

## Iceland: The Accidental Hero

*Elaine Byrne and Huginn F. Þorsteinsson*

*Elaine is an assistant professor of Politics in Trinity College Dublin and a political columnist. Her website is [www.elaine.ie](http://www.elaine.ie). Huginn is a philosopher and adjunct professor at the University of Akureyri. He was the policy adviser to the Icelandic Minister of Finance (2009–2011) and is currently the adviser to the Minister of Economic Affairs and Minister of Fisheries and Agriculture.*

The boom to bust story of Iceland's economy is well documented. After a number of years of sensational economic growth from 2002 to 2007, the economy began to destabilise with dramatic consequences in October 2008. Within a span of less than a week, the entire financial sector, ten times the gross domestic product (GDP) of Iceland, went bust. The stock market was nearly wiped out. The economic outlook was not favourable. Interest rates and inflation were at 18 per cent. Unemployment sharply rose from 1 per cent to 9 per cent. Government revenue was rapidly evaporating but government expenditure had surged. The Icelandic króna (ISK) was in free fall and the reputation of the country was in absolute tatters. The entire financial sector had collapsed lock, stock and barrel.

The three main banks, Glitnir, Kaupthing Bank and Landsbanki, collapsed creating significant turmoil in the financial markets. This in effect shut down the foreign exchange market and caused a dramatic depreciation of the króna. The immediate consequences were the nationalisation of these three banks, which accounted for 85 per cent of the banking system. The

International Monetary Fund (IMF) immediately intervened with a \$2.1 billion package in order to avert a further meltdown of the Icelandic economy.

Iceland's situation was so bad that Poul M. Thomsen, the IMF's mission chief for Iceland, described it as 'unprecedented.' Thomsen recalled how 'the sense of fear and shock was palpable – few, if any, countries had ever experienced such a catastrophic economic crash.' Others pointed to Iceland as the canary in the coal mine. Even the word 'Iceland' came to have certain connotations linked to it, such as reckless banking and financial catastrophe. Greek and Irish politicians, overwhelmed by their own growing economic problems, were keen to stress that they were not Iceland.

'Ireland is not an Iceland which has somehow acquired a series of foreign obligations and saddled them on its taxpayers' observed the late Brian Lenihan in his Dáil contribution of 1 April 2010. In his address to the Irish Taxation Institute earlier that year, the Minister for Finance argued that those who advocated for the Icelandic approach – the 100 per cent bank nationalisation – were wrong. Lenihan even felt it necessary to point out the folly of Icelandic policy with the use of an exclamation mark in his presentation to the tax consultants, accountants, barristers, solicitors and other financial professionals in attendance: 'Only one country has followed this approach in this crisis: Iceland!'<sup>1</sup>

Within eighteen months of this address, the IMF/ECB/EU troika had intervened in Ireland and the entire Irish banking sector was nationalised or part nationalised. Ireland experienced the deepest and fastest contraction of any western economy since the Great Depression. The Governor of the Central Bank, Patrick Honohan, described it as 'the most expensive [banking crisis] in history.' By August 2011, the European Central Bank (ECB) and the Irish Central Bank had pumped €150 billion into Ireland's six banks. The gag 'What's the difference between Iceland and Ireland? One letter and six months', first aired in January 2009 on the BBC daily current affairs programme *Europe Today*, was now on Ireland. Even *The Economist* magazine got

in on the act, referring to the Irish economy in February 2009 as 'Reykjavik-on-Liffey'.

Yet, in the three years since the 2008 Icelandic collapse, the Nordic country has made a remarkable and noteworthy economic recovery. The IMF approved the final loan tranche in August 2011, marking the end to a 33-month rescue package. The Finance Minister, Steingrímur Sigfússon, subsequently announced that 'All the program objectives have been achieved.' Nemat Shafik, IMF Deputy Managing Director and Acting Chair, likewise stated 'Key objectives have been met: public finances are on a sustainable path, the exchange rate has stabilized, and the financial sector has been restructured.'<sup>2</sup> The economy has stabilised, fiscal adjustment has been successful, economic growth is picking up and the sovereign financed itself successfully in the bond market in May 2011 on what were considered good terms.

