

ICELAND – POLITICAL IMPLICATIONS OF THE FINANCIAL CRISIS OF 2008 AND THE ROAD TO CHANGES IN THE ECONOMIC POLICY AND IN THE MODEL OF DEMOCRACY

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Abstract

The global financial crisis first hit Iceland, which until 2008 had remained a symbol of the economic boom and the successful experiment of the transition from state interventionism to the stage of gradual privatization and then total liberalization of the market, in which the banking sector played the leading role. In a short time it became a negative symbol of the destruction of the system creating sustainable development, rational economy and a high standard of living of citizens. The model of liberalized economy based on the principles generally considered as unshakeable foundations of liberalism, a free game of market entities led by an invisible hand of the market, suddenly crashed. In the case of Iceland, however, the point was not just the excessive liberalization, but the basic question about the possibility of joining the European Union by this small country as the only lifeline for the economy plunged into destruction. After several years of digressions, Iceland was skeptical about the concept. The Eurozone crisis questioned the European monetary union. Moreover, skeptics began to doubt the fate of the united Europe. On the other hand, Iceland seems to be conceiving their own way out of the crisis, not only by reforming the economy (but the effects will be long-lasting), but also the political system by holding a public referendum on constitutional issues and even by creating the social constituent assembly. Icelandic solutions can take place in a small society of 320 thousand people with deep – rooted values and democratic procedures. However, more thought should be given to the Icelandic model of

fighting the crisis, as well as to its impact on changing the model of the democracy system and the functioning of state institutions. In other words, the fundamental question is to what extent the reforms undertaken since the early 1990s have proved to be positive for the political system and the state institutions and to what extent the financial crisis has stimulated citizens to demand political changes affecting both the political world and the model of the state institution that it shapes.

Key words: democracy, political implications, liberalizations, Iceland.

1. Iceland's economic growth before the market collapse of 2008 – a period of liberalization (1991-2007)

The image of the Iceland economy before 2008 was created by the following: high economic growth, low unemployment rate and the extremely dynamic development of economy based on low-interest loans. The Icelandic society was one of the fastest growing ones. It would be wrong, however, to think that a gradual shift of individual sectors of economy to private hands, thus departing from the traditional Scandinavian model, led straight to the great collapse that took place in September 2008.

In the traditional presentation, the backbone of economy was the fishing industry accounting for 40% of the income from export and employing about 7% of the working population¹. The dominance of state ownership manifested itself, inter alia, in the monopoly in the tobacco, alcohol, media, steel and heating sectors. The crisis in fishery resulted in introducing the fishing limits by the state in the late 1980s and early 1990s². Moreover, through the turn of the decades, the Iceland economy was already in decline. The budget deficit reached 3% of Gross Domestic Product (GDP), consumption fell by 4% and GDP per capita in 1988-1991 decreased by 0.72% (National Economic Institute 1999: 9). As far as HDI (Human Development Index) is concerned, Iceland occupied undisputed first place, and this was due to a certain social model in which the fundamental role was played by factors such as the rate of education, health care, and GDP per capita (Gołębiowski, Szczepanowski 2008: 6). But did the classic Scandinavian model in the Icelandic form withstand the challenges of the new times?

In view of the fundamental principles, namely:

¹ CIA, the World Factbook, available at: <https://www.cia.gov/library/publications/the-world-factbook/geos/ic.html>.

² Available at: <http://www.fisheries.is/management/fisheries-management/>.

1. Pursuing a policy of sustainable development and concern for the natural environment;
2. Recognizing the role of the state in minimizing the negative effects of free-market economy;
3. Access to free education;
4. Good health care;
5. Extensive pensions and allowances,

Iceland faced the spectre of revolutionizing the domestic economy, which was already in decline (Gołębiowski, Szczepanowski 2008: 15).

That traditional model began to transform in the early 1990s. The emphasis was shifted towards manufacturing and services, especially as far as the computer software sector, biotechnology and tourism were concerned. The geothermal sector and the use of hydroelectric power created ideal conditions for foreign investment in the aluminum smelting industry and in the development of so-called green energy. Economic liberalism received another boost in 1994 when Iceland joined the European Economic Area and the Uruguay Round, changing GATT into OECD, increased the possibilities of Icelandic export. In the first case, opportunities for the free movement of capital, services, goods and labour were created in relations with the European Union markets, in the second one conditions for export to world markets were improved. In the pre-crisis period the average rate of inflation stood at 2.5%³ and the exchange rate of Euro to Icelandic krona at its peak was 72 : 1, which contrasts with the end of September 2008, when the value of ISK plummeted to the lowest level with the rate 185 : 1⁴. As it turned out, depreciation of Icelandic krona had beneficial consequences as it provided a strong impetus for exports, affecting the competitiveness of Icelandic goods⁵. However, in this case we can speak of the long-lasting consequences because in the period of crisis escalation it was rather destructive for the economy. But export itself still showed the upward trend at the beginning of 2008, and processed goods accounted for over 34% of total exports⁶.

