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Iceland's rise, fall, stabilisation and beyond

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Iceland is an unusually pure example of the dynamics that blocked regulation and caused financial fragility across the developed world for 20 years. This essay describes the statist-and-corporatist political economy of the country as it soared from near the bottom of the Western European income hierarchy at the end of the World War II to up near the top by the 1980s. It illustrates how a group of neoliberal politicians and allied civil servants drove through selective deregulation and privatisation in the 1990s and 2000s. In the space created for newly privatised banks, Icelandic financiers grew the banks and linked private equity firms through mergers and acquisitions abroad to the point where by 2007 tiny Iceland supported three banks in the world's biggest 300 banks, with assets eight times the GDP—second highest in the world after Switzerland. As profits from these overseas operations were partly redistributed back to Iceland the economy boomed, in the grip of super-Minsky processes. The government, the banks and the media interpreted the boom as testimony to the validity of neoliberal policies and went out of their way to hide increasing financial fragility from view, preventing a negative or self-correcting policy feedback loop. The accident waiting to happen happened in the wake of the Lehman collapse in September 2008. The essay charts the zigzags of the government's response and the citizens' response, and discusses the prospects for a resumption of growth on a more sustainable basis. It suggests that Iceland illustrates in miniature the ratcheting down of mass living standards underway across the Western world now that the cushion of debt has been removed, even as financiers and others in the top few percentiles of national income distributions increase their share of national income. But economic institutions and politics matter: in Iceland the large devaluation spread the cut in a relatively 'apolitical' way; the government let the banks go bust rather than bail them out at taxpayers' expense; it imposed capital controls on outflows; and it used fiscal transfers to protect the bottom half of the population from disproportionate cuts.

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Iceland should be a model to the world. (Laffer, 2007)

They [the Icelandic banks] shouldn't be worried about the fundamental soundness of their business model. I think it is very sound and very good. Any market turmoil is just prompted by some misplaced misunderstandings of market analysts. (Richard Portes, professor at the London Business School; Portes, 2008)

It was absolutely obvious that its banking model was not viable. (Buiter and Sibert, 2008)[1]

Iceland recovered from a near-death experience. The sense of fear and shock were palpable [when the IMF mission arrived in October 2008]—few, if any, countries had ever experienced such a catastrophic economic crash . . . The scale of the uncertainty was staggering. (Poul M. Thomsen, Deputy Director of the IMF's European Department, October 2011; Thomsen, 2011)

1. Introduction

The small North Atlantic island of Iceland has lessons for the world. Its experience of a financial boom and bust over the 2000s provides an unusually pure example of the dynamics that caused financial fragility and blocked regulation across the developed world for 20 years.

These larger dynamics can be thought of as operating on three levels. First, the level of broad-based Minsky-like processes that make positive, self-reinforcing feedback loops across the economy, such that asset price inflation feeds upon itself.[2] Second, the level of globally concentrated corporate power. A recent analysis identifies a global 'superentity' with a high proportion of total corporate revenues and dense cross-ownership between its constituents, comprising 147 global companies; in the top 50, only one is not a financial firm (Coghalan and MacKenzie, 2011). Such superconcentration provides a platform for subgroups of firms to capture the state and secure public policy in line with their preferences.

Third, the level of second-round Minsky effects within the state, as public policy comes to amplify rather than counter the larger positive feedback loops (Baumgartner and Jones, 2002). One channel of these second-round effects is the actions of individuals and networks of individuals able to manipulate positions across the private/public sector divide. Janine Wedel, in *Shadow Elite*, describes an expanding class of people she calls 'flexians', who perform overlapping and not-fully-disclosed roles (consultants to private companies, official advisors, unofficial advisors, lobbyists, academics and television pundits). Flexians often operate in 'flex nets', whose members are more loyal to each other than to the organisations for which they work at any one time (Wedel, 2009).[3] The reform movement known as New Public Management, based on the premise that governments should operate more like private businesses and encourage more interchange of personnel between private and public sectors, has created vast new opportunities for flexians and flex nets to gain access to strategic public sector information and policymaking and deploy

[1] The report was written at the start of 2008 for an Icelandic bank, which kept it confidential until October 2008.

[2] Pro-cyclicality comes partly from the use of short-term performance measures in managers' compensation schemes, resulting in higher appetite for risk and increased leverage (Minsky, 1992; Columba *et al.*, 2009; Goodhart, 2009).

[3] For an application to Iceland's power networks see Logason, 2011.

their influence for private profit and ideological advantage. New information technologies create many new unregulated spaces for their operations.

As the boom rolled on and came to be accepted as 'the new normal', the three-level dynamics described above all operated to raise the level of financial fragility. Corporations reduced their cushions against risk; the ratings agencies and Big Four audit firms increasingly took bank financial statements at face value;[4] corporate concentration and interconnection rose; and governments eased up on regulation, bewitched by the 'efficient markets hypothesis' and forgetting that self-regulation is to regulation as self-importance is to importance. Governments also took less care over rules governing relations between public officials and private actors.

This is the phenomenon of "state capture" (Hellman and Kaufmann, 2001). In the general case, state capture tends to be a zero-sum game. However, the financial boom of the 2000s saw the public at large apparently benefiting from the boom even as the share of national income accruing to the top few percentiles soared (Palma, 2011). The galloping growth of lightly regulated finance enabled large-scale consumer borrowing on the back of inflating asset prices, despite stagnant median incomes. Debt became the way to live.

Iceland is tiny, only 319,000 people in an area 42% that of the UK (whose population is 62 million). It might be thought that in such a small society government would be extra accountable, through greater transparency of both formal and informal processes; wrong-doing would be difficult to hide. In fact, this turns out not to be the case. It was relatively easy for the leadership class to eliminate or marginalise sources of information critical of the direction of policy; in other words, to ensure that positive information feedback loops dominated, supporting pro-cyclical trends. And it was easy for blatant conflicts of interest to be redefined as mere 'coincidences of interest'; for what critics might call 'cronyism' to be defended as 'family values'.

This essay traces the institutions and processes that generated the growth of the financial sector and the resulting economic boom over the 2000s and, then, post-crisis in late 2008, the zigzags of the government's response and the citizens' response. It discusses the prospects for a resumption of growth on a more sustainable basis and assesses the IMF's role.

