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Six myths and few facts, Recovery of the Icelandic economy post October 2008

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Abstract

The relative success of the Icelandic road to recovery in the wake of the 2008 Financial Crisis has been a source of some myth-making. This paper discusses to which extent Iceland refused to bail out bankers and sheltered the sovereign from financial losses. I also argue that Iceland responded to the crisis by Keynesian expansionary policy rather than austerity. Furthermore, I argue that the debt-relief program that the government initiated also was a key factor in cushioning the effect of the collapse of the Icelandic financial system.

Keywords: *Icelandic financial crash, recovery policy, IceSave, boom-bust*

JEL classification: E32, N14, N24

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1. Introduction

Seen from Europe, Iceland has always been far away. Iceland was not discovered until the 9th Century AD at a time when a visit would, in best of circumstances, take weeks on a vessel, capable of crossing the North Atlantic, in addition to advanced navigational skills. But once in Scandinavia or any of the northern islands of the North Atlantic a traveller could deliver news from Iceland in Icelandic (Old-Norse), see Torp & Vikör (2003).

Air-travel and fiber-optics have shortened the time it takes to deliver news, but Icelandic is now a language comprehensible only to Icelanders and the handful of foreigners that have learnt it. Hence, foreigners mostly have only secondary sources to rely on when trying to understand all matters Icelandic. News from Iceland that reach foreigners have normally been translated at least once. Distance lend wings for airing myths and legends. The collapse of the Icelandic financial system in 2008 and the corrective actions taken in order to minimize the damage has been the source of many a myth. This paper tries to disentangle six of them. The combined balance sheets of the Icelandic banks amounted to 8-10 times the Icelandic GDP in October 2008¹ when the bankruptcy of the Lehman brothers, triggered a collapse of the three largest Icelandic banks, whose operation was already seen as fragile. The collapse took most Icelanders by surprise even though many foreign observers had for some time been predicting a “hard landing” for the Icelandic economy, see Hreinsson, Benediktsdóttir, & Gunnarsson, (2010), vol. 6, page 184. Soon after the demise of the Icelandic banks, financial institutions in Ireland, in Portugal, Italy, Spain and many other countries ran into similar problems. The sovereign in some of the troubled countries tried to prevent a financial meltdown in various ways such as by off-loading bad assets off the balance-sheets of troubled banks into special vehicles, guaranteeing payment of liabilities, even supplying fresh money.

Until Cyprus sought a bailout Iceland and Greece were seen as special cases. The sovereign debt of Greece was too big to sustain, the collapse of the Icelandic banks was too big for the sovereign to swallow. Hence, Greece had its haircut and Iceland put its three largest banks into receivership. Both countries sought the help of the International Monetary Fund. Both countries have taken harsh measures to realign their economic structure to the realities of the world.

In early 2015, six years after the demise of Lehman Brothers incidence the situation in Iceland and in Greece is very much different. Unemployment in Iceland has fallen to below 5% from a high of 9,5%. The economy is growing, albeit slowly. Income inequality has been reduced, at least temporarily. The state budget is almost balanced. Greece is on a wholly different track with an unemployment-rate at 25%, and expecting some, albeit slow growth in 2015 following 5 years of contraction [(IMF, 2014); (Hellenic Statistical Authority (EL.STAT.), 2015)]. Income inequality is increasing (OECD, 2013). Table 1 compares GDP growth, unemployment development and central government debt for Iceland, Ireland, Spain, Greece and the OECD.

¹ The Special Investigation Committee into the causes of the collapse of the Icelandic bank system set up by Althing documented that the combined balance sheets of the 3 biggest banks were about 9 times GDP, see Hreinsson, Benediktsdóttir, & Gunnarsson (2010), vol. 2 page 89.

