7 FROM BOOM TO BUST: THE ICELAND STORY

The Iceland story is not representative of the Nordics, but it offers lessons that have relevance far beyond Iceland's shores

This chapter tells an Icelandic saga, albeit not one of the classic kind with more embellished heroes than villains. The story of recent events in Iceland is dramatic and stark, and it is not representative of developments in the rest of the Nordic region. However, the gross failures of policy, regulation, and governance as well as of politics in a broad sense in Iceland do point to a number of lessons that have relevance far beyond Iceland's shores. It will take years to establish what went wrong. The parliament's investigative committee is scheduled to publish its 1500-page report at the end of January 2010. Its findings were not known when this book went to print. Other reports on the Iceland story will no doubt follow.

The current financial crisis commenced in the United States in mid-2007, and reached its peak in September 2008, following the collapse of Lehman Brothers, the largest bankruptcy filing in U.S. history. The venerable financial firm, established in 1850 by a couple of Bavarian immigrants to Alabama, had fallen victim to excessive exposure to bundled mortgage securities, including subprime loans, dodgy assets that flooded the financial system of the United States and some European countries without attracting the timely attention of the Securities and Exchange Commission or other regulatory agencies. Warnings were issued, true, even within the highest echelons of the Federal Reserve, but to no avail.[1]

Confidence then crumbled as bankers began to grasp that they did not really know where all those noxious assets lay buried. Credit dried up when banks proved unwilling to lend to one another. The global financial system began to stall. Some feared the outbreak of another Great Depression. Those fears have since subsided, thanks in part to the concerted monetary and fiscal action taken by several governments inspired by the lessons from the 1930s reviewed in chapter 4.

7.1 First to freeze

The Icelandic banks had serious problems of their own making, problems with deep roots in the past

The first country to freeze was Iceland, whose three main banks, all private, accounting for 85 per cent of Iceland's commercial bank assets, crashed within a week in early October 2008. At first, the banks, echoed by the government that had all along stood behind them (or rather beside them), blamed the fall of Lehman Brothers for their own demise, implying that had Lehman Brothers endured, they, too, could have survived the turmoil. This was a false excuse. The Icelandic banks had serious problems of their own making, problems with deep roots in Iceland's economic and political past. True, the collapse of confidence in world financial markets generated the spark that ignited the flames which quickly engulfed Iceland, but the house would have caught fire anyway though perhaps a little later.

To understand Iceland and its broken banks, it is necessary to understand their history. In 1904, when Iceland was granted home rule by Denmark after more than 600 years under first Norwegian and then Danish rule, Iceland's per capita GDP was about half that of Denmark. The purchasing power of Iceland's per capita GDP in 1904 was similar to that of today's Ghana. Iceland was Ghana, with a difference: most of Iceland's impoverished population had been literate since 1800. Icelanders were thus well prepared for the modern age.

During the 20th century, Iceland's per capita GDP grew by 2.6 per cent per year on average compared with Denmark's 2.0 per cent (recall figures 4.7 and 4.9). This per capita growth dif-

In the 20th century, Iceland managed to catch up with Denmark and join Norway in the top position on the UN Human Development Index in 2006

ferential of 0.6 per cent per year may seem modest, but over the course of a hundred years it enabled Iceland not only to catch up with Denmark but even to join Norway in the top position on the United Nations Human Development Index in 2006.[2] Mainly through hard work and improved education, Iceland had catapulted itself into an egalitarian and prosperous welfare state that felt at home in the Nordic family. For various reasons, including divisive squabbling and electoral laws that favoured rural areas over Reykjavík, Social Democrats had a relatively minor direct influence on Iceland's political development, but this did not seem to set Iceland apart from the Nordic countries. The distribution of income in Iceland was until the mid-1990s about as equal as in Scandinavia and Finland according to official estimates of the Gini index of income inequality.

Iceland entered the EEA in 1994, but, like Norway, did not follow Finland and Sweden into the EU in 1995

In foreign relations, Iceland went along with its Nordic neighbours. With Denmark and Norway, Iceland became a founding member of NATO in 1949. Ten years after the others, Iceland joined the European Free Trade Association (EFTA) in 1970. With Finland, Norway, and Sweden (as well as Austria), Iceland entered the European Economic Area (EEA) in 1994, but, like Norway, did not follow Finland and Sweden into the EU in 1995. (Denmark had joined already in 1973.) Norway decided against EU membership in 1994 in a referendum, a replay of 1972. No referendum was held in Iceland, however, where the parliament, with highly disproportional representation from rural areas, was strongly against EU membership while unbiased, i.e., one-man-one-vote, opinion polls consistently suggested a popular majority in favour of membership.

In mid-2009, after the crash, Iceland applied for EU membership

In mid-2009, some months after the crash, the Icelandic parliament moved to apply for EU membership, the first time that parliament was able to muster such a majority reflecting long-standing public sentiment. However, since then, public sentiment seems to have turned against EU membership for reasons related to the insistence of the United Kingdom and the Netherlands that Iceland's taxpayers compensate them for about a half of the amount that they unilaterally decided to pay in compensation to depositors in British and Dutch branches of one of Iceland's broken banks, allegedly in accordance with European directives.

In domestic affairs, Iceland charted a course that was quite different from the Nordic norm. The main reason for this divergence appears to be the overrepresentation of rural areas in parliament that still imparts a provincial, protectionist bias to economic policy and to the structure and functioning of the economy. Throughout most of the 20th century, the number of votes needed to elect a member of parliament for the Reykjavík area was two, three, and up to four times as large as the number of votes needed in the rural electoral districts, in effect giving each farmer the ability to cast the equivalent of two to four votes in parliamentary elections. Until 2003, the provinces kept their majority in parliament even if nearly two thirds of the people now live in Reykjavík. The deliberate bias built into the electoral law resulted in a neglect of education in the provinces to slow down the migration to Reykjavík as well as a slow and lopsided transition from a rigid, quasi-planned economy toward a more flexible, mixed market economy, and in a similarly reluctant and slow depolitization of economic life, including the banks that were privatized only in 1998–2003, several years after the privatization of commercial banks in East and Central Europe and the Baltic countries.

The long-standing overrepresentation of rural areas in parliament imparts a protectionist bias to economic policy

From 1930 onward, the two largest political parties, the Independence Party and the Centre Party, could count on calling the shots with the support of about 60 to 70 per cent of the electorate between them in much the same way as the Liberal Democratic Party was able to rule Japan 1955–2009 except for eleven months. Every majority government in Iceland included one or both of those parties, with two small parties (Social Democrats and Socialists) sometimes included as junior partners. During 1930–1960, Iceland's economy was tightly regulated in favour of producers – farmers, boat owners, businessmen, wholesalers, merchants – more so than elsewhere in the Nordic countries at the time. Government interference and planning were the norm. Free enterprise and markets were viewed with scepticism if not hostility. Producers occupied the driver's seat, consumers sat at the back. The state owned the largest commercial banks and used them to allocate scarce funds and subsidized or undervalued foreign exchange to favoured industries and firms. With high inflation, well above interest rates, and an overvalued currency, bankers exercised significant power. The

Throughout the 20th century, government interference and planning were the norm and the state owned the largest commercial banks

The all-encompassing role of the political class was conducive to corruption

main political parties built themselves up as the arbiters of ordinary people's daily lives. The smaller parties went along. Apart from the black market, there was no way to get a loan to build a fence or buy a car or to obtain foreign exchange to go abroad except by going through the party functionaries in charge of rationing. This was, it should be added, rationing with a human face. Even so, the all-encompassing role of the political class was inevitably conducive to corruption, but this fact was never officially acknowledged, a state of official denial about the past that still prevails. Pervasive rationing always produces this outcome. Ask any East European.

