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ICELAND AND THE CURRENT ECONOMIC CRISIS – POLITICAL IMPLICATIONS AND THE WAY FORWARD

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1. **CAUSES AND CONSEQUENCES:**

Since the fall, Icelanders are still debating whether they were the innocent victims of outside events or if they are themselves to blame for their misfortune. Although the international crisis (the fall of Lehman brothers) was the spark that ignited the fire, there is ample evidence to show that Iceland was headed for a fall. It was only a matter of time.

In April 2008, half a year before the crash, **Willem Buiter and Anne Sibert**, well-known experts in international finance, delivered a report on the health of the Icelandic banking system. Their conclusion was, that the collapse of the banking system was the predictable end of a "*non-viable business model*". It was a house of cards. It was not a question of IF – but only WHEN it would collapse.

Iceland's state owned banks were not privatised until in the years 2001 and 2002, by a conservative government that was in power 1995-2007. Accepted norms for the privatisation process were disregarded and the banks were handed over to financial groups close to the ruling parties. It was a privatisation *á la Rus.*

In less than six years, those traditional commercial banks were turned into international investment banks or even aggressively risk-seeking hedge funds. Access to easy credit abroad was a recipe for rapid expansion and unsustainable indebtedness. In less than six years the banks expanded, from being equivalent to Iceland's GDP into ten times the GDP. Most of their activity was abroad.

Since those banks maintained their HQ in Iceland, the smallest currency area in the world, the foreign currency risk soon became uncontrolable. The Icelandic CB was not a credible lender of last resort and the Icelandic tax base (220 thousand taxpayers) was hardly a credible back-up support, when it came to the test. The financial sector had simply grown *too big for Iceland* or *Iceland was in the end too small* for the financial superstructure.

When easy credit dried up; when the banks could no longer refinance their debt since the credit-rating agencies imposed risk-surcharges, that in the end became prohibited, the game was up. The closing of loan lines made the first bank insolvent. When the UK government, acted in the interest of British savings depositors, froze the assets of other Icelandic banks in London; and even went so far as to apply recently adopted terrorist legislation against not only the Icelandic banks, operating in London, but also against the Icelandic CB and the Icelandic government as well, the *Icelandic financial system in its entirety* collapsed.

On the basis of a national emergency legislation, the banks were nationalised. Since then, officials of the nationalised banks have been negotiating with foreign creditors on the settlement of debt. The aim is to restore new banks from the debris of foreign debt, with the domestic assets being bought from the old bankrupted banks. This policy was adopted from Swedish precedent during their financial crisis in the early 1990s.

As a consequence of all this, Iceland is by now burdened by a mountain of debt. In addition to the banking crisis, Iceland was hit by a devastating *currency crisis.* Around 100% devaluation of the *krona*, doubled foreign currency denominated debt at one stroke. In addition, the inflationary spurt, caused by the devaluation, has increased the debt burden in domestic currency, because of the Icelandic system of indexing debt to the consumer price index (CPI).

According to the latest IMF estimate, Iceland's sovereign debt now amounts to 160% of GDP. The national debt – taking into account municipalities, companies and households – is estimated at more than 300% of GDP. This is despite the fact that foreign creditors have been forced to write off huge amounts of their loans to the Icelandic banks. Debt service is estimated to take between 1/4 and 1/3 of decreased budget expenditures for the next few years.

From having been rated, before the crash, as the sixth richest country in the world (in terms of income per capita) Iceland is now on the brink of insolvency. The daily news are dreary indeed: Serial bankruptcies, mounting unemployment and loss of property by a quarter of households. The state has suffered enormous loss of revenues at the same time as social expenditures explode. The state itself, *which before the crash was almost free of debt*, has lost its creditworthiness. State bonds are now reduced to junk-bond status and access to financial markets is closed. Because of discounted asset prices and sharp contraction in GDP, Iceland's ability to pay its debt, is seriously in question.

The sheer scale of this financial mess is beyond Icelanders' ability to sort out on their own. The Icelandic government has simply no choice but to seek outside help. Cap in hand, they sought help from the other Nordic countries. But the loss of confidence in the Icelandic government's ability to deal with the problems meant, that any financial assistance was made conditional upon Iceland's applying for a rescue plan from the IMF.

