ISSN 1011-8888

INSTITUTE OF ECONOMIC STUDIES

WORKING PAPER SERIES

W13:02

August 2013

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Myths and truths of the Icelandic recovery in the wake of the 2008 Financial Crisis

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27 August 2013

Abstract

The relative success of the Icelandic road to recovery in the wake of the 2008 Financial Crisis has been a source of some myth-making. First, it has been claimed that Iceland did refuse to bail out bankers. Second, it has been argued that the sovereign was sheltered. Third, the President is claimed to have blocked deals forced upon the government by the Dutch and the British (the successive IceSave-agreements that would have cost Icelandic taxpayers 4 billion Euros plus interest, or €50.000 plus per family. Fourth, the story goes, that a 50% devaluation of the domestic currency was the key to the success. Fifth, it has also been claimed that the government sheltered the wealthy by refusing an across the board debt write down. Sixth, it has been asserted that the IMF program has been counterproductive ("toxic") for the Icelandic economy. This paper examines the reality behind those claims. The paper concludes that the policy was adopted in Iceland post crisis was more of the Keynesian flavor than austerity. Furthermore, that the debt-relief program that the government initiated also was a key factor in cushioning the effect of the collapse of the Icelandic financial system.

Keywords: Iceland, recovery, financial crisis.

JEL Classification: E40, E59, G01.

Introduction[1]

Seen from Europe, Iceland has always been far away. Iceland was not discovered until the 9th Century AD at a time when it would take weeks on a vessel, capable of crossing the North Atlantic, in addition to advanced navigational skills. Air-travel and fiber-optics have shortened the distance but Icelanders still use a language comprehensible only to themselves and the handful of foreigners that have learnt it. Hence, foreigners mostly have only secondary sources to rely on when trying to understand all matters Icelandic. News from Iceland that reach foreigners have normally been translated at least once. Distance lend wings for airing myths and legends.

The combined balance sheets of the Icelandic banks amounted to 10 times the Icelandic GDP in October 2008 when the bankruptcy of the Lehman brothers triggered a collapse of the three largest Icelandic banks. The collapse took most Icelanders by surprise even though many foreign observers had for some time been predicting a "hard landing" for the Icelandic economy. Soon after the demise of the Icelandic banks, financial institutions in Ireland, in Portugal, Greece, Italy, Spain and many other countries ran into similar problems. The sovereign in some of the troubled countries tried to prevent a financial meltdown in various ways such as by off-loading bad assets off the balance-sheets of troubled banks, guaranteeing payment of liabilities, even supplying fresh money.

Until Cyprus sought a bailout Iceland and Greece were seen as special cases. The sovereign debt of Greece was too big to sustain, the collapse of the Icelandic banks was too big for the sovereign to swallow. Hence, Greece had its haircut and Iceland put its three largest banks into receivership. Both countries sought the help of the International Monetary Fund. Both countries have taken harsh measures to realign their economic structure to the realities of the world.

Now, almost 5 years after the demise of Lehman Brothers incidence the situation in Iceland and in Greece is very much different. Unemployment in Iceland has

[1] I am indebted to Nikos Theocarakis of the National and Kapodistrian Universtiy of Athens, Thorvaldur Gylfason of the University of Iceland, Sigrun Davidsdottir, Franek Rozwadowski and Jon Baldvin Hannibalsson for comments and suggestions.

fallen to below 5% from a high of 9,5%. The economy is growing, albeit slowly. Income inequality has been reduced. The state budget is almost balanced. Greece is on a wholly different track with an unemployment-rate at an all-time high of 27%, [April 2013 ElStat data] the economy is contracting 5th year in a row. Income inequality is increasing, see (OECD, 2013).

The relative success of the Iceland's road to recovery has been a source of some myth-making. **First**: Iceland refused to bail out bankers. **Second**: the collapse came at no cost to the sovereign. **Third**: the President of Iceland blocked deals forced upon the government by the Dutch and the British (the successive IceSave-agreements that would have cost Icelandic taxpayers 4 billion Euros plus interest, or €50.000 plus per family), (Matthiasson & Davidsdottir, State Costs of the 2008 Icelandic Financial Collapse, 2012) (Matthiasson T. , Ytring, 2013) (Wikipedia, 2013)). **Fourth**: 50% devaluation of the domestic currency was the key to Iceland's successful recovery. **Fifth**: the government sheltered the wealthy by refusing an across-the-board debt write down (see for instance (Mósesdóttir, The IMF's Toxic Bail-out of Greece and Iceland, 2013)). **Sixth**: it has been asserted that the IMF program has been counterproductive even "toxic," for the Icelandic economy (Mósesdóttir, The IMF's Toxic Bail-out of Greece and Iceland, 2013), (Iceland Review, 2009). At a closer scrutiny all of those claims are unfounded if interpreted literally, in other words myths obscuring the true story.