2. Iceland's rollercoaster

In 2007, just before the financial crisis, Iceland's average income was the fifth highest in the world, 60% above US levels; Reykjavik's shops were laden with luxury goods, its restaurants made London seem cheap, SUVs choked the narrow streets. Icelanders were the happiest people in the world, according to an international study in 2006 (World Database of Happiness, 2006). They also had one of the least corrupt public administrations in the world, according to Transparency International.

Much of Iceland's success rested on the superfast growth of three Icelandic banks, which rose from small, public utility organisations in 1998 to being, after privatisation and mergers, among the world's top 300 banks eight years later, increasing their assets from 100% of GDP in 2000 to more than 800% by 2007, second only to Switzerland.

[4] See, for example, Norris (2011). The US Public Company Accounting Oversight Board wrote a report on Deloitte & Touche's audit of a major US bank, in late 2007, saying that its inspections revealed 'a [D & T] firm culture that allows . . . audit approaches that do not consistently emphasize the need for an appropriate level of critical analysis . . . and that rely largely on management representations'. The rules of disclosure allowed D & T to keep the report confidential for 41 months.

They borrowed massively on the back of implicit government guarantees, and lent to private equity firms owned by the bankers themselves or their close friends and relatives, against little or no real collateral.[5] The equity firms went on an exuberant mergers and acquisitions spree, buying up firms in several parts of Europe with borrowed money. They extracted vast profits for themselves and also for paying salaries, wages and taxes back home in Iceland.

In essence, Iceland's success, which earned the country the sobriquet of 'Nordic Tiger' (to match Ireland's 'Celtic Tiger'), was based on a mechanism whereby a small group of financiers backed by the state borrowed colossal sums from international capital markets, bought foreign assets, restructured the assets and redistributed profits back to tiny Iceland, booming the economy. The Icelandic elite and masses cheered them on, much as the populations at home in Norway and Denmark had cheered on the old Vikings as they returned from their marauding raids up and down the west coast of Europe a millennium ago.

This, of course, is not how the success was interpreted in Iceland and in the rest of the world at the time. Instead, the success was said to prove the validity of free-market economics as the route to prosperity. The leading Icelandic champion of free-market economics declared in the *Wall Street Journal*: '[Prime Minister] Oddsson's experiment with liberal policies is the greatest success story in the world' (Gissurarson, 2004).[6] Arthur Laffer, the Reagan-era guru of supply-side economics, declared on a visit to Iceland in November 2007 that fast economic growth with a large trade deficit and ballooning foreign debt were signs of success: 'Iceland should be a model to the world', he announced (Laffer, 2007).

The crisis came in September 2008 when money markets seized up after the Lehman meltdown. Within a week Iceland's three big banks collapsed and were taken into public ownership. They then entered a less glorious league—Moody's list of the 11 biggest financial collapses in history.

The economy experienced the third biggest fall in output and the fourth biggest fall in employment among the 30 OECD countries. The contraction stopped in late 2010, at 11% below the peak in the first quarter of 2008. At the time of writing, real GDP is expected to grow by just over 2% in 2011 and a little higher in 2012. Thanks to increases in welfare spending, only 14% of the population say they are finding it 'very difficult' to make ends meet, well below the European Union (EU) average, though rising since 2008 (Ólafsson, 2011). The government re-entered capital markets for the first time in June 2011 when it sold $1 billion worth of bonds at a spread of only 3.2 percentage points above LIBOR (London Interbank Offered Rates), much less than the other crisis-hit governments are having to pay, which testifies to the credibility of the government's stabilisation performance in the eyes of financial markets.

Now that the economy has stabilised, let us step back and consider how Iceland came to enjoy such economic success as to be dubbed the 'Nordic Tiger' and how the increasing financial fragility was hidden from view. Then we consider how the crisis was handled and the prospects for a resumption of growth on a more sustainable basis.

[5] For similar machinations elsewhere see Black (2005).

[6] He is a professor of political theory at the University of Iceland, and also affiliated with the Instituto Millenium Rio de Janeiro and Friedrich Nauman Stiftung Sao Paulo. He was a member of the Locomotive Group, a member of the board of the Mont Pelerin Society from 1998 to 2004, and organiser of a meeting of the society in Iceland in August 2005. He published the book *How Iceland Could Be the Richest Country in the World* in 2002. He retains his university position even after being convicted of gross plagiarism in a unanimous judgement of the Icelandic Supreme Court, March 2008.

3. Iceland modernises

After more than 600 years of foreign (Norwegian and Danish) rule, Iceland's social structure was the most feudal of all Nordic countries at the beginning of the twentieth century. Agriculture dominated the economy and the majority of the population in 1900 worked as subsistence farmers or as agricultural wage labourers effectively tied to the landowners in semi-serf conditions (half the cultivated area was owned by the Danish crown or the Lutheran church; the other half by a small number of landlords who owed their wealth to the exploitation of their tenants or wage workers). It was about the poorest place in Western Europe, its bleakness vividly described by Iceland's Nobel Laureate in literature, Halldor Laxness, in the novel *Independent People*. Around the turn of the twentieth century commercial fishing developed (previously only foreign boats had fished on a commercial scale, because most of the population was tied to the land). As the twentieth century lengthened fishing came to generate most of the foreign-currency earnings. It allowed the development of an import-based commercial sector in towns: fish factories, boat construction, building construction, retail and light industry.

At the start of World War II the population was divided between those who thought the country should stay out of the war altogether and 'those who preferred the Germans [to occupy the country] because of the implicit promise of a privileged status under the Nazis [on account of the German perception of Iceland as the home of pure Aryans]' (Boyes, 2009, p. 19). To general dismay the British invaded in 1940 and were then replaced by the Americans in 1941.

After World War II, with the country newly independent from Danish rule, the economy grew strongly thanks to: Marshall Plan aid (the US–NATO military base provided 15%–20% of foreign exchange earnings between 1954 and 1960); an abundant export commodity, cold-water fish, unusually blessed with high income elasticity of demand; and a small, literate, hard-working and ethnically homogeneous population with a strong sense of national identity. At the same time the capitalist economy was heavily regulated, with elaborate trade protection and multiple exchange rates. Around 1955 about half of imports were subject to quantitative restrictions or rationing, a useful tool of patron–client politics (Jóhannesson, 2010).

