KREPPA!

What We Should Learn From the Icelandic Crisis

COVER PHOTO: Around 2000 demonstrators crowd into a city square in Reykjavik, Iceland, Monday Dec. 1, 2008, during a protest provoked by the country's economic collapse, waving various posters demanding the resignation of those thought to be responsible.

KEPPA

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Learning it the hard way

I've seen it all, I've seen the dark
I've seen the brightness in one little spark.

Björk: I've seen it all (SelmaSongs, 2000)

What happened in Iceland in October 2008 has no parallel in history. The small Icelandic economy plunged totally, following the collapse of three of the country's largest banks. The plunge was preceded by ten years of miraculous growth and complacency, during which it seemed everyone – without exceptions – would ultimately come out as a winner.

Unfortunately, the saga was far too good to be true. The Icelandic banking sector became gigantic, and the central bank was not even close to having the necessary reserves to cover huge foreign currency liabilities. Neither was it able to exercise its supervisory powers sufficiently. No-one was willing – or brave enough – to say this aloud until the markets realised the real order of things.

Kreppa (Icelandic: crisis) came and showed in a most brutal way where the place of a small country in a global economy is at times of crisis. It revealed the shortcomings of the existing financial supervisory system. Iceland became the most warning example in several ways.

In Iceland, the unhealthy expansion of the financial sector was partly a conscious political choice. A light regulatory system

underlines the sine qua non of the finance sector: confidence. Once confidence begins to slip, hell breaks loose. For a country outside the EU there are no automatic rescue mechanisms. When the other countries behave in times of crisis like the UK and the Netherlands did, protecting their own short-term national interests, the downward slope deepens. When on the top of all this the banking sector is abnormally large, the pain will become unbearable for a small nation.

A positive aspect of the crisis – dares one say so at this point – is that it made Icelanders seriously consider EU-membership. The Greek case has shown that it pays off to be in the EU and euro. In fact, when it comes to Iceland the gains would be mutual. The Icelandic membership would enable the EU to strengthen its foothold at one of the world's focal points, the Arctic region.

The aim of this book is to analyse the events in Iceland in order to prevent similar situations from happening in the future. The articles represent the opinions of the writers. Hopefully, due to their analytical quality, they encourage new discussion and bring about yet new fresh points of view.

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On surviving a man-made catastrophe

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The meltdown of Iceland's economy in 2008 is still impacting Icelandic families. Some are coping with insurmountable debt, while others are still absorbing the shock of seeing the system they believed in collapse.

Driving through the streets of Reykjavík some 18 months after Iceland experienced the most spectacular economic meltdown in history, you could be forgiven for thinking that nothing out of the ordinary had ever happened. Everything looks pretty much the same. The expected signs of a deep economic recession are absent: there are no boarded-up storefronts, no panhandlers, no homeless people on the streets. Icelandic fashionistas still fill trendy restaurants on the weekends, expensive SUVs cruise up and down the streets, and the lights are still on in those large modern homes in the suburbs. By all appearances, Iceland is still a well-managed, affluent society.

But behind the façade lurks another reality. Many of those living in their fancy homes are unemployed, and some who are driving around in luxury vehicles barely have money for food. With the real estate market frozen, many people are unable to sell their homes, yet can no longer afford to maintain them. Similarly, their car loans may have risen far beyond the value

of the car itself, making the car impossible to sell. They have become debt slaves.

At the time of writing, there were as yet no concrete figures on how many Icelandic households were in serious financial trouble as a result of the economic crisis – or kreppa, as the Icelanders call it. Numbers were being floated around, the most common being that around 30 % of households were in serious trouble due to debt, another 30 % were suffering, and 40 % felt no significant change in their circumstances. The state-run Domestic Debt Advisory Service declined to confirm or deny these figures, pending the publication of their 2009 annual report. However, they did confirm that many people were in great difficulty, and that the number of people seeking their help had doubled between years.

The level of debt in Iceland was already high prior to the collapse, but with the devaluation of the Icelandic króna it reached catastrophic proportions. So what caused this great accumulation of debt, and why did it rise so rapidly during the crisis?

Some who are driving around in luxury vehicles barely have money for food.

Indebted nation

In 2003, the largest building project in the history of Iceland got underway in the area called Kárahnjúkar, in the east of the country. Under construction was a dam that would supply power to a large aluminium smelter that aluminium giant Alcoa planned to build nearby. To finance the project, a vast amount of foreign capital was poured into the Icelandic economy, and in an effort to stop it from overheating the Icelandic Central Bank raised interest rates. This measure, however, had a side-effect unforeseen by the politically-appointed Central Bank directors, whose qualifications were questionable, at best. With interest rates in Iceland so much higher than elsewhere, financial speculators saw an opportunity: borrow large amounts of capital in places with low interest rates and transport it to Iceland, where

it would earn a high rate of interest. They could then make a substantial profit off the spread.

And so, even more foreign capital poured into the country. Consequently the Icelandic currency – the króna – grew very strong. And Icelanders went on a spending spree, high on their economic prowess. They imported foreign goods like there was no tomorrow, frequently on borrowed capital. And because the high interest made the cost of borrowing at home inordinately high, credit institutions came up with an ingenious solution: offer Icelanders loans denominated in foreign currencies that carried a much lower rate of interest than domestic loans.

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Those loans caught on like wildfire. Unsurprisingly, since credit institutions and car dealerships pushed them as the only viable alternative in borrowing. "The dealership told me I would be much better off if I took the foreign currency loan they were offering and kept my own money in the bank, earning interest," said Harpa Jörundardóttir, a teacher, who was shopping for a car in 2007. Harpa declined – not because of the risk of taking the loan, but simply because she was prudent. "I just didn't see the point of taking a loan when I had the money."

Not many Icelanders were so fortunate. Most took the foreign currency loans with hardly a second thought. Yes, many were aware there was a risk involved – that if the rate of the króna went down, the rate of the loan would increase correspondingly – but no one expected a complete economic meltdown and a 100 % currency devaluation. Most Icelanders believed the economy was fundamentally sound. Indeed, government officials, financial regulators and the media – much of which was owned by the same people who owned the banks – told them so at every available opportunity. Reports, mostly from outside Iceland, that suggested the economy might not be as stable as people liked to think, were met with great indignation by Icelandic officials and bankers. The common refrain was that foreigners just didn't understand the unique qualities of the Icelandic economy.

When they were confronted with uncomfortable questions, the bankers were quick to call up PowerPoint presentations that showed what they wanted everyone to see – figures that we now know were contrived with all sorts of creative accounting and market manipulations. Meanwhile, Icelandic politicians joined the bankers on overseas promotional campaigns designed to prove that the Icelandic economy was stronger than ever. And the foreign critics were systematically discredited. Thorgerdur Katrín Gunnarsdóttir, who as vice-chair of the Independence Party was one of Iceland's most high-ranking officials at the time, famously quipped that one particularly astute financial analyst who dared question the foundations of the Icelandic economy needed to go "back to school." Incidentally, Gunnarsdóttir's husband was a high-ranking official within Kaupthing, one of the failed Icelandic banks.

Small wonder, then, that the Icelandic public did not see the storm clouds gathering on the horizon. When the first of the Icelandic banks – Glitnir – collapsed on 29 September 2008, most Icelanders were completely taken by surprise. It was like lightning had struck out of a clear blue sky.

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Predictably, investors scrambled to pull their money out of Iceland immediately – and the previously robust króna plummeted in value. Each day there were reports that it had hit new lows as the Icelandic public stood by in shock, wishing someone would just DO something.

But there was nothing to be done. The Icelandic banking sector was already about 12 times the size of the country's economy and had no adequate lender of last resort. A meltdown was inevitable, and two weeks later, all of Iceland's three commercial banks had collapsed.

Icelandic society was thrown into chaos. In workplaces throughout the nation, productivity ground to a halt as people struggled to absorb the information coming at them. A grim prime minister addressed the nation on television and said that

national bankruptcy could very well be imminent, ending on the ominous phrase: “God bless Iceland.”

Over the next few days the media gave ever-more comprehensive insights into the gravity of the situation. Severe currency restrictions were soon implemented in an effort to save the króna, meaning no money could be transferred out of the country. This was particularly serious for Icelandic students whose student loans were sitting in bank accounts in Iceland and could not be accessed. Some had no money to buy food; others couldn’t pay their tuition fees or rent. Even if their families wanted to send them money they couldn’t. When transactions were finally permitted again, those same student loans had devalued by up to half due to the currency situation. Living on a student budget had been tight to begin with – now it was almost impossible.

Back in Iceland, those people who had taken out loans indexed in foreign currencies were panicking. The króna was in free-fall, the economy in shambles, and they were seeing their loans double or even triple in size. Already their car loans were in most cases higher than the value of the car itself. And there was no way out. No one wanted to buy a car with an astronomically high loan on it. Even if the owner was able to sell the vehicle for a reasonable price, the loan would still be higher than the value of the car and the seller would be stuck with it. Consequently classifieds began popping up, offering a sum of money to anyone who would take a car off the seller’s hands – with the loan intact.

And then there were the mortgages. In March 2008, Atli Steinn Gudmundsson, a 36-year journalist, took out an interim mortgage worth ISK 17 million that was tied to a foreign currency. He and his partner Rósa Lind Björnsdóttir were planning to sell their two respective apartments and buy a house together. Atli Steinn had received an inheritance a few years earlier and owned his apartment debt-free. They needed something to tide them over while they waited for their apartments to be sold, so

to make the down payment on the house Atli took out a mortgage on his apartment. It was only supposed to be for a few weeks, but the Icelandic real estate market froze and the two apartments, which were in prime locations and were initially expected to sell more or less instantly, stayed on the market.

From March 2008 and over the next six months, Atli Steinn and Rósa's foreign currency mortgage increased by ISK 77,000 per day. Eighteen months later, it had gone from ISK 17 million to ISK 43 million, while the market value of the mortgaged apartment was somewhere around ISK 25 million. That meant that Atli Steinn now had a debt of ISK 18 million, over and above the market value of his apartment, and was facing personal bankruptcy.

The couple finally managed to sell Rósa's apartment in September 2009, two years after it was first put up for sale. Rósa had bought it four years earlier with a mortgage of ISK 12 million from the Housing Financing Fund, run by the Icelandic state. The mortgage was not linked to a foreign currency; however, Icelandic mortgages are indexed to the rate of inflation, so as inflation goes up, the principal on the mortgage rises accordingly. In that four-year period, Rósa's mortgage had gone up by nearly ISK 6 million. The new owner took over the mortgage and paid an additional ISK 700,000, of which ISK 380,000 went to the real estate agent. All the equity Rósa had formed in her property had been consumed by the increase in the principal of the mortgage.

Atli Steinn and Rósa lost the sum total of their assets in the collapse.

Atli Steinn and Rósa lost the sum total of their assets in the collapse, save for their personal belongings. At the time of writing, both Atli Steinn's apartment and the house they had bought with that fateful down payment were due for foreclosure. The couple was embarking on a move to Norway in order to start a new life. Yet they could not escape their debt. "They can take our property and auction it off at a price that will almost certainly be below market value, and use that money towards paying off the debt. But we will still be responsible for the rest," said Atli Steinn. "We will never be able to own any-

thing – the Icelandic credit institutions can hunt us for the rest of our lives for the debt that remains. But to hell with it. If that's the way it is, that's the way it is. It's not like we were careless with our money or did anything wrong to get ourselves into this position. We just got caught up in circumstances beyond our control." However, there was comfort in numbers. As Atli Steinn remarked, "I'm not responsible for this, I didn't do anything to cause this, there are thousands of people in the same boat. That makes it easier to handle."

While Atli Steinn and Rósa's story is by no means unique, not all homeowners have been so badly hit. Yet all Icelandic homeowners have seen a substantial rise in their mortgages. With the devaluation of the króna and rise in living costs, inflation has crept steadily upwards, and the principal on domestic mortgages and loans has increased, in some cases dramatically, as in Rósa's case. The ultimate result is that little or no equity is formed in the property. Says Tryggvi Hannesson, a 75-year old carpenter, who has lived through several economic downturns: "You work and work and pay and pay, but it makes no difference, the principal just keeps rising slowly and steadily, and you wind up never owning a thing. You can never catch up. That is the trouble today."