Myth #1: Refusing to bail out bankers

The math is simple. Iceland was never in position to bail out its banks. Even if assets of the banks were only written-down by 20% from their estimated value in early 2008 it would have burdened the Icelandic sovereign with a debt amounting to 200% of GDP. More realistic valuation of the banking sector assets (50-70% of early 2008 value) would have left the sovereign with a debt of 300-500% of GDP. Hence, the only question related to how big a haircut the creditors would have to accept.

But the simple calculation of debt-to-GDP ratio did not stop the Central Bank of Iceland, CBI and the government from trying. There were attempts in early September 2008 and in October 2008 to save the banks, one or more. In September 2008, the sovereign attempted to nationalize the smallest of the banks, Glitnir and announced a plan to put up 600 million euros in equity, writing down existing equity to 200 million euros. Later events prevented the plan from completion (mbl.is, 2008). In early October, the CBI granted Kaupthing bank a loan of 500 million euros , ca 36 hours before Kaupthing Bank declared bankruptcy. The transaction left the country virtually without any currency reserves, which has proven costly in the aftermath of the crisis.[2]

Myth #2: Sheltering the sovereign

It is a widely held misconception that the Icelandic people managed somehow to force foreign banks to foot the full cost of the collapse of the Icelandic banking system. This is however not correct. Sigrun Davidsdottir and I have shown that the expected direct cost accruing to the sovereign is in the range of 20-25% of GDP, see (Matthiasson & Davidsdottir, State Costs of the 2008 Icelandic Financial Collapse, 2012). Our findings are broadly supported by the IMF, see (Laeven & Valencia, 2012).

The sovereign suffered severe losses of revenue and a surge in crisis-relief related expenditure. Hence, the net public debt in Iceland has increased by 60% of GDP from 2007/8 to 2012; a clear indicator of the direct and indirect cost of the collapse accruing to the public purse. In addition there are the severe losses of the pension system, which consequently has been forced to considerable write-down of pension rights. Losses of the public Housing Financing Fund amount to 20% of GDP. Some (not all) of the losses were caused by the collapse of the banks.

It is safe to conclude that while the foreign losses stemming from the collapse of the Icelandic banking system are ca. 5-6 times GDP Icelandic taxpayers and Icelandic pensioners shoulder a burden comparable to ¾ of GDP or more (the combined increase in public debt, Housing Fund losses and losses of Icelandic pension funds). The ratio of private losses to sovereign losses and of foreign losses to domestic losses is higher in Iceland than in most other crises ridden countries. These ratios become less "favourable" if correction is made for the exclusively foreign operation of the three big banks.

Myth #3: Iceland will not pay a penny to the UK and the Netherlands towards IceSave

This is unfortunately not true. First some background. In autumn 2006

[2] The lack of trust towards Iceland and lack of foreign funds was such that neither the CBI nor the Ministry of Finace were able to guarantee that the Minister of Finance, Árni Mathisen, could use his credit card to cover his expenses while attending an IMF meeting on October 9 2008 in Washington. Árni Mathisen joked in his memoirs that he got the last few dollars in the vaults of the CBI on that occasion. Kaupthing had already gotten everything there was at hand (mbl.is, 2010).

Landsbanki set up high-interest internet saving accounts, Icesave, in the UK and in spring 2008 Icesave opened in the Netherlands. The collapse in October 2008 of Landsbanki triggered two significant things . First, the New Landsbanki did overtake assets, mostly Icelandic, and domestic deposit liabilities of the failed bank. The value of assets transferred was higher than the values of liabilities transferred to the new bank. To close this gap the new bank issued an FX bond, i.e. to be repaid in foreign currency. The bond yield is Libor plus 175 points until principal payments kick in in 2014 and then Libor plus 290 points.

The principal amount is to be repaid during the period 2014 to 2018. The amount is approximately 5% of GDP in each year. Hence, Iceland will have to double its current account surplus from 5% of GDP to 10% of GDP during the period 2015 to 2018 unless the bond is rescheduled, directly or indirectly by refinancing with loans with longer maturity.

In addition, the collapse also triggered a €4bn claim against the Icelandic Deposit Guarantee Scheme, DGS. This claims originated from Landsbanki's Icesave clients in the UK and the Netherlands. The Icelandic DGS did not have access to funds to meet the claims. Partly in order to prevent a run on their own banks, the governments of the UK and the Netherlands decided to reimburse IceSave depositors, hoping to recover the funds, in due course, from the Icelandic government.

