First meltdown, then miracle? The history and context of recent economic development in Iceland

Örn D. Jónsson*
Ingjaldur Hannibalsson**

ABSTRACT
Iceland was one of the first countries to be hit by the 2008 financial crisis. The economic expansion in the preceding years, of a country populated by 320,000, got a worldwide attention. So did the sheer magnitude of the social and economic problems which accompanied the 'meltdown', as well as the subsequent recovery. The focus in this paper is on historical antecedents and context, in order to shed light on the mechanisms behind recent improvements in economic performance. A longer-term perspective reveals more continuity in Iceland's economic development than suggested by narratives of a total meltdown and miraculous recovery.

Keywords: Economic development, crisis, natural resources, Nordic welfare state, Iceland.

ÁGRIP
Fyrst hrun, síðan kraftaverk? Nýleg efnahagsþróun á Íslandi í ljósi sögu og sértækra aðstæðna
Ísland var eitt af fyrstu löndunum sem varð fyrir efnahagskreppunni 2008. Mikil útþensla hagkerfisins í landi með 320.000 íbúa hafði hlotið alþjóðlega athygli. Gríðarlegt umfang og áhrif ‚hrunsins' hlaut einnig mikla athygli, sem og sú endurreisn sem síðar hefur átt sér stað. Í þessari grein er horft til efnahagslegrar forsögu og staðbundinna aðstæðna í þeim tilgangi að skýra hvers vegna svo vel hefur gengið að endurreisa efnahagslífið. Lengra sögulegt sjónarhorn leiðir í ljós að meiri samfella hefur einkennt hagþróun Íslands heldur en ætla mætti af frásögnum af algeru hruni og endurreisn sem sé kraftaverki líkust.

Lykilorð: Efnahagsþróun, kreppa, náttúruauðlindir, norræna velferðarríkið, Ísland.

INTRODUCTION

The 2008 downfall in Iceland was taken to exemplify the conspicuous consumption of seemingly successful Icelandic 'Vikings' who were becoming increasingly alienated. The key Icelandic companies had been turned into hedge funds and the banks had a turnover 12 times the Icelandic GNP or even double that size, depending on the criteria used. Five years later, Iceland is faring relatively well compared to most other European countries. In the end of 2008 the foreign debt was estimated to be around 8.5 times the nation's GNP while the estimate in 2012 is down to 1.0 or about that. The recent development has been hailed as the 'Icelandic miracle'. To get a more realistic depiction we have to look at the intensified exploitation of the country's natural resources broadly defined, and the interrelationship between Iceland's real economy and the inflated bubble that burst.

In a period of less than five years, three or four Icelandic business groups became some of the largest players on the London stock exchange. The following is an attempt to offer plausible explanations as to why this happened. In order to do so, we differentiate between the parallel evolution of the real economy and the all-encompassing bubble economy. By the 'real economy' we mean the part of the economy that is concerned

* Professor, School of Social Sciences, University of Iceland. Email: odj@hi.is
** Professor, School of Social Sciences, University of Iceland. Email: ingjald@hi.is

with actually producing goods and services, as opposed to the part of the economy that is concerned with buying and selling on the financial markets.

THE LIFE OF THE RICH AND FAMOUS

Understandably, the prelude to the meltdown caught a worldwide attention and, as could be expected, the focus was on different aspects of the overall complex situation. Three approaches have been most common: accusations of irresponsibility; ridicule; and eventually, amazement.

The most substantiated critique of the widespread recklessness came from the financial analysts of Danske Bank in 2006 (Valgreen et al. 2006), but it was not taken seriously; the Icelandic banks and the Icelandic economy as a whole continued to receive high grading from rating agencies such as Moody's, Fitch and Standard & Poor's. The evaluations were seen as a sufficient guaranty.

The Range Rovers became the eye-catching icons of absurdity (Lewis 2009). One observer saw these signs as "a transparent illustration of how 'masters of the universe' confidence, sophistic ideology, mercenary gain, mendacity and sheer ignorance combined to drivers behind the boom and bust cycle" (Wade and Kristjánsdóttir 2011, 58).

