Iceland's Economic Meltdown Is a Big Flashing Warning Sign

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Iceland -- better known for its geothermal hot springs, abundant fish, all-night raves and eclectic musicians such as Björk and Sigur Rós -- has now become renowned for something else: It is the first catastrophic, and perhaps most unlikely, casualty of the 2008 economic and financial meltdown.

Iceland is now essentially bankrupt after the government took over its three major banks to prevent them from failing. It owes more than $60 billion overseas, about six times the value of its annual economic output. As a professor at London School of Economics said, "No Western country in peacetime has crashed so quickly and so badly."

What on earth happened to get Iceland and its banking sector into such a state?

It turns out that Iceland, despite its coalition governments and Nordic social values, became a poster child for neoconservative economic policies inspired by Milton Friedman during the past decade. Friedman himself visited Iceland in 1984 and participated in what was described as a "lively television debate" with leading Socialists. This inspired a generation of young conservatives who came to power through the Independence Party in 1991 and have run its government through different coalitions since then.

Friedman may be dead now, but the economic and financial collapse of 2008 is becoming a real-life battleground of his theories against those of the other giant of 20th century economics, John Maynard Keynes, and their respective followers. Will financial market bailouts put the economy back on track, or are more extensive reform and a more active role for the government needed?

Keynes' analysis was complicated and nuanced. The work for which he's best known, *The General Theory of Employment, Interest, and Money*, provided a theoretical basis for the economic reforms of the New Deal era -- investments in public works and deficit spending that helped countries recover from the Great Depression.

While Keynes did not dismiss the role of monetary policy in countering an economic downturn, some of his followers, notably recent 2008 Nobel economics prize winner Paul Krugman, in relation to Japan, have focused on the possibility of a "liquidity trap" that makes traditional monetary policies, such as cutting interest rates, ineffective.

Keynes' theories, though often misapplied, provided the basis for most macroeconomic policies in the capitalist world from the 1930s until the 1970s when the oil-price shock and stagflation hit.

Friedman, in his *Monetary History of the United States*, argued that the Great Depression was primarily caused by negligence by monetary authorities, such as the U.S. Federal Reserve, who didn't do enough to respond to an ordinary financial shock by expanding the money supply.

Friedman and his Chicago school of economics then very successfully spearheaded a reaction against Keynesianism, largely defining economic policy since the 1980s. The main policy prescriptions -- restricting the role of government, deregulation, privatization, cutting taxes, low inflation and the benefits of free markets -- were encapsulated in the "Washington consensus" and imposed with missionary zeal by IMF economists around the world.

While Friedman's narrow form of money supply monetarism was quickly abandoned in the early 1980s, most governments have relied primarily on monetary instead of fiscal policy for stabilization of their economies over the past few decades. This turned Alan Greenspan, former head of the U.S. Federal Reserve and an advocate of Friedman's policies, into the most important economic policy maker in the world. Although Greenspan was never elected, had no particular expertise in economics and was a disciple of the fringe ideology of libertarian Ayn Rand, he was able to use his considerable power to endorse tax cuts and deregulation. He is now widely considered to share the blame for creating the conditions that resulted in the current economic collapse.

Greenspan's successor as chair of the Federal Reserve, Ben Bernanke, is also a follower of Friedman, but he is an accomplished economist. Coincidentally enough, one of his areas of expertise was in the economics of the Great Depression; he once boldly stated that the Federal Reserve was responsible for causing the Great Depression and making banking panics during it "much more severe and widespread."

Bernanke is now one of the people in charge of what is probably the most expensive experiment in human history: trying to avert another Depression, using economic policies inspired by Friedman. The cost of this to the U.S. Treasury so far has already reached well over $1 trillion and continues to rise.

So how did the much smaller but perhaps more ambitious experiment with Friedmanite economic policies fare in tiny Iceland, one of the most physically isolated countries in the world with a population of only 320,000?

