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THE INTERNATIONAL
FINANCIAL CRISIS:
THE CASE
OF ICELAND –
ARE THERE
LESSONS TO BE
LEARNT?

Jón Baldvin Hannibalsson

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**The International Financial Crisis:
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Are there Lessons to be Learnt?**

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Foreign Affairs and External Trade of Iceland*

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SUMMARY:

1. Iceland became the first developed economy to fall victim to the current international financial crisis. An experiment with the smallest independent currency area in the world (pop: 300 thousand), based on the *króna* as a national currency, has ended in a national disaster. Iceland suffered a *twin-crisis*, with the value of the currency in a free fall and the national financial system in ruins.
2. Although the international financial crisis was the spark that ignited the fire (through the closing of inter-bank loan lines) the underlying causes were of domestic origin. Among them are the spectacular growth of the financial system after privatization seven years ago (to the tune of 12 times GDP) and the failure of the government, the Central Bank and surveillance institutions, either to restrain that growth, based on easy access to cheap credit and on subsequent debt accumulation, or to build up adequate reserves. Both the macro-economic policies of the government and the monetary policies of the Central Bank were misguided and ineffective. In short: The banks had grown *too big* for Iceland or in other words: Iceland remained *too small* to act as an independent currency area as well as a credible bastion of support for the banks. Despite alarming warning signals in the past few years the government of Iceland (GOI) failed to do anything about it in time.
3. The foreseeable socio-economic consequences are dire. With the currency related inflation of import-prices already at 18%, heavily indebted companies and households are facing bankruptcies and loss of property, unable to stand by their financial obligations. Foreign exchange-linked debt has almost doubled in domestic currency and internal debt is also inflation-indexed. According to the Federation of employers between 60 and 80% of Icelandic enterprises are technically bankrupt. Unemployment is already approaching 10% and rising. The State is facing a massive loss of revenue and rapidly increasing expenditures in the next few years, due to rising debt service (a quarter of total budget outlays in 2008) and unemployment benefits.
4. In the end Iceland had no choice but to appeal to the IMF for help. Apart from a US \$ 2.1 billion loan (followed up by further loans from the Nordic countries and a few other states, including Russia) the three pillars of the IMF rescue-plan for Iceland are the following: (1) To stabilize the exchange rate (through strengthened foreign currency reserves and “capital outflow restrictions”). (2) In the name of “safeguarding international relations” to force the GOI to pay foreign creditors of the fallen private banks more than strict legal obligations would demand and (3) to impose “a medium-term fiscal sustainability”. Included is an exorbitant rise in the basic bank rate (from 12 to 18%) which is a devastating blow to indebted companies, likely to add to the woes of bankruptcies and unemployment. Since capital movements are restricted this is hardly necessary to prevent potential capital flight and uphold the value of the *króna*. And since the economy is already in a deflationary spiral, this seems to be the wrong medicine at the wrong time, when central banks the whole world over are lowering the bank rate and offering massive fiscal stimulus-programs. As for forcing the GOI, on behalf of Icelandic taxpayers, to take upon themselves to pay the debts of private venture capitalists, beyond strict legal obligations, it introduces a blatant *moral hazard*. It is a classical case of accepting *private gain* at the cost of *public loss*. This sort of governance is simply incompatible with the basic principles guiding the rule of law in the field of ownership rights and obligations. It sets an indecent example.
5. The IMF rescue-program leaves two fundamental problems unsolved: One is the provision of a stable currency, since capital controls can only be maintained in the short-term. The other is the issue of the debt-burden and the ability to pay. According to the worst case scenario, taking into account expected discounts in asset prices and a

steep contraction of Iceland's GDP, the sovereign debt burden may reach as much as one and a half GDP. This would amount to a per capita debt burden at least twice the one imposed by the victors upon the German people after World War 1. A debt-burden of this magnitude could easily drown any hope of economic recovery in the near future.