2. POLITICAL IMPLICATIONS

The *social contract* underlying a capitalist market society means that the pursuit of maximising profits by the owners of the capital is acceptable to society at large, as long as the capitalists accept the rules of the game and pay their taxes for the common good of society. Incentives for maximising profits – privileges, bonuses and excessive wage differentials – are justified in the name of efficient allocation of resources, necessary for economic growth.

Specifically, fat profits are justified by the *high risk* taken by venture-capitalists, under uncertain circumstances; they are rewards for the capitalists' willingness to accept risk. If those basic premises of capitalist society no longer apply – meaning that in spite of private gain, the public is forced to cover the loss and bear the burden of debt – *then the basic premise of the social contract is no longer valid.* The whole legal framework of the protection of ownership rights is put into question. We are then faced with a deep **moral hazard**. This sets an indecent example. Why should capitalists observe prudence and play by the rules, if they know beforehand that they will be bailed out; that they will get away from any responsibility for their actions?

Allow me to cite an example from the Icelandic saga. In order to escape its dependence upon the financial markets for the continuous refinancing of its debts, one of the Icelandic banks tried to secure access to foreign capital by starting retail banking on the internet (called ICESAVE), offering high rate of interest. Whereas other banks operated their retail-banking in the form of *subsidiaries*, under the regulation, surveillance and depositors-guarantee system of the host country, this bank chose the form of establishing *branches* from their Icelandic HQ. Thus it was acting under the rules and regulations and *deposit insurance* of the home country.

This was the national bank of Iceland. When it collapsed, it had attracted savings from 400.000 customers, mainly in the UK and Holland, to the amount of 4 billion euros. Under a EU-directive, adopted into Icelandic law in 1999, Iceland was legally obliged to operate a savings depositors insurance fund, to cover the repayment of the minimum amount of ca 20.000 euros. This fund was duely established. But because of the miniscule size of the Icelandic banking system, and because most of the banks' activity was abroad, the fund was nowhere near to be able to cover the minimum insurance.

In most European countries, the failure of individual banks could be covered by the insurance guarantee system. But in the case of the failure of the *entire financial system* of a country, the guarantee funds would be wholly inadequate. This raises the question of who is responsible. The EU-directive does not stipulate a *state guarantee*. But who is then to make sure that the legal obligation of guaranteeing minimum savings accounts, will be honoured, if the worst comes to the worst?

The EU-directive does not explicitly imply, that taxpayers should pick up the bill, left behind by risk seeking bankers. Who is then responsible? In the case of *systemic failure* it is only the country concerned – which in the case of Iceland, due to its smallness, places an unbearable debt burden upon innocent people. Or should there be a common responsibility, shared by the *European union* as a whole, due to the illogical imperfection of its own regulations. This is a question that may be relevant for other small countries within the EU too.

The widespread resentment felt by the general public in Iceland and the sense of injustice at being forced by the EU, through the IMF, to accept the moral obligation – if not a legal one – to pay the enormous debt left behind by irresponsible venture-capitalists, has *poisoned the atmosphere* surrounding the domestic debate, concerning Iceland's application for membership in the EU.

Immediately after the crash a strong majority among the public was convinced that EU membership and the prospect of adopting the euro in the near future, was part of the long-term solution to Iceland's problems. Now, when the IMF has delayed the crucial review of their rescue programme for Iceland for more than half a year, since the British and Dutch governments have made it conditional for Iceland to accept responsibility for the bankruptcy of private banks, polls indicate that public support for seeking EU membership is rapidly vaining.

There is another ironic paradox concerning domestic politics in dealing with this disaster, that may be relevant for this audience. It was a conservative government, continuously in power for three consecutive electoral terms that landed Iceland in this intractable mess. It was the explicit policy of the ruling conservative party to turn Iceland into an international financial center; to make the country a “show-case” for market liberalism. And to turn it away from the “uncompetitive” Nordic model which was deemed to be inferior.

A spontaneous protest movement “drove the rascals out” and demanded new elections in April this year. Those elections brought the left to power, a coalition government of social-democrats and left-greens. Thus the left has been called upon to clean up the mess after the right wing experiment with neo-liberal economic policies, that in the end left the nation almost bankrupt.

This means that the left is forced to accept the terms of the IMF for its rescue programme, including deep cuts in social expenditure and a steep rise in general taxation, in order to enable the country to pay off its debts. Of course the heavy sacrifices that are called for by the restoration programme, are deeply unpopular. By now there are indications that the conservatives and their earlier partners, now in opposition, are gaining ground again, making one wonder about the short memory-span of the electorate, in times of political termoil.

