For *Chydenius*
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Iceland and the Art of Not Becoming Stuck

It was the first time in a generation that an OECD country had asked the International Monetary Fund for emergency assistance. This was in October 2008. Its three main banks having collapsed like a house of cards, Iceland was about to sink, and had no other option but seek help from the IMF.

Now, more than three years later, the IMF has left the stage, having helped Iceland to weather the crisis with large amounts of money and, more importantly, as always, advice.

The technical know-how necessary to navigate the treacherous waters engulfing Iceland as the banks collapsed in 2008 did not exist in the country's civil service, and so foreign assistance was essential. Had the authorities, to avoid losing face, asked the Nordic countries for help rather than the IMF, the Nordics would almost surely have referred Iceland to the Fund, the world's chief source of expertise in dealing with deep banking crises. So, the IMF was the only game in town, with significant input from the Nordics. In fact, Nordic tax payers provided more than a half of the loans required to finance the rescue operation even if the IMF lent Iceland the largest sum of money per person in the history of the institution. Not even the political opposition in the Icelandic parliament, let alone civic society, proposed serious alternatives to the Fund-supported rescue operation.

And now, more than three years after the crash, the economy is beginning to grow again, partly because, since the crash, the Icelandic króna has lost roughly a third of its value vis-à-vis the euro in real terms. The depreciation of the currency has severely curtailed the purchasing power of households, true, but it has also made various Icelandic exports as well as domestic firms competing with imports competitive in world markets. From 1870 until the crash of 2008, Iceland's exports hovered around the equivalent of a third of the country's national income, an unusually low figure for such a small country over such a long period. In 2010, however, exports shot up to the equivalent of more than a half of income, a huge jump. Why? The króna is no longer grossly overvalued. Iceland is no longer prohibitively expensive in foreign eyes because a euro can now be used to buy nearly twice as many krónur as before the crash. Tourists flock to Iceland as never before.

It follows that, at 6 or 7 percent of the labor force, unemployment is remarkably low. Even so, inflation, currently at 6 or 7 percent a year, remains too high and too many households find it difficult to make ends meet. Eurostat reports that 13 percent of Icelandic households find it very difficult to make ends meet compared with 2 percent to 4 percent in Denmark, Finland, Norway, and Sweden. In our part of Europe, only Spain (14 percent), Portugal (20 percent), Greece (24 percent), and Latvia (24 percent) have relatively more households in such dire straits. Where it counts, Iceland has clearly parted company with the Nordics. Measured by the purchasing power of national income per person, Iceland's standard of living is now a third lower than in Denmark, Finland, and Sweden (see figure). Norway, with its oil, is in class of its own.

So, Iceland still has miles to go.