In 1960 the government began cautiously to liberalise. It unified and devalued the exchange rate, reduced tariffs and quantitative restrictions, raised interest rates, and banned the indexing of wages to prices. But the government retained a large role in managing the economy, especially through rationing credit via the state-owned banks and directing investment to particular sectors. Growth zoomed ahead at an average of 4% a year from 1960 to 1989, though with high variability from year to year (related to fish yields). 1960–89 was the period of the 'Icelandic miracle' (Ólafsson, 2011).

By the 1980s Iceland had shot up from one of the poorest places in Western Europe at the start of World War II to one of the most prosperous. It established a welfare state in line with the tax-financed Scandinavian model and by the 1980s had attained a level and a distribution of disposable income equal to the Nordic average. Yet it remained both more regulated and more patron–client-dominated than its European neighbours; a local oligopoly restricted the political and economic opportunities. As recently as 1975 it was ranked 53rd in the Economic Freedom of the World index.

There is a path-dependent line of ascent from the quasi-feudal power structures of the nineteenth century to the modernised Icelandic capitalism of the later twentieth century, when a bloc of 14 families, popularly known as The Octopus, constituted the economic

and political ruling elite, living like chieftains. They controlled imports, transport, banking, insurance, fishing and supplies to the US–NATO base, and provided most top politicians. A firm controlled by people prominent in the two dominant right-of-centre political parties made particularly good profits through its effective monopoly of much of the commerce between the US–NATO base and the domestic economy. The story is told that when the firm presented its bill for building a fence around the base the Americans exclaimed, 'We could build a fence around France for this amount!', but they paid it anyway.

The Octopus controlled the right-wing Independence Party (IP), which dominated the media and decided on senior appointments in the civil service, police and judiciary. The other right-wing party was the Centre Party (CP), also known as the Progressive Party, based in the rural economy and controlled by its business arm (sometimes known as The Squid). These two parties provided most of the governments for the past 60 years. They effectively ran the state-owned banks and prominent figures within them owned the two main daily newspapers.

The small left-wing parties spent most of their time at each other's throats, to the benefit of the right-wing bloc. However, they regularly got 15%–20% of the vote, which was enough to get one or other of them occasionally into power as junior coalition partner, and that plus ideology gave them enough patronage to sustain their electoral base.

Party membership was a standard part of a person's identity, together with parentage, occupation and schooling. The parties provided access to careers in both the public and private sectors. Political cleavages went right down to small units at the base, like firms, university departments and men's choirs. Ordinary people had to go through party functionaries to get loans to buy a car or foreign exchange to travel abroad. Power networks operated as webs of bullying, sycophancy and distrust, permeated with a macho culture, resembling the former Soviet Union.

While left-wing parties were weak, trade unions were strong. One of their main aims was to defend real wages from the effects of the government's main tool of macroeconomic management: devaluation to secure profitable conditions for the export industries (mainly fish and, later, aluminium in the 1970s). All through the fast growth period of 1960–89 Iceland experienced high inflation driven by price–wage spirals and intense labour conflict, sometimes coming close to general strikes.

Not only was the work force strongly unionised, the agricultural and fisheries sectors were strongly corporatised in the sense that their collective organisations decided what they wanted to see by way of government policy for the sector, and the government mostly obliged (Thorhallsson, 2010).

Looking through neoliberal eyes, Iceland at this time was a paradox: on the one hand, a highly statist and corporatist economy with a relatively 'closed access' political and economic elite run by a right-wing bloc, which also controlled the media; on the other hand, a strong union movement; and on the other hand again, high economic growth accompanied by falling post-tax income inequality (as the right-wing bloc had no choice but to negotiate with the unions). Today's neoliberals resolve the paradox by denying it: by claiming that Iceland's fast growth dates from 1995, when the big push to apply the precepts of Reagan, Thatcher and New Zealand's Roger Douglas began. This is false.

Iceland's statist and corporatist political economy began to be challenged from within by a neoliberal faction. It coalesced in the early 1970s when some law and business administration students at the University of Iceland took over a journal, *The Locomotive*, and they became known as the Locomotive Group. Their aim was not just to promote free-market policies but also to open career opportunities for themselves, rather than wait for

Octopus patronage. At the end of the Cold War their position strengthened materially and ideologically, as 'statism' and left-wing parties lost public support. Over the decades the Locomotive members took senior positions in politics, law, the judiciary, business and academia. In Wedel's terms the group functioned as a flex net.

The future IP prime minister, Davíð Oddsson, was a prominent member from the beginning. Born in 1948 into a middle-class family, he was elected as an IP councillor to the Reykjavik municipal council in 1974, then mayor of Reykjavik in 1982. In that capacity he led privatisation campaigns, including selling of the municipality's fishing industry to the benefit of members of the Locomotive. In 1991 he led the IP to victory in the general election and reigned (not too strong a word) as prime minister for 14 years, overseeing the growth of the financial sector, before installing himself as governor of the Central Bank in 2004. He had little experience or interest in the world beyond Iceland. His Locomotive protégé Geir Haarde, finance minister from 1998 to 2005 (with a degree in economics from Brandeis University in Boston (MA, USA) in the early 1970s), took over as prime minister shortly after.

These two men most directly steered Iceland's respecialisation strategy to create an international financial centre cum tax haven in the North Atlantic, conveniently midway between Europe and America.

4. Iceland liberalises

The following figures summarise Iceland's growing financial 'success'—and fragility. Figure 1 shows the build-up of Iceland's gross foreign long-term and short-term debts from 1989 to 2008 and then beyond, together with some of the accompanying events. Figure 2 shows the build-up of the three biggest banks' assets relative to GDP from 2003. Figure 3 shows household debt in local currency and the share of different kinds of lending institutions in that debt, 1991–2008.