### **Iceland and Ireland – The Difference Is More than a Letter**

Ireland and Iceland share remarkable parallels. Both countries enjoyed enormous growth at the beginning of the twenty-first century but by the end of the first decade were clients of the IMF. This growth was, in part, fuelled by a large expansion of Irish and Icelandic financial institutions. A housing bubble, an immense increase in purchasing power and excessive lending to companies and households also occurred. Much of the policy implementation was similar. The regulatory powers of supervisory authorities were relaxed as the market was regarded as adequately self-regulating. Taxes on capital gains, corporate tax and taxes on high income were lowered because they were thought to discourage growth in the economy. The Irish Minister for Finance, Charlie McCreevy, reduced income tax rates to 42 per cent and 20 per cent in Budget 2001, earning a rebuke from the European Commission, which reprimanded Ireland for its expansionary budget policy.

The Icelandic and the Irish governments in the early to mid-2000s were thought to be daring and were lauded for being

so. Accordingly, Icelandic entrepreneurs earned the moniker 'Finance Vikings', whilst Ireland became the 'Celtic Tiger'. The two countries served as paradigms of how increasing freedom in the market place served to ensure that everybody would benefit from growth. The neo-liberal economic philosophy – the rising tide lifts all boats – was virtually unquestioned.

Iceland and Ireland have more in common with each other than with the PIG countries facing grave economic difficulties accessing the sovereign debt markets – Portugal, Italy and Greece. Iceland's and Ireland's economic collapses stem from crises within their banking systems. This was not the case in Portugal, Italy and Greece, where a public debt problem has been gradually mounting. Yes, their banks are in trouble but not in the same manner as in Iceland and Ireland. Spain's difficulties may be more akin to Iceland's and Ireland's but there are other issues that explain its weaknesses such as unemployment, which was a reality before the European financial crisis.

Nonetheless, there are important dissimilarities between the Irish and Icelandic cases. Iceland is a very small economy in the sense that the country's population of only 300,000 is just a quarter that of Ireland's capital city, Dublin. An argument can therefore be made that even though Iceland's crash was harder hitting than Ireland's, the difference in the size of the economies has allowed the Icelandic case to be more manageable. It is easier after all to turn a small tugboat around than a large tanker.

Iceland is not a member of the European Union and had the policy option to devalue its own independent currency, unlike Ireland. The devaluation of the króna, by more than half, has been difficult for Icelandic households and companies as many of them had foreign exchange-linked loans. However, it has been helpful in creating a considerable trade surplus by boosting earnings in the export sector. A devaluation of the Irish currency would have served a small, open, trade-dependent economy like Ireland's well. Ireland is particularly vulnerable given its dependence on high levels of foreign direct investment and internationally traded services sectors. Ireland's exports, for instance, accounted

for 105 per cent of GDP in the September 2011 Quarterly National Accounts.

Moreover, Ireland is in an IMF programme funded by the 27 EU nations under the watchful eye of the ECB. The United Kingdom made a bilateral loan on favourable interest rates to its closest economic neighbour. Iceland received significant funding from its Nordic neighbours and Poland. That may have contributed to the flexibility within the Icelandic programme, which in many aspects was unorthodox. Iceland imposed, for example, capital controls, something the IMF has traditionally been opposed to. It has also been lauded by the IMF for its commitment to the ideals of the Nordic welfare state.

Bank losses were not absorbed wholesale by the public sector, which was insulated somewhat from vast private sector losses. Poul M. Thomsen noted that the IMF 'had to reach for policy tools that were not part of our mainstream toolkit'.<sup>3</sup> It was private creditors rather than the national Exchequer that ended up bearing most of the losses in the failed banks.

The IMF co-hosted a high-level conference with the Icelandic government in October 2011 to review the conclusion of its programme in the country. The IMF learned three main lessons, Nemat Shafik said:

1. When countries have a clear strategy in mind, as was the case in Iceland, it becomes much easier for the IMF to engage and provide policy support and advice.
2. There are clear advantages to having a heterodox toolkit – more tools are better than fewer.
3. Iceland set an example by managing to preserve, and even strengthen, its welfare state during the crisis.<sup>4</sup>