Box 7.1
"Socialism of the devil"

The stories were legend. Party cronies usurped the agency for major foreign firms such as Coca-Cola and General Motors by convincing their American partners that other agents lacking the requisite qualifications – that is, political connections – would not be able to get hold of the dollars necessary to fulfill their obligations to their suppliers. Why not? – asked the baffled Americans. Because we allocate the foreign exchange permits, was the answer. This was during the Second World War and set the tone for the tight embrace between business and politics in Iceland for decades to come. It was also widely rumoured that the state banks were used to settle selected claims at the old exchange rate shortly before frequent devaluations of the króna, but none of these cases were ever pursued, not in the media and surely not in the courts.

Losses were passed on to a captive public

Political leaders sat side by side on bank boards, looking after essentially bankrupt business interests, if business is the right word, and divvying up the spoils. Profits were channelled to favoured clients through low-interest loans which high inflation made it unnecessary to pay back in full. Losses were passed on to a captive public with no means of protecting their savings from inflation other than spending their income as fast as they could, on housing and other durables and such. Domestic saving dried up, necessitating external borrowing on a large scale because, for nationalistic reasons, foreign direct investment was kept at bay (and banned by law from the fishing industry, a ban still in force). This convenient bargain – privatizing the gains and nationalizing the losses – was referred to by critics as the "Socialism of the Devil".

The political opposition had representatives on the bank boards, and consequently had no interest in exposing the goings on. The papers were mostly party organs and stayed in line, as did the police and the courts. Several bank scandals, described in private letters now in the public arena as well as in published articles, were hushed up. The point of this unflattering review is that Iceland's glaring and long-standing lack of a culture of accountability and of checks and balances paved the way to the crash of 2008.

How, then, did Iceland manage to grow? The short answer is that

- Iceland's political failings should not necessarily have been expected to stifle economic growth, even if growth might have been more rapid without those failings;
- Iceland did many things right, including the mechanization of the fishing fleet which was an important engine of economic growth. The gradual extension of the fisheries jurisdiction from three miles in 1901 to 200 miles in 1976 and the harnessing of the country's hydroelectric and geothermal energy potential from the 1960s onward were also conducive to growth;
- We need to distinguish between stocks and flows. Iceland maintained a rapid flow of income per person by, among other things, running down fish stocks and accumulating foreign debts.

Even so, Iceland did many things right, mechanized the fishing fleet, and harnessed its hydroelectric and geothermal energy potential

7.2 Lopsided liberalization

Two waves of major liberalization of the policy regime swept the country, but neither went very far. The first wave, in the early 1960s, helped modernize Iceland by devaluing the króna and by drastically reducing subsidies to the fishing industry – subsidies that had absorbed more than 40 per cent of government expenditure (this is not a misprint). Even so, the liberalization was incomplete. For one thing, it left the banks in the hands of the state. Also, it left in place the tight embrace of producers and the government.

In the late 1980s, a second wave of liberalization included deregulation of interest rates as well as indexation of financial obligations to prices. The result was to bring interest rates above inflation for the first time and reduce the scope for rationing of bank loans. Thereafter, the selective forgiveness of nonperforming loans took the place of credit rationing as a means of political and economic influence. The second wave also involved deregulation of foreign capital flows upon Iceland's entry into the EEA in 1994, insuring free flow within the area of most goods, services, people,

Not until 1998-2003 were two of the largest state banks privatized and capital (the four freedoms). A major component of the second wave of reforms was the privatization of commercial banks and investment funds during 1998–2003 when two of the largest state banks were sold. As originally envisaged, these reforms were necessary and long overdue. Before describing the privatization of the banks and its aftermath, however, a bit more background is required.

For starters, Iceland's position at the top of the Human Development Index in 2006 beside Norway is misleading as far the

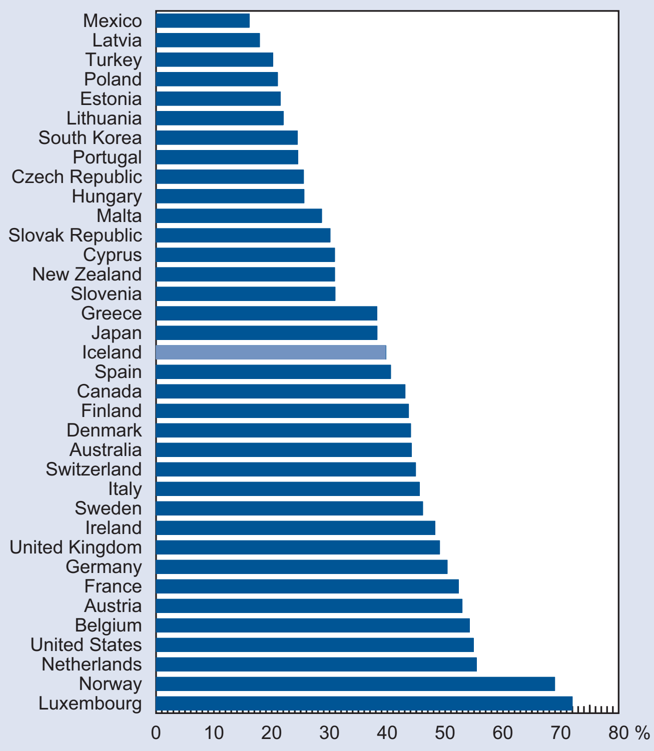

Figure 7.1
GDP per hour worked 2008 (USD at purchasing power parity)

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

income part of the index is concerned. GDP per hour worked is a better measure than GDP per person because the former takes into account the work needed to produce the output. Figure 7.1 shows GDP per hour worked in 36 countries in 2008 based on the University of Groningen database that includes internationally comparable estimates of hours of work.[3] The figure shows that, in 2008, the purchasing power of income per hour worked in Iceland was USD 40 compared with USD 44 to USD 46 in Denmark, Finland, and Sweden, USD 55 in the United States, and USD 69 in oil-rich Norway. The Icelandic figure reflects the inefficiency (e.g., from excessive farm protection with food prices to match and lack of competition in some other areas as well, including banking) that continues to plague Iceland where it still takes long hours of work – like in Japan and the United States – to sustain a high level of GDP per person. High prices and high inflation reduce the purchasing power of households and compel wage earners to work long hours, and to borrow, to make ends meet.

In 2008, the purchasing power of GDP per hour worked in Iceland was $40 compared with $44 to $46 in Denmark, Finland, and Sweden and $69 in Norway

There are further reasons for the relatively low labour productivity in Iceland. First, there has been too little investment in machinery and equipment. For years, high inflation eroded the quality of capital. After 1995, investment in construction doubled relative to GDP, crowding out more productive investment in machinery and equipment.[4] In second place, despite great strides on the education front in recent years, the share of the Icelandic labour force (25–64 year olds) with no more than primary education is still twice that of Denmark, or 37 per cent in Iceland compared with 19 per cent in Denmark, 21 per cent in Finland, 23 per cent in Norway, and 16 per cent in Sweden.[5] The long hours of work also seem likely to lower productivity and living standards. Tired hands make mistakes. Third, the LSP agenda – liberalization, stabilization, privatization – of recent years was carried out in ways that allowed the banks and their debts to grow far out of proportion to the country's capacity to cope, with the Central Bank neglecting to raise reserve requirements as needed instead of reducing them to accommodate the banks and neglecting also to build up adequate foreign exchange reserves.[6] This left the Central Bank unable to guarantee the stability of the financial system, let alone stable prices, as required by law. In fact, the Central Bank faced

High inflation hurt productivity

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The Central Bank's gross foreign reserves dropped to 7 per cent of short-term foreign liabilities in 2007 as the commercial banks' foreign debts continued to mount

bankruptcy after the crash and needed to be recapitalized at a cost to taxpayers equivalent to 18 per cent of GDP.[7] Again, high inflation hurts productivity. Lax fiscal policy made matters worse.

