ADRIFT: ICELAND, THE CRISIS OF 2008, AND THE CHALLENGE OF REINTEGRATION INTO THE GLOBAL ECONOMY

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Abstract

The Icelandic experience of boom and subsequent bust in the wake of the 2008 economic crisis is an extreme example of the vulnerabilities and tough choices faced by states in the current global economic order. This paper will use historical analysis, international relations theory, and some aspects of international political economy to illustrate how the crisis came about, was dealt with, and the options faced by Iceland going forward as it seeks to re-integrate into the global economy. In so doing, this should provide a useful analysis for scholars seeking an interdisciplinary explanation of these myriad factors in a single source.

Keywords: Iceland, Crisis, Currency, Banking

How does one small state, floating lonesome on the edge of a giant, manage its relations therewith? How can a proverbial pimple engage without being engulfed? Iceland has been an interesting case study in this; it has provided both a what-to-do and a what-not-to-do in the space of a generation. It will be the goal of this paper to explain how this has been so, and the paths that these actions now leave open to it as it moves into a new era of Icelandic/European relations. From this, lessons from the Icelandic example will be offered for other small states, which face similar quandaries.

In order to accomplish this, the paper will take a chronological approach to its analysis. We will first take a brisk ride through the history of Iceland's relations with Europe, so as to give us a historical basis. From there, we explore the boom – Iceland's rise as a banking powerhouse that punched above its weight, and the bust – Iceland's buckling like the knees of a battered pugilist from the blows of the FOREX market. We will then examine the repercussions faced, the methods with which these were dealt (especially in the case of the Landsbanki settlements), and how this shaped the relationship with Europe. From there we move to the options that Iceland faces in the future as it sets out to regain its footing in the international financial regulatory regime, especially as it relates to the FOREX market and currency exchange. We will then explore to see if there are any lessons from this bout to which future small-size contenders should adhere. In so doing, an interdisciplinary approach (historical analysis, international relations, and international political economy) should add a comprehensive viewpoint to scholarship on the Icelandic experience and its lessons for other states and actors in the global economic order.

Theoretical Background

For this paper, the ideas will be examined through the same prisms of Realism and World Systems Theory as my previous work in IR, as this approach utilizes both a state-based and a systemic approach. (McDonald, 2014).

Dougherty (1997, 68) has given a six-point framework for Realist thought that will serve as the working definition for this paper. These can be summed up as: 1) the state is the

primary actor, 2) that international systems are inherently conflictual, 3) that states have sovereignty – but that there exist "nevertheless gradations of capabilities", 4)that states are unitary actors, 5)that states are rational actors seeking to benefit national interest, and 6) that national interest lays in obtaining and preserving power. It is upon these tenets which Realism will be defined in this paper.

Consequently, the operation of the international system in Realist expectation is, if not predictable, at least comprehendible. States, as the primary and sovereign actors, will make rational choices --within the constraints that they are held – that will enable them to maximize the power they can attain.

In contrast to the state centric view of Realism, the other theoretical approach to be used in this paper is less confined by boundaries of a geographical nature. The divisions in the other world-view to be used are more economic and, to a degree, cultural. World Systems analysis goes beyond the view of a state as a dominant, unitary, and rational actor (Wallerstein, 1987). The structure of the system is instead divided into *core, semi-periphery,* and *periphery* actors, which do not necessarily correspond with state boundaries.

The core, as defined by Wallerstein (1974) and Kuznar (1999), are areas in which elites control most wealth, technological, and military resources with which to dominate the system. While Wallerstein concentrates on food in his example, others have included more "sumptuous preciosities" to augment this work, such as Kardulias (1990).

In order to sustain this position, the core areas use the discounted resources and labour of the periphery (Wallerstein, 1974). These areas/actors, often are removed from the dominant core culture in the form of language, traditions, and development history. This is a function of "the social organizations of work, one which magnifies and legitimizes the ability of some groups within the system to exploit others." (Wallerstein 1974:349).

In order to bridge this divide, actors within the sphere of the semi-periphery are utilized (Wallerstein, 1974, Kuznar, 1999). These play the role of intermediary, and often feature a mix of the means and capabilities of the core states, such as educational opportunities and core-style institutions, while retaining peripheral characteristics in cultural and labour-division aspects to relegate them to their non-core status.

