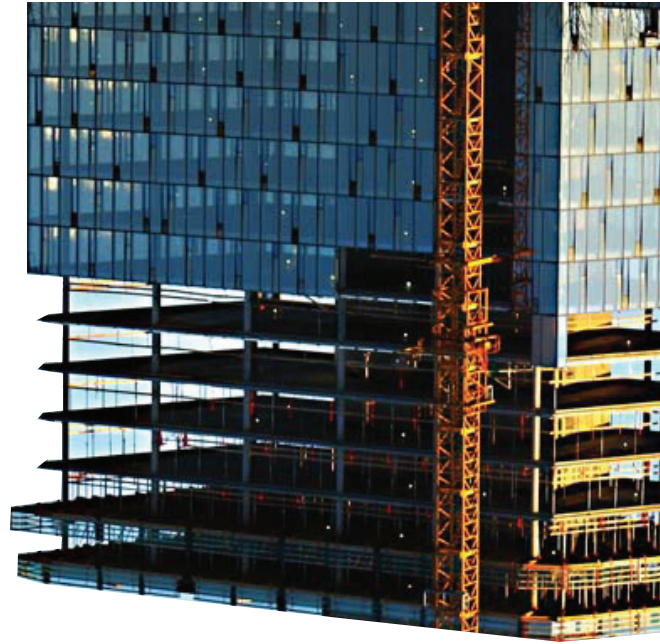


Aalborg University

Development and International Relations  
June 30th, 2009

Thesis: Ingvar Örn Ingvarsson  
Supervisor: Mammo Muchie



# Power and Interests in International Relations: Why the People of Iceland Went From Desire to Despair.



## **Acknowledgements**

I would like to extend my gratitude to my family, which provided invaluable support throughout this lengthy process of thesis writing. Especially my wife Hildur Fjóla Svansdóttir for incredible moral support and strong motivation that kept me going while the going got rough. Also, my brother Bjarni Ingvarsson, my sister Fríða Björk Ingvarsdóttir and my brother in law Hans Jóhannsson for proofreading and providing me with general commentary and other valuable input. Thanks to my father for shelter in Iceland, and my mother for support in every possible way.

I would also like to thank Úlfur Hansson, for familiarising himself with the thesis topic and for designing an interesting front page that visually captures the transformation of the Icelandic economy.

Furthermore I thank my children for tolerating a very busy father and for being so very, very sweet.

## Abstract

In October 2008 a systemic breakdown of the Icelandic financial sector followed after the bank Lehmans Brothers went bankrupt. Over the following days a series of events lead to a dispute between the government of Iceland on one hand and the governments of the United Kingdom, Holland and Germany on the other.

Iceland faced a currency crisis and resorted to extreme measures in order to avoid the economy becoming a barter economy. Actions included the guaranteeing of all deposits in Iceland. Subsequently the United Kingdom invoked anti-terror legislation and froze assets of Icelandic banks. This was done because of the Icesave deposits, which had been immensely popular in the United Kingdom. Due to the anti-terror action taken by the British and the full insurance of domestic deposits of the Icelandic a full bilateral dispute evolved. Iceland argued that it had no obligation to honour the guarantees in a systemic meltdown. The United Kingdom claimed Iceland discriminated based on nationality.

The events make for an interesting perspective on political theory on one hand and economic theory on the other; realist theory and neo-liberal and mercantilist theory respectively.

Iceland sought IMF assistance and immediately drew up a letter of intent. The IMF approved the letter of intent but withheld the financial assistance until Iceland accepted liability in the Icesave dispute. The thesis seeks to find out why Iceland was pressured into accepting the Icesave liabilities.

The method of research is mostly desk research but two fieldtrips to Iceland were conducted as well as an insider interview and furthermore the use of informants helped the progress of the research although no argumentation was based on the information from the informants.

It is argued that the United Kingdom acted out of proportion and with unforeseen consequences and coerced Iceland into accepting the liabilities

through its influence in the IMF, with the support of the EU and Scandinavian countries.

The liabilities are higher than Germany's reparations, per head, for WW I.

It is argued that the Icelandic government exposed its political naivety and lack of realist perspective. Furthermore the Icelandic government was susceptible to promises of quick EU accession made by British foreign ministry officials.

The main result is that Iceland was the victim of circumstances as regards politics, but not as regards the economy. In order to maintain trust in the European deposit guarantee, which Iceland was a part of since it adopts EU legislation because of its EEA agreement, Iceland was forced to accept the liabilities. Otherwise trust would have evaporated in the EU's banking system and a bank run would have started on banks that have operations disproportionate to the home economy.

In response to this the EU has decided to raise deposit guarantees, which will limit the opportunities of banks from smaller economies to operate in larger economies. This infringes upon the four freedoms of the EU, a cornerstone of EU cooperation.

A crisis is so serious as to demand changes. It is therefore argued that it is likely that Iceland will have quick accession to EU membership in order to alleviate the damage from accepting the Icesave deposits.

<b>Introduction.....</b>	<b>2</b>
<b>Methodology .....</b>	<b>6</b>
Limiting Factors and Literature Reflections .....	12
<b>Theoretical Considerations .....</b>	<b>19</b>
Realism, Motivation and the Global Economy.....	19
From Mercantilism to Changes in the Global Economic Order.....	24
Neo-Liberalism – A Major Catalyst for Transformation in the Modern Economy.....	26
<i>The Washington Consensus and Neo-Liberalism .....</i>	<i>27</i>
<b>Analysis .....</b>	<b>32</b>
The Events Leading to the IMF Program .....	34
<i>Heading For a Fall.....</i>	<i>36</i>
<i>Passporting .....</i>	<i>39</i>
<i>The System of Credit Creation and Role of the Economy.....</i>	<i>41</i>
The Actions of the British Government.....	49
The Actions of the Icelandic Government .....	54
Reforms and Politics: The Interactions Between the IMF and Iceland .....	61
<i>Has The IMF Been Reformed?.....</i>	<i>62</i>
<i>Neo-liberalism, Mercantilism and Credibility.....</i>	<i>66</i>
<i>The Responses to IMF Pressure .....</i>	<i>69</i>
The Wider Perspective – Implications and Complications .....	74
<i>A Hidden EU Agenda?.....</i>	<i>79</i>
<b>Conclusion .....</b>	<b>88</b>
<b>Bibliography .....</b>	<b>93</b>
Litterature.....	93
Electronic Sources .....	94
<b>Appendix .....</b>	<b>100</b>
Timeline of Events.....	100

## Introduction

On September 29<sup>th</sup> 2008 the Icelandic government bought a 75% stake in the faltering Icelandic bank Glitnir. The deal was struck after the bank had failed to secure finance when confidence and credit dried up in international financial markets after the fall of Lehman Brothers Bank in the US. Lehman Brothers had suffered unprecedented losses because of the sub prime crisis and the bankruptcy signalled the very end of cheap credit, which the Icelandic bank Glitnir had depended upon. The move did not have the desired effect and only a few days later on October 6<sup>th</sup> the Icelandic government implemented emergency law<sup>1,2</sup> in order to seize the control of Glitnir bank. Into all this played the actions of the British government where anti-terror legislation was used to freeze billions of an Icelandic bank's assets on October<sup>3</sup>. Only recently was this action criticised by a House of Commons Committee<sup>4</sup> shedding some light on the course of events and the role of the British government in the Icelandic bank crash last October which tumbled only few days after the Icelandic government had seized control in the first bank, Glitnir.

Before the systemic crash, in 2007 and 2008, Iceland was ranked as the most developed country in the world according to the United Nations Human Development Index<sup>5</sup>. However Iceland had lived on borrowed money benefiting periodically on carry trade where money was borrowed in a low interest country and invested or deposited in a high interest country such as Iceland. The money literally flowed into the Icelandic economy, thereby strengthening the Icelandic Krona (ISK) further fuelling domestic consumption and general over spending. The bubble was bound to burst. Many critics pointed to the dangers Iceland was facing but to no avail<sup>6</sup>. Iceland was the first nation to become a victim of the credit crunch. This turning point as Iceland becomes the first casualty, is

---

<sup>1</sup> [http://www.mbl.is/mm/frettir/innlent/2008/10/07/emergency\\_law/](http://www.mbl.is/mm/frettir/innlent/2008/10/07/emergency_law/)

<sup>2</sup> See appendix: Neyðarlög

<sup>3</sup> <http://www.ft.com/cms/s/0/c67abb90-dc48-11dd-b07e-000077b07658.html>

<sup>4</sup> Treasury - Fifth Report. Banking Crisis: The impact of the failure of the Icelandic banks: <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/402/40202.htm>

<sup>5</sup> <http://hdr.undp.org/en/statistics/>

<sup>6</sup> Among the critics were Robert Wade, Robert Aliber, Danske Bank, Þorvaldur Gylfason and more.



important, because there could be many more to come. In light of this, the action of the British government using anti-terror legislation and other governments using pressure on the IMF become central to answering questions about the current international monetary system and international relations in general. An example has therefore been set with the handling of Iceland's economic collapse. The British government became an active market player when securing domestic deposits by freezing the assets of, in effect, all major Icelandic banks in the UK<sup>7</sup> through legislation that includes means to deal with terrorists and rouge countries. Furthermore, Icelandic businesses outside the banking sector also suffered from the use of the terror legislation through guilt by association. The stigmatisation left the Icelandic banking system dysfunctional and extremely vulnerable and shortly after it collapsed. A run on the banks was initiated because of the actions of the British government, which no modern bank can withstand. The question is, what will happen under similar circumstances if other major banks fail, for example the Swiss bank UBS or the Benelux Bank Fortis, both of which experienced record losses after the turmoil in the financial markets? Will the Swiss banking system be handled in the same manner? Swiss and Iceland are in many cases very similar examples, both are outside the European Union<sup>8</sup> but have access to EU markets and are subject to much of the EU regulation through EEA membership or bilateral agreements respectively<sup>9</sup>, and in both cases the banking sector is overwhelmingly large in terms of GDP.

The precedent has been set with the actions of the British government in one of the world's largest financial centres, the City of London. It is therefore very interesting to analyse what motivated the actions of the British government in terms of international relations theory in order to formulate an idea of what will happen if the same situation arises concerning some other country. Moreover, the implications of the British government's action against Iceland and the interactions between the main actors in the Icelandic bank crash are examples of

---

<sup>7</sup> Will be abbreviated as UK.

