The Crisis

Iceland as Icarus

Robert Wade

Did Iceland fly too close to the sun? We have rarely had a case when a nation so avidly adopted an economic model that was bound to fail. Iceland became the poster child for this economic crisis. Robert Wade documents it graphically.

> International markets are concerned that this pace of growth [of bank balance sheets] has exposed the Icelandic financial system to vulnerabilities that could undermine its health as the economy adjusts to restore balance. Potential vulnerabilities include considerable near-term refinancing needs, credit quality, the long-term sustainability of the banks' presence in the domestic mortgage market, and the crossholdings of equity.
>
> —IMF, *Staff Report: Iceland*, July 13, 2006

> In public debate [in Iceland] it is often said that things are not as good as in our neighbouring countries. The other Nordic countries are the reference point. . . . The Chamber of Commerce suggests that Iceland stop comparing itself with the other Nordic countries, *after all we are in many ways superior to them*.
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> —*Vidskiptathing Ìslands 2015*, report published by Icelandic Chamber of Commerce, February 2008 (emphasis added)

> It is difficult to get a man to understand something when his salary depends on his not understanding it.
>
> —Upton Sinclair

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In 2007 average income in Iceland was almost $70,000, 1.6 times that in the United States. Reykjavik's shops brimmed with luxury goods, sport-utility vehicles (SUVs) choked the narrow streets, and restaurant prices made London look cheap. Icelanders were the happiest people in the world, according to an international study in 2006, just ahead of Australians. They also enjoyed the least corrupt public administration in the world, according to Transparency International's Corruption Perceptions index, an honor shared with New Zealand and Finland in 2007.

Neoliberals around the world hailed Iceland as vindication of free market principles. During the fourteen-year reign of Prime Minister David Oddsson from 1991 to 2004, the government deregulated and privatized the economy, invoking Thatcher's Britain, Reagan's America, Lange's New Zealand, and even Pinochet's Chile as models.[1] Arthur Laffer was only the last of a long stream of libertarian ideologues to visit Iceland and preach the gospel. In the fall of 2007 he assured the Icelandic business and libertarian community that fast economic growth with a large trade deficit and ballooning foreign debt was a sign of success. "Iceland should be a model to the world," he declared, in what psychologists would call a stunning demonstration of the "halo effect."[2]

However, in the second half of 2007, as the subprime crisis gathered strength in the United States, articles appeared in the international press about Iceland as the "canary in the mine." They suggested that tiny Iceland (population 315,000) was a leading indicator of how the subprime crisis was mutating into something much bigger, affecting many countries beyond the United States.

The country had built up eye-popping imbalances. The current account deficit was close to the biggest in the world, at 24 percent of GDP in 2006; the stock market had shot up nine times between 2001 and 2007, a world record; and the assets of its three main banks had risen to almost nine times GDP, second in the world after Switzerland, elevating all three banks into the ranks of the world's 300 biggest banks and putting them far beyond the capacity of the central bank to support them as lender or market maker of last resort.

In the summer of 2006 the International Monetary Fund (IMF) had rung the alarm bell as loudly as it could in its country report on Iceland (see first epigraph). Several foreign economists, as well as Icelandic economists, warned of big dangers ahead. Yet the Ministry of Finance, the central bank, and Iceland's Financial Supervisory Authority (FSA) allowed the party to continue, and Icelanders continued to borrow—often in loans denominated in low-interest Swiss francs, Japanese yen, or U.S. dollars—as though there was no tomorrow. The prevailing spirit was caught in the Chamber of Commerce's admonition, in February 2008, that "Iceland stop comparing itself with the other Nordic Countries, after all we are in many ways superior to them" (see second epigraph).

Then at the end of September 2008, reality bit. Within a week the three big banks had collapsed and were taken into public ownership. Since then Iceland has been pioneering an uncontrolled experiment in how a modern economy can function without an international banking system. The currency collapsed. The IMF was called in and, among other things, approved tight foreign exchange controls. GDP in 2009 will probably contract by at least 10 percent. Unemployment had shot up to 8 percent by February 2009 and continues to climb (from 1.5 percent in September 2008); many more people are taking wage cuts. The central bank interest rate is 18 percent, about the same as the rate of inflation (now falling). Sovereign debt is probably well over 100 percent of GDP. The losses of the banks look likely to amount to some $90 billion, although a forensic accounting has still not been conducted.

Out of the normally placid population, a vigorous, well-organized protest movement has emerged. In response to the persistent expression of public outrage, the government resigned in late January 2009, paving the way for early elections in April. It is the first government in the world to resign in response to the global crisis.

This is the Icarus story in modern dress. Icarus sought to escape from exile in Crete using a pair of wings fashioned from feathers and wax. He was warned not to fly too close to the sun. But, overcome by the excitement of flying, he did fly too close, the wax melted, and Icarus plummeted to the sea.

The following account begins with a historical sketch of the country's political economy, then describes the crisis and the buildup to it—with a particular focus on why the government hardly responded to the growing imbalances, and finishes with a discussion of the complexities of pursuing the widely mooted "solution," Iceland joining the European Union and the eurozone.

Iceland's Political Economy

Rising financial fragility over the 2000s and the lack of regulatory restraint can be understood partly in terms of the structure and operation of the state, as seen in a potted history of Iceland's political economy.

The country was a dependency of Norway after 1262, then of Denmark after 1380. It gained internal self-rule in 1918 and full sovereignty in 1944. Before the twentieth century, the economy resembled a mix of European "second feudalism" and Latin American *latifundia*. A small number of families owned about half of the landed property, and the Lutheran Church and the Crown owned most of the rest. Land was divided into farms allocated to tenants; at the start of the eighteenth century 95 percent of farmers were listed as tenants. The tenants were rather insecure in their tenancy, and their wage laborers worked in semi-serf conditions, legally bound to seek all-year employment on a farm. The landlords had no interest in allowing the growth of alternative employment in fishing or in towns—so town development hardly occurred, and Iceland's fisheries were exploited from the sixteenth century onward by Basque, German, English, Dutch, and French ships, while Icelanders were confined to seasonal fishing in open rowing boats. The social structure comprised the landlord group, the church hierarchy, the administrative class, a few merchants engaged in the monopoly trade with Denmark, a small proportion of land-owning small farmers, and a large proportion of tenant farmers and wage laborers.[3]

This all began to change quickly after 1902, when the first engine was installed on an Icelandic fishing boat. With big, engine-powered

boats, alternative employment for tenants and laborers opened up, and they flooded out of the countryside into villages and towns along the coast to work in fishing, fish factories, retail, and other "urban" services. The landlords and the administrative class could not stop them. Ever since, the idea of "independence"—from landlords, from other countries—has had powerful emotional resonance in Iceland. It provides the fuel of the great novel by Halldor Laxness, Iceland's Nobel laureate in literature, *Independent People*.

