagion. After all, the decision by one government to suspend a policy commitment can affect market participants' expectations of developments in other jurisdictions. If public authorities with an interest in regional financial stability identify such a threat, they have an incentive to ensure that the commitment is defended and contagion is prevented. These interventions can have a considerable impact on the crisis management options available to the national government.

This case is made by comparing the influence of international actors on financial crisis resolution in Latvia and Ireland in 2008–2010. Though both countries underwent severe financial crises, the Latvian government suffered relatively limited fiscal losses, while the Irish government had by far the costliest financial crisis relative to GDP in Europe (Millaruelo and R o 2017). In both cases these outcomes were to a good degree affected by decisions by international actors that aimed at retaining international financial stability.

In Latvia, international creditors, above all the Swedish government, took various decisions that aimed to allow the government to resolve the crisis without a devaluation of the currency. Swedish banks had invested across the Baltic countries and could have triggered wider regional panic if the Latvian currency was devalued. In Ireland, however, the government had to pile up fiscal losses in order to maintain investor confidence across the Euro Area. Under pressure from the ECB, the government continued its bank guarantee even for insolvent banks.

This analysis thus adds to the academic debate about the financial crisis in Europe in 2008. In a fragile international market environment, the question of how some national governments would handle the crisis became seen as a regional concern and triggered interventions aimed at maintaining international market confidence. This finding builds on existing scholarship which has emphasized the role of foreign bank ownership in stabilization in Central and Eastern Europe (Kudrna and Gabor 2013; Epstein 2014, 2017) and role of monetary institutions in crisis resolution strategies



(Mabbett and Schelkle 2015; Moses 2016). The explanation presented in the following sections adds to the literature by linking these structural factors to discretionary decisions made by various external actors that affected the fiscal costs of financial stabilization.

This article proceeds as follows. In the next section the literature on the political economy of bank bailouts so far is reviewed and the argument of this article is introduced. The third section compares the Latvian and Irish financial systems and their fiscal outcomes from the crisis. The fourth and fifth sections present these countries' experiences during the financial crisis in turn. Section six relates the empirical findings back to the argument. The final section concludes.

Understanding the costs of bank bailouts

Literature review

Since the 2008 crisis, many political economists have studied what determines the fiscal costs of bank bailouts. One set of explanations looks at conditions that may lead governments to accept more losses. Authoritarian governments tend to choose more costly resolution strategies because democratic governments have an electoral incentive to limit public losses (Rosas 2009). However, increasing middle-class wealth has over time changed that calculus and may incentivise governments to socialize bank losses instead (Chwioroth and Walter 2019). Another argument states that partisan politics makes a difference and that left-wing governments tend to provide costlier bailouts (Cioffi and Höpner 2006; Posch et al. 2009). Lastly, some governments have fared worse because of the inability of their bureaucracies to provide sufficient information for proactive crisis management (Satyanath 2005; Gandrud and O'Keefe 2017).

The other important factor to look at is the strength and organization of the banking sector. If governments succeed in finding collective solutions with the banking sector, this reduces fiscal costs (Grossman and Woll 2014), but uncoordinated and bilateral solutions turn out more costly (Woll 2014). Governments could also jawbone banks into collective solutions when banks had no exit options from the market (Culpepper and Reinke 2014). As regards links between policymakers and bankers, the literature is divided between those that argue that cronyism (Rosas 2006) and bank lobbying make bailouts more expensive (Keefer 2007; Johnson and Kwak 2011), and those that maintain that elite homogeneity can facilitate cooperation between the government and banks and result in better public–private burden-sharing (Jabko and Massoc 2012; Massoc 2020).

Both these currents in the literature have in common is that they treat the politics of bank bailouts largely as a national affair. Grossman and Woll (2014), for instance, find that the international exposure of the banking sector is not associated with increasing bailout costs over a set of European countries. But given how important the role of the international financial system has been for other aspects of financial stabilization (Allen 2013; Mabbett and Schelkle 2015), and how much emerging markets have struggled with the costs of banking crises and currency crises (Roubini



and Setser 2004; Reinhart and Rogoff 2009), a look at international market conditions may shine a light on a different dimension of the politics of financial crisis. In this regard there is some disagreement between fears that foreign banks might quickly reduce their exposure (Roubini and Setser 2004) and what Rachel Epstein (2017) has called the ‘paradox of bank ownership’ in Eastern Europe: foreign owners often provided liquidity and capital where local governments could not, and thereby contributed to financial stability. A related question refers to the capacity of governments in financial centres to compel banks to maintain international exposure and prevent disruptive capital outflows from peripheral countries (Massoc 2020). Below it is argued that international financial market structures do not just affect the power balance between banks and governments, but also provide a rationale for public actors to get involved in financial crisis management abroad.