Rising unemployment

As if the debt problems weren't enough, the economic crash also brought unemployment levels not seen in Iceland for several decades. Those who did manage to keep their jobs were almost without exception forced to take cutbacks in their pay. Add to that the sharp rise in prices for all imported goods as a result of the currency devaluation, and the effects on many households were devastating.

In 2002, just as Iceland's economic boom was starting, unemployment as a percentage of the labour force was 3%. In

December 2007, it had dropped to a mere 0.8 % and two years later, in December 2009, it had risen to 8.2 %. While that last figure may not seem exceptionally high compared with other European nations, it is high for Iceland, where unemployment has traditionally been negligible.

Unemployment has also brought an exodus from Iceland. In 2009, the country experienced a decline in its population for the first time since the 19th century. Over 10,000 people moved away – the greatest number of people in Iceland's history over the course of one year. Granted, many were foreigners who had come to Iceland to work during the boom years and who returned to their homeland after the crash. But many were not. In some cases the family breadwinners went abroad to work while the family stayed behind; in other cases, whole families moved away to seek their fortunes abroad.

Certain sectors were hit worse than others. Car dealerships, for instance, saw their sales drop by nearly 100 % and laid off employees accordingly. The construction industry all but collapsed and saw mass layoffs, from manual workers and tradesmen to specialists like architects and engineers. All of a sudden, unemployment became a serious problem in Iceland.

There is a lot of stigma attached to being out of work.

And many people felt ashamed. "In Iceland, there were always plenty of jobs to go around and there has always been a strong work ethic in this country. Some people worked two or three jobs. In fact, if you didn't have a job, it was a sign that something was wrong, that you had some sort of personal problem. There was a lot of stigma attached to being out of work," says Sigrídur Ingibjörg Ingadóttir, MP for Iceland's Social Democratic Alliance. Even though unemployment was now caused by something beyond their control, the national psyche had not kept pace with the reality of its circumstances.

Psychological shock

Indeed, the psychological shock of the meltdown was something most Icelanders were completely unprepared for. Many experienced it as a force majeure, a natural disaster beyond their control, with the accompanying sense of powerlessness and anxiety. It forced people to examine their ideas and presuppositions and to completely readjust their outlook. It was like going to sleep in one reality and waking up in another.

As mentioned above, most Icelanders believed they were living in a country with a well-managed economy. Sure, they had noticed changes taking place – the banks had grown very large and had various operations abroad, real estate prices had risen dramatically, and the number of new buildings under construction was astonishing. But no one expected there to be a complete economic crash.

The rise of the super-rich marked a significant change in a previously egalitarian society.

Another change was the rise of the super-rich in Iceland. This marked a significant change in a previously egalitarian society. Someone who had, say, gone to school with your cousin, suddenly had homes in London and New York, a private jet, expensive cars, a yacht, and owned any number of world-famous assets. This group of super-rich also owned just about everything in Iceland, including the media, which tirelessly portrayed their glamorous lifestyles and accomplishments – and conveniently failed to report their shortcomings.

Those people inhabited a different universe. Despite their humble beginnings, they were now about as real as Hollywood celebrities in glossy magazines. And most Icelanders looked on in awe, figuring they must be tremendously smart and clever to have accumulated such enormous wealth and to have such glamorous lifestyles. Little did they know that it was all a smokescreen and that those lifestyles were largely fuelled by credit – and that one day the Icelandic public would be saddled with the bill.

And that same public trusted its elected officials. In good faith they believed they were doing their jobs, keeping track of the banks, backing up the foreign currency reserve, managing interest rates, and just generally being competent. Icelanders who up to that point had had very little interest in finance or global economics were suddenly confronted with a new reality. Over the subsequent weeks and months regular Icelanders grappled with new terminology and worked overtime to process information that was coming at them, furious and fast. Much of that information concerned exposures of such incredible acts of corruption and incompetence that most people could not have conceived of it in their wildest dreams.

For weeks after the collapse of the banks there was a prevailing sense of numbness and denial in Icelandic society. Then came the anger. In January 2009, protests that had been growing throughout the autumn reached their height in the Kitchenware Revolution – so dubbed because Icelanders came out by the thousands to loudly bang pots and pans outside the parliament building. The protests soon escalated, and after four days marked by violent clashes the Icelandic government collapsed. Elections were called, and in April 2009 the Icelandic nation elected its first left-wing socialist government, made up of a coalition of the Social Democratic Alliance and the Left-Green party.

The public trusted its elected officials.

In the months since the collapse, the Icelandic government has been knee-deep in the task of cleaning up the mess in Icelandic society, with limited success. The issue surrounding the Icesave online bank accounts and the ongoing dispute over repayment has consumed time and energy that most regular Icelanders feel should have been used to address more pressing issues, such as debt adjustment. Meanwhile hundreds if not thousands of homes and cars have been repossessed and the number of bankruptcies has shot up.

The anger that came to a head in the Kitchenware Revolution has morphed into a slow-burning fuse that may well erupt into a full-blown explosion in due course. While normal people and small business owners are losing their homes and businesses, the banks, who were taken over by the state, have written off colossal debts belonging to the oligarchs. In a number of instances those oligarchs have even regained control of the companies they were instrumental in bankrupting, while their debts remain with the public.

Another source of anger and frustration is the apparent slow pace of an investigation being conducted into the bank collapse. That investigation is presided over by Eva Joly, one of the most experienced corruption hunters in the world, who has been keen to reassure Icelanders that it is on track and progressing well. However, she has stated that the scope of the investigation is such that it could take up to five years for convictions to materialise. That is cold comfort for the thousands of Icelanders who have felt the harsh effects of the kreppa on their own skin, but see those responsible still enjoying their lavish lifestyles.

Before those culpable are held accountable, it is doubtful that there will be a feeling of resolution in Icelandic society. "It is vital for the nation to have this sort of satisfaction [for culprits to be brought to justice], because if this need is not satisfied a deep rift will be created in society and there is a danger of a breakdown in the social contract. People will begin to have thoughts like, 'Why should I have to pay taxes when others have not had to pay?' That sort of dissolution in society is very dangerous," Eva Joly told The Iceland Weather Report blog in June 2009.

One thing is sure – the problems the Icelandic public faces as a result of the country's economic meltdown are unprecedented, massive and complex. One can only hope that they will, in time, lead to a healthy readjustment of values and a stronger foundation on which the residents of Iceland can build their lives. ●

Diana Wallis

Icesave – Whose debt is it anyway?

Diana Wallis has been a Vice-President of the European Parliament since 2007 and a MEP since 1999. She is a member and a former President of the EP Delegation to Iceland, Norway & Switzerland and the EEA Joint Parliamentary Committee.

Contemporary viking raiders

I first heard the name of the Icelandic company 'Baugur' some nine or ten years ago when I made my first visit to Iceland as a relatively newly elected Member of the European Parliament as part of a parliamentary delegation to meet with our Icelandic counterparts from the Althingi. Someone mentioned to me that there was an Icelandic company that was either about to or had already acquired some well-known names on the British high street. I was a bit non-plussed; it seemed unlikely but I did not really question it further. Yet already I seem to recall there was a bit of a nudge, nudge, wink, wink as though there was something a bit suspicious about this operation. No-one had heard of 'Viking Raiders' then, well, not that is apart from the original tenth century ones. Likewise the fatal criss-crossing of ownership and interests between this company, its owners and the Glitnir Bank, were webs as then still waiting to be intricately and toxically woven.

What I do clearly remember from that first meeting was the confidence bordering on arrogance of some of the Icelandic parliamentarians we met. They asserted that theirs was a coun-

try doing quite nicely 'thank you' and it had no need of the EU. The EEA agreement was fine, if occasionally a bit of a drag. That was of course before the single currency had been launched. I recognised that this was a deeply proud country, still investing much in its annual Independence Day celebrations. EU membership had little attraction amongst the political classes. There was that strand of nationalism mixed with Euroscepticism that echoed similar opinions I knew so well from the UK. Indeed, perhaps, we have a fair bit in common in terms of our national psyches. Whilst recalling the recent history of the dramatic failure of the Icelandic banks in the UK it is worth bearing in mind that to create a debt you need a willing lender and a willing borrower, both prepared to entertain the same level of risk. Only in the UK was the extent of the failure so great and just maybe that says something about the similarities between the two countries in terms of outlook.

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Population picks up the costs

If we fast forward to the publication, in April 2010, of the so-called 'truth commission', a Special Investigation Commission of the Althingi into the 2008 financial crash, the Icelandic Prime Minister Johanna Sigurdardottir then said: "The private banks failed, the supervisory system failed, the politics failed, the media failed, and the unregulated free market utterly failed." The interesting point behind all these failures is that up until now none of those pointed at as having failed have suffered; rather it is the Icelandic population that, collectively, has to pick up the costs probably for many years to come. Likewise, if we look at the banking and financial failures elsewhere; most obviously Greece, but also as we start to see with spending cuts in the UK, it is the collective population that has to pick up the tab run up by the various 'failures' in banking, regulation (or the lack of it) and politics.

However, it is certain that the Icelanders were in many ways the first victims of the financial crisis or, at least, the first victims on a really monumental national scale. Indeed, it is important to try to put the scale of Iceland's problem into perspective. The country has the population much the same size as Reykjavik's own twin city in the UK: Kingston upon Hull. It would be with some difficulty that we could envisage a city the size of Kingston upon Hull paying off the enormous debt which Iceland's collapsed national banking sector has left in its wake. Again, by another measure of perspective, it has been suggested that the rate of repayment the Icelanders are likely to face relative to a percentage of their GDP, is in fact greater than that met by the German population for war reparations after World War 1. Again, the prospects were so gloomy for Icelanders that at one stage in the late autumn of 2008 it was estimated that up to one third of the population were considering emigration. In such an event one might ask who would then be left to pay the bills? This mass exodus in the end did not come to pass and indeed the situation has been reversed with Icelanders actually returning home, sticking together in a time of national crisis and working through it together.

In the late autumn of 2008 it was estimated that up to one third of the population were considering emigration.

Striking similarities between Iceland and the UK

Looking back to the origins of the crisis, it is worth considering some of those similarities which made Iceland and the UK sympathetic to each other in the debtor and creditor risk-taking relationship. Let us start with the obvious: both are island nations; both tend to look equally to the USA and to Europe; both have a maritime heritage (and although perhaps best not to mention the cod 'wars' in the North sea ports of Kingston upon Hull and Grimsby they are nevertheless a shared experience).

The UK was historically over-reliant on income from the huge global financial services industry focused on the city of London. Iceland increasingly had aspirations in this sector, but with little or no experience. There is also much to be said by way of comparison of the political credos of the Independence Party of David Oddsson and the Conservative Party of Mrs Thatcher. Just as she inspired a generation of property speculators with the virtues (or vice) of home ownership, so the privatisation of the banks in Iceland, achieved by Oddsson, revolutionised the banking sectors so that everyone thought they could become home owners without any sacrifice or pain; all they had to do was just trust the bank. This all bears a striking similarity. Again in pure political terms the centralising tendencies of both leaders, once they had freed the markets, to then focus political power on their respective capital cities is analogous.

One cannot help but wonder if at some sub-conscious level the UK recognised a kindred spirit in Iceland.

So the respective scenes were set in both countries, although it took some time for the results to show or to be admitted. One cannot help but wonder if at some sub-conscious national level the UK recognised a kindred spirit in Iceland. Here was a plucky, Atlanticist, free market, island country with a growing and ambitious banking sector; free-wheeling, risk taking, and most critically with a light touch to non-existent regulatory regime.