More serious attempts were made by a number of national and international economists to explain the primary causes from an economic point of view in terms of the sheer irrationality of the course of events. According to them, the factors behind the underlying crisis were: inexperience in banking; political 'favoritism' when the banks were privatized; and strong ties between economy and politics (Danielsson and Zoega 2009).

An array of informative studies and analytical undertakings followed. The most comprehensive and voluminous report came from the parliamentary investigation committee (Hreinsson et al. 2008). The emerging picture shows how irresponsible the undertakings were and, in the end, chaotic and illicit.

A MIRACULOUS RECOVERY?

The post-2008 transformation has turned into a widespread myth abroad: The 'Icelandic way', letting the banks go bankrupt and lowering the wages temporarily, had become a viable solution to the crisis. Prominent economists worldwide such as Joseph Stiglitz (2011) and Paul Krugman (2010) have voiced parallel views. Krugman maintained that the 'success' of the 'Icelandic miracle', as he termed it, was due to the flexibility of the Icelandic society.

The International Monetary Fund (IMF) took on the assignment to partake in the restoration of the Icelandic economy and to rescue the society from a total collapse. Iceland was the first well-off country to apply for a loan from the IMF and it was generally understood that the representatives of the Fund saw it as a unique opportunity to improve their image, as the Fund had become increasingly criticized for representing the interests of the creditors first and foremost (Payer 1974, Perkins 2004). The program has turned out to be a successful one; however, it can be questioned to what extent the recovery was due to the Fund's plans. On close scrutiny, it was neither due to the IMF's rescue plan nor the ingenuity of Icelandic politicians. The principal reason was the fact that Iceland is a country rich in resources broadly defined, although the participation of the IMF was imperative in the early stages of the rebuilding of the economy.

In the aftermath of the 'collapse', the national debt was estimated to be 8.5 times of the GNP in size. However, in 2011 a surprisingly different picture emerged. The debt was to a large extent confined to the banks and the biggest business groups, which to a substantial extent were financed by foreign banks and funds. In actual terms, the size of the debt turned out to be less than twofold the GNP (Sighvatsson et al. 2011). In a TV interview in 2012, the director of the Central Bank maintained that the total debt of the nation was closer to being equal to the country's GNP and would be reduced to 50% of the GNP in the next couple of years (Helgason 2012). Macroeconomic indicators told only a part of the story; the general economic situation of a sizable part of the Icelandic population had improved considerably (Ólafsson and Kristjánsson 2010).

Iceland is and has been a fisheries dependent nation (Benediktsson and Karlsdóttir 2011), but in the 1990s several innovative start-ups emerged in other sectors. Iceland became increasingly attractive for tourists, and investment in hydropower has been substantial. In the following we will argue that the upsurge of the Icelandic business groups abroad and their momentary success was more of a detour, while the development was largely driven by innovative activities of the start-up companies and steep increase of the country's utilization of natural resources.

THE POST-WAR PATH TO AFFLUENCE

In the Post-WWII period, Iceland had become an affluent country in the Scandinavian mould; a mixed economy with strong welfare-oriented governance. In order to provide a brief insight into the development up until the collapse in 2008, it is important to examine the driving forces behind the overall expansion that occurred in the last decades before the downfall.

In the 1980s there was a worldwide belief that a gradual move towards a modern society could be navigated by socioeconomic planning; a trend for which the concept of 'social technologies' is appropriate (Eggertsson 2005). The Icelandic version of this reasoning was that Icelanders were latecomers and could therefore learn from the mistakes of those that had progressed further.

The modernization process in Iceland did not fit into the standard mould of industrialization. The fisheries, the fundamental contributor to the development, was in a historical sense volatile due to several factors: the fishing fleet was unfit for the hazardous weathers of the North Atlantic; the natural fluctuations of the fisheries stocks, especially the pelagic species such as herring; the wide-ranging protectionism of the most important markets, UK in particular; and the absence of investment capital. The rules of the game were based on the overall lack of material resources rather than a governable industrial process.