There is another way to look at the undisciplined stance of monetary and fiscal policy in Iceland over the years. Since 1939 when the two traded at par, the Icelandic króna has lost 95.95 per cent of its value vis-à-vis its mother currency, the Danish krone. The reason, of course, is Iceland's inflation. High inflation for decades on end is always and everywhere a sign of shoddy policies and shaky institutions. Experience shows that countries with high inflation run up overseas debts, neglect important pillars of economic growth such as foreign trade, education, investment, and good governance and, therefore, tend to grow less rapidly than they would have with stable prices. Inflation tends to create a false sense of security, even hubris, by encouraging consumption and putting responsible preparations for the future on ice. Iceland fits this pattern, even if its economic growth sufficed to catch up with Denmark. Iceland's rapid growth from 1904 onward was not, however, the result of inflation. It was, rather, the result of an ocean tide of optimism and enterprise following Home Rule, the influx of new technology after 1940, mostly thanks to American presence in Iceland during and after the war, more and better education, hard work, plenty of fish within an extended 200-mile economic jurisdiction after 1976, and freer trade in two rounds after 1960 as well as after Iceland's entry into the EEA in 1994. But this was not enough.

To bring the gross foreign exchange reserves of the Central Bank back up above three months' import coverage (an old rule of thumb), the government in 2006 borrowed a billion euros.[8] However, no attempt was made to stem the decline of reserves relative to the short-term foreign liabilities of the banking system. The Central Bank's gross foreign reserves stayed at 20 per cent of short-term foreign liabilities in 2006 and then dropped to seven per cent in 2007 as the commercial banks' foreign debts continued to mount (figure 7.2). According to the so-called Giudotti-Greenspan rule, the gross foreign reserves of the Central Bank should not be allowed to sink below the short-term foreign liabilities of the domestic banking system. Failure to keep reserves at or above

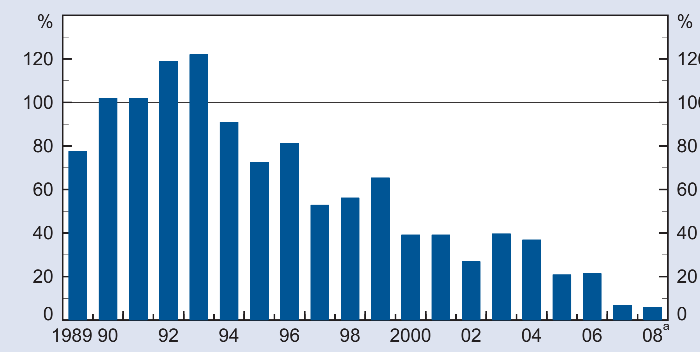

Figure 7.2
Central bank foreign exchange reserves, 1989–2008 (per cent of short-term foreign liabilities of banking system at end of year)
a = The last column refers to the end of June 2008.

Source: Central Bank of Iceland.

that level invites speculators to stage an attack on the currency, a lesson learnt the hard way in Thailand in 1997 but grossly and deliberately ignored in Iceland.

7.3 Privatization among friends

Let us now return to the privatization of two of the largest state banks in 1998–2003, Landsbanki Íslands (est. 1885) and Búnadarbanki Íslands (est. 1929), the latter of which, within months, became part of Kaupthing Bank, a private bank that had started out as an investment firm in 1982. The two state banks were sold both at once at a price deemed modest by the National Audit Office, which pointed out that by selling the two banks separately the state could have exacted higher prices. Further, the banks were sold not to foreign banks as was done in Eastern Europe – e.g., Estonia with 100 per cent foreign ownership – but to individuals closely linked to the political parties in power.

The two state banks were sold both at once at a modest price

As in the Baltic countries, foreign ownership of the banks, at least in part, would have been natural in view of the limited experience and expertise in international banking available locally as well as with a view to history. Exploratory meetings were held with Skandinaviska Enskilda Banken as a potential partner in Landsbanki, but other plans prevailed.

The bottom line is that the privatization of the Icelandic banks was deeply flawed, *à la russe*. In a celebratory essay on the Prime

Box 7.2
Fathers and sons

A couple of major players in the ruling coalition of the Independence Party and the Progressive Party that privatized the banks either became rich – very rich – or kept their seats on the banks' boards after the privatization, or both. One of them was a politician whose private-sector experience consisted of running two small knitwear factories in the provinces in the 1970s, though only for a few months. On gaining partial control of one of the banks, he became an instant billionaire, and went on to buy the national airline. Another beneficiary of the banks' privatization flew in Elton John for a birthday celebration. A third had been handed a conditional prison sentence in the 1980s (and, later, an unfavourable verdict also in St. Petersburg, Russia), so, to be on the safe side, the obliging Icelandic parliament inserted a tailor-made five-year clause into the 2002 banking law to allow banks to be owned by persons who had not been convicted of crimes in the past five years. This person, together with his son, bought Landsbanki.

A few years earlier they had entered the brewery business in St. Petersburg, and then sold the plant to Heineken, Europe's largest brewery. Later, the son made his mark on the world stage primarily through lucrative privatization deals in the telecommunications business in Bulgaria and the Czech Republic. In 2006, his father leveraged his financial and business wealth into the ownership of West Ham, the British football club (this was a few months after Mr. Boris Berezovsky, the exiled Russian oligarch living in London, had failed in his bid to buy the club). The father consolidated his position at the top of Iceland's business elite by buying Morgunbladid, until recently Iceland's largest daily newspaper with close ties to the Independence Party, the largest political party until the crash, and he served as chairman of its board.[9]

Under the banner of free-market capitalism, Iceland privatized its banks in a way that bore an eerie resemblance to Russia

In short, under the banner of free-market capitalism, Iceland privatized its banks in a way that bore an eerie resemblance to Russia. But this was not the first time. A local precedent had been set in 1984 when parliament decided to regulate fishing in Icelandic waters by handing out hugely valuable catch quotas to boat owners without charge even if Iceland's fish resources are a common property resource by law.[10] In mid-2009, to finish the story of the father-son duo, the father declared himself bankrupt in one of the largest personal bankruptcy filings on record anywhere (USD 750 million). The son remains solvent.

Minister in 2004, presumably published with the subject's prior approval, the editor of *Morgunbladid* laid out his view of the privatization process. The editor wrote that, given that the Progressive Party, then the second-largest political party, had secured its claim to the second largest state bank, 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." The Prime Minister's office has recently disclosed that the father-and-son team that bought Landsbanki borrowed from Búnadarbanki a significant part of the sum they paid the state for the bank. In turn, the buyers of Búnadarbanki borrowed a significant part of their purchase price from Landsbanki. The debt from the Landsbanki purchase remains unsettled and, through compound interest, has doubled since 2003.

