Lesson from Iceland's 2008 Financial Crisis: Let Banks Fail

The downward spiral of the Greek economy — and now likely that of Italy — has led to calls for the European Union to step in and prevent a total collapse. Portugal, Ireland, and Spain — the other three of the so-called PIIGS EU member-states — are enduring their own woes, such as downgrades of sovereign debt and corresponding jumps in the interest rates on government bonds. The cumulative effect — particularly if Italy does suffer a crisis serious enough to reduce its national credit rating to junk-bond status — will ripple throughout Europe and across the Atlantic.

Analysts have noted that continental Europeans would do well to copy the example of tiny Iceland, in how it weathered a financial crisis three years ago which stunned the placid island nation. In October 2008, its binge of bank speculation had reached a point at which the assets of the three largest Icelandic banks — Kaupthing Bank, Landsbanki (pictured), and Glitnir Bank — were 11 times greater than the entire $14 billion GDP of the nation. All three big banks defaulted on $62 billion of foreign debt, and then went belly up, not bailed out by Icelanders. Today the country's economists view that bankruptcy as a blessing in disguise. Icelandic bank analyst Jon Bjarki Bentsson put it this way:

> The lesson that could be learned from Iceland's way of handling its crisis is that it is important to shield taxpayers and government finances from bearing the cost of a financial crisis to the extent possible. Even if our way of dealing with the crisis was not by choice but due to the inability of the government to support the banks back in 2008 due to their size relative to the economy, this has turned out relatively well for us.

So the "choice" was, in large part, not actually a choice at all: Reykjavik could not prevent the bank failures. The impact of the financial crisis on Icelanders was immediate and painful. The value of the krona dropped 50 percent in one week; Commerce Minister Björgvin Sigurôsson went into personal bankruptcy and resigned from office; Iceland sought a $2.25 billion-bailout from the International Monetary Fund; and the government instituted stiff austerity measures.

Today, tiny Iceland is doing well despite the growing crisis in Europe. Beyond letting banks fail and reducing government spending, the independence of the krona from the euro has been important. Bentsson draws a contrast between Iceland's crisis and what is happening today in Europe:

> The big difference between Greece, Italy, etc. at the moment and Iceland back in 2008 is that the latter was a banking crisis caused by the collapse of an oversized banking sector while the former is the result of a sovereign debt crisis that has spilled over into the European banking sector. In Iceland, the government was actually in a sound position debt-wise before the crisis.

Columbia University economics professor Joseph Stiglitz observed, "Iceland did the right thing by making sure its payment systems continued to function while creditors, not taxpayers, shouldered the losses of the banks."

Iceland's Prime Minister during the 2008 crisis, Geir Haarde, confirms that his government acted properly by letting banks fail and insisting that creditors accept their losses: "We saved the country from going bankrupt. That is evident if you look at our situation now and you compare it to Ireland or not to mention Greece. … We did not guarantee the external debts of the banking system."

At the time of this crisis three years ago, there was agitation for Iceland to join the European Union and replace the krona with the euro. However, there was strong resistance to that move, particularly from Iceland's robust fishing industry, which disliked EU policies on fishing rights. In retrospect, analysts say Icelanders made the right decision. The country's economic growth in the first half of 2011 was 2.5 percent, with a forecast for the entire year of 3.0 percent.

So while France looks across the Alps and over the Pyrenees and sees economies that are connected at the hip with their own economy — and Germany looks west at France (not to even mention the PIIGS), which could drag down much of the German economy — tiny Iceland can look at itself with pride, with a national currency that has honest value and a government that pays its bills on time.

Photo: Former headquarters of Landsbanki in Reykjavik, Iceland's capital.