

## Learning from Bjartur About Today's Icelandic Economic Crisis

Without ever have been, I never cared much for Iceland. Too much nature and too little density for my tastes. Then, work brought me to Iceland in August 2008. I fell in love—while the Icelandic economy fell apart.

I wanted to learn about Iceland and the Icelandic culture. All the Icelanders I met told me I should read *Independent People*. So I read about Bjartur's Winterhouse transformed into Summerhouse as simultaneously I read about the land of ice and fire transformed into the land of bankruptcy and failures.

I was struck by the similarities of the two stories: the basic framework of the plot of *Independent People* and today's situation are almost the same. They both start from a status quo. There is an economic boom. There is a delusion that the boom will last forever. The boom includes a real estate boom. There are people buying things that they cannot afford. There is a bad mix of local politicians and local businessmen. There are a lot of bad loans. There is the bust after the boom. There are loans that cannot be repaid. Houses are abandoned, empty, some unfinished. Bjartur's framework strikes me as the same basic framework as today's.

But there is a difference, a big difference. After the bust, Bjartur went, on foot, to a destroyed house with no heat, no privacy, with his uneducated young daughter who is killed by a common disease. After today's bust, people drive to their large high-tech homes and send their healthy kids to college.

This is not a small difference. In a few decades, the country went from having Bjartur's lifestyles to being able to allow twenty-three year-old men to stay in school without working. To me this is an incredible and marvelous difference!

On Icelandic blogs in English, I read comments about the great figure of Bjartur and the great mistakes of Iceland today. Glory to Bjartur and disgrace to today's public figures. And I think: hold on! You cannot be serious! The difference between Bjartur's time and ours is a wonderful achievement and an almost miraculous lesson. Looking back on Bjartur's time with nostalgia is made possible only because of the wealth that today's Iceland enjoys. Today, nobody wants to live in a turf house with no electricity, no bathroom, and one bedroom shared by a mother-in-law and three kids, little food, one book, and many diseases.

True, there were mistakes during the recent crisis. Icelanders are human, like everybody else. And mistakes are an unavoidable part of the human condition. But there were also many successes. Iceland did something right, after all. The increase in standards of living from the First World War to the Second seems to me to have been minimal (my knowledge

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is based again on a novel by Laxness—*The Atom Station*). By contrast, the growth in the last couple of decades is immense and real.

There was an economic boom and a bust in Bjartur's time. There was an economic boom and a bust in our time. It is normal to have booms and busts, not just in Iceland but everywhere else in the world. Economies cycle. All of them. There have been cycles in the past, and there will be cycles in the future. They are inevitable. Booms and busts are not the issue. What matters is how well one ends up after the bust. I hope that Iceland keeps doing what it has done recently, rather than trying to go back to what generated misery for centuries.

I believe this economic crisis is an opportunity for Iceland to look at its recent success and to learn what made it possible. This is an opportunity to look back at Bjartur, rejoice at the permanent departure from his lifestyle, and understand what made it possible for very similar events to occur today without Iceland ending up in such a terrible situation.

So let's go back to Bjartur's story. Let's look at the economic boom and bust described there. Booms and busts, with all their differences, are nevertheless similar enough that we can draw parallels. Bjartur's story and today's story are similar enough that we can look at one to get a better sense of the other.

In *Independent People* there was an economic boom. But was there a boom-maker? Was there someone responsible for the boom in that story? Was there a Mr. X at whom we can point our finger and say: "Him—he is the person who made the boom"? No. The beginning of the boom is described roughly as: "and then there was an economic boom." The boom just happened. It came from abroad, from the presence of the Great War. Bjartur's Iceland reacted to international economic forces. There was no single politician or political party that was responsible for that boom. Iceland let itself be carried by those external economic forces. Bjartur did not understand what was going on. He just saw that he was making more money by selling wool. He saw the opportunity to improve his lifestyle and build a different house. He got a loan, which was now available. He did build a new house. He was happy and felt fulfilled. The local politicians and "bankers" also did not plan the boom, did not make the boom happen. They, like Bjartur, just saw an opportunity to improve their lifestyle. And they did.

Today's boom was, in many ways, no different. Icelanders saw their wealth increase, and the opportunity to improve their lifestyle. And so they did. And just like the politicians and bankers in Bjartur's time, as much as some politicians or bankers of our time may have wished to claim responsibility for the Icelandic boom of the early 2000, they were not responsible for it. Nobody was. The boom was a world-wide phenomenon. Again, there was

nobody at whom one could have pointed a finger and said: "Him! He is the cause of our (global) expansion!" Politicians and bankers saw an opportunity to better their conditions and they did—as it was done in the United States and in the rest of the world. One person, no matter how competent, is not able to expand the entire economy of a country and to drag the world economy along in that expansion.

