I. Preamble

In October 2008 dramatic events unfolded in Iceland when it became apparent that its economy could no longer sustain the sensational economic growth the country had experienced in the previous years. To most of the public the news of the downfall came as a frightening surprise. The country's banking sector, which had led the growth of the economy and expanded to over ten times the gross domestic product (GDP) in a short time span, collapsed almost completely. Nearly all of the largest companies in Iceland were owned by the notorious *financial Vikings,* who owned the controlling shares in the oversized banks. Iceland's crash was in part so drastic because of the unhealthy cross-ownership of companies and banks. As a result, share values in the country's stock market were nearly erased. Iceland's independent micro-currency, the *Króna* (ISK), that had attracted a lot of foreign hot money seeking high returns during the boom, was all of the sudden in free fall. Unemployment, which was unheard of during the boom (1%), went all of the sudden to 9% and some analysts worried that it could spiral upwards even more as events unfolded. The instability was underlined with interest rates and inflation moving upwards to a staggering 18 per cent and GDP predicted to fall around 10%.[1]

On the streets people were angry and wondered: How had it come to this? Everything was in tatters. Nothing captures this as well as the story of Landsbanki, traditionally a State-owned bank, which had functioned as a cornerstone of Iceland's economy since 1885 and played a part in the country's road to independence in 1944. Under State ownership the balance sheet of the banks had remained for decades modest in relation to GDP and yet stable even though the country did experience some turbulent times. Iceland's economy is massively reliant on fisheries and the bank had seen difficulties when fish stocks suddenly fell or even when whole stocks like herring disappeared completely. External factors like two World Wars and the Cod Wars against the British did also have their impact. In 2003 the bank was fully privatized in an attempt, as the politicians of the day would phrase it, 'to unleash the powers of the free market', which is precisely what happened. In the years from 2003-2008 Landsbanki, under their new ownership, managed to expand its balance sheet from under 50% of GDP to over 250% of GDP, when it eventually collapsed. Such massive expansion was also experienced by the other two main banks, Glitnir and Kaupthing, whereas the banks not only expanded in Iceland but led an outvasion in acquiring huge assets and leading ventures abroad. This was duly felt in the United Kingdom where the *financial Vikings* grabbed headlines with

investment in known brands on the high street as well as English football clubs.[2] One of the main owners and chairman of Landsbanki, Björgólfur Thor, made a trademark oligarch move and bought West Ham United in 2006; he became chairman in 2007, until he lost the club after the crash in 2008. This event raised eyebrows since, given the size of Iceland's economy, the room their businessman were taking in the UK and elsewhere was considerable.

The country asked assistance from its Nordic neighbours and the International Monetary Fund in order to stop further deterioration of the economy and avert a total collapse. Not only did Iceland face a banking crisis, but also a currency crisis and a huge economic crisis. Politicians in other parts of Europe, where dark clouds were gathering overhead, stressed that although they might have problems of their own, at least they were definitely not Iceland. Such voices have now been silenced, since the country has experienced a remarkable turnaround in economic terms. In August 2011 the country completed its successful IMF programme and the fund concluded that key objectives had been met and the government had stabilized the economy. Growth resumed with numbers that many troubled countries in the Europe would give a lot for (2,7% in 2011, 1,5% in 2012, 3,3% in 2013). The budget deficit was turned into a surplus, unemployment was reduced to 5% and continues to fall, interest rates went down by 12%, inflation was maintained at under 4%, the currency was stabilised albeit under capital controls. Growth for 2014 is predicted to be 3,7%.

Although several economic problems remain, the country has emerged from its deep crisis. New banks were successfully resurrected that are dwarfed, however, in comparison with the monsters that emerged during the *financial Vikings'* era. Both private and public debt stabilized and is on a downward trajectory with the sovereign successfully entering capital markets again in 2011. Iceland's economic crash and recovery has sparked huge interest in this tiny economy of 300.000 inhabitants, which managed banks whose bankruptcies are among the largest in history. The before- and after-crash tale is dramatic, full of surprises and extravagances.