In view of history, the main aim of the privatization ought to have been to sever the old ties between the political parties and the banks, but that was not to be. So, if by an emerging country is meant a country where politics matters at least as much as economics to the markets, a common definition, Iceland remains an emerging country and ought to be so classified. In this way, Iceland still differs markedly from its Nordic neighbours. Before they fell, the Icelandic banks faced no foreign competition in Iceland even if they had set up shop in several neighbouring countries, including Finland, Norway, and Sweden as well as Germany, Luxembourg, the Netherlands, and the United Kingdom. The lack of foreign competition led to significantly greater concentration of the banking industry in Iceland than elsewhere in the Nordic countries, which manifested itself, as always, in large spreads between lending rates and deposit rates at home.

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The tight embrace between the political parties and the banks had another significant consequence. It programmed virtually the entire political class and civil service to think that it was not a good idea to get in the way of the banks. The government ought to have constrained the banks through special taxes, but it did not. You do not tax your friends, especially not when they fund your party directly and indirectly.[11] The Central Bank ought to have kept the banks on a leash through reserve requirements, but it did not. On the contrary, the Central Bank lowered its reserve requirements

The government ought to have constrained the banks, but it didn't in 2002 at the banks' behest, as was later acknowledged in public by senior Central Bank staff, and – astonishingly – abolished all reserve requirements related to the bank's deposit liabilities abroad that were piled up over the internet after credit lines began to dry up in 2007. Further, the Financial Supervision Authority (FSA) ought to have applied more stringent stress tests, tailored to local conditions and to the dubious quality of the banks' assets, but this was not done either. On a regular basis, the banks made lucrative job offers to FSA personnel, depriving the FSA of experienced staff and conveying a clear message to those FSA staff members who remained behind, a pattern of behaviour known also from the Securities and Exchange Commission in the United States and elsewhere. If an FSA staff member wanted a big salary increase, he had a clear incentive to do his regulatory job in a manner that won the approval of the banks. The banks were his clients, not the taxpayers.

The assets of the banking system rose from 100 per cent of GDP at the end of 2000 to more than 900 per cent in mid-2008

Once free from government control, the banks kicked up their heels like cows in spring and went on an unprecedented borrowing and lending spree that increased the assets of the banking system from 100 per cent of GDP at the end of 2000 to more than a baffling 900 percent in mid-2008. Iceland's rapid growth of bank assets relative to GDP brought it to the top of the world rankings, roughly on par with Switzerland (figure 7.3). Iceland's banks had little else in common with Swiss banks and their long history. Their business model was, in essence, imported from abroad and operated by people with negligible experience of international banking and prone to "subprime" behaviour. With few questions asked, loan officers were rewarded according to the volume of loans they made and other transactions with emphasis on short-term profits. The banks even managed to convince unwitting customers in large numbers to borrow at low interest in foreign currency even if their earnings were solely in Icelandic krónur. The banks told their customers that, in their estimate, the króna was only modestly overvalued and that the downside exchange rate risk was small. Thousands of clueless customers signed the loans, thereby sealing their fate without realizing that at the 2007 exchange rate of the króna Iceland's 2008 per capita GDP was projected to be USD 70,000 compared with USD 42,000 in the United States. In other words, the banks' belief that, in 2007, the króna was only modestly overvalued signalled their belief that the statement that the average Icelander had become more than 50 per cent richer than the average American was only a slight exaggeration.

In Iceland, overvaluation of the króna has been the rule

For a number of reasons, Iceland has long been a high-exchange-rate country. This is not surprising in view of its persistent current account deficits and currency devaluations at regular intervals over the years (figure 7.4). First, high inflation is a common source of overvaluation because the exchange rate typically adjusts to prices with a lag, even under floating. Iceland is no exception. This helps explain why Icelandic exports have hovered around a third of GDP ever since 1870, while everywhere else in the OECD region exports have grown faster than GDP.[12] Second, mounting foreign debts produce an influx of capital that drives up the value of the currency. This mechanism was amplified by the carry trade before the crisis when Belgian dentists and Japanese housewives borrowed in Swiss francs and yen at low interest, purchased krónur, and placed the proceeds in high-interest accounts, accepting the currency risk involved in exchange for the interest differential. Third, pervasive protectionism reduces the demand for foreign

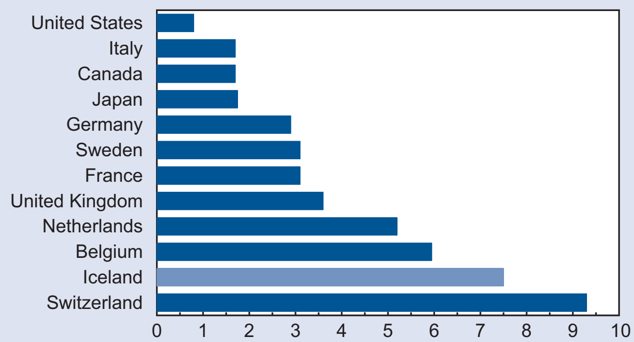

Figure 7.3
Ratio of bank assets to GDP at end-2007

Sources: Swiss National Bank as quoted in *The Economist* (3 July 2008), Central Bank of Iceland.

With lower inflation, balanced books, and less protectionism, Iceland can expect a lower value of the króna in the years ahead

exchange to purchase imported goods, thus imparting an upward bias to the currency. This is a consequence of extensive farm support and of government support for the fishing industry which, with direct or hidden subsidies, gets by with a higher exchange rate than it otherwise would. With lower inflation, balanced books, and less protectionism, Iceland can thus expect a lower value of the króna in the years ahead than before the crash. All things considered, it was not surprising to see the króna depreciate by a half in 2007–2009.

The banks claimed to believe that the state guarantees they had enjoyed while publicly owned remained in force after they had been privatized

To return to the banks, the record shows that they claimed to believe, as did at least one international rating agency, that the state guarantees they had enjoyed while publicly owned remained in force after they had been privatized. The government did little to counter this impression. For example, the FSA allowed itself to be featured prominently in brochures from Landsbanki introducing the ill-fated Icesave internet accounts in the United Kingdom. These high-interest accounts were first offered to British depositors in 2006 and became a major source of capital for the bank in 2007 when access to foreign credit began to dry up, which should have rung the regulators' alarm bells. Similar accounts were offered

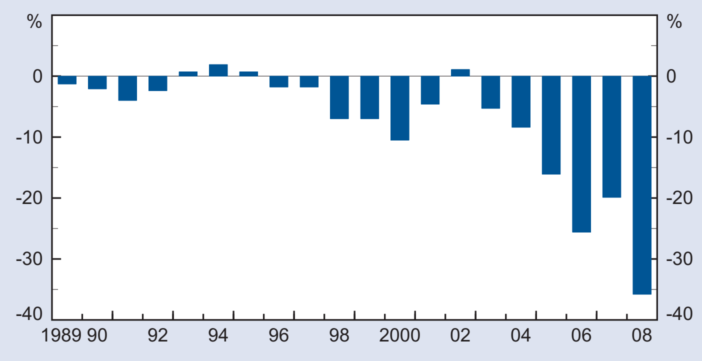

Figure 7.4
Iceland: Current account balance, 1989–2008, per cent of GDP

Source: Central Bank of Iceland.

to Dutch depositors in May 2008 even after the Central Bank of Iceland, the FSA, and the government had been sternly warned by foreign Central Banks and at least one foreign government leader as well as by foreign and domestic experts that the banks were headed for collapse and that Iceland needed urgently to seek assistance from the International Monetary Fund (IMF).

