For *Legatum Institute*
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Iceland, Rising from the Ashes

Until a few years ago, Iceland was probably best known for Björk, puffins and a neat little airline that offered transatlantic passengers an easy detour to inspect volcanoes and bask in the midnight sun. Even those who really paid attention to the place were mostly drawn by the novelty (and charm) of a remote, sparsely populated island – one described by Richard Nixon as a God-forsaken place as recently as 1973 – that had managed to raise its living standard to that of Germany in a generation.

This changed abruptly in October 2008, when Iceland become an object lesson in how far a small, globally integrated economy can fall when it is caught unprepared by an international financial crisis. By the same token, its brisk recovery in the years since suggests how a mix of decisive, unorthodox policy and timely external support can make a huge difference for an economy that would otherwise have been trapped by Europe's ongoing malaise.

Iceland had the dubious honor of becoming the first high-income country in a generation to ask the International Monetary Fund for emergency assistance. Its three principal banks had just collapsed, and with liabilities equivalent to ten times the country's GDP weighing on the economy, other options were not viable. (Well, maybe not *all* other options: "God bless Iceland," the prime minister exhorted on national television on the eve of the crash, in an appeal for divine intervention as unusual here as it is commonplace on the lips of American politicians.)

Now, almost four years later, the IMF has left the scene, having saved the day with very large loans. And (less well understood) by providing the technical know-how needed to navigate the treacherous waters engulfing Iceland – know-how in short supply in Iceland's civil service. What followed was an unusually fruitful collaboration, though hardly one managed on a bed of roses. For example, when Fund personnel entered the premises of the Central Bank of Iceland for their first work session following the signing of the loan agreement in 2008, they were summarily instructed not to enter the bank "in their dirty boots." Arrangements had to be made for the meeting to take place elsewhere.

Nothing else to do

The rescue operation rested on three pillars.

Default
First, Iceland's private banks defaulted on their debts, imposing huge losses on foreign creditors as well as on shareholders and some depositors. Those losses were equivalent to

seven times Iceland's pre-crash national income, a world record. The IMF is sometimes accused of behaving like a collection agency for big banks, but not this time. The government, with the tacit support of the IMF, decided not to bail out the banks even though the banks' foreign creditors had been led to believe that it would – otherwise they would never have extended loans of this scale in the first place. So, unlike in Ireland, where the government assumed the banks' liabilities at huge cost to taxpayers (and to the pace of economic recovery), the Icelandic government freed itself from a very heavy ball and chain.

To many observers at the time, this seemed quite radical. In fact, it was the sole practical option for Iceland. There was no other way out because the hole the banks had dug for themselves while the government looked the other way was just too deep. So there was nothing particularly brave about Iceland's decision to "stand up" to foreign banks. The decision allowed Iceland to prevent financial uncertainty from virtually shuttering the real economy. Iceland's payments system, including its credit cards and ATM machines, continued to work smoothly even during the darkest days of the crisis. New banks were quickly erected on the ruins of the old ones.

Capital Controls

The second pillar was the imposition of strict capital controls designed to prevent everyone from using domestic currency (the Icelandic króna) to buy foreign exchange, except when it was needed to pay for imported goods and services. Thus, króna assets owned by foreigners who were eager to flee with their funds were – and remain – locked inside the country. These deposits, by the way, are now roughly equal to a quarter of Iceland's annual national income.

The initial justification for the capital freeze was straightforward and convincing: Without controls, the króna would lose considerably more of its exchange value and lead to more severe cuts in living standards, including a further escalation of both household and enterprise debts denominated in or indexed to foreign currencies. The secondary consequences had the unintended effect, though, of giving the government an incentive to maintain the restrictions indefinitely. For with nowhere else to go, domestic savings became available to finance the government budget deficit at a lower interest cost than otherwise would have been possible. Now, almost four years after their imposition, capital controls are still in place, tempting exporters to circumvent the law by not bringing home their foreign exchange earnings.

The controls are selective, of course, since Icelanders still need to convert króna to dollars or euros to be able to buy imports. As one might expect, that has led to some rather arbitrary rules. For example, the controls prohibit residents from converting currency to buy second homes abroad, but do allow emigrants from Iceland to convert the proceeds of house sales in order to buy houses in other countries. Note that the IMF's decision to go along with temporary capital controls marked a reversal of its position during the Asian financial crisis of 1997-98, when Malaysia broke ranks with the Fund and other countries in the region to impose capital controls. (Successfully, it turned out.)

Countercyclical Fiscal Policy

The third pillar of the program was a patient fiscal policy – patient in that government expenditures were not cut and taxes weren't raised immediately in order to avoid deepening the recession that followed the financial meltdown. This worked rather well, stimulating output through the fiscal multiplier even as it paid for unemployment benefits and other welfare programs that eased the pain for those most adversely affected. Again, this strategy, made possible by an initially low level of public debt, was markedly different from the one adopted in Asia in 1997-98, where immediate cuts in government spending coupled with higher taxes exacerbated the consequences of the financial crisis.