Due to the increasing rivalry between the emerging superpowers, USA and the Soviet Union, Iceland's geographic location in the midst between Europe and the USA became strategically important during the Cold War when the island could serve as surveillance post. At the time there was an imminent and genuine possibility of the Soviets gaining ground. In order to avoid this, the USA granted the Icelanders economic aid in the form of direct aid and soft loans as a part of the overall tactics of the Marshall Plan (Ingimundarson 1996). The aid was categorically intended to create a lasting economic base for a modern market-oriented economy. A significant amount of the Marshall aid was used to invest in up-to-date trawlers and fishmeal factories. In the late 1950s up to the mid-1960s, it was apparent that these plans had been successful; a progressive economy had been strengthened by Iceland's strategic importance during the increasing frictions created by the Cold War (Ingimundarson 1996). Furthermore, Loftleiðir, an Icelandic airline, was granted rights outside the IATA cartel which dominated the Western airwaves. Loftleiðir was therefore in a considerably advantageous situation, being able to offer lower prices on the route across the Atlantic.

To a certain extent, it can be stated that Iceland's economy had been developed into a comprehensive and more or less closed system; a system that was to a large degree driven by political governance rather than being a market-driven economy. The rich fishing grounds, along with the ample aid, provided means to build a thriving nation state via a redistribution system.

The system served Icelanders well, but its protectionist characteristics became increasingly encumbering and taxing in the seventies. The long-term consequences seriously limited the Icelanders' experience and involvement in export and operations abroad in general. This was the downside of the complex redistribution system which was imperative in the nation's transformation phase. The relatively lucrative income from the fisheries did not turn into investment capital necessary for renewal and innovation (Jónsson and Sæmundsson 1996).

THE EMERGENCE OF AN INNOVATION-DRIVEN EXPORT ECONOMY

In order to enable Icelandic society to move forward, five preconditions had to be fulfilled:

1. Diversification of the economy with an emphasis on more varied exports.

2. Attraction of foreign capital for investment in large scale industries as a base for a varied industrial sector in order to reduce the effects of the unreliable and fluctuating fisheries dependency.

3. A move towards a more open economy through bilateral agreements.

4. Creation of a stock exchange to accelerate the process of marketization by reducing the political governance of economic activities.

5. Setting the accumulated money free and turning it into finance capital.

This was done stepwise from the mid-1960s. First, two hydropower plants were constructed to supply two energy-intensive firms, one in aluminium (production started in 1969), the other producing ferrosilicon (started 1979); secondly, the long-standing process of joining the European Free Trade Association (EFTA) was completed in 1970; and third, the most important one, the fisheries limits around the country were enlarged to 200 miles in 1975. This strengthened the economy and eventually, in 1994, a favourable agreement was made with the European Union along with Norway, Lichtenstein and Swiss, that created the European Economic Area (EEA).

These actions were in many ways successful; yet the diversification of the export economy was much slower than expected, basically due to a lack of experience in operating abroad as well as the small size of the industrial companies which were without exception operating on the domestic market. The economic problem was a structural one; the sources of foreign currency were two vertically organized sectors: fisheries and aviation. In both cases the precondition for success had initially been based on prohibiting others to enter. In the case of the fisheries, to meet the high quality demands, especially by the most important market, USA, the produce needed to be faultless (Jónsson and Jónsson 2011). In the aviation sector, security is imperative and the initial investments high. In both cases the experience and know-how was positioned close to the market for monitoring purposes while the ownership or the actual control of the business was located in Iceland. Overall, the experience and insight into marketing abroad was seriously limited and in both cases confined to a handful of people.

Things started to change in the last decade of the 20th century. A higher level of education, to be increasingly attained abroad, a generational shift in the existing companies and a number of start-ups strengthened the innovative aspects of the economy. Eventually a number of Icelandic knowledge-intensive companies entered the world market, operating in small niches at first (Jónsson and Sæmundsson 2006). Around the millennium several innovative companies had become competitive worldwide in their operating sectors. The move towards a more diversified economy was becoming more prominent.

The economy was developing an innovative basis and, in a number of cases, Icelandic companies were becoming technology makers instead of takers. The IT-controlled fish processing line developed by Marel made the Baader filleting machine redundant, but this had been the central tool for optimizing capacity and quality. Another company, Sæplast, had developed a thermoforming injection rotational blow moulding process for making containers. Eventually a viable innovative cluster had been established, serving the fisheries industry worldwide.