The argument in brief

The Global Financial Crisis in 2008 stood apart from isolated national banking crises because of the threat of international instability and cross-border transmission of financial shocks. It is argued here that in such an environment, the home authorities of internationally exposed banks take a regional view of financial stabilization. Decisions in other jurisdictions may not just affect the costs of resolution of cross-border banks (Goodhart and Schoenmaker 2009; Kudrna and Gabor 2013), but also spread financial instability to other countries and aggravate the problem.

In order to understand how, it is instructive to revisit theories of international financial contagion. Following Masson (1998), the narrow definition of contagion is used here, referring to it as the

triggering of a crisis in another country “for reasons unexplained by macroeconomic fundamentals.” Three conditions—the unholy trinity of contagion (Kaminsky et al 2003)—have been identified as exposing a group of countries to this risk. First, all countries must have run persistent external deficits, which makes them vulnerable to a sudden stop in capital flows if creditors reduce exposure (Reinhart and Calvo 2000; Kumhof et al. 2020). Second, these countries share a common leveraged creditor, often commercial banks, that could transmit financial stresses between jurisdictions (Kaminsky and Reinhart 1999). Third, a snap announcement to abandon a previous policy commitment, such as an exchange rate peg, in one country, can serve as a wake-up call for investors about similar vulnerabilities in other countries and trigger margin calls that destabilize previously stable jurisdictions (Goldstein and Hawkins 1998).

This gives financial contagion an explicit political dimension. The moment one vulnerable government decides to renege on a commitment, it damages the credibility of other governments in similar situations (Drazen 2000; Bordo 2018). The result is that questions of defending a currency parity or maintaining investor confidence are matters of regional, not just national concern. The threat of contagion provides a strong incentive for actors with an interest in maintaining regional financial stability to ensure that the government keeps its promise. These outside actors—which could include international financial institutions, the governments of similarly positioned



states, or the home authorities of foreign investors—may also provide liquidity assistance to allow the government to hold out. How this impacts the eventual fiscal costs of financial stabilization depends on the precise form of commitment to be defended.

Financial systems in Latvia and Ireland

This study compares Latvia and Ireland in a most-similar-cases set-up. In terms of the International Monetary Fund's (IMF) financial crisis indicators (Laeven and Valencia 2012), the countries appear near-identical. Both had experienced steep increases in private debt in the years prior to the crisis and these debt-fuelled consumption booms resulted in considerable current account deficits and overheating economies. During the crisis, the peak NPL rate was slightly higher in Latvia than in Ireland, with cumulative losses in the bank sector at comparable levels. For the entire crisis, both countries recorded output losses of 106% of GDP (Laeven and Valencia 2012). The differences in fiscal effort, however, were staggering. The Latvian government covered bank liabilities equal to 9% of GDP and recorded fiscal costs of 5.6% of GDP; in Ireland, by contrast, the government disbursed funds equal to more than twice its GDP and lost more than 40% of GDP (Table 1).

Yet, while both countries had run persistent external deficits, the contrasting ways in which they were funded provides a first indication of how different crisis resolution could be in practice. About 60% of the Latvian banking market was controlled by the subsidiaries of Swedish banks, which had followed a strategy of acquiring retail market shares across all three Baltic states (Danske Bank 2008; Epstein 2017). The subsidiaries built up portfolios of illiquid mortgage loans which they funded almost exclusively through their parent banks (Mitra et al. 2009). As a result, not just was Latvia highly dependent on capital inflows from Sweden, but Swedish banks, above all Swedbank and SEB, were also a common creditor to all three Baltic states, where their total claims corresponded to 16% and 13% of their total assets, more than the groups' capital (Ingves 2010). Only one systemically relevant bank in Latvia, Parex Banka, was without a foreign parent.

The Irish market, by comparison, was controlled by domestic banks (Danske Bank 2009) which depended on access to international credit markets to roll over roughly half their balance sheets (Nyberg 2011, p. 38). The biggest share of that wholesale funding came from the financial centres of Europe, especially German, British and Belgian banks, which together held about half of all foreign claims on Ireland, most at maturities shorter than one year (Bank for International Settlements 2008). This made Ireland one of several peripheral Euro Area states dependent on wholesale funding from the core (Hobza and Zeugner 2014; Schelkle 2017).