6. The desperate need for a *stable currency* to underpin economic recovery in the near future has turned the majority of public opinion in favour of Iceland applying for membership of the EU and for the adoption of the euro. Under no circumstances would Iceland have been able to avoid the impact of the international financial crisis. But had Iceland (like Ireland) been a EU-member state and a euro zone partner, the country would not have become the helpless victim of both a *bank- and a currency crisis* at the same time. This, according to current opinion polls, is the major lesson to be learnt from the case of Iceland, for the Icelanders themselves and perhaps for the smaller member-states of the European Union that are still outside the EMU as well.
7. The crucial questions on the future of Iceland therefore remain unanswered: Will the debt burden cripple the economy's potential for recovery? Are the strong fundamentals of the economy and the traditional resilience of the Icelandic people strong enough to enable them to pay off their debts in a few years' time? Will Iceland recover soon enough to fulfill the preconditions for joining a stable currency area? We simply don't know yet.
8. Superimposed upon the economic crisis there is a *political crisis* to match. The present coalition government of Conservatives and Social-democrats seems to have been caught completely off-guard by the crisis. The coalition parties are entirely at odds on the fundamental issue for the future of the country: *Should Iceland apply for membership of the EU or not? Should Iceland try to solve the currency problem in the near future by tying the króna to the euro?* Or does this emergency situation justify unorthodox emergency measures, such as adopting the euro unilaterally? In the face of such urgent questions, the current political leadership seems to be utterly impotent. While the Social-democrats are pro-European, the Conservatives, traditionally nationalistic, euro-sceptic and pro-American, seem to be unable to make up their minds. The opposition appears to be equally split. Under those circumstances the demand for new elections, to be held as soon as possible, is getting louder by the day. This *failure of political leadership, in a situation of national emergency*, makes the future still more uncertain. Will the increasing political turmoil split all the existing political parties and create new ones with the possibility of opening up an abyss of anarchy and confusion?

On Monday morning September 29th before the opening hours of banks, the government of Iceland (GOI) announced that GLITNIR, one of Iceland's three major commercial banks, had been nationalized. A few weeks earlier the financial supervisory authority of Iceland (FME) had given the bank a clean bill of health. What had happenend?

A few days earlier, the chairman of the board and the director of GLITNIR had secretly met with the Central Bank directors to tell them that GLITNIR was in trouble. Although GLITNIR had long term contracts for refinancing their short term debt - a significant part had been with Lehman Brothers. Now, Lehman Brothers no longer existed. GLITNIR, therefore,

was in desperate need for foreign currency. Having rejected collaterals offered on GLITNIR's behalf the Central Bank, in consultation with the government, decided to buy majority share in the bank.

Evidently, the Central Bank reckoned that this action would reassure the markets and restore confidence in the Icelandic banks. By hindsight, they evidently miscalculated. The ratings companies (Moody's, Standard and Poor's etc.) moved swiftly to downgrade the creditworthiness of the Icelandic state, reflecting the view that it was beyond the government's means to stand by the banks' obligations. The risk surcharges imposed on loans to the Icelandic banks rose sharply. The Icelandic bank system was teetering on the brink. Thus started a week that ended in the collapse of the *entire financial system* of Iceland.

On Monday October 6th the GOI rammed a special emergency legislation through Althingi (Parliament). It gave extraordinary powers to the FME (Financial Supervisory Board) to take over the running of the banks. To avoid a run on the banks the law stipulated that all savings deposits with the Icelandic banks were fully guaranteed by the government. The National Bank of Iceland (Landsbankinn) was next in line to declare insolvency. The National Bank had subsidiaries abroad, in the U.K., Holland and elsewhere. The British government moved swiftly to freeze their assets in the U.K. in order to safeguard their citizens' interests. By this time all Icelandic companies abroad were under a cloud of suspicion. The British government went so far as to apply the recently adopted "terrorist-law" to take over British registered companies owned by the Icelandic banks, including the third and biggest Icelandic bank, Kaupthing. The government of Iceland (a NATO ally) and both the Icelandic banks operating in London, were under this law blacklisted along with *al Qaeda* and other terrorist organizations. This was the last straw. Kaupthing fell and with it the entire financial system was in ruins.