During their brief existence, Landsbanki's Icesave accounts attracted 300,000 depositors in Britain and 100,000 in the Netherlands and elsewhere. Unlike Glitnir and Kaupthing, Landsbanki ran its offices in Britain and the Netherlands as "branches" covered by Icelandic deposit insurance rather than as "subsidiaries" – in which case they would have been secured by deposit insurance in the two host countries and subject to host-country financial supervision as well. Landsbanki disregarded repeated pleas to change its British and Dutch branches into subsidiaries, presumably to avoid unwelcome foreign financial inspection, which might have hindered the owners' reckless gambling. Also, money could not flow as freely from subsidiaries to headquarters in Iceland as from branches to headquarters.

Landsbanki ran its offices in Britain and the Netherlands as "branches" covered by Icelandic deposit insurance rather than as "subsidiaries"

The audacity is breathtaking: by this strategy, Landsbanki managed to make Iceland's population of 320,000 responsible for the deposits of 400,000 individuals and entities in Britain and the Netherlands, while its owners and managers appropriated the short-term profits. The courts will have to determine whether this deed constitutes breach of trust which, by Icelandic law, is punishable by two and up to six years in prison. When Landsbanki collapsed in October 2008, the foreign depositors were compensated – albeit not quite in full – by the British and Dutch governments which, in turn, insisted that Iceland pay a share – roughly half – of the compensation according to a formal deal between the three governments that the Icelandic parliament, after eight months of acrimonious debate, approved by 33 votes against 30. This did not settle the matter, however, because, for the second time in the history of the republic, the President of Iceland refused to ratify the law, thereby referring it to a national referendum according to the constitution.

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There is more. As banks are wont to do, they borrowed short at low interest in foreign markets to finance long-term loans, including even 25–40 year mortgages, thereby creating excessive maturity mismatches in their books and an increasing need for loan rollovers. Their entry into the housing market was intended to outcompete the government's own Housing Financing Fund. They offered attractive terms to customers many of whom seemed unaware that their mortgages were being financed by short-term loans and of the attendant risk that after the grace period ended they might have to pay significantly higher interest on the remainder of the principal or pay up. This is the Icelandic version of subprime lending. Besides, the banks sent their staff to peddle loans as well as complicated financial instruments to owners of fishing quotas and farm production quotas, using the quotas as collateral.

As another example of their aggressive tactics, the banks actively encouraged depositors to transfer their savings from ordinary accounts clearly covered by Icelandic deposit insurance to money market accounts bearing higher interest promising that

Box 7.3
The Icesave dispute

When Landsbanki collapsed, the UK and the Netherlands considered it necessary to preserve confidence at home by compensating the 400,000 depositors involved, and asked Iceland to repay them roughly half the amount at stake

When Landsbanki collapsed, the governments of the United Kingdom and the Netherlands considered it necessary to preserve confidence at home by unilaterally and immediately compensating the roughly 400,000 depositors who were unable to withdraw their moneys from their Icesave accounts. Subsequently, Britain and the Netherlands asked Iceland to repay them approximately half the amount involved. Negotiations between the three governments produced an agreement by which Iceland must during 2016–2023 pay the UK 2,350 million pounds and the Netherlands about 1,330 million euros. The sum of the two figures is equivalent to about a half of Iceland's GDP in 2009, and seems, with reasonable asset recovery, likely to overstate by a significant margin the ultimate cost involved for Iceland. The Icelandic government expects to be able to recover between 75 per cent and 95 per cent of Landsbanki's deposit claims. The interest rate on the loan is 5.5 per cent per year.

After the Icelandic government entered into this agreement with Britain and the Netherlands, the parliament approved it, at first with unilateral reservations that the British and the Dutch rejected, and then again several months later with new language acceptable to all three governments. Having received a petition from over a fifth of the electorate, the president of Iceland refused to ratify the law, thereby, as the constitution prescribes, referring it to a national referendum scheduled to take place on 27 February or 6 March 2010. Only once before has the president refused to ratify a law from parliament, in 2004, but the parliament then retracted the law rather than put it to a referendum.[13]

the money market accounts were similarly insured which, in fact, they were not. This misinformation, preserved on bank tapes, may prove to have been illegal. The banks also provided loans without collateral to privileged customers who wanted to speculate on the foreign exchange market. For yet another example of the heads-I-win-tails-you-lose mentality and *modus operandi* of the banks, they lent members of their senior staff huge amounts to buy shares in the banks with the shares as sole collateral. These loans were written off after the crash in a controversial move that seems likely to be challenged in the courts. Several other transactions are under investigation to ascertain if they constituted illegal market manipulation.[14]

The banks provided loans without collateral to privileged customers who wanted to speculate on the foreign exchange market

A further problem was extensive insider lending that has come to light with the leak of a document describing the exposure of Kaupthing, the largest bank, to its largest owners and related parties. In mid-2009, this document appeared on a website that stores leaked documents (wikileaks.org), showing that huge loans were made before the crash to the owners of Kaupthing and to firms owned by them with little or no collateral. The leak is against the law, of course, as is perhaps also some of the insider lending exposed by the leak.

Extensive insider lending has come to light

The three banks copied each other's business model. Because they faced an insignificant home market, they decided that their choice was essentially to "evolve (that is, become international) or die". They chose the former only to suffer the latter because they faced no resistance: there was nothing to hold them back. Transforming themselves at a fast pace into international financial institutions, the three banks soon derived half their earnings from foreign operations through 31 subsidiaries in 21 countries (October 2007). Keynes would hardly have been surprised. He wrote: "A 'sound' banker, alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him".[15]

The banks faced no resistance: there was nothing to hold them back

7.4 Increased inequality and other signs

Inequality in the distribution of disposable income increased sharply from 1993 to 2007 due to a deliberate shift of the tax burden from the rich to the rest

The euphoria that swept Iceland during the boom was not shared by all. While bustling private jet traffic kept residents near Reykjavík airport awake at night and the streets were jammed by monstrous SUVs on aircraft tires, many Icelanders looked on in baffled astonishment. Of the country's 182,000 families, more than 100,000 have little or no debt; clearly, they were not invited to the party, or chose not to attend. At the other end of the scale, 244 families at the end of 2008 had debts in excess of USD 1.2 million, with assets that fall short of their debts. Further, 440 families have debts in excess of their assets – that is, negative net worth – to the tune of USD 400,000 or more. Of the 182,000 families, 81,000 have assets below USD 40,000, whereas 1,400 families have assets of USD 1.2 million or more.[16] These numbers suggest gross inequality in the distribution of wealth which is hardly surprising in view of the fact that inequality in the distribution of the disposable income of households increased sharply from approximate parity with the Nordic countries in the mid-1990s to parity with the United States in 2007, a dramatic change resulting from a deliberate shift of the tax burden from the rich to the rest (figure 7.5). Before the onset of the crisis, increased disparity of income and wealth was one of several signs that Iceland was headed for trouble. Increased inequality also preceded the Great Depression in the US 1929–1939.[17]

