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# Mortgaging Europe's periphery

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LSE 'Europe in Question' Discussion Paper Series

# Mortgaging Europe's periphery

Dorothee Bohle

LEQS Paper No. 124/2017

September 2017

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# Mortgaging Europe's periphery

Dorothee Bohle*

## Abstract

This paper is concerned with the development of housing finance in peripheral European states. Interestingly, the biggest mortgage and housing booms and busts prior to the Global Financial Crisis (GFC) have occurred in these countries, rather than in the core. This is surprising, given the comparatively low level of mortgage debt and the unsophisticated financial sectors in the periphery. The mortgage and housing booms and busts have also made these countries highly vulnerable to the fallout from the GFC, and have often been associated with severe banking and even sovereign debt crises. The paper asks why peripheral countries have been particularly vulnerable to housing and mortgage booms and busts; how these have shaped their exposure to the GFC, and how the GFC has affected peripheral housing finance. Building on literature on housing financialization and varieties of residential capitalism, the paper traces trajectories of housing-induced financialization before and after the GFC in four European peripheral countries: Hungary, Latvia, Ireland and Iceland. The paper argues that their differences notwithstanding, Europe's East and peripheral Northwest have been characterized by high homeownership rates and unsophisticated mortgage markets. The evolving EU framework for free movement of capital and provision of financial services as well as the availability of ample and cheap credit has induced a trajectory of financialization, which has taken two major but not mutually exclusive forms: domestic financial institutions' reliance on funding from wholesale markets, and direct penetration of foreign financial institutions. These two forms of financialization attest to a core-periphery relationship in the recent episode of housing financialization, whose hierarchical character played out in the crisis. Peripheral European countries experienced sudden stops and reversals of capital flows, which badly affected their banking systems. Unable to solve the looming banking crises on their own, they had to turn to creditors to gain access to much needed capital inflows. Different combinations of international conditionality, domestic policy responses and the original level of mortgage debt result in different trajectories in housing finance after the crisis.

**Keywords:** comparative political economy, international political economy, housing, financialization, peripheral capitalism

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# Mortgaging Europe's periphery

## 1. Introduction

Why have the biggest European mortgage and housing booms and busts prior to the Global Financial Crisis (GFC) occurred in the continents' periphery, rather than its core? How have mortgage and housing booms affected these countries' vulnerability to the GFC, and how has the GFC affected peripheral housing finance? This paper seeks to understand the development of housing finance in peripheral European states. A small but growing body of scholarly literature in international and comparative political economy has established the centrality of housing finance in contemporary capitalism. Housing has become a most significant absorber of global liquidity, and innovations in housing finance have been identified as the root cause of the GFC (e.g. Aalbers 2016, Ansell 2014, Schwartz 2009, Schwartz and Seabrooke 2009). At the same time, national housing systems differ in how far they have been integrated globally, the liquidity of their mortgage markets, and their reliance on housing as a social protection mechanism (Schwartz and Seabrooke 2009, Schelkle 2012). While originally the literature associated volatile housing markets and soaring mortgage debt with the Anglo-American liberal market economies, recent work has shown that these phenomena cross-cut established varieties of capitalism (ibid.). The research has so far mostly focused on advanced capitalist countries.

This paper seeks to probe further into the differences of residential capitalisms in Europe, and their pre- and post-crisis trajectories. Specifically, it seeks to establish commonalities and differences among *peripheral housing finance regimes* in Europe. The paper argues that their differences notwithstanding, Europe's East, South and peripheral Northwest have been characterized by high homeownership rates and unsophisticated mortgage markets. The evolving EU framework for free movement of capital and provision of financial services as well as the availability of ample and cheap credit has induced a trajectory of financialization in these countries, which has taken two major but not mutually exclusive forms: domestic financial institutions' reliance on (increasingly short-term) funding from wholesale interbank markets, and direct penetration of foreign financial institutions setting off a – mostly foreign currency – mortgage lending boom. These two forms of financialization attest to a core-periphery relationship in the recent episode of housing financialization, whose hierarchical character played out in the crisis. Most peripheral European countries experienced sudden stops and reversals of capital flows, which badly affected their banking systems. Unable to solve the looming banking crises on their own, they had to turn to creditors to gain access to much needed capital inflows. A combination of international conditionality, domestic policy responses and the original level of mortgage debt result in different trajectories in housing finance after the crisis.

While the paper focusses on similarities in housing finance trajectories, it also takes account of the differences in timing of financialization, origins of high homeownership regimes, and policy responses. It does so by tracing the emergence of peripheral housing finance regimes, and their pre- and post-crisis trajectories with four in-depth case studies – Hungary, Latvia, Iceland and Ireland. This mix of East and West European countries with different housing finance legacies and institutions, and different degrees of integration in the EU

reflect the diversity of Europe's periphery.[1] Yet, despite their differences, all four countries have experienced major housing and mortgage booms, and all of them are still reeling from the impact of the GFC on housing and housing finance.

The paper is organized as follows. The next section reviews existing literature, establishes the puzzle and develops the analytical framework. The third section retraces the origins of housing and mortgage booms in the four peripheral European countries, and section four analyses crisis exposure and responses. The last section concludes.

## 2. Mortgage finance and housing in (European) capitalism

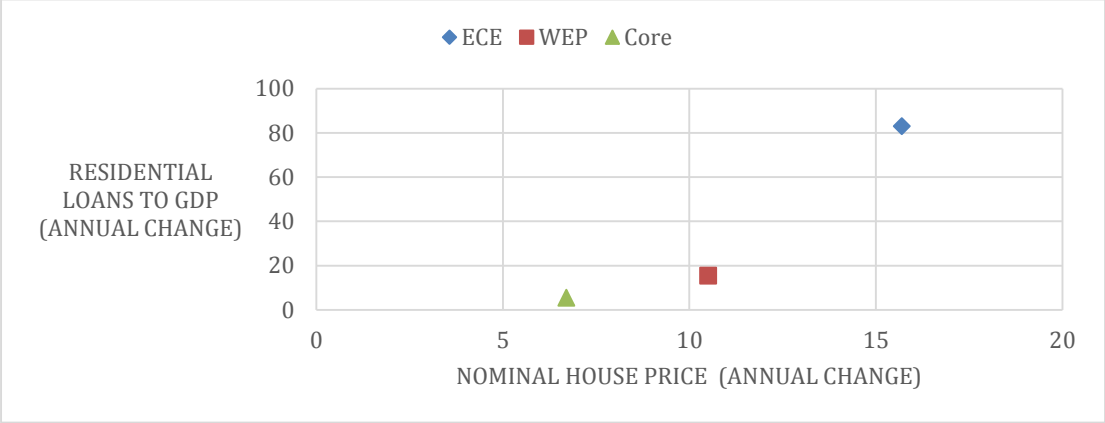
> "Ironically, under the European Union Stability and Growth Pact, government debt should be no higher than 60 percent of gross domestic product (GDP). Somehow, it has come to pass that loading the young people of the EU with mortgages some five to nine times their income has become acceptable."
>
> John F. Higgins, independent candidate in the Irish general elections 2007[2]

The quote above is from an independent candidate in the Irish general elections of 2007, who was outraged by the rapid increase of private and mortgage debt, and therefore decided to run. Although Higgins could not make an electoral breakthrough and soon disappeared into oblivion, he made a crucial point. In most European countries, private debt by far surpasses public debt, and an

[1] This paper does not integrate Southern European cases in its analysis. Yet, some of the arguments made here can also be extended to Spain, and to a lesser degree to Portugal and Greece.
[2] Available at: http://www.johnfhiggins.eu/Writings2.html.

important chunk of private debt is household debt, locked up in mortgages. In Europe, it was Iceland that had the highest mortgage debt relative to GDP. Iceland's public debt in 2007 was 28% and residential mortgage debt 119% of GDP. A close second and third in respect to mortgage debt to GDP were the Netherlands and Denmark with almost 100 and 93, whereas their public debt stood at 42 and 27%, respectively. Among the peripheral European countries, the level of residential mortgage debt surpassed that of public debt in Spain, Ireland, Iceland and the Baltic States.[3] But even in those countries where this was not the case, the level of mortgage debt has increased significantly over the 2000s.[4] Indeed, even more stunning than the level of mortgage debt has been its increase over the last (two) decades. Figure 1 depicts the increase of mortgage debt and house price increases prior to the Great Recession. It shows

**Figure 1**
House price and mortgage lending (2002-2006)




ECE countries are the Czech Republic, Estonia, Hungary, Lithuania, Poland and Slovenia. Western European peripheral countries are Greece, Italy, Ireland, Portugal and Spain. Core countries are Austria, Belgium, France, Denmark, Germany, Norway, Sweden and the UK. Data for house prices are from Egert and Mihalik 2007 and EMF 2014, data for residential loans from EMF 2013.

[3] The use of the terms European core and periphery has become more common in the wake of the Eurozone Crisis, acknowledging the fact that some European countries had been subject to much more destabilizing capital inflows than others. In line with this, I use the term 'core countries' for Europe's North Western advanced capitalist countries and 'peripheral countries' for the East Central European and Southern European countries, as well as Ireland and Iceland.
[4] The data for mortgage debt are from EMF 2011, the data for public debt from Eurostat.