Table 1: Development of Gross Domestic Product, Unemployment levels and Central Government Debt in selected countries adversely affected by the financial crisis of 2008					
	Iceland	Ireland	Spain	Greece	OECD
GDP 2007 (2001=100)	132	134	122	128	116
GDP 2012 (2001=100)	124	124	116	102	120
Unemployment 2007	2,3	4,7	8,2	8,4	5,6
Unemployment 2013	5,4	13,1	26,1	27,5	7,9
Central government debt, gross 2000	33,8	34,8	50,0	108,9	
Central government debt, gross 2007	23,2	19,8	30,0	105,7	
Central government debt, gross 2010	81,3	60,7	51,7	147,8	

Source: OECD iLibrary, retrieved Feb. 9th, 2015. Note that debt figures from national sources may differ considerably from figures reported in the table due to definitional differences. The figures in the table are from the Central Government Debt Dataset of the OECD.

The relative success of the Iceland's road to recovery has been a source of some myth-making. **First:** Iceland refused to bail out bankers. **Second:** the collapse came at no cost to the sovereign. **Third:** the President of Iceland blocked deals forced upon the government by the Dutch and the British². **Fourth:** 50% devaluation of the domestic currency was the key to Iceland's successful recovery. **Fifth:** the government sheltered the wealthy by refusing an across-the-board debt write down³. **Sixth:** it has been asserted that the IMF program has been counterproductive even "toxic," for the Icelandic economy⁴. At a closer scrutiny all of those claims are unfounded if interpreted literally, in other words myths obscuring the true story.

Myth 1: Refusing to bail out bankers

The Icelandic government did not bail out its banks when their liquidity dried up in 2008. That is a fact. But was it intentional, as claimed by the Icelandic President, (Greenstein, 2013) or was it accidental? The math is simple. Iceland was never in

² The successive IceSave-agreements that supposedly would have cost Icelandic taxpayers 4 billion Euros plus interest, or €50.000 plus per family, (Matthíasson & Davidsdóttir, 2012); (Matthíasson, 2013); (Wikipedia, 2013).

³ See for instance Mósesdóttir (2013).

⁴ Mósesdóttir, (2013), Iceland Review, (2009).

position to bail out its overblown banks with balance-sheets 8-10 times GDP. Even if assets of the banks were only written-down by 20% from their estimated value in early 2008 it would have burdened the Icelandic sovereign with a debt amounting to as much as 200% of GDP. More realistic valuation of the banking sector assets (50-70% of early 2008 value) would have left the sovereign with a debt of 300-500% of GDP. Hence, the only relevant questions were related to a) size of a haircut to be accepted by creditors or b) bail-in, i.e. write-down of deposits.

However, the simple calculation of debt-to-GDP ratio related to a bail-out did not stop the Central Bank of Iceland, CBI and the government from trying. There were attempts in early September 2008 and in October 2008 to save at least two of the banks. In September 2008, the sovereign attempted to nationalize the smallest, Glitnir and announced a plan to put up 600 million euros in equity, writing down existing equity to 200 million euros. Later events prevented the plan from completion (mbl.is, 2008). In early October, the CBI granted Kaupthing bank a loan of 500 million euros, ca 36 hours before Kaupthing Bank declared bankruptcy (Hreinsson, Benediktsdóttir, & Gunnarsson, 2010, Vol. 7, Ch. 20). The transaction left the country virtually without any currency reserves, which has proven costly in the aftermath of the crisis.⁵

Myth 2: Sheltering the sovereign

Hand in hand with the belief that Iceland did refuse to bail out bankers it is a widely held misconception that the Icelandic people managed somehow to force foreign banks to foot the full cost of the collapse of the Icelandic banking system. But as Sigrun Davidsdottir and I have shown the expected direct cost accruing to the sovereign due to the collapse of the banking system is in the range of 20-25% of GDP, see (Matthiasson & Davidsdottir, 2012). Our findings are broadly supported by the IMF, (Laeven and Valencia, 2012).