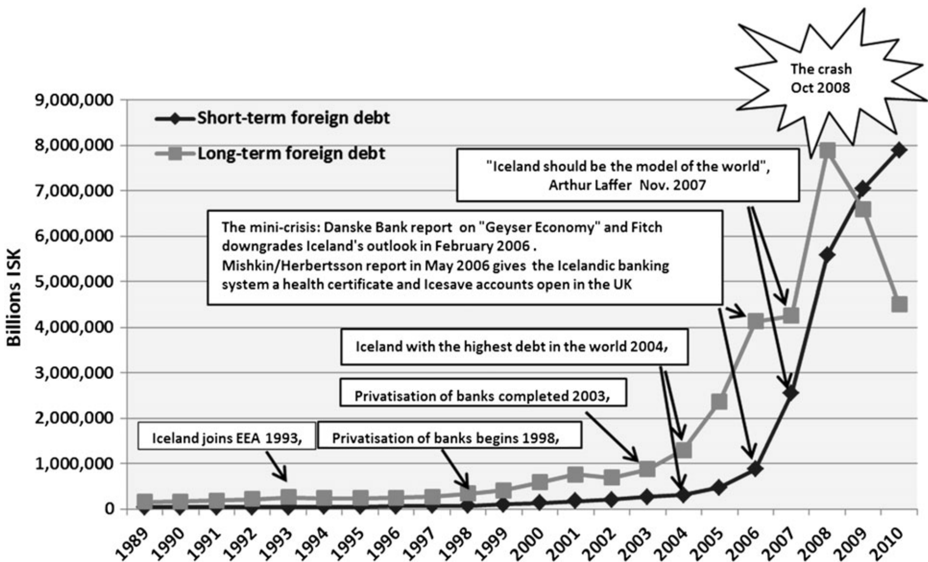

Fig. 1. *Iceland's long- and short-term foreign debt: 1989–2010. Source: Central Bank of Iceland Statistics Website [date last accessed, October 2011]. Authors' labelling of events.*

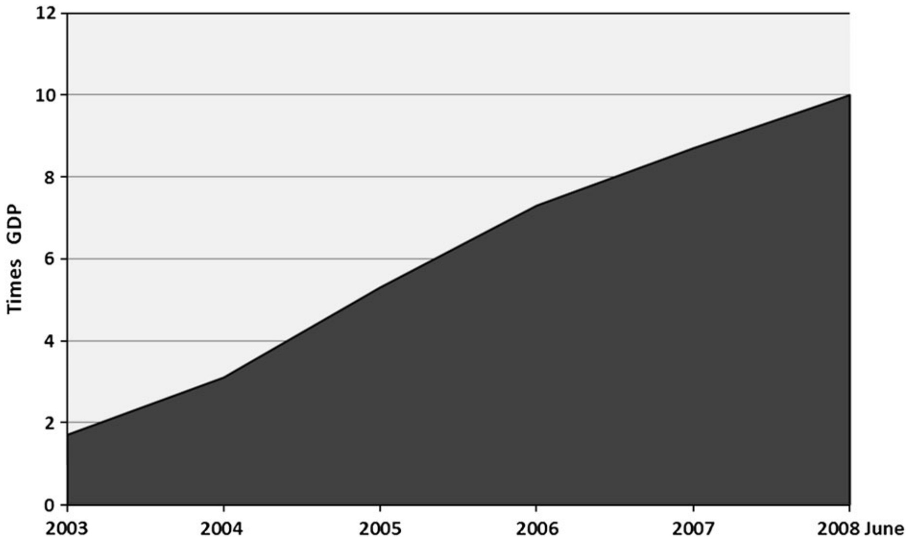

Fig. 2. *The three largest banks' end-of-year assets, relative to Icelandic GDP. Source: Special Investigation Report, April 2010, Annex 3 Viðauki 3 Mynd 9 at http://www.rannsoknarnefnd.is/ [date last accessed December 2011].*

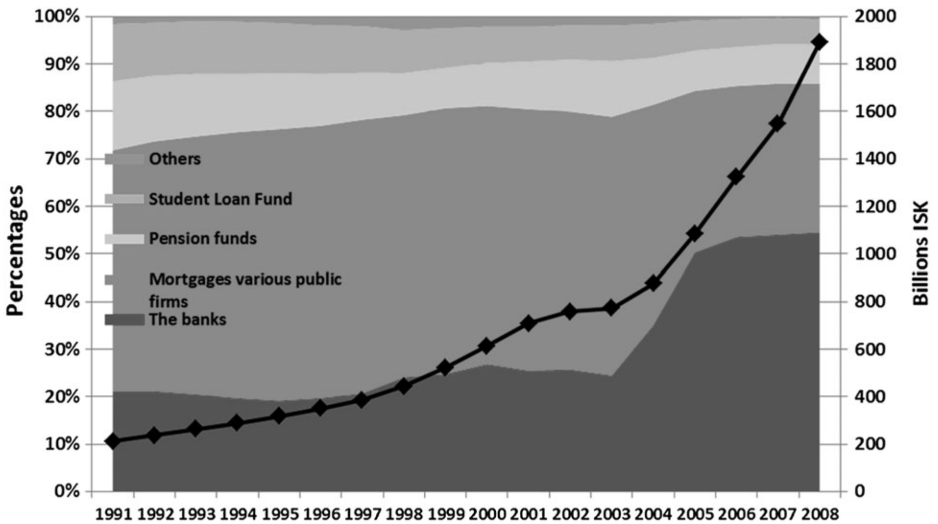

Fig. 3. *Household debts (right axis) and the share of lending institutions in household debts (left axis): 1991–2008. Source: Special Investigation Report April 2010. Chapter 4, Volume I, Website Figures in Chapter 4 (Kafli 4; Mynd 42) at http://www.rannsoknarnefnd.is/ [date last accessed December 2011].*

The story behind these trends is as follows. Liberalisation of the economy accelerated after 1994, when accession to the European Economic Area, the free-trade bloc of EU countries, plus Iceland, Lichtenstein and Norway, required lifting restrictions on cross-border flows of capital, goods, services and people. The Oddsson government then sold off state-owned assets and deregulated labour. By 2004 Iceland was ranked ninth in the world in the Economic Freedom of the World index, up from 53rd in 1975.

Privatisation of the banks began in 1998, implemented by Oddsson and the leader of the CP. Of the banks, Landsbanki was allocated to IP grandees and Kaupthing to their counterparts in the CP, its coalition partner. Foreign bidders were excluded, an important point to note for what was to come. Later, Glitnir, a private bank formed from the merger of several smaller ones, joined the league.