Interestingly, we became aware that all was not well with the financial regulatory regime in London in the early years of this century when the devastation caused by the crisis at one of England´s oldest pension providers, the Equitable Life Assurance Society (ELAS) became obvious. This was a company so old it was virtually a national institution and reckoned to be almost as safe as the Bank of England. Under the terms of the First Life Directive, ELAS had been able to sell its pension all around the EU, so that it was not just British pensioners, but also large numbers from both Ireland and Germany who were also caught by the collapse. Given the severity of the problem, as well as the various activities within the UK to try to obtain

justice for those who lost out, a Committee of Enquiry was set up in the European Parliament, where I acted as rapporteur. We took months of evidence and reached our conclusions and recommendations by consensus (excepting that MEPs from the UK's governing Labour party were extremely defensive of any criticism of their government). It is perhaps worth reproducing here some of the comments in the report[1] relative to the 'light touch' regulatory regime:

'There have been compelling accounts which indicate that the UK consistently applied over a substantial period in the past two decades....a light touch regulatory policy...'

'....there have been numerous statements which suggest that the UK's light touch regulatory policy went a step too far and thereby contributed to a weak regulatory environment, which allowed the difficulties at ELAS to grow unchecked, when in a stronger regulatory system they might have been more apparent at an earlier stage and the final crisis might have been prevented'

'It appears that UK regulators failed to react in a timely manner to the fact that ELAS had been chronically short of assets throughout the 1990s...'

'Some witnesses suggested that the regulator not only failed to fulfil its supervisory functions but also misled policyholders who approached them...the FSA have misinformed policyholders. As a result, they stayed with ELAS longer than they would otherwise have done and suffered further losses.'

'The committee considers unacceptable any attempt to interpret or to justify a passive role of national financial regulators limited only to their national jurisdictions and calls for EC legis-

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[1] The Report of the Committee of Inquiry into the Crisis of the Equitable Life Assurance Society (February 2006 – May 2007) European Parliament A6-0203/2007 Rapporteur: Diana Wallis MEP

lation to highlight the collegial responsibility of national regulators in assuring the highest standards of consumer protection and safeguarding the optimal working of the internal market in financial services on an EU wide basis.'

Not sufficient to rely on home country financial control

This last part of the Committee's recommendations is noteworthy in the sense that it makes clear that it is not sufficient to rely on home country control; host country regulators also have to be 'on watch'. This report was finalised and voted in May 2007, more than a year before the final Icelandic banking collapse. The pension holders who lost out from Equitable Life are still waiting for compensation, so long denied by the previous British government, but now actually contained as a separate item in the Coalition Agreement of the new government.

Icesave accounts offered interest rates sometimes more than 50 per cent above those on offer from comparable British high street banks.

Of course, with hindsight it is sad that, rather than spending all its time denying any liability, the British government did not heed the obvious warning implicit in the report about the role of regulators. Icesave accounts offered interest rates sometimes more than 50 per cent above those on offer from comparable British high street banks, yet the UK regulators approved these operations and kept on allowing them to attract substantial flows of investment. The construction of the Icesave operation meant that it was primarily regulated and insured in Iceland.

The continued leeway given at a time when it was well documented that the Icelandic bank with ultimate responsibility for these accounts – Landsbanki – was in substantial difficulties, is breathtaking. Indeed I remember travelling to Iceland with a Lithuanian colleague, an economist by training, not long after the EU enlargement of 2004. Coming from the background of the economic struggles the Baltic States had been through to reach EU membership, she viewed Iceland with scepticism. 'How', she

mused, ‘could a country of 300,000 people afford all this?’ It is perhaps a bit reminiscent of the Emperor’s new clothes. How could we believe that a country of 300,000 could provide financial insurance to cover the magnitude of the Icesave and other accounts? In the cold light of day the whole idea is quite absurd.

Central Bank of Iceland: “We do not intend to pay…”

I remember as the Icesave crisis broke I was actually in Germany. So that evening I watched the news both on German TV and on the BBC; the contrast was stark. On German TV there was no panic, just matter of fact reporting: that the interest rates offered by Icelandic banks were exceptionally high therefore there was clearly a risk with investment and customers should have been aware. Compare and contrast with British TV which expressed a communal howl of outrage to the effect of, ‘how could we have been allowed to put our life savings into these dodgy investments?’.

Likewise there came a shock for many Icelanders living abroad on 6th October 2008 as the Icelandic government closed the banks and froze the movement of capital outside the country because it was literally on the verge of bankruptcy. Icelanders innocently using ‘hole in the wall’ cash machines suddenly found they had no funds available, many ultimately finding they had no alternative other than to return home. At this point well wishers in the city of Hull started parcelling up knitted blankets to send to Iceland, quite what they envisaged was happening is questionable, but maybe it is the thought that counts! Meanwhile David Oddsson, as the Governor of Iceland’s central bank, went on the evening news trying to reassure Icelandic taxpayers that they would not be responsible for the banks enormous debts and that they would not be paying the debts of those who had defaulted on their foreign obligations. He said: ‘We do not intend to pay the debts of the banks that

have been a little reckless.' Something of an understatement; but one that produced a very nervous reaction in the UK.

UK response: Anti-Terrorism, Crime and Security Act 2001

It was then that the famous phone call between British Chancellor of the Exchequer Alistair Darling and his Icelandic counterpart took place. It is not entirely clear whether Mr. Darling knew who he was speaking to and the Icelander was clearly at a distinct disadvantage. The Brit was looking for reassurance vis-a-vis British investors. He was confronted with well-intentioned but ambivalent replies which seemed quite naturally to be giving precedence to the domestic Icelandic situation. It would have helped if the two men had had some previous knowledge of each other as might have been the case with two EU ministers discussing in such a way. Sadly the rest as they say is history. The conversation was so unsatisfactory that the British froze the assets of Landsbanki and set off a negative chain reaction that totally wiped out Iceland's reputation and possibilities as an international banking nation.

The worst Iceland has been guilty of is the same 'light touch' financial regulation as the UK.

Whether the UK needed to take such action, or take it in the way that it did by using the Anti-Terrorism, Crime and Security Act 2001, has been much debated. The use of this particular Act resulted in Iceland effectively being classed as a terrorist state and completely stigmatised of all of its remaining banking operations that might have legitimately survived; in short, making a bad situation worse. At the time, I issued a press release that contained the following statement, 'The worst Iceland has been guilty of is the same 'light touch' financial regulation as the UK. I don't recall either the Irish or the German governments considering invoking terrorist legislation against the UK when our government allowed the near collapse of Equitable Life where thousands of individual victims lost their life savings and pen-

sions, and remain, all these years later, without compensation. Whilst one might argue about the scale, the principle is the same.' This provoked a response against me from government politicians such as I have never experienced either before or since; I can only assume that I touched a very raw nerve.

Settling the Icesave debacle

Whatever the uncomfortable background, both countries now have to face up to the debt position they are in. Clearly Iceland's situation has to date been more intense and public and in this scenario the UK along with the Netherlands have attempted to play the part of 'wronged creditor' on the European and international stage. The UK has been accused of poisoning the position of Iceland within both the EU and the IMF unless it got its own way on the Icesave debt. It has not been a pretty picture and the former British government came out of the encounter looking rather like the bully that its Prime Minister was contemporaneously accused of being in relation to his staff. Throughout, the Icelanders insisted they were more than willing to meet the debt but it was the terms, such as interest, timing and review, that were key. They have had a tough lesson in the art of international financial negotiation, eventually seeking the help of a top US lawyer to lead their team.

The Americans might come back to Keflavik and bail Iceland out.

Along the way there have been many acres of print written about how Iceland might get out of its current indebted position – some less helpful than others. For example one suggestion was that they might pay the UK back in a steady flow of their favourite teatime supper: fish for 'fish and chips'. Another was that the Americans might come back to Keflavik and bail Iceland out. Then perhaps one of the most interesting ones was from Mark Hannam, a former banker (all bankers seem to be former bankers now), writing in Prospect magazine that Britain has no right to demand money back but that rather we should be giv-

ing Iceland cash using part of the proceeds from the windfall tax on bankers bonuses and only then would the UK have the truly ethical foreign policy the government trumpeted some 12 years ago. Perhaps that is the nub. Because Iceland is a modern functioning democracy and economy, we do not see the problem and its linkages to the UK and indeed the EU in that light.

Indeed I remember trying to demonstrate those economic linkages in the aftermath of the crash, when I visited an Icelandic company near my home and explained in the local media the knock on loss of hundreds of jobs across our regional economy if Icelandic companies with local operations went under. Again, as already stated above, there were howls of outrage from government politicians. Their main concern, and it was of course a grave concern for many individuals, was their loss of savings. It all depends on your perspective. The fact remains as debtors and creditors we are different sides of the same, single linked problem and the way out has to be comfortable for both parties. In this case for the debtor in the role of Iceland, no less than the creditor as is the UK. There is after all no such thing as the equivalent of a Victorian debtor's prison for a whole nation. Such an attitude to debt is counterproductive. We have accepted that with individuals, now we have to do the same with countries.

As debtors and creditors we are different sides of the same, single linked problem.

The process of enquiring what went wrong

What we do have to accept is that we should try to find out the reason for the failures. In this sense, perhaps, the Icelanders are in the vanguard of what may later have to happen elsewhere across Europe. Citizens and civil society rightly want answers as to what went wrong and the possibility of the criminal liability of some bankers and politicians should not be excluded. Iceland has started that process with an enquiry by a Committee of the Althingi. There will also be

a separate enquiry led by the French investigating judge Eva Joly (also, interestingly, an MEP). Some have said that there should also be a fully independent, international, external enquiry. Yet this ignores the fact that the Icelanders are doing far more to face up to their financial crisis and to look at themselves hard and long in the mirror. Other European countries could learn from this process, which also perhaps has the chance to bring a population together to work through the problems.

Europe itself has seemed to be part of the answer for the Icelanders. The larger currency base of the euro and the much vaunted principle of solidarity in times of trouble look appealing. Yet Europe's own performance has been far from exemplary. This added to the UK and Dutch attitude to Icesave has not made EU membership the most appealing prospect. If Europe is to be part of the answer for Iceland it will be have to be over the longer term; a decision that should not be rushed. The EU is nervous of an applicant who is just running for a port in a storm and Iceland needs to have the courage to realise that it has as much to bring to the EU table as to take from it. EU membership will not be a quick fix. It has to be more of a national vocation, and maybe an appreciation for the Icelanders that a regular seat at the table means that it is easier to deal with colleagues when you have a problem.

Iceland needs to have the courage to realise that it has as much to bring to the EU table as to take from it.

When I spoke in Iceland before the Icesave package referendum which was voted down, I asked the question whose debt is it any way? Perhaps at that stage I fudged the answer. Perhaps indeed there are many answers to the question which enquiry will reveal. However I remain convinced that debt and credit are so personally and internationally entwined that maybe we do all have to take some responsibility. The party is over. I just hope that my own country does not find itself regretting its lack of Nordic, or even European 'solidarity' as we begin our own clear up. ●

Daniel Gros

Key weaknesses of the Icelandic economy and long-term policy options

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What to do after a spectacular collapse of the currency and the entire financial system? The first response is clear: try to limit the damage by getting outside financial support and then hunker down to clean up the mess, protecting the country against further financial shocks with capital controls.

This was the immediate response of the Icelandic authorities after the collapse in October 2008. Almost two years later it is now time to consider the longer term future of the country. This contribution will first look at some of the key features of the Icelandic economy. It starts with the insufficiency of domestic savings and then turns to the degree of openness: this is crucial given that the economy needs to export more. The latter also relates to the question of the exchange rate regime which is discussed next. Finally, this paper looks at key issues for the stability of the banking sector and gives long-term policy options: what could be done differently in the future?

Insufficient domestic savings

Over the last decades Iceland has followed a simple economic model. It has continuously consumed most of its income and has thus over time accumulated a very large foreign debt, partially to finance excess consumption and partially to finance investment in hydroelectric projects for aluminum production. On top of this, the authorities allowed an outsized banking system to develop which took on further foreign debt in order to finance daring raids on foreign markets. The crisis, which developed its symptoms when financing was no longer available on global capital markets, was then unavoidable. It led to the collapse of the entire Icelandic banking system and a deep recession. The key lesson behind this crisis is that this economic model is dangerous because it relies on a continuing availability of foreign capital, which cannot always be taken for granted.