From 2008 and onward the sovereign suffered severe losses of revenue and a surge in crisis-relief related expenditure. Hence, the gross public debt in Iceland increased by 76% of GDP from 2007 to 2011, gross central government debt increased by 71% during the same period (Statistics Iceland, 2015); solid indicators of the direct and indirect cost of the collapse accruing to the public purse. In addition there are the severe losses of the pension system, which consequently has been forced to considerable write-down of pension rights. Losses of the public Housing Financing Fund amount to 20% of GDP. Some of the losses were caused by the collapse of the banks.⁶

It is safe to conclude that while the foreign losses stemming from the collapse of the Icelandic banking system are ca. 5-6 times GDP Icelandic taxpayers and Icelandic pensioners shoulder a burden comparable to $\frac{3}{4}$ of GDP or more (the combined increase in public debt, Housing Fund losses and losses of Icelandic pension funds). The ratio of private losses to sovereign losses and of foreign losses to

⁵ The lack of trust towards Iceland and lack of foreign funds was such that neither the CBI nor the Ministry of Finance were able to guarantee that the Minister of Finance, Árni Mathisen, could use his credit card to cover his expenses while attending an IMF meeting on October 9 2008 in Washington. Árni Mathisen joked in his memoirs that he got the last few dollars in the vaults of the CBI on that occasion. Kaupthing had already gotten everything there was at hand (mbl.is, 2010).

⁶ Asset prices in Iceland were severely overvalued in the run up to the crisis in 2008. Hence, calculating losses based on the maximum value of a portfolio may be misleading.

domestic losses is higher in Iceland than in most other crises ridden countries. These ratios become less “favourable” if correction is made for the exclusively foreign operation of the three big banks.

Myth 3: Iceland will not pay a penny to the UK and the Netherlands towards IceSave

It is a common belief, both inside and outside of Iceland that Iceland will not pay anything to the UK and the Netherlands due to the collapse of Landsbanki. This is unfortunately not true. First some background. In autumn 2006 Landsbanki set up high-interest internet saving accounts, IceSave, in the UK and in spring 2008 Icesave opened in the Netherlands. The Special Investigation Committee of Althingi noted that the introduction in the Netherlands followed a period of net outflow of funds from the UK operation and that plans for openings in new markets (for instance Germany) were in the works in October 2008. Hence, the IceSave operation of Landsbanki had many of the characteristics of a Ponzi scheme.

On October 6th, 2008, in order to contain a rush on the banks in Iceland the government issues a declaration stating full coverage of deposits in Icelandic banks and financial institution covered by the Icelandic Depositors' and Investors' Guarantee Fund, DIGF, (Office of the Icelandic Prime Minister, 2008). In a letter dated October 5th, 2008, the Ministry of Commerce gives a guarantee to Clive Maxwell of the Ministry of Finance in London that the Government of Iceland would support the DIGF in raising necessary funds to meet its obligations in the UK in the event of a failure of Landsbanki, (Hreinsson, Benediktsdóttir, & Gunnarsson, 2010, Vol. 5, p. 292). Similar pledges had been given in an e-mail exchange in late August.⁷

On October 7th, 2008 Landsbanki collapsed. The collapse triggered the establishment of the New Landsbanki and a claim against the DIGF. The New Landsbanki did overtake assets, mostly Icelandic, and domestic (i.e. Icelandic) deposit liabilities of the failed bank. The value of assets transferred was higher than the values of liabilities transferred to the new bank. To close this gap and compensate the creditors of the old bank, the New Landsbank issued an FX bond, i.e. to be repaid in foreign currency. The original bond yield was Libor plus 175 points until principal payments were to kick in in 2014 and then Libor plus 290 points (Althingi, 2011, p. 60 and p. 65).

The principal amount was to be repaid during the period 2014 to 2018. The scheduled payments amounted to approximately 5% of GDP in each year, broadly the level of current account surpluses post crisis! More on the FX bond below. While Icelandic deposits were transferred to a new, solvent operation, foreign deposits were left in the insolvent estate of the old bank. A claim of €4bn against the Icelandic Deposit Guarantee Scheme was triggered. This claims originated from Landsbanki's IceSave clients in the UK and the Netherlands. Despite guarantees given in the aforementioned letter to Clive Maxwell the Icelandic DIGF did not have access to funds to meet these claims. Partly in order to prevent a run on their own banks, the governments of the UK and the Netherlands decided to reimburse IceSave

⁷ The e-mail is sent to Clive Maxwell on August 20th, 2008. There it is stated that: "It is absolutely clear according to the law that the fund (i.e. the DIGF, auth. remark) has to pay out claims up to 20.887 Euros and therefore the Board would always seek a loan to ensure that the scheme pays out to that minimum." (Althingi, 2009)

depositors, hoping to recover the funds, in due course, from the Icelandic government.⁸

The successive IceSave agreements instructed that the estate of the failed Landsbanki would pay out most of the funds owed by the Icelandic DIGF, with the Icelandic Government guaranteeing any outstanding claims, with interest. By turning down the agreement in two referenda, it was, in effect, the top-up of the remaining balance, including interest, that Icelandic voters refused to guarantee. (Matthiasson & Davidsdottir, 2012).