Liberalization of the Icelandic market is a process that began only in the 1990s, although its symptoms could already be observed in the 1980s. For over 30 years, that is from the 1950s to the 1980s, the economy remained virtually under state control, which manifested itself in a number of

³ Central Bank of Iceland, History of Central Bank of Iceland, available at <http://www.sedlabanki.is/?PageID=192>, (accessed on 8.12.2010).

⁴ Available on: <http://pl.scribd.com/doc/48450693/Analiza-rozwoju-gospodarczego-Islandii-%C5%81>.

⁵ See: <http://www.tvn24.pl/biznes-gospodarka,6/islandzki-cud-gospodarczy-nie-ratowali-bankow-i-interesow-wierzycieli,281499.html>.

⁶ Bank Centralny Islandii..., p. 23.

regulations. The state determined the exchange rate, prices for agricultural produce, not to mention the control over imports. The level of national income kept pace with the Scandinavian countries (Mattiason 2008: 37). The agreement to build the first aluminum smelter in 1969 is a kind of turning point in the economic policy of the government, which decided to diversify the economy of the state and depart from the mono-cultural approach in the form of fishery priority. The energy intensity of aluminum production put the issue of developing energy based on natural resources on the agenda and in the case of Iceland, using hydropower and thermal springs.

The unprecedented growth of the Iceland economy by almost 25% in just four years, i.e. in the period of 2003-2007 caused a dangerous phenomena such as over-indebtedness of the private sector as well as excessive dependence on external funding sources. Excessive investments such as aluminum smelters and a hydroelectric plant, worth more than 30% of GDP, had a negative importance in terms of the current account⁷. Nevertheless, in the period preceding the Icelandic collapse, the credit market grew so extremely rapidly that it was ranked 62 by Fraser Economic Index on the list of 102 countries in 1980s and in 2002 it was ranked 14 out of 123 countries (Eggertson, Herbertsson 2005: 74).

The years 1995-2004 are the period of real deregulation and privatization, which is characterized by stable economic growth of 3-4%. The climax was the year 2005 when the economic growth reached 6%, and the inflation rate exceeded 8.6%, with interest rates at 6.9%⁸. The proponents of such a course of the economic policy were not only the accused Prime Minister Geir Haarde but initially his predecessor Davio Oddsson. As a supporter of the “invisible hand of the market”, he pursued the tax reduction policy. For 11 years corporate income tax (CIT) was reduced from 50% to 18%, and for 16 years personal income tax (PIT) was reduced from 47% to 36% in 2007 (Pruchnik 2010: 6) for big business and the financial sector tax thresholds for small and medium enterprises were increased (Ólafsson 2007: 23). In 2007 a flat tax was also introduced (not linear, as it was outside the sphere of taxation of the amount of 5 and 2 thousand dollars from adults and children respectively) (Mitchell 2007).

The privatization of the banking sector, as well as of fisheries, which had been under state control until 2004, is considered to be a fundamental cause of the financial crisis and almost the bankruptcy of Iceland. In 2003, the Prime Minister D. Oddsson, the former governor of the central

⁷ Ministerstwo Gospodarki, Islandia: stosunki z Polską, available at: www.mg.gov.pl/files/.../KE%20Islandia%2010%2010%202012.doc.

⁸ Islandsbanki, Greining krossa, <http://www.islandsbanki.is/fjarfestingar/markadir-og-vi-sitolur/gjaldmidlar/greining-krossa/?g1=EUR&g2=ISK>.

bank decided to privatize three state-owned banks: Islandsbanki, Glitnir and Kaupthing and also Telecom. The expanded activity in the sector and the excessive credit policy soon resulted in the situation that the assets of the three banks exceeded the national GDP nine times, which in fact meant it was nine times higher than the value of the Iceland economy⁹. The access to cheap loans resulted in the steadily rising debt of Icelandic companies, which in 2008 was estimated at over 308% of GDP¹⁰. The credit policy proved to be extremely dangerous in its second phase, i.e. in the period of 2005-2007, when the Icelandic banks began their international expansion, which basically was a correlation between high interest rates that allowed them to finance their credit policy in the country. It turned out to have far-reaching consequences in the case of deposits in the UK and the Netherlands, which is illustrated by Icesave, which collected British deposits amounting to more than 4 billion pounds and Dutch ones in the amount of 1.7 billion EUR¹¹. In times of the crisis it caused a diplomatic dispute resulting in the legal repercussions, when both governments decided to defend the deposit of their citizens before Icesave was declared insolvent.

The sources of the crisis were presented synthetically by K. Pruchnik in his analysis. He detailed the following mistakes:

1. Too low an interest rate for refinanced loans of the central bank in Iceland in 2001-2008;
2. Interventions in the housing market (government guarantees for cheap credits offered by the Finance Housing Found (HFF) and commercial banks);
3. Mistakes made by state institutions and identifying too late the threats posed by the state institutions in relation to the credit policy of HFF and commercial banks;
4. Cranny capitalism known as a “crony republic”, that is involvement of the people associated with the business and government circles in the privatization (Pruchnik 2012: 1).