II. Success stories

The success stories told of how Iceland bounced back from its near-death economic experience are many. Here is an example of something I have in mind:

> *In contrast, Iceland avoided a public health disaster even though it experienced, in 2008, the largest banking crisis in history, relative to the size of its economy. After three main commercial banks failed, total debt soared, unemployment increased ninefold, and the value of its currency, the krona, collapsed. Iceland became the first European country to seek an I.M.F. bailout since 1976. But instead of bailing out the banks and slashing budgets, as the I.M.F. demanded, Iceland's politicians took a radical step: they put austerity to a vote. In two referendums, in 2010 and 2011, Icelanders voted overwhelmingly to pay off foreign creditors gradually, rather than all at once through austerity. Iceland's economy has largely recovered, while Greece's teeters on collapse.[3]*

There are various versions, but what they have in common is that they attribute success to the fact that Iceland did not bail out the banks. Some of them thank not the people for halting a bank bailout, but the government at the time. From this supposed fact Iceland did not have to impose austerity policies that are thought to have had a further negative impact on crisis-ridden countries such as Portugal, Ireland, Italy, Greece and Spain (PIIGS). In Iceland policy-makers seem to have escaped an IMF bailout package conditionalized upon imposing austerity and recapitalized oversized banks with toxic assets. [4] This in turn is given as an explanation as to why Iceland experienced a rapid recovery while the other countries, especially Greece, have seen very little progress.

I think there is a need to urge for caution in comparing economic crises of different countries. Greece and Iceland had very different problems leading to crisis. Greece did not have a banking crisis like Iceland and Iceland did not have a public debt crisis before the crash like Greece. Ireland had a banking crisis like Iceland, but the former has the Euro as currency and the latter the independent *Króna*. Putting to one side the need for caution in these circumstances, then this Icelandic saga of a heroic escape from the bad banker is just a myth and lacks any factual basis. Iceland attempted a bank bailout, but it failed, and the cost of the Icelandic crash has been considerable both in economic and social terms. Although Iceland escaped better from the circumstances than many had envisaged, the impacts of them are still being felt.

III. The mini-crisis of 2006

The tragedy in the Icelandic case is that so much harm could have been averted if the authorities had only taken measures in a mini-crisis, called the *Geyser crisis*, that hit the economy in 2006. Analysts, especially outside of Iceland and most notably from Denmarks Danske Bank, gave out warnings that Iceland was heading for disaster as its banking sector was seriously unstable.[5] This is what economist Gudrun Johnsen calls the 'missed opportunity' for Iceland and points out that, rather than taking this criticism to heart, domestic politicians and bankers responded to it by shooting the messenger. They maintained that the analysts had ill intentions as they were in competition with the banks or that they did not understand the Icelandic banking miracle. So, instead of reviewing the fundamentals of the financial system and asking questions about the direction of the banking outvasion, all the wrong lessons were learned from the *Geyser crisis*. Bankers and politicians agreed that in order to correct the misperceptions over the banks, a PR campaign was needed as well as a restructuring of how they financed themselves so that they could continue to grow. The bank managers saw that they could not only rely on the international bond market, as the view was getting more commonplace that all was not fine in Iceland. Funding was getting harder and more expensive by the month, which these heavily leveraged banks could not withstand. Most notably, this meant the banks moved into introducing high-interest-rate accounts. Landsbanki, for example, introduced the now infamous Icesave online accounts out of their branches in the UK and the Netherlands. It managed to accumulate billions of pounds in deposits in just over a year. However, when the accounts became unavailable due to the collapse of the bank in October 2008, the UK authorities used anti-terrorism laws to freeze all Icelandic assets on UK soil, sparking a hefty row between Iceland and the UK that ended before the EFTA court in 2011. In 2013, however, the EFTA court came to an interesting verdict, acquitting the Icelandic State of any claims made by the UK and the Netherlands to reimburse them for moneys paid to depositors of the failed branches of Landsbanki. Rather, the UK and Dutch insurance deposit schemes stand to get reimbursed by the winding-up process of the failed bank but, importantly, the Icelandic State is not liable.

IV. Contingencies

After the 2006 *Geyser crisis,* the banks did not only change their strategy and turn to the pockets of depositors. In addition to accumulating deposits, the banks manipulated their

access to the Central Bank of Iceland and the European Central Bank for funding when international markets closed on the Icelandic banks. As Johnsen notes, '[i]nstead of using their existing asset portfolio (which was depleted), they issued new unsecured bonds in the domestic market at a favourable rate, then colluded on exchanging these bonds among themselves. Another bank could then use them as collateral against short-term lending from the Central Bank'.[6] Or to put it simply, the banks were taking money out of the Central Bank in exchange for IOU tickets they had exchanged among themselves. These tickets became known as "love letters" in Iceland. In effect, they were printing money, and on a massive scale. One of the results of this is that the Central Bank of Iceland became *de facto* bankrupt, with losses estimated at 11.1% of GDP, which is another peculiarity of the Icelandic case.[7] A court case is currently ongoing in Iceland where the CEO's of Kaupthing are charged for financial transactions and loans made in the final weeks leading to the crash. Part of the money used in those transactions, 500 million Euros, was a large portion of Iceland's currency reserve loaned to the bank by the Central Bank of Iceland.