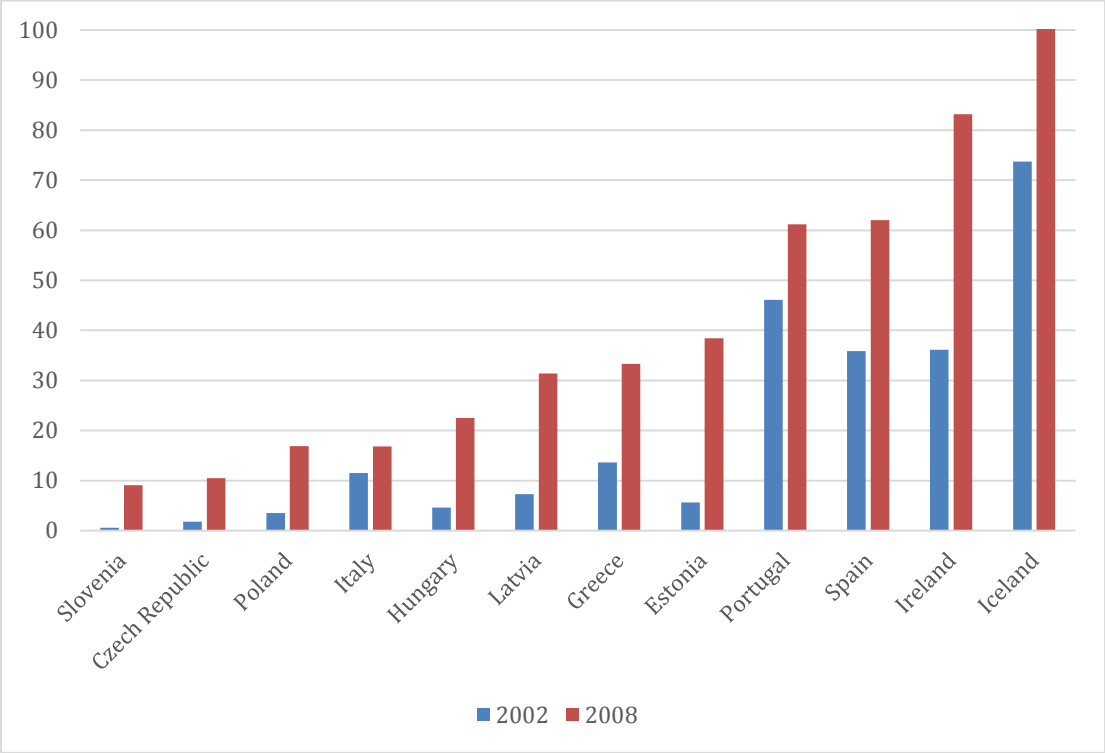
that mortgage and house price booms have been the strongest in East Central European countries, followed by Europe's Western periphery. Compared to the periphery, core countries' house price and mortgage lending increases seem rather moderate.

Of course, the three country groups are not homogenous. Among the core countries, the UK had the highest house price and mortgage lending boom, and not all peripheral countries have experienced major lending booms. Figure 2 further details mortgage lending in the sample of peripheral countries. Here, three groups of countries can be identified: The first group had already experienced a boom in mortgage debt during the 1990s – as witnessed by relatively high mortgage debt in 2002 – and still registered high growth rates during the first decade of the 21st century. Incidentally, these are all Western peripheral countries. A second group of countries started with almost no mortgage debt in 2002 and registered very high growth rates until 2008. These are mostly East Central European countries. Finally, the third group, made up of both Western and Eastern peripheral countries did not experience much increase in their mortgage debt over the 2000s. All in all, however, it is fair to say that a large majority of peripheral European countries experienced very high mortgage lending growth rates during the 2000s.

As several recent studies have pointed out, the build-up of household debt is crucial to understanding the severity of the financial crisis (IMF 2012, Jordà et al. 2014, Glick and Lansing 2010, Mian and Sufi 2014). It is therefore not surprising that peripheral European countries, which encountered the highest build-up in mortgage debt, also experienced the steepest recessions. Against this background, it seems indeed somewhat misplaced that the EU's post-crisis economic governance is mostly concerned with reining in public debt and restoring competitiveness, especially in Europe's periphery. While the issues of

housing and mortgage debt are not completely ignored, the EU's focus is elsewhere. In this it mirrors the comparative capitalism literature, which by and

**Figure 2**
Residential Debt/GDP




Source: EMF 2013.

large looks at issues of public debt, and national institutions governing the manufacturing and public sector wage formation to explain the uneven repercussions of the GFC in Europe, and to define the needs of adaptation (e.g. Hassel 2014, Hall 2014, Johnston et al. 2014).[5]

Despite the centrality of housing and housing finance in the GFC, the specific challenges of peripheral housing finance regimes have not yet been well understood. A small but growing literature that investigates the centrality of

[5] But see Johnston and Reagan (2017) for an attempt at teasing out how labor market institutions influence house price inflation, and Baccaro and Pontusson (2016) and Stockhammer et al. (2016) for integrating issues of debt in their typologies of growth models.

housing and mortgage debt for contemporary capitalism provides an important starting point to the inquiry. Thus, in their pioneering work Herman Schwartz and Len Seabrooke (2009) point out that housing and the associated mortgage debt are "the single largest asset in people's everyday lives and one of the biggest financial assets in most economies" (Schwartz and Seabrooke 2009: 1), and have important consequences for macroeconomic growth, social stability, welfare states, and political behaviour. Arguably, one of their most important contributions is the development of a typology of residential capitalism based on two dimensions: tenure types (owner occupation vs social rental), and mortgage markets (level of mortgage debt and liberalization of mortgage markets). They distinguish between four types of residential capitalism. The first, *liberal market* type is characterized by high levels of owner occupation, mortgage debt and liberal mortgage markets; and contrasts with the *statist-developmentalist capitalism* with low levels of owner occupation, mortgage debt, and highly controlled mortgage markets. The *corporatist-market capitalism* has low levels of home ownership but high levels of mortgage debt despite relatively controlled mortgage markets, whereas *familial residential capitalism* exhibits very high homeownership levels but low mortgage debt. Interestingly, all European peripheral countries considered by Schwartz and Seabrooke except for the Czech Republic cluster in the familial type of residential capitalism. Table 1 summarizes Schwartz and Seabrooke's VoRC typology.

**Table 1**
Varieties of Residential Capitalism

| | | **Owner occupation rate** | |
|---|---|---|---|
| | | **Low** | **High** |
| **Mortgage as % of GDP** | **High** | Corporatist market | Liberal market |
| | **Low** | Statist-developmentalist | Familial |

Source: Schwartz and Seabrooke 2009: 10.

While Schwartz and Seabrooke's typology is crucial for understanding the starting point of peripheral (or familial) housing finance regimes, it does not provide an answer to the question of why it was these regimes that have experienced massive credit growth over the last two decades. To seek an answer, I turn to Manuel Aalbers' and his co-authors' work on the financialization of housing, which complements Schwartz and Seabrooke's work (Aalbers 2008, 2016, Fernandez and Aalbers 2016, Aalbers and Christophers 2014). Financialization is defined as a process in which financial markets, institutions, actors and ideas gain increasing and transformative influence over the economy (Epstein 2005: 3, Aalbers 2016: 2). Building on heterodox analyses of financialization, Aalbers argues that in the last one to two decades, a "global wall of money" – a global pool of liquid capital that looks for investment opportunities – has been built up. The global wall of money results from the rise of accumulated corporate profits which are not being reinvested in the real economy or shared with workers; the recycling of trade surplus of export-oriented economies; and the privatization of pension schemes and build-up of funded pensions. Housing and mortgage debt, which are considered high quality collateral have absorbed an increasing amount of liquidity (Fernandez and Aalbers 2016, Schwartz 2009, Jordá et. al 2014).

While privatization of housing, liberalization of finance and the wall of money have induced a common trend towards more financialized housing finance, these processes are filtered by national institutions and policies. Fernandez and Aalbers (2016) sketch four different trajectories. Not surprisingly, there is a strong affinity of these trajectories and the VoRC as identified by Schwartz and Seabrooke. Thus, somewhat simplified, Fernandez and Aalbers find that the liberal market and corporatist-market varieties have embraced financialization, while in the statist-developmentalist and familial varieties, the transformation of the housing and housing finance regimes have not yet reached the critical

point of financialization – that is, the increasing dominance of finance has not yet led to a systemic transformation of these regimes.[6] Aalbers and Fernandez are, however, not concerned with building typologies but rather with identifying a set of trajectories of housing centered financialization.

My paper will delve further in examining trajectories of housing centered financialization by focusing on the similarities and differences among the trajectories of peripheral – or familial – varieties of residential capitalism.[7] In order to get at the specificities of the mortgage lending booms across Europe's periphery, and to assess the post-crisis fate of financialization, this paper will build on VoRC's insight that familial housing (finance) regimes are set apart, and combine this with digging deeper into the mechanisms of what Lapavitsas (2013) calls "subordinated financialization", where peripheral countries are joining an increasingly financialized world economy while lacking the state power and capacities for shaping the processes of financialization. To this aim I study four cases that have experienced major mortgage and housing booms during the 2000s. My case selection includes two peripheral countries that according to Aalbers and Fernandez have crossed the threshold of housing financialization – Ireland and Iceland – and two that have not – Latvia and Hungary. These countries are also representative of the diversity of Europe's peripheries. Located in Europe's East and West, they are often considered to represent different varieties of capitalism, and are integrated in different ways in the European economy.

[6] The country grouping, however, differs somewhat. For Fernandez and Aalbers, Iceland, Ireland and Spain are grouped together with the Anglo-Saxon countries that have embraced financialization, while the familial model is mostly populated by Mediterranean and East Central European peripheral countries.

[7] I use peripheral and familial housing regimes interchangeably. As will become clear in section 3, the reliance on family resources for housing finance is related to these countries' peripheral late industrialization.