Equity prices rose by 44 per cent per year from 2001 to 2007, a world record

Another sign of pending trouble was the boom in the housing market. You only need to count the cranes, said Professor Robert Z. Aliber, a University of Chicago expert on financial crises, on his visit to Iceland in 2007 when asked to elaborate his prediction that Iceland would probably crash a year later, as it did.[18] Real estate prices rose by 11 per cent per year on average from 2001 to 2008. Yet another sign was the stock market boom that had seen equity prices rise by a factor of nine from 2001 to 2007, or by 44 per cent per year on average six years in a row, a world record. The three main banks accounted for 73 per cent of the stock market index in 2008. In short, Iceland was an accident waiting to happen. And then, within a week in October 2008,

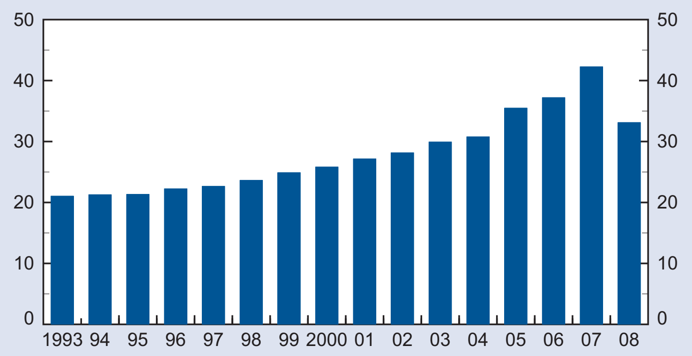

Figure 7.5
Gini index of inequality, 1993–2008
The Gini index ranges from 0 when all households have the same income (perfect equality) to 100 when all incomes accrue to a single household (perfect inequality).

Source: Calculations based on data from Internal Revenue Directorate, www.rsk.is.

following the collapse of Lehman Brothers, the banking system collapsed, and the IMF was asked to rush to the scene, the first time an industrial country asked the IMF for help since the United Kingdom did so in 1976.

7.5 Enter the IMF

As always, the economic reconstruction and stabilization program in place since November 2008 with the support of the IMF emphasizes monetary restraint, with a gradual reduction of the Central Bank policy rate, but it also contains some unusual features.

The IMF program features strict but temporary capital controls to protect the króna

The program emphasizes the need for transparent restructuring of the failed banks. The floating króna is supported by strict but temporary capital controls intended, among other things, to prevent the owners of the glacier bonds left over from the carry trade, equivalent to about a half of GDP, from rushing to the exits. Were they free to exit, the króna might plunge to new depths, and might remain undervalued for a long time as happened, for example, in Indonesia after 1997. This aspect of the program differs markedly from the programs supported by the IMF in Asia 1997–1998.

The IMF program stomachs a government budget deficit in 2009 equivalent to 14 per cent of GDP, postponing discretionary fiscal restraint until 2010

The Iceland program also differs from the Asian programs in that it stomachs a government budget deficit in 2009 equivalent to 14 per cent of GDP, thus postponing discretionary fiscal restraint until 2010. The program envisages deep cuts in government spending from 52 per cent of GDP in 2009 to 43 per cent in 2014 and increased revenue from 38 per cent of GDP in 2009 to 44 per cent in 2014. A fiscal retrenchment equivalent to 15 per cent of GDP in five years is a tall order.

The IMF program is supported by the Nordics, Poland, and the EU

The financial support from the IMF is supplemented by the Nordic countries, Poland, and the EU; Russia pulled out. The government put all three banks into administration, splitting them into new banks and old banks. The new state banks took over deposits and provided uninterrupted banking services at home, no small feat under the circumstances, and received fresh injections of new capital. In keeping with the program, the old private banks were left with their dodgy assets and foreign debts that the resolution committees appointed to liquidate them will have to write off in large measure, triggering massive litigation from disappointed overseas creditors as well as investors and depositors.

The banks were first renationalized, and then two of them were reprivatized by exchanging their debts for equity

In effect, the banks were renationalized, based on the successful method behind the Nordic governments' handling of their banking crises of 1988–1993 as discussed in chapters 6 and 11.[19] Plans to reprivatize the new banks by exchanging their debts for equity, inviting at last foreign ownership, materialized rather quickly as Kaupthing and Glitnir passed into foreign majority ownership at the end of 2009. Landsbanki, however, the most problematic and now the largest of the three, must remain in government hands a while longer. The government has no plan to sell its 81 per cent stake in Landsbanki.

7.6 Checks and balances, and trust

Iceland's economic crisis destroyed wealth equivalent to about seven times GDP

Iceland's economic crisis is considered to have destroyed wealth equivalent to about seven times GDP, an estimate that may come down if asset recovery goes reasonably well. The damage inflicted on foreign creditors, investors, and depositors amounts to about five times GDP, while the asset losses thrust upon Icelandic residents account for the rest. These figures do not include the cost of Iceland's increased indebtedness. The damage due to Iceland's tarnished reputation is difficult to assess. How could this happen?

The absence of checks and balances that had led to an unbalanced division of power between the strong executive branch and the much weaker legislative and judicial branches came to haunt the country when unscrupulous politicians put the new banks in the hands of reckless owners who then found themselves in a position to expand their balance sheets as if there were no tomorrow.

Just to give two examples: 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 that the recently privatized banks' unfailingly optimistic economic departments, among others, could fill the gap. When the Competition Authority a few years ago raided the offices of oil companies that were later found guilty of illegal price collusion, the Authority was summarily abolished and then reincarnated under new, more compliant management.

The *primus motor* behind both decisions was Iceland's Prime Minister during 1991–2004, who went on to have himself appointed Central Bank governor and was summarily removed from the governor's office after the crash and shortly afterwards became editor of *Morgunbladid* – roughly the equivalent of making Richard Nixon editor of the *Washington Post* to ensure fair and balanced coverage of Watergate.

These actions and events may help explain why the FSA looked the other way when the banks went amok. And this may also help explain why Statistics Iceland, Iceland's Statistical Office, looked the other way while Iceland's income distribution jumped off the Scandinavian pattern and headed toward that of the United

States according to research conducted at the University of Iceland.[20] Iceland, increasingly, became not so much a scaled-down version of Scandinavia as a combination of Italy, Japan, and Russia with a dash of Scandinavia on top.

Iceland's predicament raises old questions about collective guilt and responsibility

Iceland's predicament raises old questions about collective guilt and responsibility. Many wonder how taxpayers can be held responsible for the failures of private bankers. But taxpayers are also voters: many of them voted for the politicians who sided with the bankers; having abstained or voted for the opposition is clearly not a valid excuse. Guilty or not, many feel responsible as taxpayers, but not all. Opinion polls suggest that a majority of the electorate did not want parliament to approve the Icesave deal between Iceland, the United Kingdom, and the Netherlands by which Iceland agrees to repay the British and the Dutch about a half of the amount that the latter unilaterally decided to pay out in compensation to depositors in the Icesave accounts of Landsbanki.[21] The stakes are high because Iceland's agreement with the IMF appears to hinge on the parliament's approval of the deal with the British and the Dutch. As it turned out, even this is not enough, because the president chose to intervene by referring the Icesave law to a national referendum (recall Box 7.3). It is a matter of record that the stipulation concerning the deal on the Icesave accounts is part of the IMF-supported program at the behest of the Nordic countries, or at least some of them. Without their support the program, with less financing available, would require stricter adjustment of public expenditures and taxes. In other words, without a settlement of the Icesave dispute, Iceland's short-run crisis would deepen.