A second important difference between both countries can be found in the monetary regimes that they were operating under. Ireland, as a member of the Euro Area, did not face any exchange rate risk and had a powerful potential lender of last resort for its banks, namely the ECB. Latvia's capacity to provide emergency financing for banks was, however, significantly more limited. To begin with, the Latvian central bank operated a hard currency peg, like its Baltic neighbours (European Central



Table 1 Comparison Latvia and Ireland, *Sources* Eurostat; (Laeven and Valencia 2012; Grossman and Woll 2014; Millaruelo and Río 2017)

	Latvia	Ireland
Current account balance 2007 ^a	-20.6% of GDP	-6.5% of GDP
Private debt in 2007 (2004) ^b	105.3% of GDP (68.5% of GDP)	198.1% of GDP (149.4% of GDP)
Cumulative losses in the banking sector	5.3%	5.8%
Peak NPL rate	15.9%	12.9%
Government guarantees (actually disbursed)	38% (9%) of GDP	232% (229%) of GDP
Fiscal costs	Laeven and Valencia 2012 5.6% of GDP	40.7% of GDP
	Millaruelo and Río 2017 4% of GDP	28% of GDP

^aCurrent account balance—annual data, retrieved 15 March 2021, <https://ec.europa.eu/eurostat/databrowser/view/tipsbp20/default/table?lang=en>

^bPrivate sector debt, consolidated—% of GDP, Eurostat, retrieved 1 May 2018, <https://ec.europa.eu/eurostat/databrowser/view/tipspd20/default/table?lang=en>



Bank 2005). This meant that it would be unable to provide emergency liquidity to the financial sector since it had to back up its currency with foreign reserve holdings (Bindseil and Winkler 2012). Latvia had among the lowest foreign reserves among all emerging markets (Schadler 2008) which might have left it unable to defend its currency in the face of severe capital flight. The Central Bank of Ireland looked therefore initially better placed to step in and provide liquidity for its banks than the Bank of Latvia.

Can these institutional differences help explain the vast gap in fiscal outcomes? At first glance they would seem to stack the deck against the Latvian government, which had slightly worse financial starting conditions and seemed to be worse-equipped to stabilize its banks than the Irish government. This comparison also shows that both countries were potential cases for financial contagion because they had run external deficit and shared a common creditor with a group of similar countries. Latvia, together with the other Baltic states, had funded its external borrowing largely through Swedish banks and committed to a currency peg; Ireland, was one of several peripheral Euro Area states that had borrowed from banks from the core. The following individual case studies will show how these institutional backdrops, combined with policy commitments by the national governments led the Swedish government to support burden-sharing while the ECB's decisions increased the costs to Irish taxpayers.

Latvia: key to stability in the baltics

Latvia's crisis response initially centred on the need to stabilize the situation around Parex. The bank was on course to default on a syndicated loan in early 2009 and lost about a quarter of its deposits, most of them from foreign depositors, between August and November 2008. The government initially acquired a 51% stake in the bank, but a simultaneous run on Parex deposits and euro reserves in mid-November stoked fears of an imminent currency devaluation. Following the first mission by the IMF, the European Commission, and Sweden's Riksbank, the government increased its stake in the bank to 85% (FCMC 2009b). Already in its Letter of Intent, the Latvian government promised to move towards resolving Parex soon, while assuring the IMF that it counted on foreign parent banks to provide both liquidity and capital for their subsidiaries (International Monetary Fund 2009).

Latvia's troubles intensified already before a stabilization agreement with the IMF and the European Union (EU) could be concluded. The situation got so strained that the Swedish and Danish central banks lent out euros from their own foreign reserves to the Latvian central bank under a short-term swap agreement of €500m to shore up Latvia's foreign reserves until the disbursement of the first IMF tranche (Ingves 2010; Allen 2013). Though Latvia was granted the IMF's biggest-ever loan on a per capita basis, €1.7bn or 1200% its quota, as well as €3.1 bn from the European Commission and €500m from several multilateral banks, this was insufficient to meet its financing needs. The Swedish government closed that gap of €2.3bn by brokering bilateral backup credit lines from Nordic and Eastern European countries in a rushed meeting at Arlanda airport (Åslund and Dombrovskis 2011).