On the other hand, the Irish government responded to the economic crisis by guaranteeing not only all deposit holders, but also most bank bondholders, in September 2008. This in effect socialised the losses and liabilities of the private sector, thereby

exacerbating public debt liability. This in turn limited growth capacity because of severe internal structural problems and the inability to borrow on the markets at viable rates of interest. Irish taxpayers were obliged to undertake arduous austerity with no consequent losses for bondholders. Ajai Chopra, the IMF's mission chief for Ireland, has said that if it wasn't for contagion risks amid turmoil in European financial markets, Ireland would have significantly lower bond spreads. The problems that Ireland faces are not just an Irish problem; they are a shared European problem.<sup>5</sup>

### **The Icelandic Fairy Tale?**

When comparisons between the economic crises of Ireland and Iceland are made, it is often stated that Ireland, unlike Iceland, bailed out its banks. It is also added that the Icelandic authorities were prepared with a blueprint that saved the sovereign from bailing out the banks and made the private creditors suffer by giving them a proper haircut. Only the last part of this story has a grain of truth, but the rest is a fairy tale.

The fact is that when it comes to bank bailouts Iceland is second to Ireland in the post-2008 financial crisis. The Organisation for Economic Co-Operation and Development (OECD) reckons that the '[t]otal direct fiscal costs of the recent financial crisis amount to about 20% of GDP, which is higher than in any other country except Ireland'.<sup>6</sup> Ireland's cost is estimated to be 49 per cent of GDP. The development of Ireland's and Iceland's general government debt is almost exactly alike. Both countries lowered their public debt during the boom years. Ireland's debt was about 25 per cent of GDP in 2006 and 2007 and Iceland's stood at 28–29 per cent GDP in 2007. At the end of 2010 both countries' public debt was around 95 per cent.

However, there is an important differences as to how the banks were bailed out which has important consequences for stabilising the debt. If Iceland had followed Ireland's bank bailout example, then presumably Iceland's public debt should have been twice as

high as that of Ireland as its financial system was twice the size of Ireland's when measured in terms of GDP.

So what is the crucial difference between the two countries? In essence, Iceland did not have a choice, whereas Ireland did. Iceland had no possibility whatsoever to bail out its banking system whereas Ireland did, or at least believed it had the means to do so. A belief that the European Commissioner for Competition, Joaquin Almunia, described in June 2011 as a mistake because its sweeping scope served to concentrate losses on taxpayers that would have been 'better distributed' in the absence of an unlimited guarantee.<sup>7</sup>

The pre-crash Icelandic government had watched the financial sector expand to well over ten times Iceland's GDP. It did not all of a sudden see the light and stop believing in what it considered as miraculous financial institutions and prepare for a collapse of those banks. On the contrary, the government fought valiantly to the very end to save the banks, and it cost the Icelandic taxpayer dearly.

The Prime Minister of Iceland and the Foreign Secretary went on a roadshow to Copenhagen and New York in March 2008 to assure an increasingly critical business community and the foreign press that the Icelandic banks were sound financial institutions. Despite the looming catastrophe in the banks, the roadshow occurred just seven months before the financial collapse. Extraordinarily, the chair of Iceland's Financial Supervisory Authority gave an interview, published in a prospectus for an Icesave branch which opened in Holland in May 2008. Even in the last days before the collapse the government affirmed that the banks would be backed by the sovereign. Iceland's system of financial management was compromised by regulatory capture, the influence of interest groups and political participants to shape laws and regulations in a way that is beneficial to them.

When the Icelandic banks could no longer finance themselves on international markets they turned to the Central Bank of Iceland (CBI) for financing. Their financing troubles started in 2007 but this was viewed as a temporary problem for the banks

and it thought appropriate that the CBI would, as a lender of last resort, assist in financing the banks. This could only go on for a brief period as the banks were so much vastly larger than Iceland's economy. This meant that if the CBI was to keep fueling the financial institutions external financing would inevitably be necessary.

When it became manifest that this external financing was not forthcoming other measures were required to deal with the inevitable collapse of Iceland's financial system. The country's fortune paradoxically is that in these circumstances the government had zero credibility and the banks were considered to be so toxic that no one was willing to offer financial backing or assurances. It was at this moment that the Icelandic authorities realised that saving the banks was virtually impossible and measures would be needed to minimise the impact of their collapse on the state and on Iceland's economy.