Without Nordic support the IMF program, with less financing available, would require stricter adjustment of public expenditures and taxes

In 2009, while the unemployment rate shot up to 9 per cent of the labour force, a very high rate by Icelandic – if not by European – standards, GDP fell by 7 per cent, and is not expected to be restored to its 2008 level until 2014 in local currency at constant prices. In dollars or euros, however, per capita GDP will take longer to recover enough to regain parity with the Nordic countries because the króna is not expected to rise in value for a number of years to come. Due to emigration, Iceland's population fell slightly in 2009 for the first time since 1889. Significant emigration over the next few years would weaken the tax base, thereby depressing the living standards of those who stay.

In view of all this, what Iceland now needs most of all is to rebuild cohesion, confidence, and trust. The people of Iceland have expressed their anger at the political establishment, banging their pots and pans loudly enough in the streets to sweep the Independence Party and the Progressive Party into opposition both at once for the first time in history. Even before the crash, opinion polls showed that only 30 per cent of the population had great confidence in the parliament or the judicial system that the political class created in its own image.[22]

Iceland needs to rebuild cohesion, confidence, and trust

Many think they understand perfectly well what happened: aided and abetted by politicians, the owners of the banks and their accomplices robbed them in broad daylight as described by Professor William Black in his 2005 book *The Best Way to Rob a Bank Is to Own One: How Corporate Executives and Politicians Looted the S&L Industry*.[23] And not just the banks: one of the largest insurance companies as well as the national airline suffered the same fate as the banks had to be nationalized at significant cost to the taxpayers, and no doubt others will follow.

A common attitude among the general public to the bankers, businessmen, and politicians responsible for the collapse and currently under investigation was neatly captured by writer Einar Már Gudmundsson in his account of a cannibal flying first class. When a stewardess hands him the menu, he looks at it and says: "Nothing here strikes my fancy. Could you please show me the passenger list?"[24] Most likely, though, when the truth about the goings on comes out, as it must, one way or another, some will react like French police captain Louis Renault in *Casablanca* who was "shocked – shocked! – to find that gambling is going on in here."

7.7 Prospects

Iceland now faces a heavy burden of gross public and private foreign debt equivalent to more than 300 per cent of GDP even after writing off private debts equivalent to another 500 per cent, a world record. The gross public debt, domestic and foreign, is estimated to increase by more than 100 per cent of GDP as a

Gross public debt, domestic and foreign, will increase by more than 100 per cent of GDP as a result of the crash result of the collapse of the banks, or from 29 per cent of GDP at end-2007 to 136 per cent at end-2010. In 2009, the government spent almost as much on interest payments as on health care and social insurance, the single largest public expenditure item. Some observers warn that the debt burden threatens to match or exceed that which the allies imposed on Germany at Versailles after World War I, with well-known economic and political consequences.[25] Others emphasize Iceland's strong fundamentals and resilience, convinced that the country will get back on its feet and rejoin the Nordic family in good standing within a few difficult years.

The EU membership application ought to signal that Iceland intends to clean up its act

Iceland's recovery from the crash must rest on two pillars. First, the government must effectively implement the reconstruction program supported by the IMF, the Nordic countries, Poland, and the EU. There is no other way. The EU membership application ought to send an encouraging signal to the outside world that Iceland intends to clean up its act. Second, the authorities must uncover and squarely face the causes of the collapse, including the massive failure of policy and institutions and the absence of checks and balances.

For this to be done properly, Iceland would need an international Commission of Enquiry. The government, however, remains unwilling to appoint an international commission, preferring its own domestic parliamentary investigative committee and thus risking a deepening crisis of confidence if the committee fails to convince the public that it has adequately exposed the rot that caused the crisis. Many mistrust the domestic investigation which postponed until the end of January 2010 the publication of its report that was initially scheduled for release in November 2009.

Under pressure, the government accepted an offer of help from Ms. Eva Joly, a renowned French-Norwegian investigative magistrate who led what has been described as the biggest fraud inquiry in Europe since World War II, involving France's leading oil company, Elf Aquitaine, and resulting in four prison sentences for big fish as well as heavy fines. On November 13, 2009, the *Financial Times* of London quoted Ms. Joly as saying about the Icelandic investigation: "This is so much larger than Elf, but we don't know just how much larger. Not yet." The EU has promised to conduct an independent investigation. Britain's Serious Fraud

Office has launched an investigation into the British affairs of Kaupthing and Landsbanki.

In finance as in civil aviation, there is a need for credible crash analysis

The National Transport Safety Board investigates every civil-aviation crash in the United States. In Europe, national Civil Aviation Accidents Commissions perform this vital role. Their principal concern is public safety. Also, when commercial planes crash, there are usually foreigners on board, so the government owes full disclosure also to the outside world. There is a case for viewing finance the same way as civil aviation, in Iceland and elsewhere. This is why, when things go wrong, there needs to be a credible mechanism in place to secure full disclosure. If national governments hesitate, perhaps because they may have something to hide, the international community needs to consider mutually acceptable ways to fill the gap. If history is not correctly recorded, it is more likely to repeat itself with unpleasant consequences.

7.8 Eleven lessons

What can we do to reduce the likelihood of a repeat performance? – in Iceland and elsewhere. Here are eleven main lessons from the Iceland story, lessons that are likely to be relevant in other less extreme cases as well.

Effective legal protection is needed against predatory lending

Lesson 1. We need effective legal protection against predatory lending just as we have long had laws against quack doctors. The logic is the same, and is derived from the idea of asymmetric information. The essence of the problem is that doctors and bankers typically know more about complicated medical procedures and complex financial instruments than their patients and clients. This asymmetry creates a need for legal protection through judicious licensing and other means against financial as well as medical malpractice to protect the weak against the strong.

Lesson 2. We should not allow rating agencies to be paid by the banks they have been set up to assess. The present arrangement creates an obvious and fundamental conflict of interest, and needs to be revised. Likewise, banks should not be allowed to hire employees of regulatory agencies, thereby signalling that by looking the other way, remaining regulators may also expect to receive lucrative job offers from banks.

Lesson 3. We need more effective regulation of banks and other financial institutions for the reasons discussed in chapters 4, 6, and 11; presently, this is work in progress in Europe and the United States.

Greater attention needs to be paid to warning signals, including signs of increased inequality

Lesson 4. We need to read the warning signals. We need to know how to count the cranes to appreciate the danger of a construction and real estate bubble (Aliber's rule). We need to make sure that we do not allow gross foreign reserves held by the Central Bank to fall below the short-term foreign debts of the banking system (the Giudotti-Greenspan rule). We need to be on guard against the scourge of persistent overvaluation sustained by capital inflows because, sooner or later, an overvalued currency will fall. Also, income distribution matters. A rapid increase in inequality – as in Iceland in 1993–2007 (recall figure 7.5) and in the United States in the 1920s as well as more recently – should alert financial regulators to danger ahead.

Banks must not be allowed to outgrow the government's ability to cope with them

Lesson 5. We should not allow commercial banks to outgrow the government and Central Bank's ability to stand behind them as lender – or borrower – of last resort. In principle, this can be done through judicious regulation, including capital and reserve requirements, taxes and fees, stress tests, and restrictions on cross-ownership and other forms of collusion.

Lesson 6. Central banks should not accept rapid credit growth subject to keeping inflation low – as did the Federal Reserve under Alan Greenspan and the Central Bank of Iceland. They must take a range of actions to restrain other manifestations of latent inflation, especially asset bubbles and large deficits in the current account of the balance of payments. Put differently, they must distinguish between "good" (well-based, sustainable) growth and "bad" (asset-bubble-plus-debt-financed) growth.

