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Back from the Brink

Iceland's Successful Economic Recovery

Bent Sofus Tranøy and Throstur Olaf Sigurjonsson

From Ruin to Recovery

When it reached Iceland a few days after the Lehman bankruptcy, the financial crisis of 2008 brought one of the biggest banking collapses in history on this small, but economically successful island. Indeed, according to IMF and *The Economist* (2008), Iceland's systemic banking collapse was the largest experienced by any country in economic history, relative to the size of its economy. At the time, no other country had a bigger banking sector relative to its GDP, and Iceland's three major international banks all went bust simultaneously. The challenge to the government was epic. 'At least we have fish', the president sighed during a press conference held following the collapses. Yet the response to this existential crisis produced the policy success that will discussed in this case study: through balanced economic crisis management a financial collapse worse than anywhere in the severely stricken eurozone, *did not*—as it did in Southern Europe, with gruesome social consequences—translate into a sustained recession.

Towards the end of 2008 Iceland stared into a financial abyss as the sharp burst of growth which had characterized the noughties had ground to a halt and trust evaporated. Access to short-term funding in international money markets dried up completely as the credit squeeze of 2007 morphed into a full-blown panic after the Lehman bankruptcy in September 2008. When credit dried up, the banks collapsed, and the value of the currency fell by a total of 50 per cent. This had repercussions for households, companies and the public sector which had borrowed in foreign currency back when the ISK was strong and foreign interest rates were lower (what was referred to as 'carry trade'). This had a domino-effect on the Icelandic stock market which collapsed to the tune of a 90 per cent fall. Corporate bonds also fell precipitously, while the bonds issued by the holding companies—the 'vessels' used by the raiding entrepreneurs—became worthless (Vaiman et al. 2011).

The three 'Viking banks', as they were admiringly called at the time, Glitnir, Kaupthing and Landsbanki had amassed foreign assets and liabilities that were completely disproportionate to Iceland's economic size and financial resources,

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and to its capacity for meaningful financial regulation. By the summer of 2008 the balances of the three banks corresponded to roughly 10 times the size of Iceland's GDP: a remarkable ratio by any standard (Sigurjonsson et al. 2015). As the consequences of what turned out to have been a corrupt and nepotistic financial elite came to light as the crisis broke, serious political unrest ensued. People took to the streets to protest against the government in what has later become known as the 'pots-and-pan revolution'. Within less than four months the coalition headed by the Liberal–Conservative Prime Minister Geir Harde was replaced by the first left-wing government in the history of Iceland. At the same time, a former Prime Minister and erstwhile key player in creating the circumstances that allowed for the transformation of Iceland into an international financial centre, David Oddson, was removed from his position as central bank governor.

Iceland's policy mix in dealing with the crisis, helped by fortuitous circumstances, secured a return to growth after less than three years, and by 2017 unemployment was back down under 3 per cent, while GDP was 15 per cent higher than its 2007 peak, the dramatic fall from 2008 to 2010 notwithstanding. This growth performance was on par with the US's, considerably better than the OECD average (11%) and three times as strong as that of the eurozone (5%) (The Central Bank of Iceland 2018:73–74). In order to gauge the success of Iceland's recovery more precisely, we need to distinguish between financial losses (money lost by banks and investors) and damage to the 'real economy' (i.e. production, growth and employment). Our point is that while Iceland suffered financial losses of world-beating proportions, these did not translate into long-term real economic losses of the same magnitude.

Reinhart and Rogoff (2014) offer two interrelated metrics that are vital to thinking about recoveries. Firstly, how large are the losses measured in terms of output (which in turn reflect employment and general welfare) and secondly how long does it take from peak to trough and back to pre-crisis output levels? They combine the two in a *severity index* by adding the sum of the absolute value of the fall in per capita GDP and how long (in years) it takes to get back to the pre-crisis peak. The two metrics are related because the faster you manage to bottom-out on your losses, the quicker you can start your recovery, which then reduces the time 'available' to accumulate further losses. In short: a 'v-shaped' recovery.

In Iceland, the real economy reached its nadir after just two years. By 2010 output had contracted by 10 per cent per capita in real terms. Consumption fell by 22 per cent, while unemployment rose from 2.3 to almost 8 per cent even as there was a significant reversal of Iceland's migration balance. The 2011 state budget moved from 2009's plus 6 to minus 6 per cent while state debt rose from a mere 28 to a whopping 130 per cent of GDP. This was as bad as it got. By 2011 the economy was growing again and in 2016 in reached its pre-crisis peak in per capita terms,

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neatly befitting Reinhard and Rogoff's operationalization of a v-shaped recovery.[1] By the end of 2017 GDP was, as already noted, 15 per cent above the pre-crisis peak; in per capita terms this corresponded to 7 per cent above the numbers for 2007 (The Central Bank of Iceland 2018: 73–74).[2]

Other crisis countries like Greece and Spain suffered relatively smaller financial losses, yet the real economic impacts were both more severe and more sustained. This emerges from Benediktsdóttir et al.'s (2017: Table 10) updating of Reinhard and Rogoff's index. Greece's total loss of GDP per capita from peak to trough was 26.3 per cent; it took no less than six years to bottom-out and (according to estimates made before Covid-19 hit) 15 years to return to pre-crisis levels. The corresponding figures for Spain were 10.6 per cent, accumulated over the same six years as Greece, while Spanish recovery measured as GDP per capita was achieved in 2019, 11 years after the crisis broke. One very important achievement, therefore, is that Icelandic unemployment (not to speak of youth unemployment) didn't stick. Two important reasons for this are firstly that it never reached the heights it did in Southern Europe and secondly that the devaluation of the Icelandic krona fostered rapid growth of both traditional exports and tourism (Sigurjonsson et al. 2015).