The potential costs accruing to the sovereign of Iceland as result of the successive agreement is hard to estimate. The first agreement was based on a prolonged payment holiday (that would temporarily have enhanced the currency holdings of the Icelandic Central Bank) while later variations were based on repayments in step with liquidation of the estate of the fallen bank. Fact is that early in 2015 the estate of the fallen bank had paid off more than half of the Icesave debt to Netherlands and the UK and the estate will in due time cover the rest of the principal and some of the interest.

The pace of the repayment is now mainly governed by the bond issued by New Landsbanki to the estate of the failed bank, not by governmental agreements as originally planned. Albeit harsh, the successive IceSave agreements were tailored to macro-economic conditions of the country (current account prospects, growth prospects, interest rates on loans to the Icelandic sovereign etc.) as seen at the time of signing. From initially being a matter of internal accounting between the failed and the new Landsbanki the Landsbanki bond created an unforeseen risk for the solvency of Iceland until the New Landsbanki and the Old Landsbanki finally managed to acquire the blessing of the government for restructuring the terms.⁹ Until then, The CBI and other observers, i.a. the IMF did see the term structure of the bond as a macro-economic risk (Central bank of Iceland, 2013).

The EFTA Surveillance Authority, ESA, asked the EFTA court to consider if the government of Iceland was in breach of the European Economic Space Agreement (EES Agreement) by treating Icelandic subjects in preferential way compared to subjects of other EES countries and by not reimbursing the governments of the UK and the Netherlands. The EFTA court verdict was made public at the end of January 2014. The Icelandic government was acquitted partly on a technical detail (accounts in the the Icelandic part of Landsbanki were moved out of the estate before the bank was declared insolvent, thus freeing the sovereign of Iceland from differential treatment of subjects) and partly due to legislative mistakes (the EFTA court did not exclude that Iceland would have been liable according to a 2009 version of the directive in dispute). Interestingly, the arguments of acquittal were mostly the invention of the court and not the legal teams of the involved parties.

⁸ Diplomats, politicians and central bankers tried to work out a plan to contain the damage caused by the fallout of the Icelandic financial system. Guðni Th. Jóhannesson (Jóhannesson, 2014) and the SIC rapport document some of the activity. From the scant evidence now available it seems plausible that the Icelandic and the UK governments did not have a coherent approach. Jóhannesson quotes e-mails from the UK ambassador to Iceland suggesting that the UK would have been prepared, possibly in co-operation with EU, to throw a "lifeline" to secure the solvency of the operation of the DIGF. Icelandic officials contacted Russia and China in order to make a "geopolitical" move as, then advisor to PM Haarde, Tryggvi Þór Herbertsson has claimed. What the intended outcome was to be will never be known fully. But one hypothesis is that the Icelandic officials hoped to force the UK (and the Netherlands) to pick up the bill for the IceSave guarantees.

⁹ Act 17/2012 from Althingi brought the assets of the estates of the fallen banks under the realm of the currency controls. Hence, the winding-up boards are unable to transfer assets to the creditors without the explicit consent of the Central Bank.