Lesson 7. Commercial banks should not be authorized to operate branches abroad rather than subsidiaries if this entails the exposure of domestic deposit insurance schemes to foreign obligations. This is what happened in Iceland. Without warning, Iceland's taxpayers suddenly found themselves held responsible for the moneys kept in the Icesave accounts of Landsbanki by

400,000 British and Dutch depositors. Had these accounts been hosted by subsidiaries of Landsbanki rather than branches, they would have been covered by local deposit insurance in Britain and the Netherlands.

There is a need for strong firewalls separating politics from banking

Lesson 8. We need strong firewalls separating politics from banking because politics and banking are not a good mix. The experience of Iceland's dysfunctional state banks before the privatization bears witness. This is why their belated privatization was necessary. Corrupt privatization does not condemn privatization, it condemns corruption.

There is a need for uncovering the truth about what went wrong to foster reconciliation and rebuild trust

Lesson 9. When things go wrong, there is a need to hold those responsible accountable by law, or at least try to uncover the truth and thus foster reconciliation and rebuild trust. If history is not correctly recorded without prevarication, it is likely to repeat itself.

A financial crisis typically wipes out only a small fraction of national wealth

Lesson 10. When banks collapse and assets are wiped out, the government has a responsibility to protect jobs and incomes, sometimes by a massive monetary or fiscal stimulus as described in chapter 4. This may require policy makers to think outside the box and put conventional ideas about monetary restraint and fiscal prudence temporarily on ice. A financial crisis typically wipes out only a small fraction of national wealth. Physical capital (typically three or four times GDP) and human capital (typically five or six times physical capital) dwarf financial capital (typically less than GDP). So, the financial capital wiped out in a crisis typically constitutes only one fifteenth or one twenty-fifth of total national wealth, or less. The economic system can withstand the removal of the top layer unless the financial ruin seriously weakens the fundamentals.

Banking and politics are not a good mix, but private banks need proper regulation

Lesson 11. Let us not jump to conclusions and throw out the baby with the bathwater. Since the collapse of communism, a mixed market economy has been the only game in town. To many, the current financial crisis has dealt a severe blow to the prestige of free markets and liberalism, with banks – and even General Motors – having to be propped up temporarily by governments, even nationalized. Even so, it remains true that banking and politics are not a good mix. But private banks clearly need proper regulation because of their ability to inflict severe damage on innocent bystanders.

Endnotes

[1] See Gramlich (2007). Edward Gramlich was Governor of the Federal Reserve Board 1997–2005.

[2] The Human Development Index is an average of three indices representing the purchasing power of per capita GDP, life expectancy, and education, measured by a weighted average of adult literacy (2/3) and school enrolment (1/3).

[3] See http://www.ggdc.net.

[4] See Gros (2008).

[5] See OECD (2007, Table A1.2a).

[6] See Buiter and Sibert (2008) and Wade (2009).

[7] The cost to the taxpayers of recapitalizing the commercial banks constitutes another 18 per cent of GDP.

[8] This was a eurobond issue under the European Medium Term Note Program (EMTN). Repayment is due in December 2011.

[9] Landsbanki did not act alone. The owners of the other two large banks, Glitnir and Kaupthing, also bought newspapers, a common feature of the buildup to financial crises (see Kindleberger and Aliber, 2005, pp. 194–195).

[10] In 2007, the United Nations Committee on Human Rights, the international community's highest authority on human rights, ruled that the Icelandic fisheries management system, by its discriminatory nature, constitutes a violation of human rights and instructed the Icelandic government to change the system. The government's official reaction was that the UN Committee had misunderstood the matter. The UN Committee will make the next move. See Gylfason (2009).

[11] Under pressure from The Council of Europe's Group of States against Corruption (GRECO), a new law on the financing of political parties and candidates was passed in 2006. Under this law, the Icelandic National Audit Office has disclosed that during 2002–2006 three of the four main political parties accepted huge contributions from the private sector in addition to similarly generous support from the government. During 2002–2006, the Progressive Party accepted private contributions equivalent to 202 dollars per vote cast for the party in the parliamentary election of 2007, not including contributions to individual candidates. The Independence Party accepted 77 dollars per vote, but this figure only covers payments, from undisclosed sources, to the party's central office and does not include contributions to other party organizations or to individual candidates. The Social Democrats accepted 65 dollars per vote, not including donations to individual candidates. The largest single donors to the three parties mentioned were the banks. The Left Greens took much less. As a rule, political parties in Denmark, Finland, Norway, and Sweden do not accept contributions from corporations.

[12] In Finland and Sweden, for comparison, the ratio of exports to GDP rose from a bit more than 20 per cent in 1960 to 45 per cent and 52 per cent in 2007.

[13] The last time a referendum was held in Iceland was in 1944 when Icelanders voted overwhelmingly to break all constitutional ties with Denmark by terminating the 1918 treaty by which Iceland had become a separate state under the Danish crown, with only foreign affairs remaining under Danish control, and to adopt a new constitution and establish a republic.

[14] In the first verdict issued by Reykjavík District Court in a market manipulation case, two Kaupthing traders were sentenced in December 2009 to unconditional eight-month prison terms.

[15] Keynes (1931, p. 76).

[16] Source: Directorate of Internal Revenue, Reykjavík, 2009.

[17] See Galbraith (1988, pp. 177–178). Long-term trends in the distribution of income in the United States are described in Piketty and Saez (2003).

[18] See Aliber (forthcoming).

[19] See also Jonung, Kiander, and Vartia (2009).

[20] Source: Various articles by Professor Stefán Ólafsson and others, see http://www3.hi.is/~olafsson/.

[21] According to the Icesave agreement, Iceland must during 2016–2023 pay the UK 2,350 million pounds and the Netherlands about 1,330 million euros. The sum of the two figures is equivalent to about a half of Iceland's GDP in 2009, and seems, with reasonable asset recovery, likely to overstate the ultimate cost involved. The interest rate on the loans is 5.5 per cent per year.

[22] After the crash, in March 2009, 13 per cent of the population expressed great confidence in the parliament. See www.capacent.is/Frettir-og-frodleikur/Thjodarpulsinn/Thjodarpulsinn/2009/03/03/Traust-til-stofnana-og-embaetta.

[23] The title of Black's book has a distinguished precedent. In the *Threepenny Opera*, first performed in Berlin in 1928, Berthold Brecht has Mack the Knife say: "What is the burgling of a bank to the founding of a bank?" See also Akerlof and Romer (1993); again, the title says it all.

[24] See Gudmundsson (2009). For a detailed account of events before the crash and its aftermath as well as of some of the personalities involved, see Boyes (2009).

[25] Listen to Keynes (1919): "The policy of reducing Germany to servitude for a generation, of degrading the lives of millions of human beings, and of depriving a whole nation of happiness should be abhorrent and detestable, – abhorrent and detestable, even if it were possible, even if it enriched ourselves, even if it did not sow the decay of the whole civilised life of Europe. Some preach it in the name of Justice. In the great events of man's history, in the unwinding of the complex fates of nations Justice is not so simple. And if it were, nations are not authorized, but religion or by natural morals, to visit on the children of their enemies the misdoings of parents or of rulers." But clearly, there are differences. Civilized life of Europe is not at stake here. The similarity is that the burden on Iceland should be dictated by the country's ability to carry the burden and to prosper, to the benefit also of its trading partners.