Reinhard and Rogoff's severity index also provides a point of departure for thinking about the timeline for this chapter. Though it was not until after 2015 that Iceland was completely back on track, our emphasis will be on the years from 2008 to 2011. In these years the financial (and related fiscal) issues were dealt with in a manner that facilitated the v-shaped recovery, which in turn reduced the harm done to the real economy. In proceeding, we will make a distinction between policies that dealt with the crisis (with 2011 and 2015 as our cut-off points) and the more difficult question of whether the underlying issues that created the crisis in the first place have been sufficiently dealt with.

Context: EEA, Privatization and the Icelandic Boom-Bust Cycle

In its survey of the Icelandic economy in 2008, the OECD noted that Iceland had grown at double the OECD rate since the mid-1990s and drew the inference that: '[t]his impressive performance is attributable to extensive structural reforms that deregulated and opened up the economy, thereby unleashing entrepreneurial dynamism, as evidenced by an aggressive expansion of Icelandic companies abroad' (OECD 2008: 11). Three years later the political economist Herman Schwartz summed up the background for Iceland's financial collapse with this

[1] This a measure that downplays the fact that an economy that does not suffer sudden reversals would normally be at a higher level at this point in time. Economists sometimes refers to this as a permanent loss that will never be recovered.

[2] Iceland's population grew by about 10 per cent between 2007 and 2017.

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metaphor: 'Iceland came late to the global party, drank too quickly, and hit the floor rather harder than larger economies' (Schwartz 2011: 299).

What these two otherwise very different appraisals have in common is that they both home in on the relationship between entrepreneurial businessmen and the financial sector. The unparalleled economic boom Iceland enjoyed in the 2000s was strongly associated with the growth of its banking sector. The growth trajectory followed a sequence of deregulation, liberalization and privatization (Sigurjonsson 2015). This began when Iceland joined the Internal Market of the EU. On becoming a member of the European Economic Area (EEA) in 1993, the country started a process of adaptation to the pro-market rules and regulations of the Single European Market (SEM). An era of dramatic structural and legislative reforms ensued. The financial sector was opened up to international capital. Innovation and risk-taking was facilitated through lending abroad at low interest rates. This business model worked fine as long as the Icelandic krona (ISK) was appreciating, making debt less worth measured in the currency which the Icelandic debtor typically had its income. Meanwhile the tax code was overhauled and tax rates were slashed to a level among the lowest in Europe (Portes et al. 2007). Liberalization of the financial markets also opened up new opportunities for provisions of securities and eased adaptation to the pro-market rules and regulations of the Single European Market (SEM).

Growth of the financial sector was turbo-charged in 2003 when two of Iceland's three main banks were fully privatized as part of a larger privatization drive that started upon entering the EEA. The EEA-agreement granted Icelandic banks what was referred to as a 'European Passport', that is, the freedom to set up branches or subsidiaries anywhere in the EU. This marked a dramatic break with the past. Historically, Iceland had been characterized by a strong state, employing capital controls in order to protect a weak currency, and extensive public ownership in, and regulation of, the economy. In less than 10 years the small island country opened itself up entirely to free flows of capital.

The performance of the big three banks (Landsbanki, Kaupthing and Glitnir) in the early noughties' boom was truly extraordinary—and, with hindsight, too good to be true: explosive credit growth all too often ends in tears. Based on quantitative evidence Steve Keen (2017) even argues that the rate of credit expansion is a more significant variable than the volume of outstanding credit relative to GDP when predicting troubles ahead. That said, Iceland hit the upper echelons on both scores. At the end of 2003, the total value of outstanding bonds issued by the big three banks, that is the stock of funds borrowed from (primarily international) investors, was 6,160 billion euros. Just two years later, at the end of 2005, the corresponding figure was a staggering 42,629 billion (Flannery et al. 2010: 99, Table 7).

The privatization process itself had been highly contentious, both in terms of how it was orchestrated and the outcomes it had yielded. An 'Executive Committee' for the larger privatization process had been in operation all the way back to

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1991. For several years the process was run according to principles established by that committee, but not so when the banks were privatized between 2001 and 2003, when in its role as regulator of the system and steward of its values the government had allowed two vital principles to be eroded: to avoid dominant owners and to keep the privatization process open and transparent. Instead, what began as an apparently open process ended up with a select group of investors—closely related to the two governing political parties—being given the opportunity in backroom deals to take the spoils.

As the crisis broke, dubious business practices quickly came to light. The three big banks had engaged in self-dealing and hidden cross-ownership arrangements, creating fake capital that served as the basis for leveraging each other's balance sheets up (Special Investigation Commission 2010). They also lent enormous amounts of money to their owners. As the Special Investigation Commission's report produced for the Icelandic parliament (SIC 2010:10) put it in the understated tone that is the norm for such documents:

> [T]he operations of the Icelandic banks were, in many ways, characterized by their maximizing the benefit of the bigger shareholders, who held the reins in the banks, rather than by running reliable banks with the interests of all shareholders in mind and showing due responsibility towards creditors.

