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## **Iceland** **After the Fall** **By Thorvaldur Gylfason**

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What comes to mind when you think about Iceland? Until recently, chances are the island conjured images of puffins or geysers or maybe Björk – or, if you're a history buff, Ronald Reagan plotting a nuclear-free world with Mikhail Gorbachev. Today, alas, nostalgic thoughts have been crowded out by the grim reality of the financial meltdown: no country suffered comparably severe damage.

Iceland's three main financial institutions, accounting for 85 percent of the banking system, crashed within a single week in October 2008. All three (along with the government that had encouraged their forays into the Himalayas of global finance) claimed they were merely pawns caught in Wall Street's nefarious games. But the truth is more sobering. For this crisis has exposed the fundamental weakness of Iceland's economic and political cultures, which are hobbled by institutions more akin to those of the Third World than the First.

### **How Iceland caught up**

To understand Iceland's fall from grace, one must understand how Iceland managed to do so well for so long. When Iceland was granted home rule from Denmark in 1904, income per capita was about half that of its colonial parent – a miserable four dollars a day in today's purchasing power. But the island's people were better prepared for modernity than one might infer from that figure. Most Icelanders, for example, had been literate going back as far as 1800. Thus it should not be entirely surprising that Iceland managed to average about a half a percentage point faster growth than Denmark over the course of the 20<sup>th</sup> century. Or that this modest advantage enabled Iceland to catch up in output per person.

What's more, it used the income well, transforming an island in the middle of the North Atlantic into a prosperous state with little or no real poverty. In 2006, the United Nations Human Development Index ranked Iceland first in the world, tied with egalitarian, oil-glutted Norway.

Over the years, Iceland had accumulated various sorts of capital at a rapid pace: physical capital through investment, human capital through education, foreign capital through trade, and social capital through democracy, institution-building and a dedication to equality. Natural capital also played a role – first, in the form of rich fishing grounds (thanks to the gulfstream), and later in hydro power and geothermal energy. Even the preference for small families (and lack of hospitality to immigrants) that kept Iceland's total population below that of Bakersfield Calif. proved no economic handicap. To the contrary: the inefficiencies associated with lack of scale were probably more than offset by the gains linked to social cohesion and low information costs.

In foreign relations, Iceland deferred to its Nordic neighbors. It entered the European Economic Area along with Finland, Norway and Sweden in 1994, which gave the country easy access to European markets. But Iceland chose to remain apart from the European Union – a choice that reflected some Icelanders' preference to chart an independent economic course.

In domestic affairs, Iceland departed in some ways from the Nordic norm. While two-thirds of Icelanders live in greater Reykjavik, rural areas are vastly overrepresented in the Icelandic parliament -- and institutions were accordingly skewed in favor of farmers, fishing boat owners and businesses. Free markets were viewed with skepticism, if not outright hostility. The state owned the large

commercial banks and used them to allocate subsidized loans and undervalued foreign exchange. There was no way to borrow to build a fence or buy a car, or to obtain dollars to go abroad without kissing the rings of political functionaries.

This was, it should be added, capital rationing with a human face. Even so, the all-encompassing role of the political class in the economy inevitably led to the soft corruption of patronage and influence peddling.

The stories are legend. Party cronies usurped the agency for major firms such as Coca-Cola and General Motors by convincing their foreigner partners that only they would be able to procure the permits needed to import foreign exchange. Political leaders sat side by side on the boards of the banks, looking after supporters in the business community that could not manage without preferred access to capital.

Bank profits were channeled to favored clients through low-interest loans, while losses were passed on to the public in the form of high fees and heavy taxes. This convenient bargain – privatizing the gains and nationalizing the losses – was rarely challenged. The political opposition, after all, had representatives on the bank boards, too. And the newspapers were mostly organs of the political parties and stayed in line, as did prosecutors and the courts.

