

Published in Icelandic in *Morgunblaðið* on February 20, 2009

## **Quo vadis Iceland – PART 2**

**By Dr. Christian Ketels**

Three months ago, Professor Michael Porter and I analyzed how Iceland had moved from a poster child of globalization to a symbol of the current global financial crisis. Since then, the economic repercussions of the banking industry collapse have fully engulfed Iceland, while emergency financial support has been provided by the IMF and the Nordic countries. The government has changed, new elections have been announced, and the three Central Bank governors have been asked to leave their positions.

Much of what has happened so far has focused on dealing with the immediate consequences of the crisis and assigning responsibility for the dramatic events that unfolded over the past few months. This is understandable and necessary. But Iceland now needs to start looking ahead and engage in a somber debate about what needs to happen for the country and its economy to recover. In our earlier article, Professor Porter and I expressed the opinion that Iceland's solid foundations give it a real opportunity to regain growth. But recovery cannot be taken for granted and time is not on Iceland's side. The longer Iceland remains occupied with coming to terms with the immediate past, the more severe the damage on the country's competitiveness will be. Swift action is necessary both in the short- and long term.

We see five elements as central in getting Iceland back on the road. First, Iceland needs a discussion about the causes and implications of the current crises. There is a significant danger that all reforms of the past are being implicated in the sharp fall the country has experienced. Our previous analysis made clear that such a view is mistaken: The policies that improved competitiveness were not the cause of the unsustainable dynamics that developed in the financial sector. That is also why Iceland today faces serious financial and macroeconomic problem, but not a competitiveness problem. Other countries, like Hungary and the Baltics, face trouble in both areas and will find it much harder to regain growth.

The challenge now is to introduce policies that avoid future excesses in the financial sector without undermining the competitiveness of the overall economy. In the current political climate in Iceland this will not be easy. Understandably there is a lot of anger and a desire for a clear break with the past. However, only policies consistent with high competitiveness can help Iceland deal with the consequences of the crisis. And many of these policies have been in place under the previous government(s), even if that now seems hard to accept in the face of their failure to contain the fateful overheating in the financial sector. A fundamental change of economic policy, notably a move away from the focus on competitiveness, might feel like a well deserved judgment on past governments. But it would come at a huge cost to the Icelandic people.

Second, there is a clear need to ensure the long-term macroeconomic stability of the Icelandic economy. Short-term measures are already under way, in dialogue with the IMF and other international partners. But more fundamental changes need to be discussed. A decision to apply for membership in the European Union and the Eurozone would provide a path towards a credible external anchor for the

Icelandic economy. Making a decision on such a politically and economically complex question out of short-term desperation would be wrong. Not seriously considering it as an option given the new realities Iceland finds itself in would be foolish.

Third, Iceland needs to even strengthen its focus on upgrading competitiveness. If there is one lesson from the current crisis, it is that only high productivity in providing real value for customers can sustain prosperity, not macroeconomic stability alone and certainly not financial engineering. A clear focus on skills and innovation has to be part of the action agenda. Despite past improvements, Iceland was even before the crisis surprisingly weak on productivity, education, and science. The steps to address these weaknesses taken in the recent past have to be dramatically reinforced. This is not an easy task in the current situation. But remember that Finland raised its investments in education and research during the deep crisis in the mid-1990s despite cutting back across all other areas of public spending.

Fourth, the active mobilization of clusters has to be part of the agenda. Iceland has clear areas of strengths around fishing, renewable energy, and a few other sectors. But so far, little has been done to leverage the potential for collaboration within and across these clusters. Many of the successful Icelandic companies have been isolated rather than part of a network of local partners with reinforcing strengths. This makes them much more vulnerable in a crisis (not the least against relocation to another country) and fails to create the full possible value for the Icelandic economy. Clusters are also important to set clear priorities in spending, for example in research, in a small country that needs to focus scarce resources on areas with high impact.

Finally, Iceland needs to have a national dialogue about its economic strategy and the role that it intends to play in the global economy. While Icelandic companies were successful in the past, it was in many cases unclear how much their success was grounded in a clear set of reinforcing qualities in the Icelandic business environment. An understanding about what type of value Iceland wants to provide for which type of markets will give orientation to economic policy and send a clear signal to potential partners abroad. The existing and emerging clusters will need to part of this strategy; the focus on knowledge in managing natural resources (fish, energy) might be another.

A deep economic crisis can easily lead a country into a negative spiral of blame and depression. But it can also mobilize a new level of energy to change and improve. We believe in the ability of the Icelandic people to take this second path.