Before the edifice came crashing down, however, Icelandic financial entrepreneurs were viewed as heroes. Viking metaphors were thick on the ground. As noted earlier, the OECD (and other influential bodies and commentators) heaped praise on the Iceland that emerged from liberalization, privatization and integration into the world financial system. In March 2006, the Norwegian Foreign Minister, Jonas Gahr Støre (Utenriksdepartementet 2006) gave a speech on the occasion of the opening of the Icelandic–Norwegian chamber of commerce in Oslo: 'We have taken notice of "the Icelandic wave" ... In Norway, it has manifested itself through several acquisitions in the financial sector. Brave, young, innovative, inventive and hard-working Icelandic entrepreneurs ... Norwegian business has a lot to learn.' The major credit-rating agencies awarded Iceland the much-coveted AAA-ratings. Academics writing reports at the behest of—and paid for by—the Icelandic Chamber of Commerce praised 'Icelandic style' dynamic management characterized by daring and quick decision making (Wade and Sigurgeirsdottir 2011). Another sign of international approval was the large-scale issuance of so-called 'glacier bonds': bonds denominated in ISK that were used to finance acquisitions abroad. The willingness of investors to buy these bonds meant that they were willing to take on the risk of the ISK falling in value.

At the macro-level Iceland's growth model in many ways replicated the model the US had developed over the previous decade (Schwartz 2011): excessively leveraged (that is financed by a lot of borrowing and not much own funds), financed

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by maturity-mismatched funding (which means to borrow short term to finance long-term assets). In other words, the three Icelandic banks borrowed short term at low interest rates which they used to buy longer-term, higher-risk and higher-return assets. Risky enough in itself, but being relative latecomers to the noughties financial boom they also overpaid for what soon turned out to be shaky assets (Vaiman et al. 2011).

An important difference between the traditional model of bank funding (growing through deposits, what is often referred to as 'retail' money markets) and the model that emerged in nineties and noughties is that 'wholesale' money markets have no insurer. There is no parallel to the government guaranteed deposit insurance schemes that most countries have had since the interwar crisis. Quite simply, the risk entailed by switching from insured to uninsured sources of funding was not legislated for in any set of financial regulations. Neither EU regulations nor Bank of International Settlements (BIS) recommendations addressed the issue. This proved to be highly problematic. A system of short-term borrowing used to fund long-term, less-liquid assets is a vulnerable one. This is so because it is dependent on creditors renewing your loans (what is called rolling over your loans) every three months or so. If confidence in your ability to pay back evaporates and panic sets in, you get the functional equivalent of a traditional bank run.

A bank run happens when depositors panic and all rush to the bank to take their money out at the same time. To guard against this happening most governments have deposit guarantee schemes. But in the international money market there is nothing to stop creditors from collectively refusing to roll over short-term credits. This problem confronted almost all institutions struck by the September 2008 crash one way or another, but none more violently than the three highly leveraged banks located in Iceland, backed only by a central bank with miniscule currency reserves (Sigurjonsson et al. 2011; Special Investigation Commission 2010).

Towards the end of the boom Iceland went through a mini-crisis, a precursor event that lead up to and exacerbated the big crisis of 2008. Doubts about Icelandic risk-taking started to creep in, which meant that funding from the money markets got more difficult to come by. Two of the big three banks responded by going on an aggressive hunt for interest-rate-sensitive deposits by establishing internet banks in countries like the UK and the Netherlands (Landsbanki/ Icesave) and Germany (Kaupthing/Edge). While Kaupthing established subsidiaries with separate capitalization and therefore subject to host country regulation—and crucially—deposit insurance, Landsbanki established branches *subject to home country control and insurance*, laying the foundations for the conflict that would later break out between UK and Dutch authorities on the one hand and the Icelandic government on the other (Tranøy 2011).

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Challenges: Money's Too Tight to Mention

The overarching task the new centre-left government faced can be summarized in one phrase: protecting the welfare of the Icelandic population and the financial integrity of the state in the face of an enormous, multifaceted crisis. This entailed a long list of challenges facing Iceland from October 2008 onwards, which we here will break down into two clusters: the need to simultaneously handle a banking and a currency crisis; and the parallel need to address the collateral damage: fiscal crisis, diplomatic/foreign policy crisis (i.e. dealing with foreign creditors and the states that backed them) and a crisis of trust in the political system and Iceland's institutions. We will describe how the currency and banking crises were dealt with initially in this section and return to the other three in the section titled 'Design and Delivery'.

Being a very small and very open economy, Iceland is highly dependent on imports. From the onset of the crisis in October 2008 the loss of confidence in Island's ability to finance its imports was so severe that there was a real danger that supplies of basic necessities would dry up—hence the president's 'we still have fish' remark. Although Greece would suffer from shortages at a later stage in their drawn-out crisis trajectories, the immediate concern for the IMF—according to Poul Thomsen (2018) who headed its mission to Iceland—in countries like Spain and Greece was about avoiding defaults, whereas in Iceland it was the prospect of food shortages and lack of critical medical supplies.

An immediate challenge was to prevent a runaway deprecation of the krona (ISK). Both foreigners and Icelanders had strong financial motives for fleeing the currency. After the collapse of its financial system and the British government's placement of Iceland on a 'terrorist list' (under the UK Anti-terrorism, Crime and Security Act 2001), that were normally reserved for entities like al-Qaeda, the Taliban, Sudan, North Korea and Iran, there was scant demand for the nation's money. An illustrative example is a story relayed in *Time* magazine in early November 2008. According to the magazine's sources, the ad agency Saatchi & Saatchi pulled its plans to film a commercial in Iceland in late October 2008, 'because [its] insurance company didn't want to insure equipment and people in Iceland because they were on this list' (*Time Magazine* 2008).

The ISK had risen in a self-reinforcing process during the early noughties where interest rate differentials attracted capital, meaning that higher interest rates attracted more foreign investors which then led to an even stronger krona. This fuelled inflation which made an inflation targeting central bank raise interest rates even more. In turn, this attracted more capital in an upwards spiral of inflation, higher interest rates, currency appreciation and even more capital inflows.[3] In 2008

[3] These dynamics were similar to what several Asian countries experienced in the run-up to what is now known as the Asian crisis.