Emergency legislation was rushed through the Althing, Iceland's parliament, which gave the financial services authority and the government unprecedented powers to intervene in the financial markets by, for example, moving domestic deposits, loans and assets into new banks. Most of the foreign loans and assets were left in the old banks and they went into administration. The CBI lost most of the loans it had provided to the old banks, which is an amount equivalent to 13 per cent of Iceland's GDP. Effectively the CBI went into bankruptcy, which is another peculiarity of the Icelandic case. A similar amount of money went into establishing the new banks that took over the deposits, loans and assets of the old banks. The government received a stake in the new banks which since then is estimated to have gained in value. So that does not constitute a loss of taxpayers' money as the bankruptcy of the CBI undoubtedly is. The state could always get some of its money back if it decided to sell its stake in the banks.

The emergency legislation came about because all other routes were closed for Iceland and it is since then an important ingredient in the country's recovery, mainly because of two factors. The



first is that the taxpayer was not put at further risk by the financial system. As already explained, the loss of taxpayers' money was considerable but the emergency legislation resulted in the old banks going bust. It meant losses for the creditors of the banks but that is how it should be as they were responsible for lending to the banks. The second is that the country's external debt was minimised. Instead of having a banking sector that was ten times the country's GDP the new banks amounted to twice the value of Iceland's GDP. The difference is vast and is extremely important in the volatile financial climate in the Eurozone.

Ireland's path is considerably different in this respect. The Icelandic banks were too big to save. Although the same ultimately proved true in the Irish case, it took three years to reach this realisation. The Minister for Finance, Brian Lenihan, determined in 2008 that Anglo Irish Bank was of 'systemic importance to Ireland' because of its €100 billion balance sheet. The bank, Lenihan said, 'had grown to half the size of our annual national wealth, so clearly the failure of a bank on that scale would do huge damage to the local economy here in Ireland.' This is a view shared by the Governor of the Central Bank, Patrick Honohan, in his 2010 Banking Report. Honohan argued that if Anglo had been allowed to default it 'would undoubtedly have put funding pressure on the other main Irish banks via contagion .... In this sense, the systemic importance of Anglo Irish Bank at that time cannot seriously be disputed.'<sup>8</sup>

In addition, Ireland received backing to support its banking system from the troika of the ECB, the IMF and the EU. Therefore, unlike in the Icelandic case, the banking system remains oversized and what may even turn out to be worse is that taxpayers' money is what has sustained its size. The question is, of course, whether Ireland should have done something similar to the emergency legislation enacted in Iceland and watched the banks go into administration but rescue assets that were of national interest?

In our opinion such drastic measures may not have been needed but neither was it necessary to back the entire financial system.

## *What if Ireland Defaults?*

Ireland's financial system did not achieve the size of Iceland's when compared in terms of GDP but many of the same factors contributed to its growth, such as extensive borrowing that fuelled a housing bubble, excessive consumption and contributed to an overall growth in the economy in the short term. This means that there are severe inherent weaknesses within the Irish financial sector that the National Asset Management Agency (NAMA) initiative may not be able to isolate and resolve so that the sovereign is adequately protected. The Irish authorities should rather have considered a policy that did defend all of the banks but let the riskier ones go bust, and moved certain assets into other banks that were deemed necessary to rescue from a financial stability point of view. Such a move would have minimised the exposure of the taxpayer and downsized the financial system effectively, which is what Ireland needs.

Iceland initially tried to salvage its oversized banking sector but in the end received no backing for such a move and was forced to use other means to tackle its crisis. These measures have since led the country to become an accidental hero. In retrospect this turned out to be good fortune for Iceland and has helped with the resurrection of its economy. It is, however, important to remember that Iceland incurred severe costs because of the financial crisis. Although Ireland should have not followed Iceland's path completely, one can argue that it would have made sense for Ireland to use a pick and choose policy as to which financial institutions were worth saving. It may seem strange to say this but what seems to be Ireland's misfortune in this regard is just that the Irish banks were not big enough for policy makers to deem it virtually impossible to salvage them. Instead the decision was taken to bail them out because saving them was deemed 'manageable', and that may turn out to be a very difficult route to take. As Professor Morgan Kelly forlornly noted in an *Irish Times* editorial in May 2011, 'While most people would trace our ruin to the bank guarantee of September 2008, the real error was in sticking with the guarantee long after it had become clear that the bank losses were insupportable.'