I seek to makes four contributions to the existing literature. First, I include the trajectories of East Central European housing finance in a debate which so far has mostly focused on the West. Second, I further explore specificities of peripheral financialization. Third, I analyze recent changes by studying the interaction of the transnational liberalization of finance and domestic housing and housing finance policies. This way, I open the "black box" of housing finance institutions and policies, and show how they have developed over time. Fourth, I do not only look at the build-up of the mortgage boom, but also ask how the GFC has affected housing finance in Europe's periphery.

## 3. Peripheral homeownership regimes meet transnational financial markets

As Schwartz and Seabrooke (2009) note, there are some features that set the European familial variety of residential capitalism apart from that of the advanced capitalist world. To put it in a pointed fashion: most European peripheral countries started their journeys in the world of transnational finance as *debt-free or financially repressed high-homeownership societies*. That is, while the owner-occupation rate in Europe's periphery is significantly higher than in the core, mortgage debt has traditionally been much lower and/or mortgage lending has not been market based. Thus, homeownership rates in the periphery (in 2000) range from more than 75% in Portugal and Ireland to around 90% in Spain, Iceland, Hungary and Romania. Concomitantly, these countries have among the smallest rented sectors in Europe and virtually no social renting (Allen et al. 2004, Hegedüs 2013, Norris 2016, Sveinsson 2011). Under these conditions, large parts of the population have difficulties gaining access to housing as they cannot afford buying a home and have no choice of alternative tenure.

Western peripheral societies' status as high homeownership regimes predates the neoliberal turn towards private homeownership, even if it has still increased since the 1980s. While the reasons for the peculiar tenure structure differ across countries, there is a common thread, namely the role of late and limited industrialization and weak state capacity that is characteristic of the periphery. In core Europe, the promotion of a social rental sector aimed at accommodating the urban industrial labor force is associated with large public or co-operative ownership (e.g. Esping-Andersen 1988). In contrast, late and limited industrialization in the periphery decreased the pressure for accommodating masses of new city dwellers. At the same time, social relations originating in the countryside were more important for the development of housing regimes and their relations to welfare states than capital-labor relations. Thus, as Norris (2016) shows on the Irish example, agrarian politics and land distribution policies of the 19th century played a key role in the development of a highly subsidized and decommodified system of property redistribution which has been the backbone of the Irish welfare state.[8] At the same time, the peripheral states often lacked the capacity to finance and manage a big rented sector (Allen et al. 2004: 166). It is true that many peripheral European countries launched major public housing programs after WWII. However, they were sooner or later sold to tenants, often at low prices. Promoting homeownership rather than social rentals was also a device to achieve social stability (Allen et al. 2004, Norris, 2016, Dellepiane et al. 2013).

Remarkably, all these countries came to high homeownership via very limited mortgage markets. Norris (2016: 7) coined the term "socialized home ownership regime" for Ireland to denote that "most capital for home purchase

[8] See also Allen et al. (2004) for the link between late industrialization, high homeownership and patchy welfare states in Southern Europe.

and construction came from the Irish government and many homeowner dwellings were also government constructed". Versions of socialized home ownership regimes also were in place in Southern Europe and Iceland (Allen et al. 2004, Sveinsson 2011). Another way to put it is that until the 1980s even in those countries that made widespread use of mortgages, neither homeownership nor mortgage credit had been commodified.

The East Central European road to high owner-occupation with limited mortgage markets was different. While East Central Europe (with the exception of Czechoslovakia) was industrializing late too, it achieved an industrial break-through under state socialism. The communist ideology and its bureaucratic form of governance, rapid industrialization and urbanization, and heavy war destruction all implied that the state took a leading role in providing large scale housing after World War II. The high homeownership rates in Eastern Europe are therefore a direct result of transition policies after 1989. [9] Indeed, transferring the predominantly public housing stock into private hands was among the first steps undertaken by post-communist governments. The most common method to transfer the housing stock was to sell it to current occupants at low prices (Hegedüs 2013). In this sense it can be argued that their past as late industrializer caught up with post-communist Eastern Europe: after 1989 private home-ownership was considered the norm, and large scale public housing stock a socialist aberration. At the same time, the neoliberal inclinations of most early transition governments in the region have further boosted the normative power of private home ownership, and international financial organizations, especially the World Bank, actively lobbied for fast privatization to individual tenants (Stephens et al. 2015). Another reason for

[9] At the same time, most East Central European countries had institutionalized de facto home ownership already during socialism, and outside of the urban centers, self-help construction played an important role (Palacin et al. 2005)

fast privatization is that private housing acted as a "shock absorber", making it easier for the population to cope with the shocks of transformation (Struyk 1996 referred to in Hegedüs 2013: 38). Finally, fast privatization of public housing was to relieve the state from the burden of having to manage large housing stocks under the fiscal constraints of turbulent transition times.

In East Central Europe, high ownership rates were achieved without the institutions and policies that are part of a private real estate market. Institutions such as land registries, consumer credit rating agencies, or property appraisal firms were non-existent, and property rights and their enforcement had to be established. Banks were still undergoing transition and many countries experienced banking crises. The absence of a functioning banking sector largely explains the very low levels of mortgage debt in East Central Europe in the early 2000 (see Figure 2).

Thus, in Eastern Europe, as in peripheral Western Europe, high homeownership rates were achieved despite the absence of liberal mortgage markets. This made homeownership for new entrants very difficult. For southern Europe, the consequences are well established: young people leave their family homes at a very late age, and pooling family resources for acquiring a home is crucial (Allan et al. 2004) – hence, Schwartz and Seabrooke's label of this variety of residential capitalism as familial. Eastern Europe exhibits a similar reliance on family resources for housing (Stephens et al. 2015).

With transnational liberalization of the financial sector and the build-up of ample international liquidity, things however started to change. While the rise of global liquidity looking for investment opportunities had its origins in changes in the real economy, privatization of pensions, and the accumulation of global current account imbalances; it was the EU's initiatives towards

financial market integration which channeled an increasing share of it through banks to Europe's periphery and specifically its mortgage markets. Most importantly, the Second Banking Directive, which entered into force in 1993, was a key driver of banking market integration, based on the principles of mutual recognition, minimum regulatory harmonization, and home country control. With this directive, European banks could establish branches and provide cross-border financial services in the EU and European Economic Area (EEA) (Decressin et. al 2007: 2). At the same time, the EU's Directive on Own Funds and Solvency Ratio, which also took effect in 1993, "introduced a preferential weighting for residential loans and significantly increased the lenders' ability to finance mortgage credit" (Whitehead et al. 2914: 10). Finally, the introduction of the euro eliminated the currency risk and pushed for further regulatory convergence. All of these initiatives fuelled cross-border lending, thus allowing the banks of peripheral states to escape their narrow deposit base, and made financing of mortgage credit much easier (ibid., Allen et al. 2011: 22). In addition, interest rates set by the European Central Bank (ECB) for the whole eurozone made borrowing for peripheral states disproportionally cheap, often resulting in negative real interest rates (Honohan 2010: 11, Hay et al. 2008).

This is the background against which most of the west European peripheral countries started to experience major mortgage lending booms from the 1990s onwards, and Eastern Europe joined during the 2000s. The remainder of this section will look in more detail at how the "wall of money" (Aalbers 2016) translated into mortgage and housing booms in Ireland, Iceland, Hungary and Latvia. Table 2 gives a snapshot view of their housing (finance) systems during the 2000s. The table shows that while all four countries have very high homeownership rates, they differ substantially in respect to the significance of a mortgage system. In Ireland and especially Iceland a significant share of

homeowners has a mortgage, whereas this is only a tiny fraction in Hungary and Latvia. All four countries however experienced significant mortgage and housing booms. In addition, investment in housing experienced very high growth rates during the 2000s.

**Table 2**
Selected characteristics of housing (finance) systems before the crisis

| | Homeownership (2007) | Owners with loans (2007) | Outstanding residential loans (% of GDP, average annual change, 2002-2008) | Nominal house price increases (annual growth rate, 2000-2007) | Investment in Housing (real gross fixed investment, average annual change, 2000-2007 (2005)) |
|---|---|---|---|---|---|
| Latvia | 86 | 7** | 75 | 20* | n.a. |
| Hungary | 89 | 15 | 68 | 15 | 5 (9) |
| Iceland | 84 | 71 | 48 | 14 | 12 (11) |
| Ireland | 78 | 33 | 25 | 10 | 7 (10) |

* 2002-2007 ** 2008

Sources: Columns 1 and 2: EU-SILC. Column 3: EMF 2013. Column 4 and 5: EMF 2011.