The economic model Iceland had before the crisis relied on a continuing availability of foreign capital.

The importance of sufficient domestic savings can be seen in the experience of Switzerland, which also had a financial sector composed of two giant banks, each of which had a balance several times larger than GDP. The Swiss banks were also engaged in risky investment banking activities. However, the Swiss banks have survived, Icelandic banks did not. One important reason why Switzerland was able to save its banks was simply that the country as a whole was a net creditor towards the rest of the world, whereas Iceland (i.e. mainly its households and enterprises) was a net borrower. Switzerland was thus able to mobilize considerable domestic and foreign resources to support its banks during the critical moments of the financial crisis.

By contrast Iceland could not support its banks because, as a nation, it had a huge foreign debt.[1]

How would Iceland look today if it had followed a different approach? A simple calculation can show the difference frugality can make over time. The 'average' EU member country consumes about 80 % of its income, which implies that it has about 20 % left for investment. Iceland, however, has often consumed much more than this 'norm' of 80 %. What would be the position of Iceland today if it had instead followed this 'EU' norm? If it had done this its current account would have been most of the time much smaller and thus its foreign debt would have been much lower. Cumulating, over the last decade, the 'counterfactual' current account deficits that would have resulted from saving 20 % of income one arrives at the result that Iceland's foreign debt would be 10 billion USD lower. This means that during the acute phase of the crisis in 2008 Iceland would have had this sum available to support its banks. Or, if one assumes that the banks would still have gone under, Iceland would at least be able to service without problems its foreign debt today.

Even if it had followed the EU savings 'norm' Iceland would still have accumulated some foreign liabilities (albeit about 10 billion USD less) over the last decade because its investment rate was also higher than the EU average. From a purely economic point of view one could argue that it makes sense for Iceland to finance investment in electricity generation and aluminum smelters with foreign capital. This has not been the ap-

1 There were of course other reasons why Switzerland did not have a crisis like Iceland. Its central bank received a Swap line from the US Federal Reserve and its banks were widely regarded as 'too big to fail' even on the European and global scale. However, the fact that Switzerland had such a strong net foreign asset position was also one of the key reasons why the Federal Reserve decided to grant the Swiss National Bank a line of credit. One of the reasons why Iceland was not given a similar treatment was its shaky overall external position.

proach taken by Switzerland which has almost always had more than enough domestic savings to finance all of its domestic investment on its own.

It might be interesting to ask what the position of Iceland would be had it followed the Swiss approach and consumed even less than the average in the EU in order to finance all of its investment with domestic savings. In this case the consumption rate would have had to be even lower, namely about 75 % of GDP, and the country would not have had a net debtor position before the crisis, thus increasing even more the likelihood that the banks would have survived.

Moreover, without the huge external debt, the country would not need to transfer about 10 % of its income to foreigners. Consumption would thus be much higher today.

These considerations provide another way to look forward: Iceland should now decide whether it intends to continue the model it has followed over the last decades or whether it wants to change towards a model of higher savings which will allow over time to repay its foreign debt and hopefully start accumulating some assets for a rainy day. This approach would lead to much higher standards of living in the long term, but it also requires short term sacrifices.

Iceland could not support its banks because, as a nation, it had a huge foreign debt.

Greater reliance on domestic savings does not mean necessarily less financial openness.

The most remarkable feature of Iceland's economy prior to 2008 was the explosion of financial openness. In a very short period of time Iceland reached the level of a traditional financial centre, such as Switzerland (on a per capita basis) as shown in the table below. However, this explosion of financial integration proved short lived because it was not sustainable. The Iceland of today is, at the same time, cut from global financial capital markets through capital controls and totally dependent on them because it has to service a huge foreign debt which periodically needs to be rolled over.

TABLE 1. Net foreign investment positions
$ billion

	ICELAND			SWITZERLAND	
	2000	2006	Change	2006	Scaled to size of ISL
Net FDI	0.2	5.7	5.5	314.1	9.5
Net PI	–1.9	–37.8	–35.9	119.1	3.6
Net PI Eq	2.1	7.9	5.8	–262.5	–8.0
Net PI debt	–4.0	–45.7	–41.7	381.6	11.6
Net banks	–2.0	14.6	16.6	–55.1	–1.7
Net other	–1.3	–4.0	–2.7		
Net IIP	–5.3	–19.5	–14.1	459.2	13.9

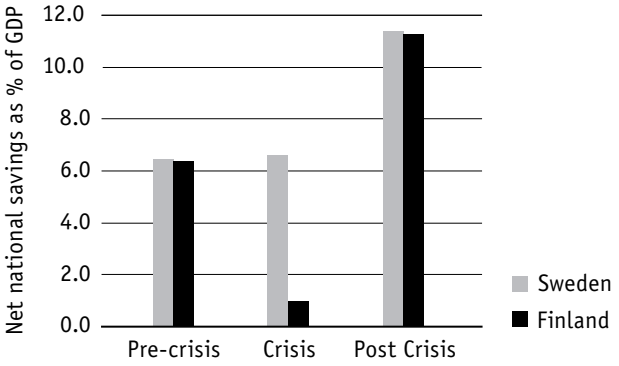
Source: IMF, IFS.

The key difference between Switzerland and Iceland was that, on a per capita basis, Switzerland had accumulated a surplus position equivalent in size to Iceland's net debtor position (close to one full year of GDP). Moreover, Icelandic banks have issued a total of over $40 billion in debt securities in the space of a few years of which 'only' $14 billion were needed to finance the cumulative current account deficits since 2000, with the remaining funds (around $28 billion) used to finance foreign equity acquisitions (about $11 billion) and in banking assets abroad ($17 billion).

The experience of the Scandinavian countries during the 1990s is also instructive in this respect. Finland and Sweden both experienced deep currency and banking crisis during the early 1990s. Both crises were preceded by strong consumption and housing related booms. These booms were of course the result of very low savings rates which then found their counterpart in large current account deficits. In both countries the

savings rates increased considerably after the crisis was overcome, making the economy much more robust to the vagaries of international financial crises.

FIGURE 1. National Savings in the Nordic Countries
Net national savings rates around crisis



Iceland started this crisis on even shakier grounds than either Sweden or Finland because the national savings rate was already below zero (compared to plus 6 % of GDP in the two Nordic countries, see Figure 1) in 2006 and 2007; i.e. before the crisis hit (only Greece had similar negative values for the national savings rate). It is clear that this has to change radically.

It is impossible to measure the exact size of the foreign debt of Iceland.

By how much savings has to change is difficult to determine. Unfortunately it is impossible to measure the exact size of the foreign debt of Iceland since, after the collapse, many claims and counter claims with the estates of the old banks are still unsettled. Determining even the approximate size of Iceland's indebtedness will remain difficult as long as the recovery values from the assets of the old banks are not known. Experience with the bankruptcy proceedings for large internationally active

banks suggests that a final settlement might be possible only after many years. Given this uncertainty, the country would be well advised to build up sizeable reserves, not by borrowing, but running large current account deficits. A net national savings rate of at least 10–15 % of GDP, as in Finland and Sweden post-crisis, thus seems appropriate.

Limited real openness

One surprising aspect of Iceland is that despite its small size, the country had until the crash a smaller trade-to-GDP ratio than Germany or many other EU member countries. This changed radically after 2008 because the exchange rate devaluation reduced GDP measured in foreign currency by almost one half whereas trade flows remained relatively stable. During 2009 Iceland actually benefitted from the fact that most of its exports consisted of resource based products (fish and aluminum) which were not affected by the sharp global contraction in trade in manufacturing products.

As shown in Table 2, in 2007 the export-to-GDP ratio was at around 35 %, much below the average euro area member country, and only a fraction of that of the smaller euro area countries (e.g. Luxembourg), or that of Switzerland (also financially active) or even that of Germany. However, as mentioned above, the devaluation of 2008 changed this, making Iceland now a much more open economy.

TABLE 2: How important are exports (of goods and services)?

% of GDP

	1995	2007	2010
Germany	24	47	43
Cyprus	50	48	40
Luxembourg	106	177	161
Iceland	36	35	49
Switzerland	36	56	51

Exports of manufacturing goods in particular seemed to be very small relative to its comparators.

Table 3 shows that especially in terms of exports of manufacturing goods (which amount to less than 9 % of GDP and about 25 % of total exports), Iceland is a rather closed economy. The distinction between manufacturing goods and other resource-based goods is important because the supply of the latter is really not influenced by domestic wage and cost elements. An adjustment in the real exchange rate can stimulate the economy mainly by making domestically manufactured goods more competitive on the world market. However, this mechanism seems to be less important in Iceland than one would expect given the small size of the economy. For Germany and Switzerland, exports of manufacturing goods are almost three times as important. Only Cyprus has an even lower export ratio for manufacturing goods, but Cyprus exports mainly services (tourism) to an extent that could never be replicated in Iceland.

In terms of exports of manufacturing goods Iceland is a rather closed economy.

TABLE 3. The importance of manufacturing exports
% of total

	2007
Germany	71.4
Cyprus	8.8
Luxembourg	16.4
Iceland	24.8
Switzerland	60.5

Source: UN trade database, European Commission (Ameco) and author's calculations

These data suggest that the post-crisis stimulation of non-traditional (manufacturing) exports or exports of services is the key issue for Iceland.

The exchange rate regime: independent vs. foreign currency

For small open economies the exchange rate assumes particular importance, not only as a shock absorber, but potentially also as a source of shocks during financial market crises. This could be observed with particular force during 2008 when the country was simply overwhelmed by the fallout from the turbulence of global financial markets.

The collapse of the currency and the banking system showed that the combination of an independent currency and an oversized financial sector was simply untenable. The Icelandic financial sector is now only slowly being reconstructed and will in all likelihood remain much smaller for quite some time to come. However, the problem for the Icelandic authorities remains: what to do about the currency regime?

The official response is clear: capital controls constitute a temporary measure. The aim is to go back to the "status quo ante collapse" with a fully convertible national currency. However, this might set the stage for a repeat of the standard sequence for floating currencies in small countries: as incipient inflationary pressures develop, the pressure on the central bank increases to be serious about its inflation target. This forces the central bank to raise interest rates, which in turn leads to 'hot' money inflow which fosters currency appreciation. The appreciation is welcome as it reduces inflation, but together with globally easy credit conditions it also leads to a consumption and real estate boom. This sequence also played out before the crisis in Scandinavia that marked the early 1990s.

For a very small economy like Iceland it remains thus worthwhile to consider the alternative of adopting a foreign currency, for example the euro. This might come about in the normal way if Iceland joins the EU and become eligible for full euro area membership. But this process would anyway take a long time and if the people of Iceland decide against EU membership the question arises whether Iceland should consider adopting the euro unilaterally.

The question arises whether Iceland should consider adopting the euro unilaterally.

The prime example of a country adopting the euro outside the euro area is Montenegro. The euro in Montenegro has been a success so far. Even the European institutions (especially the ECB), which were very hostile at the start, have now come to the conclusion that Montenegro should keep this arrangement for the time being. Montenegro is also a very small state (with a population of ± 600,000). Before the collapse in Iceland it was widely assumed that its experience could offer few lessons (except that unilateral euroisation is technically feasible) for Iceland because Montenegro did not have any banking system and was not integrated in the global financial system. However, Iceland is now de facto in a similar situation.

In short the argument would be that adopting the euro should stimulate trade in non-traditional products. However, it is also clear that the choice of the currency cannot affect the fundamental problem of Iceland, namely that the country now has to service an enormous foreign debt. Whatever the choice of the currency, living standards in Iceland will have to adjust downwards given the debt service the country has to bear for the next generation.