<sup>8</sup> Will be abbreviated as EU.

<sup>9</sup> Both Switzerland and Iceland are EFTA Members. Switzerland is however not part of the EEA Agreement, where Iceland, Norway and Lichtenstein partake in the free movement of goods, services, persons and capital – the four freedoms of Eu legislation, but has a bilateral agreement with the EU.

political economy in action, unfolding in real time during the most interesting and challenging time of the global economy for decades.

The aim is to provide answers to the above-mentioned questions. The research question has been formulated as follows:

*Why did certain Member States of the European Union pressure Iceland into accepting liability in the Icesave dispute, before they gave their support for IMF assistance to Iceland, this being done despite EEA regulation stipulating that in a systemic bank failure a nation could not be held liable?*

In order to answer this main research question a series of other questions will arise and have to be asked and answered as well. They will form the backbone of the thesis, guiding the reader through what is at times a rather complicated and challenging reading because of the nature of the topic and the immense recent material available to the researcher.

The main aim is to provide some insight into why Iceland was pressured into accepting liabilities before the IMF loan was granted and also why the Icelandic government actually gave in. However the answer will ultimately be connected to the actions of the British government in October as these actions, in light of realist theory for example, have set the precedence for other potential victims of the credit crunch. It is therefore also vital to know why the British government acted in the way it did, especially since the settling of the Icesave deposit accounts mainly concerned the UK. This link between EU banking regulation and local action is the key to knowing what will happen in similar situation in the immediate future and therefore the following sub questions will be dealt with in order to provide the necessary red thread:

- What sparked the crises and where the responses appropriate?
  - What did the British do?
  - What did the Icelandic do?
- The role of the International Monetary Fund (IMF).



- Was there political pressure on the IMF and if so why was the pressure exercised and in what way?
- What were the responses of the Icelandic government, before and after elections?
  - EU Membership
  - Failure or surrender of the government
  - Inability
- Examination of both sides.
  - Possible implications resulting from the crisis.
  - The four freedoms.
  - Political implications.

To promote better understanding of the main events and in order to ensure better cohesion a timeline of the economic crisis as pertains Iceland is provided in appendix immediately after the Bibliography.

The next couple of sections will introduce the methodology and the theoretical considerations before moving on to the analysis and then the final piece, the conclusion.

## Methodology

The idea for this thesis was born last autumn when the financial crises finally claimed its first victim, Iceland, a country that had in a few years gone from being a relatively unknown barren volcanic island in the North Atlantic to becoming notorious for high consumption, a country that was often even thought of as one giant hedge fund<sup>10</sup>. Since then the author has followed the events and what occurred with great detail and interest, gathering information, articles and viewpoints along the way. Furthermore the economic developments of the last couple of decades, for example with increasing privatisation and the rolling back of the state have been of great interest to the author, since the Cold War thaw after the meeting of the President of the United States Ronald Reagan and Soviet General Secretary Mikhail Gorbachev at Höfði, Reykjavík, in 1986.

Consequently the events that unfolded in October 2008 in Iceland were of immediate interest, history in the making so to speak, and furthermore it became apparent that since Iceland was a player in providing global financial services, and used the same rulebook as major players in the global economy, it was quite possible that other countries would suffer similar fate as Iceland.

But that on its own is of course not enough. Economies go through deep recessions all over the world, all the time and the examples are plentiful. However, it is argued here that this time things are different and according to the current economic order, what happened in a modern western country like Iceland should be unlikely to happen in a free market economy. This makes the events even more interesting theoretically speaking. Moreover, there are immediate implications of the meltdown in Iceland that involve the EU and that in itself can, if not handled correctly by decision makers, have devastating effects on the whole economy of Europe. This would ultimately have ripple effects throughout the global economy. In effect, what happened in Iceland concerns a much broader constituency because of policy implications and the fairness of the current economic order. The actions resulting from the crises, and indeed how

---

<sup>10</sup> <http://www.vanityfair.com/politics/features/2009/04/iceland200904>

far reaching the current depression will be and what will happen afterwards matters a great deal as well.

In other words, the topic at hand is therefore not only of interest to the population of Iceland and countries that have something at stake in the Icelandic economy. It should also appeal to a much larger audience as the events in Iceland highlight weaknesses in the current economic order, at least as concerns the EU, but possibly also on a larger scale as concerns theory or politics. Additionally it can be argued that the dispute over the Icesave deposits highlights a conflict of interest in the field of international relations. Again the EU will have to accommodate for what happened regarding policy changes in the coming months and years and it is likely that the events since October 2008 will have implications far beyond of what was originally intended.

Of course there is not enough time or enough resources to examine this very interesting topic to such depths as mentioned here above, but instead a rather limited scope of inquiry is required. The Icesave dispute has therefore been chosen as the main friction point to examine. Moreover there are naturally limitations to the use of theory and analytical dimensions and for that reason great care has been taken in trying to portray as nuanced and balanced a picture from the available sources as possible. Hopefully this method will highlight the forces that are at work as concerns the research question.

The Icelandic financial meltdown has aroused enormous interest in the world. Because of how recent the events are, and indeed events are still unfolding, and as well as because of the enormous interest news agencies and the public around the world has shown, a wealth of information is available to the author, both in Icelandic and English. The available material is mostly from articles in trustworthy newspapers and other media such as online news agencies, many of which are interested in what is happening in Iceland. Additionally, many people seem to share the same interest in what happened during the autumn of 2008 and therefore many of the questions that will be asked in this thesis will have been put forward before by someone else, sometimes even in interviews with some of the world's most respected scholars and intellectuals or by respected

bloggers, from Iceland as well as from the rest of the world. The high exposure has therefore to some degree guaranteed some intriguing answers from many known and respected individuals. The interviews, that are either published texts or video streams, are available to download and will be provided in appendix on a CD, along with a large number of articles from the world's leading media.

Additionally, as a journalist for Iceland's leading newspaper, the author has almost unlimited access to information about the bank crisis in Iceland through databases. A chronological order of events has been introduced in the introduction in order to give a timeline of events and to ensure coherence in the material introduced. Most of the analysis will be based on the plentiful relevant aforementioned media and the chronological order forms an important red thread throughout the chapters.

In the analysis the main undertaking is to handle, what is for the purpose of this thesis, more or less raw data available to the author. The goal is to provide a brief and coherent picture of the topic at hand by tying the information together. The method resembles finding the correct pieces in a giant and complex jigsaw puzzle and finding their place in order to provide a clear picture. The research is therefore qualitative and to a great extent based on desk research.

Although the desk research may be regarded as the primary research, there has however been considerable field research carried out in Iceland specifically for the purpose of answering the research question. In a two-week trip to Iceland in March the purpose was to retrieve information that could be used in guidance mostly, requiring desk research to back up the information.

In Iceland information was gathered informally through discussion with informants as well as the general public to get a feel of the situation. Towards the very end of the thesis writing a second trip was undertaken to Iceland in the beginning of June. In the time between the two trips a new coalition government had been formed and some policy changes had been carried out.

Moreover, on June 7<sup>th</sup> a settlement with the British and Dutch authorities in the Icesave dispute, was signed by the Icelandic authorities. As a result the topic of the thesis turned in the very end from being about speculative circumstances to

factual circumstances. The second trip was used to account for the policy changes that had been carried out and ultimately to get some idea if left wing or right wing politics really played such an important role as many have argued. Interestingly, two coalition governments on opposite ends of the political spectrum sought to settle the Icesave dispute in the same manner.

Combining the desk research and the use of informants will mark an inductive approach to find an answer to the research question. A fair amount of investigative work has therefore been carried out in order to finish the jigsaw puzzle.

The use of expert *informants*<sup>11</sup> was necessary in order to establish an unofficial sequence of events that is intended to guide the research into a direction, independent of what the media has normally covered. However, due to the seriousness of the bank crises in Iceland and because of the close proximity of people in such a small society the informants have not been willing to comment unless absolute anonymity is ensured. This involves no timeline on comments, no audio or video records and no clarification of professional position.

For this reason the informants have mainly been used as guidance as stated above, for example in asking the most probing questions enabling the use of a *Counterfactual approach*: "The problem with counterfactuals, of course, is that they cannot actually be observed. So, one must make educated guesses based on theory and evidence."<sup>12</sup>

In other words, the informants can be used to pick up the thread where the media left it and therefore the field research is carried out in a similar fashion as private investigative work – full confidentiality is vital and hopefully more pieces will be found for the puzzle as well during the investigation. To elaborate and explain the problem it should be sufficient to mention that quality news media cannot

---

<sup>11</sup> Ib Andersen and Steinar Kvale in two Danish books, Dataindsamlinger og spørgeteknikker – i projektarbejder inden for samfundsvidenskaberne (Data Collection and Questionnaire Techniques – for project work in social sciences) and Interview: En introduction til det kvalitative forskningsinterview (Interview: An Introduction to the Qualitative Research Interview) respectively.

<sup>12</sup> Vreeland, James Raymond. (2007). The International Monetary Fund: Politics of conditional lending. Routledge. New York. P. 74.

publish hear say; all evidence must be backed by data, full disclosure of the source or a secondary source if the material is to be publishable. For this reason there are still many questions that have not been asked in the aftermath of the crisis since sources have been reluctant to speak up.

There is however information available that simply needs to be tied together in order to provide a clear picture. This takes time and resources that are available to a long-term project such as in this research. This is more difficult to do for example at a newspaper, as it is immensely costly in resources<sup>13</sup> and most media in Iceland are already suffering from extreme cutbacks from a long-standing media war.

There are four main informants used in this project. All are from inside the Icelandic banking sector with many years of experience. The bank crash is still fresh and unresolved and hence it has been difficult to find people that have inside knowledge and are willing to comment on the record. In such a small country as Iceland, people are afraid to speak out on record. It can jeopardize their job opportunities and they even fear that they can incriminate themselves as task forces have recently started investigating the bank crash. As a result some people have already been interrogated with the status of suspect along with many more that have been interviewed for investigation purposes. On May 23<sup>rd</sup> this year this assessment was substantiated when the Office of Special Prosecution acquired warrants searching houses of suspects<sup>14</sup>.