The years between 2006 and 2008 are key in understanding the Icelandic case. One of the main questions one gets when discussing the lessons from Iceland is: Was the quick recovery due to how the country 'burned' the creditors? Myth has it that when things got tough for the banks, the Icelandic government denied to bail them out and the country therefore escaped the difficult long-term consequence felt by, for example, Ireland. But that is a serious distortion of what happened. The Icelandic banks were on Central Bank life support from 2006 to 2008. After the Geyser crisis, the banks got the funds needed in order to continue their ventures. Paradoxically, what turned out to be Iceland's luck in the circumstances was that heads of other Central Banks did not abide to the demands of their colleague in Iceland, Davíð Oddsson, for a loan to continue funding the banks. In all actuality, it turns out that it was the Icelandic authorities that were the last to spot the ill health of their own banks. In a response to a letter from the Governor of the Bank of England Mervyn King, where he proposes the need for a downsizing the banking system and that more funds are not what is needed, Mr. Oddsson writes:

> '*The Icelandic banks are well capitalized but they are dealing with a problem of perception. The signals we receive from the markets are that a swap facility for the Central Bank would contribute immeasurability to the alleviation of the problem. I hereby kindly ask you to reconsider this matter.*'[8]

Mervyn King did not reconsider nor did any other Governor of a Central Bank in Europe, which then meant that the authorities, out of necessity, had to switch to plan B i.e. to split up the banks and make them go into administration. For admirers of historical contingences, this case is a treat. Iceland did not take a calculated decision to let the banks fail, but an attempted bail-out failed. This meant that that its tackling of a banking crisis took an unexpected turn, as banks were put into a winding-up process, a move only considered in the face of failure. If drastic measures against the banks had been taken in 2006, then Iceland would offer a role model for averting crises. But then an interesting political question arises. The banks fuelled sensational growth. What politician would stop the promoters of such growth and who would vote for him? And in a political climate of complete confidence in the self-regulation of markets, the role of regulators gets very small.

V. Iceland's bad/good bank move

Iceland's bank manoeuvre has received a lot of interest because it deviates in important ways from the current orthodoxy in crisis response in Europe, where the argument for a bank bail-out is the standard. The recipe needs mentioning. In response to the crisis, the Icelandic Parliament passed emergency laws in 2008 that gave the financial services authority (FME) the tools to take drastic measures and intervene in the financial market. An important part of the legislation was to give all depositors (wholesale and retail) priority status over other creditors such as bondholders. On this basis domestic deposits were moved into new banks that received a capital injection from the State and assets and loans from the old banks matcing the deposits. The failed banks were then put into administration, which makes this a good/bad bank split. And even though Iceland did not deliberately choose this route, it turned out to be beneficial, which proves an important point that alternatives to bank bailouts are possible. One should also note, however, that the good bank / bad bank move is based on sound principles that are sadly overlooked by policy-makers in Europe. If the State finds it necessary to salvage a financial institution, then State funds should only be allocated to such bail-outs provided that the assets of the financial institution are sound and important for the functioning of society. Rather, it may be sensible to seize the opportunity to minimise risk by downsizing the banks and eliminating toxic debt. A bank that faces default is doing so for a reason and the government needs to ensure that it is not throwing good money after bad money. The argument that banks should always receive tax-payer money because of

systematic importance and contagion fears should not be accepted as a wholesale argument. The State does not of necessity need to bail out the banks in the exact shape they are in when they seek assistance.

So, although Iceland stumbled upon the correct route eventually, the attempt to sustain the banks since 2006 became immensely costly. Despite the much-praised route taken by Iceland, the total cost of the economic crisis for the State has surpassed Ireland's, which was thought to be the very bad case, in terms of GDP (Ice 70% Ire 60%).[9] The most recent IMF report discusses this surge in debt and estimates it for Iceland even higher than previously assumed, stating that 'the collapse of the banking system led to an increase of Icelandic public-sector debt to almost 100 percent of GDP'.[10] The reason is that the pure size of the banking system was such that even though a late good/bad bank manoeuvre rescued Iceland from complete economic annihilation, the crash remained immensely costly for the tax-payer. But there are also important caveats to stress here. The fiscal costs are in part caused by the refinancing of the new banks. A lot of the increase in public debt is due to establishing an adequate foreign reserve of currencies to support the Icelandic *Króna*. The State also recapitalised the new banks and so the majority of the financial sector is now largely owned by it. And as Iceland's economy is growing again, the assets of the banks are improving and the State will in the future be able to receive considerable revenue from the banks to repay its own capital contribution. Hopefully, it will all be repaid in full and with interest, which would make up for some of the costs of the crisis. Nevertheless, Iceland did not miraculously escape the crisis; although its recovery has been positive.