1. Roots of the problem: Complacency and Exuberance

The American bank crisis (with the fall of Lehman Brothers) can be said to have been the spark that ignited the fire that consumed the financial system of Iceland. Nonetheless this national disaster can only be fully explained in terms of domestic Icelandic policies of the past few years. Most economists agree that coordinated macro-economic policy to restrain an imbalanced economy had been conspicuously lacking. The government presided over a major investment boom in the energy sector as well as letting loose a real estate bubble through easy credit. A rapid rate of growth (4.6% per year on the average since the turn of the century) fueled by foreign loans and unrestrained consumer spending, was reflected in explosive balance of trade deficits.

The expansion of the public sector (from 36% to 48% of GNP during the boom) under a conservative government, was a world record. The Central Bank since 2001 declared a floating currency regime and pretended to restrain inflation within 2.5% limit, plus or minus 4%. This turned out to be totally unrealistic. In the phase of easy access to cheap money from abroad, double digit Central Bank rate turned out to be not only ineffective in restraining inflation but had the unintended side effect of strengthening the value of the *króna*. This had many adverse consequences. It stimulated excessive imports, consumption and debt accumulation as well as a balance of trade deficit, that spiraled out of control. When the interest-rate differential between Iceland and abroad reached double digit numbers, speculative capital started flowing in, collecting quick profits in currency speculation. This further strengthened the exchange rate and the imbalance of the overall economy.

When foreign speculators, sensing imminent danger, started withdrawing their money, the value of the króna fell. Collapse is actually a better word to explain what happened. From the beginning of the year 2008 until the fall of the financial system in October, the value of the króna had fallen by 70%. For a while the króna was no longer an officially registered currency and could only be traded in the black market. Iceland is thus suffering a *twin crisis: A bank-crisis and a currency crisis at the same time*. And of those two, the currency crisis is the more devastating.

2. Iceland and Ireland: A fateful difference

In this context it is interesting to compare the fates of the sister islands of Iceland and *Ireland*. Both island economies had been enjoying sustained periods of rapid economic growth. In both countries economic growth had been fueled by a steady influx of foreign capital investments. In both countries the real estate boom spiralled out of control and turned into a bubble. In both countries the standard of living and the level of consumption exploded. Both economies were thus feeling the strain of overheating. But that is where the comparison ends. The big difference is that Ireland is a member of the European Union and a partner in the European Monetary Union, using the euro as a national currency. Iceland, on the other hand, has been experimenting with its own króna, within the smallest currency area of the world, in an environment of a free flow of capital under a regime of wide open financial markets. This has turned out to be a world of difference.

When the Icelandic commercial banks expanded from having been one third of the Icelandic GNP into becoming twelve times the GNP, the GOI and the Icelandic Central Bank were unable to provide the necessary back-up. *The banks had grown too big for Iceland; or Iceland was simply too small for the banks*. This explains why the Irish taoiseach, Mr. Brian Cowen, said: “Thank God that Ireland is a member of the European Union and has long ago adopted the euro. Else we might have been in the same situation as Iceland”. He is right. *Of all the fateful policy mistakes made by the GOI and Central Bank of Iceland in recent years – and they are many – the stubborn resistance against joining the European Union and adopting the euro, were the gravest*

It is beyond doubt that had Iceland been a member of the eurozone relying on the European Central Bank in addition to the domestic authorities, Iceland would not be in such dire straits as it finds itself in now. Of course the Icelandic banks could have gotten themselves into trouble nonetheless, just as individual banks within the eurozone certainly have. But it was not the lack of Icelandic *krónur* that made the Icelandic banks ultimately insolvent. *It was the lack of foreign currency – euros – and the fateful weakness of the Icelandic government and the Central Bank, that caused the crash.*

Had Iceland been a member of the European Union and a eurozone partner as well it would not have escaped the impact of the international financial crisis any more than Ireland. But it would not have been the helpless victim of both a bank – and currency crisis at the same time. This is the major lesson to be learnt from the case of Iceland, both for the Icelanders themselves and also for the smaller nations within the EU, still trying to fend off the impact of the financial crisis with their weak national currencies.