Iceland's success with what amounts to Keynesian countercyclical fiscal policy puts it squarely in the middle of the current controversies over the need to bailout banks or to use fiscal stimulus to speed recovery. Joseph Stiglitz, the Nobel-prize winning economist at Columbia University who criticized the IMF harshly for its role in the South-East Asian crisis in 1997-98, has complimented the Fund for its handling of the Iceland crisis. And another Nobel Prize winner, Paul Krugman of Princeton University and *The New York Times*, has favorably compared Iceland's experience to that of the eurozone and the UK, which until very recently have been heavily committed to austerity as a cure all that ails.

Growing again

Nearly four years after the collapse, Iceland's economy is expanding, at a 2½ to 3 percent annually. This reasonably healthy growth rate (for an economy that has been through the wringer, anyway) is due in part to Iceland's increased competitiveness in export markets. Since the crash, the króna has lost roughly a third of its value vis-à-vis the euro in real (i.e., inflation-adjusted) terms. That's a problem for Icelandic consumers. But currency depreciation has made a variety of Iceland's export a bargain, and also made domestic firms competing with imports more competitive at home – a correction that was decades overdue.

From 1870 – this is not a misprint – until the crash of 2008, Iceland's exports of goods and services hovered around a third of the country's national income, an unusually low figure for such a small, open economy. In 2011, however, exports represented more than a half of income, a huge jump. Tourists flock to Iceland as never before, making it one of the few countries in which tourist arrivals per year exceed the country's population. A restaurant meal in Reykjavík now costs no more, perhaps even a little less, than a comparable meal in Scandinavia.

The sharp depreciation of the króna and the bankruptcy proceedings resulting in default on the failed banks' debts denominated in other currencies both help to explain why unemployment remained relatively low after the crash. True, at 6 percent of the labor force, joblessness is high by Icelandic standards; but it is nonetheless modest compared with, for example, Ireland's 14 percent rate. Meanwhile inflation, currently running at a 5 percent rate, remains at the top of the European charts. That's hardly new, though: Since 1960, Iceland has consistently had the OECD region's second highest inflation rate, after Turkey.

While the bank's foreign-denominated liabilities have been shed, families are still heavily burdened by debts in króna. The Central Bank of Iceland reports that, two years after the crash, two-thirds of all 30-39 year-old homeowners are stuck with homes worth less than their mortgages. Outstanding overdraft loans, at 13 percent interest the most expensive bank loans available, amount to the equivalent of $2,500 per adult.

Perhaps it shouldn't surprise, then, that Eurostat (the EU's statistics agency) recently reported that 13 percent of Icelandic households find it very difficult to make ends meet, compared with 2 percent to 4 percent in the Scandinavian countries. In Western Europe, only Spain (14 percent), Portugal (20 percent) and Greece (24 percent) report relatively more households in dire straits. Measured in terms of purchasing power, Iceland's income per capita is now a third lower than that of Denmark, Finland and Sweden. (Norway, with its well-managed oil wealth stashed away in foreign stocks and bonds, is in a class all its own.)

Iceland clearly parted company with the Nordics in other unfortunate ways, too. There was a steep increase in economic inequality in Iceland during the 15 years preceding the crash, but the upheaval reversed the trend.

GDP is expected to reach the pre-crash peak in 2014. That is not the most relevant measure of recovery, however, because Iceland imports over a half of everything that the local population consumes. A better benchmark of economic revival, then, is the recovery of residents' purchasing power, measured with an appropriate mix of domestic and imported goods and services. Just how long this figure will take to pass its previous peak is anybody's guess.

For one thing, no one knows how long the stringent capital controls will remain in force – controls that were originally intended to last only two to three years, but seem firmly integrated in the government's fiscal planning. Also, no one knows whether the political class will revert to its nasty pre-crisis habits, now that the IMF is no longer calling the shots from a short distance via analysis and persuasion.

The central bank has started to repay the Fund (with borrowed money) ahead of schedule – something that countries sometimes do to avoid unwelcome post-crisis attention. No one knows, moreover, how the cases against those who nudged Iceland off the cliff will fare in court. Failure to make the culprits face justice could have a demoralizing effect on an already-alienated citizenry. In fact, there's a possibility it would lead to a significant exodus of highly skilled citizens to Scandinavia and elsewhere. This would be a serious blow for a country with a population of just 320,000 people spread over an island the size of Ohio – economies of scale apply to countries, too.

Other people's money

Little by little, the clouds are clearing. But it remains to be seen how one bizarre element of the meltdown, the dispute between Iceland, the Netherlands and the UK over liabilities for IceSave accounts, will play out .