The fact that a relatively high proportion of the population were literate in Icelandic helped this pride in independence. It owed much to the happy accident that the Lutheran Church in Iceland operated in Icelandic and early translated the Bible into Icelandic (whereas the Lutheran Church in Norway continued to use Danish, and the Norse language virtually died out there, modern Norwegian being a dialect of Danish). Pride in the Icelandic language remains core to the sense that "we Icelanders are special."

During World War II several thousand British troops were stationed in and around Reykjavik to defend the island from a threatened German invasion. In 1941 the United States took over Iceland's defense. The foreign forces built vital infrastructure, including roads and airports. Generous Marshall Plan aid after the war helped to build more infrastructure (including hydroelectric power plants) and capitalize the fishing industry. Iceland joined NATO in 1949, and U.S. civilians and soldiers built up the wartime base (Keflavik, the present international airport) and stayed there, several thousand strong, until they withdrew in 2006.

Through the 1950s to the 1980s the economy was closely regulated. The government partially eased exchange controls in the 1960s, but continued to set the exchange rate (an adjustable peg) and influenced the allocation of foreign exchange, set the price of domestic agricultural products and the maximum rate of return in retail, and maintained import controls until the 1960s. It also owned the banks. A former finance minister related that the first decision he had to make on taking office in the 1980s was about the price of Coca-Cola.

Critics called it "a dysfunctional socialist economy," yet Iceland

had an exceptionally good average (but volatile) economic performance from the 1950s to the late 1980s, bringing its average income into the same league as the other Nordics. Indeed, as early as 1980 Iceland was ranked number two on the UN's Human Development Index (reflecting GDP per capita, health, and education).[4] It had a highly educated population, ready to leap into opportunities being opened by the new information technologies, and it produced an export commodity, cold-water fish, with the unusual property of a high income elasticity of demand.

Independent Iceland has long been ruled in a duopoly between the Conservative (Independence) Party and a smaller party—generally since the 1970s the Center Party (sometimes misleadingly translated as "Progressive" Party). The Conservative Party had its economic base in importing, wholesale, transport, insurance, and fishing. The Center party had its economic base in the countryside and the cooperative movement. The Center Party, acting as kingmaker, was able to extract disproportionate rewards in return. Occasionally smaller left-wing parties (social democrats and socialists) got a share of the action.

The complex web of state regulations and state-owned firms and banks allowed each of the two governing political parties to divide up the main "rental" opportunities roughly fifty-fifty, and especially the banks. The central bank was run by three governors—the chairman was usually nominated by the Conservative Party, the second governor by the Center Party, and the third was up for grabs. Before they were privatized, the commercial banks were closely aligned with one or another of the main political parties. If you wanted a large loan, especially if in foreign exchange, you had a better chance by going to the bank linked to the political party you and your family belonged to. When the banks were privatized in the late 1990s and early 2000s, they were bought by friends of the main parties, with next to no experience of modern banking. No foreign ownership was sought.

In fishing, Iceland moved to a quota system in 1984, and the government allocated the quotas to ship owners in proportion to their catch

in 1981–83. But this equated to giving them to friends of the two main political parties, for free. In 1991 the quotas were made transferable, allowing the original owners to sell or rent them or pledge them as collateral against loans. Although the fish stocks are defined in the constitution as the common property of the nation, the state receives next to no rent from their exploitation.

Similarly within the government: ministries and civil service positions were divided between the parties. Recruitment and promotion in the civil service often depended on support from one of the political parties, and it was not unusual for senior civil servants, including permanent secretaries, to be officers in a party hierarchy. A former Social Democratic Party finance minister related that when he took office, the permanent secretary of the ministry was simultaneously the chair of the finance committee of the Conservative Party.

Then came the radical deregulation and privatization of the economy between 1991 and 2004, under Prime Minister David Oddsson. While the government cut taxes on business and financial earnings drastically, it raised taxes on low- and average-income earners by enough to raise tax revenues from 39 percent to 49 percent of GNP between 1995 and 2006.[5] This result was wrongly hailed as proof of the proposition dear to supply-side economics that tax cuts on business increase tax revenues.

But the civil service and the political structure remained largely intact during the economic reforms. The cozy duopoly between the Conservative and Center parties continued, and also the importance of political-party ties in public-sector recruitment. While Iceland was celebrated as a neoliberal model, public-sector employment grew, bringing more of the population into the sway of the two political parties.

In short, Iceland's economy for most of the postwar period was more inward-looking and more regulated, and its economic management more politicized, than its European neighbors. Now back to the present.

The Meltdown

Iceland's meltdown began at the end of September 2008, when the central bank refused to bail out Glitnir Bank, which went into receivership; and within a week Landsbanki and Kaupthing, the other two big banks, also collapsed. All three passed into public ownership. The Icelandic krona (ISK) fell from about 90 to the euro at the start of 2008 to 190 in November 2008—a massive cut in purchasing power. The foreign exchange market stopped working; international investors are unable to sell ISK except in small quantities in a parallel offshore market, and foreign exchange is available only for government-approved imports. The stock market collapsed by about 98 percent in 2008. The senior bonds of the banks are currently trading at between 2 and 10 percent of their face value. Average gross national income fell from 1.6 times that in the United States in 2007 to 0.8 times that level in February 2009. These are measures of the calamity.

An IMF team arrived in October and prepared a crisis-management program.[6] To stabilize the ISK it offered a loan of $2.5 billion, and other Nordic central banks offered the same again; and the IMF approved stringent foreign exchange controls to stop capital from fleeing. It also called for an increase in the central bank interest rate from 15 percent to 18 percent, and moderate fiscal tightening, with the main pain to come in 2010. It helped the government begin to restructure and recapitalize the banking sector. Since February 2009 the IMF has stationed a staff member full-time in the central bank.