The successive IceSave agreements instructed that the estate of the failed Landsbanki would pay out most of the funds owed by the Icelandic DGS, with the Icelandic Government guaranteeing any outstanding claims, with interest. By turning down the agreement in two referenda, it was, in effect, the top-up of the remaining balance, including interest, that Icelandic voters refused to guarantee. (Matthiasson & Davidsdottir, State Costs of the 2008 Icelandic Financial Collapse, 2012).

The potential costs accruing to the sovereign of Iceland as result of the successive agreement is hard to estimate. The first agreement was based on a prolonged payment holiday while later variations were based on repayments in step with liquidation of the estate of the fallen bank. Fact is that the estate of the fallen bank has already paid off half of the Icesave debt to Netherlands and the UK and the estate will in due time cover the rest.

The pace of the repayment is now to a large extent governed by the bond issued by New Landsbanki to the estate of the failed bank, not by governmental agreements. The repayment-schedule is not tailored to macro-economic conditions of the country as was intended in the Icesave agreement..

From initially being a matter of internal accounting between the failed and the new Landsbanki the Landsbanki bond now determines the rate of repayment, thereby creating an unforeseen risk. The CBI and other observers, i.a. the IMF now see this as a macro-economic risk (Central Bank of Iceland, 2013)

Bottom line: Refusing to ratify the successive IceSave agreements has not been costless. The UK and the Netherland managed to delay payment of the first tranches of the IMF loan to Iceland in 2009, thus delaying efforts to restart the economy. Furthermore, in absence of a repayment-profile-agreement with the UK and the Netherland Iceland will either have to issue new bonds on the international capital market (crowding out other domestic actors and/or increasing risk-premiums) or alternatively strive to double the current account surplus.

Myth #4: Value of independent currency

In the run up to the collapse the Central bank had increased its policy rate several times making investment in Icelandic securities an alluring option for carry-trades. The high interest drove up the price of the domestic currency, the krona or ISK.

The real exchange rate of the krona was 20 to 30% above its PPP value in 2005 to 2007. The real exchange rate was in constant fall from late 2007 and may well have reached its equilibrium value in purchasing-power-parity terms by mid 2008. That did not, however, stop the currency from going into tailspin in October 2008. The distrust in the currency was so widespread that Iceland, in agreement with the IMF, had to suspend freedom of movement of capital, which is one of the fundamental freedoms of the European Economic Area agreement. Five year on, the controls are still in effect.

The immediate effect of the collapse of the krona was to destroy the balance-sheets of most businesses in Iceland and of families that had been lured by low interest rates to switch from domestic to foreign currency financing of their debt. The government, which came to power after elections in March 2009, put into place one of the most comprehensive debt-write down programs in the world to prevent whole-sale bankruptcy of the business sector.

The long-term effect of the devaluation was to boost the revenue side of exporting businesses and restrict imports dramatically. So far the effect of devaluation is according to the book: Export-income are expected to increase, import-expenditure to contract. Furthermore, exporting sectors are supposed to expand in size, imports are expected to be substituted by domestic products.

In theory a devaluation is also expected to trigger flow of labour and capital from importing activities toward exporting activities. The problem in Iceland is that exports in important export sectors (aluminum, fishing) are constrained by natural restrictions (electricity generation capacity, quotas) that do not respond to variations in the price of currencies.

With such as small consumer-base as the Icelandic one it is restricted which consumer goods can be produced domestically. Tourism is the only sector that responded to changed terms-of-trade. Some economists worry as tourism is considered a low-pay industry and because there are signs that capacity-restrictions are being reached in some part of that industry too.

The cost-benefit analysis of the krona includes tallying the cost of prolonged capital-controls[3] and the cost of excessive debt-relief programs as well as the traditionally recognized costs of holding own unstable, currency (higher interest rates, more volatility, transaction costs). Reducing unemployment by a percentage point or two over a two-year period would account on the benefit site, but might well be dwarfed by the posts on the cost side.

Myth #5: Sheltering the wealthy

By Act 107/2009 the government did enact one of the most comprehensive debt relief programs anywhere, see (Matthiasson T. , Iceland+s debt-relief lessons for eurozone, 2012) and (Matthiasson & Kirby, Iceland+s debt write downs cleared a path to recovery, 2013). The program caused a heated debate on how it should be structured and what its reach should be.