These do not necessarily have to be divided along national boundaries. In China, for example, Shanghai billionaire financiers share a national boundary with peasant rural farmers, many of whom are among the 21 million Chinese who live below the official "absolute poverty' line of $90 US Dollars per year (Moyo, 2009).

Iceland and Europe: Background

Iceland and Europe have a relationship with deep roots. From supposed original settlement by Irish monks, to Norwegian rule, and then long-standing Danish rule, Iceland's civilization and society has its origins in Europe (Hjálmarsson , 1993). As the CIA Factbook describes it, Iceland is made up of "a homogeneous mixture of descendants of Norse and Celts 94%." It is difficult to be much more European than that.

There is in fact, even a German origin to Iceland's final steps towards independence in the 1940s (Hjalmarsson, 1993). Iceland had existed as a quasi-independent state since 1874, but had left the responsibility for its foreign affairs with the government of Denmark. In 1903, Iceland became an officially sovereign state, but through a "personal union" with the Danish king, still retained no control over its foreign affairs. The German influence on the process came, not through diplomacy, but through war. It was the invasion of Denmark in 1940 that gave Iceland the final push into the foreign policy realm, but its attempted stance at neutrality was for naught, as the British came to set up camp shortly thereafter, soon replaced by the Americans (*Ibid.*). After the war, flush with foreign currency and Marshall Plan

money, Iceland set to secure its position in world affairs, most especially through becoming an original NATO signatory (Brittanica, 2013).

In modern times, the economy has continued to grow, but it has had a fluctuating rate, due do it makeup (Danielson, 2008). First off, it is unusually dependent upon the fluctuations of the fish market, with 40% of its export earnings coming from a product both unstable in supply and demand. This is compounded by its second large-export product – aluminum – also being subject to the vagaries of the international metals market, one that is also prone to fluctuation. Nonetheless, it was not these variables that would prove to be the undoing of the Icelandic economy – it was something much bigger, and much more ephemeral.

Iceland: Banks and the EEA

Just as in the old Hebrew tale of the Golem, it was the Icelanders themselves who created the monster that – while aiding them in the short term – proved to be destructive in the end. The financial sector of Iceland was tightly regulated into the 1980s (Carey, 2009). All three of the main banks were government owned, and currency controls were tightly implemented. The economy continued on at a moderately successful rate, but maintaining a highly-valued currency held up the development of industries that were not related to the fishery. To get around this symptom of 'Dutch disease', Iceland entered in the European Economic Area in 1994. It was this that proved to be the Golem – as it created a brief opportunity for the society to thrive, but left massive destruction in its wake.

EEA membership represented a seismic shift in the design of the Icelandic financial sector. The three major banks very privatised over the period of time up to 2003. Alongside this, there was a shift in currency policy. Tight currency controls were exchanged for bands of acceptable fluctuation. These bands were gradually widened until, in 2001, they were eliminated altogether, and the Krona was allowed to float unfettered on the FOREX market.

These two changes would be much for any economy to handle on their own, but it EEA membership meant that Iceland had to conform all of its banking regulations with those required for membership in this organization. This meant that it was now party to a reciprocal branch and subsidiary arrangement with all 29 other member states (*Ibid.,* p.6). In short, this meant that any of the Icelandic banks (having been recently privatized amid accusations of political favouritism) were now able to open branches *or* subsidiaries in any of the other EEA countries. The essential part of this agreement would prove to be this 'or', as there was an important distinction in the regulation of a branch or of a subsidiary. For subsidiaries, the supervisatory burden laid with the host country. Due to this, the EU Deposit Guarantee Schemes Directive regulation stipulates that the weight of possible repayment rests upon the host country. For branches, however, this was not the case. Any EEA bank could open a branch in another member country and still have its regulators – and deposit insurance scheme – situated in Iceland. This quirk of the law would prove to be a contentious point in the tumultuous times that lay ahead for Iceland's banks, and the EEA countries in which they were to establish branches.

2008: Meltdown

Everything was fine until it wasn't. In 2008, the storm clouds gathered, and then unleashed a hellstorm that decimated this new-look Icelandic economy in the blink of a historical eye. It didn't originate in Iceland, and one could even say that the Icelandic banks were sustainable without the foreign shock, but one could also say that Titanic floated very well without icebergs – this does not absolve the decision not to carry enough lifeboats.