Iceland's meltdown is much more severe than in the United States or the UK (for all that London is now sometimes referred to as "Reykjavik-on-Thames"). The United States has a bust banking system and millions of insolvent households, but the government (the sovereign) is able and willing to socialize private losses by increasing public debt. The UK is in a similar position. Its public debt/GDP ratio is about 40 percent, low enough for the government to absorb the fiscal costs of bailouts and the costs of additional fiscal stimulus and still not go much above 60 percent, which is doable. Iceland, however, has a currency crisis, a banking crisis, and a near sovereign debt crisis. Its

banks' losses are much bigger than the capacity of government to bail them out, and its sovereign debt is probably well over 100 percent of GDP, though estimates vary widely, even four and a half months after the crisis hit.

The striking feature about Iceland in February 2009 is the disjunction between what one sees with the eyes and what one hears with the ears. It looks very prosperous, as before. Traffic in Reykjavik is heavy, few people have switched from cars to buses (bus ridership in 2008 held steady at 2007 levels, having steadily fallen for years), and scarcely anyone has switched to motorcycle or bicycle. The boutiques still display designer clothes that would grace the fashion houses of Paris.

But money market funds have collapsed, savings accounts are frozen, and international banks refuse to make transactions in the ISK. The Swiss bank UBS has informed clients living in Iceland who have ISK accounts with the bank that it will not even allow them to transfer krona from their UBS krona account to their krona account in an Icelandic bank. The financial sector, which accounted for 8–10 percent of GDP and about a thousand mostly highly paid jobs in Reykjavik, has now shrunk to a fraction of its former size. The number of people turning up for free food at Reykjavik's three food distribution centers (sponsored by the Salvation Army and nongovernmental organizations) has shot up since October 2008.

Just about every conversation at coffee break and dinnertime turns on the crisis, fueled by visceral anger at the government and the bankers and fear of what the future will bring. Under the sponsorship of the newly formed Voices of the People, some 2,000 to 10,000 people—many of them middle-aged and middle-class, not stereotypical protesters—have gathered in Reykjavik's small central square every Saturday afternoon since October to articulate popular demands on the government. Sometimes they stand elbow to elbow for two hours in subzero temperatures, cheering the speakers, banging saucepans, lighting fireworks, and pelting the adjacent parliament building with eggs, paint, and other (soft) objects. Every Monday evening, up to a thousand have attended meetings in Reykjavik's biggest theater, at one

of which government ministers petulantly took questions.

Visitors to Buenos Aires in 2000–2002 reported a similar atmosphere—an outward semblance of prosperity, combined with desperate anger on the part of middle-class households suddenly plunged into debt, poverty, and anxiety. In Argentina four presidents were turned out of office in a single month. Iceland lags behind this particular curve, because the president remains in place.

Was a Meltdown in Iceland Likely Even Without a Global Crisis?

Two stories circulate in Iceland. The first, championed especially by the long-ruling Conservative Party, is "Alpha Iceland hit by global perfect storm." It says that Iceland's meltdown was caused largely by the U.S. and the UK crises and their respective governments' responses. To the extent that factors internal to Iceland mattered, they were merely "psychological factors," such as fear of contagion from elsewhere, not structural factors rooted in Iceland.

There is no doubt that the global financial crisis, which began to spiral out of the United States and the UK and go global in the summer of 2008, made the situation in Iceland much worse than it otherwise would have been. There is also no doubt that what the Icelandic bankers were doing was just an extreme version of what bankers in the United States, the UK, and other parts of the Anglo-American world were doing; and that what the Icelandic regulators were not doing was just an extreme version of what regulators in those other countries were not doing.

Nevertheless, the second story, "Iceland was an accident waiting to happen, global crisis or not," is more plausible. Any of many events could have triggered a meltdown, for two main reasons.

First, the idea of making Iceland an international banking center in the North Atlantic was crazy from the start.[7] When Icelanders celebrated the fact that their tiny country had three banks among the world's biggest 300 banks, they ignored the dangers of having such big banks domiciled in a small economy with its own small currency,

small tax base, and unrestricted inflows and outflows of capital. The banks became far too big for the Icelandic central bank to function as their lender or market maker of last resort or to recapitalize them out of Iceland's tiny tax base. The banks should never have been allowed to grow to such a size while remaining domiciled in Iceland. Some of the Baltic economies had also loaded up on foreign debt and are now in crisis, but not as badly, because they were not trying to make themselves into international financial centers, and the banks operating there were mostly foreign owned, with foreign lenders of last resort.

There is no mystery about how it happened. The publicly owned, locally oriented, "savings and loan" type banks were quickly privatized in the late 1990s and early 2000s, sold to owners friendly to the ruling political parties, deregulated, and set loose. They quickly transformed themselves from "utilities" doing retail banking to "utilities attached to casinos" using their retail deposit base and the central bank's associated pledge of lender of last resort to leverage investment/speculation both on their own account and via their linked private equity firms. They expanded their loans and assets much too fast, domestically and abroad, financing a large part of their activities with short-term borrowed money. Their linked private equity firms bought up large swaths of foreign retailers, including sixteen in Britain, among them the House of Fraser, Hamleys, and Debenhams and the fashion brands Karen Millen and All Saints. In Denmark they bought a large share of the prestigious Magasin chain, merged two Danish airlines to create the low-fare Sterling Airlines in September 2005 (which by the end of 2005 had 1,600 employees, twice the size of Icelandair, the national carrier), and launched a free daily newspaper in March 2006.[8]

By 2007 Iceland had a ratio of bank assets to GDP of just under 9, the second highest in the world behind Switzerland. Switzerland's ratio was much too high for safety, but at least Switzerland had long experience of international banking. A simple comparison tells the story: Switzerland's ratio of bank assets/GDP rose from about 3.5 in 1994 to 9 in 2007; Iceland's rose from 0.3 in 1994 to just under 9 in 2007.

This is how the banks became an accident waiting to happen. They were in a position similar to that of the savings and loan banks in the United States in the late 1980s, which were hastily deregulated, leaving their inexperienced managers free to play in the big leagues, with little regulatory restraint. The result was the "savings and loan" crisis, which cost several percentage points of U.S. GDP to put right.