The crucial issue during Latvia's stabilization was the defence of the fixed exchange rate against the euro. After the IMF had initially advocated abandoning the currency peg to restore competitiveness (Lütz and Kranke 2014), its mission chief soon agreed with all other creditors that the lats had to be defended. A devaluation, it was reasoned, was no option because 85% of resident loans in Latvia were denominated in euro and would have become more expensive to service (FCMC 2009a). The resulting increase in bankruptcies would furthermore have borne heavily on the Swedish bank subsidiaries that held these loans, thus spilling over to their parents and potentially spreading to the other two Baltic countries, where those were just as heavily invested (Árvai et al. 2009). It was feared that “a devaluation would have severe regional contagion effects” (Rosenberg 2009). If Latvia had to abandon its peg, Estonia and Lithuania would come under pressure on the currency markets, too, and end up unable to defend their currencies (Riksrevisionen 2011). The result of such a scenario was projected to be a full-blown currency crisis in the Baltics with severe repercussions for the whole region—something that many observers warned about at the time (Krugman 2008; Roubini 2009).

Resolving Parex was key for the success of the stabilization package. Soon after the government had taken control of the bank in October, it exchanged the management and imposed limits on withdrawals to stem the deposit flight (International Monetary Fund 2009). In April 2009, the European Bank for Reconstruction and Development (EBRD) acquired a 25% + 1 share in the bank and afterwards supported the government's recapitalization and resolution efforts (Griffiths 2012). Maintaining the currency peg was also crucial for containing the costs of the Parex stabilization, since the costs of servicing the government-guaranteed syndicated loan would have increased as a consequence of devaluation (Åslund and Dombrovskis 2011). The swift move towards the resolution of the bank both contained the costs of the bailout—which were €2bn lower than initially budgeted (Åslund and Dombrovskis 2011, p. 106)—and restored sufficient confidence to prevent a second deposit run, thus staving off another moment of financial panic.

Unlike Parex, the subsidiaries of Swedish banks in Latvia managed without government ownership, largely thanks to the continued support from their parent banks. While only 16% of Swedbank's and 13% of SEB's operations took place in the Baltic countries, the region was responsible for 60% and 75% of their losses during the crisis, respectively (Ingves 2010). Still, in a first evaluation in 2008, the Riksbank determined that the parent banks were sufficiently capitalized to provide support to their subsidiaries and declined from taking regulatory measures. Instead of cutting their losses, the banks maintained their exposure to Latvia, with the explicit encouragement of finance minister Anders Borg who urged banks to “behave responsibly—to perceive these Baltic countries as their home market” (Dougherty 2009). Swedish banks were also a constructive player in a reform of the bankruptcy laws which facilitated debt write-downs for insolvent households (Braslina 2010). Overall, the Swedish parent banks accepted about €900m in losses, corresponding to 4.5% of Latvia's GDP (Kudrna and Gabor 2013) and recapitalized their subsidiaries with almost €500m (SEB Banka 2010; Swedbank 2019), providing substantive relief for the Latvian government.



Besides the political encouragements, Sweden's domestic crisis response package contained several policies that contributed to the stabilization of Latvia. To begin with the Riksbank's liquidity operations enabled the parent banks to keep their subsidiaries afloat. Via internal lending, they refinanced more than 90% of the operations of their subsidiaries in 2009, circumventing the absence of any potential lender of last resort in Latvia (SEB Banka 2010; Swedbank 2019). This represented a departure from EU rules on liquidity provision for cross-border banking groups, which stated that the host (that is the Latvian) authorities were legally responsible for liquidity support to subsidiary banks (Altmann 2006). By supplying liquidity for the entire banking groups, the Riksbank thus allowed the parent banks to maintain exposure and reduce the need for the Latvian authorities to intervene.

Second, the Swedish deposit guarantees for the parent banks, even if it did not include their overseas subsidiaries, maintained the confidence of their Latvian depositors that their money was safe (Mayes 2009). Thanks to the backing of their parent banks, Swedish banks' subsidiaries even attracted some of the deposit outflows from Parex (Mitra et al. 2009), which eased the drain on Latvia's foreign reserves. Finally, even though SEB and Swedbank did not require capital injections from the Swedish state, the government had promised to stand by its banks if they should require government support because of their losses in the Baltics (Dougherty 2009). Thus, while in the end Riksbank governor Stefan Ingves was right in stating that "the Riksbank [...] has not lost any money on the transactions with the Baltic countries" (Ingves 2010, p. 6), this underplayed the contribution that Swedish government policy had made for the stabilization of Latvia.

The danger that Latvia posed for the whole Baltic region became clear when the economic situation deteriorated in mid-2009 and fears about devaluation resurfaced (Roubini 2009). Even though two successive governments enacted several rounds of painful budget cuts, they failed to meet the headline deficit target agreed with the international lenders. This led the IMF to withhold the payment of the tranche scheduled for March, and it was only released after further budget cuts of 3.5% of GDP in June (Åslund and Dombrovskis 2011). Testimony to the contagion risk, speculation against the stability of Latvia also reached Lithuania and Estonia. Interbank rates, Credit Default Swaps and currency forwards in the neighbouring countries moved alongside Latvia's and only calmed down after the IMF tranche was finally released in July (Purfield and Rosenberg 2010).