On 15 September 2008, US financial services firm Lehman Brothers filed for bankruptcy protection (Sorkin, 2010). The Dow Jones dropped 500 points in just that day, but for the purposes of this paper, that is not the crucial point. Financiers and regulators

everywhere were afraid of other collapses; industry giants such as Merrill Lynch (who had long been pegged as the next-most likely to fail after Lehman) and Wachovia (who had to immediately cover about $500million in Lehman assets contained just in its 'Evergreen Investments' hedgefund) were all looking dangerously unstable.

More importantly for Iceland, the exposure was not just limited to Wall Street (*Ibid.*). Japanese giant Mizuho Trust and Banking was forced to write down 11.8 billion yen in lost loans to Lehman. The Royal Bank of Scotland faced more than one and a half billion in unrecoverable loans to the same. The contagion was spreading – and it would manifest itself through one symptom that would be near-fatal to the Icelandic economy: an unwillingness to give short-term credit.

Credit Default Swaps are the lifeblood of the 'shadow banking system', which is the actual circulatory system of the global economy (Carey, p,32; Krugman, 2010). They allow the giant banks of the world to exchange huge amounts of capital overnight, and thus keep meeting short term obligations as riskier long-term obligations accumulate. The problem in September 2008 was that, given the prevalent threat of institutional collapse, this overnight lending dried up instantly. Thus, the financial crisis of 2008 for Iceland was actually more of a liquidity crisis, but it still hit home.

The economy imploded. The stock market dropped 90% of its value (Bloomberg, 2012). Inflation increased to 18%, and unemployment rose ninefold. The government took control of the second and third largest banks on 7 October, and then the next day had to take control of the largest. The IMF had to come in with a bail-out loan of $2.1 billion USD, the fund's first loan to a Western nation since 1976 (BBC, 2013). It imposed strict currency controls, and, amid egg-pelting protests in the streets, the government resigned. The fallout did not end domestically, either, as the UK government of Gordon Brown invoked harsh 'Anti-Terrorism' legislation to freeze all UK assets of Icelandic bank *branches*, calling Icelandic policy "effectively illegal".

Causes of Collapse

It was, as the scholars put it, "the predictable end of a non-viable business model." (Baldwin, 2008, p.1)

There are myriad reasons as to why the Icelandic economy bit the dust in the aftermath of the chaos on Wall Street in 2008. There was a rapid expansion in the level of household and non-financial corporation debt (Carey, p. 21) An overheated labour market was fed with high levels of immigration, making it harder to sustain full employment. High demand for housing led to equity borrowing that increased general exposure, and the list goes on. For the purposes of this paper, though, it will be best to focus on the design of the banking industry, as this is the part that, through the EEA, was most linked with the EU. The collapse will also be examined through the above-presented lenses of Realism and World Systems Theory.

The Icelandic banks were not over-extended in terms of credit – by the loose relative standards of their global competitors. Danielsson, in fact, stated that "Icelandic banks were better capitalized and with a lower exposure to high-risk assets than many of their European counterparts." (p.11) This is not to say, however, that these banks were prudently run.

As was stated above, there was controversy about the manner in which the Icelandic public banks were privatised. They were predominantly sold to local investor groups, against the misgivings of the Financial Supervisory Authority (FME in Icelandic) (Carey, p.6) The sale was largely seen as a political decision, had ramifications in the outlook of the bank's investment portfolios, as the new owners were not traditional commercial bankers, per se. As Carey quotes from the Janarri report – commissioned in the aftermath of the crises to improve

regulation of the financial sector – the new owners had "the mindset of investment bankers, which favoured a strategy of rapid growth and highly leveraged, aggressive deals." (*Ibid.*)

In a classic example of sticking to what one knows best, these so leverage-inclined pushed the Icelandic banking sector to unprecedented levels of immersion in – and exposure to – the world economy, especially the shadow banking system. These 'new' banks set out on a course of daring that would have perhaps even shaken the heads of their Norse ancestors. The banks would borrow large amounts of money in foreign capital markets, loan the money to Icelandic investment companies (often controlled by the same majority shareholders as the banks), who would then use this money to buy stakes in other foreign firms. This hat trick of market exposure created profit as long as credit was forthcoming, but the level of foreign exposure became high even by modern banking standards. As Carey (p. 8) notes, Iceland's International Investment Position (IIP) spelled out the results of such a strategy. Net external debt increased by 142% in the four year bloc leading up to 2007, and net equity assets rose by 99%. The rise in equity assets by itself would of course not be a bad thing, especially if it resulted from revaluation of internal assets, but that was not the case here. It instead represented foreign assets purchased with foreign money denominated in foreign currency – an ominous hat trick for a relatively small economy. Indeed, these levels represented, by far, the highest levels of any OECD country, most of whom had been investing abroad for decades, not a few years like the banks of Iceland.