So Iceland roared into international finance aided globally by abundant cheap credit (thanks to US loose monetary policy during the 1990s and 2000s) and domestically by strong political backing for the banks. The new banks merged investment banking with commercial banking, so that the former shared the implicit government guarantee of the latter. And the country had low sovereign debt, which gave the banks high marks from the international credit-rating agencies. The major shareholders of Landsbanki, Kaupthing, Glitnir and their spin-offs reversed the earlier political dominance of finance: finance now dominated government policy.

Here the established format of Iceland's corporatism was helpful. As noted, from the start Iceland's statism had been integrated with a form of corporatism in which both agriculture and the fishing industry more or less regulated themselves. When aluminium smelting began in the 1970s the government extended the same governance dispensation to the (foreign-owned) aluminium firms. It was only 'natural', then, that when finance emerged as the big new growth sector after 2000, both it and the IP-led government *expected* that it would tell the government what it wanted and the government would oblige. The result was very light regulation and a regulatory body (the Financial Supervisory Authority, FME) that—for regulating a financial system including three of the world's 300 biggest banks—had a total staff of 45 in 2006, many of whom were biding their time before crossing the street to join a bank, multiplying their salary several times. It was largely a 'shop-window' operation, justified by general euphoria and the efficient markets hypothesis.

Oddsson's government relaxed the state-provided house mortgage rules in 2004, allowing 90% loans. The post-crash government inquiry into the bubble identified this one decision as perhaps the most serious economic policy blunder of many, given that the economy was already in the grip of bubble dynamics (SIC, 2010). It prompted the newly privatised banks to rush to offer even more generous terms, accelerating the house price bubble (see Figure 3). Brokers criss-crossed the country urging people to refinance their house mortgages in Swiss francs and Japanese yen to get much lower interest rates. At the same time the government lowered income tax and VAT rates with the aim of turning Iceland into a low-tax international financial centre. The stock market soared. Pushed by the banking elite, euphoric city planners aimed to move Reykjavik from the trajectory of an ordinary city to that of a world city (despite its small population of 110,000), and approved several grandiose new public and private buildings. 'If Dubai, why not Reykjavik?' was the spirit.

Meanwhile, Iceland's small banking elite was driving through mergers and acquisitions at home and abroad, competing and cooperating with each other. Using their shares as collateral, some took out large loans from their own banks and bought more shares in their own or related banks, inflating share prices. It worked like this: Bank A lent to shareholders in Bank B, who bought more shares in B using shares as collateral, raising B's share price. Bank B returned the favour. The share prices of both banks rose without new money coming in. The banks not only grew bigger, they grew more and more interconnected.

The owners and managers of financial firms and law firms remunerated themselves on an ever more extravagant scale. The richer they became the more political support they attracted. Their private jets, roaring in and out of Reykjavik's domestic airport, provided visual and auditory proof of their success to the part-admiring, part-envious population

below. The bankers made large financial contributions to the governing parties and giant loans to key politicians.[7] Below the surface several flex nets competed and cooperated at the top level of the state, incorporating varying combinations of bankers, lawyers, politicians, judges, civil servants and academics.

Income and wealth inequality surged, helped by government policies that shifted the tax burden to the bottom half of the distribution (Ólafsson and Kristjánsson, 2010). In 1995 the Gini coefficient of disposable income including capital gains was about 0.26; by 2000 0.31; by 2005 0.39 and by 2007 0.43. Then, as capital gains collapsed, the Gini fell back to 0.34 by 2009.

But the Gini hides as much as it reveals. Most of the rise of inequality happened in the share of the top few percentiles of the distribution as they galloped away from the rest. The share of the top 10% increased over the 2000s at an even faster rate than in the USA, though from a much lower base. Increasing concentration at the top triggered a 'consumption cascade', thanks to easy access to credit. Those below the top borrowed to keep within sight of the top, and so on down. Against the background of the earlier decades of credit rationing, people saw themselves as fully independent at last as they consumed with abandon, which may help to explain their happiness ranking over the 2000s. They lived in the spirit of Plautus, the third century BC Roman playwright, who had one of his characters declare, 'I am a rich man, as long as I do not repay my creditors'.

In the euphoria the dangers of a strategy of 'economic growth with vast foreign borrowing' were overlooked (Pereira, 2010). With almost all the media controlled by the IP and CP, there were few cautionary voices. The Chamber of Commerce told its members in 2006 that Iceland should 'stop comparing itself with the other Nordic countries—after all we are in many ways superior to them' (Icelandic Chamber of Commerce, 2006).

5. The mini-crisis

In 2006 worries began to be expressed in the foreign and domestic financial press about the stability of the big banks, which were starting to have problems raising funds in the short-term money markets (on which their business model depended). Iceland's current-account deficit had soared from 5% of GDP in 2003 to 20% in 2006, one of the highest in the world. The stock market multiplied itself nine times over between 2001 and 2007. You did not have to be a rocket scientist to see that things were unstable.

Landsbanki, Kaupthing and Glitnir were operating far beyond the capacity of Iceland's central bank to support them as lender of last resort; their liabilities were real, but many of their assets were dubious. In February 2006 Fitch downgraded Iceland's outlook from stable to negative and triggered the 2006 'mini-crisis': the krona fell sharply, the value of banks' liabilities in foreign currencies rose, the stock market fell and business defaults rose, and the sustainability of foreign-currency debts became a public problem. The Danske Bank of Copenhagen described Iceland as a 'geyser economy', on the point of exploding (Danske Bank, 2006). The IMF wrote an alarmed Article IV consultation report in 2006. Its private version to the government described the imbalances as 'staggering', toned down in the public version to 'remarkable'.