Next step: stabilizing the banks

Given the collapse of all of the banks in the country it is clear that the stability of the banking system is a key policy issue in Iceland today. In principle, the new banks which were created out of the insolvency mass of the old ones should be very strong because they acquired most of their assets at a hefty discount from the estates of the old banks. Only time will tell, however, whether these discounts were large enough to compensate the higher rates of non-performing loans that came with the deep recession.

One key aspect of the stability of a banking system is the credibility of the lender of last resort (lolr). Under normal circumstances, this not an issue because the public institutions that provide this function (either central banks or national treasuries) have deep pockets compared to the size of any individual bank. In an economy that functions as a global financial centre, however, this is no longer the case as could be seen also in Iceland in 2008. It is instructive to note how different financial centers have addressed this problem.

In Luxembourg, where the banking sector is even larger (compared to the local economy), the problem does not arise because the Luxembourg authorities have always insisted that the subsidiaries of foreign banks have a clear owner that is also a bank so that the home country remains the lender of last re-

sort. This is a key aspect that should serve as an example for Iceland: the government should consider selling the dominant stake (close to 90 %) it has in the largest of the new banks to a solid bank from an EU country with a strong fiscal position.

Liechtenstein is less useful as an example as it has retained responsibility for lending of last resort, but has a special arrangement with the Swiss National Bank in order to be able to dispose of Swiss francs, its national currency.

Cyprus also does not constitute a useful example because the main foreign financial activity there is not via banks, but investment via Cyprus-domiciled enterprises that take advantage of existing favorable double-taxation treaties to re-cycle savings from Russia and other Eastern European countries.

Another indicator flashing warning signs prior to 2008 was the loan-deposit ratio because it indicates to what extent banks depend on sources other than (usually very stable) deposits to finance their business. Given the large size of the Icelandic banking system it might not be useful to compare it to other large OECD countries, but Iceland constitutes an outlier even among financial centres such as Switzerland or Luxembourg.

The government should consider selling a dominant stake to a solid bank from an EU country with a strong fiscal position.

TABLE 4. Loan-deposit ratios

	ISL	CH	LUX
2007/11	3.42	2.22	0.52
2003/11	1.93	1.04	0.48

Source: IMF banking statistics.

It was clear from the onset of the difficulties in the Icelandic banking sector in 2007 that this extreme dependency of Icelandic banks on the capital market constituted a potentially deadly problem. And so it was. All the major Icelandic banks collapsed when they could not refinance themselves. Fortunately the new

Icelandic banks do not face this problem as they start with a deposit to loan ratio close to one.

Lessons to be learned

Iceland developed an oversized banking system during the global credit boom that preceded the great crisis. With banking assets (and liabilities) at close to 10 times its GDP, the country was particularly hard hit by the financial crisis. The entire domestic banking system collapsed, and the exchange rate went into such a tailspin that it had to be supported by capital controls.

The country is now slowly emerging from the crisis, burdened by a huge foreign debt and only with a rudimentary banking system being re-created slowly from the insolvency mass of the old one. GDP declined somewhat less than initially feared ("only" about 10 %) but is unlikely to recover its previous level any time soon.

Icelandic banks had leveraged a relatively small capital base to buy up banking assets worth several times the country's GDP.

The nature of the Icelandic economy has been profoundly modified by the banking and exchange rate collapse. Prior to the collapse the most useful comparators for Iceland should be other small economies with large and sophisticated financial sectors like Luxembourg, Switzerland and possibly Cyprus. After the total collapse of its banking system Iceland has become a very small and over-indebted economy, isolated from the global financial capital market and in search of a new growth model.

Over the space of a few years (essentially 2003–2008), Icelandic banks had leveraged a relatively small capital base to buy up banking assets worth several times the country's GDP. These assets were bought close to the height of the global credit and banking boom. When the boom turned to a bust and banking assets had to be revalued everywhere, it became clear that these foreign banking assets turned out to be worth much less than what Icelandic banks paid for them making them insolvent. Given that the banks were several times larger than the economy of the

country and that the country did not have any net reserves, there was really nothing the government could do to save them.

This experience should teach the country two lessons: **I)** An oversized banking sector represents always also an oversized potential danger; **II)** Only countries with a strong net foreign asset position can withstand the recurrent crises in global financial markets. Sweden and Finland learned that lesson after the deep currency and banking crisis they had to face in the early 1990s. Both countries turned their economies around and reinvented themselves as dynamic but also high savings economies which fared very well during the global crisis. They provide an example for Iceland to follow.

Towards a viable growth strategy

Sweden and Finland provide an example for Iceland to follow.

What are the options for the Icelandic policy makers at this point?

First of all, they must realize that there is no magic bullet to restart fast growth. It would be dangerous for the country to even try to return to the previous growth model which consisted essentially of huge imports of capital to finance a combination of international financial activity and heavy capital investment in domestic resource extraction (hydroelectric power plants for aluminum production).

A viable growth strategy for the country needs to combine the following elements:

1. Emphasis on savings. The country cannot regain control over its destiny until it has repaid the foreign debt resulting from the mishandled banking collapse.

2. Stimulating exports outside the traditional sectors fish and aluminum. This requires a competitive and stable exchange rate. The easiest way to achieve this would be adoption of the euro. Ideally this would follow EU membership; but

unilateral adoption of the euro should be considered as an option should EU membership not materialize within a reasonable time horizon.

3 Solving the lender of last resort problem for the banking system. This can be done by selling the largest Icelandic banks to sound financial institutions from fiscally strong euro area member countries. ●

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Alyson Bailes

Iceland’s entry would give the EU a stepping-off point in the Arctic

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Iceland’s choice to stay outside the European Union so far may be explained by factors of geography, economy, politics and governance,[1] but also as a matter of strategic outlook. The first features help to understand why Iceland has not been pulled towards the Union by positive calculations of economic profit, or by the yearning for a more-than national identity. Strategically, meanwhile, it has not felt pushed towards the EU – at least until very recently – by any outside threat that the Union seemed best qualified to deal with.

The surge of popular support for EU entry in late 2008, which helped Iceland’s Parliament to agree on a formal membership application in July 2009, reflected a hope that the nation’s fragile fi-

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[1] Geography places Iceland on the far edge of Europe, like Norway which has also so far turned its back on integration. The Icelandic economy is strongly geared to natural resources that are often seen as needing to be defended against outside interference, while the EU is already largely open to Icelandic exports through the European Economic Area (EEA). Politically Iceland’s history from independence in 1944 until very recently has been dominated by an anti-EU, pro-Atlantic party (Independence Party), while fishing and farming communities have been somewhat over-represented in parliament.

nances could find safety within an economic and monetary union. But that vision quickly faded as Iceland struggled through 2009 with more immediate aspects of the crisis, including the claims of two EU nations – the UK and Netherlands – for compensation over 'Icesave' banking deposits. By the end of the year public opinion had shifted so far that polls showed less than 40 % support for the EU, lower in fact than before the global crash. So is there any other, broader, logic that might offer a more convincing case for Iceland to join the EU: and indeed, might persuade other EU members to make real concessions to accommodate it?

A possible answer explored in this text is the expected opening up of the world's Northern polar regions to new patterns and levels of human activity as the sea ice melts due to climate change. This new 'Arctic' or 'High North' agenda has implications for Iceland and implications for the EU that will surely have to be given higher priority in each side's thinking from now onwards. Here we shall briefly define the challenges in prospect, look at emerging Icelandic and EU responses, and consider how far they may converge. We will also need to note some forces pulling in the other direction.

The Arctic agenda

Even while scientists argue over exactly how fast the Northern ice will melt, there is broad agreement among political observers on what issues it will throw up for the world of nations. To start with, retreating ice itself will not necessarily pull greater human activity after it. Much will depend on how lengthy and reliable the ice-free stretches will be, what the weather conditions are like, and how many free resources governments and private companies will have to invest in the very large and probably risky new development schemes required. The global crash has added a

new reason for caution here. However, even while avoiding hype it is possible to predict greater economic interest in at least four sectors: the exploitation of newly accessible oil and gas deposits (and maybe other minerals), transit shipping, fisheries, and tourism. Secondary and consequential activity may include the construction of platforms, pipelines, cables, and various kinds of processing, storage, and service facilities onshore. All this in itself raises security issues in fields like shipping safety, search and rescue, pollution events, infrastructure safety, security of supply to local residents, and perhaps challenges for health, social cohesion and law and order. Exploitation of the new environment by terrorists, smugglers and illegal migrants may sound far-fetched but is not totally to be excluded.

Levels of military activity across the Arctic region are gradually rising.

On top of this comes the potential for political dispute or even conflict arising from the overlapping claims of several Arctic nations for jurisdiction over the seabed outside existing territorial waters. Commercial competition might itself become aggressive and could draw in large players like Japan, China and South Korea from outside. Levels of military activity across the region are gradually rising and several nations have announced plans for further deployments. While it could seem natural to have more military capability available, also for monitoring and handling accidents, as civilian activity grows, there is bound to be concern about possible clashes not least as no tailor-made arms control framework exists for the area. Last and not least, the Arctic will remain a key battle-ground for the future of global warming and man's ability to survive it. While global processes disrupt Arctic habitats for flora, fauna and human life, the Arctic melting could threaten populations around the world with flooding, violent weather and natural disasters, as well as dramatic local climate shifts triggered by change in ocean currents.

None of these problems comes entirely unexpected to the states of the Arctic region, including Iceland.[2] Shipping through the lanes on both sides of Iceland is already growing as a result of development in Norwegian and Russian hydrocarbon fields, and Iceland and Greenland have already sought help to explore possible oil and gas beneath their own territorial waters. Signs of new growth in military activity have been clearest in the European Arctic as Russian warplanes have started patrolling further West than before and a Russian flag was planted from a submersible on the seabed at the North Pole. Climate change has already brought tangible shifts in local environments including some that are not so unwelcome, such as longer more temperate summers for agriculture and tourism.

International efforts to tackle the emerging challenges have not been lacking either. On the national level, Russia, Norway, Denmark, the USA and Canada have published new Arctic 'strategies' in the last few years. Since 1996, the long-standing traditions of scientific cooperation around the Arctic have been solidified in the institution known as the Arctic Council (AC), which brings together the five states having substantial land territories around the polar sea (Canada, Denmark, Norway, Russia and the USA) with the other three Nordics and indigenous peoples' representatives. While not a law-making or resource-distributing body, the AC has produced important analyses and recommendations on environment protection, resource management and guidelines for shipping among others. The AC and other actors see the global International Maritime Organization (IMO) as a key forum for adopting binding regulations on shipping, while the UN Convention on Law of the Sea (UNCLOS) has a tribunal to which

2 Iceland is one of eight nations having full membership of the Arctic Council, together with the four other Nordics, Russia, the US and Canada. Although its own territory barely grazes the Arctic Circle at the island of Grimsey, the government claims it to be 'the only country entirely within the High Northern region'.

current national territorial claims are being submitted and where they should in principle be resolved. In May 2008 at Ilulissat in Greenland, the five circumpolar nations issued a political declaration committing themselves to use all these institutions and legal frameworks to mange the future of the Arctic in a peaceful, cooperative, environmentally responsible and productive way.

So where is the problem? At one level it arises from national actions that sometimes seem at odds with the 'spirit of Ilulissat'. At another level it involves the question whether existing institutions and laws are strong enough to turn the solutions identified in principle into hard reality, while stopping militarization and other clashes of interest from getting out of hand – if only by accident. The AC is at best a 'soft law' body that lacks competence to govern military affairs or the private economy. Yet all Arctic nations are unanimous that they do not want a comprehensive, Antarctic-style 'Arctic Treaty' to fill the governance gap; and it is hard to see how anyone else could impose one over their heads. It is this situation that has started to draw in increased attention to the region from strong but hitherto less engaged institutions like the EU and NATO. Policy developments in the EU are covered below, while NATO has so far sketched out its own role in cautious and non-provocative terms, offering help mainly with 'situational awareness' and civil emergency response.[3]

The Arctic Council is at best a 'soft law' body that lacks competence to govern military affairs or the private economy.