Bottom line: Refusing to ratify the successive IceSave agreements has not been costless. The UK and the Netherlands managed to delay payment of the first tranches of the IMF loan to Iceland in 2009, thus delaying efforts to restart the economy and possibly increasing the financing costs of the Icelandic sovereign. Furthermore, as of the beginning of 2015, six years after the crash, Iceland still has to have capital controls in effect. Capital controls are partly the result of a mismatch of the currency denomination of assets and claims of the estates of the fallen banks. A liquidation of the estates, without capital-controls, would entail a net outflow of ISK assets and a rapid devaluation of the krona. Lifting capital controls must be accompanied by some form of agreement between creditors and the government. Most scenarios of such agreements assume that some of the ISK assets would be handed over to the government in return for swift access to the foreign assets. Now, the amount that the government can expect accruing from finalizing the liquidation of the estates of the fallen banks will be governed by macro-economic factors. Hence, when accounts are finally tallied it may well be a fact that the financial effect of the IceSave dispute was to decrease payments to the governments of the UK and the Netherlands and increase the payments accruing to other claimants to the estates of the fallen banks, leaving neither a direct loss or gain to the Icelandic public. Indirect costs are hard to estimate, but can be substantial and accrue to both the claimants and the claimers.¹⁰

Myth 4: Value of independent currency

In the run up to the collapse the Central bank had increased its policy rate several times making investment in Icelandic securities an alluring option for carry-trades. The high interest drove up the price of the domestic currency, the krona or ISK.

The real exchange rate of the krona was 20 to 30% above its long term average in 2005 to 2007.¹¹ The real exchange rate was in constant fall from late 2007 and may well have reached its equilibrium value in purchasing-power-parity terms by mid 2008. That did not, however, stop the currency from going into tailspin in October 2008. The distrust in the currency was so widespread that Iceland, in agreement with the IMF, had to suspend freedom of movement of capital, which is one of the fundamental freedoms of the European Economic Area agreement. Six years on, in January 2015, the controls are still in effect, and seem hard to get rid off.¹²

The immediate effect of the collapse of the krona was to destroy the balance-sheets of most businesses in Iceland and of families that had been lured by low interest rates to switch from domestic to foreign currency financing of their debt.¹³ The government, which came to power after elections in March 2009, put into place one of the most comprehensive debt-write down programs in the world to prevent whole-sale bankruptcy of the business sector.

The long-term effect of the devaluation was to boost the revenue side of exporting businesses and restrict imports dramatically. So far the effect of devaluation

¹⁰ Cost of serving a debt is not necessarily a linear function of the size of the debt. Thus, Andri Geir Arinbjarnarson has noticed that the cost accruing to Iceland with public debt of about 100% of GDP is relatively higher than the cost accruing to Greece with public debt of 175% of GDP. Greece enjoys much better terms on her debt than Iceland, see (Arinbjarnarson, 2015).

¹¹ See <http://data.is/1r4Mrxv>

¹² See <http://uti.is/2015/01/new-adviser-group-new-phase-next-steps/>

¹³ According to a study by CBI in 2015 (Friðriksson, 2015), the equity ratio of the 500 biggest companies in Iceland fell from 20% in 2007 to 5% in 2008. The ratio had returned to 26-27% by 2011/2012.

is according to the book: Export-income increases, import-expenditure contracts, as expected. Consequently, the textbook predicts that exporting sectors expand in size and imports contracts as foreign products are substituted by domestic.

In theory a devaluation is also expected to trigger flow of labour and capital from importing activities toward exporting activities. Of course the text-book prediction on effects of a devaluation comes with modifying qualifiers. Which apply to the case of Iceland: Production of important export sectors (aluminum, fishing) is constrained by natural restrictions that do not respond to variations in the price of currencies, expanding electricity generation capacity takes decades, quotas in fisheries depend on biology and environmental factors.

With such a small consumer-base as the Icelandic one it is restricted which consumer goods can be produced domestically. Tourism is the only sector that responded to changed terms-of-trade by expansion.¹⁴ Some economists worry as tourism is considered a low-pay industry and because there are signs that capacity-restrictions are being reached in some part of that industry too.

The cost-benefit analysis of the krona includes tallying the cost of prolonged capital-controls¹⁵ and the cost of excessive debt-relief programs as well as the traditionally recognized costs of holding own unstable, currency (higher interest rates, more volatility, transaction costs). Reducing unemployment by a percentage point or two over a two-year period would account on the benefit side, but might well be dwarfed by the posts on the cost side.