3. After the Crash: The Plight of a Nation

Before the crash Iceland was classified in OECD statistics as the 6th most affluent nation on earth in terms of per capita GNP. The crash will change all that. The question remains if the debt burden will turn out to be way beyond the nation's *ability to pay* so that it will cripple recovery through economic growth any time soon. The immediate consequences of the fall of the banking system are that the shareholders have lost their overvalued equity.

But the crash of the currency has immediate and severe consequences for the nation as a whole. Import prices are increasingly inflated. This is reflected in the consumer price index (the measurement of inflation). Since all long-term loans in Iceland are price indexed, any inflationary spurt is permanently projected through every household mortgage. Foreign currency denominated loans will double in a short space of time. For heavily indebted firms and households, this is beyond their ability to pay. And the fall in real estate and other asset prices precludes the possibility of relying on liquidity of assets as a solution.

An IMF stipulated bank rate of 18% makes this debt burden unsustainable. The shock effect is being felt immediately throughout the economy: Purchasing power is falling, the debt burden is getting heavier and bankruptcies are increasing daily. Unemployment – unknown in Iceland since the early nineties – is rapidly spreading. The pensionfund system – a bastion of strength in the Icelandic economy – suffered heavy losses through the fall of the banks. Hard won pension rights will foreseeably be severely cut. But the youngest generation – the best educated in the history of Iceland - will be most severely hit by the crisis. They are the most indebted ones and they will lose their jobs disproportionately. Young professionals are already seeking jobs abroad. The most severe long-term consequences of the crash will be emigration of the young – the best and the brightest.

4. A Failure of Preventive Action

The rapid expansion of the Icelandic banks, coupled with the evident vulnerability of the króna, should have sent strong warning signals to the government and the Central Bank of Iceland several years ago. What were the options? One was to expand the Central Bank's foreign currency reserves commensurate at least with the banks' short term debt. This would have been a very expensive solution as well as a risky one. Later, when access to cheap money abroad became more difficult, this solution was no longer feasible.

Another solution would have been to have the banks, or at least the bigger ones, relocate their headquarters to the euro- area. Approximately 4/5ths of their activity was by then outside of Iceland, mostly within the euro-area. This would have removed the present currency risk and brought the banks under the savings guarantee system of the relevant central banks as well as secured the support of the European Central Bank. Although this issue was raised in public dialogue it was never seriously contemplated by the authorities.

The third option was for Iceland to join the European union and to seek fulfilling the Maastricht criteria for adopting the euro. This option was never politically feasible due to the anti-European instincts of the Conservative Party's leadership which was, and still is leading the government. Their euro-scepticism is in part inspired by their soul-mates among the British Tories, in part by the influence of American neo-conservative ideologues, who look upon the European Union as some sort of a socialist conspiracy, and in part by their nationalist heritage.

By the year 2007 the warning signals were already flashing both at home and abroad. The American bank crisis, initially due to reckless subprime mortgage lending, was spreading fast. The fall of Northern Rock in the U.K. was a milestone. Access to cheap money for refinancing short-term debt was no longer easy. The rate of interest was rising. Ultimately the rating agencies had a second look at countries and financial institutions that had become heavily indebted. Although the Icelandic state was at that time relatively debtfree, Icelandic banks and households were hugely indebted. Hence, the rating agencies imposed heavy risk-surcharges on loans to Iceland which in the end became prohibitive. Ultimately the rating agencies downgraded the credit-worthiness of both the Icelandic banks and the State as well. By that time, by mid-year 2008, Iceland had no option left but to seek help from abroad.