Iceland, the EU and NATO

Iceland became a founder member of NATO in 1949 despite choosing to have no armed forces. Its defence against potential Soviet threats was secured by a bilateral US-Iceland treaty of 1951 under which US troops and aircraft were stationed at Keflavik in the South-west of the country, and also helped with some civilian tasks like search and rescue. For the Right and Centre of

3 NATO reached conclusions along these lines at its first major civil-military-academic conference on the High North, held at Reykjavik in January 2009.

Icelandic politics this was a win-win-win solution, completed by the fact that it brought considerable economic benefits. It had the effect of focusing Icelandic thinking and debate about security on a narrowly military agenda, while arrangements for self-management of 'softer' security issues within the country were rather slow to evolve. The nation's spirit expressed itself most robustly over fisheries protection, and the Coastguard was and remains the closest thing Iceland possesses to a military force.

This status quo was first upset by the US decision to close the Keflavik base, which was finally pushed through unilaterally in 2006 in the face of sustained Icelandic protests. It was a shock that opened up both practical and more fundamental questions. In the short term the government looked for ways to patch the gap by inviting NATO nations to bring their forces to Iceland for temporary exercise deployments, by making general agreements on cooperation with several neighbouring states and by finding ways to run the remaining NATO air defence and air traffic control radars with local personnel. The larger question that remained was whether Iceland really needed this kind of 'hard' defence protection at all – after all, would the US have withdrawn if there was any real remaining threat? From Iceland's first days as a modern state there had been voices on the Left that rejected the NATO connection and would have preferred the new state to opt for neutrality. For them the closure of Keflavik was a relief and a vindication, opening the way for a more nationally-owned and socially-based security policy that would focus on 'softer' (including environmental) security needs.

Coastguard was and remains the closest thing Iceland possesses to a military force.

Against this background, an independent working group was convened in 2008–9 to review Iceland's security risks and needs in the 21st century. Its report presented in March 2009[4] made one important breakthrough by surveying a wide range of 'military, societal and transnational' threats, and offering prac-

4 Text including English summary at http://www.mfa.is/speeches-and-articles/nr/4823.

tical guidelines in non-military fields that ranged from terrorism to cyber-security and food. It was less clear in its judgement on the core military issue, maybe because the group's own members represented the whole span of opinion and could only really agree that the NATO relationship should be looked at again from first principles. Moreover, the shock of the economic and financial crash was still too massive at the time of writing for the report to offer more than a basic narrative on it, with no clear prescriptions on the relevance of joining the EU in this context or indeed on anything else.

Politics took over at this point with the handover of power in February 2009 to a Left-Left coalition government (Social Democrats and Left Greens) that was confirmed in office by the April elections. The Social Democrats, long the most pro-European party, were determined to use the historic window to apply to the EU, and managed to get a parliamentary majority for this step in July even while the smaller coalition party was split and prevailingly hostile. Pushed by the then Swedish Presidency, the EU Council of Ministers agreed to process the application with unprecedented speed and Commissioner Olli Rehn was able to bring the detailed questionnaire on qualifications for membership to Reykjavik in early September. It was returned before Christmas and at the time of writing, an EU Ministerial decision to allow the start for formal negotiations is expected in June 2010.

The EU Council of Ministers agreed to process the application with unprecedented speed.

So the European door is opening for Iceland, but everything else remains open as well. The hostile turn in public opinion has already been mentioned and is crucial because the Icelandic people have been promised the right to vote on the eventual terms of entry in a referendum. Like the Norwegians twice before, they are quite capable of saying No if they feel that the terms detract too much from Iceland's control of its fish stocks or are too damaging to economic interests and traditional ways of life in agriculture. Any number of other factors could swing the vote including the economic climate at the time, continued complications involving

Icesave, the composition of the government and influence of individual politicians, and so forth. On the EU side, meanwhile, it is generally accepted that Iceland should be a relatively easy case given its EEA and NATO membership, and assuming that the IMF as well as European institutions will keep its economic recovery on track. There are indeed some who would like to use Iceland´s entry to leverage fishery policy reforms that they agree are overdue. Yet some member states have specific national interests to push in fishing and other fields, while others are concerned that this prosperous (despite everything) and blue-eyed applicant should not distract attention from or be unfairly promoted over the more needy Western Balkan states.[5]

Iceland and the Arctic

Has Iceland made an effort to leverage its central position – geographically speaking – in the European approaches to the Arctic as a way to win more EU attention and a better deal on accession? The answer is not yet or not too seriously, essentially because Arctic policy has so far been a rather low-key and specialized branch of Icelandic diplomacy.[6] The first significant official interest was shown by a previous government in 2005–6 when the focus was on economic opportunities, including the ideas of building a trans-shipment facility in Iceland (probably the North-West) to take advantage of growing shipping traffic, and encouraging more transit flights. Iceland's clean energy expertise was also, and still is, stressed as an asset in the effort

5 Before Iceland applied Croatia was first in line for actual EU entry ,while Montenegro is closest behind, and the Commission considers FYROM (Macedonia) ready to negotiate were it not for Greek political opposition. All states in the Western Balkans have the ambition to join the EU at some stage.

6 The apparent exception was a series of remarks in March 2010 by Iceland's President Grimsson, who technically does not speak for the government; these are discussed in the closing section below.

to minimize both local pollution and climate change generally. With pollution as well as accidents in mind, Iceland in 2008 passed regulations diverting larger ships into channels further away from its South and South-Western shores.

Iceland's decision to host the NATO High North conference in January 2009 was a symptom of the issue's rising profile that year, partly because of the general surge in international interest and concern and partly because of Iceland's own search for ways of renewal after the financial crash. Icelandic politicians had more reason than most to call for peaceful, legal and institutionalized approaches to Arctic management, but at the same time identified a broader range of options to benefit from the region's development. While trans-shipment facilities remained on the table, the government also expressed interest in hosting an international civil/scientific monitoring centre, and/or a search and rescue centre to boost the area's almost non-existent capacity for rescuing victims of any large shipwreck. It spelled out more clearly than before the uncertainty created by climatic effects on fish stocks and Iceland's determination to protect its own fishermen's interests – fish being one of the few concrete resources still exploitable after the banks' collapse. All these points and more were developed in a lengthy and professional report published by the Ministry of Foreign Affairs in April 2009 on 'Iceland in the Arctic', which plays the same functional role for Iceland as other states' recently published 'strategies' without actually using that title.[7] In a parallel development, Iceland used its influence during a study of Nordic security cooperation commissioned by the Nordic Council of Ministers to support especially close Nordic cooperation on tackling the Arctic's moni-

Fish is one of the few concrete resources still exploitable after the banks' collapse.

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[7] Text in Icelandic at http://www.utanrikisraduneyti.is/media/Skyrslur/Skyrslan_Island_a_nordurslodum.pdf.

toring needs and 'soft' security issues, and to suggest that all Nordic nations might help in air patrolling over Iceland.[8]

The explicit connection between Arctic policy and EU membership has been made most often and openly by present Foreign Minister Össur Skarphedinsson, a pro-EU Social Democrat. He has stressed two aspects of common interest, the first being that the EU is committed to letting all local and European states have a say in the agenda, which is also in Iceland's interests given the risk of further 'inner-circle' caballing by the five Ilulissat signatories. Secondly, if Iceland were in the EU it would have a better chance of attracting and channeling international investment, including the EU's own funds in areas like scientific R+D, monitoring and shipping development. Össur and the rest of the government have not played up the other logical point that would come to mind, namely the general value of the EU's power as a 'strategic shelter' for little Iceland in a potentially rougher regional scramble. There could be good diplomatic reason for this since such reasoning would imply a risk from Russia, and pro-EU Icelanders cannot wish to portray EU entry as in any sense an anti-Russian action. However, the fact is also that the present government is ideologically inclined to de-emphasize security issues especially of the 'harder' kind; and for reasons outlined above, they could not count on wide public understanding if they did try to make the case for EU in existential/strategic terms.

There is a risk of further 'inner-circle' caballing by the five Ilulissat signatories.

The EU and the Arctic

Compared with the AC, or other regionally targeted groups like the Barents Euro-Arctic Council set up in 1993, the European Union is a relative newcomer on the High North policy scene.

8 The study was led by former Norwegian foreign minister Thorvald Stoltenberg and published its report in Feb. 2009, see www.regjeringen.no/en/dep/ud/Whats-new/News/2009/nordic_report.html?id=545258.

Its formal proceedings began with a Resolution on Arctic Governance passed by the European Parliament in October 2008[9] and a Communication on Arctic Strategy released by the European Commission one month later.[10] In December 2009 under a Swedish Presidency, the EU Council of Ministers adopted policy guidelines on the Arctic which they deliberately stopped short of calling a 'strategy'.[11]

Common themes in all three of these documents are the wish to preserve the High North as a zone of peace; respect for existing institutions and frameworks including UNLOSC as the key legal instrument; and recognition of the multi-dimensional challenges of the Arctic future. It is hardly surprising that their language reflects elements from Danish policy and the Ilulissat declaration that Denmark masterminded, plus influences from Norway which – as an EEA partner – was keen to be consulted in the drafting. However, interesting differences of approach can also be seen between the three EU institutions. The Parliament is the only one to have embraced the popular but probably fruitless call for a new 'Arctic Treaty'. The Commission tries to set the Arctic primarily in the context of European maritime strategy where European commercial and fishing interests are balanced against considerations of environment protection and safety. EU Ministers in December 2009 (NB: just before the Copenhagen summit on climate change) chose to push the issue of the environment and climate right up front. They saw the most important bases for a good Arctic policy as being the

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[9] See:http://www.europarl.europa.eu/sides/getDocdo?type=TA&reference=P6-TA-2008-0474&language=EN.

[10] European Commission Communication on The European Union and the Arctic Region, COM(2008)763final of 20 November.2008, http://ec.europa.eu/maritimeaffairs/press/press_rel201108_en.html.

[11] Council Conclusions on Arctic Issues, 8 December 2009, http://www.consilium.europa.eu/App/NewsRoom/loadDocument.aspx?id=1850&lang=EN&directory=EN/foraff/&fileName=111814.pdf.

maximum effort to mitigate climate change; respect for existing institutions and regulations including UNLOSC; adjustment of relevant European policies to Arctic needs including the interests of local populations; and a ëresponsible, sustainable and cautiousí approach to developing the regionís resources.

If these principles sound almost too altruistic to be true, the Council document is not lacking in pointers towards the EU's more concrete interests. When it picks out areas for the EU to make a particular contribution, the second of three is *Promoting sustainable use of national resources* – hinting at the fact that European oil and gas companies, oil and gas consumers, shipping firms, fishermen and tourist agencies may all see potential profit in the opening up of the Arctic and want to get their fair share of it. The Council also follows the Commission in stressing the need to respect the freedom of shipping and rights of innocent passage through polar waters, a position shared by the USA but potentially sensitive for Canada and Russia who own most of the coastlines in question. The EU offers its own Northern Dimension policy, a cooperation framework set up in 1999 and renewed in 2006 for working with Russia, Norway and Iceland, as a contribution to stabilization and good governance in the North.[12] It suggests a temporary moratorium on fishing in new ice-free waters until a multilateral regime of conservation has been extended there, an idea not necessarily welcome to Arctic locals (though Iceland officially supports it). Finally it pushes the claims both of the EU as an organization and of Italy as a country to be granted Permanent Observer status within the AC system, where some of the non-European members have so far preferred to keep them out. The Commission is supposed to report back on progress on all these fronts by June 2011.