A mark of the great economic boom, which Iceland had become, was reduced to an artificially prosperous economy, which was quite cynically depicted in one of the press articles: the country with four times more sheep (more than 1.2 million) than people has more than 600 thousand foreign bank accounts (Matracka 2013). The artificial boom ended in less than four

⁹ http://finanse.wnp.pl/b-premier-islandii-prywatyzacja-bankow-byla-powaznym-ble-dem,76767_1_0_0.html.

¹⁰ World Economic Outlook database, MFW oraz Financial Stability (2002-2007) Central Bank of Iceland, 2007.

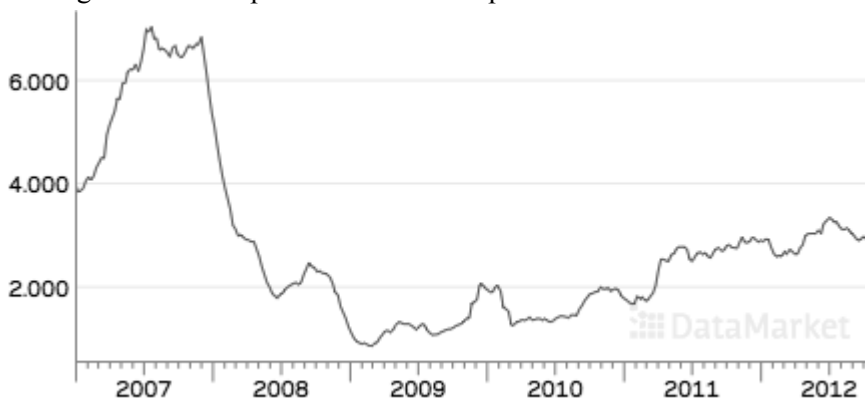
¹¹ Britain Vows to Protect Savers, <http://www.news.com.au/business/breaking-news/britain-vows-to-protect-savers/story-e6frfkur-1111117699445>.

weeks after the collapse of the U.S. Lehman Brothers, showing fragile foundations of the Icelandic boom based on a policy of economic liberalization and cheap loans.

2. The financial collapse in 2008

The very fact of the privatization of the banking sector cannot be considered as a factor stimulating the crisis processes in Iceland. It would be more appropriate to say that it was freedom with which privatized banks operated in the domestic and then foreign market. The *idee fixe* of the government led by the Prime Minister D. Oddsson of making Iceland the country where economic barriers are overcome effectively and where everybody is given equal opportunities resulted in a peculiar credit situation, in which the state institution, Housing Financing Fund, which initially was to provide lending to people who could not afford to buy their own accommodation, competed with commercial banks. Soon, however, in the free market, it became an institution influencing commercial banks, which lowered the requirements for obtaining the mortgage loans, leading ultimately to the credit policy based on loan to value ratio of 100%. It resulted in a growing demand for real estate, and thus increase in its prices (incommensurate to the real value, because their value increased by 200% since 2000). This syndrome also occurred in the United States of America. Another important factor was the government's decision to reduce the required bank reserves from 4 to 2%.

Figure 1. Development of real estate prices in Iceland in 2007-2012



Source: Icelandic Property Registry, 2012

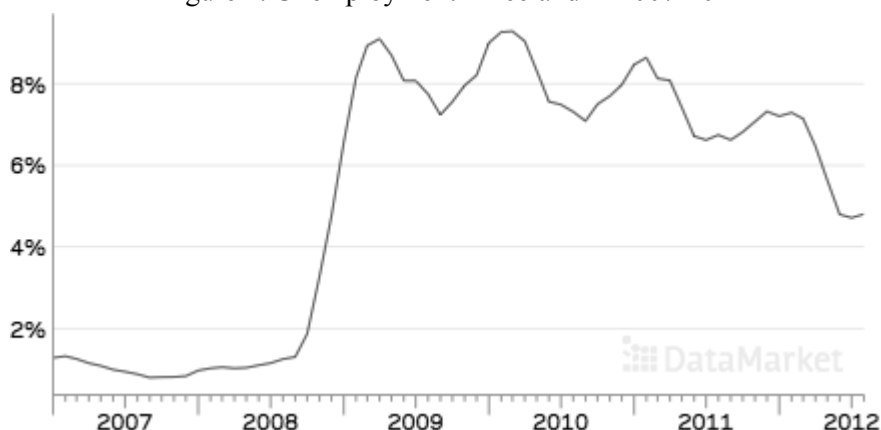
In 2005-2007, the commercial banks (Landsbanki, Kaupthing and Glitnir) started expansion activities outside by offering high interest rates (over 15%), including the possibility of starting accounts online. Landsbanki founded a subsidiary called Icesave, which collected deposits mainly from the UK and the Netherlands. Surplus profit financed cheap domestic loans. The remaining surplus was used to fund the unsuccessful investment, especially for foreign entities and what is worse, also for the organizations whose representatives had shares in banks. In this way, the idea of the “republic of cronies” was implemented. For example, Glitnir granted a loan to Bangura company with the total value of 80% of the equity, which obviously resulted from personal links between the company and the bank. The same was the issue of loans granted by Kaupthing to Exista hf company for a total value exceeding \$400 million EUR. Einskip company was granted a loan of 1 billion EUR by Landsbanki.