Icelandic bankers and politicians brushed aside the crisis. The central bank took out a loan to double the foreign exchange reserves, while the Chamber of Commerce, run by

[7] Ten out of 63 MPs had 100 million ISK (Icelandic Krónas) loans from the banks in September 2008. At this time the average household debt was 18–20 million ISK.

representatives of Landsbanki, Kaupthing, Glitnir and their spin-offs, responded with a PR campaign. The Chamber and the University of Iceland invited a string of conservative economists to come to Iceland to assure the audience of the stunning success of the neoliberal model. The Chamber paid the American monetary economist Frederic Mishkin $135,000 to lend his name to a report attesting to the stability of Iceland's banks (Mishkin and Herbertsson, 2006).[8] It allegedly paid the London Business School economist Richard Portes £58,000 to do the same on a later report (Portes and Baldursson, 2007).[9] Either these economists did not know how to identify a bubble, in which case they took the money under false pretences, or they did know but ignored the signs because they accepted an implicit contract to endorse the Chambers' conclusions. With their blessing no one paid attention to the Danske Bank and IMF reports.[10]

In the elections of May 2007, the Social Democratic Alliance (SDA) entered a coalition government with the still-dominant IP. To the consternation of many supporters, SDA leaders ditched their election pledges to assert greater control over macro stabilisation policy and, instead, left it to the IP side of the coalition; and gave enthusiastic support to continued expansion of the financial sector, while knowing next to nothing about conditions in the financial market. They were happy to sit at the top table of government at last and were not about to rock the boat.

Though they survived 2006, Landsbanki, Kaupthing and Glitnir had trouble raising money to fund their asset purchases and repay existing debts, largely denominated in foreign currencies. So Landsbanki pioneered Icesave, an Internet-based service that aimed to win retail savings deposits by offering more attractive interest rates than high-street banks. Established in Britain in October 2006 and in the Netherlands 18 months later, Icesave caught the attention of best-buy Internet finance sites and was soon flooded with deposits. The staff of the bank could scarcely believe their eyes as the deposit numbers kept rising on their computer screens week after week, month after month. Millions of pounds rolled in from Cambridge University, the London Metropolitan Police Authority, even the UK Audit Commission, responsible for overseeing local government funds, as well as 300,000 Icesave depositors in the UK alone.

At the insistence of Landsbanki, Icesave entities were legally established as branches rather than subsidiaries, so they were under the (more colludable) supervision of the Icelandic authorities rather than their hosts. No foreigner noticed the tiny size of the Icelandic regulatory agency. No one worried that, because of Iceland's obligations as a member of the EEA (European Economic Area) deposit insurance scheme, its population of 319,000 would be responsible for compensating the depositors *abroad* in the event of failure. Landsbanki's employees and shareholders reaped the short-term profits, while the general public in Iceland knew nothing about Icesave and the obligations it was imposing on them.

[8] After the crash the title mysteriously changed to 'Financial instability in Iceland', as listed on his web site: (see Charles Ferguson, the director of the documentary film, Inside Job, interviewing Frederic S. Mishkin here http://movieclips.com/KCct-inside-job-movie-financial-stability-in-iceland/ [date last accessed December 2011]. Mishkin's fee is given in 'Mishkin resigns: a look back', *Wall Street Journal*, 28 May 2008; 'Ex-Fed governor's report on Iceland stability missed crisis', *Wall Street Journal*, 17 October 2008.

[9] Portes's fee is given in the SIC Report, April 2010, vol. 8, annex III, p. 3 See here http://www.rannsoknarnefnd.is/html/vidauki1.html [date last accessed December 2011].

[10] Nor did people pay attention to Wade's warnings in semi-public lectures from summer 2005 onwards, in which he drew attention to parallels with the build up to the East Asian crisis of 1997. Wade's *Financial Times* article (2008) FT.com July 1st http://www.ft.com/cms/s/0/061070b8-4781-11dd-93ca-000077b07658.html#axzz1fxUjMkxW [date last accessed December 2011] and published in the printed version July 2nd 2008, 'Iceland pays the price for financial excess' (2 July 2008) promoted a letter to the editor from Portes and Baldursson, which began 'Robert Wade gets Iceland very wrong' (4 July 2008).

6. Love letters

The second 'solution' to difficulties in raising new funds was to get more access to liquidity without pledging real assets as collateral. The Big Three sold debt securities to smaller regional banks, which took these bonds to the central bank and borrowed against them without having to supply further collateral; they then lent back to the initiating big bank. The bonds were called 'love letters'—mere promises. By participating in this game and accepting as collateral claims on other Icelandic banks, the central bank was conniving in the banks' strategy of gambling for resurrection.

Then the banks internationalised the process: the Big Three established subsidiaries in Luxembourg and sold love letters to them. The subsidiaries sold them on to the Central Bank of Luxembourg or the European Central Bank and received cash in return, which they could pass back to the parent bank in Iceland or use themselves. The OECD calculates that just the domestic love letters, between the central bank and the Icelandic banks, incurred losses to the central bank and the treasury of 13% of GDP (OECD, 2011).

7. The financial collapse and political response

The Icelandic banks fell two weeks after Lehman Brothers. On 29 September 2008, Glitnir approached Oddsson at the central bank for help with its looming liquidity problem. To restore confidence Oddsson suggested that the treasury should buy 75% of Glitnir's shares. The effect was not to boost Glitnir but to undermine confidence in Iceland. The country's rating plunged, and credit lines were withdrawn from Landsbanki and Kaupthing. A run on Icesave's overseas branches began.

On 7 October 2008 governor Oddsson made a characteristic decision. Consulting no one and informing only the prime minister (as far as is officially known), he ordered the krona pegged to a basket of currencies at close to the pre-crisis value. When the central bank's chief economist heard about it on the Internet he threw up his hands and exclaimed, 'Oh no, now we are really going down the tubes!' Pegging the krona in a falling market offered an opportunity for those in the know to make a short-seller's fortune. The peg lasted only a few hours, when billions of krona fled the currency. Then, with the reserves exhausted, the governor ordered the krona to be floated, and it sank like a stone. On 8 October the then UK prime minister, Gordon Brown, froze Landsbanki's UK assets under anti-terrorism laws. The stock market, bank bonds, house prices and average income went into free-fall, along with the currency.

The IMF arrived in Reykjavik in October 2008 to prepare a crisis-management programme, the first time the Fund had been called in to rescue a developed economy since Britain in 1976. It found a country in a 'near-death experience', in the words of a senior IMF official (see epigraphs). It offered a conditional loan of $2.1 billion to stabilise the krona; it supported the government's decision to let the banks go bust rather than be bailed out by the taxpayers (which, given the size of the banks' liabilities, was impossible in any case); and it supported the imposition of temporary capital controls on outflows. It also backed the British and Dutch governments' demands that Iceland should honour the obligations of the European deposit-guarantee scheme and recompense them for their bailouts of Icesave depositors.