3. ARE THERE ANY SOLUTIONS?

Iceland’s problem is basically its heavy indebtedness, its loss of creditworthiness and the risk that the debt service will prove to be beyond the country’s *ability to pay* – thus inviting the dire prospect of national insolvency.

He who is indebted is not free. This applies to nations just as individuals. Highly indebted nations are at the mercy of their creditors. In the case of Iceland that means IMF-receivership, under the preordained conditions of the “*Washington consensus*”.

The IMF-rescue programme is based on the following four pillars:

- (1) attempting to *stabilise the national currency* through a combination of a high rate of interest and capital controls, aimed at preventing capital flight.
- (2) *negotiations with foreign creditors*, accepting public responsibility for private debt and restoring and refinancing the domestic banking system.
- (3) *fiscal austerity* according to the IMF-rulebook: that means deep cuts in social expenditure as well as a steep rise in taxation.
- (4) restoring the economy to health, stimulating economic growth, enabling the government *to repay foreign debt* under a programme reaching far into the future (2024).

To support the programme there is an additional loan package from the IMF, the Nordic countries and Poland, to enable the government to stand by its obligations and to strenghten the foreign currency reserves of the CB, meant to stabilise the krona.

What are the prospects for success? It remains to be seen, but the experience so far, more than a year after the crash, is not very encouraging. Inflation has not been brought down to anticipated levels. The rate of interest remains high. The currency has neither stabilised nor gained strenght, from the depth of devaluation. The planned abolition of capital controls risks a new dive in the value of the krona, if implemented prematurely with forseeable disastrous consequences. And the fiscal austerity programme risks reducing purchasing power still further, and thus to weaken effective demand.

Ironically, the weakness of the national currency, after massive devaluation, means that the Icelandic exports – fish, aluminium and revenues from tourism, as well as those sectors that compete with imports - have gained a *competitive advantage*. To holders of foreign currency Iceland has become cheap. This means that the sky-high trade deficit has been turned around into a positive balance. At the same time one should not forget, that devaluation has also doubled foreign debt, meaning that increased foreign currency earnings go mostly into servicing foreign debt.

In this context it is interesting to compare the fates of the sister islands of Iceland and Ireland. Both island economies had been enjoying sustained periods of rapid economic growth. In both countries economic growth had been fuelled by a steady influx of foreign capital investments. In both countries the real estate boom spiralled out of control and turned into a bubble. In both countries the standard of living and the level of consumption exploded. Both economies were feeling the strain of overheating.

But this is where the comparison ends. Cynics are saying that the difference between Iceland and Ireland was one letter and one week. The big difference is that Ireland is a member of the European Union and a partner in the monetary union, using the euro as a national currency. Iceland, on the other hand, has been experimenting with its krona within the smallest currency area of the world, in an environment of free flow of capital, under a regime of wide open financial open markets.

This has turned out to be a world of difference. Iceland has suffered a *twin-crisis*: a collapse of the financial system and a massive devaluation of the krona. The currency crisis has magnified Iceland's foreign debt and caused serial bankruptcies of both companies and households. But Iceland's weak currency – itself the cause of so much misery – evokes the prospect of a quicker recovery, due to an improved competitive position. This raises the question of what price to pay for long term stability? For some the euro may look like a salvation. After the crash, maintaining our own weak currency, Iceland may entertain the prospect of inflating itself out of debt. But at what price, in terms of the stability required for long-term growth?

In assessing the prospect for success or failure of the IMF rescue-programme for Iceland, Icelanders cannot but notice the difference in the recipe applied to them, and to the rescue programmes being pursued by almost every government in the rest of the world. In the US, as well as in Europe and Asia, central banks are cutting interest rates and governments are supporting stimulus-programmes, through deficit financing. This is being done to strenghten effective demand and increase investment and employment, as well as resurrecting productive capacity. This is classical **Keynes** being applied to a deflationary situation, or worse still, *a market failure.*

The IMF programme, as applied to Iceland, goes into a contrary direction. They started by raising the rate of interest, although applying capital controls at the same time, in order to prevent capital flight. The high rate of interest either makes borrowing prohibitive, or its sucks up what little there is left of operating capital in indebted companies. And far from offering a stimulus-package, they are administering a fiscal austerity programme that further reduces purchasing power and effective demand.