However, before Lehman Brothers collapsed, Europe became the scene of the first signs of the crisis, revealing the lack of liquidity in mutual settlements. Loans granted by Icelandic banks were premature and as a result of the crisis in the USA, European banks were not able to pay them off, also because they had very high interest rates. As a consequence, the Icelandic banks lost their liquidity and the entire banking sector collapsed. The collapse of Lehman Brothers only reinforced the policy, but it also had a significant direct impact on what happened in Iceland in autumn 2008.

In the same month, the government announced that the Central Bank of Iceland would acquire a commercial bank Glitnir¹². The next piece of news was insolvency of Icelandic banks which meant the total collapse of the financial market. The Icelandic society faced bankruptcy. Almost immediately Icelandic krona depreciated against the euro by 50%, GDP shrank by 3%, unemployment rose from 1 to 9% (Figure 2) and OMX15 Iceland stock index saw an unprecedented decline of 90%. The public debt-to-GDP ratio was 115%. Over 65% of Icelandic companies became insolvent.

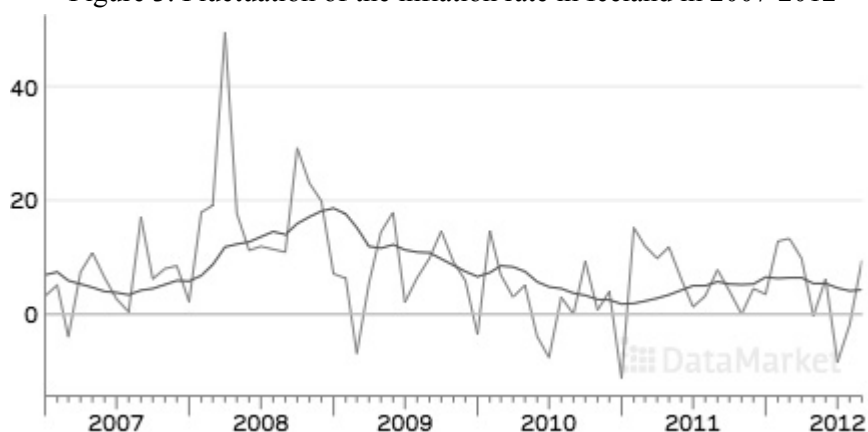
¹² The official announcement of the government said that the acquisition of the bank by the State was to be short-term, in order to improve bank's assets and its liabilities, then it would be transferred back to private hands, but it was not mentioned that the bank debt was 750 million USD, which in fact meant bankruptcy: Iceland nationalises Glitnir bank. BBC News. 29 September 2008.

Figure 2. Unemployment in Iceland in 2007-2012



Source: Eurostat, 2012

Figure 3. Fluctuation of the inflation rate in Iceland in 2007-2012



Source: Statistics Iceland, 2012

3. Direct personal consequences

The collapse affected mainly the Independence Party, ruling continuously since 1946, which was in coalition government either with the Social Democratic Alliance or the Progressive Party. The dismissal of Prime Minister, G. Haardee in January 2009 led to early elections and a new government of Prime Minister Johanna Sigurdardottir was appointed. At the same time it was the announcement that not only appropriate measures would be taken against the rulers but also that far-reaching reforms aimed to stabilize the country's economy would be undertaken .

It was the first time the Prime Minister of Iceland had been threatened with the State Tribunal. On the one hand, Geir Haardee admitted that the Party of Independence had accepted “controversial donation” in the amount of 8 million from the FL Group investment group USD and a slightly smaller amount from Landsbanki¹³. But the most important thing was the Prime Minister’s personal responsibility for the policy of the banking sector privatization and for the lack of proper supervision of the sector, which led to charges of “ negligence“. It was an unprecedented trial on a world scale. Although acquitted, the Prime Minister G. Haardee is a classic example of personal responsibility for the decisions taken, which certainly is an example for the future. G. Haardee himself admitted that the privatization process beyond the control of any state factors had turned out to be a fiasco¹⁴. In addition to the Prime Minister, people who were in the dock and were sentenced to several years of prison included former CEOs of BYR and CEO commercial banks. They were classic examples of relations between the bank, company and bank shareholders, which involved granting loans.