Here's the tale. When the global financial bubble first started showing signs of strain in 2007-8 and the foreign credit lines of the Icelandic banks began to dry up, the banks launched an aggressive marketing campaign to attract foreign-currency deposits to Internet-based accounts. They offered too-good-to-be-true interest – at six percent one of the highest deposit rates available anywhere in pound sterling or euroland. Landsbanki, owned and operated by a father-and-son duo with entrepreneurial experience from the brewing business in Russia in the early 1990s, was especially aggressive, marketing its accounts in the Netherlands and the UK under the IceSave brand.

Much later, testifying at the criminal trial of the pre-crash prime minister, one central bank official likened the IceSave debacle to the Ponzi scheme operated by Bernard Madoff in the US. But the Central Bank of Iceland was plainly an enabler, since during this period it continued to lend money to the banks without adequate collateral.

When Landsbanki was finally forced to freeze the IceSave deposits because the cupboard was bare, the British and Dutch governments unilaterally chose to cover the guaranteed deposits of about 340,000 British and Dutch residents. The objective, apart from responding to political pressure from outraged depositors, was to preserve confidence in their own banking systems.

Not surprisingly, Britain and the Netherlands demanded their money back from the Icelandic government. What is a bit surprising is that they accepted a settlement with only partial compensation. One reason is that their political and legal leverage was limited. But they were perhaps also implicitly acknowledging partial responsibility for the fiasco, which included failure to require the legal status of the IceSave operations to be changed from bank branches (subject to Iceland's meager deposit insurance and dysfunctional supervision) to foreign subsidiaries, which would have been covered by British and Dutch deposit insurance – and, of course, supervision.

This, however, is the story that seemingly never ends. Iceland's parliament approved the roughly fifty-fifty split in responsibility, only to be rebuffed by the president of Iceland who exercised his constitutional right to refuse to ratify the agreement. This triggered a national referendum in which the settlement deal (which wasn't really on the table any longer) was defeated.

A second deal – this one more favorable to Iceland – was subsequently negotiated by an Iceland team headed by Lee Buchheit, a New York-based lawyer specializing in international and corporate transactions including sovereign debt management. This agreement was approved by the parliament, now with significant support from the opposition parties. Again, however, the president refused to ratify it, instead calling for another national referendum. And once again, it was defeated – this time by a decisive 60-40 margin.

Iceland is a member of the European Free Trade Association, not the European Union. After the second referendum, EFTA's Surveillance Authority (i.e., its executive) referred the dispute to the EFTA Court, which had the authority to adjudicate Iceland's alleged breach of its treaty obligations to EU members. It now appears, however, that bank workout specialists will recover sufficient sums from the wreckage of Landsbanki to pay back depositors (who have first claim under Icelandic law). This means that, whether Iceland eventually wins or loses the case before the EFTA court, the payments to foreign governments will, in effect, come at the expense of the creditors of Landsbanki who are in line behind the depositors, rather than from Icelandic taxpayers.

Economics and justice

One of the Icelandic nation's chief challenges ahead is to look in the mirror and admit what it sees. Back in 2010, the nine-volume, 2,300 page report of the Special Investigation Committee of the parliament stated categorically that the banks had violated the law. Thus economic recovery is not enough. Iceland needs accountability, responsibility, transparency; the cause of all three would be served by the adoption of a new constitution that parliament has moved to put to a national referendum on 20 October 2012.

It also remains to be seen how the criminal cases stemming from the bank failures will fare in court. The number of employees at the special prosecutor's office has gradually expanded from three (yes, *three*) following the crash to about 100 today, thanks, in part, to Eva Joly, a Norwegian-born French magistrate and French presidential candidate (for the Green Party) in the last election. She advised the special prosecutor during 2009 and 2010, assuring the people of Iceland on television that some of those responsible for the crash would be put in jail.

All told, Iceland's Financial Supervisory Authority has referred 80 cases to the special prosecutor for suspected violations of the law – among them, instances of insider trading, market manipulation, and breach of fiduciary trust. But it's been a bumpy ride: Repeated attempts to unseat the director of the FSA succeeded in early 2012.

Even so, those who thought from the outset that no one would be held responsible for breaking the law have been proven wrong. The general secretary of the Ministry of Finance, a consummate political insider, is already serving a two-year prison sentence for insider trading with Landsbanki stocks. In the first of several such cases pending, two mid-level bankers were recently given four-and-a-half years each for market manipulation.

Bringing those who are guilty to justice is more than a matter of symbolism. For along with helping to imprint the lesson on a body politic that will soon enough be tempted to let bygones be bygones, criminal convictions would have the practical impact of preventing the wrongdoers from doing it again. Under the *Law on Financial Institutions* "Directors and managers must … have an unblemished reputation… and must not have been convicted over the past 10 years of a criminal offense under the Penal Code, ..."