How this medicine is meant to be remedial in a deflationary situation, is beyond my economic comprehension. It reminds one uncomfortably of the policy mistakes made by the IMF during the Asian crisis in 1997/98, for which they had to apologise later. Some respectable commentators in Iceland are by now wondering aloud, whether possible future apologies from the IMF to Iceland will not be offered a bit too late – after the damage is done.

4. ARE THERE LESSONS TO BE LEARNT?

Are there any lessons to be learnt from this experience?   Let me first say a few words about the domestic situation in Iceland; and then venture to offer some modest ideas on the need for structural reform of the European and the international financial system.

The present left-of-center government in Iceland, embattled as it is, has proposed, through an application of membership of the European Union, that the main lessons to be learnt from Iceland's debacle, is to *join the EU and adopt the euro*. This is the only way for a small country to escape the risks, vagaries, fluctuations and instability which is the byproduct of a small country maintaining an independent currency area, and at the same time participating fully in globalised markets, hoping to benefit from international trade and foreign direct investments.

The conservative opposition and their partners offer a different reading of the current situation. Although they themselves bear most of the responsibility for landing the country in the current mess, the dominant conservative elite is unrepentently anti-EU maintaining that Iceland will be better off in the future outside the EU rather than within; and with the "flexibility" offered by an indpendent national currency. Due to the deep resentment, felt by the majority of the population, at being forced by "the international community", including the IMF and the EU, to take on the burden of paying the accumulated debt of a few plutocratic cliques, - this resentment and sense of injustice can easily be harnessed in a populist campaign against participating in European integration.

This feeling is actually being substantiated in recent polls. Unfortunately, public support for EU membership has been gradually eroding, under the current circumstances. That may, of course, change, in a year or two, depending on the hopeful improvement of the economic situation; and depending on the ultimate membership-agreement being in accordance with Iceland's basic national interest, when it comes to the ownership, control and utilisation of our natural resources.

Strangely enough, the political line-up in Iceland, when it comes to basic attitudes towards European integration, is quite different from the most common situation elsewhere. In most other countries, the conservative elite within the business community is pro-EU, while the left maybe more sceptical or even antagonistic.

In Iceland the business elite, traditionally close to the conservative party, is either euro-sceptic in the British Tory mould, or pro-American, on idealogical grounds. Those groups tend to look upon the EU as some sort of a socialist bureaucracy, whereas the leading spokesmen of the left-green, although supporting the government, tend to be wary of the EU for being too supportive of the interests of international capital. Admittedly most political parties are split on the European issue. The only political party to have EU-membership on its agenda, consistently since 1994, has been the social-democratic party, with strong support of the trade union movement as well. How this line-up will turn out, in the constellation of political forces, in a year or two, when the negotiated agreement will be put to a referendum, remains an open question.

As a matter of fact, Iceland is *de facto* already a partner in the internal market of the EU, through the EEA agreement (since 1994) and the Schengen regime as well. This means that approximately 2/3 of the *aquis communautaire* have already been adopted into domestic law. Of the 35 chapters under negotiation, 22 are already covered by the EEA. Of those remaining chapters, three will prove to be crucial during the negotiations: fisheries, agriculture and finance. Success or failure in the negotiations, as well as in the ultimate national referendum, will depend on the outcome, in particular of those three issues.

The proposed negotiations have, uptill now, proceeded so far:

- Althingi, the national parliament, aproved the application by a narrow majority on July 16th
- the application was formally presented to the Swedish precidency on July 23rd
- the questionnaire, involving 2500 questions, was presented by the Commission to the Icelandic government on September 8th
- on October 16th the Icelandic foreign minister returned the Q and A dossier to the Commission
- the Icelandic government therefore hopes that the EU Council, meeting in Brussels on December 10-11, will give the *avis* – the green light for starting negotiations, early next year
- Iceland is not expecting any *fast track* treatment during those negotiations – it simply has a shorter way to go due to its EEA and Schengen membership

- the duration of the negotiations is expected to be 12-24 months, depending on the progress made on the crucial issues, as well as on the prospects of recovery from the current recession
- this means that we may expect the national referendum in Iceland at first in early 2012

There are those who maintain that entering into such important negotiations at a time of utter economic weakness – and in a vulnereable negotiating position - as is currently the case of Iceland, is inadvisable. Others point out, that many other countries, including both Finland and Sweden, applied for membership during deep domestic crisis.. A lot will depend on how accomodating or flexible the EU-negotiating stance will turn out to be. Admittedly Iceland is, as was stated in the so called *"agreed guidelines"*, that were negotiated under the French EU-presidency with Iceland in November 2008, in a *uniquely* difficult position. This means, in simple language, that Iceland may need special assistance from the European Union, in order to make membership negotiations successful.