The author uses interviews, from news analysis television programs in Iceland and other news material that is abundant. There is however one vital source used in this project that was willing to come on record. That source is Ólafur Elíasson, one of the organisers of the Icelandic *Indefence*<sup>15</sup> group that was established in order to protest to the use of anti-terror legislation by the British government when it froze Icelandic bank assets in October 2008 immediately

---

<sup>13</sup> One might add here that newspapers in Iceland have suffered dramatically after the introduction of free newspapers in 2001. Since then downsizing has been necessary and ultimately the result is that there are less resources and less staff to carry out important and extensive investigative work.

<sup>14</sup> [http://mbl.is/mm/frettir/innlent/2009/05/22/husleit\\_gerd\\_a\\_10\\_stodum/?ref=fphelst](http://mbl.is/mm/frettir/innlent/2009/05/22/husleit_gerd_a_10_stodum/?ref=fphelst)

<sup>15</sup> <http://www.indefence.is/>

after the crash. The group has carried out serious and extensive investigative work and has stated that Iceland should not be held liable for the Icesave deposit guarantees and some evidence for this argument has been produced which will be disclosed in the analysis.

Furthermore, to highlight how serious this act of Gordon Brown's government is considered in Iceland, it can be revealed at this point that the Indefence managed to gather more than 83 thousand signatures in a petition that was sent to the British government in protest to the use of the anti-terror legislation. That is no mean feat considering that the whole population of Iceland is only around 320 thousand people. Moreover the group even caught the attention of the Wall Street Journal, which along with most other major media, came to Iceland to follow the events after the bank crises. Such has been the global exposure of the Icelandic bank crash. News travels fast in the electronic age but that is not the only reason for the immense exposure Iceland has received. Iceland is generally seen as the first casualty of a global recession brought about because of a flawed economic system, this at least is one of the main arguments of the critics of the current economic order. Hence people question the policy changes that have been made in the recent years and fear that their country can be the next casualty since many countries have been playing by the same rules. Therefore it is very interesting to examine what happened in Iceland and why – it indeed concerns a much wider audience than just the Icelandic population.

The main source, Ólafur Elíasson, managed to confirm many of the leads the informants had given to the author and although this use of sources limits the scope of information, the wealth of other information available through different media, from various different countries, is more than adequate to maintain a reasonably neutral position. In addition new information is being introduced every week as more and more people come forward with information concerning the financial crises in Iceland.

As concerns the theories there are three main theories used to shed light on the subject and they all have different purposes. Realist theory is being used to analyse the international relation aspect of the topic while mercantilism and



neo-liberalism is used to handle the more economic aspects of the thesis. This will be explained in more detail in the following section of theoretical considerations but first a short introduction of the main literature as well as limiting factors is in order.

### ***Limiting Factors and Literature Reflections***

Given the choice of theory there are almost endless possibilities in choosing sources as much of today's literature within economics or international relations deals with the theories used for this thesis. The main point has therefore been to find the most relevant sources and here great care has been taken in choosing authors that are renowned for their positions, positions that can either be for or against the current economic order or the political hegemony of today.

The literature is divided into two categories to accommodate for the two tiers of theory.

However, much of the literature is used in arguments on both the economic side and the international relations side due to the interconnection of the areas.

Obviously the method involves some limitations and therefore some room for generalisations is necessary regarding the theoretical and methodological framework. Moreover, it would have been helpful in this regard to have more interviews conducted in the field, preferably with identified sources. This proved to be much more difficult than expected and therefore a shift in focus was deemed necessary, from basing the analysis more on data gathered specifically for the thesis to basing the analysis more on desk research. To counteract this problem considerable resources have been used on working in the field, but mostly for guidance and the gathering of stories, that must be substantiated through other methods before being used.

Since the research question has focused, among other specifics, on the IMF approach in Iceland, it was necessary to have up to date information from the IMF itself as well as from an independent source. James Raymond Vreeland's book about the IMF, *The International Monetary Fund: Politics of conditional lending* (2007) has been used extensively in the thesis. Vreeland is an Associate Professor at the School of Foreign Service, Georgetown University and is an

expert in the field since most of his research has to do with the IMF. The book provides a very balanced account of the IMF with criticism as well as praise of the IMF and in fact it leaves the reader with enough information to make up his or her own mind. The book is useful as it is directly relevant for studies within the field of international relations and as such the book is mostly used regarding the international relations side of the thesis.

The book *Political Economy and the Changing Global Order (2006)* by Richard Stubbs and Geoffrey R. D. Underhill is one of the main textbooks for the program of Development and International Relations at Aalborg University and has been extensively used in order to gain a comprehensive view of contrasting theories. Moreover the book is used to introduce the most common arguments regarding theory. The book covers both the economic and the international relations areas as it in typical fashion concerns itself with political economy.

The work gives considerable advantages as it highlights main arguments and quotes the most influential scholars within the fields. This leads to further inquiries into the main schools of thought and the work of the other scholars with the aim of providing a balanced theoretical account. Some of those scholars are introduced in the following paragraphs.

The work of Robert Gilpin is extensively used, but as regards international relations theory it is the book *War and Change in World Politics (1981)* that has been the main source of information about Gilpin's work. The book is especially useful as it deals with changes in political systems, which is of great value given that many expect that the political economy of today might spell the end of an era. The book is therefore mostly concerned with the international relations side but it has a fair element of economic theory in it as well.

Another book by Gilpin has also been used, *Global Political Economy: Understanding the International Economic Order (2001)*. The book has proven useful in addressing the most recent changes in the field of political economy. In the book Gilpin deals with the views of most of the other scholars used in the thesis and thereby explains with his own words the different approaches used

for explaining international relations today. The perspective of Gilpin is of course a realist's perspective and as such is useful as regards the theory chosen.

As one of the main theories is realism it is hardly surprising to see the work of Kenneth N. Waltz on the literature list. Waltz has for a long time been one of the most prominent scholars within international relations theory and as such he has been a senior scholar at Columbia University and is one of the founders of neo-realism. Waltz provides a good account of how the balance of power can be shifted in his book *Realism and International Politics* (2008) and as such his work is invaluable for the progress of the thesis. Waltz has furthermore debated with other prominent scholars such as Robert O. Keohane who provides some alternative to Waltz's theories and is therefore also used to provide for a better theoretical balance.

Essentially the use of Waltz's theories involves some introduction and use of alternative approaches from Robert O. Keohane. Keohane is currently Professor of International Affairs at Princeton University and is generally known for neo-liberal institutionalism and as such he offers a useful approach to analysing the current economic order and international political system.

The book that has mainly been used is *International Institutions and State Power: Essays in International Relations Theory* (1989) where Keohane mainly differs from Waltz on the applicability of neo-realist theory. Keohane argues that although neo-realist theory is useful for analysis it overlooks the institutionalisation of international politics, much of which is based on rules, norms and conventions<sup>16</sup> which is useful for example in analysing the complex relations between the EU, UK, Iceland and the IMF. The book mainly covers the international relations side of the theory although there is a fair amount of economic related theory where Keohane deals with international economic regimes and changes there of.

Susan Strange was one of the leading scholars of international relations in Britain and she wrote a series of controversial and interesting books that seem

---

<sup>16</sup> Keohane, Robert O. (1989). International Institutions and State Power: Essays in International Relations Theory. Westview Press. Boulder. Preface.

more appropriate today than ever before. Her theories are mostly based within international political economy and as a result her book, *States and Markets* (1994) is mostly used to cast light on the economics side, but with a fair bit of international relations influence as well. The book about states and markets is vital in understanding the more unorthodox view on the current global economic order. Strange argued convincingly that technological change has eroded institutional and political regulatory framework in today's economy<sup>17</sup>. Unfortunately her book, *Mad Money* (1998) and the older book *Casino Capitalism*<sup>18</sup>(1997) were not available for research since the books are out of stock and not available in the University library. However it is possible to view a great deal of Strange's books on Google Books but as stated above the theoretical backbone is provided by *States and Markets*, which was available from the University library.

According to *Foreign Policy* magazine James N. Rosenau is among the most influential scholars in international relations<sup>19</sup>. The choice of Rosenau's work is though rather the result of using Susan Strange as Rosenau seems to agree with Strange on certain issues such as the technology influences in the global economy. It is interesting to note in this respect that many claim that today's economic problems are the results of complex financial products that were previously impossible to produce<sup>20</sup>. Moreover Rosenau's research into the interconnectedness of national and international political systems is relevant since the research question of the thesis deals with the effects of and reasons for a crises in international relations, specifically dealing with banking and related regulatory problems. There are two books that were available, *Global Changes and Theoretical Challenges* (1989) by Ernst-Otto Czempiel and Rosenau and *Governance Without Government: Order and Change in World Politics* (1992),

---

<sup>17</sup> <http://www.cepr.org/GEI/GEI9SS.htm>

<sup>18</sup> [http://books.google.com/books?id=0C2\\_Qs8bP04C&printsec=frontcover&dq=mad+money#PPA15.M1](http://books.google.com/books?id=0C2_Qs8bP04C&printsec=frontcover&dq=mad+money#PPA15.M1)

<sup>19</sup> [http://en.wikipedia.org/wiki/James\\_N.\\_Rosenau](http://en.wikipedia.org/wiki/James_N._Rosenau)

<sup>20</sup> [http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?\\_r=1&scp=3&sq=how%20risk%20models%20started%20the%20crises&st=cse](http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?_r=1&scp=3&sq=how%20risk%20models%20started%20the%20crises&st=cse)

which was available on Google Books<sup>21</sup>, also by Ernst-Otto Czempiel and Rosenau.

Other books, more focused on the economic sides were also used substantially. One of the main books that highlight the connection between the political and the economic sides is *The Globalisation of World Politics: An Introduction to International Relations* by John Baylis and Steve Smith. The book is an excellent resource on the main theories as well as the more unorthodox ones. The book usefully summarises the work of the main theorists and has been helpful in linking the different theories thereby providing good oversight.