This exposure came home to roost quickly once the crisis hit. The cost of credit default swaps exploded, and then they became unavailable altogether (Sorkin, p.429). As the 'assets' (i.e. debts) of Icelandic financial institutions had reached almost ten times the size of the Icelandic GDP, investors worldwide knew that trouble for the banks meant trouble for the economy, and thus the value of the Krona crashed (Danielson, p.11). This made the potential repayment of foreign currency denominated loans even more difficult, and thus unlikely, leading to a run on the banks as investors and depositors tried to salvage as much of their assets as they could. Trading was halted, the banks were nationalized, currency controls were implemented, but the damage was already done. Iceland's economy had been wiped out by this hat trick of market exposure, and it was going to be a painful road back. This was exacerbated by the fact that one of these banks – Landsbanki – had opened branches in the UK and the Netherlands, and had taken on deposits of more than 4 billion Pounds (Economist, 2013).

Landsbanki – Troublemakers, Terrorists?

Landsbanki were adroit in exploiting the 'branch' loophole in the EEA agreement that was discussed above. Through an online subsidiary (also registered in Iceland) known as Icesave, it offered high-interest savings accounts to UK and Dutch depositors, offering higher return on savings to depositors from these nations while avoiding the regulatory gaze associated with their markets.

Once the run on the banks started, Landsbanki, of course, was overextended. The repayment totals would have amounted to a staggering $17,000 per Icelander (WSJ, 2013). Once the bank was nationalized, the government declared that they would not repay foreign depositors. The UK and Dutch governments paid the amounts to their domestic affected, and then took Iceland to the EFTA Court to sue for damages – alongside the UK's punitive anti-terror legislation, there have been whispers of the Netherlands blocking any future EU membership for Iceland.

This year, the EFTA has ruled in favour of Iceland, absolving them of further responsibility in the matter outside of normal liquidation of a bankrupt asset. This selloff of assets should cover most of the cost, so the financial impact of the ruling is not as severe as it was first thought to be, but it does reveal a regulatory hole that needs to be closed.

IR Lessons

So how then, does the Icelandic experience fit into the international order? This question will now be examined, through the two schools of thought presented above.

Realism

Iceland is a small player who tried to run with the big boys, a realist thinker would likely say. Other countries could support banks that got in over their heads – Iceland simply could not. Moreover, because of their small size and influence, their institutions were shut out of the credit default swap market, as other institutions could not place faith in Iceland's ability to back its institutions.

The same goes for Iceland's currency problems. No one was going to lend Iceland money in a bit-player currency like the Krona, thus it had to increase its exposure by borrowing in another currency. Thus, trouble in the Icelandic economy became a vicious cycle – lower confidence in ability to honour debt led to higher default swap rates, leading to higher debt loads, which meant that their size relative to GDP increased, which lowered confidence in the Icelandic economy as a whole, which led to depreciated value for the Krona, which in turn increased the cost of repayment, starting the whole process over again. There was simply no way for a small state to pay its way of crisis in the manner that a large state that borrowed in its own currency such as the USA could.

It is interesting to note, in a realist perspective, the decline of former power-players like the Netherlands and the UK in this affair, but it is not related to the central theme of the paper.

World Systems Theory

It would seem, in a world systems point of view, that Iceland is suffering the role of the semi-periphery. It models the behaviour of the core, yet is perpetually unable to enjoy the same sustained benefits of the system in the manner that core actors do. It emulates their institutions, but the global power-balance is set up such that the dominant core remains dominant; the semi-peripheral states are given the institutions to facilitate 'exchange' with the core, but never the control of enough resources so as to facilitate a transition to core status.