Myth 5: Sheltering the wealthy

The balance sheets of the commercial banks erected post-crash consisted on the asset side on debt owed by Icelandic families and firms while the liabilities consisted of deposits by Icelanders and share capital provided by the government (and the winding-up boards of Kaupthing and Glitnir). Debet and creditcards form the backbone of the payment system. Neither the cards nor the payment system can operate without deposits. Deposits in an assets-less bank are worthless. Hence, debt and deposits are two sides of the coin needed to establish a working payment-system. If debt was to be wiped out, deposits would also have to be deflated or eliminated. A bail-in with haircuts on deposits over a given minimum, as later applied in Cyprus in 2013, was considered and rejected (Althingi, 2011). Some argued that a bail-in and debt write-downs would enhance equality in society, probably by assuming that debtors are poor and deposit-owners rich. Bail-in was dismissed for two reasons: a) customers of the banks would consider their deposits a possible target of a second bail-in and withdraw, causing a second run on the banks; b) many viable firms kept their operating capital in the banks and would almost certainly have to declare bankruptcy if they lost access to their accounts (Althingi, 2011, p. 11).

Even if a bail-in and automatic debt-write down was rejected the government did engage in considerable effort to ease the burden of debt ridden firms and families. By Act 107/2009 the government did enact one of the most comprehensive debt relief programs anywhere, (Matthiasson, 2012); (Matthiasson & Kirby, 2013). Long-

¹⁴ AirBnB has turned every other flat in central Reykjavik into a "hotel", number of real hotel-rooms has increased by 100% between 2000 and 2012, (visir.is, 2013)

¹⁵ In a recent report the IMF suggest implementation of severe "speed controls" during liberalization of movements of capital out of Iceland (IMF, 2013). These speed controls will presumably have to be in place for a decade or maybe more.

term loans to businesses and families were either linked to the CPI or a basket of foreign currencies. Collapse of the value of the krona and the ensuing inflation inflated the nominal cost to service such loans. Furthermore, many economic actors saw their income dwindle. Hence, the case for debt-relief was obvious. Recipes for how to formulate a program were as many as distressed debtors. All medias reported miseries endured by debtors. The attention given to the problem, by media and by politicians, was so high that debtors were fair in expecting far-reaching solutions. The program announced was bound to cause disappointment. Many debtors had wished for an across the board write-down amounting to 20-30% of the face value of all debt. Household debt amounted to 120% of GDP and the corporate sector debt measured 300% of GDP in late 2008 (Central Bank of Iceland, 2014, p. 23). It was immediately pointed out that such a move would a) be very costly (80-100% of GDP) and b) increase the net-worth of firms and families regardless of if they were underwater or not. Furthermore, it was pointed out that the biggest owner of debt in the country were the pension funds, which, incidentally, had almost the entire population as forced members. Any debt write-down hitting the funds would in the end come at the expense of the general population

Ultimately, the government chose to restrict its debt relief to legal entities (firms) that could a) prove that they had enough cash-flow to sustain the necessary expenditure or b) had physical assets. Firms had their debt written down to the present value of expected cashflow or the fair value of physical assets. Debt write-downs to families was restricted to 110% of the fair value of the family house. These guidelines secured that the amount of the write-down was in sync with what financial institutions had already allotted to their impairment account. Hence, tax money was not used to finance debt write downs in private banks.¹⁶ (An aside, a new government, voted to power in spring 2013, promised to “do more” during the election campaign. As a result some 80 billion kronur of taxpayer money will be handed over to debtors in accordance with the gross value of their debt. Many observers including the OECD and the IMF fear the move will be inflationary. Other observers point out that this program will enrich high-income families, as debt and income tend to vary together).

Myth 6: the IMF program was counter-productive

Some members of parliament were strongly against the IMF involvement. The loudest protest came from within the parliamentary group of the Left Green, which sat in the coalition government in power from March 2009 until summer 2013. These critics maintained that IMF had a track record of demanding consolidation of public finances with cuts in welfare expenditure and increasing taxes on the poor (Mósesdóttir, 2012). Others pointed out that taking a loan to strengthen the currency reserves would not alter the net external position of the country (Iceland Review, 2009).

