How Iceland Recovered from its Near-Death Experience

By Poul Thomsen

When I traveled to Reykjavik in October 2008 to offer the IMF's assistance, the situation there was critical. The country's three main banks—which made up almost the entire financial system—had just collapsed within a week of each other. The sense of fear and shock were palpable—few, if any, countries had ever experienced such a catastrophic economic crash.

There was a lot of concern that a disorderly depreciation of the exchange rate would be ruinous for households and companies if nothing was done or that deposit runs would cripple what was left of the financial system. The scale of the uncertainty was staggering—the three banks had assets worth more than 1,000 percent of GDP, and no one knew at that point how large the losses would turn out to be and how they would be divided between Icelanders and foreigners.

Today, three years later, it is worth reflecting on how far Iceland—a country of just 320,000 people—has come since those dark days back in 2008. Growth has returned to the economy, and new jobs are being created: unemployment, although still unacceptably high for a country used to near-full employment, has dropped below 7 percent of the work force. In June this year, the government successfully issued a $1 billion sovereign bond, marking a return to international financial markets.

And while public debt, currently at around 100 percent of GDP, is much higher than before the crisis, an impressive consolidation program has put the country's finances back on a sustainable path during the past couple of years. As for the banks, they have been shrunk to about 200 percent of GDP, and are now fully recapitalized.

There are, of course, still many unresolved issues, including the vexed Icesave case involving disputed liability for lost deposits in the U.K. and the Netherlands, but Icelanders have shown their resilience and their strength as a people. They took control of their destiny and implemented some very tough policies that are now bearing fruit. But the work is not finished, and additional efforts are needed to reduce unemployment and boost growth.

Picking up the pieces

So how did Iceland put its economy back together? The program we ended up agreeing in record-time with the Icelandic authorities had four important elements.

- First, a team of lawyers was put to work to ensure that **losses in the banks were not absorbed by the public sector**. In the end, the public sector did of course have to step in and ensure the new banks had adequate capital, but it was insulated from vast private sector losses. This was a major achievement.

- Second, the initial focus of the program was exclusively on **stabilizing the exchange rate**. Here, we reached for unconventional measures, notably capital controls.

- Third, automatic stabilizers were allowed to operate in full during the first year of the program—effectively **delaying fiscal adjustment**. This helped support the economy at a time of severe strain.

- Fourth, conditionality was streamlined and focused on the key issue at hand—**rebuilding the financial sector**. While there are some issues in the broader economy where reforms will eventually be needed, these were not a part of the program.

In sum, what the $2.1 billion IMF-supported program provided was breathing room for the authorities to figure out how to deal with the enormous challenges and tasks ahead. With loan commitments from the Nordic countries and Poland, Iceland was able to start the painstaking task of rebuilding its economy.

The government quickly put its own stamp on the program. The authorities were committed to implementing the measures, but wanted to do it their way. One of the government's key objectives was to protect Iceland's social welfare state, and that goal has been accomplished. "The dynamic cooperation with the IMF helped preserve the Nordic welfare model in my country," Minister of Economics Árni Páll Árnason said recently.

Outside the mainstream

In putting together the program for Iceland, we at the IMF had to reach for policy tools that were not part of our mainstream toolkit. This eclectic policy mix has been effective in Iceland's case, but whether the lessons we have learned are applicable elsewhere, including in the crisis-stricken euro area, is far from clear.

To take stock of Iceland's crisis and recovery, the IMF and the Icelandic government are co-hosting a conference on October 27 that will see prominent economists such as Nobel Prize winner Paul Krugman and international economists Willem Buiter and Simon Johnson debate civil society, academics and IMF officials on whether the lessons learned can be applied elsewhere. Do join the discussion.