The second reason the Icelandic economy would have experienced a financial meltdown even without a global crisis is that the economy had come to be based on a growth model that was more phony than miraculous. In the name of "inflation targeting," the central bank set a high interest rate (15 percent by 2007), which failed comprehensively: it failed to lower inflation, it encouraged domestic households and firms to borrow abroad in lower-interest-rate currencies, and it attracted huge quantities of hot money seeking to benefit from the interest rate differential and from the appreciation of the ISK (by 2007 the stock of speculative capital was estimated at more than 50 percent of GDP). The speculators saw it as a one-way bet, because they knew the central bank would be reluctant to lower interest rates in view of the fact that the likely fall in the ISK would raise the already heavy burden of foreign currency debt of households and firms.

Brokers criss-crossed the country offering cheap loans denominated in low-interest foreign currencies. People borrowed with little thought to the dangers; household debt reached 103 percent of GDP by 2007. The financial regulators sat on their hands. Between 2003 and 2007, gross foreign debt shot up to between 700 and 800 percent of GDP. This must be close to a developed-world record for a macroeconomic imbalance.

The combination of high interest rates, capital inflow, and overvalued krona created a boom, and from the early 2000s to 2008 it was bliss to be alive in Iceland. Average income rose to near US$70,000, about the highest in the world, on the back of the overvalued ISK. Icelanders joined oil-rich Norwegians as the only people in the world who found London cheap.

But the growth model depended on foreign lenders' being willing to keep on lending, and the moment foreign capital stopped coming in,

the spiral of debt-driven consumption began to unwind. The process became as damaging in reverse as it was bliss going forward.

Think of it this way: If my tailor lends me the money with which to buy his suits, I will keep buying his suits with his money. For a time I will be very happy and I will be admired by all my friends for my swelling wardrobe. The problem comes when my tailor insists that I repay the credit. Then I will not be so happy, and I may have to sell my suits at fire-sale prices. If lots of clients and tailors are in the same situation, the forced selling of suits pushes down the prices of suits and spreads trouble throughout the suit-making value chain. Or, to return to the real world, the forced selling of assets pushes down the price of assets, and the resulting fall in the capital base of banks obliges them, individually and collectively, to sell yet more assets, pushing the price down again. Icelandic society now faces a long period—several years at least—of having to repay the tailor for years of borrowed consumption.

In a sense, the problem of Iceland is not the current crisis. The problem is how to scale down from the unsustainable consumption standards of the past decade to sustainable living standards for the next decade. Icelanders have been enjoying a nearly free lunch, and at the end of the day, as Milton Friedman said, there is no free lunch.

Could the Government Have Taken Preemptive Action to Soften the Crisis?

There were a lot of warning signs. One was the rise in the stock market by 9 times between 2001 and 2007. Another was the rise of real estate by 2.5 times between 2001 and 2008—in real terms, an annual average of 11 percent. A third was the ratio of short-term foreign debt to foreign exchange reserves (whose conventional danger threshold is 100 percent), which reached nearly 1,000 percent by 2007. After Korea's crisis in 1997–98, people asked how the Korean government could possibly have let the ratio rise to above 300 percent. Only ostriches and ideologues-for-hire could fail to read the danger signs in Iceland—but there were a lot of ostriches and a lot of ideologues-for-hire.

The vulnerability of Iceland's banks was already known to the wholesale money markets by the summer of 2006, when conditions in the global financial market were still healthy and when scaling down would have been possible. It was also well known to the IMF, and to those who read IMF reports on countries of interest to them. The IMF's report on Iceland, based on a visit in May 2006, described the expansion of the banks' balance sheets as "staggering," a word that the always-diplomatic IMF toned down in the published version (July 2006) to "remarkable." It went on to say, "International markets are concerned that this pace of growth has exposed the Icelandic financial system to vulnerabilities that could undermine its health as the economy adjusts to restore balance."

By the summer and autumn of 2006, Icelandic banks found it difficult to sell bonds in order to borrow money, because potential buyers of their bonds became aware that the banks were taking on far too much debt. This should have sent a clear message to the owners of the banks, to the boards of the banks, to the central bank, and to the FSA that something was seriously wrong, and that the banks had to cut back their borrowing and their acquisitions.

Instead, the banks went to the retail money market, by opening Icesave Internet accounts and Singer and Friedlander accounts. They proceeded to suck up retail deposits by offering UK and Dutch depositors a slightly higher interest rate than their own banks were offering. By the time of collapse in October, 108 British local councils had invested £800 million and 15 police authorities had invested another £95 million in Icelandic banks, plus more millions by organizations as diverse as cat rescue charities, Cambridge University, and even the UK Audit Commission.[9] The Icelandic banks' operations in the UK and the Netherlands were registered as a branch, not a subsidiary, and as such it was meant to be supervised by the home rather than the host regulator. The host regulator only looked (if at all) at a branch's liquidity, not at its assets. But Iceland's regulator paid little attention to the overseas branches—even as they incurred giant liabilities against the Icelandic deposit insurance scheme and ultimately against Icelandic taxpayers.

This tactic allowed the Icelandic banks to avoid taking action to make themselves and the banking system safer. Indeed, their success in attracting UK and Dutch deposits encouraged them to take even bigger gambles and to further disregard prudential limits.

In short, it is true that the crash of the Icelandic banking system in September–October 2008 was a direct reflection of the global crisis. But a crash would surely have come anyway, for structural and not merely "psychological" reasons. The structural reasons could have been kept in check by serious regulation: the Ministry of Finance could have restrained the banks by taxation; the FSA could have done serious stress tests of their balance sheets, tailored to local conditions; and the central bank could have restrained them by instruments such as reserve requirements. In contrast, the central bank at first lowered reserve requirements as the boom developed over the 2000s and then left them unchanged, when it should have raised them. The central bank defended itself first by saying that reserve requirements were not a preferred monetary policy instrument in neighboring countries, which is true, and later by admitting that it was responding to pressure from the banks, which did not want them to be raised.[10]

A crash was all the more likely because the banks and the private equity companies (such as FL Group, Exista, Novator, Bauger) fueled their expansion by dubious and possibly fraudulent activities. They were grouped into holding companies controlled by a handful of owners. The banks could sell shares by lending money to a linked private equity company, which pledged only the shares as collateral. The investment companies could buy assets at deliberately inflated values with high leverage from their linked banks. These related-party transactions created fake "new capital," appearing to strengthen the balance sheets of both the companies and the banks. They might have been studying the playbook provided by William Black in *The Best Way to Rob a Bank Is to Own One: How Corporate Executives and Politicians Looted the Savings and Loan Industry* (University of Texas Press, 2005), about the deregulated savings and loan banks in the United States.