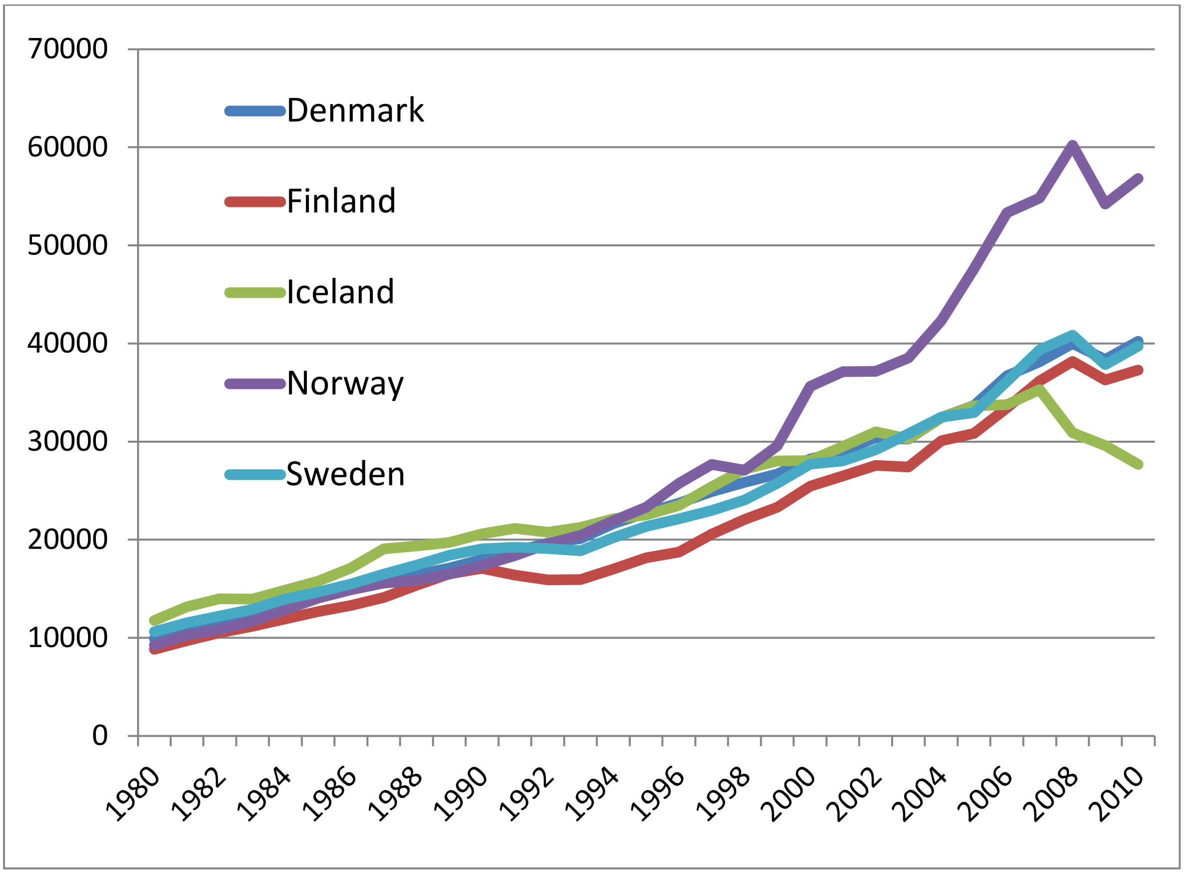
Besides, it remains to be seen how the IceSave twist will play out in court. When the foreign credit lines of the Icelandic banks started to dry up in 2007 and 2008, the banks went on a campaign to attract internet deposits abroad, offering trusting customers some of the highest deposit rates on the market. In particular, Landsbanki, owned and operated by a father-and-son duo with entrepreneurial experience from the brewing business in Saint Petersburg, Russia in the early 1990s, started its internet campaign in the UK and the Netherlands in 2007 and 2008 after it had become clear to many observers that the banks could not possibly survive. In particular, Iceland's senior central bankers recently testified before the Court of Impeachment hearing the criminal case brought by the parliament against Iceland's pre-crash Prime Minister that the writing was on the wall already in 2006. Yet, the Central Bank continued to 'lend' money to the banks, bankrupting itself in the process. The IceSave case is now in a European court. It appears quite possible that Iceland will be required to pay a significantly larger sum than was stipulated in the agreement between the Icelandic, British, and Dutch governments that was defeated in the second IceSave referendum of 2011. It also remains to be seen how the cases expected be brought by the Special Prosecutor against those suspected of having robbed the banks from within and others will fare in court in 2013 and 2014.

To achieve its aim, the cleanup after the crash must, as I see it, rest on two pillars: first, economic reform and reconstruction now underway, and, second, court cases against those suspected of having broken the law. The nine-volume, 2.300 page report of the Special Investigation Committee of the parliament paved the way. Under competent post-crash management, the Financial Supervisory Authority referred to the Special Prosecutor nearly 80 cases of suspected violations of the law in connection with the crash. But this has been a bumpy ride. Repeated attempts to unseat the post-crash director of the FSA succeeded at last in early 2012. Some of those who the FSA had investigated and referred to the Special Prosecutor could not conceal their joy, awakening suspicions of illicit connections between the government and some of those under investigation.

How long will it take for Iceland to regain economic and social parity with the Nordics? This is impossible to know. For one thing, no one knows how long the rather stringent capital controls will remain in force, controls that were originally intended to last only two to three years but remain firmly entrenched. Also, no one knows whether the political class will revert to its nasty old habits now that the IMF is no longer calling the shots from a short distance. Further, no one knows how the cases against those who pushed Iceland off the cliff will fare in court.

A failure by the authorities to produce convictions – to make the culprits behind the crash face justice – may have a demoralizing effect on the population to the point of triggering significant exodus from the country, to Norway and other places. This must not be allowed to happen. Iceland cannot afford it. Economics and law, efficiency and fairness, must go hand in hand.

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



Source: World Bank, World Development Indicators 2012.