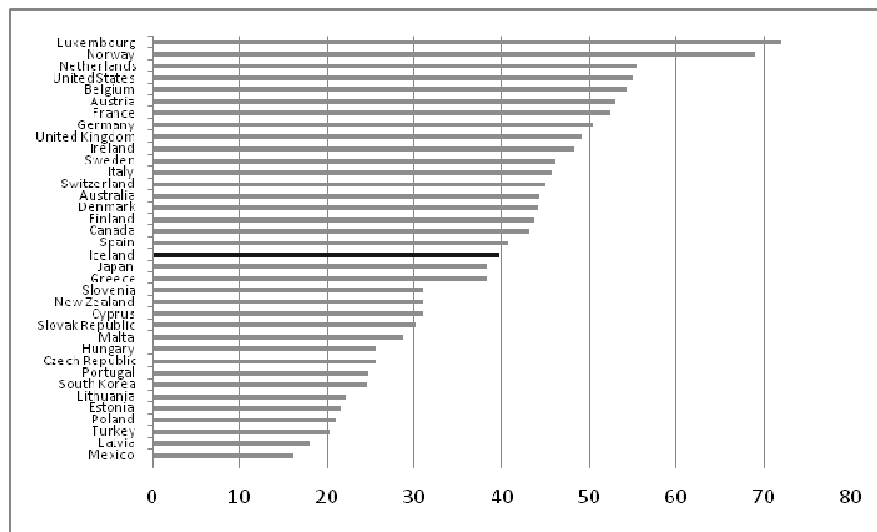
### **Lopsided liberalization**

Two waves of liberalization of the policy regime did relieve some of the economic drag associated with Iceland's brand of crony capitalism. The first, in the early 1960s, drastically reduced subsidies to the fishing industry – subsidies that had absorbed an astounding 40 percent of the government budget. The króna was also devalued, making Icelandic enterprises more competitive in export markets. But as economic reforms go, this one fell short. For one thing, it left the banks – and thus the allocation of capital -- in the hands of politicians. More generally, it did not loosen the suffocating embrace between producers and their patrons in government.

A second wave of liberalization in the 1980s deregulated interest rates. This made it possible for interest rates to rise above the (chronically high) rate of inflation, reducing the implicit subsidies funneled through the banks. Selective forgiveness of non-performing loans effectively took the place of credit rationing.

Once Iceland joined the European Economic Area (in 1994) the government effectively abandoned controls over trade and capital flows. The privatization of commercial banks and investment funds followed in the 1998-2003 period. But before analyzing the impact of the deregulation and privatization of financial markets, it makes sense to look more closely at the broader real economy.

Iceland may have come out on top of the UN's Human Development Index in 2006 (and a more-than-respectable third in 2007), but it lagged by narrower measures of economic development. In 2008 the purchasing power generated per hour worked in Iceland averaged \$40 – far below Norway (\$69), the United States (\$55) and Germany (\$50), and even a bit below Italy and Spain. Icelanders certainly live well, but only by working longer hours than other Europeans. The best explanation: protection of agriculture and a lack of competition in key sectors (notably banking) raise the cost of living and weigh heavily on productivity.



### Gross Domestic Product per hour worked 2008 (US\$ at purchasing power parity)

Source: The Conference Board and Groningen Growth and Development Centre, Total Economy Database, January 2009, <http://www.conference-board.org/economics/>.

Other factors are at play here, too. Iceland lags in investment in machinery and equipment, most likely because the financial sector favored less productive investment in real estate. Second, despite great strides on the education front in recent years, the share of the Icelandic labor force (25-64 year olds) with no more than a high school education is still twice that of the Scandinavian countries.

It's also worth noting that the central bank, so long compromised by the less-than-arm's-length relationship between policymakers and the private sector, has never managed to make price- and exchange-rate stability a priority. One number says it all: Since 1939 when the two traded at par, the Icelandic króna has lost 99.95 percent of its value relative to its mother currency, the Danish krone.

### Privatization among friends

Return now to the privatization of Iceland's big banks – the particular, Landsbanki Íslands and Búnadarbanki Íslands, two of the largest. (The latter was subsequently merged into the Kaupthing Bank in 2003). The recent experience of the Baltic countries in the transition from Soviet-style planning offered plenty of precedent in how to manage such privatizations. The idea was to maximize the return to the state by casting the net widely for bidders, and by seeking buyers that could manage the international banking in a small country dependent on trade and foreign investment.

But in Iceland, the two banks were sold at prices deemed suspiciously low by the National Audit Office. What's more, they were sold to Icelanders lacking experience in the business.

Why? Because it suited the ruling Independence and Progressive parties – or, more precisely, some leading politicians who saw privatization as a chance for their cronies to become richer. One major investor was a politician whose private-sector experience consisted of running two small knitwear factories in the provinces in the 1970s for a few months; he became an instant billionaire. Another needed special legislative treatment to qualify because he had been in deep legal trouble in Russia. Previously, he had been awarded a conditional prison sentence in Iceland for fraud. To make matters worse, his son (a co-investor) was a wheeler-dealer who had made his mark on the world stage through shady privatization deals in the telecommunications business in Bulgaria and the Czech Republic.

Crony capitalism was so much a part of daily life in Iceland that this back-scratching was openly discussed. Consider a celebratory essay on the prime minister -- one presumably published with the subject's approval -- by the chief editor of the newspaper *Morgunbladid* in 2004. The editor wrote that, since the Progressive Party (then the second largest party) had secured its claim to the Búnadarbanki, the prime minister "considered it necessary that Landsbanki would land in the hands of persons within at least calling distance of the Independence Party."