But it is probably not true that "the crash was caused by fraudulent activities," in the sense that without the alleged fraud the banks would

not have overexpanded. It is quite plausible that most of the activity that generated the financial fragility was within the letter of the (not very specific) law, as was also the case at Enron.

Who Is Accountable?

Who should be held accountable? First, the bankers and the boards of the banks were the active agents in driving their organizations into insolvency and the economy over a cliff. Beyond the banks, the whole Icelandic business model involved converting firms into investment funds, where productive assets were used as collateral to support (foreign) borrowing used for purposes of speculation or prestige. Thus, for example, the CEO of a fishing company used his fishing quota as part of his collateral on a loan to buy an English Premier League football team.

The big question is why the bankers got away with this behavior. Their job, after all, is to make money for themselves and their shareholders in a structure of incentives and regulation designed by political authorities, not to advance the public interest. It is the job of the Ministry of Finance, the central bank, and the FSA to make sure that they do not act in ways that put the stability of the financial system at risk. Their officials are paid high salaries from public revenues to maintain prudential standards and protect the public interest. Yet it is widely alleged that the FSA was captured by the banks and began to act more like a member of the bankers' team than a regulator. This is not to deny that the banks often complained about the paperwork the FSA required them to submit. But this point (now used to counter the suggestion that the FSA was captured) should not obscure that the FSA did not do genuine tests of the accuracy of the balance sheets of the banks and the private equity companies they financed. It may even have helped Icesave to raise deposits in the Netherlands after the UK authorities tried to restrict Icesave's activities (or so people in Iceland's financial community allege). In short, the second category of people who should be held accountable are the regulators in the central bank and the FSA.

Yet not until late January 2009, four months after the crisis hit, were there any changes in personnel at the top of the regulatory structure. This is when the minister of commerce and banking first forced the resignation of the head of the FSA, and then resigned in turn. Then the whole government resigned, taking with it the minister of finance. The new prime minister immediately sent letters to the three governors of the central bank requesting their resignation. One resigned, another announced his intention to resign in June, and Oddsson, the chairman, replied two weeks later that he refused to comply.

Icelanders were ill-served by some foreign and Icelandic economists who looked only on the bright side. Arthur Laffer has already been mentioned. The American economist and subsequently a governor of the Federal Reserve Frederic Mishkin, together with the Icelandic economist Tryggvi Thor Herbertsson, wrote a report called "Financial Stability in Iceland" (May 2006), commissioned by the Icelandic Chamber of Commerce. Their report said, "Although Iceland's economy does have imbalances that will eventually be reversed, *financial fragility is not high and the likelihood of a financial meltdown is very low"* (emphasis added). It was published in the same month that the IMF mission to Iceland came to very different conclusions. Mishkin alone pocketed $135,000 for his contribution to the modest report.[11]

The British economist Richard Portes and Icelandic economist Fridrik Mar Baldursson wrote another optimistic report, "The Internationalization of Iceland's Financial Sector" (November 2007), also commissioned by the Chamber of Commerce. After the present author published an article in the *Financial Times,* "Iceland Pays the Price for Financial Excess" (July 2, 2008), Portes and Baldursson trashed it in a letter to the same paper. They began, "Robert Wade gets Iceland very wrong." They continued,

> In the European Economic Area, Iceland could not get away with "as light a regulatory touch as possible." It has had to apply exactly the same legislation and regulatory framework as European Union member banks, and its Financial Services Authority is highly professional.

Adopting a set of rules is one thing; enforcing them is another (and in any case, the regulatory framework of the European Union is orien-

tational, and it is left to national authorities to translate it into specific legal clauses). To describe Iceland's FSA as highly professional was wishful thinking and begs the question "Professional at doing what?"

Further, they stated, "By end-2007 [the banks'] funding structure was similar to their peers in other Nordic countries, in many cases with better deposit-loan ratios and maturity structures."

However, this conclusion depends on taking the banks' balance sheets at face value (in particular, their asset and goodwill valuations), ignoring their offshore activities, and above all ignoring the fundamental lender-of-last-resort problem.

The Mishkin and Portes reports show selective inattention to data that would upset the conclusions to which they and the Chamber of Commerce were driving. The whitewashers' prestige in the international financial community meant the Chamber got good value for a mere few hundred thousand dollars. The party could continue.

Not only the IMF in the summer of 2006 but also several foreign economists visiting Iceland warned of big dangers ahead, and were ignored.[12] One of them was Robert Aliber, one of the world experts on financial systems and financial crises, who came to Iceland in 2007 and again in 2008 and gave public lectures.[13] In 2007 he drove around Reykjavik counting the number of building cranes and then said in a speech, "You've got a year before the crisis hits." Aliber was asked what should be done to get the government to take the warnings seriously. He replied, "Those who can see what is happening just have to keep shouting, louder and louder." In May 2008 he gave a lecture at the University of Iceland. He suggested that the professional competence of staff at the central bank and FSA was about what would be achieved from random selection of names in the telephone book. At the end, in an off-the-cuff remark, he said, "The bankers were stupid or greedy for buying assets at these inflated prices, and they must now be on planes trying to sell them." This was distorted into the headline blazed across the front page of the main newspaper the next morning (May 6), "Bank run has started." Sure enough, a mini bank run did start.

Why Were the Banks Not Reined In?

All this raises the question of *why* the central bank—the key agency on the government side—did not rein in the financial excesses. Part of the answer revolves around the figure of David Oddsson, the most dominant—not to say domineering—politician in Iceland for many decades. He was prime minister from 1991 to 2004, fourteen years, during which time he was in charge of the privatization of the banks; then foreign minister for a short time; and the chairman of governors of the central bank since then. He was the patron of Prime Minister Geir Haarde, who appointed him governor. (Haarde and his government resigned in late January 2009.) Oddsson's friends and critics alike attest to his manipulative abilities in interpersonal relations, as though he could out-Machiavelli Machiavelli. His many critics describe him as Iceland's J. Edgar Hoover, a serial collector of resentments, feuds, and information about the intimate lives of colleagues to be deployed in later negotiations. Throughout his long political career there is no record of his ever agreeing to participate in a debate with another person. He has agreed to interviews only on condition that he is alone with the interviewer (a "queen interview," as it is called), and as prime minister he was not even subject to parliamentary debate, there being no equivalent of the Westminster model's Prime Minister's Question Time. He does not use a computer or e-mail.