The Financial Supervision Authority (FSA) in Iceland was criticised as well and was accused of incompetence. Being under pressure, FSA board resigned (which did not happen in the USA). The re – nationalization of the Kaupthing and Islandsbanki banks was a clear signal of departing from the policy of liberalization beyond the state control. Landsbanki was placed under supervision of the Icelandic FSA. In contrast to the Irish or Greek variant, the Icelandic government decided not to fund the bank deficit with taxpayer money, which in the longer term seems to be a reasonable step in the Icelandic economic reality.

4. The International Monetary Fund and the European Union –programmes of support and accession to the EU

Negotiations with the International Monetary Fund (IMF) started on 24 October 2008, when a preliminary agreement was concluded to give Iceland a loan of 2 billion USD payable in several tranches¹⁵. The first one available in October amounted to 827 million USD, then a further seven tranches were

¹³ <http://www.allvoices.com/contributed-news/12007671/video/86539062-geir-haarde-i-iceland-s-former-pm-to-be-tried-in-historic-first-session-of-the-landsdomur>.

¹⁴ http://finanse.wnp.pl/b-premier-islandii-prywatyzacja-bankow-byla-powaznym-bledem,76767_1_0_0.html.

¹⁵ <http://wiadomosci.wp.pl/kat,1356,title,MFW-pomoze-Islandii-uporac-sie-kryzysem-finasowym,wid,10573322,wiadomosc.html>.

to be paid (Andersen 2008). What motivated the IMF offering assistance to Iceland? Firstly, the goal was to stop the depreciation of the Icelandic krona, but as previously mentioned, its devaluation stimulated the export policy. Secondly, the focus was on the need to restructure the Icelandic banking sector, which required direct capital injection. Thirdly, the goal was to ensure the medium time range financial sustainability¹⁶. Other institutions that supported the bankrupt Icelandic economy were the Scandinavian countries, the European Central Bank and the U.S. Federal Reserve – a total of 4 billion USD¹⁷.

The crisis put the issue of the accession of Iceland to the European Union on the agenda – then treated on the island as a possible remedy for the bankruptcy of the state. As for the EU, it was the initiative of the President of the European Commission Jose Manuel Barroso. Iceland applied to join the European Union formally on 16 July 2009, and negotiations began a year later¹⁸. However, despite many economic links with the European market, membership of Iceland in the EU aroused much controversy, related for example to the fishing policy, making their own fisheries available for the EU countries and complying with the EU restrictions in this matter. European exports to Iceland in 2009 (the year the negotiations started) was 1.34 billion EUR, while imports stood at 2.7 billion EUR¹⁹.

The problem of accession to the European Union has, in fact, a political dimension rather than economic one. Traditionally, the Independence Party (a conservative one) and the Progressive Party (a more liberal one) did not hide their skepticism about the alternative. But the Social Democrats were a staunch advocate of negotiations on this issue. In 2006, the year 2015 was presented as the time when accession negotiations have been finalized²⁰. They were just announcements as the new coalition government with the participation of the Social Democrats was by no means eager to start accession negotiations. The problem of accession appeared again when the financial crisis hit²¹. At that time, the Party of Independence of Prime Minister Haardee began to present the concept of starting negotiations with the European Union, seeing it as a remedy for the financial crisis and when parliamentary elections were approaching in April 2009, the Party called for development of the agenda for negotiations. It became one of the items in the election manifesto

¹⁶ IMF Executive Board approves US\$2.1 billion stand-by arrangement for Iceland.

¹⁷ <http://www.wprost.pl/ar/143901/UE-chce-pomoc-Islandii/>.

¹⁸ Timeline of events – Iceland's application for membership of the EU, Icelandic Ministry for Foreign Affairs.

¹⁹ <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/iceland/>.

²⁰ <http://euobserver.com/enlargement/20865>.

²¹ http://www.icelandreview.com/icelandreview/daily_news/?cat_id=16567&ew_0_a_id=315505.

for the Social Democratic Alliance. The issue of accession to the European Union was seen in terms of the election manifesto as the element ensuring the stabilization of the internal market and most of all state finances²². What is more important – a few days after the election victory, the Prime Minister Johanna Sigurdardottir announced the immediate start of negotiations with the EU and a programme of adopting euro within the next four years (i.e. until 2013)²³. On July 16, 2009, Iceland officially started negotiations on accession to the EU, but as a result of the Icelandic economic reform processes, initiated in 2010 and the implementation of the repair process of finance and national economy, most Icelandic society in 2012 were skeptical about the demands of the Social Democrats. This was due to several reasons:

1. Starting the economic and financial reforms;
2. Problems that the European Union faced, no longer seen in terms of a remedy for the Icelandic crisis;
3. Taking the citizens' initiative that provides new democratic foundations of society with high level of political awareness, capable of putting forward the initiative to change the constitution of the state.