Appeals for loan guaranties were made to the Nordic Central Banks, to the Federal Reserve, the Bank of England and even to the European Central Bank in Frankfurt. But by this time Iceland was considered “too hot to handle.” The banks’ size compared to the Icelandic economy and their scale of indebtedness was considered extraordinary and suspicious. After consultations the GOI was advised to seek help from the IMF.

The first perfunctory analysis of the Icelandic situation did not inspire confidence in the capacity of the Icelandic government or Central Bank to handle the situation. Under the circumstances an IMF rescue-plan for Iceland was considered a precondition for help from other central banks. Thus Iceland became the first so-called developed country to seek shelter with the IMF in 36 years. There was no other option left open. Since then other European countries have had to follow into Iceland’s footsteps. By now the IMF has become a major player on the international scene in dealing with the international financial crisis.

5. The Ice-save Dispute: David vs. Goliath

Iceland’s appeal for help to the IMF, urgent as it was, was none the less delayed for many weeks. The reason was the so called “*Icesave*” - dispute between the Icelandic and the U.K. governments. What was at issue? The National Bank of Iceland (Landsbankinn) had established branches in the U.K. and in Holland, offering a competitive rate of interest for savings deposits. Other Icelandic banks did the same but in the form of subsidiaries that were under the surveillance authorities and savings guarantee system of the relevant countries. This was the Icelandic Banks’ method to solve their liquidity problems in foreign currencies.

When the Icelandic banks went down, the question rose immediately who should guarantee the savings deposits. Under the EEA-agreement bank branches abroad are under the surveillance authority and the savings guarantee systems of the home country. Each country is obliged to run a savings guarantee fund which is financed by contributions from financial institutions. This fund is an independent entity without a formal state guarantee. If this fund had insufficient money to stand by its obligation it was meant to borrow in the market. The Icelandic fund had nowhere near the resources required to guarantee all the savings deposits in the Icelandic banks’ branches abroad. The relevant EEA-directive stipulates a minimum amount (20.887 euros) to be guaranteed to individual savings depositors.

This raised several questions for legal interpretation: Was the amount guaranteed actually dependent on the fund’s resources? Or was it the minimum amount defined in the EEA-directive? Was there an effective state guarantee, although it is not clearly defined in the text of the directive? Did the directive apply only when individual financial institutions failed or was it meant to apply as well in the case of *total collapse of a national financial system*? What

about *national emergency rights*? These are some of the impertinent legal issues raised in this dispute. Also, the U.K. government's application of the "terrorist-law" against Iceland, which ultimately brought down the Icelandic financial system, raised the question of the legality of the U.K. government's action and indemnities in case they were deemed illegal.

The Icelandic prime minister initially insisted that the two issues, the Ice-save dispute and Iceland's application for IMF support, were unrelated. He even gallantly declared that he would not submit to British threats on this issue. Instead he offered to have the issue solved by independent arbitration. In the end it was France, in her capacity as acting presidency of the European Union, who solved the issue. Iceland was simply told that the EU would prevent the implementation of the IMF rescue-plan, unless Iceland accepted to pay the minimum guarantee as defined by the EU directive, and decreed by the Commission.

At the same time the EU made sure that Iceland would receive loans that enabled the government to pay up. The EU argument was that any doubt shed on the validity of the EU-wide savings guarantee system could undermine the stability of the financial system of the EU as a whole. Also, Iceland was told that since the government of Iceland had in the emergency legislation of October this year guaranteed all savings deposits of Icelandic citizens, the same rule should apply to all citizens of the EEA-area. Non-discrimination on the basis of nationality is a fundamental rule that applies without exemption throughout the EEA area.

6. A Crippling Debt-burden?

This settlement raises two fundamental issues: One is if Iceland's debt burden in the near future will be beyond the country's ability to pay and thus destroy the country's prospects of recovery any time soon. The other is the classical issue of *moral hazard* that always presents itself in the wake of financial crisis of this sort. The IMF calculates that Iceland's debt burden in the wake of the crisis will amount to 80% of GNP. This is many times the amount Sweden had to borrow to bail-out the banks, as a percentage of GDP, during Sweden's financial crisis in 1992-95.