Thinking that there is a boom-maker is a mistake based on human pride and hubris. It is a common claim. But that does not make it true. The economy of a country, even of a small country, is too complex a phenomenon to be controlled by one person or by a small group of people. And when the economy is subject to global forces, that claim becomes even more nonsensical. Politicians like to think of themselves as directing the economy: "See? Look how good I am. I did this!" But claiming to do something is not the same as actually having the power to do it. An economy is not a machine that can be controlled at will. An economy is not a car. An economy is an order that, in a sense, has a life of its own. It lives off the interactions of many, many people—off their decisions, their knowledge. Even the most consciously-designed of human economies did not follow the intended plans and took on lives of their own. An economy is an order, to repeat an old expression, that emerges from human actions but not from human design. We know it exists. We know it works. But at a deep level, we do not know how.

And the bust? Well, again look at the story in *Independent People*. The bust, like the boom, happened. No politician was able to stop it. It came from abroad. It came with the end of the war. It came with some warnings, which were not taken seriously. And it was no politician or banker's fault. No individual politician or banker was directly responsible for it.

Similarly, today, the economy experienced a bust. A big one, but still a bust, like others before it. And as with other busts, the local politicians, whether competent or incompetent, honest or corrupt, are not the direct cause of it, no matter what some are willing to claim. One single politician, or even one political party, does not have that kind of power.

The economy in Bjartur's time cycled. The economy in our time cycles. All economies cycle. They always have. An economy is not stable. No economy is. They expand and they contract. It is a normal part of economic life. The cycles of economies are like heartbeats in humans. A heart that does not beat is a dead heart. Similarly, an economy that does not cycle is not a functioning economy. The difference is that a heartbeat usually comes at a regular rhythm, while economic "beats" are irregular and unpredictable.

Why do economies cycle? Because they are built upon human beings. Human beings make economic decisions. Some decisions turn out to be correct and some decisions turn out to be

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incorrect. Why do people make decisions that turn out to be incorrect? Ignorance, incompetence, overconfidence, or, often, just bad luck. Circumstances change. So decisions made under different circumstances are no longer applicable. Cycles are important because often they are ways to make ourselves aware of decisions that are not appropriate under present circumstances and to try to change our behavior accordingly. Busts can therefore be valuable in the life of an economy. Busts allow us to adjust to different circumstances.

Nevertheless, we hear all the time that we should avoid busts, that we should smooth the cycle. The idea of smoothing the cycle is appealing. We do not like changes, especially changes that may hurt us in the present or immediate future. Additionally, the idea of smoothing the cycle implies that someone can control the economy and knows how to do it. This is a very appealing idea indeed. Who does not want to play rain-maker? But no one really possesses the power or knowledge necessary to control the economy. Economists know a lot. But they also know a lot about what they do not know. They know that an economy is not a car to be driven at pleasure. And even if the economy were a car, they know they would not necessarily know how to fix it or drive it. The attempts of the past ended the same way—as wrecks. Some economists become policy advisers and their salaries come from leaders who want to be, and publicly claim to be, the drivers of the economic machine. What can we expect such economists to say? “Listen, there is not much we can do...just make sure people play by the rules”? Or instead: “Yeah, we can fix this!”

Saying that the economy is an order that has a sort of life of its own and that it cannot be driven like a car does not imply that there is absolutely nothing that politicians can do. What politicians can do is set up institutions and incentives that either let the economy live or strangle it.

In a sense, if one really wants to think about the economy as a car to be driven by some politicians, then I think that the best car to fit this image would be Herbie, the Volkswagen Bug of many Disney movies. Herbie, to the shock of all its drivers, is alive. It moves independently of the will of its drivers. It moves by itself to attract attention when it needs care. It stubbornly refuses to cooperate when something wrong is done to it. It behaves differently with different drivers: with the “good” drivers it goes fast, but with the “evil” drivers it goes very slowly, if it goes at all. “Good” drivers, of an economy, are good institutions. “Evil” drivers are bad institutions.