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this process was reversed. But as one would expect, the downward spiral took shape much faster than the one that went upwards. Thus, capital controls were put in place in an effort to stem the flow. Capital controls helped but were not enough to stop the ISK from seeing its value halved in a matter of days. In turn, this led to imported inflation dragging down the purchasing power of households, increased unemployment and because most household's debts were (and are) indexed to inflation, debt levels increased considerably.

The second immediate concern was what do with the banks. Three banks going belly up at the same time meant that the Icelandic state had to deal with foreign creditors while simultaneously seeking to re-establish a domestic banking system able to provide financial services to the Icelandic population. The size of the combined balance sheet of the three now-defunct banks meant the government could not even come close to having the means to save them. On October 6, parliament passed an emergency act, reordering claims, giving depositors first priority. Previously, depositors had shared priority with bondholders. The act also granted the Financial Supervisory Authority (FSA) extraordinary powers over financial institutions (law 75/2010).

The FSA used its newfound authority to fashion an unconventional scheme for dealing with their collapsed banks. Instead of the more traditional cleaning-up strategy of creating a 'good bank/bad bank' split, where all loss-making investments are collected in one special purpose entity, the government chose a domestic/foreign split. New domestic banks were carved out of the carcasses of the big three, while foreign assets and liabilities were left in the 'old' banks that were now organized as holding companies in receivership. The assets the holding companies inherited were still massive, even after severe write-offs and write-downs (Thomsen 2018). The newly created banks took over the domestic activities of the old banks, with all Icelandic deposits guaranteed in full by the government. This guarantee was possible because it concerned claims denominated in local currency (ISK), the supply of which the government ultimately controlled. The Icelandic assets were handed over at their new crisis-affected estimated market value, which translated into a discount of 60 per cent (Benediktsdóttir et al. 2017: 240).

Even so the new banks' assets outstripped their liabilities (i.e. the side of the balance sheet that documents how the assets of a bank are financed), hence they needed recapitalization. This was partly solved by drawing on the assets left in the estates (i.e. the 'old banks') to provide capital injected into the new banks. This way the estates became co-owners of the new banks, with claims on future earnings. The government provided equity and subordinated loans (bonds with higher interest rates and lower priority than other bonds) to the tune of 12 per cent of GDP. The government also took partial ownership of the new banks, proportionate to the financing it had made available. An important result of all these moves was that the domestic operation of the Icelandic banking system was never halted (Benediktsdóttir et al. 2017: 234).

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Actors: The Old and New Regimes

When the crisis broke the two men vested with most formal power to handle it were Prime Minister Geir Harde and David Oddson, Central Bank governor, and former (record) long-serving PM. Both represented the market liberal but EU-sceptic Independence Party (IP) which dominated Icelandic politics from about 1990 and onwards. And both have—not unreasonably—been blamed for being chief architects of the political–economic environment that evolved during the noughties which facilitated the reckless credit growth, and the dubious business practices that created the crisis (Sigurjonsson et al. 2015; Vaiman et al. 2011; Special Investigation Commission 2010). Both were blamed for negligence and poor governance in the years leading up to the crisis, but before they were purged, the old regime that they led got two big calls right in the early crisis response phase (the banking split and capital controls), while also securing what was both literally and metaphorically a big deal with the IMF.

Two big decisions were made by the Icelandic government and Central Bank in the week from Monday 6 to Friday 10 October. The split between domestic new banks backed by the state (while the estates of the old international banks were left to recover whatever they could), secured both a viable domestic banking system from day one, and a bail-in of foreign creditors. The bail-in, that is a policy of actually making creditors share in the losses, stands in contrast to how things were handled, for example, in Ireland, where a blanket government guarantee was issued to all creditors. Capital Controls were first introduced as a panic measure to avoid running out of foreign exchange and to stop the ISK from plummeting further (its value had slumped to 50% from its peak the year before). In November 2008, after the IMF had entered the scene, capital controls were strengthened and made part of the formal programme Iceland was subjected to. At the time, IMF's embrace of capital controls was surprising, not to say shocking. Over the previous 30 years tying the holders of capital down through such restrictions had come to be considered something of a heresy (Thomsen 2018). A topic we will return to later on. The third positive achieved in the fall of 2008, while the old guard was still in power, was agreement with the IMF which released a total of 4.4 billion US dollars, 2.1 from the IMF itself, the rest in the form of bilateral loans from Nordic countries and Poland. We will return to the IMF-programme under the section headed 'Design and Delivery'.

We have argued that the long-term effects of the decisions made in October/November 2008 were beneficial, but there and then the multi-crisis that nevertheless ensued was beginning to bite. As details of the bankers' shenanigans were beginning to emerge, large swathes of Icelandic houseowners saw payments on their foreign exchange denoted mortgages rise dramatically. Even so, by the end of 2008, no minister or official had resigned from their posts as a result of the crisis. This frustrated the 'pots and pans' protesters who assembled weekly on the

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lawn in front of the parliament building. 'Throw the rascals out!' became a commonly heard refrain (Bernburg 2016), eliciting major media interest around the world.

In January 2009 things came to a head. The Social Democratic Alliance (SDA) had only participated in government since May 2007 and initially seemed to avoid most of the blame for the crisis (Harðarson 2009). However, the January 2009 polls showed that support for the SDA (Social Democratic Alliance) was tumbling while public sympathy for the protesters was on the rise. The SDA's response was to demand the post of prime minister. This was not acceptable to the IP (Independent Party), precipitating the end for the coalition between the two parties. Both IP-leader Prime Minister Geir Haarde and SDA-leader Ingibjörg Sólrún Gísladóttir decided to step down, both struggling with serious illness in the midst of the crisis they were being blamed for.