Many debtors had wished for an across the board write-down amounting to 20-30% of the face value of all debt. It was immediately pointed out that such a move would increase the net-worth of firms and families regardless of if they were underwater or not. Furthermore, it was pointed out that the biggest owner of debt in the country were the pension funds, which, incidentally, had almost the entire population as forced members. Any debt write-down hitting the funds would in the end come at the expense of the general population

[3] In a recent report the IMF suggest implementation of sever "speed controls" during liberalization of movements of capital out of Iceland (IMF). These speed controls will have to be in place for a decade or maybe more.

Ultimately, the government chose to restrict its debt relief to legal entities (firms) that could prove that they had enough cash-flow to sustain the necessary expenditure. Debt write-downs to families was restricted to 110% of the fair value of the family house. (An aside, a new government, voted to power in spring 2013, promised to "do more" during the election campaign. Time will show if they can deliver promises, which many observers including the OECD and the IMF fear will be inflationary).

Myth #6: the IMF program was counter-productive

Some members of parliament were strongly against the IMF involvement. The loudest protest came from within the parliamentary group of the Left Green, which sat in the coalition government in power from March 2009 until summer 2013. These critics maintained that IMF had a track record of demanding consolidation of public finances with cuts in welfare expenditure and increasing taxes on the poor (Mósesdóttir, Þrælslund ríkisstjórnarinnar er þjóðinni dýrkeypt, 2012). Others pointed out that taking a loan to strengthen the currency reserves would not alter the net external position of the country (Iceland Review, 2009).

The critics have been proven wrong on all accounts. The IMF and the government agreed to take only a very gradual approach to consolidation of public finances accepting a budget deficit of up to 10% of GDP in 2009 and nudge towards a balanced budget over a period of 4 years. Furthermore, the IMF did leave it to the government to figure out the details in prioritizing and implementing the consolidation plan.

The financial system was restructured and the zombie-bank problem avoided. Capital controls and enlarged currency reserves calmed foreign capital markets to the extent that the Icelandic sovereign was able to issue a 1 billion USD bond in late 2011, (Ministry of Finance A, 2011) (Ministry of Finance B, 2011).

The response of the IMF and the government was Keynesian in effect and not austerity as predicted by the critique. Without the assistance of the IMF the Icelandic government would not have been able to implement policy with Keynesian flavor. On its own, Iceland would have had hard time implementing capital controls, in breach of the fundamentals of the EEA agreement. On its own Iceland would also have had hard time defending its position on the foreign capital markets.

Visions, reality and political turmoil

The fall of the Icelandic financial system did take the Icelandic people by surprise. The reaction was muted to begin with, but soon grew into the so-called Pots-and-Pans revolution (Wikipedia, 2013) demanding the resignation of the government, the governors of the Central Bank and the CEO and Board of the Financial Services Authority, FME, in addition to the dissolution of the Parliament and new elections.

The protests culminated in late January of 2009 after which they tapered off as demands were partially fulfilled with the resignation of the government, the director and the board of the FME. A minority government led by the Social Democrats with the LeftGreen party, defended against votes of no-confidence by the Progressive party (Framsóknarflokkur) was in power until the election held in late April 2009. It brought a landslide victory for the Social Democrats and the Left Green. (Hardarson & Kristinsson, 2010)

The election campaign revealed that a majority of voters were in favour of negotiating EU membership, i.a. to get rid of the domestic currency and adopting the Euro. They also seemed in favour of reducing the influence of finance and business in politics and of collecting higher fees for use of natural resources (fish-stocks).

There was also a vocal demand for a new constitution, referred to as Iceland 2.0 in the spirit of the computer-literate young generation. In spite of divergent views on important issues such as EU membership the Social-Democrats and the Left Green stayed together in government after the election. The solution was to apply for membership on condition of a majority in Parliament, even if a majority of the Left Green parliamentary group voted against.

The opposition soon realized that this decision-making process gave the individual parliamentarians in government freedom to act on their own on other issues as well. The opposition used that knowledge to split the government parties when other sensitive issues were up for vote. Hence, seemingly small fires lit by the opposition often ended up as all-engulfing blazes. The leaders of the two governing parties had to use much of their energy on damage control and deals within the government parties were unstable.

The government did deliver on matters related to repairing the economy post-crisis such as bringing the budget close to balance, restoring growth and containing unemployment. It did however not deliver a final solution to some of the contentious issues discussed in the 2009 election-campaign, such as fishing levy, concluding the rewriting of the constitution and the EU accession. The biggest triumph of the opposition was in the complicated IceSave saga where it, with a helping hand from the President, managed to split the government parliamentarians and discredit its efforts to find a solution to a particularly difficult problem.