Another key literature on the economic side is John Ravenhill's *Global Political Economy (2007)*. The book covers the most important issues that the global economy needs to deal with and although the book is older than the credit crunch it has to some degree included theorists that have criticised the elements in the current global order that were likely to be catastrophic if not dealt with. The book is therefore useful in examining the Bretton Woods system, monetary policy and the move from the gold standard to floating currencies, the creation of credit and the results of debt accumulation to name a few issues.

A book by Andrew Baker, David Hudson and Richard Woodward, *Governing Financial Globalization: International Political Economy and Multi-Level Governance (2008)* has proved useful on matters relating to the EU banking regulation, which is a large factor for understanding the fundamentals in the financial meltdown in Iceland. The book is published by Routledge in a series on global political economy and covers other related areas of interest such as what role global finance has, financial markets, the IMF and changes that are needed or likely to be made to the current economic order.

In the same field the book *Regional Monetary Integration (2008)* by Peter B. Kenen and Ellen E. Meade can provide useful insight into the inner workings of the euro-zone. The authors examine monetary unions and given the great

---

<sup>21</sup> [http://books.google.dk/books?id=lexwc-iBDs4C&dq=rosenau&printsec=frontcover&source=bl&ots=wLmIBSY57s&sig=neb0ussf56613Ualdw8Mvr3JFC8&hl=en&ei=V60WSoaiBtfPjAet\\_oHkDA&sa=X&oi=book\\_result&ct=result&resnu m=2#PPP1,M1](http://books.google.dk/books?id=lexwc-iBDs4C&dq=rosenau&printsec=frontcover&source=bl&ots=wLmIBSY57s&sig=neb0ussf56613Ualdw8Mvr3JFC8&hl=en&ei=V60WSoaiBtfPjAet_oHkDA&sa=X&oi=book_result&ct=result&resnu m=2#PPP1,M1)

support in Iceland for adopting another currency the book plays a large role in providing background knowledge, necessary for understanding what is at stake, what is possible and what is not as pertains Iceland's economy and its resurrection.

*The Globalizers: The IMF, the World Bank, and Their Borrowers (2006)* by Ngaire Woods is imperative for developing a deeper understanding of the IMF. There has in recent years been much criticism of the IMF and many have maintained that the IMF has lost its role in the global economy due to the effectiveness of the latter. Obviously the IMF has been called into action recently but it is essential to know how the IMF has reacted to the criticism in order to understand how it reacts to national problems resulting from the credit crunch.

The book by Barkley J. Jr. Rosser and Marina V. Rosser, *Comparative Economics in a Transforming World Economy (2004)*, has been useful in providing alternative insights into various economies and the different approaches used over the world. The book is therefore imperative for understanding the flaws of the current economic order and possible alternatives or improvements of the current system. In particular the book has been useful for this thesis as regards system differences rather than political differences of economic systems. Such a viewpoint is very current as it is hard to justify that what is happening in the world today is a result of left or right wing politics rather than simply a result of a specific systemic approach.

There have been many other books that have been used in the initial stages of the thesis. Some may have had influence on the routes chosen in theory and methodology even though they might not be directly cited in the thesis. It is therefore prudent to mention other main literature even though it may not be used in the argumentation.

*IMF Essays From a Time of Crisis (2004)* by Fischer Stanley has provided insight into IMF failures and successes and also into the different motives of governments participating in IMF programs. The book was intensively used, along with James Raymond Vreeland's *The International Monetary Fund*, which is mentioned above, during the first field trip to Iceland in March as the

seriousness of the IMF program was at the time becoming apparent to the general public of Iceland.

And finally *The Impact of International Debt Relief (2007)* by Anneke Geske Dijkstra was briefly used during the phase where the IMF was researched.

As a result it can be said that the choice of literature has been influenced by what is often called snowball sampling<sup>22</sup>, that is during the research for one topic the result have lead to another area, theory or theorist that required looking into and so forth. The result has been the increasing use of data that hopefully will suffice to finish the jigsaw puzzle of the research question. This has required research in several fields and a great deal of reading about institutions and regulations that may or may not be useful when it comes to argumentation but is imperative for establishing an understanding of the basic elements influencing the field of research. A limiting factor of this method is obviously that the research material can be biased and in order to counteract this possible bias the snowball method has lead the author to specifically seek contradicting theorists and material. Another important element here is that through the use of informants as guides, it has been easier to conduct respondent-driven sampling to counteract the limiting factors of the literature. In other words the result takes into account the views from the literature on one side and the informants on the other, both being unaware of each other thereby isolating the data from cross-influence. This has in turn influenced the author of the thesis; as an example what previously may have looked like a struggle between left and right wing politics may now look more like a struggle between structure and agent. As a result some biases have been subdued while others have been exaggerated.

Consequently these limitations need to be taken into account and they do explain to some degree the choice of theory and theorists in the following chapter of theoretical considerations.

---

<sup>22</sup> <http://www.socialresearchmethods.net/kb/sampnon.php>



## Theoretical Considerations

Realist theory provides the backbone of this thesis. The reason for this is explained in the following paragraphs. However, since the global financial crises takes place against the backdrop of economic development over the last decades, it is necessary to involve two other theoretical schools, mercantilism and neo-liberalism. This section will outline the theoretical considerations and the reasoning for choosing the above-mentioned theories. Along the way some critique of the theories will be introduced, but the aim is mainly to use the theories as tool to understand what happened in Iceland and why the thesis will theoretically be limited to these three main posts of theory. The intention is to introduce the factors at play, what effect they had on economic policy globally as well as locally in Iceland, and last, but not least, to understand the implications of the Icelandic meltdown, against the background of the aforementioned theories. This requires some speculation about what will happen in the nearest future, pertaining the research question, but only to the extent where conclusions are based on theory and logic, although with some degree of empirical data as a support.

### ***Realism, Motivation and the Global Economy***

Iceland has now entered an IMF program. The goal of the program is to bring Iceland back on track. However the IMF, some argue, has been used as a tool to pressure Iceland into accepting liabilities for deposit accounts beyond what is legally demanded of Iceland. This requires a short introduction to the IMF and how, concerning the theory, it can be used to influence debtor countries.

The IMF is dominated by the United States as it provides the greatest financial support. The United States holds 17.40% of the votes<sup>23</sup>. This voting share gives the United States a veto power over decisions that require more than 85% support to be effective<sup>24</sup>. This may seem very important, but most decisions in the IMF are reached through consensus in Executive Board meetings<sup>25</sup>. Realists have argued that the IMF is being used by the United States to promote United

---

<sup>23</sup> Vreeland, James Raymond. (2007). The International Monetary Fund: Politics of conditional lending. Routledge. New York. P. 41.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

States interests<sup>26</sup>. Therefore it is necessary to take into account the inherent scepticism of realism regarding the role of international organisations such as the IMF.

This view has been supported in studies conducted by Axel Dreher of the Swiss Federal Institute of Technology in Zurich<sup>27</sup> and directly concerns the multifaceted question of why Iceland was forced to accept the liabilities of the Icesave deposits, for example in spite of the interests the United States needs to look after in the North Atlantic<sup>28</sup>.

Another interesting aspect of United States's role in the IMF is that usually it is the exposure of American banks that decides the United States exerting influence. In the case of Icesave, it is, on the other hand European banks that are most exposed, giving the United States the opportunity to be neutral.

It must be noted here though, that generally it is recognised in the United States that Iceland fell victim to the sub-prime crises that originated in the United States. John F. Burns, a Pulitzer Prize winning journalist at New York Times, expressed this view when asking Prime Minister Jóhanna Sigurðardóttir about the government's policy towards Nato, in the light of the sub-prime loans had caused the meltdown of the Icelandic economy<sup>29</sup>.

Realist theory can provide explanation why certain EU nations handled the matter in the way they did contrary to what might have been expected of them. That is rather putting the pressure on a long time ally, rather than to find a diplomatic solution, or a legal one as the Icelandic authorities had wished for. One might suspect that the classic big fish eats small fish saying is indeed fitting regarding this particular dispute.

---

<sup>26</sup> <http://www.petersoninstitute.org/publications/papers/paper.cfm?ResearchID=307>

<sup>27</sup> Vreeland, James Raymond. (2007). *The International Monetary Fund: Politics of conditional lending*. Routledge. New York. P. 44.

<sup>28</sup> Examples can be taken of Nato, if for example shipping routes open up in the arctic. The immediate explanation for this short-sighted policy of the United States, as concerns Iceland, seems to be the end of the Cold War and the current economic problems the United States is facing, resulting in a more domestic policy perspective of the United States government. In other words, in the case of the IMF dealings with Iceland, other countries, e.g. the UK, Germany and Holland, have been left with more influence that would normally be the case.

<sup>29</sup> <http://www.visir.is/article/20090425/FRETTIR01/167991999/1288>

In terms of realist theory directly concerning the IMF it is clear that powerful nations have an opportunity to exert influence through the IMF which can furthermore be influenced by private lending institutions as may have been the case in the Icesave issue where the UK, Germany and Holland all had great exposure through private lending institutions<sup>30</sup>. Such an explanation would be close to the core of realist theoretical argumentation, that is, in international relations, nations look after their own interests first and foremost. Rules and legislation is only used, more or less for guidance, when less is at stake.

“On Thursday [October 2<sup>nd</sup> 2008], Ireland's government enacted legislation that insures all deposits in Irish-only banks, Reuters reported. At present, the EU minimum bank deposit guarantee is €20,000. The UK strongly opposed the decision and has already seen outflows of cash to Irish banks.”<sup>31</sup> Here is an example how the increased deposit guarantees of the Irish banks promoted capital outflows of UK banks, and others, simply because of higher guarantee. In the same way an economy that has a lesser guarantee, e.g. because of a systemic failure of the banking system as in Iceland, will have deposit owners fleeing from banks coming from a similar background, e.g. countries that have a relatively large banking sector in relation to GDP such as Swiss and Luxembourg. For this reason it is quite strange to see complains from the UK financial authorities about the Irish guarantee while at the same time wishing for increased guarantees from Iceland.

In the same article it says: “As EU banks become increasingly international, the Irish move could pose problems for European competition rules because it gives Irish-only banks an advantage at present.”<sup>32</sup> This argument can of course also be used to argue that in the same way, an overwhelmingly high percentage of deposits would be required to insure deposits in banks from small nations operating overseas, such as the Icelandic, Luxembourg and Swiss banks, thereby

---

<sup>30</sup> Vreeland, James Raymond. (2007). The International Monetary Fund: Politics of conditional lending. Routledge. New York. P. 48.