There is a potential positive development here, though, from a World Systems perspective. Normally, these core/periphery relations do not stop at the water's edge; these relationships are usually present in domestic affairs as well. In Iceland, however, the presumed impunity of the core actors has met a wall of resistance. Voters twice rejected proposed Landsbanki repayment deals in referenda, and there has even been some prosecution of those core members deemed responsible for the maelstrom, with former chiefs of two of the banks having been indicted and standing trial (Bloomberg, 2012). Iceland's thumbing of its nose against the norms of the system – austerity for the periphery, impunity for the core – would surely be seen as a welcome development for a World Systems devotee.

Epilogue: Moving Ahead as an Example?

"For a country that four years ago plunged into a financial abyss so deep it all but shut down overnight, Iceland seems to be doing surprisingly well," opined the New York Times' Sarah Lyall in 2012. In this assessment, she is not alone. The indicators are strong: unemployment is at 6% and falling, and the economy is expected to grow by 2.8% for fiscal year 2012. How then, has Iceland carried on, where others have failed?

First of all, it did not succumb to pressure to over-insure the private debts that other small states have swallowed to poisonous effect. Ireland took a different tack, and the results are not as encouraging. Ireland guaranteed the obligations of its banks to "a reckless degree, wrecking the country's public finances." (Charlemagne, 2013) Ireland's tax payers will be on

the hook for this debt for years to come, while Iceland is already moving ahead, with half of the jobless rate of Ireland, and healthier deficit, debt, and credit default swap rates than its Celtic compatriot.

It does, however, have at its disposal a tool that many small states have lost – an independent currency. The devaluation of the Krona – while difficult on imports in a northern island nation – has allowed for a quicker recovery of the export sector (Lyall). This is an option that other small states, such as this year's crisis-child – Cyprus, would surely enjoy having in their toolbox of fiscal and monetary repair. Also, the Icelandic government had a small debt ratio going into the crisis, having paid down debt in the boom of the 2000s (Carey, p.28). This allowed it to have a more sustainable outlook going forward when seeking new debt, and thus receiving lower rates. Indeed, Iceland is already ahead of schedule on its repayment of international obligations taken on during the crisis (Lyall).

As for what happens next with Iceland, the answer is unclear. The debate will largely centre on the choice of currency (Valmardsson, 2012). The most obvious choice for many would be entry into the Eurozone. As it is already an EEA member, Iceland has already conformed to much of the legislation that the EU requires for membership (as an aside, the rules that led to the Landsbanki 'branch' situation have also been amended). EU and Eurozone membership would allow it to "cooperate with EU countries as a sovereign nation, which has a say in the decision and policy making in all fields of cooperation," according to Prime Minister Johanna Sigurdardottir (*Ibid.*).

This is not the only option, though. Some have made the suggestion of adopting the use of the Canadian dollar as an official currency (Icelandic Review, 2013). There is logic to the argument, as both have large export sectors (including fishing and aluminum industries), and that the Canadian dollar has been stable throughout the crisis and has a similar outlook going forward. The downside though, is that almost 80% of Iceland's trade goes to the EU, not to Canada, so efficiencies there would be lost.

There are questions about either course of action that persist, though. Perhaps Iceland should maintain its trend-bucking ways and hold on to 'the world's smallest independent currency."(*Ibid.*) Indeed, as Bloomberg editors asked in September 2012, "Why would Iceland want to join (the Euro) now? Euro-member nations such as Greece and Ireland offer testimony to the risks of being yoked to a currency along with stronger economies." There would be pains associated with removing the capital controls in a country that imports a great deal of its products for domestic consumption. Would these be any worse than the losses of policy autonomy (especially in the fishery) and the monetary flexibility that Euro inclusion requires? It is not an easy question to answer. Similarly, the Canadian dollar is relatively steady, but it is steady at a high value, and could potentially rise higher (depending on resource prices and other factors) – thus affecting the exports upon which Iceland has rebuilt its economy. Perhaps the best option would be for Iceland to maintain its own currency while joining the eleven EU states in their transaction tax regime (McManus, 2013). This would allow Iceland to retain maximum sovereignty, while providing both revenue and a disincentive for investors to flee the Krona. Iceland has weathered the storm, and the option of joining the Euro has only gotten dimmer in light of the Cypriot mess. Perhaps maintaining the Krona while joining the Transactions Tax regime would be the best way to ensure that it keeps the all the tools it needs to navigate the choppy waters ahead, and thus chart a course for other small states that sail the same seas.

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