



Book Meltdown Iceland

Lessons on the World Financial Crisis from a Small Bankrupt Island

Roger Boyes
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Recommendation

Most people aren’t very familiar with Iceland, an isolated, homogenous, near-Arctic island. Now, thanks to Roger Boyes’s wonderfully told tale of its financial collapse, readers can learn what happened to the economy, politics and culture of this unusual, mostly-frozen nation. Iceland was the unlikely first victim of the 2008 global financial collapse – the actual canary in the coal mine. Its financial excesses, cronyism and poor governance serve as a microcosm of the problems facing the largest capitalist nations. Boyes’s financial case study flows like a novel. He is unafraid to draw biting conclusions from his detailed presentation: here, villains are villains, greed is greed, names are named. This fast-moving story puts the global fiscal meltdown into perspective. *BooksInShort* rates this as important reading for anyone who seeks insight into the 2008-2009 international economic crisis, which began in this lone, cold outpost and then burst into global flames.

Take-Aways

- The 2008 world financial crisis began in Iceland, which has a population of only 300,000.
- Throughout the 1990s and early 2000s, Iceland’s Prime Minister David Oddsson promulgated Reagan-style policies and privatization.
- The privatization of Iceland’s banking sector created a new, wealthy elite with political and financial power. Cronyism became rampant.
- The banking sector grew rapidly, propelled by borrowed money. Icelanders could access credit easily. Housing prices escalated and consumption soared.
- To attract international currency investments, Iceland raised its interest rates to 15%.
- Between 2003 and 2004, prices on the Iceland stock market increased 900%.
- By 2006, the average Icelander was 300% wealthier than in 2003.
- Iceland opened high-interest online bank accounts, attracting global investors.
- In 2008 Iceland’s banks collapsed, wiping out 50,000 people’s savings, plunging Icelanders into debt and putting 25% of homeowners into mortgage default.
- Iceland’s financial failure forced its government to resign, and caused citizens to re-evaluate the merits of lavish spending, borrowing, consuming and speculating.

Summary

It Started in Iceland

The economic recession that engulfed the world in 2008 began in subpolar Iceland. The nation lacked the resources to fight back, given that its entire population is only 300,000, barely a mid-sized town’s worth of people in many countries. Its financial and political leaders could all fit in the same bus. Iceland is so small that it could have staved off financial calamity with only \$20 billion, but it didn’t have the money. Instead, it suffered a national crisis that ravaged its citizens, its financial institutions and the foundations of its Nordic culture. The crisis became a national issue in October 2008, when Prime Minister Geir Haarde (who served from 2006 to 2009) told

citizens that Iceland was on the verge of bankruptcy. This came as a national shock since local entrepreneurs had embraced globalism, buying supermarkets in the U.S. and Scandinavia, fashion and retail companies in the U.K., as well as England's West Ham United soccer club.

“One could not hide from this crisis, not even on a chunk of volcanic rock in the north Atlantic.”

Icelanders purchased some of these assets with unsecured loans after globalization vaulted it into the economic fast lane. Newfound wealth was a welcome change in a country whose primary resources, prior to globalization, were thermal springs, fish and sheep. Iceland became the world's first nation to succumb to the financial crisis, falling victim to massive outflows of cash and an abrupt end of credit. When the U.S. and the European Union tightened credit, they asked Iceland to repay its loans immediately. It defaulted, destroying its credit rating and precipitating an economic tailspin. Iceland became linked to the subsequent decline in world financial markets. It suffered first and was deeply wounded, as were other small tax-haven countries, notably Estonia, Latvia and Lithuania.

Culture Clash

Iceland has a tight close-knit society. Today, people tolerate nonislanders, but in the past, especially during World War II, they did not welcome outsiders. In this culture, many residents can trace their lineage to the ninth century. Iceland's telephone book lists people by first name. The often-duplicated surnames indicate whether someone is a son or daughter. For instance, Kristín Ólafsdóttir is “Ólaf's daughter.” Reykjavik, the capital, has only two elementary schools; one can trace its roots to 1056. In this environment, the inner cadre of political and business leaders share long histories going back to childhood. Not surprisingly, blatant nepotism riddles the nation's politics.

“There was greed, incompetence, feuding, revenge and deceit: the themes of the ancient Viking sagas transplanted into a modern age.”

Under Prime Minister David Oddsson's administration (1991-2004), Iceland adopted privatization initiatives – as pushed elsewhere by Margaret Thatcher and Ronald Reagan – even though this change altered the relationship between the citizens and the state. Upon his election, Oddsson began privatizing immediately, telling Icelanders they needed to modernize. His first move was to sell a state fishing business, which he managed to accomplish without incurring the opposition of Iceland's 14 most powerful, rich mercantile families – a group dubbed “the Octopus.” Understanding that privatization would make them even wealthier, they embraced the idea.