<sup>31</sup> [http://www.acus.org/atlantic\\_update/new-irish-bank-deposit-guarantees-stir-eu-controversy](http://www.acus.org/atlantic_update/new-irish-bank-deposit-guarantees-stir-eu-controversy)

<sup>32</sup> Ibid.

infringing the competition rules of the EU and especially the *four freedoms*<sup>33</sup> of the EU.

It is precisely because of the aforementioned exposure of European banks, in the Icelandic economy, that further theoretical considerations are required. The reason for this is that up until the meltdown of the Icelandic banking sector, the banks, and indeed other European banks, had been operating on the EU principles of the four freedoms. The four freedoms involve the free movement of people, goods, capital and services.

An important aspect to examine more closely in the analysis is that according to Article 43 of the EU Treaty, a Member State can not treat a foreign owned company discriminately, in other words, if deposit guarantees are set to high then only the largest nations will be able to provide financial services since small nations will never have enough GDP to generate sufficient trust in that guarantees will be honoured. This is mainly because deposit guarantee funds are always calculated in hindsight, e.g. deposit funds for the year 2008 are based on deposits made in 2007 since the insurance funds collect premiums from the banks based on previous experience.<sup>34</sup> The correct term would be to call the fund prefunded<sup>35</sup> but in case the funding is inadequate to reimburse deposits of value up to €20 thousand then the fund can also be post-funded voluntarily. However, the dispute is, whether the excess is to be covered by the state in case of a systemic crash.

As a result, the four freedoms of the EU are especially interesting in relation to the research question but require more theories to work with than merely realist theory. Neo-liberalism and mercantilism will be useful in explaining how the current world economic order has been integrated and implemented in the EU institutions and financial system and how the system has directly had a role in the Icelandic bank crises.

The focus is very much on the global economy and the state it is currently in, during one of the largest recessions since the Great Depression in the late 1920's.

---

<sup>33</sup> [http://en.wikipedia.org/wiki/Four\\_Freedoms\\_\(European\\_Union\)](http://en.wikipedia.org/wiki/Four_Freedoms_(European_Union))

<sup>34</sup> <http://www.voxeu.org/index.php?q=node/748>

<sup>35</sup> <http://en.sff.is/news/spotlight/nr/165>

In effect, Iceland is not only caught in a financial melt down but an international relations crisis as well and that commands the use of realist theory. However, since the bust is always hidden in the boom it is also necessary to examine what created the boom thereby utilising the explanatory value of mercantilist and neo-liberal theory.

The goal is not to prove or disprove a theory as much as to use the theory to explain what has happened and to give an indication of where things might be heading from now on if similar circumstances arise. It may be likely that over the next years similar events will unfold, especially if the crisis is in its early stages and has yet to advance to a similar level, in other countries, as it reached in Iceland.

It could be said, that in this respect realist theory provides the backbone of the thesis but neo-liberalism and mercantilism take over where realist theory loses its strength in explaining the economic motives and behaviour, for example, in explaining the decentralisation and marketization that has been going on for the past decades. The central market of Europe and the four freedoms are in some respects traditional mercantilist and neo-mercantilist recipes for a common market where economies of scale can be utilised for the benefit of the nations and where adequate protection can be offered to those within the union from external market pressures. The EU operates by extension on similar principles and the continent of Europe can therefore orchestrate an appropriate response to increased competition from Asia and the Americas<sup>36</sup>. Mercantilist and neo-liberalist theories also represent the underlying conflicts in the European integration, the monetary union for example and the internal market on one hand, and the global economy on the other. Large corporations in Europe operating in the home market, such as banks, have relied to a great extent on the mercantilist theory of the internal market while the more globalised corporations of Europe have favoured the neo-liberal approach<sup>37</sup>. In any case, it

---

<sup>36</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P. 309.

<sup>37</sup> Ibid.

is difficult to deal with the research question without referring to these important theories and certain related strands.

Neo-liberalism also serves a great role as the theory is under pressure after the onset of the credit crunch. Many have argued that neo-liberalism has reached the end of the road, like communism did when the Berlin wall finally fell. Furthermore, the main critique of the IMF has usually centred on the institution's promotion of neoliberal economic theories<sup>38</sup>.

All these theories have been instrumental in the making of the internal market and the regulatory system used by the EU. It is therefore appropriate to use these theories in order to see what lies ahead for Iceland and other countries that might face similar problems in Europe.

### ***From Mercantilism to Changes in the Global Economic Order***

It is necessary to turn the clock back to the middle of the last century to elaborate theoretically on the aforementioned paragraphs. That way it will be possible to see the effect of mercantilism on the Bretton Woods. In effect the central idea of the system took account of that governments were at the time mostly concerned about the promotion of local industries, the control of credit and barriers that were intended to protect local production<sup>39</sup>. Actions based on similar policies are put into the spotlight every now and then, the banana dispute<sup>40</sup> and the hiking of oil prices by OPEC<sup>41</sup> can be used as examples.

In relation to the theoretical considerations for this thesis it is argued that mercantilist economic policies formed the basis of the current economic system which then evolved or was modified with neo-liberal theories over time. However, when adhering to the original goals and spirit of the Bretton Woods system became too difficult for the leader of the global economy, the United States, the neo-liberal policies became an overriding factor with extreme growth in financial services as a result.

---

<sup>38</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P: 77.

<sup>39</sup> Ibid. P: 146.

<sup>40</sup> <http://www.euractiv.com/en/trade/eu-us-banana-dispute-resolved/article-113506>

<sup>41</sup> <http://news.bbc.co.uk/2/hi/business/3768971.stm>

The Bretton Woods system has often been credited with the greatest economic boom of the last century, a system that was based on liberal principles but had some mechanisms that were intended to safeguard or contain the volume of credit. The original idea was that employment should be safeguarded and credit should reflect the real economy in order to minimize violent swings in the global economy. The gold standard was one of the tools intended for this use but the gold standard was abandoned completely in 1973 since it had become too difficult for the United States to adhere to the standard. In any case it has been argued that because of the Bretton Woods system was an unprecedented progress and growth in the global economy<sup>42</sup> with continuous economic expansion, improvement in living conditions and better access to education and health services<sup>43</sup>.

Susan Strange has however argued that the progress over the second half of the twentieth century is not primarily due to the Bretton Woods system. Strange argues:

It is the financial structure – the credit-creating mechanisms – that should take the main credit for the “golden years” of the 1950’s and 1960’s; and it was not the decline of American hegemonic power in the 1970’s and 1980’s so much as the misuse, exploiting the system rather than managing it, giving too much freedom and responsibility for credit creation to the banks, that was at the root of the subsequent troubles. It was the pursuit of short-term instead of long-term national interest that sowed the seeds of monetary disorder and financial instability<sup>44</sup>

Perhaps it is Strange that best shows how a basically mercantilist, long term national interest perspective, gave way to a more neo-liberal system that favoured, as it turns out, short term interest of the global *electronic heard* as Thomas Friedman coined the owners of the world’s capital<sup>45</sup> in his book *The Lexus and the Olive Tree* from 1999. This argument is in any case a major one for explaining what brought about the current economic crises, both globally and

---

<sup>42</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P. 146.

<sup>43</sup> Ibid.

<sup>44</sup> Strange, Susan. (1994). *States and Markets*. Pinter Publishers. London. P: 104.

<sup>45</sup> [http://www.unc.edu/depts/diplomat/AD\\_Issues/amdipl\\_13/yarmolinsky.html](http://www.unc.edu/depts/diplomat/AD_Issues/amdipl_13/yarmolinsky.html)



specifically in Iceland. This is because the change in policy over the last couple of decades resulted in an extremely liquid and tradable global market of financial products that grew rapidly, at the expense of controls of domestic credit supply<sup>46</sup>.

In other words, the electronic heard calls the shots or as described by Underhill: "Bretton Woods was undermined by fiscal excess: governments often wail at the consequences but they were willing participants in this process"<sup>47</sup>.

To summarize this part of the theoretical considerations, it is argued, in line with Underhill, that the Bretton Woods system originally "assumed that mercantilism is the norm, and that countries and companies may be induced towards an ideal of open markets and thus avoid the worst of self-centred behaviour"<sup>48</sup>. This was however changed by the incredible momentum neo-liberalism has enjoyed in recent time.

Moreover, when the current economic order starts trembling, nations will desperately seek ways to secure their interests. Neo-mercantilism might be one of the chosen routes as countries are likely to seek ways to limit imports, conserve currency reserves and generally seek to isolate themselves from the turmoil of the global economy.

### ***Neo-Liberalism – A Major Catalyst for Transformation in the Modern Economy***

The general principles of free market and free trade have been the overriding factor in the world economy for decades but the main school of thought gained momentum in 1970's, especially with the theories of Milton Friedman. For the purpose of this thesis, neo-liberal theories play an important role since the *Independence Party*<sup>49</sup> in Iceland, which has been the ruling party since 1991, was under great influence from the advocates of liberal policies. Influence has come

---

<sup>46</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P. 146.

<sup>47</sup> Ibid.

<sup>48</sup> Ibid. P. 150.

<sup>49</sup> Centre-right political party formed in 1929.

from high profile intellectuals such as Friedrich Hayek, James M. Buchanan, Karl Popper, Ludwig Von Mises and Milton Friedman, as well as from politicians such as Margaret Thatcher, Ronald Reagan and even Carl Bildt. The interest in neo-liberal policies was so intense that Friedrich Hayek, James M. Buchanan and Milton Friedman were even invited to Iceland in the early 1980's by influential people in the Independence Party<sup>50</sup>.

This history of neo-liberal influence in Iceland, through the most influential political party of the last 20 years, is the main reason neo-liberal theory is imperative to explain what happened in Iceland, and furthermore to provide some clue as to what will happen now the initial shock from the crash is fading. It is indeed necessary to look into whether the systemic bank crash in Iceland is the result of neo-liberal policymaking and alleged reforms over the last couple of decades, and how all this relates to the Icesave liabilities. Furthermore, neo-liberal policy has been very influential in Europe in general, especially in Britain and as such must be included as theoretically it is possible that Britain's economy will suffer the same fate as Iceland's did.