He has not lived outside Iceland, has no background in monetary economics, and understands little about international finance. He is his own expert and likes to dispense with real experts, including those in the central bank. If he had listened to them, he would not have announced on Icelandic TV on October 7, 2008, the day after the collapse of Glitnir Bank, that "The government will not repay debts of people [meaning, given the context of the question, depositors in Icelandic bank branches abroad] who have not exercised due diligence about where they put their money." This sentence was repeated again and again on CNN news broadcasts around the world, and sparked even more panic. He then announced that Russia would provide a large loan, which the Russian government promptly denied. He then announced a peg of the ISK against the euro at a time when Iceland

had hardly any foreign exchange reserves left, a decision he made himself without consulting even the central bank's chief economist. It was about the shortest-lived currency peg on record, less than one day. He at first cut interest rates to 12 percent, and thirteen days later raised them to 18 percent. Thanks to his opposition, it was not until many weeks after the IMF team had arrived and two weeks after it had prepared its crisis-management program that the central bank requested IMF assistance.

So part of the explanation for lax regulation and slow crisis response relates to the figure of the central bank governor, who had a propensity for making decisions more or less on his own on the basis of little understanding of international finance. Another part of the explanation is that the Icelandic central bank was unusually isolated from other central banks, including the other Nordics. One prominent Icelandic official, who worked in international financial organizations abroad for many years, related that in 2008 when the central bank realized it had to seek help from abroad, the governor turned out to barely know the names of his counterparts in the other four Nordic central banks (all of whom were on first-name terms with each other); and other central bank staff also turned out to have hardly any personal connections in the Nordic or British or other European central banks. They were mostly trained in Iceland and the United States, and suffered from a strange combination of arrogance in comparing their go-go society to "slothful," "socialist" Europe, pride in insularity (a kind of "If this wheel is not made in Iceland, I will not put it on my car" attitude), and lack of confidence in dealing with counterparts as the "kid brother." Another foreign monetary economist related that he often went to international meetings of central bankers, where he met central bank governors and staff from Albania, Bosnia, and Malta, but never one from Iceland.

So it was that the Icelandic central bank was hardly even aware that Icelandic banking had developed a bad reputation in the other Nordic countries. It came as a great shock when the agreement between the U.S. and Nordic central banks to provide currency swaps, in September 2008, excluded Iceland, even though Iceland clearly needed

the support and the support was tiny relative to the resources of the Fed and the other Nordic central banks. They probably excluded Iceland on grounds that they did not trust the central bank's figures on debts and assets; that Icelandic banking had serious "reputational problems" (partly to do with allegations of involvement in money-laundering operations for Russian oligarchs); and that none of them had personal connections with Icelandic central bankers.

The Civil Service

Iceland's small size means that nepotism, patron-client obligations, and cronyism (friends of friends) are constant dangers in civil service recruitment and promotion. In political science terminology, the danger is that the bureaucracy functions in a "neopatrimonial" way. The danger is all the greater when the same political party or parties have been in government for decades. In Iceland the Conservative Party has been the dominant party in most governments since the 1930s.

Ministers operate like "small kings," without even the discipline of collective cabinet responsibility under the prime minister. They have autonomy to appoint almost whomever they want. Vacancies at permanent secretary level (the top official position in a ministry) must be advertised and a short list drawn up by an outside human resources firm. But the minister typically decides who on the short list is appointed, not infrequently after conducting only one-on-one interviews with each. Political party allegiance is typically important in the selection.

Once appointed at permanent secretary level, a person has a right to stay at this level for life (a modest reform a decade ago put the permanent secretaries on five-year contracts, almost always renewed). The process is similar for positions like the CEO of a parastatal agency. The other side of this relaxed approach to merit is the employment of consultants on short-term contracts to help the officials do their work.

Other parts of the same syndrome are an intensely inward ori-

entation of each ministry and a lack of cooperation between ministries assigned to different parties in the governing coalition. For example, before October 2008 the governor of the central bank and the minister for commerce and banking (who belonged to different parties) had not exchanged a word during the previous year, despite the fact that their offices are in buildings on opposite sides of a narrow street. Ministries other than Foreign Affairs tend, like the central bank, to have few international contacts. When in October 2008 the Icelandic finance minister (a veterinary surgeon by training) telephoned UK chancellor Alistair Darling about Icesave, they had to introduce themselves to each other over the phone—they had never met, though by then they had each been in office for fifteen months or more.

It is understandable that the civil service insiders in this system have shown little interest in a third-party check, such as an independent civil service commission. Fortunately, successive governments have given high priority to education, including university education (mainly in the United States). The high average level of human capital has enabled Iceland's neopatrimonial bureaucracy to function much better than such bureaucracies elsewhere. But the current crisis might be fundamental enough to provide room for newcomers intent on changing the structure of recruitment, promotion, and remuneration, so that Iceland can go forward with a more professional and more cosmopolitan set of public officials.

European Union Membership

It is puzzling to an outsider that Iceland is already deeply integrated into European and other international treaties and organizations (including the European Economic Area, the Schengen border-control agreement, the Council of Europe [consisting of parliamentarians from more than forty European countries], NATO, the Nordic Council, the Arctic Council, the Organization for Economic Cooperation and Development, the World Trade Organization, and the United Nations) and has accepted the "sovereignty" constraints implied

by these memberships. But a strong political consensus has united groups across the political spectrum against membership in the European Union. Whereas most other nations have modified their implicit concept of sovereignty to include as an important component the right to participate in international organizations and sit at the table where regional and global decisions are being made, a majority of Icelanders have stuck to an older notion of sovereignty as freedom from outside influence—freedom to remain "special" in the ranks of nations.[14] The leader of the Left-Green political party said in 2000, "Membership [in the EU] would mean diminished independence and sovereignty, loss of speciality." A prominent Left-Green politician echoed him, saying that "membership in the EU will undermine Iceland's self rule." Toward the other end of the political spectrum, then prime minister David Oddsson declared in 2002 that the EU was "one of the most undemocratic bureaucratic monsters man has ever created."

