
THE TRUE COST OF AUSTERITY AND INEQUALITY

Iceland Case Study

Iceland is a small country, with a population of just over 300,000 people. Although Iceland is not a member of the EU, it presents a useful example of the alternatives to austerity available to countries responding to the financial crisis. Iceland has been praised for its handling of the financial crisis, during which citizens' protests pushed politicians to allow banks to fail, rather than bailing them out. By putting people before banks, Iceland proved that there is another way of dealing with the financial crisis.

Being a member of neither the EU nor the Eurozone, Iceland is less tied to other countries and this has given it more flexibility to act, in particular over its monetary policy. One of the key aspects of Iceland's recovery has been its ability to devalue its currency, thereby promoting exports.

Between 1991 and 2004, Iceland implemented several major reforms, including: reduction in government spending; lower tax rates on labour and capital; privatization of state-owned enterprises; liberalization of the labour and product markets; greater global economic integration; pension reform; deregulation of the financial market; and reform of the public sector.¹ In the years that followed inequality rapidly increased, further gaining momentum from 2003. The Gini coefficient, the indicator for measuring inequality within a country, went from 0.19 in 1993 to 0.24 in 2003, and reached a peak of 0.29 in 2007.²

In 2001, Iceland's banks were deregulated, which enabled them to privatize their resources and facilitated banking speculation. The banking sector took advantage of lower interest rates abroad and expanded its activities in the UK, the Nordic countries and the rest of the world.³ In 2007, Iceland's three main banks drastically expanded their balance sheets and made loans equivalent to about nine times the size of the island's booming economy.⁴ The banks' investments in the real estate market caused a boom that saw unlimited credit granted: all citizens were given equal access to mortgages from the Housing Financing Fund (HFF, a government institution formed in 1999 to provide low interest

mortgages with government guarantee of debt) provided at artificially low rates. The result was increased demand for housing across the board, leading to a sharp increase in mortgage lending and a steep decline in mortgage interest rates. By mid-2004, almost 90 per cent of Icelandic households held an HFF loan, and HFF-issued bonds comprised more than half of the Icelandic bond market.⁵

When the financial crisis began in 2008, Iceland's currency, the krona, strongly depreciated and the three major commercial banks (Kaupthing, Glitnir and Landsbanki) announced that they were unable to refinance their debts. Iceland's external debt was equivalent to €50bn (contrasted with GDP in 2007 of €8.5bn); more than 80 per cent of this was due to the banking sector. Iceland's central bank could no longer act as lender of last resort. The government, which had praised the banks' activities for more than 10 years, was forced to nationalize the lenders in early October 2008, handing over their control to the Financial Supervisory Authority (the supervisory authority for the financial sector in Iceland). All national assets were held in what became the public-owned domestic versions of the banks, while their foreign assets were put into receivership. The government insisted that these actions would ensure that Iceland would not go bankrupt. They would protect the Icelandic economy and Iceland's citizens, as they would not suffer any losses from the systemic bank failure.

The government then asked the International Monetary Fund (IMF) for an emergency loan in exchange for a commitment to reduce spending and pay back the money (€3.5bn) to foreign investors via a massive tax rise for Icelanders. The main steps proposed to combat the crisis were:

- Enforcement of strict capital controls (including temporarily suspending the official currency exchange) on 6 October 2008, to help protect the currency;
- Activation on 17 November 2008 of a €6.5bn sovereign bailout package (of which €2.7bn came from the IMF and the remaining €3.8bn from a group of Nordic countries), to help finance budget deficits and the creation of the domestic banks;
- Implementation of austerity measures as part of the fiscal consolidation;
- Activation of 'minimum deposit guarantee repayment loans' to help finance the minimum deposit repayment to foreign account holders who lost their savings when the Icelandic banks went bankrupt. The sum of €1.2bn came from Germany but the offer of €4bn in loans from the UK and the Netherlands was not accepted.

These measures prompted a series of popular protests – until then unheard of in Iceland – which forced the government to hold an early election. The newly elected government proposed a plan to pay back the debt incurred through the bailout package. However, in response to this the protests became even more widespread, focusing on a demand that the government hold a referendum to ratify this proposal. In January 2010, popular pressure forced President Ólafur Ragnar Grímsson to hold

a referendum in March of that year. Ninety-three per cent of Icelanders rejected the government's proposals and also rejected the proposal that the people (rather than the country's bankers and leaders) should pay back the debt.