5. Reforms undertaken by the government of the Prime Minister J. Sigurdardottir

The reform package presented by the new government of Iceland included a number of key issues that needed immediate intervention of the state. The first of them was the consolidation of public spending²⁴. This was associated with the stabilization of the labour market (stopping rapidly rising unemployment), stimulation of the investment policy especially towards foreign capital and restrictions on the transfer of capital and the restructuring of the banking sector, a reform of the tax system, not to mention both natural and model activities like cuts in the area of the social policy, including health care and education.

As far as the labour market is concerned, concluding collective wage agreements to secure the lowest income groups became a paramount issue. The investment policy is seen as quite ambiguous due to capital transfer restrictions until 2015, which as a result kept over 6 billion EUR in Iceland, which foreign businessmen invested in real estate, leading to an increase in

²² <http://www.eubusiness.com/news-eu/1238178722.13>.

²³ <http://www.theage.com.au/world/iceland-may-join-eu-after-leftwing-victory-20090426-ajbg.html>.

²⁴ Confederation of Iceland employers, reforms providing foundations for Iceland's economic recovery, August 2009.

their value²⁵. The situation in the real estate market was so worrying that since 2000 property value had increased by 240%, which could lead to a new price “bubble” in the sector²⁶.

As for restructuring the banking sector, participation of the IMF providing financial support to Iceland turned out to be necessary, and the institutions had to be subjected to the FSA supervision and then obligations were to be taken over by the state. This policy consisted of replacing the old banking institutions with new ones taking over their assets and also of selling foreign bank branches and covering (at least in part) the obligations arising from Icesave. Moreover, one of the most important political solutions was to establish the special banking supervision with increased administrative powers as regards to the banking sector²⁷.

A tax reform primarily consisted of the idea of increasing tax rates without adversely affecting the planned sustainable growth. Personal income tax rates (PIT) were lowered by 1.2% while local government rates increased from 13.12% in 2010 to 14.41% in 2011²⁸. Moreover, the following taxes were raised: corporate income tax (CIT), from 18 to 20%, which resulted in budget revenue increase by 0.03% of GDP, inheritance tax from 5 to 10% and VAT from 24.5 to 25.5%²⁹.

6. The Icesave issue as a test of a citizens’ initiative – the foundations of new participatory democracy

The case of debt of Icesave online bank (Landsbanki branch) had significant political consequences, at the same time stimulating the Icelandic society. Icesave bankruptcy could mean that the high-interest deposits mainly of customers in the UK and the Netherlands were lost, the consequence of which was a dispute between three countries. Initially, the government in Reykjavíku said that bankruptcy of a banking institution was a natural phenomenon, and it involved risk of depositors. The response from London was unequivocal – it threatened to apply anti-terrorism legislation to Iceland,

²⁵ Only in 2011 r. their value increased by 10% compared to the previous year, cf. Kamil Pruchnik, p. 18.

²⁶ The assessment of the situation in the Icelandic market in 2009 – the International Monetary Fund, Survey Magazine Interview, Iceland quiet progress on key reforms, Washington D.C. October 21, 2009.

²⁷ Ministry of Foreign Affairs of Iceland, Reforms in the Iceland financial sector, Reykjavík, April 2010, p. 1.

²⁸ International Monetary Fund, Iceland: Advancing tax reform and the taxation of natural resources, Country Report, No 11.138, Washington D.C., June 2011, p. 10.

²⁹ Ibidem.

which in fact meant that the Icelandic state had committed one of the most serious crimes. Eventually, British and Dutch governments agreed to cover the Icesave debt to their own citizens, demanding that the Icelandic government takes action to pay off the debt.

Assumption of liabilities by the Icelandic government forced the authorities to hold the national referendum on the issue, in other words, the question was whether the Icelandic taxpayers should pay out of their own pockets for activities of a commercial bank. Therefore, the issue of a national referendum on the matter was put on the agenda. This form of direct democracy had not been used in Iceland since its independence in 1944. The precedent began to pave the way for a citizens' initiative and an increased degree of direct democracy³⁰. The first referendum was held on 6 March 2010³¹. Definite rejection of the government proposal of guarantees for private British and Dutch deposits meant that the opinion of citizens had to be respected. The President of the Republic of Iceland Olaffur Grímsson was a kind of inspiration for the civil protest, as he had not enacted the law passed by the parliament in January 2010, aimed to impose liabilities of a commercial bank on the public³². Rejection of the proposal to repay liabilities under the agreement with the government in 2010 led again to discussing the issue of British and Dutch deposits in the parliament.

This time an agreement was concluded, under which Iceland would repay debt to the British and Dutch governments within 30 years starting from 2016, accepting the debt interest rate at 3.3% for the UK and 3% for the Netherlands. President Grímsson again refused to countersign the agreement, leading to another referendum on the issue, which rejected the proposal in April 2011. This in turn led to a sharp response of the British government, especially the Treasury Minister Danny Alexander, promising to bring the case before the International Court of EFTA (European Free Trade Agreement)³³. As it was expected in both countries, this solution would definitely put the issue of Iceland's accession to the European Union on the agenda. However, as a result of improved economic condition of the country in 2012, it seems to be unimportant in the light of the growing skepticism about this issue. Nevertheless, this can affect the international position of Iceland as a trading partner, not only in the European market. Eventually,

³⁰ http://wiadomosci.gazeta.pl/wiadomosci/1,114873,7435528,Islandia_W_referendum_zdecyduja_czy_oddac_pozyczke.html.