All in all, the comprehensive support that Latvia received throughout its crisis can be attributed to the risk for regional financial stability that it posed. The deep involvement of Swedish banks meant that losses from a sudden devaluation would have been transmitted to Sweden and would likely have caused contagion in the other Baltic countries. Yet, it also ensured that Sweden could support Latvia's financial stability through the parent banks, which freed up the Latvian government to focus on a single bank, rather than the entire financial system, which the government would have struggled to do. The successful defence of the exchange rate did not just have the effect of preventing a currency crisis, but thereby also reduced the bill for stabilising Parex.



Ireland: taking one for the team

Irish banks' dependence on international wholesale markets became painfully clear when the interbank market froze in September 2008. In order to ensure continued access to funding, the government on 29 September decided to issue a blanket guarantee to the six major domestic banks that covered almost all their liabilities in the next two years. The goal of this hasty decision—whose scope was €375bn, more than twice Irish GDP (Nyberg 2011)—was to avoid an outright default of Anglo Irish, a mortgage lender on the brink of collapse. The underlying concern, shared by the ECB, was that the failure of one bank might have triggered a run on other Irish banks as well (Houses of the Oireachtas 2016). The guarantee was aimed at ensuring continued access to wholesale financing, since at the time deposit movements were limited and a bank run was not in sight (Nyberg 2011, p. 78).

But the guarantee had several flaws. First, probably owing to the time pressure that surrounded its decision, the measure was not coordinated with other stakeholders. The ECB reportedly only learned about the guarantee a few minutes before it was passed and the Irish decision set a precedent across the EU (Houses of the Oireachtas 2016). Both the British government and the European Commission voiced objections to the fact that the guarantee was limited to Irish banks and eventually forced the Irish government to extend it to all banks. Second, the guarantee was clearly too broad. Its design prevented even subordinated bondholders from making losses, which made it impossible to shift at least part of the burden from taxpayers to bondholders (Lane 2011, pp. 67–68). By covering institutions whose capital was being wiped out, and which would subsequently be nationalized, the government committed to absorbing the losses of banks that should have been put into resolution (Nyberg 2011; Honohan 2012).

By December, it was clear that the guarantee would not be enough to calm markets. The government announced the first recapitalization package for Anglo Irish and two other banks (Woll 2014, p. 146). The full nationalization of Anglo followed in January 2009 and further recapitalizations in early 2009 left the government as major shareholder of the banking system.

The Irish government had to devise increasingly creative ways of keeping its banks afloat. The creation of the government's bad bank, the National Asset Management Authority (NAMA), in 2009 enabled banks to sell bad mortgage loans in return for government securities which they could use as collateral with the ECB to obtain liquidity (European Commission 2011). When the nationalized banks ran out of eligible collateral for the usual refinancing operations from the Eurosystem, they were provided Emergency Liquidity Assistance (ELA) by the Central Bank of Ireland. ELA offered a cheap way of keeping banks afloat, but required ongoing approval by the ECB's Governing Council (Whelan 2012, p. 655). When Anglo ran out of good collateral in August 2010, the government sidestepped bond markets and furnished more collateral by offering promissory notes, effectively a government IOU, which the bank used for ELA (Whelan 2012). Servicing these promissory