The anti-EU forces are able to play on the fishing issue by presenting the gallant Icelandic fisherman as a symbol of the sovereign Icelandic nation whose livelihood would be crushed by Iceland's having to come within the EU Common Fisheries Policy.

In short, the project of applying for membership of the EU has been a symbolic step too far for the political and popular majority, because of the way that sovereignty and independence are conceived. But the current economic collapse may well change the balance of opinion toward seeing the EU as a safe haven from an otherwise fearful and impoverished future. The argument may prevail that Iceland has already accepted most of the constraints that EU membership would entail, and that the government should push hard to get Iceland's fisheries declared a special administrative zone within the Common Fisheries Policy under the full control of the Icelandic government, on grounds that most of the fish stock within Iceland's 200-mile zone remains in Icelandic waters, and is therefore no more a "common resource" than Finnish forests or British oil. The Common Fisheries Policy is aimed—as its name implies—at controlling fishing of shared stocks in common waters.

A New Currency?

The credit crunch has brutally reminded many small European nations that in a world of free capital mobility, keeping their own currency is a recipe for wild booms and busts. Adopting a better-resourced currency looks much safer.

In some Icelandic circles there is talk of *unilateral* adoption of the euro or the dollar or anything other than the ISK. The problem is that the unilaterally adopted currency would have no lender-of-last-resort support and would therefore expose the financial system to even bigger risks than with the ISK. Also, with reference to the euro, such a currency would anger the European Union and make Iceland's negotiations more difficult. It would be inconsistent with the principle that the European Central Bank and the Council of Ministers must set the conversion rate between the applicant currency and the euro. Iceland has no bargaining power for it to risk angering the European Union. Some people want unilateral adoption of the euro precisely because it would make the EU less willing to accept Iceland's application to join the EU. Only one other country in the world has unilaterally adopted the euro: Montenegro. But Montenegro is not a good model, not least because—as a low-income economy—it has hardly any banking sector and did not have its own currency before it unilaterally adopted the euro.

Another possibility is forming a currency union with another country, the most likely candidates being Norway or Denmark. This might be done as an alternative to joining the euro, or as an interim measure while eurozone membership is pursued. In such a currency union, the ISK would be managed so as to shadow the Norwegian or Danish krona, and the other central bank would stand ready to provide currency swap support and maybe more to the Icelandic central bank. This would have substantial advantages for Iceland.

Would it be politically acceptable in the partner country? To illustrate the complexities, take the case of Norway. There is strong popular support in Norway for staying out of the EU. (The country was forcibly subordinated in political unions for 400 years, and many Norwegians—like Icelanders—have no desire to give up a political in-

dependence that is only a century old.) Norway would be less isolated in the European Economic Area if Iceland continued to stay out of the EU, and the two together might even explore the possibilities of North Atlantic Closer Economic Relations (NACER) with the Faroes and Greenland. Norway might also be better placed to defend its fisheries policy against the destructive EU fisheries policy if Iceland did not adopt the EU fisheries policy. So Norway might be interested in helping Iceland to stay out of the EU and the eurozone. On the other hand, many in the Norwegian business elite wish Norway to join, and from their perspective it may be in Norway's interest to help Iceland join—and negotiate an opt-out from the EU's fisheries policy—in order to pave the way for Norway's later accession. Whether to help Iceland stay out or go into the EU/eurozone, Norway may also be interested in the quid pro quo of a lease on the shuttered U.S. air base at Keflavik for its fighter planes to patrol the western reaches of its North Sea oil fields.

Still another option is for another central bank (such as Norway's or Denmark's) to agree to provide guarantees of commercial transactions involving the ISK at home and abroad, in much the same way that an export guarantee agency provides guarantees of export contracts, but on a bigger scale. Or the World Bank could undertake such a guarantee function. This, after all, was the original idea of the World Bank—to provide guarantees for borrowing that a country would make in its own currency: it would issue its own bonds guaranteed by the World Bank. The idea was then dropped in favor of the World Bank's issuing its own bonds guaranteed by the rich-country member states. Regardless of who provides the guarantees, they would help overcome the crippling problem of the lack of trust in the ISK. And the guarantee scheme would entail less commitment of resources by the guarantor organization, be simpler to set up than a currency union, and give Icelanders the advantage of retaining the symbol of their national currency.

Finally, a muddling-through option might be "joint adoption" of the euro rather than unilateral adoption. Iceland would obtain agreement from the European Central Bank, the European Commission,

and, most important, the Council of Ministers (especially Gordon Brown [UK], Nicolas Sarkozy [France], and Angela Merkel [Germany]) that Iceland will adopt the euro alongside the ISK as an interim step to joining the eurozone. The European Commission rejected this idea before the crisis—but the present emergency conditions might induce a rethink. If they agreed, both currencies could be used as legal tender within Iceland, as the euro came to be gradually substituted for the ISK. Whether Europe would play along with a scheme that is against the spirit of the accession procedure but within the letter of the law is an open question.

The Social Democratic Alliance is committed to seeking EU and eurozone membership, and until the crisis was the most popular party. It had entered a coalition with the Conservative Party after the May 2007 elections as the junior partner, but grew in popularity until it surpassed the Conservatives. However, its dogged determination to keep the coalition in power post-crisis eroded its support, to the benefit of both the Left-Greens and the Conservatives. The most popular party now is the Left-Green Party, which in opposition was strongly against EU membership. Since late January 2009 it has formed an interim government in coalition with the Social Democrats and has gone quieter on the EU issue. The Conservative Party, out of power for the first time in decades, is busy trying to undermine both the new government and Iceland's agreement with the IMF.

Conclusion

Iceland is in danger of being trapped in a vicious downward vortex of debt default, unemployment, and an exodus of people, all the more so because the whole eurozone is likely to contract at the rate of –3 percent of GDP in 2009.