All this amounts to a fairly robust assertion by the EU of its right to become a player in the High North game, even while

12 On the Northern Dimension see: http://ec.europa.eu/external_relations/north_dim/index_en.htm.

vowing to abide by the rules. At this early stage, however, one might question both what leverage the Union has to win a place among the circumpolar powers, and how much genuine enthusiasm there is in its ranks for contesting the issue. On the latter point, Southern and Eastern members of the EU cannot be expected to get excited about a still-vague Northern bonanza, and still less want major efforts to be diverted to it, while they face more obvious security challenges on their home fronts. Some nations may also be reluctant to open a new front of potential friction with Moscow. When it comes to European clout in the North, the EU starts with a weaker geographical base than NATO so long as Norway and Iceland are not members, the territories of Greenland and Faroes have opted for exemption from Denmark's EU membership, and Finland and Sweden lack direct access to the Arctic seas. If commerce develops peacefully the real strengths of European business might make their mark, but if militarization starts to dominate most Europeans would surely prefer to let the US and Canada face the heat (it is worth noting that the UK, one of Europe's most ambitious military powers, has yet to adopt an Arctic strategy).[13]

The EU starts with a weaker geographical base than NATO as long as Norway and Iceland are not members.

This is where it becomes relevant to ask if Iceland's entry would give the EU a stronger stepping-off point in the Arctic and if so, whether existing members would think that a prize worth making some effort to secure. On the face of it, the answer to the first question can only be Yes. Even if Iceland lacks territories or extensive national waters above the Arctic Circle, it does sit in the middle of the Atlantic sea-roads to the North and underneath much-used air-lanes. Its people, including scientists and the private sector, are used to coping with the vagaries of a cold climate and rough seas as few others are. It is also a supremely

13 France has actually shown somewhat more interest, securing a place for its company Total in the exploitation of a new Russian Arctic gas field and carrying out one of the first supportive air and sea deployments to Iceland after the US withdrawal.

non-threatening country that has managed to stay on easy terms with Russia despite a close and not entirely extinct friendship with the USA. For all these reasons, Iceland has been a respected and problem-free participant in the AC and other regional groups and could help to channel a stronger EU partnership with all concerned. On the other hand, if EU interests are assessed in more cynical and mercenary terms, Iceland is at best on the margin of the oil and gas game where Norway would be a far more powerful collaborator – and there are few grounds to hope that Iceland's accession would spur Norway to follow any time soon.[14] Should the EU want to support and profit from infrastructure development in Iceland, to use Iceland's facilities for spatial monitoring or to work together on new shipping and fishery concepts (for example), it can do so in the existing EEA framework without needing to worry about protecting Iceland's interests overall – as it should do for a full member state, especially in view of the new Lisbon Treaty provisions on 'solidarity'.[15]

If EU nations did not treat Iceland wisely, other large powers such as China might be interested in establishing a stake there.

The last and simplest point to make is that the Arctic angle has not (yet) become central in the European discussion on Iceland, any more than it has become central in internal Icelandic opinion. The exception that proves the rule were some reported remarks by President Ólafur Ragnar Grimsson in March 2010, when he hinted that if EU nations did not treat Iceland wisely, other large powers including perhaps even China might be interested in establishing a stake there. This particular linkage does not seem to have won wide credence, not least because it is far from clear how China could use Iceland; whether that would necessarily be

14 In fact, the influence of Iceland's EU application is clearer in the Faroes where an official study has been looking at options to bring the islands more closely in touch with Brussels.

15 The reference is to the clauses in Lisbon that oblige member states to come to each others' aid in face of non-state attacks, natural disasters, and (in principle) military aggression. In practice the EU has also had to try harder to bail out its own members when hit by the economic crash.

a bad thing for Europe; and whether it is the EU's business as such to worry about the prospect.[16] In practical terms, Icesave, financial system failures, fish and agriculture are the catch-words most often linked with Iceland in Brussels and there are concrete reasons why they should concern people more strongly than distant polar prospects. Even if the idea of EU strategic interests and potential EU expansion into the Arctic did come more into play, it would have to contend with the strong member-state interests in favour of prioritizing the South-East – the Western Balkans – and/or giving the EU at 27 more time to digest its latest acquisitions and recover from enlargement fatigue.

In conclusion: Icelandic and European interests run largely parallel in the Arctic and will continue to do so whether Iceland joins the EU or not. The High North context gives the EU a definite added motive to acquire Icelandic 'real estate' but this is not, yet, the strongest or most widely recognized issue at play. It certainly cannot be counted on to make the EU side negotiate less toughly on things like fisheries – or still less, to make London and The Hague give way on Icesave – in the near term. On the Icelandic side, the logic of seeking EU 'shelter' is intrinsically far stronger in every context: strategic, economic, and in terms of amplifying Iceland's voice in other fora. The fact that most Icelanders would not yet see that point is maybe an epitome of why Iceland's road towards European integration is so bumpy and still as unclear as it looks today. ●

Icelandic and European interests run largely parallel in the Arctic.

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[16] President Grimsson was responding partly to a SIPRI publication released 1 March on Chinese interests in the Arctic, text at http://www.sipri.org/media/press_event/oslomarch1. However, this analysis and the subsequent expert comments on it have only served to highlight the many uncertainties and difficulties about any Chinese military or strategic, as distinct from commercial, engagement in High Northern waters.

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Gylfi Zoega

Privatisation blurred the lines between banking and government

Gylfi Zoega is a Professor of Economics at the University of Iceland and at Birkbeck College, University of London.

The collapse of Iceland's banking system can be traced to several factors, some of which are global while others are local. In spite of the overall benefits of EEA membership to the country, the single capital market has been somewhat of a mixed blessing.

To some extent, Iceland's problems are of the same origin as those of Greece, Spain and Portugal as well as the Baltics. The current account surplus of Germany and the lending by its banks to countries on the periphery of the Union has caused a housing bubble in many of these countries as well as an increase in tax revenues which enabled governments to increase government spending. The sudden stop to these capital flows has made the recipient countries face fiscal problems as well as a loss of competitiveness among the euro zone countries due to high unit labour costs.

But Iceland was not a passive player when it came to the imbalances. By coincidence, the country had just privatised its banking system when capital became abundant in international markets. The banks were privatised by selling them to entrepreneurs who were affiliated with the two major political parties.

The lines between the banks, the government and its institutions were thus blurred from the very beginning. What was even more ominous was that these entrepreneurs used the banks to further their own business interests and appear to have had the support of the government in doing so.

Daniel Gros describes the economic development that led to the collapse: the credit boom, the current account deficit and the development of a huge banking system. However, the domestic credit and construction boom that preceded the crash was only a sideshow to the overall operations of the banks since these were primarily investment banks used in borrowing money internationally to fund foreign acquisitions. The rapid rise of the banking system and the use of its funds to finance foreign investments by the owners and their friends is a key to understanding the seeds of the crisis.

The banks lent money to employees and customers to finance their purchases of shares in the banks.

Second, the rapid increase of the banking system was self-propelling in that the capital inflow caused an asset price bubble that increased the banks' capital through their direct ownership of shares. The banks also lent money to employees and customers to finance their purchases of shares in the banks. This had the effect of enabling the banks' management to expand their balance sheet at an extraordinary rate. It follows that the capital base of the banks was bound to collapse when the credit inflow came to an end.

Lastly, the banks lacked a lender of least resort because of their size when it came to their operations abroad.

Clearly, the Icelandic financial supervisor was only capable of following the letter of the law when it came to international regulations. Lax regulation helped the banks to expand and prevented them from moving their headquarters abroad. A move to a country with a better supervisor would have wiped out a significant part of their capital and probably made them insolvent.

Although the collapse of the banking system was not caused by the prodigality of ordinary Icelanders, it affected

their lives strongly because household debt had increased significantly during the boom years. The insightful article by Alda Sigmundsdóttir describes vividly the experience of the general population. Foreign-currency linked loans to finance the purchase of automobiles and even housing during the boom period made the stock of debt jump when the currency collapsed and the system of consumer price indexed fixed interest rate mortgage debt made inflation raise the stock of debt. At the same time the housing market froze and the standard of living fell due to an increase in the price of imports, rising unemployment and the prospects of much higher taxes and reduced public services. Sigmundsdóttir describes well the initial reaction of disbelief among the population that then turned into anger that brought down the government.

Lax regulation helped the banks to expand and prevented them from moving their headquarters abroad.

Iceland emerged with a collapsed banking system in a world where its external relations were in disarray. The article by Alyson Bailes is an attempt to redraw Iceland's geopolitical position after the end of the Cold War. She argues that it is in Iceland's interest to join the European Union for strategic and economic reasons and, last but not least, as a forum for expressing its interests and concerns. She argues that the anticipated opening up of the world's Northern polar region provides an additional reason for Iceland to benefit from membership and also for the Union to benefit from Iceland's membership. Membership would help Iceland to defend its interests and to attract investment needed to exploit opportunities in this area. At the same time the EU would, through Iceland's membership, extend its territory to the Arctic Circle which would give it an opportunity to protect other member's interests in the area.

In the more distant future, membership of the European Union would strengthen the institutional framework but as the experience of Greece and the Baltics shows, it is not a substitute for good local institutions or competent decision making. If Iceland had been a member of the euro zone, its banks

would probably still be standing. It would not be facing a currency crisis but having large insolvent banks would put a big burden on the population.

We must hope that the population of Iceland will learn from the experience, as did the other Nordics in the early 1990s, and be more critical of their government and businesses than in the past. ●

Ivo Thijssen

National savings guarantees are outdated

Ivo Thijssen is a Financial Economist and an Advisor for the Dutch social-liberal party D66. His main area of expertise is financial supervision.

It was public knowledge that the Icelandic banking industry was highly dependent on international capital markets.

Internationally, the bankruptcy of the American investment bank Lehman Brothers in September 2008 marked the existence of a global financial crisis. Nevertheless, it is the fall of internet bank Icesave that is the true symbol of the financial crisis in the hearts of the Dutch population. Unfortunately, the ongoing dispute about Iceland's (assumed) obligation to pay back Dutch depositors only adds to its symbolic value.

The Dutch government has vigorously tried negotiating a deal with its Icelandic counterpart. Aside from legal arguments regarding the savings guarantee scheme (Tryggingarsjódur), the actions of both the Icelandic and Dutch governments are worrisome on an ideological, pro-European point of view.

By guaranteeing deposits at Icelandic branches but not at overseas branches, the Icelandic government is de facto favouring Icelanders. Yet the EU and the EEA (European Economic Area) are based on non-discrimination on grounds of nationality. It is this principle that has so greatly contributed to the peace and prosperity that we enjoy throughout Europe.

As a result, the Icelandic local authorities generally had their deposits guaranteed at 100% by the Icelandic govern-

ment, while their Dutch counterparts suffered major losses. Considering that local and provincial authorities had deposited almost €200 million at Icesave, this resulted in considerable dissatisfaction. The Dutch government was even forced to use a royal decree to prevent the province of North Holland from attempting to seize Landsbanki assets through the courts outside the Netherlands. Apart from an embarrassment on the international stage, this would indeed have only complicated the already difficult negotiation with the Icelandic government.

As always, there are two sides to a story. The Dutch are not without blame either. Indeed, it was public knowledge that the Icelandic banking industry was highly leveraged and highly dependent on international capital markets. Moreover, the króna, which was ranked by the Economist in early 2007 as the most overvalued currency in the world, had already dropped significantly in the run-up to the crisis. Yet, we eagerly moved large amounts of money to our new Icesave accounts, thereby forgetting the economic rule that a higher return always comes with a higher risk.

In recent years, much has been said and written about the causes of the financial crisis. Although I do not intend to repeat this exercise, I do wish to shed a different light on what Diana Wallis calls the 'free-wheeling, risk taking, light touch to non-regulated free market'. In my opinion, we also need to find fault within ourselves, as consumers and as (European) politicians. Where did we go wrong and what can we learn from the Icesave case?

Let's begin with the current savings guarantee scheme. Firstly, this scheme, which is financed by banks (and as a last resort, by the government) provides insufficient incentives to banks to limit their risks. Secondly, it allows consumers to defy the said economic rule up to a maximum set by the scheme. Finally, these national savings guarantees are outdated. There are no more national players in a common European market,

why should the schemes be national? Iceland's experience has shown that these are inadequate in the settlement of cross-border insolvencies. To this date, European political leaders have failed to set up a European savings guarantee scheme. Such a scheme is urgently needed and needs to be paid for by the market itself using risk-based fees e.g. fees based on the solvency level of the bank. This would ensure a financial sector with more self criticism, which is forced to build larger capital buffers. Not just in Iceland, but everywhere in Europe.