### **The Washington Consensus and Neo-Liberalism**

The current economic world order is one that has been under great influence from neo-liberal theory as argued above. The culmination of neo-liberalism was in the aftermath of the fall of the Berlin wall where a new wave of liberalisation gathered momentum. The trend started in the early 1980's when trade and market regulatory framework was considerably liberalised as well as privatisation become much more frequent which had great impact in western countries where privatisation was extensively carried out<sup>51</sup>.

The term *Washington Consensus* was coined in the late 1980's and is generally thought to refer to a set of economic policies, initially tailored for crises stricken third world countries<sup>52</sup>. As such the Washington Consensus is of interest to Iceland because of the recent IMF program the Icelandic government has taken

---

<sup>50</sup> [http://en.wikipedia.org/wiki/Hannes\\_H%C3%B3lmsteinn\\_Gissurarson](http://en.wikipedia.org/wiki/Hannes_H%C3%B3lmsteinn_Gissurarson)

<sup>51</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P. 77.

<sup>52</sup> <http://www.cid.harvard.edu/cidtrade/issues/washington.html>

part in but also because it will be interesting to see if Iceland really needs to set a new course regarding economic policies pertaining the IMF conditions. After all, Iceland was in many ways one of the most enthusiastic followers of the neo-liberal policies that the Washington Consensus is often associated with. In terms of the policies set forward by the Washington Consensus; fiscal discipline, redirection of public spending toward high economic yielding fields, tax reforms, interest rate liberalization, competitive exchange rate, trade liberalization, liberalization of inflows of foreign direct investment, privatization, deregulation and property rights, Iceland has already implemented all of the above during the reign of the Independence party. It is only after the systemic bank crash that Iceland will have the chance to challenge the Washington Consensus, since immediately after the crash a series of policy changes were implemented in order to safeguard the continued function of the monetary and credit systems in Iceland.

The main challenges to the Washington Consensus will therefore come from increased nationalisation of crises stricken businesses, an *optimal exchange rate policy*<sup>53</sup> where the Central Bank tries to sustain a certain exchange rate, limited trade liberties and foreign direct investment due to currency restrictions intended to limit outflows of foreign currency. Furthermore many fear increased bureaucracy will follow the first left wing majority government<sup>54</sup> in the country's history.

The Washington Consensus may already have been on the way out as neo-liberal policies have increasingly been under attacks since the credit crunch started. Even Gordon Brown, the UK Prime Minister, declared recently that the Washington Consensus was dead<sup>55</sup>.

As a result, the aforementioned requires that neo-liberal theory is included in the theoretical considerations of this thesis since neo-liberal policies have been instrumental in the success and failure of Iceland's economy. The theory which

---

<sup>53</sup> <http://www.sedlabanki.is/uploads/files/Wp8.PDF>

<sup>54</sup> <http://news.bbc.co.uk/2/hi/europe/8017927.stm>

<sup>55</sup> <http://www.washingtonpost.com/wp-dyn/content/article/2009/04/09/AR2009040903241.html>

proclaims that the *electronic herd*<sup>56</sup> of global finance seeks out liberal democracies because they are the most likely to provide the herd with stability, predictability, transparency and generally as little red tape as possible<sup>57</sup>, brought abundant capital to the island in the North while at the same time, it seems, it cemented the fate of the very same island.

The people of Iceland blame the policies of the last couple of decades for what has happened, stating that the neo-liberal economic system simply is not working any better than the socialist or communist economic systems did<sup>58</sup>. The population also claims that the freedom that followed liberalisation in Iceland was too much and hence the theory is imperative in answering how on earth Iceland managed to crash this hard, this fast.

This requires criticism of neo-liberal policy to be examined, such as the effect of neo-liberal economic policy favouring the electronic herd, big bonuses and business leaders who seemingly have to be narcissistic<sup>59</sup>, rather than long term profit businesses, full employment and a powerful welfare state which would have been more typical for the followers of John Maynard Keynes, an embedded liberal himself<sup>60</sup>. In fact it is ironic, that Keynes, who was very concerned with policy that was much more focussed on social welfare, influence less vanished along with the break down of the Bretton Woods system<sup>61</sup>.

In fact, the criticism of embedded liberals has been heard ever since as they have sounded warnings that if the market is unregulated it may lead to a similar crises as in the Great Depression with the fabric of social and economic welfare and cohesion torn and tattered<sup>62</sup>.

There have been other critics as well. Social movements have recently labelled neo-liberalism as neo-colonialism or free-trade imperialism<sup>63</sup>, an economic order that is designed to suppress the poorer nations of the world through what

---

<sup>56</sup> Waltz, Kenneth N. (2008). *Realism and International Politics*. Routledge. New York. P: 235.

<sup>57</sup> Ibid. P. 232.

<sup>58</sup> <http://www.vb.is/frett/1/49194/>

<sup>59</sup> [http://www.huffingtonpost.com/dr-drew-pinsky/narcissism-and-the-econom\\_b\\_178541.html](http://www.huffingtonpost.com/dr-drew-pinsky/narcissism-and-the-econom_b_178541.html)

<sup>60</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). *Political Economy and the Changing Global Order*. Oxford University Press. Ontario. P. 307.

<sup>61</sup> Ibid. P. 78.

<sup>62</sup> Ibid.

<sup>63</sup> Ibid.

a century ago would probably have been called capitalist exploitation. This would typically be done by keeping capital in industrialised countries and by forcing poor countries to limit themselves to the exports of raw material and commodities<sup>64</sup>.

Some have argued that it is only the global economic boom of the last decade that has allowed these more radical groups the resources and the liberty to speak up. Such criticism has even been directed at feminist groups, environmentalist and other grassroots organisations. It is worrying that now, in the middle of the worst economic crises in decades, there is little criticism to be heard from the aforementioned groups. This may be because the crises has not developed far enough as of yet. It has however in Iceland and it may therefore not come as a surprise that criticism from grassroots organisations in Iceland has been loud. In fact louder than ever before in the history of this young republic. The blame for the crises has even been put on the human male and as a consequence it is the women that have to clean up the mess<sup>65</sup>.

The main theme of the criticism is that another world is possible, a slogan that was popularised at the World Social Forum in Porto Alegre, Brazil, in 2001<sup>66</sup>.

As far as neo-liberal theory goes the world has probably seen even greater influence of similar policy in the 1850's and 1860's when the movement of capital, workers and goods was even more liberal than it is today<sup>67</sup>.

The main point here however is that neo-liberal policies have played such a large role over the last decades that it is unavoidable to include neo-liberalism in the theoretical considerations for this thesis.

To summarise it can be said that realist theory will primarily be used to examine and explain the topic pertaining the international relations side while neo-liberalist and mercantilist theories will primarily be used for the more economic aspects of the thesis. The crises may only be an economic crises on a global scale, but as concerns Iceland the crisis is also an international relations crises.

---

<sup>64</sup> Ibid.

<sup>65</sup> <http://www.guardian.co.uk/world/2009/feb/22/iceland-women>

<sup>66</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P. 79.

<sup>67</sup> Ibid. P. 85.

Furthermore the precedent of what has happened in Iceland should be of great concern to any nation that has played by the same rules. Hence, it is imperative to examine the rulebook more closely with the supplementary economic theories.

## Analysis

The argument that is the starting point of this thesis argues that the crisis in Iceland is different from previous economic crises as pertains to the theoretical aspects and the circumstances under which the crisis occurs, circumstances that are created to a great extent by decades of neo-liberal policies and the resulting framework of a free market economy.

Such an argument is obviously moulded by privilege rendered by hindsight. Through structural changes in the Icelandic economy of the last twenty years changes have been made that did not turn out as planned, even, Geir Haarde, the prime minister during the crisis, has admitted that serious mistakes were made during the privatisation process of Icelandic banks<sup>68</sup>. Today Iceland suffers the consequences in the form of economic constraints that might last for generations. At the core of the international relations perspective is imbedded the question whether such dramatic results are acceptable consequences in times of peace. Evidence shows that even nations that have waged world wars paid less in reparations for the damage they caused<sup>69</sup>. To add insult to injury in Iceland's case the people left to pick up the bill had nothing to do with the damage caused by the banks since the banks were privately owned.

For citizens of Iceland the past months have been devastating and nerve wrecking, and the amounts involved are unfathomable. However it is not the sheer amount that has been demanded of the nation in settlements that prompts concern it is rather the treatment the nation received from the hands of long-term allies. It seems, that rather naively the population of Iceland counted on being treated fairly by equals. There was very limited, if not total lack of a realist's perspective. As it turns out, Iceland does not seem to be counted as an equal in the Western world, nor could it rely on the benevolence of former allies and diplomatic resolutions as was expected. Iceland simply seems to have become another row of numbers on a balance sheet. Through a sequence of chaotic responses to the extreme anti-terror measures taken by the British

---

<sup>68</sup> [http://www.mbl.is/mm/frettir/kosningar/2009/03/26/mistok\\_gerd\\_vid\\_einkavaedingu/](http://www.mbl.is/mm/frettir/kosningar/2009/03/26/mistok_gerd_vid_einkavaedingu/)

<sup>69</sup> [http://www.economist.com/world/europe/displayStory.cfm?story\\_id=12762027](http://www.economist.com/world/europe/displayStory.cfm?story_id=12762027)



government, the Icelandic government threw away the only bargaining chip the country had; the only firm ground to stand on - i.e. to demand fair treatment according to international conventions, traditions and law. It seems the government of Iceland fell victim to naïve Idealism; an unwise move according to the realist Morgenthau<sup>70</sup>. In fact the way the relations with Iceland were handled by the British government was more akin to state-centric realism, as Gilpin would call it, than the system-centric<sup>71</sup> realism the Icelandic authorities most likely expected. Given the circumstances, the Icelandic authorities should not have expected a favourable treatment. After all, the banks that had collapsed used the good name of Iceland for their benefit, and the population rooted for them while things were going well.

Speculations that the turn of events might have developed in a more system-centric way if Iceland would have been a member of the EU are important in this respect. It can be argued that rather naively the Icelandic authorities expected a constructivist response to the dispute. And as it happens constructivism is one of the main opposing theories to realism<sup>72</sup>.