The crisis has discredited the strategy of the long-ruling Conservative Party to run the country in alliance with a smaller party, while the rest of the population busies itself with consumption. It tried to handle the crisis in the same way, but its impulse was to some extent thwarted by the intervention of the IMF, the Nordic central banks, and

a few foreign economists with no vested interest in fees or Icelandic society. And, of course, it was thwarted by the remarkable "saucepan banging" movement that sprang up and mobilized opinion in a way not seen since the government took Iceland into NATO in 1949.

The meltdown is already shifting the tectonic plates of Icelandic politics, and its repercussions will occupy Icelandic politics for several more hard years. The newly formed Organization for Civic Action is pressing the parliament to call for a special national assembly to draw up a new constitution of the state in place of the existing one inherited from Denmark. With a new constitution and a more social democratically inclined government in place (the likely outcome of the elections scheduled for April 2009), the society could emerge stronger than before, with a more democratic political system and a more cosmopolitan approach to the rest of the world.

Iceland's collapse will provide a field day for social scientists for years to come. Topics include:

- how measures of "happiness"—and health—are affected when people's livelihoods are threatened en masse and the whole economic structure is thrown in doubt
- how Transparency International's measures of "corruption" could miss the kind of neopatrimonial practices endemic to the Icelandic civil service—and how such a bureaucracy nevertheless delivered good-quality public services in many fields
- how the bankers were able to zoom from obscurity to world players in less than a decade (a Russian money-laundering connection?)
- how the IMF dealt with the first rich country to seek its assistance since Britain in 1976, how it decided to support Iceland's capital controls, and what was the role of the U.S. government and the Nordic governments in its strategy for Iceland
- how timely warnings of danger ahead were drowned out by Panglossian assurances that inflating asset prices equaled rising wealth.

The Iceland case shows that arrangements for cross-border banking supervision and deposit insurance need urgent strengthening. It has exposed loopholes in EU legislation about deposit insurance in the context of bank branches, bank subsidiaries, and online cross-border accounts. And by showing the dangers of mixing commercial and investment banking, it underlines the need to separate them (by re-instating Glass-Steagall, for example). But not just to separate them; also to keep the big commercial banks, performing the key financial intermediation function, in public ownership, even post-crisis. Stable commercial banking has a large public-good element to it, which can justify public ownership. The argument that only private, profit-seeking banks can do financial intermediation well is implausible, now that they have been seen to be acting like drunken air traffic controllers. The experience not just of Iceland but also of the United States and the UK suggests that the combination of incentives for private profit-seeking plus instant communication of optimism and pessimism across the Internet (Keynes's animal spirits) is fatal to the stability and prosperity of capitalism, because real-world regulators are often unable to stop its booms and busts.[15]

—March 1, 2009

Notes

1. Hannes Gissurason, "Miracle on Iceland," *Wall Street Journal*, January 29, 2004.

2. Arthur Laffer, "Overheating Is Not Dangerous," *Morgunbladid*, November 17, 2007. The halo effect is the tendency to assume that an individual or a country that excels on one dimension also excels on many others.

3. In 1703 virtually the entire population of 50,000 gave farming as their main occupation. About half of the landed property was owned by private individuals; of the other half, about two thirds was owned by the Church and one third by the Crown. The landlords frequently held offices in the state, or their sons did. About eighty individuals owned a quarter of the landed property. Half of them were also officials of the state or Church (sheriffs or clergy), and the other half were landlords whose main source of income was farming.

"It was a feudal society in the inclusive sense of being largely ruled by men who made their living from exploiting the labour of peasants" (Gunnar Karlsson, *Iceland's 1100 Years* [London: Hurst, 2000], 155, 165). Around the mid-nineteenth century, 17 percent of the total number of farmers owned their farms, and 83 per-

cent were tenants. The Church owned 35 percent of farms, the Crown 18 percent, and the big landowners most of the rest (S. Snaevarr, *Haglýsing Íslands* [Reykjavik: Heimskringla, 1993]).

4. See Stefán Ólafsson, "Iceland's Economic Miracle: From Prosperity to Libertarianism and Financial Collapse," *Stjórnmál og stjórnsýsla* (Autumn 2008): 231–56.

5. For a detailed study of Iceland's taxation policy, see Stefán Ólafsson, "Taxation Policy in Iceland," *Stjórnmál og stjórnsýsla* (Autumn 2007): 231–63.

6. International Monetary Fund, *Iceland, Request for Stand-By Arrangement*, November 25, 2008, available at www.sedlabanki.is/lisalib/getfile.aspx?itemid=6606.

7. Several Icelandic economists said so. See, for example, Gylfi Zoega, "Iceland Faces the Music," *VoxEU,* November 27, 2008, and earlier articles on *VoxEU* about Iceland. See also Jon Danielsson and Gylfi Zoega, "Entrapped by Banking," *VoxEU,* February 9, 2009.

8. Hyman Minsky would have been only too familiar with their operations. See "The Financial Instability Hypothesis," Levy Economics Institute, working paper 74, 1992.

9. Robert Wade, "Iceland: Wiser Counsels Should Have Prevailed," FT.com, October 19, 2008.

10. The admission that the central bank was responding to the wishes of the banks was made by the central bank's chief economist at a public meeting at the University of Iceland, June 2, 2008.

11. "Mishkin Resigns: A Look Back," *Wall Street Journal*, May 28, 2008; "Ex-Fed Governor's Report on Iceland Stability Missed Crisis," *Wall Street Journal*, October 17, 2008.

12. The Danish bank Danske Bank issued "Iceland: Geyser Crisis," in 2006, warning of big financial vulnerabilities. See http://danskeanalyse.danskebank.dk/link/FokusAndreIceland21032006/$file/GeyserCrises.pdf. Iceland's prime minister publicly denounced the report. Drawing on my earlier papers about the East Asian crisis, I gave the first of several alarm bell talks in Iceland in August 2007, to general disbelief ("us like the East Asians?"). London School of Economics economist Willem Buiter also warned of structural instability in the financial sector in a public talk in July 2008.

13. Robert Aliber, "Monetary Turbulence and the Icelandic Economy," lecture at the University of Iceland, May 5, 2008, available at www.hi.is/files/skjol/icelandlecutre-May-2008.pdf.

14. See Eirikur Bergmann, "Sense of Sovereignty: Iceland, a Reluctant Participant in the European Project," Bifrost University, Iceland, January 2009.

15. Robert Wade, "Reflections on the Global Economic Crisis," *Development and Change*, forthcoming, 2009.

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