Legal moves and welfare protection

Iceland is the only country in the world to have launched legal proceedings against a politician for presumed involvement in the financial crisis. The country's courts were asked to rule on whether Geir Haarde, the former prime minister, could be held responsible for the financial crisis. Haarde was acquitted on three out of four charges against him, but was found guilty of breaking the law on the responsibility of ministers. Members of the senior management of the banks in question, as well as business leaders, also faced charges in court, accused of fraud and manipulation during investigations by Iceland's special prosecutor into the collapse of the country's banks.⁶

The government that came into power in February 2009 pledged to be a Nordic welfare government with the aim of sheltering lower and middle-income groups against the worst consequences of the crisis.⁷ It also declared that, as far as possible, it would safeguard the welfare state against cuts.⁸ That appears to have happened: recent budgets have included a mix of spending cuts in sectors other than welfare, and tax increases have focused on higher income groups.⁹

In terms of real living standards, public spending cuts in Iceland have affected higher income groups more than vulnerable and lower income groups. This was achieved through increases in minimum pensions for old age and disabled pensioners, the minimum wage, social assistance allowances and the universal flat rate unemployment benefit have all seen (though wages in general remain unchanged).¹⁰

Direct tax rates on lower incomes were also, in effect, slightly cut, both in 2009 and 2010, while being raised for those on higher incomes.¹¹ The burden of taxation has been significantly shifted on to the shoulders of higher-income families.

The government has also written-off the mortgage debts held by a quarter of the population and has introduced social measures (in the form of rent rebates) to help those in rented housing.

Iceland has used the social protection system to shelter more vulnerable groups during the crisis. Moreover, a trend towards increasing inequality was reversed during the crisis years of 2008 and 2009, and continued to drop in 2011, in which Iceland recorded a Gini coefficient of 0.23.¹²

However, about 15 per cent of households still experience great difficulty in making ends meet. Various programmes for the unemployed have been introduced, and existing ones strengthened, but there is disappointment over the lack of investment in new jobs. Despite this, unemployment has not become as big a problem as might have been expected given the size of the country's collapse and the severity of its economy's contraction. Iceland's unemployment rate in 2010 was 7 per

cent, but, by April 2013, it had fallen to 6.6%, below the EU average.¹³

In 2011, Iceland's GDP grew by 3.1 per cent compared with the previous year (in 2010 it contracted by 6.8 per cent, having shrunk by 4 per cent in 2009). Inflation in 2011 was 4.2 per cent (compared with 16.3 per cent in 2009); and the Icelandic government owes €10.139bn, 98.8 per cent of GDP. The Icelandic economy has recovered after the worst economic crisis in the country's history. While much of Europe still battles with crisis, the economy of this island in the North Atlantic is growing – thanks to a currency decline, an export increase, a boom in tourism and the fishing industry and growing consumer confidence. The Icelandic way of dealing with the crisis could inspire alternatives to austerity in the EU.

NOTES

¹ R. Spruk (2010) 'Iceland's Economic and Financial Crisis: Causes, Consequences and Implications', European Enterprise Institute, <http://mpira.ub.uni-muenchen.de/29972/>

² S. Olafsson (2011) 'Iceland's Financial Crisis and Level of Living Consequences', Working paper # 3:2011, Social Research Centre, University of Iceland, http://thjodmalastofnun.hi.is/sites/thjodmalastofnun.hi.is/files/skrar/icelands_financial_crisis_and_level_of_living.pdf

³ R. Spruk (2011) *op. cit.*

⁴ *ibid.*

⁵ P. Bagus and D. Howden (2011) 'Deep Freeze: Iceland's Economic Collapse,' Ludwig von Mises Institute, Auburn, Alabama, p. 56, http://mises.org/books/deep_freeze_howden.pdf

⁶ Lárus Welding, CEO of Glitnir, and Guðmundur Hjaltason, Managing Director of Corporate Banking of Glitnir, were sentenced to nine months in prison by the District Court of Reykjavík for a major breach of trust. Out of the nine months, six are probationary for two years (see: <http://visir.is/larus-welding-og-gudmundur-hjaltason-daemdir-i-fangelsi-/article/2012121229270>)

Sigurjon Arnason, CEO of Landsbanki, and Hreidar Mar Sigurdsson, CEO of Kaupthing, are charged with hatching a plan to buy bank shares in order to keep the share prices from falling, and then sell the stock, according to the Wall Street Journal (V. Finkle (2013) 'Iceland Indicts Bankers Over Financial Crisis', American Banker, 28 March, <http://www.americanbanker.com/people/iceland-indicts-bankers-over-financial-crisis-1057928-1.html>)

⁷ S. Olafsson (2011) *op. cit.*

⁸ *ibid.*

⁹ *ibid.*

¹⁰ *ibid.*

¹¹ *ibid.*

¹² Last available data is 2011; Data Market, <http://datamarket.com/data/set/23a8/iceland-2020-objective-to-achieve-greater-equality-in-iceland-by-lowering-the-gini-coefficient-for-disposable-income-to-around-23-by-2020#!display=line&ds=23a8!2k2g>

¹³ S. Olafsson (2011) *op. cit.*

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