The debacle around the IceSave saga, the failure to deliver on EU accession, constitutional reforms and fishing fee collection alienated those who voted the two parties in. Former supporters found shelter in various discussion groups that fostered dreams of building new parties that might be an alternative for the alienated supporters of the Social Democrats and the Left Greens.

In the 2013 election the Left Greens and the Social Democrats lost 55% of the votes compared to the 2009 election. Two new parties managed to get mandates, but the winners were the two old parties, the Progressive Party and the Independence Party. The former on an agenda for extensive write downs of mortgages, the latter on promises of tax reduction. Hence, the parties that had been punished in the 2009 elections for being in charge of the policies leading to the collapse of the financial system in 2008 are again at the helm. Their first priority seems to be to unwind the doings of the former government: The accession talks with the EU will be stopped, the fishing levy lowered (against loud public outcry) and the constitution reform process defused. Iceland might now be on its way into an era of political un-stability and distrust towards politicians so characteristic for the countries in Southern Europe.

What is the difference between Iceland and Greece – two IMF program-countries?

Iceland and Greece both had to rely on the financial strength and the technical expertise of the IMF to cope with the consequences of the Global Financial Crisis. Prior to the crisis both countries endured Dutch disease like spells, i.e. the high internal price and wage levels in both countries did discourage exports and encourage imports. Why is Iceland on a track to recovery while Greece is still contracting? There is no simple answer to that question.

The cause of Greece Dutch-disease spell is probably that the country entered the Euro at too high a conversion rate and that its creditors were mistaken about the real cost of lending to the sovereign of Greece (Ioannou & Ioannou, 2013). In fact, for many years after Greece joined the Eurozone, the risk premium of Greek sovereign bonds was a few paltry base points over that of the German Bund.

The real cost of financing the Greek sovereign debt increased dramatically after the breakout of the Global Financial Crisis when sovereign bonds became the bad boy of the capital markets. Financial and macroeconomic data that had been plain for all to see including the vociferous rating agencies were reinterpreted. The infamous "Greek statistics" can hardly be blamed for the irrational exuberance that took hold on all sectors of the global economy for a while. By bad luck Greece was in the eye of the needle.

Greek austerity was dictated by a hegemonic Germany, whose main concern was to save German banks from failure. In stead of using measures that could have saved Greece because of its miniscule size compared to other European economies, measures were chosen always with an eye not to create a precedent, when much larger economies such as those of Italy, Spain and possibly France, would require a similar bailout.

The cause of the Icelandic Dutch disease is the overheating of the economy during the early 2000s and the ensuing carry trades (Matthiasson, 2008). Iceland could start the process of correcting the real-exchange rate by devaluating the currency, Greece has had to go the hard way through internal devaluation. Traditional devaluation instantly enhances the competitiveness of an economy. But the competitiveness position has tendency to be eroded if inflation is not contained. Internal devaluation is a time- and effort-consuming activity. Competitiveness improves slowly. But the gains tend to stick. Hence, the Greek path to recovery was bound to be much slower than the Icelandic path.

Both the Greece and Iceland could have avoided the Dutch Disease situation with better economic policy or better institutional arrangements. Note also that even if we leave out the long-term costs of the Icelandic devaluation it would not explain much in terms of employment effects as already accounted for.

One of the keys of the agreement between Iceland, the IMF and the governments that co-funded the Icelandic IMF program was that Iceland was allowed to have "automatic stabilizers" work their way for the first 2-3 years of the program. In effect, this meant that Iceland did not follow the path of austerity staked out for Greece. Keynesianism was accepted in effect.

In Greece, on the other hand, which was at the center of the public debate and the litmus test of competing fiscal ideologies, neoliberal politicians had shown no compassion in order to drive their point home, even by consciously underestimating the costs of austerity as the case of the fiscal multipliers[4] has shown (Blanchard & Leigh, 2013). In Iceland the public sector deficit was 10% of GDP in 2009. Without the support of the IMF the Icelandic government would not have had funds to finance such a deficit. The support of the IMF signaled that the Icelandic government had some sort of a plan for future consolidation of the public finances. A second difference is the debt-relief programs already mentioned. It cannot be overemphasized that the debt relief programs put in place for viable businesses in Iceland saved many jobs and probably prevented a cascade of bankruptcies where bankruptcy of one firm erodes the equity position of one or more other firms.

[4] A small fiscal multiplier implies that a cut in public spending will have negligible effect on GDP and employment. A big fiscal multiplier implies the opposite. As alluded to by (Blanchard & Leigh, 2013) fiscal multipliers and thereby the potential harm caused by fiscal consolidation (austerity) were, until mid year 2012, assumed to be small even if the econometric evidence for that assumtion might not "carry the argument".

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