The critics have been proven wrong on all accounts. The IMF and the government agreed to take only a very gradual approach to consolidation of public finances accepting a budget deficit of up to 10% of GDP in 2009 and nudge towards a balanced budget over a period of 4 years. Furthermore, the IMF did leave it to the

¹⁶ Tax money has had to be used to finance debt write-downs in the State owned House Financing Fund.

government to figure out the details in prioritizing and implementing the consolidation plan.

The financial system was restructured and the zombie-bank problem avoided. Capital controls and enlarged currency reserves calmed foreign capital markets to the extent that the Icelandic sovereign was able to issue a 1 billion USD bond in late 2011, (Ministry of Finance A, 2011); (Ministry of Finance B, 2011).

The response of the IMF and the government was Keynesian in effect and not austerity as predicted by the critique. Without the assistance of the IMF the Icelandic government would not have been able to implement policy with Keynesian flavor. On its own, Iceland would have had hard time implementing capital controls, in breach of the fundamentals of the EEA agreement. On its own Iceland would also have had hard time defending its position on the foreign capital markets. On its own the Icelandic government would not have been able to run a 10% of GDP deficit on its budget. On its own Iceland would have had to engage in one of the harshest austerity programs in Europe.

Visions, reality and political turmoil

The fall of the Icelandic financial system did take the Icelandic people by surprise. The reaction was muted to begin with, but soon grew into the so-called Pots-and-Pans revolution (Wikipedia, 2013) demanding the resignation of the government, the governors of the Central Bank and the CEO and Board of the Financial Services Authority, FME, in addition to the dissolution of the Parliament and new elections.

The protests culminated in late January of 2009 after which they tapered off as demands were partially fulfilled with the resignation of the government, the director and the board of the FME. A minority government led by the Social Democrats with the LeftGreen party, defended against votes of no-confidence by the Progressive party (Framsóknarflokkur) was in power until the election held in late April 2009. It brought a landslide victory for the Social Democrats and the Left Green, (Hardarson & Kristinsson, 2010).

The election campaign revealed that a majority of voters were in favour of negotiating EU membership, i.a. to get rid of the domestic currency and adopting the Euro. They also seemed in favour of reducing the influence of finance and business in politics and of collecting higher fees for use of natural resources (fish-stocks).

There was also a vocal demand for a new constitution, referred to as Iceland 2.0 in the spirit of the computer-literate young generation. In spite of divergent views on important issues such as EU membership the Social-Democrats and the Left Green stayed together in government after the election. The solution was to apply for membership on condition of a majority in Parliament, even if a majority of the Left Green parliamentary group voted against.

The opposition soon realized that this decision-making process gave the individual parliamentarians in government freedom to act on their own on other issues as well. The opposition used that knowledge to split the government parties when other sensitive issues were up for vote. Hence, seemingly small fires lit by the opposition often ended up as all-engulfing blazes. The leaders of the two governing parties had to use much of their energy on damage control and deals within the government parties were unstable.

The government did deliver on matters related to repairing the economy post-crisis such as bringing the budget close to balance, restoring growth and containing unemployment. It did however not deliver a final solution to some of the contentious

issues discussed in the 2009 election-campaign, such as fishing levy, concluding the rewriting of the constitution and the EU accession. The biggest triumph of the opposition was in the complicated IceSave saga where it, with a helping hand from the President, managed to split the government parliamentarians and discredit its efforts to find a solution to a particularly difficult problem.

The debacle around the IceSave saga, the failure to deliver on EU accession, constitutional reforms and fishing fee collection alienated those who voted the two parties in. Former supporters found shelter in various discussion groups that fostered dreams of building new parties that might be an alternative for the alienated supporters of the Social Democrats and the Left Greens.

In the 2013 election the Left Greens and the Social Democrats lost 55% of the votes compared to the 2009 election. Two new parties managed to get mandates, but the winners were the two old parties, the Progressive Party and the Independence Party. The former on an agenda for extensive write downs of mortgages, the latter on promises of tax reduction. Hence, the parties that had been punished in the 2009 elections for being in charge of the policies leading to the collapse of the financial system in 2008 are again at the helm. Their first priority seems to be to unwind the doings of the former government: The accession talks with the EU will be stopped, the fishing levy lowered (against loud public outcry) and the constitution reform process defused. Iceland might now be on its way into an era of political un-stability and distrust towards politicians so characteristic for the countries in Southern Europe.