Dénouement

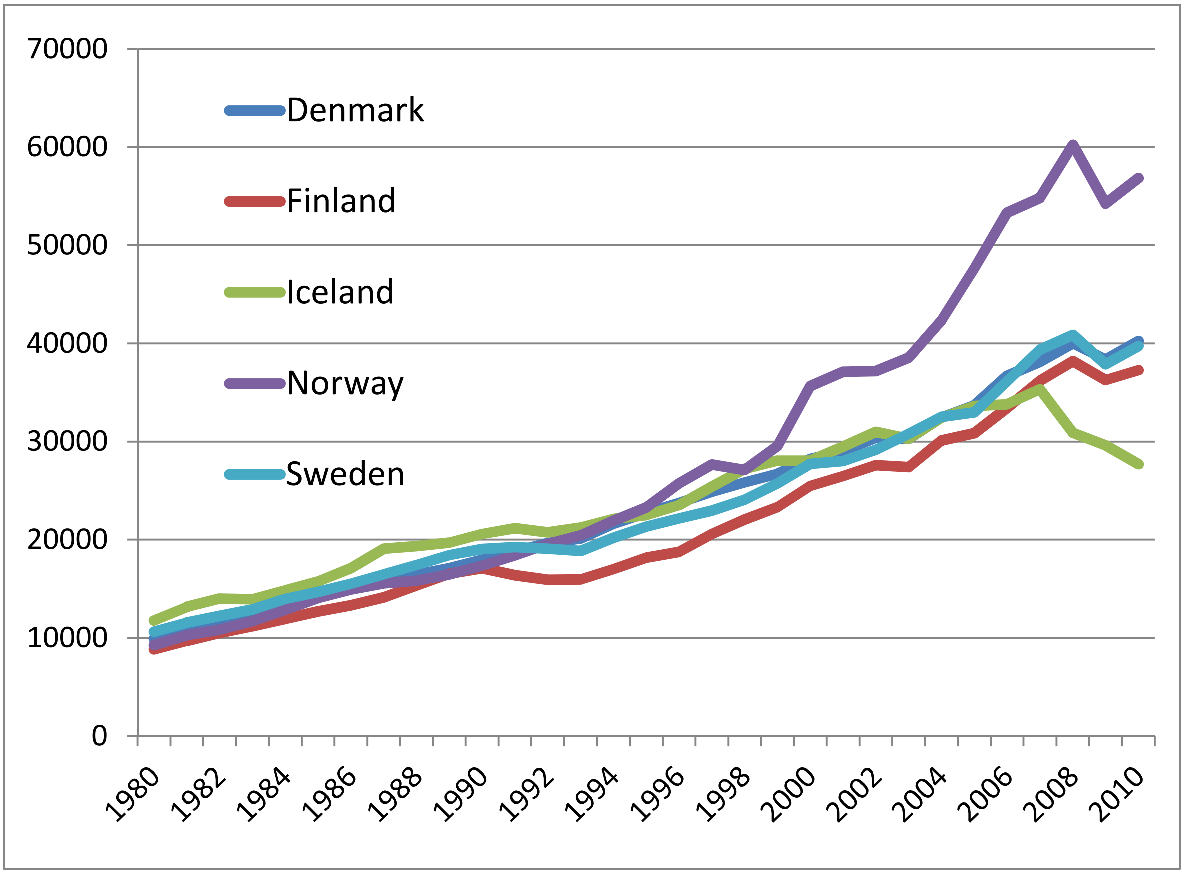
Financial crises never wipe countries out – firms, yes, people, sometimes, but not nations. For nations always come back, even after they default. (Which, by the way, Iceland did not do: While the government refused to cover the debts run up by the private banks, it continued to service Iceland's sovereign debt.)

One reason is that most of the wealth of every middle- and high-income country is in the form human and social capital. Financial wealth is generally of second-order importance; indeed, according to the World Bank, it typically constitutes only about one-twentieth of the total. So, for a financial crash to do deep and lasting economic damage, it needs to destroy human or social capital by, for example, undermining the country's institutions – democracy, the rule of law, respect for private property, the consensus behind universal education and health care, etc.

This seems an unlikely outcome in Iceland. There is no evidence that Iceland's social indicators, a useful barometer of national morale, have been adversely affected by the crisis. Suicides did not increase in number; life expectancy – a remarkable 82 years – shows no sign of decline. Belt-tightening hasn't been fun, but it hasn't shredded the social fabric.

In short, Iceland's economic miracle has been sullied, and in spectacular fashion. But for all the inclination toward political myopia and crony capitalism displayed in the run-up to the crash, Iceland's traditions of civility, social cohesion and just getting on with it have paid off in the interim.

Chart 1. Nordic Countries: Gross National Income per person 1980-2010
(US dollars at purchasing power parity)



Source: World Bank, World Development Indicators 2012.