- Due to its heavy indebtedness, Iceland may need special arrangements for *debt-relief*, meaning bilateral negotiations on the terms of repayment and rate of interest.
- Due to the weakness and inexperience of the Icelandic administrative system, Iceland definitely will need assistance in the form of expertise in dealing with the consequences of *international financial fraud.* There will never be a lasting, political reconciliation within and amongst the general public in Iceland, until those actually responsible for this national disaster have been brought to justice. So far, more than a year after the crash, no one has yet been indicted, let alone sentenced for breaking the law. A Parliamentary commission of "three wise men", which was established to investigate political responsibility; and to delineate major political mistakes and actual *breach of duty* among the political leadership, previous governments and institutions, such as the CB and the Financial Surveillance Authority, has unfortunately announced a delay of their final report until early next year.

- A crucial factor in Iceland's recovery programme will depend on the ability to *stabilise the national currency,* in the near future, until Iceland may have recovered sufficiently to fulfill the Maastricht criteria for joining the EMU. In order to achieve this, Iceland definitely needs support in the interim period. The question is: *Does the European Union have the political will and the means to offer such support?*

5. THE WAY FORWARD

What have Icelanders learned from the misfortune that has engulfted the nation?
The Social-science Institute of the University of Iceland has recently presented the results of an extensive and in-depth investigation into the attitudes of the Icelandic public towards optional policies and value systems, in the future. Many questions were asked

on the respondents' attitudes towards the role of the state, the proper functioning of markets, freedom of enterprise, wage differentials and equality of opportunity, as well as on basic attitudes towards the institutions of the welfare state (public education, social insurance and health care) and opinions on democratic reform and public participation in the decision-making process. The results can best be explained in the following table:

TABLE 1

This table reveals strong support for the important role of the democratic state in running the economy and strong support for the institutions of the Nordic welfare-state. Those results are presented in the following table 2, where the questions were:
(1) should Iceland aspire to follow the policies and institution building of the Nordic welfare states or
(2) should Iceland aspire to a lesser role for the state and freer reign for market solutions as practised in the USA

TABLE 2

As shown in table 2, an overwhelming majority of respondents gave positive answers to the following questions:
(1) Is it important to preserve and protect the healthcare system, despite necessary cuts in social expenditure?
(2) Is it important to preserve the social insurance system during the current economic crisis?

The answers to those question gave a strong indication of what the general public has learnt from the economic failure of their country and the subsequent political upheaval.

If there are any other lessons to be learnt from the Icelandic crisis, surely they will have to include the following:

(1) In a world of massive and unfettered capital movements across national borders, a tiny independent currency area does not have a chance of survival, in a financial hurricane of the present (and future) fortitute.
(2) Had Iceland shown the foresight, like Ireland, of joining the EU and aopting the euro, when it fulfilled all the Maastricht criteria, following in the footsteps of her former EFTA-partners (Finland, Sweden and Austria) in 1995, or in the period thereafter, Iceland surely would have had to face the domestic bank-crisis, - but the people would have been spared the devastating currency crisis, which now threatens to make Iceland's foreign debt burden unbearable.

Looking beyond Iceland, to the overall picture of the international financial crisis, the question of what needs to be done is waiting for an answer. May I, in all modesty, propose the following ideas:

(1) For the other small nations of Europe, in central and eastern Europe, the lessons seem to be to speed up disciplinary economic programmes, with the aim of fulfilling the Maastricht criteria for adopting the Euro.
(2) For the EU as a whole, it is time to reconsider *the regulatory framework* for surveillance of financial markets as well as to coordinate the EU-wide insurance guarantee-systems for savings depositors.
(3) For the world at large, the lessons to be learnt from the current spectacle of financial markets run amock by greed and recklessness, are to reimpose discipline, through an international agreement on a new regime of tough *regulation and supervision* – with harsh disciplinary powers against errant actors.
(4) The final lesson to be learned by the international community is to put an end to the shady operations of tax havens, in the midst of Europe, as well as in faraway places, operating as moneylaundering shelters, beyond the reach of the rule of law.