FROM PROTECTIONISM TO MARKETIZATION

Given the long standing protectionism and high import taxes as well as the miniscule size of the Icelandic economy, neither the Icelandic SMEs nor the most powerful business blocks were in a position to leapfrog into foreign markets. For a considerable time it was evident that there were more financial resources available than could be invested in a profitable manner nationally.

The organizational principles of the two main businesses, fisheries and aviation, were not capital intensive after the initial start-up phase. The two fundamental technological innovations, the jet engine in aviation and the move from side trawlers to stern trawlers in fisheries, were financed by soft loans from the state banks, which meant that, in general, only working capital was required. The largest business conglomerate was based on cross-ownership of the country's largest firms. The second largest consisted of clusters of co-operatives operating in disperse fields. A co-operative is in most cases obliged to return a revenue exceeding 10% to its owners, i.e. the public. Reinvestment derived from long term organic growth becomes almost obligatory in the eyes of the managers. This is a commonly known problem in business literature or what Weber termed the 'iron cage' of organizational success – when efficiency becomes more important than the original purpose (DiMaggio and Powell 1983). Both of these business models were adjusted to organic growth to a sizeable extent rather than to external financing. This was a model well adapted to a micro-economy like the Icelandic one, but extremely vulnerable for outside investors.

Transforming the three major banks from savings banks into investment banks was a radical move, to say the least. By privatizing the banks the nation's savings were turned into investment capital and to the surprise of almost everyone, new players or outsiders took hold within a period of two to three years.

Most of the firms in the fishing industry were taken off the stock exchange, along with those companies that produced predominantly for the domestic market. The original intentions of the fisheries sector and non-export firms were not considered interesting in comparison with the blooming companies gaining ground in other countries (Magnússon 2007).

Instead of invigorating the Icelandic economy, the privatization and expansion of the banks had an opposite effect. At first, the opportunities via a stock exchange boosted the economy. The opportunities to invest nationally were limited, taking into account the available financial resources which had accumulated over decades.

In order to systematically enlarge the domestic economy and empower the existing firms to export and support the new innovative start-ups that were already operating abroad, protectionist measures were abandoned. Firms which had been serving the domestic market for decades, like the fisheries-related firms, could not grow quickly enough to utilize the financial influx of money available on the stock market in a profitable way. At the turn of the 20th century, the move towards a market-regulated economy was stifled; there was still too much money with too few investment opportunities nationally. The new Icelandic export firms were all gaining ground on relatively segmented markets and their growth was based on cautious learning by doing.

Here we find the underlying reasons for such a large discrepancy between envisioned development and the actual chain of events. Leveraged takeovers are a much more efficient and speedy way to grow than innovation and gaining foothold on new markets. Product development, manufacturing and marketing skills increased productivity on all levels and opened new and unexplored market niches.

The rift between the Icelandic real economy and the rapidly engulfing bubble economy led to a radical and unexpected shift. The financial resources were there, but the skills to invest in a profitable manner outside the Icelandic economy were lacking.

BOOM–BUST

In a simplified manner, the development can be visually stylized as a three-step move. In the first step, the processes relate to the export of product, tangible as well as intangible; the second is a managerial one, running the businesses from London instead of Reykjavík; the third step has an opportunistic character, where the Icelandic relationship becomes a mere means to expand the operations from the London hub.

Several Icelandic companies became active in diverse sectors; the world of investment banking, among the leaders in the production of generic drugs; a dominant player in wet lease aviation; the strongest player in the Nordic insurance market; a prominent force in the UK retail industry and leaders in own-label convenience food. In actual fact, some of these goals were reached for a period in time (Hreinsson et al. 2008).

The technological, organizational and market relations are different from one sector to another. With the rapid move from the real economy, the hollow monetary transactions on the stock exchange became less transparent, and the investors relied more on the ratings companies, even on hearsays, as the abundance of cheap money required quick decision making (Sigfússon and Þorbergsson 2005).

It is important to recognize the development as a limited number of groups started playing the role of the risk takers on the stock exchange in London and, to a lesser extent, on the Nordic markets. Their actions were in a lesser degree based on calculated measures of ways to optimize profits, but reminiscent of a Ponsi scheme (Magnússon 2007, Schramm et al. 2007). It would of course be too deterministic to state that the daring young individuals who took the key roles in the Icelandic outreach were just puppets in a larger scheme.