The IMF, it seems, takes it for granted that the Icelandic banks' assets, meeting their debts, will maintain their nominal value after the crash, despite weak markets. This is hardly realistic. Some of those assets have already been sold at fire sale prices. The global recession is also negatively affecting such asset prices. Thus authoritative chartered accountants reckon that the outstanding assets of the National Bank of Iceland have by now lost half their value.

The Icelandic authorities are still in the process of sorting out the net position of the bankrupted banks and negotiating with their foreign creditors. The overall picture is therefore far from clear yet. But the worst case scenario, taking into account expected discounts in asset prices and a serious contraction of Iceland's GNP indicates, that the debt burden may reach one and a half GNP. This would amount to a per capita debt burden at least *twice the per capita debt burden for Germany after World War I*. In the case of Germany, the post war debt burden imposed by the victors was so heavy as to cripple the German economy for many years, leading to hyper-inflation and political upheaval that in the end led to a new world war. In the case of Iceland the consequences may not be so far reaching. But they may be tough enough to kill off any hope for recovery in the near future.

7. Moral hazard: Private gain – Public loss

In economic theory hefty gains from risky investments are justified as a reward for venturing capital under uncertain circumstances. High risk brings generous rewards because the danger of loss is ever present. This means that when risky investments fail, the investors themselves should cover the loss. If not, *the entire capitalist system is undermined by moral hazard*. Why should any investor remain prudent, or even play by the rules, if he can count on others, i.e. the taxpayers, to come to the rescue? In the United States, the present-day citadel of capitalism, the fundamental rule applying to bail-outs of venture capitalists is, that since they enjoyed all the profits, justified by risk, they should also bear the burden of failure. The big exception is when the failing capitalist is *big enough* to threaten to bring down the whole system with him. This is what happened in the case of Long Term Capital (LTCM) in 1998 and it has applied to a few cases in the current crisis.

This justification does not apply to Iceland. The financial system of the entire country is already down and out. The question is: *Why should Icelandic taxpayers be forced by foreign governments or international institutions to pick up the bill left over by Icelandic venture capitalists?* The answer seems to be, because they have no other choice left – apart from emigrating. That is actually what a sizeable proportion of the younger generation of Icelandic professionals is preparing to do. Iceland is now in the not so enviable position to be at the mercy of the IMF.

8. Enter the IMF: A Rescue-Plan or Collective Punishment?

During the last two decades both the World Bank and the IMF have been working under the heavy influence of the so called “*Washington Consensus*.” This means they have been guided by the neo-conservative ideology that the state is always a part of the problem but never a part of the solution. Countries should for their own benefit open up for free trade and free capital flows, without any restraint or government interference. All problems should be left for the markets to solve since they are also by nature meant to be self-correcting. Those countries that play by the rules will be rewarded by dynamic innovation and rapid economic growth, that will gradually trickle down to the general public. Those countries that disobey, will be punished by stagnation and unemployment, since they will turn out to be non-competitive in the global market place.

Many of the poorest countries of the world have, because of heavy indebtedness, been forced to accept this medicine. The ideological prejudice against the proper role of the democratic state in economic development has led to a serious neglect of investment in infrastructure and human capital, making domestic production hopelessly non-competitive in the face of imports, leading to balance of payments problems and further indebtedness. Far from keeping the promise of economic growth, those countries have been locked up in a vicious circle of stagnation, deteriorating living standards, and general misery.

In the case of the Asian crisis 1997-98 the IMF applied its austerity program to the countries inflicted by massive capital flight. The main pillars of the program were a steep rise in the bank rate (to prevent capital flight and maintain the value of the currency) and a fiscal austerity program, involving deep cuts in social expenditure, both for investment and welfare. It is generally accepted that the IMF misread the situation and applied the wrong medicine. In the case of South-Korea for instance, the program failed to prevent capital flight and maintain

the value of the won (it fell by 49%) and it made the economic and social situation much worse than was needed.