The demonstrations were primarily propelled by unorganized groups, but the Left-Greens (LG), the party occupying the left flank of the party system, was also a driving force. The LG argued that their long-standing admonition of privatization and neo-liberal capitalism had been justified by the crisis. When the centre-oriented Progressive Party (PP) granted its passive support for a left wing government (they named themselves 'Nordic welfare government') the SDA and LG formed a new cabinet on the first of February. The new Prime Minister was Jóhanna Sigurðardóttir. Iceland's first female Prime Minister and the world's first openly LGBT head of government. She had been an MP for the SDA since 1978, a well-liked and outspoken spokesperson for underprivileged groups and had been Minister of Social Affairs for two periods. Another veteran, Steingrímur J. Sigfússon, became the new Minister of Finance. Founder and leader of the Left-Greens, he was first elected to Alþingi in 1983. In his new role as Minister of Finance he negotiated and presided over reviews of the IMF programme the previous regime had agreed to.

In response to demands from the demonstrators, the new government promised to call an election at the earliest opportunity (25 April was agreed upon) and to remove Oddsson from the Central Bank. Oddson refused to resign, pointing to the CBI's formal independence, subsequently a new law was enacted demanding that the CBI's head had to be an economist (Oddson was a lawyer). Oddson resigned the day the law was passed in Althingi, and a Norwegian McKinsey consultant, economist and former Deputy Minister (Secretary of State) Svein Harald Øygard, was installed as temporary Central Bank governor in late February 2009. The Sigurðardóttir government wanted time to select the new permanent CBI-chief in an orderly manner, so the appointment of Øygard served two purposes: to get a highly competent and experienced individual (he had experience from the Norwegian banking crisis of the early nineties) in place immediately, and buy time for its own process. The election in April gave the hitherto minority government a new and solid mandate. The two socialist parties together got 51.5 per cent of the

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vote. The IP suffered its worst defeat ever, their share of the vote decreased by 13 percentage points. For the first time in Iceland's parliamentary history, the Social Democrats—and not the IP—emerged as the largest party at the polls.

Given the complex subject matter, and different subset of problems this chapter deals with, several other actors could have been worth a mention. One is unavoidable, though, Iceland's President, from 1996 to 2016, Olafur Ragnar Grimsson. The position as President had evolved into a figurehead with important constitutional functions, but de-facto limited powers over the affairs of the state. In the Icesave dispute, however, Grimsson decided to break with tradition and use his formal powers to great effect (see section headed 'Bail-ins and Icesave').

Design and Delivery

The design of the IMF-programme stands out as arguably the most important factor behind Iceland's rapid recovery from its deep financial crisis (Baldursson and Portes 2018). We can distinguish between four fundamental components or aspects of the programme: its highly restricted use of conditionality, its active use of capital controls, its tolerance of bail-ins as well as (domestic) bail-outs, and, perhaps most importantly the fiscal space it allowed.

Limited conditionality

According to Poul Thomsen, who headed the mission that travelled to Iceland on 12 October, the programme's conditionality was narrowly focussed on dealing with the acute fiscal and financial issues: '...compared to most other IMF supported programs at the time ... [t]here were no broader structural reforms whatsoever' (Thomsen 2018: 3). This absence of what other crisis countries often found to be irrelevant and sometimes downright abusive demands, facilitated cooperation between Icelandic governments and the IMF. A hard-headed socialist like Sigfússon took what the IMF refers to as 'ownership' of it, and became a willing participant in the further shaping of the programme—which went through five reviews before it was ended in 2011 (Baldursson and Portes 2018).

Capital controls

Utilizing capital controls was in clear breach of pre-crisis neo-liberal and IMF-orthodoxy. Despite its historical position as a key instrument in the IMFs toolkit, by 2008 it was so out of fashion that the IMF only had one person left with the relevant expertise: all the others had retired (Thomsen 2018: 5). The IMF also had

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to worry about the example it set. Could other countries in Europe's periphery be subject to capital flight because of investors fear that Iceland was the first of many? In the end this effect did not manifest itself. One possible explanation is that Iceland, with its enormous per capita credit losses and small economic base, was perceived as an outlier.

Capital controls come with the advantage of freeing up countries in crisis from using extreme interest rates to defend the value of their currencies. This is because the alternative to imprisoning foreign exchange is to entice it to stay. In normal times the market-based means of doing this is to raise interest rates and create an interest rate differential with other states. In effect, if not by design, this was an integral part of Iceland's growth model before the crisis. In reality the ISK had become an object of speculation. When the bubble burst, interest rates differentials were not enough to stem the outflow and the deprecation that followed many years of appreciation. Capital controls thus defended the currency *and* helped keep interest rates lower than they would have been if they had been fully mobilized to defend the currency. Indeed, the high interest rates that had fuelled economic growth by drawing capital into Iceland before the crash, would now have acted as a break on recovery of the real economy. Capital controls prevented this from happening.

Bail-ins and Icesave

The de facto emphasis on, and the IMF's tolerance of, bail-ins was a third core feature of Iceland's recovery programme. The banking resolution allowed for delayed asset recovery on part of the foreign creditors. Meanwhile capital controls meant that the holders of 'glacier bonds' could not exchange their ISK-assets into their currency of choice. All this placed risk on foreign creditors and allowed the Icelandic banking system and the Central Bank breathing space through the most critical years.