## 3.1 Mortgage booms in Ireland and Iceland

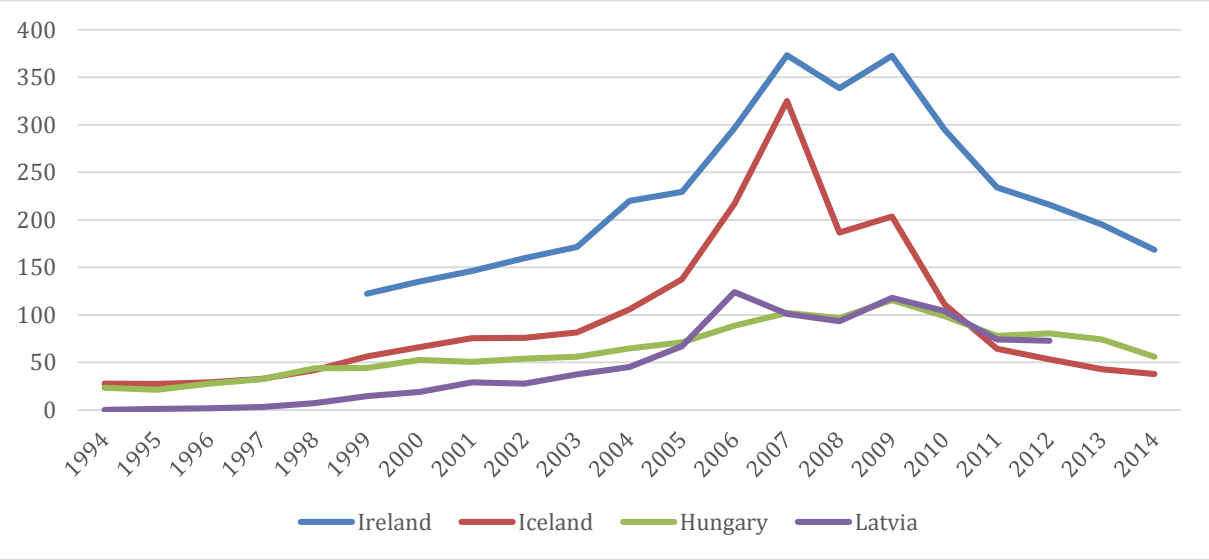
Both Iceland and Ireland are infamous for the stellar rise of their banking sectors during the 2000s. In 2008, the banking systems' total assets amounted to a staggering 800% of GDP in Iceland and close to 700% in Ireland (Eckholdt Christensen 2011: 116). In Ireland, the rapid growth of the banking sector was intrinsically linked to a property and mortgage boom. In Iceland, banks have been most famous for their international shopping spree. But also here, housing finance has played a major role.

In both countries, the dismantling of the socialized home ownership regime (Norris 2016) combined with the liberalization and European integration of the banking sector led to unsustainable mortgage lending booms. In Ireland, a major crisis in the 1980s made the government turn away from publicly subsidizing homeownership. Instead, it began to deregulate mortgage finance. This allowed private banks to move into the market, replacing the earlier

mortgage system dominated by mutual building societies and local governments (Dellepiane et. al 2013, Kelly and Everett 2004, Norris and Coates 2014, Norris 2016).

From 2003 on, Irish banks started to rely heavily on interbank lending not only from the euro area, but also the US and UK (Honohan 2010, Lane 2015). Figure 3 shows the development of foreign claims of BIS reporting banks for all four countries since 1994. Before the crisis there has been a rapid increase of foreign claims everywhere, but the levels differ: in Ireland and Iceland the claims have reached above 300% of GDP and in Hungary and Latvia around 100% of GDP.[10] Figure 3 also shows the sudden stop of foreign claims once the crisis hit, a development I will return to later in the paper.

**Figure 3**
Consolidated Foreign Claims of BIS Reporting Banks (% of GDP)




Source: Worldbank and BIS Global Financial Development Database, http://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database

[10] Not all of Ireland's cross border lending was channeled into the housing market. Ireland's high level of foreign claims is closely linked to its position as an offshore financial center, which it has developed since 1987 (Tax Justice Network, 11/11/2015).

The established Irish banks also faced fierce competition by new foreign entrants that started to expand aggressively – most infamously Anglo-Irish Bank. Competition as well as a pronounced lack of regulation fostered reckless lending practices (Dellepiane et al. 2013, Lane 2015). Policy makers did little to rein in risky lending practices. Rather, "[i]n the Irish case, the issue was a naïve and uncritical acceptance of the efficient market hypothesis, and excessive trust on the part of the policy-makers in government, the Central Bank, and the Financial Regulator's office, that the banks knew best how to run their own business. They explicitly sought to emulate the British practice of light-touch … But in effect, light regulation meant no regulation" (Dellepiane et al. 2013: 30). It was only in 2003 that the Irish Financial Service Regulatory Agency was established, and its independence from the Central Bank as well as the shortage of skilled staff made it an utterly useless agency (Barnes and Wren 2012). The government, in turn, fueled the housing boom by tax incentives. Arguably, the Irish property and housing boom was greatly enhanced by a cozy relationship between the main banks, politicians of the ruling Fianna Fáil party, and developers; a relationship that dates back to the earlier phase of the social home ownership regime (Dellepiane et. al 2013, McDonald and Sheridan 2008).

In comparison to Ireland, Iceland was a latecomer both in terms of banking and mortgage deregulation. The seeds of Iceland's ultra-liberal finance regime were however also sown in the 1980s, when a radical neoliberal faction emerged within the ruling Independence Party. The end of the Cold War swept a prominent member of that faction, Davíð Oddson, to power. He was Prime Minister from 1991-2004, and subsequently became Governor of the Central Bank. It was under his leadership that the Icelandic financial sector was unleashed. The first crucial step was Iceland's accession to the EEA, which lifted restrictions on cross-border capital flows. Bank privatization followed suit, with the two large state banks – Landsbanki and Búnaðarbanki (later to

become Kaupþing) privatized to loyal supporters of the Independence and the Center Party, respectively (Wade and Sigurgeirsdóttir 2010: 12). A third bank, Glitnir, was the result of a merger of several smaller banks, controlled by the *nouveaux riche* Ásgeir family. Privatization and deregulation enabled investment banks to enter the commercial banking markets, gain access to consumer deposits, and resulted in a heavily concentrated banking sector (ibid, Schwartz 2011).

The newly privatized banks soon began to expand into the mortgage market, hitherto dominated by the government backed Housing Financing Fund (HFF), which "provided a steady if limited flow of credit through simple, vanilla mortgages. Interest rates tended to be below market European rates, but loan to value ratios were capped at 65–70 per cent" (Schwartz 2011: 296). Banks started to offer more attractive loans, and competition over mortgage provision started in earnest when the government relaxed the rules for mortgage lending in 2004. From then on, Icelandic homeowners faced increasingly favourable borrowing conditions. The newly privatized banks out-competed each other and the HFF by offering housing loans with 90% of the purchase price or more, longer maturities, and lower interest rates. The option of refinancing loans gave homeowners the possibility to withdraw some of the home equity, and to lower their repayment costs by taking new loans with more favourable conditions. Banks also aggressively pushed homeowners to convert existing or take out new loans in foreign currencies, mostly Swiss franc and Japanese yen, in order to take advantage of the lower interest rates. In 2008, 15% of all mortgages were foreign currency denominated (Mendez Pinedo and Domurath 2015: 103). As in Ireland, the rapidly increasing availability of cheap credit fueled a house price boom (Benediktsdóttir et al. 2011, Sveinsson 2011, Hart-Landsberg 2013, Schwartz 2011, Viken 2011).

As is well known, not only did Icelandic banks lend recklessly at home, they pursued even more reckless practices abroad. Arguably, the Icelandic elites bought even more into the idea of light touch regulation than their Irish counterparts. Iceland's financial supervision was fragmented between three government departments, the Central Bank, and the Financial Supervisory Authority, which had no functioning cooperation. Even if they had wanted to, it is highly doubtful whether they had the professional skill to exercise supervisory authority (Viken 2011).

## 3.2 Mortgage booms in Hungary and Latvia[11]

For Hungary and Latvia, the most important trigger for mortgage lending has been these countries' deep transnational financial integration that went hand in hand with their EU accession. The combination of convergence on the institutional and regulative standards of the European financial area, the privatization of the banking sector, and the liberalization of capital movements, all of which were part of EU's entry requirements, allowed these countries to catch up fast in financial matters (e.g. Enoch and Ötker-Robe 2007, Mitra et al. 2010, Pistor 2009). Perhaps most notable is the high share of foreign ownership of their banking sector, a development fostered by the EU which saw in foreign banks a guarantee for a sound banking system. From the early 2000s onwards, Austrian, Italian and Swedish banks moved into Eastern Europe. In the mid-2000s, the share of foreign banks was more than 82% in Hungary, and above 60% in Latvia.[12] In the Hungarian market, a fierce competition between Austrian, Italian and the former domestic savings bank, OTP, took off. While the overall share of foreign banks in Latvia was smaller, Nordic banks, above

[11] Some of this subsection draws on Bohle 2014.
[12] http://www.worldbank.org/en/publication/gfdr/data/global-financial-development-database

all two rival Swedish banking groups – SEB and Swedbank – dominate the residential banking market (Zubkova et al. 2003). Latvian banks in domestic ownership overwhelmingly manage non-residential capital, mostly of Russian origin (Eglitis et. al 2014).

Foreign banks were instrumental in developing the hitherto almost non-existing mortgage markets. They brought expertise in mortgage lending from their home countries and could easily tap into foreign sources of credit expansion, usually through borrowing from their parent banks. This is reflected in the increase of foreign claims (see Figure 3). In both countries, foreign banks issued loans denominated in foreign currencies, mostly Swiss francs in the Hungarian case and euros in Latvia. Taking advantage of the ECB's expansionary monetary policy in 2004-2007, banks engaged in large scale carry trade of cheap international credit (Aslund and Dombrovskis 2011: 29). In 2008, more than 85% of loans were denominated in foreign currency in Latvia, and more than 70% in Hungary (Mak and Pales 2009, Blanchard et. al 2013: 333). For consumers, foreign currency loans were attractive because of the favourable interest rates.