Later on the IMF formally apologized for their mistakes, thus entertaining some hope that they had learnt from their mistakes. In the current crisis it is remarkable that no developed country has applied the standard IMF austerity medicine. On the contrary Governments are competing with each other in administering stimulative packages, based on deficit spending, and even resorting to outright nationalization. The rich world is certainly not practising what they have so far preached to the poor.

Since Iceland is the first so-called developed country that has ended up under IMF tutelage in 36 years, there is every reason to ask: Has the IMF learnt from its past mistakes? The answer, it seems, is both yes and no. The three pillars of the rescue-program for Iceland are the following: (1) To stabilize the exchange rate. (2) In the name of “safeguarding international relations” to force Iceland to pay foreign creditors more than strict legal obligations would demand, according to the government view. And (3) to impose “a medium-term fiscal sustainability”. Remarkably, the IMF has accepted the fact that the Icelandic króna has lost all credibility. In relaunching it they therefore allowed “*capital outflow restrictions*” in the near term. This is realistic. But imposing a Central Bank rate of interest of 18%, said to be necessary to maintain the value of the króna, and to keep the remainder of speculative capital still within the system, will only make a bad situation worse.

The Icelandic economy is by now in a *deflationary spiral*. Raising the rate of interest beyond 20% will indeed be highly effective in bankrupting what is left of indebted companies still in operation in the country and thus increasing unemployment and general misery. This goes contrary to what central banks are doing all over the world, namely lowering the bank rate in the hope of stimulating the economy. By under-estimating Iceland’s long-term indebtedness the IMF may be crippling the economy and thus putting at risk any recovery in the near future. On the other hand the fiscal austerity program must be considered relatively mild since it does not really begin to bite until the year 2010. But even that is a doubtful strategy as the former prime minister of Sweden, Göran Persson, has pointed out, but he administered the Swedish rescue- program during the Scandinavian financial crisis in 1992-95.

9. Future Prospects

Iceland’s prospects in the near future are bleak, to say the least. The present coalition government of Conservatives and Social-democrats seems to have been caught completely off-guard by the crisis. By hindsight it is beyond dispute that the government, the Central Bank and the supervisory authorities all disregarded the warning signals and failed to act in advance to prevent the crash or to stave off the worst consequences. The government reacted helplessly to events rather than initiating any preventive action in time. After the event, attempts at damage control have been fumbling and erratic. The handling of the Icesave-dispute was slow and ineffective. Work on the restoration of the banking system, now under state ownership, has been secretive and conspicuously lacking in transparency.

General lack of concrete information on government action in mitigating the consequences of the disaster, for both businesses and households, has created an atmosphere of suspicion and mistrust. The government and the Central Bank have been unable to conceal their differences on major issues, such as the IMF rescue plan, foreign debt obligations, the rate of interest and

the relaunching of the króna. There is a divergence of opinions on all of those issues and more.

To add further to the confusion, the coalition partners are entirely at odds on basic issues. The Social-democrats have officially denied any responsibility for the Central Bank director's actions and utterances. It is a lamentable anomaly in this situation that the Central Bank director is a former chairman of the Conservative party and ex-prime minister, without any academic qualifications in monetary economics. Despite his position as Central Bank director he is generally seen to be playing politics as the *de facto* leader of the anti-European Union faction of the conservative party.

This is the crux of the matter: The coalition parties are entirely at odds on the fundamental issue for the future of the country: *Should Iceland apply for membership in the European Union or not?* The Conservatives say no (applauded by the left-wing opposition); the Social-democrats say yes (supported by now by the middle-of-the road Progressive party). According to opinion polls a vast majority of the population now wants Iceland to start membership negotiations and to adopt the euro as soon as possible. According to those same polls the Conservative party's following has fallen from almost 40% down to approximately 20%. But to confuse the situation further still, the anti-European Left-green opposition party has doubled its following from 15% to above 30% and is by now seen to be the biggest party, followed by the Social-democrats with a little less than 30%.