Major creditor countries' exposure to Ireland 2007-2011

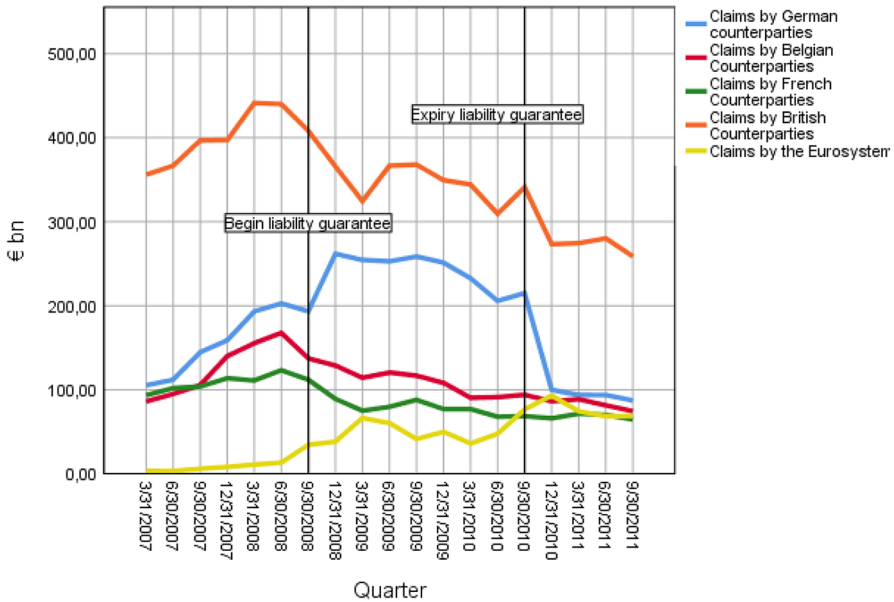


Fig. 1 Sources Bank for International Settlements, Locational Banking Statistics (<https://stats.bis.org/statx/toc/LBS.html>, Retrieved from 10 May 2019) Table 6.2; Central Bank of Ireland, Bank Balance Sheets (<https://www.centralbank.ie/statistics/data-and-analysis/credit-and-banking-statistics/bank-balance-sheets/bank-balance-sheets-data>, Retrieved from 10 May 2019) Table 4.2

notes would cost the government 2% of GDP annually for ten years (Eichengreen 2015).¹

The liability guarantee notwithstanding, foreign creditors successively reduced their exposure to Irish banks. They refused to renew maturing bank bonds after they had been redeemed by the government under the guarantee, which lead to a net outflow of liquidity (Whelan 2012). As can be seen in the diagram below this outflow was somewhat compensated by ELA and Eurosystem financing. It is worth noting though that German banks increased their holdings of Irish bonds for so long as they were guaranteed by the government and only sold them off when the guarantee expired. Irish banks received €130bn in liquidity support from the Eurosystem and ELA between 2009 and late 2010, three times government spending on bank recapitalizations. This reliance on European funding sources for bank funding, however, also left the government dependent on ongoing approval from the ECB's Governing Council. The ECB could at any point object to the use of ELA by a national central bank, effectively cutting off this emergency funding. It did, however, not take

¹ In 2013, the promissory notes were restructured into bonds, which reduced their eventual fiscal impact by about a third (Eichengreen 2015).



an official position on promissory notes, its “non-objection” against a manoeuvre this close to monetary financing is quite surprising (Eichengreen 2015). It would later use its leverage over the Irish government to influence another major decision regarding burden-sharing (Fig. 1).

When the liability guarantee expired in September 2010, there was little political appetite for piling on further fiscal costs to make foreign banks whole. Yet, whereas junior bondholders of the insolvent banks were forced to accept haircuts between 70 and 90% (Ahearne 2012), unsecured senior bondholders were spared. The scale of these claims that could still have been restructured was about €20bn, or 13% of Irish GDP at the time (Sandbu 2015). Though while the government and public opinion clearly wanted to ‘burn the bondholders’, Taoiseach Brian Cowen had to admit that

[a]t no stage during the crisis would the European authorities, especially the European Central Bank, have countenanced the dishonoring of senior bank bonds. The euro area policy of “No bank failures and no burning of senior bank creditors has been a constant during the crisis” (quoted in Woll 2014, p. 152).

The ECB, in a thinly veiled reference to the promissory notes, threatened to demand back from the Treasury around €50bn that the Central Bank of Ireland had disbursed in ELA to nationalized banks (Trichet 2010a). After the ECB had given a nod to the promissory notes deal, it now used them as a bludgeon to constrain the government’s choices for creditor bail-in.

At first sight, it seems surprising that the ECB would be opposed to shifting part of the losses from bank failures away from the Irish taxpayers. One former Irish politician recalls that the objection of the ECB, or at least its president Jean-Claude Trichet, at the time was that the losses from the restructurings would primarily fall on big German and French banks (Mac Sharry 2014). Yet the reason, it appears was not just to protect these banks against losses, but to consider the Euro Area-wide effects of restructuring senior bond tranches in one country. As the Deputy Director of the IMF, Ajai Chopra, explained: “...the key issue became the issue of contagion... they [the European institutions] were very concerned that moving on imposing losses on senior bondholders in Ireland would adversely affect Euro Area banks and their funding markets” (Chopra, quoted in Houses of the Oireachtas 2016, p. 360). Indeed, when the Irish Times reported that losses for senior bondholders were under discussion during the Irish bailout negotiations, funding conditions deteriorated for Greek, Irish, Italian, Spanish, and Portuguese banks (Kelly 2011). This risk of contagion was too big for the ECB to agree to and as a result, it made sure that all debt would be honoured, even if that concentrated the losses on Irish taxpayers.