Governments mostly acted in collusion with banks to create more liquid (and inherently riskier) mortgage markets. In Hungary, the first national-conservative government under Premier Viktor Orbán (1998-2002) adopted a program for generously subsidized housing loans, and grants for young families to build or buy houses. In addition, people who took a housing loan also received income tax exemption (Rózsavölgyi and Kovács 2005). The continuous expansion of the program, however, turned out to be financially unviable, and was phased out from 2003 (Hegedüs 2011: 119). It is from this moment on that foreign currency lending really took off. As demand for housing remained very high, low interest rate Swiss franc lending provided a

substitute for publicly subsidized mortgage lending (Committee on Constitution, Justice, and Standing Order of the Hungarian Parliament 2012). A very liberal financial environment and intense competition among banks fueled increasingly risky lending practices (Banai et al. 2012, Józon 2015). Even though the Hungarian National Bank, the Financial Supervisory Authority and the IMF issued warnings about the foreign currency exposure, Hungarian politicians remained passive on the issue (Bohle 2014).

In Latvia, before the large-scale entry of foreign banks, mortgage lending was scarce and expensive, with interest rates between 12-14%. In 2000, the Berzins government adopted the first stage of a housing lending development program which aimed at encouraging the purchase or renovation of dwellings via subsidized mortgages (Osa 2005: 200). Similar to Hungary, commercial banks' foreign currency lending soon overtook publicly subsidized lending (Henilane 2015: 2). Foreign currency lending seemed a somewhat more natural choice in Latvia than in Hungary. In the early 1990s, Latvia, as a newly independent state, settled on a fixed exchange rate to signal the credibility of its new currency to financial markets. It initially pegged the currency to the Special Drawing Rights, and in 2000 to the euro. Latvian governments were also firmly committed to joining the euro (Bohle and Greskovits 2012). Latvia's currency peg, limited monetary autonomy, capital convertibility and informal euroization combined to trigger a major lending and mortgage boom. During the 2000s, Latvia became one of the most financialized economies in East Central Europe. Its growth model relied almost entirely on investment in banking, real estate, and construction (Becker et al. 2010, Bohle and Greskovits 2012). Finance-led growth spurred high inflation rates, and given that Latvia's Central Bank could not use interest rates to rein in inflation, borrowing became increasingly cheaper (Blanchard et al. 2013: 333). Tax policies further contributed to the boom: Latvia did not levy any property tax on residential

buildings or capital gains taxes (Aslund and Dombrovskis 2011: 29). No small wonder that Latvians took out increasing mortgage loans to buy ever more expensive homes.

As in Hungary, the IMF and the Central Bank started issuing warnings about the unsustainability of the lending boom (IMF 2006, interview 6) from the mid-2000s onwards. However, neither regulators nor politicians seemed to be particularly concerned, while banks even stepped up their aggressive lending behaviour (Interview 2 and 3, Bukeviciute and Kosicki 2012: 5). Given the fierce competition, banks also saw their hands tied. At the height of the boom, the head of the banking association and the Central Bank asked policy makers for more stringent regulation. Policy makers rejected this request on the grounds that tougher regulation would constitute "state capture" (Interview 1 and 4). Indeed, the government had no interest in curbing excessive lending. It profited from the budgetary income that exuberant growth brought about by engaging in expansionary fiscal policies (Aslund and Dombrovskis 2011, Rimšēvičs 2010).

## 3.3 Summary

This section has identified several similarities but also differences in the build-up of the mortgage booms in peripheral Europe. Differences in EU integration – EMU membership, EU membership, or membership of the European Economic Area – do not seem to imply systematic difference in terms of the mechanisms that have offset the lending booms. In all four countries, EU induced external liberalization and domestic policies of deregulation and privatization of the banking sector has channeled dominantly international liquidity into mortgage finance. Borrowing in euro reduced the costs of credit significantly for Ireland, as the ECB set interest rates with a view of the whole

eurozone and not its peripheral, inflation prone members.[13] However, non-EMU members found functional equivalents, namely borrowing in foreign currency denominated loans. In all cases, peripheral countries could thus piggyback on interest rates set for much less inflation prone economies.

Integration in European financial markets – whether as EMU, EU or EEA member – allowed all four countries to escape the narrow confines of their domestic financial markets. International finance of emerging mortgage markets has taken two forms: in Ireland and Iceland, banks relied strongly on wholesale markets while in Latvia and Hungary, direct foreign bank penetration and the financing of local affiliates through their parent banks played a key role. These differences notwithstanding, both forms have led to excessively leveraged banking systems and extensive maturity mismatches, as short-term funds borrowed in markets abroad were invested in long term mortgages (Schwartz 2011). The four countries were not entirely stripped of regulatory instruments to circumvent the systemic danger inherent in this. Rather, governments and supervisory authorities were either unwilling or unable (and typically both) to curb foreign borrowing and domestic lending, and hedge against the risks. However, as much of the literature on the GFC points out, systemic banking risks have been largely ignored in the run up to the crisis. Anecdotal evidence shows that EU financial authorities underestimated the lending booms' systemic risks (Bakker and Gulde 2010: 27-29, European Court of Auditors 2015).

[13] Of course, the flip side of the ECB's one-size-fits-all interest rate, which generated negative real interest rates in Ireland, is its dampening effect on the low inflation economies, such as Germany, exerting further pressure on domestic consumption. This reinforces the export orientation of northern capitalism, generating additional liquidity that could be channeled into the periphery (Scharpf 2011).

The high dependence on foreign borrowing proved to be the Achilles heel of the housing finance systems. The next section will explore how the crisis has exposed the hierarchical nature of peripheral financialization, and how governments in the four countries have responded to the crisis of (mortgage) finance.

# 4. The mortgage boom turns bust: crisis and crisis management

Table 3 provides a snapshot view on the exposure of the Latvian, Hungarian, Icelandic and Irish populations and banks to the housing and mortgage crisis. It reveals that while the depth and mix of the exposure differs across the four countries, in all cases households have faced increasing risks of over-indebtedness related to rising unemployment and decreasing house prices, and in three cases they also faced significant exposure to exchange rate risks. All of this has resulted in a ballooning of non-performing loans, threatening the stability of the banking sector. The latter was further endangered by the high share of foreign debt that banks had accumulated, as shown in column 5.

The banking systems were adversely affected by the financial turmoil from 2008 onwards. All four countries experienced sudden stops of capital inflows, resulting in sharp recessions (Berthaud and Colliaque 2010, Gross and Alcidi 2013, see also Figure 3), and when the sudden stops turned into liquidity or solvency crises of their banks, Europe's peripheral countries learned who the "ultimate guardian" of their transnationally integrated financial systems was (Pistor 2009). In none of the four countries was the national central bank able to act as lender of last resort. All four countries had to turn to the IMF and/or EU to get access to much needed liquidity, and these organizations coordinated

the processes and set the terms for restructuring the financial systems. The terms differed, and governments faced tough decisions whether to comply with the conditionality, or risk being shut off from international markets altogether.[14]

**Table 3**
Household and bank exposure to the crisis, 2008-2010

| | Mortgage debt/GDP (in %, 2009) | Nominal house price (annual % change, 2008-2010) | Non-performing household loans (2010) | Share of foreign currency loans in total loans to households (2008) | Foreign claims of BIS reporting banks (% of GDP, 2008) | Exchange rate | Unemploy-ment (2008 ->2010) |
|---|---|---|---|---|---|---|---|
| Latvia | 37 | - 47 ↗ | 17 ↗ | 85 | 94 | peg | 8->20 |
| Hungary | 24 | - 12 ↘ | 11 ↗ | 70 | 97 | (managed) float | 6->7 |
| Ireland | 92 | - 24 ↘↘ | 7 ↗↗ | n.a. | 338 | euro | 6->14 |
| Iceland | 119* | - 15 ↗ | 20 ↘ | 15 | 187 | float | 3->7 |

* 2007

Sources: Column 1 & 2: EMF: Hypostat 2013. ↘ denotes a further fall, ↘↘ a rapid further fall of house prices, and ↗ an increase of house prices. Column 2: Hungary: share of loans in arrears over 90 days in the household loans portfolio, EMF 2011: Study on non-performing loans in the EU, Latvia: share of overdue (>90 days) loans in housing loans portfolio, SEB Baltic Household Outlook 2014, Ireland: non performing mortgage loans as a share of total mortgage loans, Bank of Ireland, quoted in Schoenmaker 2015: 16, Iceland NPL as a percentage of total loans granted to households by largest banks and HFF, Financial Stability Report 2012, 2: 23. ↘ denotes a decreasing, ↗ an increasing, and ↗↗ a rapidly increasing trend. Column 4: Hungary: National Bank of Hungary (2009, figure 2/17), Latvia Blanchard et al 2013: 333, Iceland: Mendez Pinedo and Domurath 2015: 103, Column 5 World Bank, Global Financial Development Database, Column 7: Eurostat.

Below I explore how the four countries negotiated the international constraints, choices and trade-offs that they faced once the crisis broke out, and how these have shaped the housing finance regimes.

[14] Once the "fast burning" phase of the crisis was over, peripheral housing finance regimes also became increasingly shaped by international policies emerging as a response to the crisis (for the concepts of fast and slow burning crises see Callon 1998 and Seabrooke and Tsingou 2014). Macro-prudential regulation and the EU's Mortgage Credit Directive, which was adopted in 2014, are likely to have an important impact on mortgage lending. This paper does not explore this impact systematically.