Meanwhile, Iceland's normally placid population erupted in an angry protest movement, principally targeted at Haarde, Oddsson and the IP, although the SDA's foreign minister was considered tarnished too. Thousands of people assembled in Reykjavik's main

square on freezing Saturday afternoons between October 2008 and January 2009, banged saucepans, linked arms around the parliament building to demand the government's resignation and pelted the building with food.

In January 2009, the IP–SDA coalition broke. To date, Iceland is the only country to have shifted distinctly to the left after the financial crisis. An interim SDA–Left Green Movement (SDA–LGM) government was formed in January 2009 to lead into April's election. In the election the IP was reduced to 16 seats despite the bias of the electoral system in its favour, its worst result since its formation in 1929. Remarkably, this was the first time since World War II that Iceland had a left-wing government, which has been the standard governing power bloc in the other Nordic countries during this time.

8. Icesave debt rejected

The SDA–LGM government came under immediate pressure to repay the Icesave debt; much of the IMF loan was withheld until Reykjavik agreed. The new government was also divided on whether to apply for full membership of the EU and eurozone, with most of the SDA strongly in favour. After long negotiations the government presented the terms they had agreed on the Icesave debt to the parliament in October 2009: €5.5 billion, or 50% of Iceland's GDP, was to be paid to the British and Dutch treasuries between 2016 and 2023 (a high but uncertain part of this would be recovered from the sale of the failed bank's assets).

The government's health minister resigned in protest and five dissidents refused to vote with the government. The bill was forced through on 30 December 2009, against high feelings in the country. On 5 January 2010 President Grímsson announced that he would not sign it into law, out of respect for the national sentiment. In the ensuing referendum (the second in the republic's history) the bill was decisively rejected by 93% of the voters. In the May 2010 Reykjavik municipal elections the SDA slumped to 19% and a comedian was elected as the city's mayor. In October 2010 protests resumed and the coalition conceded the election of a constitutional assembly to draw up a new constitution (the existing one having been inherited from Denmark on independence in 1944). When the (IP-linked) Supreme Court invalidated the election, the parliament reconvened it as a constitutional council.

The British and Dutch negotiators put a new deal on the table, which was put to a referendum in April 2011 and rejected by 66% of the voters. After the 'no' vote, the Icesave case has been referred to the EFTA Court. But in the meantime it seems that the failed bank's assets, slowly being recovered, may cover more than 90% of the outstanding principal. The Icesave debt is no longer a burning issue.

9. The postponed crisis

The cost of losses on loans and guarantees, added to the cost of restructuring financial organisations, brings the total direct fiscal costs of the crisis to about 20% of GDP, higher than in any other country except Ireland (OECD, 2011).[11] But the cuts to the national purchasing power have been more hidden in Iceland than in other crisis-affected countries, because the steep devaluation of the krona (90 to the euro in early 2008 to 160 today) carried more of the burden of adjustment and cuts in public spending relatively less. Krona devaluation raised consumer prices in an import-dependent economy and cut aggregate

[11] Other estimates suggest the total cost is more like 60% of GDP, the amount by which public debt is estimated to rise over the medium term after the crash.

spending, while the indexing of loans to the consumer price index further lowered household and business purchasing power. The devaluation helped to generate a trade surplus for the first time in many years, due mainly to import compression.

GDP contraction stopped in late 2010 at 11% down from the peak, and modest growth is expected for 2011 and 2012. The unemployment rate, only 2% in 2006, has been between 7% and 9% since 2009, relatively low by European standards; but the rate of outmigration, of Icelanders and other European workers (predominantly Polish), has been the highest since the late nineteenth century. Inflation is around 5%, net public debt is manageable, fiscal consolidation is proceeding. The fall in the krona boosted the domestic profits of export firms.

However, the SDA–LGM government announced more cuts in public spending for 2011 and beyond, with the aim of generating an overall budget surplus (including interest payments) by 2013. Local governments have no budget for fresh projects. Hospitals and schools are cutting salaries and sacking employees. The freeze on house repossessions expired in 2010.

Political resistance is rising. People say, 'We have been in this crisis for three years. Surely we can't be expected to take more cuts. This government is working for the financial sector and failing us.' In contrast, the big public spending slashers like Ireland, Estonia and Lithuania now have a worse economic situation to deal with than Iceland, but an easier political one—because their governments cut deeply when the population was too shocked to resist.

10. Where is growth to come from?

What comes after stabilisation? Sustainable economic growth faces at least three big obstacles. The first is that more than half of Iceland's exports are lightly processed natural resources (aluminium and fish) and their response to the now sharply devalued exchange rate faces volume constraints. The overvalued exchange rate of the boom years hindered the growth of non-natural-resource-based export firms or induced them to move abroad. There is certainly scope for the growth of intellectual property-based exports in the information industries and on the margins of the natural resource industries (in fishing services, geothermal turbines, higher value-added food, etc.), but starting from a low base. For now, the potential for an export-led recovery on the back of the depreciated exchange rate is limited.

Second, domestic investment is constrained by weak corporate balance sheets. The simultaneous banking, stock market, property and currency collapses plunged about a third of firms into or close to insolvency. Of the biggest 120 firms, more than half are now (October 2011) controlled by banks. It may take years for enough debt to be written down and enough equity rebuilt to permit significant new investment. Investment was 13% of GDP in 2010, as compared with the long-term average of around 24%, the lowest since records began.

Third, investors face high uncertainty about market conditions. One source is the exchange rate. The currency restrictions imposed after October 2008 have sustained a higher-valued exchange rate than the market rate. Pressure is growing, including from export firms, to remove the restrictions and let the krona further depreciate. But the powerful labour federations are opposed (their members include 85% of the work force). Also, the government is worried that non-residents will seek to convert large holdings of krona-denominated bonds and deposits (about 30% of GDP) into foreign exchange,

resulting in not just further devaluation but collapse. The upshot is that potential investors have little idea of what the exchange rate will be in two or three years.

The other source of uncertainty is political. The governing coalition of the SDA and the LGM stuck together during the crisis, but now that stabilisation is assured it is at loggerheads on some key issues. For example, the SDA, backed by the pension funds, wants to stimulate investment in roads, hospitals and other public assets via public–private partnerships; however, the LGM interior minister will have none of it, being opposed to public–private partnerships in principle.