Under the leadership of Prime Minister David Oddsson and explicitly inspired by Friedman, Iceland's neoconservative young Turks implemented a radical (but now familiar) program of privatization, tax cuts, reductions in spending and deficits, inflation targeting, central bank independence, free trade and exchange rate flexibility. Corporate taxes were cut from 50 percent down to 18 percent. Privatization and deregulation were driven directly through the prime minister's office, and the major banks were privatized.

Economic missions and reports on Iceland issued by the influential International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) largely praised and encouraged these reforms, often disregarding the rising risks for its financial sector until recently.

It wasn't as if everyone was unaware of the growing dangers of these policies. In 2001, Joseph Stiglitz, recipient of the Nobel prize in economics and one of the leading lights of the "New Keynesian" school of economics, wrote a remarkably prescient paper for the Central Bank of Iceland. In the paper, he raised alarm about a vulnerable, small, open economy such as Iceland suffering from a severe financial and economic crisis from such policies. In the absence of reforms in the "global financial architecture," Stiglitz outlined a set of regulatory and tax measures that Iceland should implement "both to reduce the likelihood of a crisis and to help manage the economy through a crisis."

Stiglitz's paper (PDF) has invaluable advice that should have been considered by any nation -- and especially Iceland -- but it appears these recommendations were ignored. The right-wing reformers certainly didn't change their course. Why would they? Life was good and getting better in the small island state, with showrooms full of fancy cars and booming real estate, business and financial industries.

At first, the policies appeared to be very successful. The economy grew at a strong pace, rising until Iceland achieved one of the highest per capita GDPs in the world. In 2007 it also topped the score for the United Nation's *Human Development Index*.

Iceland rocketed to the top 10 in the indexes of economic freedom designed by the Fraser Institute and the Heritage Foundation. It was lauded by the conservative Cato Institute for its flat taxes, privatization and economic freedoms. The institute also criticized Naomi Klein for not mentioning Iceland (along with Ireland, Estonia and Australia) as an example of success in her book about the rise of disaster capitalism, *The Shock Doctrine*.

Icelandic banks and businesses, with the support of their government, expanded aggressively overseas, particularly into the U.K. and the Netherlands. The banking industry and private businesses flourished and created a number of new billionaires on the island.

Then it all came crashing down.

Inflation and short-term interest rates escalated to 14 percent, and Iceland's currency lost half its value. Now Iceland has an external debt equivalent to about $200,000 per person with virtually no prospect of repaying it.

Iceland's economic collapse wasn't caused by the subprime crisis or by the Wall Street shenanigans in the biggest economic powerhouse in the world. Instead, it was caused by the same Friedman-inspired economic policies being independently applied in one of the smallest countries in the world.

Back in the United States, it appears that Washington's experiments with Friedman-inspired economic policies are not meeting with much success. Each action taken by the U.S. Treasury and the Federal Reserve until mid-October was met with a further decline in stock prices.

Stock markets didn't start to recover until European nations moved to effectively nationalize their major banks. This move was quickly followed by Washington, although it is far outside of what Friedman advocated. It is also diametrically opposed to a number of the 10 economic policy commandments of the old "Washington Consensus." While stock markets may recover, or continue more along their roller-coaster ride, we have yet to see how far down these Friedmanite free market policies will take the real economy of people's jobs, incomes and living standards.

What is somewhat incredible is the apparent lack of remorse or self-reflection and doubt being expressed by the ideologues who put these policies in place. Amazingly, many neocons continue to argue that the financial collapse was caused by regulations that were too strong, or by a confluence of unlikely events, including a rise in "leftist attitudes."

There seems to be a belief among many that a financial market bailout will soon relieve the credit crunch caused by the subprime fiasco and then we can go back to business as usual. We don't need to look too far back in time or too far abroad to see how misguided these views are. Clearly it is time to broaden our horizons, learn from Keynes and successful New Deal economic policies, and consider other imaginative solutions to our economic crisis.

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