## 4.1 Hungary and Iceland: rejecting financialization

### 4.1.1 Hungary

Hungary turned to the IMF when its banking sector faced a liquidity crisis resulting from the turmoil in the foreign currency swap market (Aslund and Dombrovksis 2011). Its crisis response evolved in two distinct phases. The first phase was overshadowed by the conditions of the IMF stand-by agreement signed in autumn 2008, and the fear that foreign banks would pull out from the region.[15] By 2008 a debate erupted about the exposure of foreign parent banks in the region and many observers were persuaded that Western banks would cut their losses and run (Epstein 2014). In this situation, the socialist administration of Gordon Bajnai (2009-2010) showed little appetite for taking on the banks. Rather, it signed the so-called Vienna Initiative, a series of accords signed by several East Central European states with ten major European banks and the IMF to maintain the presence of exposed banks. In the agreements, parent banks committed to support their subsidiaries in the region, roll-over their credits, and capitalize them adequately. In those countries that had stand-by agreements with the IMF, banks made their commitment dependent on their host governments' compliance (Pistor 2011). Under these conditions, the housing question was not a priority for the government. It rather saw as its most urgent tasks to rein in the public debt and deficit, as defined by the IMF stand-by agreement signed in autumn 2008.

As the crisis unfolded, the question of foreign currency loans however became increasingly pressing. After the Hungarian Central Bank had scrapped the currency band in 2008 and let the forint float, the latter massively depreciated

[15] In November 2008, the IMF approved a €12.5 billion loan to Hungary to support weathering the crisis. The IMF-supported economic program had two key objectives: fiscal consolidation and the stabilization of the financial sector. This was part of a broader IMF-World Bank and EU administered loan of €20 billion in total (Lütz and Kranke 2014).

against the Swiss franc, leaving forex indebted homeowners in dire straits. By 2012, Swiss franc mortgage holders faced a 60% increase of their debt service due to the exchange rate alone (IMF 2012: 19). This is the background of the second phase of crisis response under Viktor Orbán's FIDESZ government. Soon after coming to power in 2010, Orbán declared Hungary's fight for independence from "a world symbolized by banks, multinationals and a bullying IMF" (Oszkó 2012). In the fight's course, Hungary severed its ties with the IMF. It paid back its stand-by loan in full and well in advance and consequently asked the IMF to close its Budapest office. The government also sought to alleviate the burdens for households with foreign currency loans. In 2011, it introduced the possibility to exchange foreign currency loans in forint at a preferential exchange rate for debtors who could repay their debt at one stroke, and introduced an exchange rate protection mechanism, where repayments are calculated at an advantageous fixed exchange rate. In late 2014, finally, the government forced almost all debtors to swap their forex loans into local currency at the then current rate. This step indeed saved many households from a financial ruin, as it occurred just before a major appreciation of the Swiss franc in early 2015 (Bogler 2015).

In addition to dealing with the forex loans, the government also imposed special taxes on banks, insurance companies and other financial services. These taxes, levied from 2009 onwards, were eventually lowered in 2015. In turn, credit institutions had to pledge to increase lending to the corporate sector, especially SMEs, rather than to households (Portfolio.hu, 21/5/2015). Furthermore, in 2014, legislation also took on unfair banking practices, which forced banks to pay significant compensation to indebted households (IMF 2016a: 44). The government also introduced a temporary moratorium on the repossession of homes whose owners were lagging behind with their mortgage payments. This moratorium was extended several times and it was lifted only

in 2016. As banks were until then only allowed to designate a tiny fraction of homes in their non-performing loans (NPL) portfolio for sale, their balance sheets deteriorated. These measures have curtailed the capacity of banks to lend to households (ibid.)

All taken together, the national-conservative government in Hungary has used its two-thirds majority to redesign central elements of the Hungarian housing finance system in the context of a deep economic and social crisis. Its overtly nationalistic and anti-finance-capital discourse aims at pitting vulnerable households against foreign banks, thereby generating support for its interventionist policies among all strata of society. Its interventionist policies have pushed much of the costs of the various support schemes on banks rather than tax payers. The explicit objective of a Magyarized banking system indicates that its financial system will be significantly altered, at least concerning the ownership structure and mortgage finance (Johnson and Barnes 2015). Yet, these unorthodox policy responses have also contributed to the return of the traditional woes of its housing regime. Mortgage finance has become a rare good, housing construction is only slowly recovering, and people are once again stuck to their homes. A newly developed system of publicly subsidized mortgages for families with children has not substantially altered this picture (see Table 4 below).

### 4.1.2 Iceland

Iceland, as Schwartz (2011: 299) writes, "came late to the global party, drank too quick and hit the floor rather harder than larger economies". When the crisis erupted, the tiny country found itself with a hugely over-leveraged banking sector and population, and overvalued property prices. As Schwartz argues, "leveraging up without a reserve currency is a titanic mistake" (ibid: 292). Its banks were indeed too big to be saved, and in contrast to Hungary,

where parent companies of banks were ready to take major losses, in the Icelandic case, British and Dutch depositors insisted on guarantees. Iceland had to turn to the IMF for emergency lending, which, together with the Nordic Central Banks also contributing to the bailout, administered the usual austerity medicine.[16] The IMF also backed the British and Dutch governments' demand that Iceland compensates them for bailing out the Icesave depositors. Crisis and austerity triggered a wave of social unrest, which succeeded in ousting the government. During the protests, debt-write down emerged as one of the central demands (IMF 2012: 106). As in Hungary, homeowners who had borrowed in foreign currencies were particularly hard hit by the devaluation of the Iceland krona, which depreciated around 60% in the wake of the crisis.

In April 2009, a Social Democratic-Green coalition government came to power, for the first time in the country's history. This government took a number of policy actions that were quite different from those of other hard-hit states. "Most importantly, rather than trying to resuscitate existing structures and patterns of economic activity through austerity measures, it actively intervened in financial, currency and housing markets, as well as strengthened targeted social programs that protected majority interests" (Hart-Landsberg 2013: n.p.). In terms of housing policies, the government adopted a number of measures fast in order to prevent over-indebted homeowners from losing their homes. These included "a moratorium on foreclosure, a temporary suspension of debt service for exchange rate- and CPI-indexed loans, and rescheduling (payment soothing) of these loans." (IMF 2012: 106). These measures reduced current debt service payments significantly (up to 40% for those with foreign exchange or indexed loans). In addition to the government, the Supreme Court has

[16] The IMF and Nordic countries together offered a $4.6 billion loan to Iceland (Wade and Sigurgeirsdóttir 2012: 22).

played a major role in dealing with the legacy of foreign currency loans. In 2010, it ruled that foreign currency indexation had not been in line with existing laws and loans had to be recalculated (Méndez Pinedo and Domurath 2015: 112).

The government also created an Office of the Debtor's Ombudsman, which negotiated, on behalf of debtors, debt restructuring out of court. In 2012, a debt forgiveness plan was introduced which writes down underwater mortgages (IMF 2012: 107). In addition, the government subsidized a large share of mortgage interests for a period of up to two years, and offered a means-tested tax rebate on interest payments (Ólafsson 2011: 20). Most of these measures relieved above all vulnerable social groups, such as low income households and families with children. They did not target homeowners with negative equity or those who had bought more extravagant property.

Some more fundamental changes in the housing system have also been on the agenda. According to Ólafsson (2011: 20), the government has put special effort into developing, together with NGOs and local authorities, alternative tenure models to homeownership. Indeed, the homeownership rate has decreased by 11% since its peak in 2005 from 87% to 78% in 2014 (see Table 4 below).

A substantial part of the costs of loan restructuring was "born indirectly by foreign creditors, who took significant losses when the banks collapsed" (IMF 2012: 107). As to future mortgage lending, a number of initiatives point to a more restrictive environment. A new Act on Consumer Loans, based on the EU mortgage directive, which entered into force in 2013, aims to promote "responsible lending". It requires lenders to assess borrower's creditworthiness carefully before granting a loan and to provide detailed information about the conditions of the loan. An assessment of the consequences of the act comes to the conclusion that it will most likely make borrowing for low income families with children more difficult. The HFF reported a decline of 25% in approved

credit assessment after the directive entered into force (Bank of Iceland 2014: 71). Another step concerns the abolition of indexed consumer loans which has started in 2016. Although the changes are being implemented over a longer period, they also predict a more restrictive credit supply (ibid).

All in all, as Iceland was to discover in the crisis, there was no ultimate guardian that was able or willing to keep a lifeline for its massively overleveraged banks. What is more, when Landsbanki, and with it Icesave, collapsed, a diplomatic tug-of-war started about who ought to compensate the British and Dutch depositors for their losses. The British and Dutch authorities asked for a sovereign guarantee for their countries' depositors, and the "Icesave dispute" overshadowed the country's attempt to negotiate EU membership (Wade and Sigurgeirsdóttir 2011, FT, 29/1/2013). The collapse of the banks, their nationalization, and the tightening of lending conditions imposed severe restraints on mortgage lending. It is not entirely clear how long this restrictive financial environment will last. On the one hand, the government has privatized two of the new banks, is in the process of increasing the private share for the third, and lifted its capital controls (IMF 2017). On the other hand, the old political forces associated with Iceland's financialization were able to make a comeback in the 2013 and 2016 parliamentary elections.

## 4.2 Ireland and Latvia: accepting financialization

### 4.2.1 Ireland

Pundits and the media alike often depict Iceland's crisis management as the polar opposite of Ireland's. While Iceland let its banks go bust, Ireland saved them at enormous costs. While Iceland's economy profited from the substantial devaluation of the krona, Ireland had to accept the straightjacket of EMU and pursue internal devaluation. While Iceland pushed some of the costs of the

crisis onto foreigners, Ireland had to internalize the costs to save German and French bondholders. Although some of the crisis response was related to domestic choices, Ireland's EMU membership weighed hard on the country's options.