This came at a price of conflict with foreign creditors and governments, particularly in the case of the Icesave scheme. As we have seen this stemmed from Landsbanki's desperate hunt for deposits in British and Dutch retail markets, as a way of getting out of the mini crisis of 2006. When the 2008 crisis broke, faced with huge demands far exceeding its financial position, the government refused to assume responsibility for debts owed to foreign creditors through its deposit insurance fund. The response in countries like the UK and the Netherlands—where several local and provincial governments themselves had invested in the now worthless Icesave scheme—was visceral. A diplomatic crisis ensued when the UK government—in lieu of other legal means—placed the republic of Iceland on their 'terrorist list'.

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The dispute over Icesave ended up before the Eurpean Free Trade Area (EFTA) court which adjudicates on legal issues that arise between the EU and members of the European Economic Area (EEA). The court ruled in favour of the Icelandic authorities in January 2013. In the meantime, three Icesave bills has been presented to the parliament, each offering increasingly less austere terms for the Icelanders. Both bill number two and three, were, however, rejected in popular referendums after having been sanctioned by parliamentary majorities. The reason they ended up in referendums in the first place was that President Grimsson responded to public outrage and refused to sign the second bill in 2009, which he had a constitutional right to do. UK and Dutch authorities tried to block Iceland's access to IMF funds, but payments from the IMF-programme were never delayed. All priority claims relating to the Icesave case were eventually paid out from the estate of Landsbanki, which proved to be larger than originally estimated. This process was finalized in 2016, when most asset prices were no longer depressed, and the Icelandic economy was more or less fully recovered.

Fiscal space: Hybrid austerity

A crucial element in the fiscal strategy first drawn up by the IMF and the Harde administration concerned timing. Iceland was granted a one-year breathing space before any fiscal cuts were implemented. During that year, the so-called automatic stabilizers (i.e. unemployment benefits and other types of social spending that increase when the economy is depressed) were doing the acutely needed buffering work. To quote Thomsen (2018: 5) again: 'A time when private demand is collapsing is not the time to slam the brakes on public spending or raise taxes … We only began working on balancing our budgets in June 2009,' Minister of Finance Sigfússon is quoted as saying in Øygard's (2019: 224) account of his stint as Iceland's Central Bank boss for hire. The public deficit surged from zero before the crisis to 14 per cent of GDP in 2009, as tax income went down and spending increased, without any alarm bells going off. This stands in contrast to how IMF/Troika programmes were implemented elsewhere. One reason for this pacing of the Icelandic programme was that Iceland had solid public finances before the crisis; another is the aforementioned 'ownership' of the programme which Icelandic authorities old and new displayed, which made the IMF trust them.

The priorities were, according to Sigfússon, to strengthen public finances, that is, reduce debts to a level that made interest and debt payments sustainable (60% of GDP was the target). Secondly to protect the social safety net and make the distribution of income more egalitarian. In pursuing the latter goal, the Icelandic strategy reflected the political hue of the government that took over in January 2009 (Olafsson et al. 2014). It had a clear Keynesian bent in as much as

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it prioritized supporting the purchasing power of lower-income groups, thereby protecting aggregate demand as much as one could in the midst of a depression.

More specifically, fiscal policy under the programme consisted of a combination of expenditure cuts: 13 per cent down from 2009 to 2013 (Øygard 2019: 225), tax hikes (which took almost half of the austerity burden) and a redistribution downwards. Direct money transfers to households grew, while services were cut. Benefits targeting the lowest-income groups grew, while those to higher-income groups were cut. This pattern was replicated in changes to direct taxation. Part of the tax burden was transferred from lower-income households to higher-income ones and to firms. The labour-market partners raised the minimum wage, though average wages remained at nominal values (while inflation spiked in response to a weaker currency). A temporary wealth tax on net assets above a given threshold was levied. Lastly, the government opened up some pension funds in order to boost consumption. It also instigated some debt relief, aiding the lower echelons of the income distribution more than others. After a few years of pursuing these policies, income distribution was much more compressed than it had been pre-crisis (Ólafsson 2014: 1).

Winners and Losers

The main winners of governmental and IMF crisis responses were Icelandic society and institutions. Almost everyone in Iceland (apart from bankruptcy lawyers and special investigators) incurred losses, but relative to other crisis countries the pain was short, sharp and possible to recover from. The single most important factor in this regard is the unemployment level, which decreased quickly and consistently as the response programme unfolded, reaching a healthy 3 per cent by the end of 2016. Among other winners we can count fisheries whose export incomes became much more valuable at home due to the fall of the ISK. The most important growth industry, however, was tourism. It also benefitted from the cheap ISK, but even more so, it turned out, from the volcanic eruption of 2010. This stirred an enormous interest in visiting Iceland, and there was a concerted effort from government and industry to build on this initial windfall. From playing a fairly marginal role before the crisis, by 2016 tourism accounted for 40 per cent of total exports (Benediktsdóttir et al. 2017: 286). One estimate holds that one-third of the employed population may at the time have moved from construction and banking to tourism (Benediktsdóttir et al. 2017: 304).

The most obvious losers of the crisis were the owners and management of the fallen banks and the risk-taking business tycoons. They lost money, social standing and in quite a few cases their freedom. In total the Icelandic judiciary sentenced 36 bankers to a total of 96 years in prison. They came from all three big banks, with Kaupthing topping the incarceration table in terms of both number of bankers and years, Glitnir came second and Landsbanki third. Most of these individuals

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became persona non-grata in Icelandic business circles for years to come. It is noteworthy that the cases were initially tried in the Reykjavik District Court before being reheard in the Supreme Court. In some instances, cases that were adjudged in the lower court as not guilty were overturned by the superior court or sentences were increased (Hrunid thid munid 2018).