And how, you might wonder, did the ousted central bank governor under whose stewardship as prime minister turned banker all this transpired fare after the system collapsed? He became editor of *Morgunbladid* -- roughly the equivalent of making Richard Nixon editor of the *Washington Post* to ensure fair and balanced coverage of Watergate.

The point of bank privatization ought to have been the creation of independent institutions with incentives to allocate capital to its most productive/profitable use. But the political culture of Iceland saw it quite differently: this was a grand opportunity to reward friends and family. And in this sense, Iceland, which is typically cast as an extension of Scandinavia in the middle of the Atlantic, was (and is) very different than its Nordic cousins.

Privatization thus generated the worst of possible worlds, reducing the stability of Iceland's financial system without increasing its efficiency. The government could have changed the banks' incentives to take enormous risks in search of profit through changes in taxes. But it did not -- you do not tax your friends. The central bank could have contained the explosion of liquidity that followed privatization through higher reserve requirements. But it did not: on the contrary, it *lowered* reserve requirements in 2002 at the banks' behest. And -- this proved a particularly expensive error -- it abolished all reserve requirements on the bank's deposits at branches in other countries.

Iceland's Financial Supervision Authority had the discretion to apply stress tests, tailored to the quality and volatility of the banks' assets. But the FSA was hopelessly compromised. The banks routinely hired away FSA personnel at fat salaries, thereby depriving the FSA of experienced staff and conveying a clear message to the FSA staff that remained behind.

Free to do what they pleased, the banks went on an unprecedented borrowing and lending spree that increased the assets of the banking system from about 100 percent of national income in 2000 to an astonishing 900 percent in mid-2008. The banks' business model was, in essence, imported from abroad. Loan officers were rewarded according to the volume of loans they made, regardless of quality. The banks even managed to convince large numbers of customers to borrow in foreign currencies, even though their earnings were solely in Icelandic currency.

That practice may or may not have been legal. But it was certainly imprudent: Comparing the market exchange rate of the króna with its relative purchasing power suggests that Icelandic currency was at least 50 percent overvalued in 2008. And while it's true that exchange rates often wander far from purchasing power parity, the idea that most Icelandic businesses would bet their futures on the continuing misalignment of currencies is bizarre.

Lack of due diligence seemed the order of the day. The banks claimed to believe -- as did at least one international rating agency -- that the government continued to guarantee all the liabilities of the banks after they were privatized. Moreover, the government did little to counter this impression. The FSA was featured prominently in brochures from Landsbanki offering high interest rates on British pound sterling "Icesave" accounts managed over the Internet.

These high-interest-rate accounts were first offered to British depositors in 2006, and morphed into a primary source of capital for Landsbanki as it became increasingly difficult for the bank to borrow abroad through conventional channels. Similar accounts were offered to Dutch depositors in 2008 even after the Central Bank of Iceland, the FSA, and the government had been sternly warned by foreign central banks that the big banks were headed for collapse.

During their brief existence, Icesave attracted 300,000 depositors in Britain and 100,000 depositors in the Netherlands. Landsbanki ran its offices in Britain and the Netherlands as branches rather than as subsidiaries. For a very good reason: as accounts in foreign subsidiaries, they would have been subject to financial supervision by foreign regulators.

When Landsbanki collapsed in October 2008, the foreign depositors were compensated by the British and Dutch governments -- which, in turn, demanded that Iceland pay them back. In effect, then, Landsbanki managed to make Iceland's population of 320,000 liable for the losses of 400,000 foreign depositors.

Actually, the story gets worse. The banks peddled loans as well as complicated financial instruments to the holders of fishing quotas and farm-production quotas, using the quotas as collateral. They actively encouraged depositors to transfer their savings from ordinary accounts covered by government deposit insurance to money market accounts paying higher interest, promising that the money market accounts were also covered by government guarantees. The banks also provided large loans without collateral to customers who wanted to speculate on the foreign exchange market. And they lent members of their own senior staffs huge sums to buy shares in the banks, using only the shares as collateral.

### **Folly proves infectious**

Iceland's financial mania extended well beyond the banking system. Between 2001 and 2007, stock market shares rose an average of 44 percent annually -- a world record. Meanwhile, house prices rose 2-1/2 fold. When Robert Aliber, an economist from the University of Chicago, visited Iceland in 2007, he predicted a bust within a year. "You only need to count the cranes," quipped the expert on asset bubbles.

And, of course, Aliber was right. Iceland became the first wealthy country to seek help from the IMF since the UK extended a palm in 1976. The rescue package also drew on money from the Nordic countries, Poland, and the European Union.