In 2008, the Irish government reacted to large losses in the banking sector by issuing a blanket guarantee of the liabilities of all troubled banks, and subsequently by injecting massive capital into the banking sector and by nationalizing its banks. The guarantee was, as O'Toole (2010, quoted in Mair 2011: 3) put it, "the most momentous political decision in the history of the state". As a result, public deficit and debt soared and Ireland had to turn to the Troika of the EU, IMF and ECB for emergency lending to avert a sovereign default.[17] Thus, for Ireland the Troika turned into the ultimate guardian of its troubled banks and set harsh conditions for the rescue. The most contentious and weighty condition was that Ireland had to bailout senior bond holders. It was the ECB that insisted on this to prevent crisis contagion in the Eurozone. In contrast, the IMF wanted a senior bondholder bail-in for Ireland (Schoenmaker 2015, European Court of Auditors 2015, The Irish Times, 8/2/2014).[18]

The massive austerity that has followed the bank guarantee and the EU-IMF bailout has led to a veritable crisis in housing and housing finance. Non-performing loans soared and the Troika pushed Ireland for a tougher eviction legislation (Irish Times, 11/12/2012). In this context, it is not surprising that Ireland – together with Latvia – is one of the few EU countries in which the number of evictions have increased between 2010 and 2013 (Kenna et al. 2016).

[17] The loan totaled some €66 billion (European Court of Auditors 2015: 17).
[18] According to the Irish Times, the president of the Bundesbank, Jens Weidmann, also supported a bail-in for senior bondholders. This challenges the assumption that Germany insisted on taxpayers paying for the Irish banks (The Irish Times, 8/2/2014; 24/1/2014).

However, the absolute number of repossessions remains relatively low, mostly because banks have not been eager to foreclose the property, as this step might have resulted in real losses and brought the undercapitalization of banks into the open (Phillips 2013). By 2013, a lively debate broke out about a supposedly large share of strategic defaulters among indebted borrowers. According to some, up to 35% of mortgage arrears is due to people preferring to spend their money on other things than servicing their debt (Independent, 14/8/2913). This discourse is to justify harsher treatments of indebted homeowners.

Social housing also suffered during the crisis. Although it has been neglected for decades, the remaining meager budget was further retrenched in 2008-2014 (Department of the Environment, Community and Local Government 2014). It is only in 2014 that the government has outlined a new strategy towards social housing. Most of the support, however, is not dedicated to public social housing, but rather subsidizes rental payments. This dovetails a more substantial change in the Irish housing regime, namely the rise of private rentals. Already before the boom, the Irish mortgage providers have issued an increasing number of buy-to-let mortgages (Norris 2016). In 2011 almost one in five families lived in private rentals and the proportion in cities is even higher (Threshold 2014: 3). The increased share of renting is due to three factors: first, before the crisis, the house price boom made it very difficult for first time buyers to find affordable housing, while it allowed wealthier segments of the population to accumulate housing property. Second, the private rental sector compensates for the absence of a social housing sector, and third, the crisis has made homeownership unaffordable for an increasing number of people. What this all amounts to is that housing wealth is becoming distributed increasingly unequally across the population.

Overall, it is evident that in contrast to both Hungary and Iceland, Ireland's approach to the mortgage crisis has been mostly concerned with saving its banks. The blanket guarantee for the liabilities of all troubled banks was a decision made entirely by the domestic ruling party, while later policies have been designed under the influence of the "Troika". Given the size of the housing and mortgage debt problems after the crisis, the government has been remarkably abstinent in its policy making. A law for debt restructuring has only been drafted in 2012 and a new policy for social housing in 2014. Meanwhile, housing prices in Ireland (especially Dublin) have been on the rise. Regan (2016: n.p.) explains this with the fact that banks are not interested in a rise of housing supply, as this "would reduce prices and expose the underlying debt dynamics of the bank's balance sheet".

### 4.2.2 Latvia

Latvia's policy response to its banking and mortgage crisis has been most similar to that of Ireland. Its immediate policy response was overshadowed by the run on its biggest domestic bank, PAREX. In response to the run, the government took over the majority control for a symbolic price. The costs of recapitalizing and the need for restructuring PAREX were the major reasons why the Latvian government turned to the IMF in 2008 (Aslund and Dombrovskis 2011: 35). At the same time, Latvia's currency came under tremendous pressure. The major focus of the IMF-EU-Nordic bailout package were macroeconomic aspects of the crisis, including the exchange rate. [19]

A crucial policy decision of the Latvian government was to avoid devaluation of the lats and instead prepare for euro entry. This was a very controversial

[19] Latvia's IMF-EU-Nordic countries loan was €7.5 billion, 40% of its GDP (European Court of Auditors 2015: 17). For a thorough discussion of the loan and conditionality, see also Lütz and Kranke (2014).

decision: a number of internationally renowned economists and also the IMF team suggested that Latvia abandon its currency peg to regain competitiveness. At the same time, the European Commission and the Swedish Government took a different stance, a position that ultimately prevailed (Lütz and Kranke 2014). The Latvian government's decision not to devalue was, however, not the result of international pressure. Bank of Latvia's governor, Ilmārs Rimšēvičs, was an adamant defender of the currency peg. For him, "devaluation is not a medicine, but poison" (quoted after Interview 5, see also Rimšēvičs 2010). The government followed suit, and there was very little public discussion about the issue, with the few dissenting voices quickly being silenced.[20]

There were many reasons for the government and Central Bank to stick to the currency peg (Aslund and Dombrovskis 2011: 51-54). One crucial aspect certainly was that a devaluation of the lats would have inflicted heavy losses on the exposed Swedish banks, which explains the Swedish position on devaluation (Becker and Jäger 2010). Instead, however, the cost of adaptation was pushed onto the population. The adjustment program was tough even by IMF standards, and the government stayed on course to achieve an early repayment of the bailout loan and EMU membership. In fact, it often outstripped the austerity requirements set by the international organizations (Eihmanis 2017). The severity of Latvia's austere adjustment was one of the major reasons for over-indebtedness. Unemployment soared while wages decreased. These negative income shocks had detrimental consequences on Latvian households' capacities to service their debt, as manifest in an increase of non-performing housing loans (Rudzītis 2014, Table 3).

[20] One journalist who publicly advocated devaluation was jailed, and an economist voicing a dissenting opinion was called in by the Central Bank to explain himself (Interview 5).

The government did little to help over-indebted homeowners. Under the pressure of banks, and also because mortgages were mostly held by more affluent segments of the population, the government decided against public support for household debt restructuring (Erbenova et al. 2011: 16). Instead, it sought to strengthen the framework for market-based forms. Hence, it was banks that were restructuring loans, typically, however, without reducing the overall value of the debt (ibid: 11). In addition, the government has strengthened the framework for voluntary out-of-court debt restructuring and the personal bankruptcy regime, which now allows responsible debtors a fresh start at the end of the insolvency procedure (ibid: 18). In addition to these measures focusing on individual debtors, the government also strengthened the supervisory framework of banks.

Market-based debt restructuring has led to a significant amount of evictions and repossessions. By 2010, 18% of all loans to households were in "workout" – i.e. banks were in the process of foreclosing on collateral (Erbenova et al. 2011: 20). Like Ireland, Latvia is among the few EU member states where evictions were on the rise between 2010 and 2013. The highest increase occurred in the enforcement of evictions from repossessions of owner-occupied housing, peaking in 2012 with 375 cases. The same year, 5600 properties were sold in forced auctions, which is a very high number in international comparison (Kenna et al. 2016: 61). Indeed, one of my interviewees stated that "There are in my opinion more people displaced by repossessions than by the early privatization" (Interview 1). Most of the Scandinavian banks founded their own property companies to manage and ultimately sell repossessed property.

One of the most worrisome features for over-indebted homeowners is that "in the case of mortgage default at the moment, banks can repossess the property, take second properties if owned, and also recoup further debt from the future

earnings of the borrower" (Traynor 2009). Successive Latvian governments tried to change this by shifting some of the risks of underwater mortgages on the banks. These attempts by and large failed because (mostly the Nordic) banks put up huge resistance. Thus, at the height of the crisis, in 2009, the Dombrovkis cabinet proposed laws that aimed at limiting the liability of property borrowers in case of default to the current market value of their property, rather than the value at the time of the purchase. This would have inflicted huge losses on the banks because of the rapid decline in house prices. But banks threatened that this would mean the end of lending, and under the joint attack of the commercial banks and Bank of Latvia, the laws were shelved (Traynor 2009). In 2015, another set of laws, which would have allowed new borrowers to choose a "non-recourse" mortgage – a mortgage that gives them the option of returning the keys to the banks in case they are unable to repay their loans – were significantly watered down after the Nordic banks threatened that they were to cease to issue loans altogether. Indeed, in what looked like a collusion of the Nordic banks, all major mortgage lenders doubled their down payment requirements, forcing lawmakers to backtrack on their proposal. A watered down version of the law was finally adopted, allowing homeowners the choice between a significantly more expensive non-recourse and a cheaper full recourse mortgage (Eglitis 2015, Kaza 2015).

Overall, despite a relatively fast recovery of the economy, mortgage lending has remained slow since the crisis broke out, while house prices have been increasing, especially in Riga. This, however, is mostly due to the Latvian government offering second residency for foreigners who buy real estate. The second residency scheme has attracted above all wealthy Russians who buy up luxury apartments in the capital city (nomadcapitalist, 3/2014). For locals, access to housing remains difficult, with unemployment still high, incomes low, and banks only lending cautiously (IMF 2016b). To revive the stagnant

mortgage market, more recently the government has decided on a state guarantee program for families with children. The main aim of the program is to reduce the down payment for first time buyers, with state guarantees increasing per number of children (The Baltic Course 2016).