Other significant losers were Prime Minister Geir Haarde who was impeached on grounds of negligence but was acquitted on three out of four charges. He did not serve any time. Later, after his party, IP, had been returned to power, he was made Iceland's ambassador to the US. David Oddsson on his part may have lost his job as Central Bank governor, but soon reappeared as editor of Iceland's major daily, *Morgunblaðið*, which he remained, even if the announcement of his appointment was followed by several resignations and a large volume of terminated subscriptions. He ran for president in 2016, but lost. Former SDA and Foreign Minister 2007–2009, Ingibjörg Sólrún Gísladóttir, was also a candidate for impeachment, but parliament eventually decided against it. Two other ministers were also let off the hook by parliament. Hence, the only impeachment process that ran all the way was the one that concerned former Prime Minister Geir Haarde.

Other losers include Icelandic pension funds—for example, future pensioners—who lost 25 per cent of their assets. We have asserted that Icelandic economy as such was a relative winner. That said it is worth emphasizing that 80 per cent of households had their debt payments indexed to inflation, which in most cases translated into higher interest rates and reduced purchasing power. Another 13 per cent of households had denominated their debts in foreign currencies. This had much the same effect but via a different mechanism: The reduced value of the ISK could for a while double the size of a mortgage loan before the ISK rose again. Importers of foreign capital and luxury goods more or less saw their markets dry up for a period of three to four years. Finally, another large group of losers were foreign investors and creditors. Over time, and as asset prices improved, many foreign creditors got at least some of their money back, but massive losses were still suffered.

'There Is No Alternative': A Policy without Counternarratives

Though we can find opposition against single items in the recovery strategy, there was no coherent opposition to the programme as such. Oddsson used his new pulpit (as newspaper editor) to criticize: Øygard, for instance, was labelled a 'shitbag' (Øygard 2019: 20) but was unable to offer a real alternative. A lot has been written about the Icelandic financial crisis and recovery and there are different nuances bordering on disagreements about the relative weight of different explanatory factors behind both crisis and recovery. We have not, however, come across anything that qualifies as a counternarrative. Iceland's financial fall was, as stated, the deepest relative to GDP, but when things were to go bad, there were some fortuitous

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circumstances. First of all, the fact so much of both the lending and the assets were abroad arguably made it easier to buffer the domestic impact and it certainly made it easier to avoid a larger bail-out. Secondly, Iceland had sound public finances when the crisis hit, which created fiscal leeway and made negotiations with the IMF easier. Thirdly, having one's own currency which can depreciate made it easier to fix the balance of payments. Fourthly, the volcanic eruption proved to be a blessing disguised by ashes and lava. From a methodological point of view, it is impossible to establish experimental conditions or even systematic comparisons between crisis cases between Iceland and the rest of Europe because of radical differences in size and along a few other key variables. What we have tried to zoom in on, however, are some crucial policy choices and the mechanisms these activated. In short, the Icelandic story is about making the best out of the circumstances you are facing.

Assessment: An Exemplar of Successful Economic Crisis Management

This case of a policy success is different from most other cases in this book. It deals not with ongoing public policy but with episodic crisis management: events in 2008–2010 presented Icelandic policymakers and institutions with an extraordinarily demanding combination of high threat, high uncertainty and very little time to act (cf. Boin et al. 2017). Furthermore, while the typical policy success studied in this volume refers to a more easily circumscribed programme, a full-scale economic crisis demands that fires are put out all over the place. Authorities in Iceland had to deal with simultaneous short- and long-term foreign policy, financial, economic and social issues. Despite these formidable challenges, Iceland's recovery from her financial meltdown can arguably be deemed a policy success along all four dimensions specified by the PPPE framework applied in this book—although the political success experienced by those who handled most of the clean-up job turned out to be more precarious than they would have hoped for.

Programmatic success

The public-value proposition underpinning policy choices was simple enough in principle, if difficult to achieve: Save the Icelandic economy and minimize harm to the welfare of the Icelandic population. Through purposeful action Iceland achieved a fast and robust recovery in terms of growth, employment, current account surpluses, debt reduction and distributional outcomes. It is also possible to discern an underlying theory of change. Simply put, while Southern European countries had recovery programmes of a neoliberal and ordoliberal hue foisted upon them, the Icelandic government dipped into the Keynesian toolbox. Given

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their commitment to the euro, countries like Greece and Spain were forced into a destructive policy of internal devaluation through austerity and precious little debt restructuring.

In contrast to this, Iceland's room for manoeuvre was significantly larger. It could let the krona depreciate sharply, install capital controls in order to stem flows out of the country, obtain (some would say force through) significant debt write-offs and implement a programme of cuts combined with compensatory measures. This programme, with the IMFs blessing was also designed to shield the most vulnerable. That is, those with the highest propensity to consume were protected. Thus, Iceland was able to retain a functioning welfare state while reducing growth-stilting effects on aggregate demand.

Political success

The financial crisis produced a deep political crisis for the ruling elites, and the resultant change of government secured initial public legitimacy for the crisis policies chosen. In uncertain times such newly minted political capital is particularly precarious. This also turned out to be the case in Iceland. The left–green alliance did not survive the election of 2013. This probably reflected a combination of the penalty incumbents often have to pay increased by the costs of administering austerity. In addition, there were three specific issues thrust on the agenda by the economic crisis—mortgage relief, Icesave and European Union accession/ negotiations (Indriðason et al. 2017: 28). The accession question came up with renewed force after the crisis, as Iceland—with good reason after being condemned by powerful countries in the initial phases of the Icesave dispute—felt it needed more allies and access to ECB funding. As recovery progressed, however, the salience of the issue slowly evaporated, until it was taken off the agenda in 2014.