### **Public v Private – The Fate of the Sovereign**

When countries are faced with the question of whether it is sensible to bail out banks immediate questions are raised about sovereign default. This can be seen in both the Irish and Icelandic cases and in other instances as well. This is one of the peculiarities of the current financial crisis in that financial institutions which are in principle private entities are linked to the sovereign if they are thought to be close to insolvency. During the boom years, when the banks provided handsome dividends to their stock owners and large staff bonuses on top of high wages, little attention was paid to the implications of financial institutions in crisis on public funds. Any critique of big salaries and bonuses was dismissed because the banks as private entities could decide how much of their profits they allocated to meet the demands of their top-level staff.

In the aftermath of the financial crisis it seems, however, that either it was always tacitly assumed that the sovereign backed banks in trouble or few people imagined that they would get into a crisis and difficult questions were never asked. It is clear that the lack of preparation and denial of the severity of the situation within the financial sector in many countries has cost many nation states dearly and also the Eurozone as a whole.

In our view the onus of justification is always on those who want to use public funds to keep a financial institution in business. There are often strong arguments for bailing out banks because it can turn out to be more expensive for an economy not to do so. Nevertheless, those arguments start to lose their appeal in countries with oversized financial institutions that are systematically failing. Then a clear divide needs to be made between private entities and the sovereign. The lesson from Iceland is that if Iceland had been able to continue to finance its banks in 2008 with public funds the sovereign would have probably ended up defaulting, with devastating consequences.

Ireland, like other western democracies, has been captured by big finance but is not cognisant of this reality because moral

outrage has been directed towards isolated scandals in the market and unjustified bonuses for individual bankers. It is supposed that the economic collapse is a problem intrinsic to the weaknesses of regulation and the hubris of bankers and property developers. The capture of the state by an oligopolistic financial sector, due to excessive risk taking without consequence, was complemented by the failure of political institutions to anticipate the collapse.

The result from Ireland remains to be seen in the context of a rapidly escalating Euro crisis. The justification for the measures taken in rescuing banks then regarded as of 'systemic importance to Ireland' has become emaciated and unconvincing over time. The fears of contagion amongst financial institutions within other EU member states are understandable and logical. However, if that is the case then the problem ceases to be a problem. The assumption that the Irish taxpayer should exclusively shoulder the burden of private debt is also a problem for those whom they are saving. The weights should be lifted equally by those affected. Otherwise the task becomes too difficult. And *unmanageable*.

## Endnotes

- <sup>1</sup> Minister for Finance, Mr Brian Lenihan, 'Returning to Economic Growth: The Next Steps', Address to the Irish Taxation Institute Annual Dinner, 26 February 2010, available from: <<http://www.finance.gov.ie/documents/speeches2010/spl43irishtax.pdf>>.
- <sup>2</sup> IMF (2011) 'IMF Completes Sixth and Final Review Under the Stand-By Arrangement for Iceland', Press Release No.11/316, 26 August.
- <sup>3</sup> Poul M. Thomsen (2011) 'How Iceland Recovered from its Near-Death Experience', *IMFdirect*, 26 October 2011, available from: <<http://blog-imfdirect.imf.org/2011/10/26/how-iceland-recovered-from-its-near-death-experience/>>.
- <sup>4</sup> International Monetary Fund (2011) 'Iceland's Unorthodox Policies Suggest Alternative Way Out of Crisis', *IMF Survey Magazine: Countries & Regions*, 3 November 2011, available from: <<http://www.imf.org/external/pubs/ft/survey/so/2011/car110311a.htm>>.

## Iceland: The Accidental Hero

- <sup>5</sup> *iMFdirect* (2011) 'No Country Is an Island: Ireland and the IMF', 14 July, available from: <<http://blog-imfdirect.imf.org/2011/07/14/no-country-is-an-island-ireland-and-the-imf/>>.
- <sup>6</sup> Organisation for Economic Co-Operation and Development (2011) *OECD Economic Surveys: Iceland*, Paris: OECD.
- <sup>7</sup> Arthur Beesley (2011) 'Leading EU Official Says State Bank Guarantee a Mistake', *Irish Times*, 17 June.
- <sup>8</sup> Patrick Honohan (2010) *The Irish Banking Crisis Regulatory and Financial Stability Policy 2003–2008: A Report to the Minister for Finance by the Governor of the Central Bank*, Dublin: The Stationery Office, p. 131.