Meanwhile, the right-of-centre IP, which enabled the bubble to grow through the 2000s, is impatiently waiting to regain its rightful place as the ruling party (for almost all of the past 60 years). Polls show that it has succeeded in convincing a majority of the population that the current government (which took office in April 2009) is somehow responsible for their troubles and it would be re-elected if an election were called tomorrow. Majority opinion in the IP continues to believe that 'alpha Iceland was hit by a perfect storm from abroad', meaning that 'the crisis was not our fault', and it continues to believe in the vision of Iceland as an international tax haven in the North Atlantic and earner of rents from the sale of long-term franchises to the private use of natural resources.

Still, all things considered, the governments of Ireland and the Southern European countries would surely sooner face Iceland's problems than their own.

11. Finance in the driving seat

Iceland illustrates what can happen when banker capitalism gets the state and democracy over a barrel, reworking them to be its useful idiots—while redistributing enough to other elites and the population at large to buy their support. As the boom continued over the 2000s a Minsky effect occurred in banks and non-financial companies as they cut their cushions of reserves, and a second-round Minsky effect occurred in the public administration. The boom induced civil service complacency about the government's regulatory role and a general loosening of civil service procedures (meetings with no minutes, the appointment of senior civil servants on the basis of one-on-one meetings with the minister, etc.). Concern about the appointment of people to public positions with a clear conflict of interest—e.g. a state prosecutor in the line of responsibility for a case involving his son—tended to be anaesthetised with a shrug of the shoulders and the claim that it was merely a 'coincidence of interest'. Then as the banks got into trouble the pre-existing shadow elite gained even more room to manoeuvre as the government tried to rescue them without imposing conditions, telling itself and the public that protecting the private interests of the banks was in the interest of the public.

The IP–SDA government's decision in 2008 to provide *unlimited* bank deposit guarantees to domestic savers illustrates its debt to the financial elite and the strength of financial corporatism. Had it limited the guarantee to five million krona ($70,000), it would have protected the entire deposits of 95% of depositors; only the wealthiest 5%, including many politicians, benefited from the unlimited guarantee, which now further constrains public spending.

Iceland's tiny scale seemed to make it easier for the public to challenge the government's financial deregulation and then its denial of impending crisis, but the opposite was true. The predominance of positive feedback mechanisms generated bandwagon effects and herding behaviour; the few economists and others who raised concerns were marginalised (Baumgartner and Jones 2002). The main media were controlled by people close to the

dominant political parties supporting the financial project. The Oddsson government abolished the National Economic Institute in 2002, which had established a reputation for independent thinking, sometimes critical of the government. From then on the banks, international rating companies and the Chamber of Commerce provided almost the only information and running commentary on the economy; in effect, the supply of relevant public information was privatised (Wedel, 2009). The powerful Confederation of Labour might have been a cautionary voice, but for decades it has been the co-manager, with the Federation of Employers, of the enormous pension funds[12] (Baldvinsdóttir, 1998) and, as such, inclined to favour people and policies promising high rates of return to assets. While the boom lasted it was all too willing to buy in to the bankers' claims that Iceland had discovered a new sustainable growth model.

Paradoxically, a number of critical reports were published when the bubble was in the early stages, including one by the central bank. However, by 2007–08, when the dangers were acute, reports became noticeably softer in tone, including those from the IMF. It seems that the official financial organisations understood that the situation was so fragile that just to speak of it might trigger a crisis. From the perspective of the top politicians the less they knew about negative information the more easily they could escape accountability (Logason, 2011).

What has been the follow-up? In terms of holding people to account, in October 2010, the parliament decided to charge Prime Minister Haarde for breach of ministerial responsibility. The permanent secretary of the finance ministry (and former member of the Locomotive group) has been given two years in prison for using inside information for his personal advantage when selling his shares in Landsbanki in September 2008. But the special prosecutor in charge of the investigation of the banks has been working with a team of 60 lawyers and others for more than two years and so far brought no charges. He does not expect to finish until 2014, by which time the IP will probably be back in power and concerned to 'let bygones be bygones'. 'Iceland's talent pool is so small, we should harness the skills of the bankers rather than prosecute them', is the commonly heard sentiment.

Meanwhile, Oddsson was appointed in September 2009 as editor-in-chief at *Morgunblaðið*, the leading Iceland daily newspaper, and orchestrated the coverage of the crisis. A commentator said that was like appointing Nixon editor of the *Washington Post* after Watergate. The elite looks after its own.

The government has driven through impressive reforms to the financial regulatory regime, but has so far managed to do little to make the public administration work in a more bureaucratic, less informal, less clientelistic way.

The constitutional council presented a draft constitution in July 2011, after intense Internet-based consultation with the population at large. The draft helps to crystallise out what the saucepan-banging protestors were protesting *for*. It directly tackles the reform of public administration and the ownership of natural resources. If approved in a national referendum it would provide a constitutional obstacle to the modus operandi of the dominant political parties—which may try to stall its approval indefinitely (Gylfason, 2011A, 2011B).

The IMF comes out of its Icelandic experience if not smelling of roses, then certainly as a more user-friendly organisation than the one that in 1997–99 dictated harsh austerity and market opening to countries swept up in the East Asia/Russia/Brazil crisis (Grabel, 2011; Wade, 1998). It did not press for quick 'fiscal consolidation' (knowing that the steep

[12] The pension funds now equal 130% of GDP.

devaluation was helping to spread the downward adjustment of purchasing power quickly over both the public and private sectors in an 'apolitical' way); it went out of its way to consult widely and transparently; it supported controls on capital outflows; and it brought in technical experts to help restructure the banks. At the same time the left-wing government in power since 2009 has made it a high priority to use the welfare state and employment legislation to protect people at the lower end of the income scale, as reflected in the low proportion (14%) of the population who say they are finding it 'very difficult' to make ends meet, well below the European average. Whether the government will reap electoral rewards for doing so is another question, as the IP and its shadow elite wait impatiently to reclaim their rightful place at the centre of power and resources. But so far, at least, Iceland stands as a rebuke to the new classical economics prescription for bank bailouts and steep public spending cuts as the way to satisfy financial markets and create jobs.

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