³¹ <http://www.icenews.is/index.php/2010/03/07/official-confirmation-of-huge-iceland-no-vote-in-icesave-referendum/>.

³² Declaration by the President of Iceland, http://english.forseti.is/media/PDF/10_01_05_declaration_w_sign.pdf

³³ <http://www.bbc.co.uk/news/world-europe-13022524>.

the case was before the EFTA court, which declared the Icelandic government responsible for repaying the debt to the British and Dutch authorities, which covered the Icesave liabilities in 2009, which in fact means accepting the claims made by London and Hague³⁴. The response of authorities in Reykjavik was negative. This meant that the Icelandic authorities did not want to cover the liabilities of the Icelandic commercial banks. Although the problem has a political dimension, it should be noted that the citizens' initiative proved to be stronger than the parliamentary laws and supported by presidential veto, it made the institution of referendum credible, at the same time showing the political force of politically aware citizens.

7. The referendum on the constitution – the second citizens' initiative

The financial crisis stimulated the citizens of Iceland, who appealed to the institution of referendum. After the results of the referendum on the Icesave case, humiliating the Icelandic authorities, the referendum on constitution was held. Political maturity of the Icelandic society, which in 2003-2007 was inspired by the fantasies of getting rich on credit, manifested in inferring conclusions from the painful lessons of the artificial prosperity period and in the need to introduce new political mechanisms. It inevitably led to a constitutional initiative, because the majority of people recognized the political changes as a necessary factor in the process of economic reforms. In a way it confirms the primacy of political decisions over economic ones. In addition, it is a testimony to a grassroots initiative aimed to shape the system of increased control over state institutions and economy. A goal is to prevent the repetition of mistakes resulting from the activity of the Prime Minister Haardee and the FSA, who virtually left banking institutions, demanding to cover their liabilities at the expense of citizens, beyond control.

235 thousand Icelanders entitled to vote were expected on 21 October 2012 to express their opinion on changes in the supreme law of state proposed by the 25-member Constitutional Council. The questions to the public were about:

1. Changes in the Constitutional Act;
2. Nationalization of natural resources;;
3. Establishment of a national church;
4. A possibility to elect to parliament people not belonging to any political party;

³⁴ <http://www.icenews.is/index.php/2011/06/10/esa-iceland-is-responsible-for-icesave-refund/>.

5. Equality of votes cast in different parts of the country;
6. Determining the statutory number of persons entitled to call a referendum³⁵.

Despite its non-binding nature, the referendum revealed that the society was determined to change the system of democracy for more direct democracy. The item of the statutory number of people required to hold a referendum should be of particular importance, which means that in the future this institution will be even more important than so far. The referendum results should not be surprising – 80% of Icelanders were in favour of proposals for amendments, which implies that it was necessary to take into account the vote of the overwhelming majority in the state political reforms³⁶.

Support for the reform of the state results from a need for preventing previous practices, from awareness that the natural resources of the country should be supervised, which has long-term consequences as well as from the gradual recovery from the crisis, which result from the rationalized government policy.

8. The effects of economic reforms and skepticism about accession to the European Union

The reform programme announced by the Prime Minister J. Sigurdar-dottir created the foundations for a controlled activity of the banking sector. First of all, the government pursues a policy of gradually separating the investment activity from that of depositing, which is supported by a growing number of Icelandic parliament members. They demand the introduction of an American-like Glass-Steagall Act of 1933 legislating such a diversification³⁷. In October 2012, investment activity of the Icelandic banks stood at 5%, which represents a decrease of 28% compared with the period 2005-2008 (Turliński 2012). The reforms of the banking sector shrank bank assets nearly 5 times, which had a stabilizing impact on state finances and on overall economy. The strict discipline of keeping the exchange rate determined by the IMF led significantly to stabilizing the exchange rate, restructuring the financial system and to improving public finances.

Current economic growth stands at 5.6%³⁸. In contrast to many European countries in crisis, Icelandic GDP is 2.6% (Baj, Maciejewicz 2013). The

³⁵ <http://www.kosning.is/thjodaratkvaedagreidslur2012/english/>.