“The calamity that hit Iceland was, in short, a microcosm of what was happening elsewhere in supposedly more complex societies.”

Oddsson reduced the corporate tax rate from 48% to 18%, ended subsidies for unprofitable firms and liberalized the currency. During privatization's first 18 months, he sold several state companies, including a fertilizer plant, a printing company, fish processors and alcohol distillers. He believed the island had to diversify from fishing, its main industry, into finance. Oddsson's first financial sector privatization, in 1999, was the FBA investment bank, followed by two other large state banks, Landsbanki and Bunadarbanki. Soon a new group, nicknamed “the Orca,” began making large bank stock purchases to challenge the Octopus for control of the privatized banks. In turn, the banks began making big political contributions to defuse regulatory oversight.

Privileged Information

Privatization created cultural and political clashes. The Orcas, the new oligarchs, saw the world as their playground. The nationalistic Octopus group considered the Orcas to be crass and unpatriotic. The Orcas revamped established political alliances, using cronyism and other tactics to buy companies that were being privatized. For instance, in 2002, a friend of Oddsson and his Independence Party bought a 45% share in Landsbanki for \$140 million. The buyer had limited bank management experience, and he already had legal problems involving charges of improper bookkeeping and embezzlement. Even so, the state sold him the bank and he soon began hiring Independence Party members. When the fiscal system fell, everyone could see that he had failed, and that Iceland's bankers and politicians could not secure the nation's prosperity.

“The old Vikings had specialized in rape and pillage; the New Vikings put clothes on the back of British womanhood.”

A new, independently wealthy entrepreneur soon challenged Oddsson. Jón Ásgeir Jóhannesson, the son of a grocer, had made his fortune in food distribution. He had no allegiances to the Octopus or the Independence Party. Unlike the other new Icelandic billionaires, Ásgeir, as he is known, spent his money away from Iceland. Oddsson often turned political disputes into personal grudges, so when Ásgeir, in many ways an outsider, sought to buy a small newspaper to expand his commercial base, Oddsson pressured him by seeking government control over food distribution – Ásgeir's core business. He subjected Ásgeir to police searches, subpoenas and investigations. The feud simmered as Ásgeir eventually received a three-month suspended sentence for minor infractions.

“Without change at the top – with plainly compromised politicians declaring themselves to be indispensable in their country's darkest hour – there seemed no serious chance of restoring trust in the mechanical workings of capitalism.”

Oddsson refocused on making Iceland a big financial player, as Ásgeir built a media empire. He came to own radio stations, a TV station and a national newspaper. In 2004, Iceland's parliament (the world's oldest) passed a law restricting ownership of broadcasting companies under certain conditions. Critics said the law existed specifically to prevent Ásgeir from mounting a political challenge against Oddsson and the Independence Party. President Ólafur Grímsson (elected in 1996) considered the law discriminatory, and exercised the first veto in 60 years to reject it.

“Politicians had somehow...come to believe in the infallibility of bankers, the new hero class.”

In the summer of 2004, Oddsson was treated for thyroid cancer. He re-entered government in 2005, serving in the foreign ministry and then becoming governor of the central bank. He criticized self-serving bankers and moved to strengthen Iceland's currency, the krona. He was agitated that his political enemies were becoming wealthy via secret bank cross-ownership deals. Iceland's banks were growing with dangerous speed. With privatization plans only half accomplished, banks accounted for 96% of Iceland's GDP. Oddsson realized that borrowed money was propelling the expansion, but, even though he was its main bank regulator, he ignored the situation. He and his central bankers did not even know the total of Iceland's banks' assets.

Foregoing Moderation

As prime minister, Oddsson had sought to diversify Iceland's economy away from fishing. He harnessed its vast thermal energy reservoirs to power new aluminum smelting plants and built hydroelectric dams. But by privatizing Iceland's banks, he was attempting to convert the island into the "Nordic Tiger." Some citizens criticized the government for accelerating modernization too rapidly, a violation of the Nordic concept of moderation. But most people were infatuated with loose credit and the possibility of wealth.

"The point of privatization was not only to push the state gradually out of everyday life, but also to diversify ownership and make Iceland a nation of shareholders."

By 2003, Iceland had three main privatized banks that were extending easy credit. Given that the island had only 200,000 wage earners, the aggressive banks could not make enough money lending just to locals. Thus, they expanded quickly into international markets – emerging as willing lenders just as the global speculative bubble was inflating. To attract money from international markets, Iceland raised its interest rates as high as 15%, making the krona a destination currency for the "carry trade," where speculators borrow at a low rate, say 3% in Japan, and invest at a high rate, like Iceland's 15%. As long as money flowed into Iceland, its big banks and its currency remained strong. Average Icelanders became currency speculators, too, as they borrowed to buy houses and cars.