VI. Emerging from crisis

There are many factors that explain Iceland's emergence from the crisis. Economists would point to the stabilizing and downward path of private and public debt and stabilization of currency, which brought down inflation. Another peculiarity of the Icelandic case is the introduction of capital controls in an IMF programme, which helped stabilize the currency. Some would point to how the depreciation of the currency helped hasten the recovery for an export-driven economy. But keeping in line with the peculiarities of the Icelandic experience, I want focus on other factors that I consider pivotal in its recovery. Bergmann notes that in terms of the recovery, a key component of it was that it was welfare-orientated.[11] One of

the main aims of the government was to do as much as it could to protect Iceland's Nordic welfare system and the consolidation measures implemented after the crash were based on social principles.[12] Cuts in the budget were curtailed to shelter the most important elements of the welfare structure. To meet the rising costs of such a social protection scheme after the crisis hit, in addition to falling revenue, considerable tax reform was introduced. An increase in income tax on the highest wages was introduced instead of a flat rate. Capital and corporate income tax rates were raised, new special wealth taxes and a bank levy introduced, environmental and carbon emission taxes launched. The capital controls also helped by preventing capital flight once they were set in place and they also retained the assets of the creditors of the failed banks. A special resource rent tax on the export-driven fishing industry that targeted substantial increases in profits resulting from the depreciation of the *Króna* was introduced. This and running a deficit to fund certain social programs necessary to soften the impact of the crisis were important in achieving economic progress. For example, in 2011 and 2012, 1% of GDP each year was used to subsidize interest rates to indebted households and a special social stimulus package was introduced in 2011 which increased wages and benefits. Both the IMF and OECD have pointed to this social emphasis with the latter claiming that "[c]onsolidation policies appear to have been designed in an overall equalising manner."[13]

As a result Iceland was the only country within the OECD where the average income of earners at the top of the scale fell more than that of those at the bottom of the scale. During the boom inequality increased significantly, making Iceland an interesting test case for the debate surrounding Professor Thomas Piketty's claims on wealth inequality and the development of capitalism.[14] But in tackling the crisis, socially just principles contributed to Iceland's recovery. The Icelandic authorities were terrified of the prospects of a double-dip crisis which could have easily become the reality if funds were not redistributed through the tax system and social protection shielded from cuts. Strong moral arguments support such an approach, as measures should focus on getting the whole of society through the crisis and not just financial institutions, but they are also economically sensible. The focus should be on maintaining as much as possible the purchasing power of low- and middle-income groups. A counterproductive move would have been to cut unemployment benefits when it peaked, in the name of cost-cutting, and then introducing extra costs in areas people highly rely on, such as education or health services. Austerity not only hurts the individual who lost his job, but also the community that relies on him as a consumer, as his diminished income needs to

pay for public services he previously did not have to.

The Icelandic boom, bust and recovery story offers a fascinating study for policy-makers, journalists, academics or just anyone interested in understanding financial crises. The big question is whether Iceland can offer any lessons to other countries that face a crisis. I think the verdict is mixed. There are lessons in the failures leading up to the crisis and in what made the country emerge from crisis. It is right to stress that every country faces a different set of circumstances, even though they are all lumped together as countries facing economic crisis in discussions on "crisis". But maybe the most important lesson from Iceland is that when tackling a crisis there are always more possibilities available than are usually laid on the table. Even when facing serious consequences, taking the unexpected route is not so disastrous.

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[1] For an overview of main economic indicators before and after crash see IMF 2011, 2012 & 2014 and Halldórsson & Zöega 2010.

[2] Financial Vikings are discussed in Loftsdóttir 2010 and see Baruchello 2014 for discussion on the neoliberal ethos during the boom years.

[3] Stuckler & Basu. "How Austerity Kills". New York Times. May 12, 2013. See also Karanikolos et. al. 2013 and see discussion in Byrne & Thorsteinsson.

[4] See Lane 2012 on crisis packages for European countries especially p. 57-59. On the

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history of the idea of austerity see Konzelmann 2014.

[5] Christensen 2006

[6] Johnsen 2014:93

[7] Byrne & Thorsteinsson 2011. See also Magnússon 2010.

[8] Johnsen 2014:185

[9] IMF 2013b

[10] IMF 2013b: 11.

[11] Bergmann 2014:159

[12] For detailed argument consult Huijbens & Thorsteinsson forthcoming.

[13] OECD 2013: 3. Gender issues are discussed in Thorsdottir 2013. See also Ólafsson & Kristjánsson 2012 for discussion on how changes in the tax system sheltered low income groups.

[14] Piketty 2014.