As part of its recovery plan, the government split the three failed banks into "new" banks and "old" banks. The new banks took over domestic deposits and provided uninterrupted banking services at home -- no small feat under the circumstances -- and received fresh injections of capital from the taxpayers. The old banks were left with the dodgy assets and foreign debts that will largely have to be written off in the ensuing liquidations, no doubt triggering litigation from disappointed overseas creditors. In effect, the banks were re-nationalized on the model used by Nordic governments to handle of their own banking crises of 1988-1993. Iceland ultimately plans to re-privatize the new banks by exchanging their debts for equity -- inviting, at long last, foreign ownership.

Some other businesses, by the way, suffered the same fate in the crisis as the banks. One of the largest insurance companies as well as the iconic national airline -- the airline that millions of Europeans and Americans have used over the decades to cross the Atlantic -- had to be nationalized. No doubt other businesses will follow.

Iceland's economic crisis has destroyed wealth equivalent to approximately seven times the country's annual income – that's right, seven times the GDP. The damage inflicted on foreign creditors and depositors amounts to about five times Iceland's national income, while the losses thrust upon Icelandic residents amount to about two times income.

Even without the benefit of hindsight, it's clear how all this happened. The absence of checks and balances gradually eroded the inhibitions of unprincipled politicians and their greedy counterparts in the private sector. When the National Economic Institute, a decades-old institution set up to offer impartial economic counsel to the government, was no longer found obliging enough, it was disbanded on the grounds, among others, that the recently privatized banks' economic research departments could fill the gap. When the Competition Authority raided the offices of oil companies in search of evidence of price collusion, the Authority was summarily abolished and then reincarnated under new, more compliant management. Iceland, you see, is not so much a scaled-down version of Scandinavia as it is an amalgam of Italy, Japan and Russia, with a dash of Denmark for show.

The people of Iceland have expressed their anger at the political establishment, sweeping both the Independence Party and the Progressive Party into opposition at once for the first time in history. Even before the crash, opinion polls showed that only 30 percent of Icelanders had confidence in the parliament or the judicial system. The public's attitude toward those who brought down the economy was neatly captured by writer Einar Már Gudmundsson in his story about a cannibal flying first class. When a flight attendant hands him the menu, he looks at it and says: "Nothing on the menu strikes my fancy. Could you please show me the passenger list?"

### **Reading the tea leaves**

Iceland now faces gross public and private foreign debt equivalent to about 300 percent of national income, even after writing off private debts equivalent to another 500 percent. As a consequence, the government was forced to spend almost as much on interest payments in 2009 as on health care and social insurance.

There is bound to be friction over how this interest burden should be apportioned in coming years. A decade ago, Iceland could boast of a distribution of income akin to that of egalitarian Scandinavia. But, in large part due to a reduction in tax rates on higher income earners, income distribution is now closer to that of the United States. And in the lean years ahead, there will be pressure to pare government income transfers to the lower end of the distribution. That spells trouble for governments asking for the major sacrifice in living standards needed to repay Iceland's external debts.

It's not surprising, then, that observers have likened the debt burden to the reparations imposed on Germany at Versailles, and predict equivalent consequences – though obviously ones that will concern the world less.

There are still some optimists out there, however. Those who focus on Iceland's strong fundamentals remain hopeful that the country can get back on its feet within a few (albeit difficult) years. For while the economy remains dependent on a mature fishing industry for two-fifths of its export earnings and one-sixteenth of its GDP, it still has great potential to grow in other sectors. Abundant hydropower and virtually unlimited geothermal resources make it an ideal location for producers of energy-intensive materials such as aluminum and ferrosilicon. And, thanks to its highly educated technocratic elite, Iceland has had some striking successes in developing information technology.

Recovery must rest on two pillars. First, the government will have to implement the IMF's reconstruction program. Iceland's belated application for EU membership (and the implied willingness to follow EU rules on governance) is evidence that the government really does intend to clean up its act.

Second, Iceland's political establishment must face up to the causes of the collapse, including the massive failure of policy and institutions in the absence of checks and balances. For this to be done properly, the country will need objective analysis from outsiders. The government, however, remains unwilling to appoint an international commission, and that risks a deepening crisis of confidence if a home-grown review doesn't convince the public. Happily, the government has accepted an offer of help from Eva Joly, a renowned French-Norwegian investigative magistrate who led an investigation of the oil giant Elf Aquitaine, arguably the biggest fraud inquiry in Europe of the post-war era.

For those who take the long view, Iceland's fall from grace should not be all that surprising. In the 19<sup>th</sup> century, the tail end of the Little Ice Age, the worsening climate effectively destroyed Iceland's agricultural economy and forced a good portion of the population to emigrate. But Iceland is also a country that has made the most of relatively little through hard work and a knack for adapting to change. Don't count it out just yet.