What is the difference between Iceland and Greece – two IMF program-countries?

Iceland and Greece both had to rely on the financial strength and the technical expertise of the IMF to cope with the consequences of the Global Financial Crisis. Prior to the crisis both countries endured Dutch disease like spells, i.e. the high internal price and wage levels in both countries did discourage exports and encourage imports. Why was Iceland quickly on a track to recovery while Greece contracted for more than 6 years? There is no simple answer to that question.

It has been suggested that the cause of Greece Dutch-disease spell was too high a conversion rate when Greece entered the Euro and that its creditors were mistaken about the real cost of lending to the sovereign of Greece (Ioannou & Ioannou, 2013). In fact, for many years after Greece joined the Eurozone, the risk premium of Greek sovereign bonds was a few paltry base points over that of the German Bund.

The real cost of financing the Greek sovereign debt increased dramatically after the breakout of the Global Financial Crisis when sovereign bonds became the bad boy of the capital markets. Financial and macroeconomic data that had been plain for all to see including the vociferous rating agencies were reinterpreted. The infamous “Greek statistics” can hardly be blamed for the irrational exuberance that took hold on all sectors of the global economy for a while. By bad luck Greece was in the eye of the needle.

Greek austerity was largely dictated by Germany, whose main concern may well have been to save German banks from failure. In stead of using measures that could have saved Greece because of its miniscule size compared to other European economies, measures were chosen always with an eye not to create a precedent, when

much larger economies such as those of Italy, Spain and possibly France, would require a similar bailout.

The cause of the Icelandic Dutch disease is the overheating of the economy during the early 2000s and the ensuing carry trades (Matthiasson, 2008). Iceland could start the process of correcting the real-exchange rate by devaluating the currency, Greece has had to go the hard way through internal devaluation. Traditional devaluation instantly enhances the competitiveness of an economy. But the competitiveness position has tendency to be eroded if inflation is not contained. Internal devaluation is a time- and effort-consuming activity. Competitiveness improves slowly. But the gains tend to stick. Hence, the Greek path to recovery was bound to be much slower than the Icelandic path. Furthermore, Greece was forced to add insult to injury by addressing excessive bureaucracy through engross shrinking of the state sector, causing contraction and deflation. In contrast Iceland, with the assistance and blessing of the IMF, was put on an Keynesian expansion path from day one.

Both the Greece and Iceland could have avoided the pre-crisis Dutch Disease situation with better economic policy or better institutional arrangements. Note also that even if we leave out the long-term costs of the Icelandic devaluation it would not explain much in terms of employment effects as already accounted for.

One of the keys of the agreement between Iceland, the IMF and the governments that co-funded the Icelandic IMF program was that Iceland was allowed to have “automatic stabilizers” work their way for the first 2-3 years of the program. In effect, this meant that Iceland did not follow the path of austerity staked out for Greece. Keynesianism was accepted in effect.

In Greece, on the other hand, which was at the center of the public debate and the litmus test of competing fiscal ideologies, neoliberal politicians had shown no compassion in order to drive their point home, even by consciously underestimating the costs of austerity as the case of the fiscal multipliers¹⁷ has shown (Blanchard and Leigh, 2013). In Iceland the public sector deficit was 10% of GDP in 2009. Without the support of the IMF the Icelandic government would not have had funds to finance such a deficit. The support of the IMF signaled that the Icelandic government had some sort of a plan for future consolidation of the public finances. A second difference is the debt-relief programs already mentioned. It cannot be overemphasized that the debt relief programs put in place for viable businesses in Iceland saved many jobs and probably prevented a cascade of bankruptcies where bankruptcy of one firm erodes the equity position of one or more other firms.

¹⁷ A small fiscal multiplier implies that a cut in public spending will have negligible effect on GDP and employment. A big fiscal multiplier implies the opposite. As alluded to by (Blanchard & Leigh, 2013) fiscal multipliers and thereby the potential harm caused by fiscal consolidation (austerity) were, until mid year 2012, assumed to be small even if the econometric evidence for that assumption might not “carry the argument”.

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