Aware of the risks that were involved with Icesave's entrance to the Dutch savings market, it is also interesting to reassess the roles of the financial authorities Dutch Central Bank (DNB) and Iceland's Financial Supervisory Authority (FME) in the Icesave case.

There are no more national players in a common European market, why should the schemes be national?

Customers have complained that DNB told them Icesave was safe right up until the moment their accounts were frozen and the banks put under Icelandic government control. However, in reality, it was both legally and practically impossible to warn the public against the risks involved. Any warning would have had the potential to cause a bank run on Icesave, thereby damaging both the Dutch and the Icelandic financial sector.

One could however criticize DNB for allowing Icesave into the Dutch savings guarantee scheme without demanding additional safeguards. This was essential for Icesave, as the Dutch scheme guarantees roughly twice the amount of the Tryggingarsjó ur through a nationally organised 'topping up' of existing European regulation. This is why Icesave postponed its activities on the Dutch market until DNB permitted Icesave to participate in the 'topping up'. Without participation in the topping up, Icesave could not have gained such popularity in the Netherlands as this would have been a major competitive disadvantage.

The Icesave case also shows the problems that can arise within the European system of home-state control. DNB was not able to act on its concerns because it had to abide by the judg-

ment of the FME. The FME is allegedly the only financial supervisor in the world to be located above a Chinese restaurant, which is a sharp contrast to the sixty temporary employees DNB hired when it started to reimburse Dutch Icesave depositors. This is not to say that considering the size of the Icelandic economy and population the Icelandic financial sector needs to be smaller. I believe that the size of a bank or banking sector in Europe should primarily be established by the market i.e. the quality it offers to consumers and shareholders, not by national borders or limitations. The problem lies in the fact that supervisory bodies and their instruments have not been kept in line with European developments, and have remained national. The current patchwork system of financial supervision in Europe should therefore be replaced by a strong single European regulator.

Unfortunately, Europe learned the lessons above the hard way and Iceland took the hit. Once the world's oldest democracy needed international solidarity more than ever and turned to the IMF, Dutch finance minister Wouter Bos regrettably argued it would oppose any IMF loan to Iceland unless agreement was reached over Icesave. And the Dutch government did not stop at this point. The Dutch government continues to try to block the opening of EU accession talks. Certainly, trying to bully the Icelandic government into a deal does not correspond to my pro-European ideals either.

The FME of Iceland is allegedly the only financial supervisor in the world to be located above a Chinese restaurant.

I certainly agree with Diana Wallis that our governments' attitude to the reimbursement negotiations is counterproductive. In fact, I believe the Dutch government's narrow focus on the reimbursement is detrimental to its own self-interest. Instead, the Dutch government should switch its focus to the Icelandic people. The prospect of joining the EU and adopting the euro would help to boost the Icelandic economy. Needless to say, a boost of the Icelandic economy is in the interest of the Netherlands as it only increases Iceland's reimbursement capabilities. Indeed, it is not desirable for entering member states to be in conflict

with current EU member states. The Icesave dispute thus needs to be settled before Iceland can join the EU. As Iceland's current prime minister, Jóhanna Sigur ardóttir, insists that settling the Dutch reimbursement is integral to Iceland's economic revival, I am convinced that our governments will succeed. After all, Iceland has a lot to offer to the EU. ●

Björn Sundell

Nothing is as fragile as the financial markets

Björn Sundell is a Research Advisor for the Finnish think tank Magma. He has previously worked as both Editorial Writer and Business Editor of Hufvudstadsbladet. He has held the position of Communications Manager both in industry and banking.

At some point in time every country wants to show off its importance. Big countries are assisted by their sheer size and can use brute force when they decide to leave their mark on history. Small countries like Iceland have to be more careful.

For small countries one mistake can be disastrous.

Business expansion is a means for a nation to improve its image, enhance the living standards of its citizens and increase the tax revenue of the state. If pursued wisely, this strategy can be very successful. The size of the nation affects the choice of strategy. Big countries have big companies with great resources, and they may meet misfortunes with a smile. For small countries one mistake can be disastrous.

The rapid international expansion of Nokia and some other Finnish industries in the 1980s nearly ended in disaster when the companies became too indebted and thorny, with dozens of totally different product lines. Corrections where made in the eleventh hour and today Nokia is an international success. Its stardom improved the image of Finland and benefited the Finnish standard of living.

Expansion in the financial world is much more dangerous than it is in manufacturing. There is less transparency in the financial markets and processes evolve faster as money moves around the world in a fraction of a second, whereas it takes a year to build a factory. For some reason Iceland chose the fast but dangerous track when the modern Vikings set out to conquer the world.

This book is about the Icelandic crisis and the lessons to learn from it. There are many lessons, as the articles show. I wish to point out one factor which probably better than any other explains why things went wrong. In Iceland, the government, the bankers, businessmen, individual politicians and the central bank together, in great harmony, guided the country on the road to rapid expansion disregarding the risks, apparently with the support of many journalists. This rare form of national consensus is highly dangerous. To transform Iceland into a big player on the financial markets became the common goal for those in power. Nobody was supposed to kill the dream and not even the parliament set any limits whatsoever to this raid into the unknown.

For political reasons there were no major foreign banks in Iceland.

The decision-makers aimed at making the country and/or themselves rich by expanding on the financial markets. By concentrating all efforts and by taking great risks the country experienced some kind of miracle. It took the Icelandic banking sector only ten years to grow from a modest size into something gigantic, corresponding to 900 per cent of GDP before the crash. Iceland tried to do in only ten years something that had taken the Swiss generations to accomplish.

Any driver knows that when he drives much too fast he misses the details on the way.

A special investigation

On 12th of April 2010 the Special Investigation Commission delivered its report to the Althingi, the Icelandic Parliament. The commission, with the ominous acronym SIC, had received the

task of analyzing "the processes leading to the collapse of the three main banks in Iceland". These three banks in fact formed the banking sector. For political reasons there were no major foreign banks in Iceland. Thus, there were no different foreign business strategies to view, only an all-embracing Icelandic expansion saga that faced no competition in the minds of the people.

In its 2,000-page report the SIC lists several reasons for the collapse. Some of them are similar to those recognized in many other countries in recent years. Incentive schemes in banks encouraged risk-taking. High leverage and failure of the supervisory authorities to act in time deepened the crisis.

The report presents other reasons more specific for Iceland, such as the incredible growth of bank lending. The commission notes that the annual growth in lending of the banks´ parent companies was 50 per cent from 2004 until the bitter end. Such a breath-taking annual growth leaves any company susceptible to risk. Another factor mentioned by the commission was the high level of foreign loans in relation to GDP. This high proportion is hardly surprising for a small but fast-growing country with limited resources, but the influx of high amounts of foreign currency made it possible for many Icelanders to live beyond their means. This fact was one reason for the relative popularity of the expansive economic policy of the government.

The close friendship between the tightly knit and small Icelandic elite impaired the control functions of the banking sector.

Highly dangerous was the close relationship between many politicians, business people and bankers – and the general lack of transparency and good corporate governance. The commission notes that the largest owners of the banks had "abnormally easy access to the credit at the banks they owned". Many owners, thus, used "their" banks whenever they needed funds for their pet projects. The close friendship between the tightly knit and small Icelandic elite, such as representatives of the government and the Central Bank, impaired the control functions of the banking sector. The commission notes the lack of any written records, documents and minutes from several im-

portant meetings. The participants obviously knew each other so well and trusted each other to such an extent that they felt no need for any documentation.

Finally, the banks invested a substantial proportion of their funds in their own shares, a procedure that undermined their strength as the global financial markets got shakier. And, as difficulties started to arise internationally, the prime minister, the government, the central bank and the parliament did not react to international signals indicating danger to the Icelandic financial sector. There was, according to the SIC-report, no joint governmental contingency plan available. Things simply could not go wrong.

In short: Influential Icelanders worked together with the aim of making the banking sector strong and Iceland more influential. The press seldom questioned this risky strategy. The living standards of the citizens rose for a long time, which resulted in popular support. And when the alarm bells started to toll, the banks, the government and the central bank felt they were still in control. There was never any need for a plan B.

Or so they thought. The Icelanders lived in a different reality.

Five lessons

Today several small countries are fighting off the effects of the financial crisis – Iceland, Greece, Ireland and many more. All cases are unique, because important domestic factors interact with the international ones. What, then, should the international community learn from the Icelandic crisis?

The first lesson is that very fast growth tends to be hazardous, because at top speed the details get blurry and the vehicle easily runs out of control. As a goal for a business organization several years of double-digit growth is risky both for those who pursue it and for others in the vicinity.

The second lesson is that small countries ought to encourage open debate when designing their growth strategies. Otherwise those criticizing the strategy will be too easily silenced in close-knit societies and, accordingly, only one universal truth will prevail. Small countries with small resources must be careful with expansionary strategies, because they may not be able to afford a second try.

Thirdly, small nations may lack some of the expertise necessary for international expansion. A country should not grow faster than the human resources allow.

The fourth lesson points at the danger that looms in the lack of foreign competition. This reduces the number of alternative views and paves way for a local brotherhood that nobody dares to question.

The final lesson concerns the popular vote in Iceland regarding the responsibilities of Iceland´s taxpayers with respect to the Icesave affair. The March referendum gave the citizens a vote on banking affairs. Will the bankers of the world see the sign in the sky?

Small countries ought to encourage open debate when designing their growth strategies.

The taxpayers' dilemma

When times are good and profits are growing bankers want to expand internationally and wish to know nothing of national borders impeding growth. When times turn bad and banks start stumbling, national borders matter again and the local taxpayers are called upon to clean up the mess. This we have seen time and again during the banking crises of the past, and we see it now in Iceland.

Taxpayers seldom have a choice, because supporting the banks is considered to be a lesser evil than accepting bankruptcies and experiencing the pain of a bank run. Therefore, governments automatically use the taxpayers´ money to support banks in dire straits.

In the case of Iceland the issue became more complicated than usual, partly because of the huge size of the banking sector in relation to GDP and partly because of the need to repay Britain and the Netherlands the 3.9 billion euros lost in the failed Icesave bank. There was considerable opposition among the people of Iceland. The economic burden was considered too heavy, the terms of the deal grossly unjust. Iceland's president Ólafur Ragnar Grímsson triggered a referendum when he blocked the law defining the terms of repayment and the responsibility of the Icelandic people. The situation was unique. Suddenly there was a display of people power against economic injustice. The taxpayers got the chance to say no to cleaning up the mess the bankers had created.

Well, the people had a choice in theory, at least.

An overwhelming majority voted "no" to the deal. Of course this will only slightly change the course of the repayment process because in the end the Icelanders cannot defy the will of powerful creditors. They can only get a better deal.

In the future bankers and governments cannot be sure of the taxpayers´ willingness to take full responsibility.

The important lesson here is that a nation can question the traditional procedures. In the future bankers and governments cannot be sure of the taxpayers´ willingness to take full responsibility for the clean-up process if it seems to become very expensive.

A people who votes "no" to supporting the banking system will not escape the pain. On the contrary, a financial meltdown will be extremely painful for everyone. But the fear of a future popular uprising should make today's bankers think again before embarking on new risky, expansionary raids.

The population of tiny Iceland has spoken. Listen carefully, bankers! ●

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www.e2.fi
www.neuvosto.fi
www.mittengruppen.org

What happened in Iceland in October 2008 has no parallel in history. The small Icelandic economy plunged totally, following the collapse of three of the country's largest banks. The authors of this book, representing politics, economics, research and media from both within and outside Iceland, analyse the unfortunate events that took place in the country. The aim is to learn from the experience in order to prevent similar situations from occurring in the future.

Kreppa is the Icelandic word for crisis.

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