In the above context, the 'entrepreneurs' in the City became alliances of three to four groups deriving their mandates from the banks. Standard and Poor's and Fitch regarded the groups reliable and gave them high ratings. But as one of the key players said, they were always referred to as 'Icelanders' with negative connotations (Hreinsson et al. 2008).

RE-EMERGENCE OF THE RESOURCE BASED ECONOMY

At a closer look, the Meltdown had more to do with leveraged and erratic takeovers by the clustered Icelandic financial groupings. The firms, now defining themselves as financial groups detaching themselves from their branch-specific origins, were financing themselves with foreign funds which were relatively easy to get hold of at the time. For Icelanders in general, the actual impact on the real economy was surprisingly low. The impact of the recession had serious consequences, but it is misleading to see these as a meltdown, because the aggregated outcome turned out to be relatively less than the overall impact the crisis had on most of the European countries.

Icelandic society was severely hit, but its foundations were relatively robust after a steadfast growth of a resource-based economy during the last decades. Alongside the vertigo of the remarkable activities abroad, the fundaments of the real economy had grown: the overexploitation of the fisheries was prevented. Further utilization of hydro- and geothermal power was hastened; aluminium export increased from 30 000 tons in 1969 to nearly 900 000 tons in 2011 and is set on 1200 000 tons in 2013. The number of tourists grew from around 90 000 in 1985 to 550 000 in 2011 and considerable growth is foreseeable. In addition, the recurring devaluation of the króna was a situation to which Icelanders had become accustomed. As a result of the 2008 collapse, 20 to 30% devaluation was generally accepted and thought of as a temporary measure to adjust the króna to new realities.

Several of the knowledge-intensive companies which had been start-ups in the late nineties have not only retained their position, but also grown to become leaders in their specialized niches. Quite a number of the new start-ups in the knowledge-intensive sectors have been a success. In the context described above, it can be argued that the outreach was to a considerable extent a detour, the moneyed turbulence, which manifested itself in the first decade of the 21st century. Iceland is one of the most open economies in the world and will continue to be so taken into account its stature as a micro economy.

The situation is far from being unproblematic, but the Icelandic society is faring better than most European countries. Furthermore, it is a probable assumption that the state deficit will be reduced by further 20 to 30% in a matter of years because the largest shocks of the downturn have been coped with. Four or five years after the seemingly total collapse of the Icelandic economy, the tasks are more of a structural character than debt-related; the strategic question is to foster and retain the innovative aspects of the economy and society in general.

Taken together, the economical situation, measured by the national and public debt, will be better than in most European countries. The serious aspect is the overall debt situation of individuals and SMEs – a condition for which no solution seems to have been found – and the overemphasis on resource exploitation rather than fostering the dynamics of innovation.

CONCLUDING REMARKS

Any attempt to predict the future development in the coming years is a shaky endeavour, if not pure guesswork. Large issues have to be dealt with; one is of a fiscal nature, and the other having to do with the long-term structural changes of the real economy.

Intensified exploitation of the nation's otherwise abundant natural resources is nearing its limits and will become destructive. Under present conditions, fisheries are profitable and will probably become even more lucrative in the future, due to global overfishing. Additional use of hydropower and energy generated by the utilization of geothermal sources is technically possible, but foreseeably reaching its economic and environmental limits (Stýrihópur um mótun orkustefnu fyrir Ísland 2011). As for tourism, the debate over quantity and quality is a necessary one. Tourism is a low-wage industry characterized by seasonal fluctuations difficult to overcome. The most important policy question here is to what extent the innovation-driven companies are located in the country and will be active and thrive.

To conclude: the meltdown turned out to be a serious downturn, a crisis situation to which Icelanders have become accustomed over the decades. The size of the unrestrained growth of the banking sector as well as the key entrepreneurial clusters was of such a format that local solutions were unrealistic by any measures. The widespread bankruptcy was not a strategy or 'the Icelandic way". It is not and has never been a deliberate strategy, but an unavoidable consequence of the utter rift between the real economy and the bubble economy. This is a global occurrence that has shown itself to have had less damaging effects in Iceland than in most of the more affluent Western countries.