The bases for the aforementioned arguments will be provided in the following analysis; divided into three sections. The aim is to analyse the case of Iceland specifically as pertains to the research question. This will be done first by establishing what the relationship is between Iceland, the main counterparty in the Icesave dispute on the one hand – the British authorities, and the IMF on the other.

At the centre of the dispute lies the assumption that private banks cannot under any circumstances undertake liabilities that the nation of the banks home country can be made responsible for. At the very core of the current economic order lies the common assumption that in a business relationship all the benefits and the risks of a business deal concern only the parties that willingly participate in it. What happened in Iceland is strangely controversial. The Icelandic banks collected deposits in Iceland as well as in the UK and other countries. When,

---

70 Gilpin, Robert. (2001). *Global Political Economy*. Princeton University Press. New Jersey. P. 17.

71 Ibid. P. 16.

72 Ibid. Pp. 19-20.

however the Icelandic government fully guaranteed deposits in Iceland, no one realized that such steps could actually be more damaging than if the local deposits were lost. The average family of four people in Iceland hardly had eight million ISK on a deposit account<sup>73</sup>. After the crash the debt of every single man, woman and child in Iceland is roughly two million ISK. In effect, money is being taken from depositors' pockets in Iceland to fill the pockets of depositors in the UK and other countries the Icelandic banks operated in.

It seems safe to argue that Iceland would have been much better off loosing all deposits in Iceland. It would surely have meant that Iceland would not have had to borrow enormous amounts to repay depositors in the EU, at least according to the arguments used by the British government, which claims discrimination because of nationality. That argument will be covered in more detail later in the analysis.

The current deposit guarantee system of the EU, of which Iceland is a part of through the EEA agreement, has turned this common understanding of the system up side down. A more diplomatic solution would have been possible where the countries facing the risks from the credit system within Europe would have pooled resources in order to deal with a very unusual situation brought about by the systematic failure of the Icelandic banks.

However, Iceland was left to bail out the European credit system on its own and at its own expense. Strangely the Icelandic authorities accepted that. However, there are some indications that the IMF was used as leverage on behalf of the more powerful parties involved in the dispute but that does not excuse the inability of the Icelandic government<sup>74</sup> in settling the Icesave dispute.

### ***The Events Leading to the IMF Program***

What happened in Iceland concerns fundamental theoretical questions in international relations such as whether the profits were privatised and the losses

---

<sup>73</sup> At the current exchange rate eight million ISK is roughly 44 thousand EUR. Before the crash that would have been closer to 96 thousand EUR.

<sup>74</sup> The first government is the one of prime minister Geir Haarde, which ruled during the crisis. The second government under prime minister Jóhanna Sigurðardóttir took over the helm after Geir Haarde had announced elections in the spring.

socialised. Furthermore, the regulatory framework Iceland has is the same one as in the EU. Will some EU countries suffer the same fate as Iceland because of how the system works or were other more underlying political factors at work that were only intended to safeguard narrow national interests of the parties involved? Do the events have to do with realism or even neo-colonialism, or is it the classic case of big fish eating small fish? Or perhaps it was simply a failure of the neo-liberal economic order?

Such rhetorical questions will be answered over the following pages, hopefully shedding some light on what happened in Iceland last autumn. During the research for the thesis evidence was found that the Central Bank's chairman, Davíð Oddson, was aware of the implications the crash involved when he stated that the people of Iceland would not pay the liabilities of reckless business people<sup>75</sup>. Michael Hudson, an economist and professor at the University of Missouri who has been very active in discussions about the Icelandic meltdown agreed with the assessment of Davíð Oddson: "There is no legal requirement for "Iceland" - meaning its government and people - to pay the debts of irresponsible bankers. Even former P.M. and central bank head David Oddsson emphasized this to me. He's right."<sup>76</sup>.

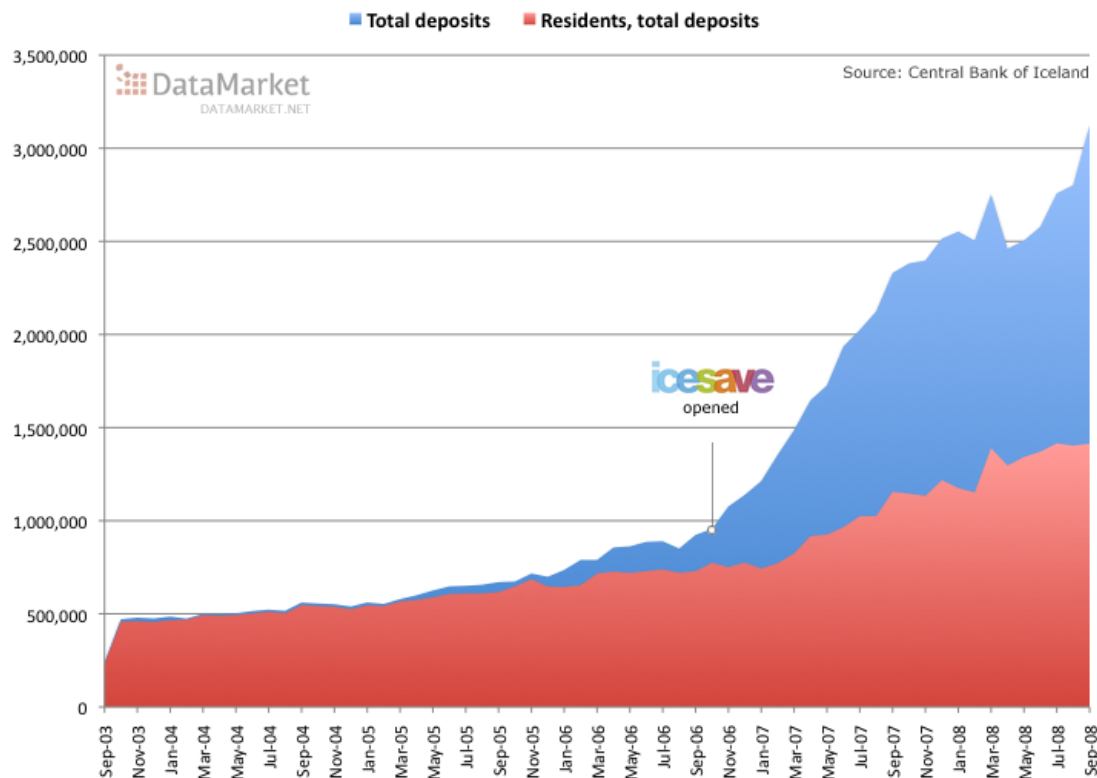
Nonetheless the very same policy may have been the one that finally caused the burden of the Icelandic nation because Mr. Oddson refused to give Landsbanki a credit line that was necessary for moving the deposits from a branch to a subsidiary in the UK, which would have meant the deposit guarantees would have become the responsibility authorities in the UK rather than Icelandic authorities<sup>77</sup>. One of the informants confirmed this information in March.

---

<sup>75</sup> <http://bernardrooney.blogspot.com/2009/04/real-issue-is-icelands-economic.html>

<sup>76</sup> <http://larahanna.blog.is/blog/larahanna/entry/871136/>

<sup>77</sup> <http://eyjan.is/blog/2008/12/22/geir-neitar-vitneskju-um-tilbod-breska-fjarmalaeftirlitsins-um-ad-faera-icesave-abyrgd-til-bretlands/>



**Figure 1: The graph shows in millions of ISK how quickly the Icesave accounts gathered momentum. The amount in blue would have been covered by the UK deposit guarantee scheme if the Icesave accounts had been opened in subsidiaries rather than branches.**  
Source: <http://datamarket.net/>

However the events before and after Mr. Oddson's statement are in best case rather controversial and in the worst case constitute an atrocious act carried out by a friendly nation during a moment of distress. From an international relations perspective it is relevant to examine what happened in order to understand how the world works and if indeed it has become more civilised over the past couple of decades as regards relations between nations.

### Heading For a Fall

As explained at the start of this thesis Iceland's economy seemed to enjoy tremendous success on borrowed money. At the height of the economic boom banks were becoming increasingly vulnerable to fluctuations in the global economy because of mismanagement, but nonetheless there were little complaints from the regulatory authorities in Iceland. Unexpectedly it was the market that complained and the banks responded to market demands showing in effect how a free market system should operate in supervising itself. They did

so however obviously because they had much to loose. A Merrill-Lynch report highlighted the worries of the market:

We see several practices in Iceland (e.g. substantial cross-shareholdings, significant loans to shareholders, loans for the purchase of shares by management) that make us uncomfortable. Furthermore, these practices are in the process of being corrected not because the regulator directed so, but because the credit market complained about them. Why were the credit markets unhappy but the regulator apparently not?<sup>78</sup>

In this respect conversations with an employee in the banking sector at the time about the reasons for the regulator's apparent lack of concern, confirmed that the banks had used extreme legal leverage in order to quench any attempts on the behalf of the regulatory authorities to reign in the growing risks of the banking sector. The informant claims this was done for example by the banks attending meetings with the Icelandic Financial Supervisory Authority (IFSA – FME in Icelandic) with abundance of lawyers on the bank's behalf while the FME only had a few representatives. Any complaints the FME had about the operations of the bank in question were met with so much legal entanglements and side issues that most likely the regulatory authority was simply drowned in paperwork while trying to prove its point. The information came from the informant early in the thesis process but was however substantiated a few months later when a former employee at the FME disclosed similar information<sup>79</sup>.

Elín Jónsdóttir who worked for the FME disclosed that she “remembered meetings where you sat at a long table in a conference room facing a massive group of lawyers and executives from the bank, all red in the face because of the FME meddling in their affairs”<sup>80</sup>. This was further substantiated in Kaarlo Jännari's report, a retired Director General of the Finnish Financial Supervision who was asked to assess the regulatory framework in Iceland as well as the function of the supervisory authority. He said:

---

<sup>78</sup> <http://eyjan.is/silfuregils/files/2009/05/merrill-lynch-2006-07-21.pdf>

<sup>79</sup> [http://www.mbl.is/mm/frettir/innlent/2009/01/08/raudir\\_i\\_framan\\_af\\_reidi/](http://www.mbl.is/mm/frettir/innlent/2009/01/08/raudir_i_framan_af_reidi/)

<sup>80</sup> Ibid.