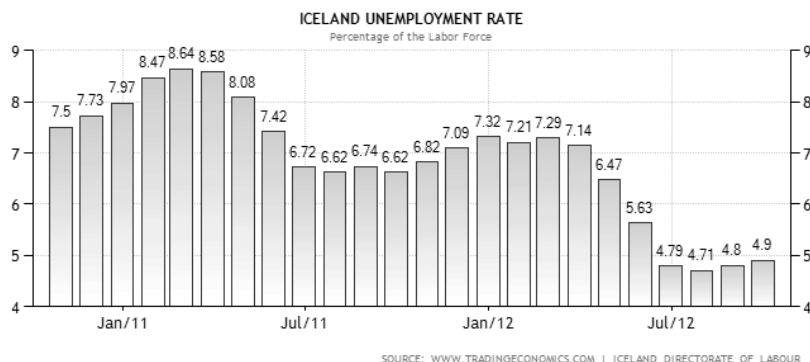
³⁶ http://m.interia.pl/fakty/news,1854963,4?utm_source=fakty&utm_medium=&utm_campaign=polecane.

³⁷ www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html.

³⁸ <http://www.phrasebase.com/countries/iceland/>.

good condition of the Icelandic financial market is also reflected in a higher position on the lists of credit rating agencies, among others Fitch, according to which Iceland moved to the investment category from the speculative one³⁹. The unemployment rate stands at 4.9%, which is high, given the fact that it is a small economy, but compared with the peak of the crisis, it was brought down by almost 50% (Figure 4).

Figure 4. Fluctuations in the unemployment rate in Iceland in 2011-2012.



Source: www.tradingeconomics.com

However, one of the most serious phenomena is unemployment among Icelandic youth. Over 16.4% of young Icelanders are out of work, for whom emigration to the European Union countries is one of the solutions (Jónsson 2010). The collapse of the Icelandic financial market resulted in a number of pathological phenomena, previously unknown on the island, among others domestic violence and increased alcohol consumption. It is extremely dangerous in such a small market. On the other hand, political awareness has proved to be an inspiring example for many European societies, where governments are struggling in different ways with the effects of the crisis. It is also important that the accession to the European Union no longer wins so many supporters like in 2008. The view that their own particular benefits will be lost for the Union is increasingly dominating.

9. Summary

Is Iceland a model of solving the economic problems in the modern world? Although the Icelandic crisis in 2008 resulted from classic activ-

³⁹ <http://wolnemedi.net/gospodarka/islandia-ma-lepsze-notowania/>.

ities of the banking sector, based on low-cost loans, the lack of financial supervision and a wrong investment policy abroad, Iceland turned out to be a country that is trying to solve its own problems positively by itself. In contrast to many cases of crisis ranging from the USA to Greece, the Icelandic authorities, having found themselves under exceptional social pressure, were forced to take unprecedented steps. Bringing the former Prime Minister G. Haardee to the State Tribunal, although he was not convicted, showed determination in personalizing responsibility for decisions taken. G. Haardee himself had to publicly admit government mistakes in the banking sector. Arresting some of the presidents of commercial banks and sentencing them for irresponsible activity in the financial market convinced the public that the country was able to take appropriate measures against people representing the sector, called “too big to fail” in the USA. In other words, a small Icelandic market did not enable activities that took place in the U.S. economy.

But the activities in the political sphere are most important – grassroots social demands stimulating the government reforms. Allowing commercial banks to go bankrupt was an unprecedented move. While European countries and the USA decided to save the banking sector using the taxpayer money, Iceland yielded to public pressure and did not allow an Icelandic taxpayer to bear the consequences of wrong decisions taken by commercial bank presidents. A diplomatic conflict between Reykjavik, London and The Hague triggered by deposits of the bankrupt Icesave would in fact be resolved due to the decision of the Icelandic parliament, ready to fulfill the demands of the British and Dutch governments. Backed by the President’s decision, the society imposed a definite veto, which forced the Icelandic government to renegotiate the agreement, to hold a referendum twice and finally to be taken to court by the United Kingdom and the Netherlands. This phenomenon led to a process of developing direct democracy, which resulted not so much in changing the constitution top-down by a special constitutional committee as in appealing to the public, who decided about the shape of constitutional reforms in a referendum. The referendum is an institution that has existed in the Icelandic political system since 1944 but it had never been applied before 2009, which was due to the development conditions for the society since independence.

One key question remains, namely about the nature of the privatization reforms. Many researchers blame the privatization process itself as the reason for the collapse of 2008, while the economic stagnation of the late 1980 and the early 1990s was ignored. Privatization in the 1990s proved to have positive effects; it was an incredible economic boom caused by uncontrolled privatization of banks and virtually leaving their activities beyond control

of the government that led to the crisis. Not differing from the crisis model of 2008, Iceland however, is a perfect example of the particular method of fighting with crisis effects, of determination of the government to implement reforms. The effectiveness of support from the IMF depended on consistency in implementing the reforms, from 2009 onwards. However, the social problems that arose, for example unemployment, especially among the younger generation, or an increase in real estate prices show the scale of the problem in such a small market. Therefore, it seems reasonable that the positive results achieved today by the Icelandic economy are due to the specific nature of the society, the political and economic system, for which the excess is extremely dangerous. As it turns out, citizens' initiative is feasible only with a high degree of political awareness in society, functioning in a small country.

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