Today economists know that institutions matters. The institutions that usually matter for allowing an economy to flourish are freedom and open markets, definition and protection of property rights, political stability, immigration, and development of human capital. As I mentioned at the beginning of this essay, I was struck by the similarity between Bjartur's

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time and today. But I was also struck by their differences. What happened between Bjartur's time and today that made Bjartur's miserable conditions disappear? Iceland developed many good institutions in the past few decades. Ones it lacked in Bjartur's time.

What matters, then, is not to avoid every fall, which is not possible, but to fall in the least painful way. The fall of Bjartur was painful. The fall of today is painful too, but it takes place on a much softer and warmer surface than Bjartur's hard and frozen ground. Bjartur, in his quest for self-sufficiency, basically killed everybody around him (with the exception of his mother-in-law!). Bjartur's is a life of misery and death. And Bjartur's Iceland was a miserable economy, poor and isolated from the rest of the world. As *Independent People* shows us, self-sufficiency is a recipe for misery. Iceland started its way to wealth when it allowed itself to be "dependent," when it opened itself to the rest of the world. I used the word "dependent" in quotation marks because "dependent" seems to be the most obvious opposite of independent. But it is not. The correct word is actually interdependent. Iceland was able to abandon its poverty when it embraced the rest of the world. The more open a country is, the larger the markets in which it trades, the more interdependent it becomes, the more prosperity that country will have.

Good institutions matter. Having well-defined and enforced property rights matters. Having light regulations and taxation matters. Having an open policy for immigration matters. Having good incentives for the development of human capital matters. But for Iceland, this does not necessarily imply joining the EU. Iceland can benefit from the open markets of the union even without joining it, as it has done in the past. By contrast, actually joining the EU can be used as a blame-shifter. In the future if something goes wrong, one can blame the EU, lending undeserved cover to local politicians. Joining the EU can also be used to add economic disruptions to political games. The more regulations and the more bureaucracy, the more power politicians have. Corruption will have an added layer, rather than being eliminated. The more regulations, the more opportunities to bribe or curry favor though offering to close one eye, or both eyes, or to make an exception. Iceland did well in the past few decades by building the right institutions, without joining the EU. It should keep going in that direction even now.

The current crop of politicians seem to worry about how Iceland can meet the standards necessary to join the EU. But they should be worrying about the cost that that would impose on Iceland. On top of the additional laws, regulations, and taxations that will burden the economy as a whole, fishing (the most valuable industry in Iceland) would be particularly hard hit. The replacement of the Krona with the Euro would also be another major cost. Having the choice between more than currency is by all standards better than not being able to choose. If the prospect of joining the EU would indeed bring hope for Iceland, why

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are so many Icelanders leaving? Why is even McDonald's leaving—and saying that there are no plans to come back in the near future? Herbie is coughing and spitting; the threat of the return of some bad institutions seems strong. What if Bjartur's times come back?

If Iceland did so many good things in the recent past, if Iceland was lucky enough to develop good institutions when the global timing was right, why did Iceland tumble? To ask why Iceland? is like asking why Lehman Brothers? We can point to a direct, immediate cause, but in many ways we have to simply say the answer is "bad luck." It could have happened to someone else. Iceland, like Lehman, was the first to go. Ignorance and uncertainty about what was going on seem to have mattered. Remedies taken later by others were possible in part because both Iceland and Lehman provided examples for the world of how bad things could get.

How bad is it if a developed country asks for emergency loans and those loans, for some unknown reason, are not granted? Now we know. It is very bad. It is a financial meltdown. Other countries, which asked for emergency loans after Iceland collapsed, got their loans. Their fall was not as bad as Iceland's. How bad is it if a foreign country causes a bank run (as the UK did in the case of Iceland) and simultaneously freezes the assets of that bank (and of the country to which that bank belongs)? Now we know. It is very, very bad. It is a collapse of the banking system. This, actually, we knew even before. Banks work on a fractional reserve principle. This means that a bank assumes that all the people who have deposits in it will not ask for their money back at the same time. So the bank can use part of those deposits to finance loans. But if all the depositors do ask for their money back at the same time, the bank goes belly up since it will not have enough reserve to pay back all the customers. Maybe the UK forgot? Now, surely, it is reminded, as is the whole world.

So this is what I learned from Bjartur. I hope not to be alone when I look at Bjartur and appreciate how Iceland grew in the past few decades, how much more better off people are today than in Bjartur's time. I hope that Icelanders will be able to appreciate the miracle they experienced thanks to their successful attempts to build good institutions, and that they will continue on the road to openness and growth.

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