Process success

Transparency is a key criterium in our judgement of the Icelandic recovery as a process success. Iceland's post crisis government was vigorous in its efforts to restore public confidence in its institutions, the single most important move arguably being the establishment of a parliamentary Special Investigating Committee. Hiring an untainted central banker from abroad, and a anti-corruption investigative judge of global reknown as an assistant to the special investigator—the Norwegian-born French magistrate, Eva Joly—were also legitimacy-enhancing moves. It is also noteworthy that some 22 police officers and six accountants from France and Norway were delegated to assist the government investigator on 1 October 2009. On that day the investigator raided the offices of both KPMG and

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PwC, the auditors of Glitnir, Kaupthing and Landsbanki in their search for evidence that became part of the Special Investigation Commission's report (Special Investigation Commission 2010).

Endurance

It is difficult to assess the endurance when assessing an instance of crisis management. The problem was acute and dramatic and needed immediate and undivided attention. But as the crisis was tackled, the crisis management regime that was put in place in response to the collapse, was no longer needed. Perhaps a more relevant way of approaching the endurance issue is to ask if the preconditions (structural imbalances, lax oversight, corrupt practices and poor corporate governance) that facilitated the crisis (or at least the enormity of it) have been rooted out? Regarding imbalances the answer is a clear yes. Before Covid 19 struck, the current account and the fiscal balance had again turned positive, while Icelandic assets abroad outstripped liabilities. When it comes to corruption and corporate governance there is some evidence to the contrary. The Panama papers contained the name of 600 Icelanders, politicians and business people amongst others. The Icelandic Tax Authority has investigated these cases and prosecuted many for tax avoidance. Speaking on an Icelandic talk show in 2016, Eva Joly contended that Iceland still had a corruption problem (Iceland Monitor 2016). The Icelandic parliament hasn't been able to update the country's constitution, as promised shortly after the crisis. An updated constitution is to make clearer the nation's rights to the country's natural resources, commit to increased transparency in public administration, protection of media and whistleblowers, the public's right to information at the societal, political and economic levels, and more.

On the positive side, improvements have been achieved on many of these issues. Increased transparency has been enhanced by updating corporate governance codes and making them more comprehensive. Iceland also became one of the first countries in the world to introduce a gender quota for corporate boards. The prosecution of bankers and various others has opened up many positions on the upper echelons of Icelandic business life, with women filling many of these. The Financial Supervisory Authority has gained more leverage in its supervisory efforts and so has the Central Bank. The two institutions were merged in 2020 in order to further this goal. Icelandic universities have increased the number of courses on business ethics. This is the result of managers themselves complaining about lack of solid preparation for managing ethical dilemmas in business situations.

Lessons from a Crisis Iceland Had to Have

If by lessons we mean those pertaining to the pre-crisis period, Iceland is just an extreme case of what has been learned in many other places. Most of these

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lessons were available—also in formalized form—before the crisis, but the schools of thought they stemmed from (post-Keynesian economics and economic history) were out of fashion and simply not taught in most economics departments. These lessons include the need to display extreme caution in the face of rapid credit growth, the need for tighter regulation and supervision of financial activities in general, mindfulness of how euphoric phases tend to stimulate rule-breaking and the tendency of actors who have assumed enormous risks to double down at the first sight of real trouble (the Icelandic internet banks being one of several cases in point) (Aliber and Kindleberger 2017).

One lesson that springs from even a casual comparison to Southern European crisis experiences post-2008 is that hybrid austerity with Keynesian components works better than uncompromising austerity with strong conditionality to boot. A second lesson is that bail-ins and delayed payments of recovered funds are helpful to a country in crisis. The underlying moral issue is also worth reflecting upon. Is credit going bad the sole responsibility of the debtor, or is it a two-way street? One argument for the latter position is that a main function of credit markets—in both theory and practice is to price risk. The higher the risk, the higher interest rates you as a creditor can demand. Thus, complete bailouts, where creditors suffer no losses, fly directly in the face of the notion of credit risk being assumed and priced. Finally, one can speculate that vigorous prosecution of an economic fiasco's culprits increases political legitimacy for the broader crisis response effort and helps a stricken society move on psychologically.

Questions for Discussion

1. Is liberalization of the financial sector different from other types of liberalization?
2. Which were the most important problems decisions makers dealt with when managing the crisis?
3. Why was the Special Investigation Committee important?
4. What was the role and importance of the IMF in the recovery process? Do you see differences between the strategy chosen for Iceland from those chosen elsewhere?

Links to online resources

The Icelandic banking collapse: was the optimal policy path chosen? https://www.cb.is/library/Skraarsafn—EN/Working-Papers/WP%2062.pdf/.

Iceland: High growth, low inflation and ... What's behind remarkable performance? https://ec.europa.eu/info/sites/info/files/economy-finance/eb037_en.pdf/.

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Comparison of crisis Iceland and Greek:
https://voxeu.org/article/imf-programmes-greece-vs-iceland/.
Iceland independent economic policy, holding finance accountable: https://www.resilience.org/stories/2019-08-16/iceland-independent-economic-policy-holding-finance-accountable-and-experimenting-with-local-democracy/.
Report of the special investigation commission (SIC):
https://www.rna.is/eldri-nefndir/addragandi-og-orsakir-falls-islensku-bankanna-2008/skyrsla-nefndarinnar/english/.

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