As the costs for the bank bailout piled up, the Irish government found it more and more difficult to finance itself on the bond markets. Until the Greek bailout, bond yield differentials had been modest with spreads over Germany of only 100 basis points, but by the end of the year they surpassed 7% which made it necessary for the government to request international assistance. The sudden deterioration followed a downgrade of Ireland’s credit rating by Standard & Poors which coincided with the expiry of the liability guarantee (Beesley 2011). Without the protection of the guarantee, foreign banks sold off their bonds and many overseas depositors withdrew



their funds from Irish banks. Another letter from the ECB in November threatened to withhold ELA should the government not apply for a sovereign bailout (Trichet 2010b). The government shortly thereafter requested a bailout from the IMF and the EU, in which another €35bn were earmarked for bank recapitalization. A second request for bailing in bondholders by a newly elected government in 2011 was once more rejected by the ECB and the Commission (Houses of the Oireachtas 2016), though by that time only €3.7bn in eligible bonds were outstanding—all previous issues had been redeemed in full by the government (Ahearne 2012).

The Irish government had clearly overextended when it guaranteed its entire banking sector, but the costs only really started piling up in late 2010, when more fiscal resources had to be deployed to keep Anglo operating. The ECB's actions regarding ELA, first when it silently approved the promissory notes deal and later, when it vetoed senior bondholder bail-in both allowed the government to delay adjustment and enabled foreign bondholders to reduce their exposure in an orderly fashion and without facing haircuts. Through these measures the ECB succeeded in pre-empting the risk of contagion across the Euro Area periphery—but these decisions increased the fiscal losses for the government.

Discussion: the regional implications of national commitments

This section turns to the rationales that motivated the Swedish government and the ECB to take such opposite stances towards spreading the costs of financial crisis resolution in Ireland and Latvia. Recall that the Swedish government explicitly encouraged its banks to stand by their Latvian subsidiaries, whereas the ECB intervened to bar the Irish government from bailing in senior bondholders. The argument made here is that while both Latvia and Ireland posed regional contagion risks, their differences in international exposure help understand why this lowered the fiscal burden in Latvia, but increased the costs for Irish taxpayers.

To recall, the 'unholy trinity of contagion' stated that external deficits, common leveraged creditors and suspensions of policy commitments can trigger contagion. Though in both cases there were external deficits, the funding of banks was quite divergent because Irish banks relied mostly on market funding, whereas Swedish-owned banks in Latvia received almost all funding from their parent companies. For Swedish banks, the common creditor in the Baltics, the risk was that devaluation across the Baltic countries would have all but wiped out a part of their core business; German banks, which had even increased their exposure to Irish banks after the guarantee, could have spread the crisis to banks in Southern Europe. These were the reasons why potential devaluation in Latvia or senior bondholder bail-in in Ireland were considered risks not just for national, but also regional financial stability.

The principal way in which the ECB and the Swedish government could support the commitments was by providing additional liquidity and delaying adjustment. The ECB tolerated the promissory note deal, which allowed the Irish government to fulfil the liability guarantee but threatened to bankrupt the Irish government if it was to bail in bondholders. But neither the ECB, nor, for that matter, the German government (see Massoc 2020) was able to ensure German banks would maintain



exposure in case they were bailed in. The Swedish government, by contrast, helped the Bank of Latvia to defend the currency peg both directly, via a central bank swap line, and indirectly, by allowing the parent banks to forward liquidity from their home market. In addition, the assistance of the IMF and, later, the EBRD ensured an efficient and timely resolution of the only major Latvian bank that needed recapitalization. Hence, the precise nature of the policy commitment to be defended and the sort of contagion risk it posed help explain why the result were lower fiscal costs in Latvia and higher costs in Ireland.

It could of course be objected that the ECB had an explicit responsibility for the financial stability of the entire Euro Area, whereas the decisions by Swedish policymakers were still ultimately aimed at domestic stability (Hilmarsson 2018). However, this underplays the extent to which policymakers in the Nordic-Baltic region had internalized the concept of the ‘extended home market.’ Already before the crisis the Riskbank had closely monitored banks’ exposure to the Baltics (Sveriges Riksbank 2007; Leung 2020). Since Swedish banks controlled more than half of the financial assets in the Baltic states “the Swedish state had an implicit responsibility for these systems and, therefore, for the countries’ economic stability” (Riksrevisionen 2011, p. 60).