## 4.3 Summary

This section has argued that the crisis has revealed the hierarchical nature of core-periphery financial relations. In light of a sudden stop of capital flows, none of the four countries were able to stabilize their economies on their own. The conditions set by the ultimate guardians of their transnationally integrated financial systems differed, as did domestic crisis responses. Thus, Hungary and Iceland have by and large rejected the previous paths of financialization, with Hungary's answer being more extreme, while Ireland and Latvia have mostly accepted the discipline of financialization. Table 4 summarizes some of the trends of housing (finance) in these countries after the crisis. The last, concluding section will take a step back and ask how the different policy responses relate to the broader trajectories these countries have embarked upon, and what all of this tells of for the future of peripheral housing finance(ialization).

**Table 4**
Selected indicators of housing (finance) after the crisis

| | Homeownership rate (2014) (in brackets: homeowners with mortgages) | Residential lending (gross, average annual growth rate 2012-2015) | Gross fixed investment in housing (average annual growth 2012-2015) | Non-performing loans (households, 2015) | Nominal house prices (average annual growth 2012-2015) |
|---|---|---|---|---|---|
| Latvia | 80 (20) | 10 | -2 | 7 | 4 |
| Hungary | 86 (18) | 16 | -7 | 17 | 3 |
| Iceland | 78 (63) | n.a. | 7 | 7 | 7 |
| Ireland | 70 (34) | 41 | 1 | 18 | 9 |

Sources: Column 1: EU-SILC. Columns 2, 3, 5: EMF 2016. Column 4: IMF country reports for Latvia, Hungary and Iceland, ECB 2016 for Ireland.

# 5. Concluding discussion: The past and future of peripheral housing finance

Puzzled by the rapid increase of mortgage lending in a number of European peripheral countries, this paper has shed light on the trajectories of housing finance in four countries. It argued that many differences notwithstanding, there are a number of common themes that run through the rapid build-up of mortgage debt. EU-induced external liberalization, deregulation, and, in the East Central European cases, privatization of the banking sector has washed these countries with excessive liquidity. Additionally, integration into the European single market, economic area, or eurozone dramatically decreased the costs of borrowing for the peripheral countries and allowed them to escape their narrow domestic deposit base. An important share of international liquidity went into housing finance. In three of the four countries, unexperienced banks were at the origin of the mortgage booms and in all countries governments and supervisory authorities were either unwilling or unable (and typically both) to rein in banks and the risky lending boom.

Is there anything specific to these mortgage booms which makes them peripheral? After all, the liberalization of mortgage finance, an increasing reliance on foreign funding, and regulatory forbearance has been the hallmark of mortgage booms prior to the crisis elsewhere, notably in the US and UK (Rodrigez and Aalbers 2016). I show that, first, the nature of demand for housing finance differs. Demand for housing finance was high in Europe's periphery and reflects the predominance of high homeownership rates which are related to late industrialization. The nature of high demand differs: in Europe's East, high homeownership rates, virtually non-existing mortgage markets, and stagnant housing construction during the 1990s have led to a pent-up demand for housing and housing finance (Bohle 2014). In Europe's

North West, highly decommodified property based welfare systems have become marketized (Norris 2016). This differs from the more sophisticated deepening of already commodified mortgage finance and its expansion to subprime segments particularly in the US.

Second, the form of internationalization of mortgage finance differs. In the four cases, banks were at the origin of mortgage booms. In Europe's East, transnational banks were dominantly financed by parent banks, whereas in the two Northwestern countries, domestic banks borrowed on wholesale markets via interbank lending. In contrast to the US or UK, securitization of mortgages and their selling to institutional investors did not play a key role.

Third, all countries leveraged up internationally without the benefits of a reserve currency (Schwartz 2011). This is what made these countries particularly vulnerable to sudden stops and reversal in credit flows. As Schwartz writes, "[t]he United States survived its catastrophe and continues to have access to global credit markets without much penalty because the dollar is the international reserve currency." (ibid: 292). The sudden reversals of credit flows shook the foundations of the peripheral financial systems, and their stabilization has revealed the hierarchical nature of peripheral financialization. None of the countries were strong enough to stabilize their financial systems on their own, and it was only during the crisis that it turned out who the ultimate guardian of their transnationally integrated financial systems was (Pistor 2009: 3). The international constraints stemming from the conditionality of the ultimate guardians differed considerably across the cases. Arguably, Hungary was the country least constrained. Its banking sector was less exposed to the crisis as it only faced a liquidity crisis resulting from the turmoil in the foreign currency swap market (Aslund and Dombrovksis 2011). In the Hungarian case, it was the Vienna initiative that brought about the ultimate

guardian of its financial system: coordinated by the European Bank for Reconstruction and Development, transnational banks, regulators, central banks and international financial institutions agreed on the terms of stabilizing the banking system. In the agreements, parent banks committed to support their subsidiaries in the region, roll-over their credits, and capitalize them adequately. In those countries that had stand-by agreements with the IMF, banks made their commitment dependent on their host governments' compliance (Pistor 2011). Ultimately, the reliance on foreign banks allowed Hungary to outsource much of its troubles to the parent banks.

This was also true for Latvia, with the difference that its financial troubles were triggered by a run on its biggest domestic bank, PAREX. In response to the run, the government took over the majority control for a symbolic price. The costs of recapitalizing and the need for restructuring PAREX were the major reasons why the Latvian government turned to the IMF (Aslund and Dombrovskis 2011: 35). The run on PAREX however also affected the subsidiaries of Swedish banks negatively, and without a bailout from the Swedish parent banks the financial system would have crashed. After the crisis, Swedish banks, however, reduced their exposure to the Baltic States, making access to credit more difficult (Coppola, 28/5/2015).

The constraints facing Ireland and Iceland were of higher magnitude, but of polar opposite nature. Iceland found out that there was no ultimate guardian that was able or willing to stabilize its vastly oversized banking sector. Its own Central Bank was unable to act as lender of last resort and an international stand-by credit by the IMF and the Nordic countries helped to stabilize the economy; but only after the banking sector collapsed, Iceland imposed capital controls, and foreign creditors and shareholders experienced massive losses. In contrast, Ireland discovered that belonging to the eurozone does not provide

shelter for peripheral countries in crisis. Because of the no bailout clause of the Maastricht treaty, it found its access to capital markets blocked, while its Troika rescue package reflected concerns for the eurozone system as a whole, rather than the particular Irish woes. As a consequence, Ireland had the harshest conditions for the revival of is defunct banking system.

What do these different constraints mean for the future of housing financialization? I have highlighted two issues – on the one hand the policy responses through which each country tried to negotiate the international constraints, and on the other hand, the level of mortgage debt prior to the crisis. Thus, Hungary and Iceland have by and large rejected the previous paths of marketization of mortgages, while Ireland and Latvia have submitted to the discipline of international finance. However, given their different initial financial depth of mortgage markets, results of policy choices differ. Arguably, the Hungarian policy response has successfully reversed the path of housing financialization. Squeezing the banks has certainly relieved upper middle class over-indebted homeowners, but it also has led to a dramatic decline in mortgage lending. This is welcomed by the government, which seeks to limit the overall role of finance in the economy and to direct bank lending towards productive capacities. As it does not offer comprehensive alternatives to home-ownership or public housing finance, the consequence is a return to the peripheral housing regime. Interestingly, the outcome is quite similar in Latvia. In this case, however, it is unintended: In contrast to Hungary, the Latvian authorities never sought to curtail lending or rein in the banking sector. Rather, a combination of more prudential international norms, more cautious lending by the international banks, and borrowers whose economic outlook is still not stable have driven out housing financialization for the time being.

This contrasts with the Irish case. Banks remain major players in mortgage and housing markets. Here, arguably policy responses have taken financialization of housing to the next level. Limited supply and rising house prices combine with tight mortgage lending to produce increasing wealth inequality, with a "generation landlord" increasing their housing capital at the costs of "generation rent" (Ronald et. al 2015, Regan 2016).

While there might be alternatives to being stuck once again in the familial housing regime, and the increasing inequality of wealth that the post-crisis phase of financialization produces, the Icelandic post-crisis pathway shows that this is a thin line to walk. The state took back control over mortgage finance, ruled out risky forms of peripheral financialization, and tried to revive public housing. At the same time, however, the IMF (2015: n.p.) has recently warned that "the loss-making government-owned Housing Financing Fund, which currently dominates the mortgage market, needs to be unwound as its business model is no longer viable and replaced by a financially viable successor housing program".

Table 5 summarizes the findings.

**Table 5**
The future of peripheral housing financialization

| | | **Domestic rejection of financialization** | |
|---|---|---|---|
| | | **Yes** | **No** |
| **International Contraints** | **high** | Reduced financialization, but vulnerability remains (Iceland) | Financialization taken to a new level (Ireland) |
| | **low** | Voluntary return to peripheral housing regime (Hungary) | Unintended return to peripheral housing regime (Latvia) |

While the paper thus shed some light on the development and diversity of peripheral housing finance, future research needs to connect peripheral housing finance better to other aspects of the research program of varieties of residential capitalism. Thus, as mentioned in the first section, not all peripheral countries have opened up to financialization in the first place. The varieties of peripheral housing finance might thus be even broader than discussed in this paper. In addition, it would be important to link the findings of this paper to the broader comparative capitalism literature and to evaluate the consequences for macroeconomic growth, social stability, welfare states and political behaviour.

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