"Buried in the details of this sale is one of the causes of the Icelandic meltdown: political cronyism."

In their search for global, high-return investments, Icelandic banks had very little exposure to U.S. packaged mortgage loans, but Iceland's domestic home loans became troubling enough. In 2003, Iceland's government liberalized house-loan standards, in some cases lending purchasers up to 100% of value. Housing prices skyrocketed. Equity refinancing boomed, and people bought more cars, motorcycles and summer homes. Between 2003 and 2004, prices on Iceland's stock market increased 900%. By 2006, the average Icelander was 300% wealthier than in 2003. As the bubble bulged, Iceland's banks encouraged customers to buy bank stock.

"The failure of the financial system was also a failure of journalism."

Iceland's banks began aggressively offering consumers exotic products, such as car loans in foreign currencies. By 2006, the British bond rating agency, Fitch, sounded the alarm about Iceland's rising external debt. A Danish bank issued another warning. When the Bank of Japan raised interest rates in 2006, investors sold their positions in Iceland, but Oddsson said it was "absurd" to talk about an imminent financial crisis. To repair their damaged credit ratings, some Icelandic financial institutions created online banks, attracting new retail customers, especially from Britain, Germany and the Netherlands. They offered interest rates of more than 6%, drawing some 300,000 British and 125,000 Dutch depositors. Many British institutions – including 116 local governments, plus Oxford and Cambridge Universities – invested in Icelandic banks.

Two years later, when Iceland's banks failed, parliamentary investigations found that local authorities had to bear full responsibility for their bad financial judgment. Taxpayers in the U.K. had to assume their own losses. To secure repayment to British depositors, the U.K. used a section of its 2001 Anti-Terrorism Crime and Security Act legislation, saying in effect that Iceland was a terrorist nation. This ruling let British regulators freeze British depositors' assets in Iceland's banks in the U.K. as part of a repayment program. The comparison to terrorists made the Icelanders irate. After a tense period, the two nations reached an agreement on repaying U.K. depositors.

Crushed Ice

During Oddsson's term as prime minister and, later, when he was central-bank governor, economist Joseph Stiglitz and others warned him that Iceland was very vulnerable to a global economic shock. He ignored advice to join the European Monetary Union because he did not want to surrender Iceland's sovereignty, even though it wanted to be a global player. The government dismissed critics who noted the bubble as alarmists. Still, some of those in power knew that the central bank lacked the foreign currency reserves to cover its domestic exposure. By September 2008, Iceland's banks had to ask the central bank for more money. The world shifted on October 6, when Prime Minister Geir Haarde interrupted state-run TV to announce that Iceland faced a grim period of adversity. It was an emotional, national moment. The speech stunned the country. Citizens could not comprehend that their homeland could go bankrupt. One economist later estimated that the nation was €20 to €30 billion in debt. On the personal level, the average Icelander was \$403,000 in debt and 25% of homeowners faced mortgage default.

"Thatcher had understood that the first step in a market revolution that deregulates and disperses initiatives must be to centralize political power."

Later in October, Iceland nationalized the Glitnir and Landsbanki banks. After meeting with bankers and key ministers, Haarde said Iceland's banks still held valuable portfolios. Oddsson made similar optimistic assessments, but he had ignored reality previously. Faced with hard information, the nation panicked. It had tried to move too quickly from poverty to prosperity. As it staggered, aid came from a new source: Russia promised massive loans. Iceland was an ideal fit for its strategic plans to expand its military and commercial ventures in the Arctic.

"So Iceland became not only the first country to go broke, but also the first to chase its government out of power."

As the crisis grew, the numbers became staggering: 85% of the banking system failed and more than 50,000 people lost their savings. Eventually more than 7,000 protestors filled the street outside parliament. On January 23, 2009, Haarde announced early elections and said he would not run. The commerce minister fired the head of the financial regulatory authority and then resigned. The Social Democrats and the Left Greens formed a new interim government led by Jóhanna Sigurðardóttir. She took office in January 2009 and was re-elected in the April 2009 general election. She called for joining the EU, and stressed Iceland's traditional virtues: modesty, hard work, respect and, in all things, moderation.

About the Author

Roger Boyes is an award-winning correspondent. He has written about Western and Eastern Europe for the past 30 years for the *Financial Times* and the *Times of London*. He has been reporting from Iceland since 1976, when he went there to cover on the Cold War.