The effect of the unholy trinity of contagion on international burden-sharing becomes even clearer when the case of Cyprus is considered for comparison. Like Ireland and Latvia, Cyprus had an outsized financial sector and previously posted massive current account deficits. However, at the time, the contagion risk was more limited because the major source of bank funding were offshore deposits which did not come from leveraged banks, but mostly Russian depositors (Demetriades 2017). In coordination with the Troika, Cyprus dispensed with a major policy commitment when it froze deposits and instituted capital controls to bail in depositors. Yet this did not trigger a run on banks across the Euro Area (although this had been feared by some, see Orphanides 2014). Russian savers had all their eggs in one basket and no other country looked similar to Cyprus. Absent a risk to regional financial stability, drastic measures could be taken to limit the fiscal costs of financial crisis resolution.

Conclusion

This article has set out to address the question why national governments end up incurring higher or lower fiscal losses during a financial crisis. The argument presented here states that other actors in the regional financial system intervene in national crisis resolution plans when they perceive the risk of contagion effects. The case studies of Latvia and Ireland have shown that these governments had only a limited say about policy decisions that might have triggered international instability. Though both governments received support to defend a prior policy commitment, these commitments had different effects for the fiscal costs. When the Latvian government struggled to maintain its currency peg, Swedish banks recapitalized their subsidiaries and the Riksbank provided liquidity support, which reduced the burden on the Latvian government and prevented a disastrous currency devaluation.



In Ireland, by contrast, the ECB barred the government from bailing in bankrupt banks' creditors out of concern about the financial stability of the Euro Area periphery. The ultimate cost to the taxpayer, therefore, depended on the commitment that needed to be defended.

For the political economy of regional financial systems, the identification of contagion risk thus establishes a new link between market structures and political decisions by external lenders. The presence of a common leveraged creditor has proven sufficient to compel outside actors to prevent sudden decisions with regional repercussions. The effect of contagion risk on fiscal cost, however, seems conditional on the capacity of foreign investors to reduce their exposure quickly. Swedish banks were trapped with illiquid assets and voluntarily contributed to stabilization to prevent currency devaluation. ECB policymakers were however frightened by the threat of foreign, primarily German, banks cutting and running not just from Ireland, but also other countries, and therefore vetoed bail-ins. In the end, it appears that central banks with externally exposed financial markets have learned some lessons from previous regional financial crises and preferred to err on the side of caution in both cases.

These findings contribute to the comparative literature on bank bailouts by proposing one way in which the international financial system can matter for crisis resolution in addition to decisions on the national level. In integrated financial systems, the crisis decisions by governments can be perceived as interdependent. If one country fails to uphold a policy commitment, this could spread financial instability and worsen financial conditions abroad. This gives external actors, such as central banks, an incentive to provide liquidity to the government and allow it to keep its promise. This argument builds on insights about the effects of transformed state-bank ties (Avdjiev et al. 2016; Epstein 2017) and monetary institutions (Mabbett and Schelkle 2015) for financial stabilization by providing a novel explanation for discretionary interventions in financial crises that is rooted in international market structures.

It can of course be debated to which extent there existed an actual contagion risk in both cases discussed in this study. Both the IMF and other analysts have argued that a bail-in in Ireland might have had a limited impact on borrowing costs for banks in Southern Europe (Hughes 2010) and that bank linkages were rather weak in the Euro Area (Bonaldiet al. 2015). Likewise, some analysts expected the Swedish banks to be able to withstand even a currency meltdown in the Baltics despite their deep linkages (Roubini 2009). Yet the argument of this paper, that if the risk of a transmission of financial panic is identified, external interventions will aim at preserving a national policy commitment, remains intact. After all, the point is not to argue that decision makers can foresee the regional implications of abandoning national commitments, but just that they will intervene to mitigate that risk.

These findings suggest that national decision makers' influence on the costs of financial stabilization can be constrained. International conditions matter a great deal to the options that a national government has available and bring other actors, such as foreign banks, central banks, or other governments, to the fore. International cooperation is motivated by regional financial stability; the fiscal costs, as the case of Ireland made painfully clear, are only a secondary concern.



Acknowledgements The author would like to thank Dermot Hodson for the supervision of the thesis on which this article is based and Amy Verdun, Matt diGuiseppe, and David Howarth, the editors and anonymous reviewers of *Comparative European Politics*, as well as the participants at the NKWP Politicologenetmaal 2019 in Antwerpen for their comments and suggestions on previous drafts. Winner of the CEP/CES-GPE 2019 Early Career Scholar Prize.

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Publisher's Note Springer Nature remains neutral with regard to jurisdictional claims in published maps and institutional affiliations.

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