In short: *Super-imposed upon the economic crisis there is a political paralysis.* The Conservative Party leadership is trying to gain lost ground by convening an extraordinary party congress at the end of January 2009 where the party will try to redefine its policy on the European issue amidst a serious threat of a party split. Should they fail to unite on a pro-European program the days of the government are generally considered to be numbered.

10. A Political Upheaval?

The demand for new elections is getting louder day by day. Thus the economic crisis has generated political turmoil and uncertainty about the future. The demand for new elections, early in the new year, can hardly be resisted much longer. The overriding issue to be settled by new elections is the European issue. During the boom years it was easy for the political leadership to sidestep the issue. Iceland seemed to be doing pretty well on her own, admittedly to a large extent on borrowed money. Therefore most Icelanders felt little incentive to make up their minds on this issue. The crash has changed all that. The majority of Icelanders seem, at least for the time being, to have drawn the lesson from their economic misfortune, that *this would not have happened, if Iceland had joined the European Union and adopted the euro while the going was good.* This seems to be the main lesson to be drawn from the crisis.

But even European Union membership within a year or two will not help Iceland a lot in her present dire circumstances. What Iceland needs beyond anything else, to help her recovery, is a *stable currency*. Unfortunately the prospect of being able to adopt the euro seems to be receding far into the future. The Icelandic economy is in a terrible shape. With a weak and volatile currency the prospects for recovery any time soon look dim. Despite the strong long-term fundamentals of the economy (recovering fish stocks and plenty of clean and renewable energy) the short-term outlook is grim: Rampant inflation, serial bankruptcies and subsequent unemployment, coupled by heavy fiscal deficits and a crushing debt burden. The crucial

question on the future of Iceland therefore remains unanswered: Will the debt burden cripple the economy's potential for recovery? Or will the strong fundamentals of the economy and the traditional resilience of the Icelandic people enable them to pay off their debt and fulfill the preconditions for joining a stable currency area?

This is what early elections will be all about. But the political line-up remains uncertain: On the one hand there will be the Social-democrats and the Progressives, propagating a pro-European future. On the other hand there will be the Left-green anti-European movement with the question of the Conservatives hanging in the balance. Will they split at the extraordinary party congress in January, with the right wing joining the nationalist anti-European forces, and the more liberal wing joining the Social-democrats on the road to Europe? Or will the increasing political turmoil split all the existing parties and create new ones with the possibility of opening up an abyss of anarchy and confusion?

11. Lessons to be learnt?

If there are any lessons to be learnt from Iceland's debacle, surely they will have to include the following:

1. In a world of massive and unfettered capital movements across national borders, a tiny "independent" currency area does not have a chance of survival in a financial hurricane of the present (and future) fortitude.
2. Had Iceland shown the foresight, like Ireland, of joining the EU and adopting the euro, following in the foot-steps of her former EFTA-partners (Finland, Sweden and Austria) in 1995 or the period thereafter, Iceland would surely have had to face the domestic bank-crisis, - but would have escaped the devastating currency crisis which threatens to make Iceland's foreign debt burden unbearable.
3. For the other small nations of Europe, in central and eastern Europe, the lesson seems to be to speed up disciplinary economic programs with the aim of fulfilling the Maastricht criteria for adopting the euro.
4. For the EU it is time to reconsider the regulatory framework for surveillance of financial markets as well as to coordinate the EU-wide guarantee systems for savings depositors.
5. For the world at large the lessons to be learnt from the current spectacle of financial markets run amok by greed and recklessness is to reimpose discipline through an international agreement on a new regime of tough regulation and surveillance – with harsh disciplinary powers against errant actors.
6. The final lesson to be learnt by the international community is to put an end to the shady operations of tax havens in faraway places, operating as money laundering shelters, beyond the reach of the rule of law.