REFERENCES

Benediktsson, K. & A. Karlsdóttir 2011: Iceland: crisis and regional development – thanks for all the fish? *European Urban and Regional Studies* 18(2): 228–235).

Danielsson, J. & G. Zoega 2009: *The collapse of a country*. Reykjavík: Hagfræðistofnun Háskóla Íslands (Working Paper W09:03)

DiMaggio, P. J. & W. Powell 1983: The iron cage revisited: institutional isomorphism and collective rationality in organizational fields. *American Sociological Review* 48(2): 147–160.

Eggertsson, Th. 2004: *Imperfect Institutions: Possibilities and Limits of Reform*. Ann Arbor: University of Michigan Press.

Hreinsson, P., S. Benediktsdóttir & T. Gunnarsson (eds.) 2008: *Aðdragandi og orsakir falls íslensku bankanna 2008 og tengdir atburðir*. Reykjavík: Rannsóknarnefnd Alþingis.

Helgason, E. 2012: *Silfur Egils*. Reykjavík: RÚV, 5. November. (TV Programme)

Ingimundarson, V. 1996: *Í eldlínu kalda stríðsins: Samskipti Íslands og Bandaríkjanna 1945–1960*. Reykjavík: Vaka-Helgafell.

Jónsson, G. & Ö. D. Jónsson 2011: The convenience of the fish sticks. Comparative study of industrial fish processing in Iceland and Norway. Twelfth ICREFH Symposium. The History of the European Food Industry in the nineteenth and the first half of the twentieth century, Bologna, 13–16 September.

Jónsson, Ö. D. & R. J. Sæmundsson 2006: Isolation as a source of entrepreneurial opportunities: overcoming the limitations of isolated micro-state. *In:* C. S. Galbraith & Curt H. Stiles (eds.), *Developmental Entrepreneurship: Adversity, Risk, and Isolation*. Bingley: Emerald Group Publishing. Pp. 217–233.

Krugman, P. 2010: The Icelandic post-crisis miracle. *New York Times*, June 30. http://krugman.blogs.nytimes.com/2010/06/30/the-icelandic-post-crisis-miracle/ Accessed 3 September 2012.

Magnússon, G. 2007: *Markaður verður til: Saga íslenska hlutabréfamarkaðarins*. Reykjavík: Hagfræðistofnun Háskóla Íslands.

Ólafsson, S. & A. S. Kristjánsson 2010: *Income Inequality in a Bubble Economy – The Case of Iceland 1992–2008*. Reykjavík: University of Iceland.

Payer, C. 1974: *The Debt Trap: The International Monetary Fund and the Third World*. Harmondsworth: Penguin Books.

Perkins, J. 2004: *Confessions of an Economic Hit Man*. San Francisco: Berrett-Koehler Publishers.

Schramm, C. J., R. E. Litan & W. J. Baumol 2007: *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity*. New Haven, CT: Yale University Press.

Sigfússon, Þ. & H. B. Þorbergsson (eds.) 2005: *Útrás íslenskra fyrirtækja til Lundúna*. Reykjavík: Viðskiptaráð Íslands.

Sighvatsson, A., Á. Daníelsson, D. Svavarsson, F. Hermannsson, G. Gunnarsson, H. Helgadóttir, R. Bjarnadóttir & R. B. Ríkarðsson 2011: *Hvað skuldar þjóðin? Hin dulda staða þjóðarbúsins og viðskiptajöfnuður.* Reykjavík: Seðlabanki Íslands.

Stýrihópur um mótun heildstæðrar orkustefnu 2011: *Orkustefna fyrir Ísland.* Reykjavík: Orkustofnun.

Stiglitz, J. 2011: Professor Stiglitz on Iceland's Crisis and Recovery. *IMF Videos*, 27 April 2011. http://www.imf.org/external/mmedia/view.aspx?vid=1234323638001. Accessed 11 July 2012.

Wade R. H. & S. Sigurgeirsdottir 2011: Iceland's meltdown: The rise and fall of international banking in the North Atlantic. *Real-world Economics Review* 56: 684–698.

Valgreen, C., L. Christensen, P. Andersen & R. Kallestrup 2006: Iceland: Geyser Crisis. (Research report, March 21). http://www.mbl.is/media/98/398.pdf Accessed 11 July 2012.