The FME, too, was too small to supervise a complex banking system like that in Iceland. The powers of the supervisors were too limited, and the Nordic tradition of jurisprudence did not allow much leeway into discretion. The tycoons of the financial system could circumvent the underlying purpose of the regulations by sticking to the letter of the law with the help of diligent lawyers and complicated corporate structures.<sup>81</sup>

As a result it may not be so strange that Merrill-Lynch found little evidence of regulatory authorities' unease, since the FME had little leverage against the massive resources the banks used to defend themselves. It may also be pointed out that what worried Merrill-Lynch was not necessarily the massive creation of credit, but rather how it was spent on shares rather than on something that creates real value. In other words, the money was used to maintain the share price; in order to re-inflate the bubble instead of creating actual value for the economy. The regulator kept a lid on any discomfort with what was happening and as such seriously misjudged its role.

Additionally, the same informant stated that as early as spring 2008 Glitnir bank, who became the first one to fall, had systematically failed stress tests designed by the FME regulatory authority. However, the bank tidied up the reports to the FME, claiming the bank had passed the stress test and while the real information was obvious in appendixes that follow the stress tests it never raised the alarm in the FME. The financial authority never seems to have checked the data, but still confirmed the results claimed by the bank.

As late as August 14<sup>th</sup> there were reports in the media that all the Icelandic banks had passed recent stress tests<sup>82</sup> only to fall one after another a few days later.

As of yet there has been little news confirming what the informant claimed about the stress tests in early 2008<sup>83, 84</sup>. However some criticism has been directed at the stress tests themselves, as the tests do not cover liquidity tests, i.e. what will happen if liquidity suddenly decreases. Such arguments do however not refute what the informant said since the banks still did not pass the stress tests. Even

---

81 [http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari\\_2009.pdf](http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari_2009.pdf)

82 <http://www.vb.is/frett/1/46179/>

83 <http://www.ruv.is/heim/vefir/pistlar/sigrund/eldri/store807/item258441/>

84 [http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari\\_2009.pdf](http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari_2009.pdf)

though they may have fallen victim to the credit crises because of liquidity problems, they still would have failed the stress tests as well.

The main issue is the operating system for the financial environment in Iceland, and indeed in other countries in Europe. Under circumstances where every pillar that the financial sector is resting on is crumbling, the regulatory system will have a greater incentive to look the other way rather than react, because of the inherent laxness in the regulatory environment. Kaarlo Jännari found evidence of this when examining the regulatory framework the Icelandic banks operated in<sup>85</sup>.

The banks in Iceland became too large to fail, but they grew so large because of passporting allowed by the EEA agreement. What the informant, Elín Jónsdóttir and Kaarlo Jännari have in fact said is that the banks managed to move into a position where they could in effect regulate themselves by means of exerting influence through lawyers, extreme resources and manipulation, out of fear they might collapse.

### **Passporting**

The Single Market Policy of the EU concerns three main elements in finance. The first element, the liberalization of capital movements was achieved in the 1988 directive implementing Article 67 of the Treaty of Rome<sup>86</sup>. The second element created the “single passport” which allows banks carrying a licence for operations in one EU country to operate in any EU country<sup>87</sup>. This principle rests on mutual recognition. The third element concerns “home-country control”, which basically means that a bank licensed in a EU state can open a branch in another EU state which will be supervised by the home country<sup>88</sup>.

These three main elements spell out the core of the troubles Iceland is currently dealing with. Furthermore, Iceland had no say in the design of the legislation, as the country is not a member of the EU. The legislation made it possible for the

---

<sup>85</sup> [http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari\\_2009.pdf](http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari_2009.pdf)

<sup>86</sup> Baker, Andrew, Hudson, David and Woodward, Richard eds. (2008). *Governing Financial Globalization: International Political Economy and Multi-level Governance*. Routledge/Ripe. New York. P: 132.

<sup>87</sup> Ibid.

<sup>88</sup> Ibid.

banks to operate with limited supervision due to the limited capacity of the Icelandic regulatory authorities, which had not kept up with the growth of the banking sector.

The EU regulation is flawed in this respect and the burden of dealing with the consequences should therefore not rest solely with the population of Iceland, but rather with the EU. The initiatives were intended to level the playing field in finance but the actions of the British authorities have undermined the initiative as the British authorities will be forced to deal with other failing EU banks, and from outside of the EU, in the same way as they dealt with the Icelandic ones.

It can be argued with good reason that the crisis in Iceland is the offspring of a lax regulatory environment as developed by neo-liberal policies of the last twenty years. Baker et al maintain that some of the blame can be put on reversal of capital controls:

Regulatory policies in banking and finance have been profoundly transformed in the past fifteen or twenty years. National regulatory regimes have undergone radical change, putting an end to capital controls and all types of “exceptional” regulation where it existed.<sup>89</sup>

Coupled with the fact that Iceland has to introduce EU legislation through the EEA agreement, the small country is at the mercy of a monetary policy more suited to larger countries. Kaarlo Jännari also pointed this out:

Iceland has been a member of the European Economic Area (EEA) since 1994. In effect, EEA membership means that Iceland must incorporate the European Union directives and regulations in the financial field into its legal framework. Accordingly, Iceland has implemented EU legislation through its own laws and regulations.<sup>90</sup>

This explains to a degree the pressure on the Icelandic authorities as pertains accepting the deposit liabilities since the banks were operating under EU regulation, even though domestic interests were contrary to the European

---

89 Baker, Andrew, Hudson, David and Woodward, Richard eds. (2008). Governing Financial Globalization: International Political Economy and Multi-level Governance. Routledge/Ripe. New York. P: 130.

90 [http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari\\_2009.pdf](http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari_2009.pdf)



interests. Failure to comply would have jeopardised the whole European banking system.

Stories of regulatory authorities being powerless in reigning in the rapidly growing financial sector are typical of what happened previous to the banking crises. Banks had enormous resources and at the same time criticism of the business model the banks were using was mounting. In such a small community rumours circulate.

### **The System of Credit Creation and Role of the Economy**

In order to fully understand how the above came to happen it is necessary to examine the structure of the current economic order and how it has been influenced by theories that in one way or another promoted the crash the global financial system now faces.

Susan Strange once argued that it was not as much the economic liberalisation, e.g. the mobilising of resources, that has brought about the economic development of the last four decades, but rather the credit system that was responsible for the growth. A growth that ultimately cannot be sustainable and will always have bubbles bursting<sup>91</sup>.

It is the financial structure – the credit-creating mechanisms – that should take the main credit for the “golden years” of the 1950’s and 1960’s; and it was not the decline of American hegemonic power in the 1970’s and 1980’s so much as its misuse, exploiting the system rather than managing it, giving too much freedom and responsibility for credit creation to the banks, that was at the root of subsequent troubles. It was the pursuit of short-term instead of long-term national interest that sowed the seeds of monetary disorder and financial instability.<sup>92</sup>

This mirrors what happened in Iceland during the reign of the centre-right coalition governments of the last 20 years. The boom was created through credit it seems; the privatisation of fishing rights, banks, and various businesses that were government owned and through the subsequent real estate bubble that

---

91 Strange, Susan. (1994). States and Market. Pinter Publishers. London. P: 105.

92 Ibid.

grew rapidly as newly created money flowed into the economy. Too much liberalisation of the credit system in Iceland brought with it greater financial instability than the regulators imagined.

Davíð Oddsson recognises this in hindsight when he acknowledges that the regulatory authority was too weak to deal with the privatisation<sup>93</sup>. Furthermore Geir Haarde who succeeded Davíð Oddsson as chairman of the Independence Party stated that the gravest mistake during the reign of the Independence Party was indeed not taking care to ensure a broad ownership of the banking sector<sup>94</sup>.

But what was done in Iceland over the past decade has also been done elsewhere. For example, due to the exporting of inflation of the US in the 1970's, the number of dollar IOU's<sup>95</sup> went out of proportion, which ultimately leads to lack of confidence in the dollar and the subsequent and harsh devaluation of the currency<sup>96</sup>. The same thing happened in Iceland as a result of the credit creation of the banks.

However, the EU, the UK and the United States have all used the same system of credit creation, which basically means that this will probably be one of the most instrumental things in bringing Iceland back on track, as it will devalue the foreign debts of Iceland. Furthermore this explains why the current credit system will always have bubbles bursting.

An IOU is the current method of creating credit while gold reserves should represent the growth or return of investment and hence provide a more stable financial environment. That does not mean that a gold standard is necessary, merely that credit creation needs to reflect the real economy.

Basically, the economic boom in Iceland is not any different from the economic golden years in the 1950's and 1960's in the United States as both were the

---

<sup>93</sup> <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5231082/Former-Iceland-bank-governor-David-Oddsson-defends-role-in-meltdown.html>

<sup>94</sup> <http://www.vb.is/frett/34/53902/geir-h--haarde-bidst-afsokunar-a-mistokum-vid-einkavaedingu-bankanna>

<sup>95</sup> A dollar note was while the gold standard was effective essentially a statement of "I owe you" which is abbreviated IOU.

<sup>96</sup> Strange, Susan. (1994). *States and Market*. Pinter Publishers. London. P: 105.

result of decreasing barriers in credit creation. There is one slight difference though; in the case of Iceland it was mostly credit creation by private banks, meaning that the state itself had little debt, while in the United States it was mostly the state that created debt through the printing of more dollars<sup>97</sup>. This makes the aftermath of the crash all the more unfair as regards the people of Iceland. Fewer barriers may therefore lead to larger and more frequent economic crises, not the other way around.

Another popular trend of the current economic order that became a huge problem for Iceland was the business of carry trade. Carry trade basically involves borrowing money from a low yielding economy and investing it in a high yielding economy like Iceland. Interest rates in Iceland fuelled this business and typically money flowed into Iceland from countries like Japan and Switzerland where interests were extremely low. The result was, on top of too much credit creation, the addition of cheap credit as well.

Neo-liberal policies implemented, both in the global economy as well as in Iceland, are directly responsible. Waltz explains the workings of the system as follows: "Capital moves almost instantaneously into countries with stable governments, progressive economies, open accounting, and honest dealing, and out of countries lacking those qualities."<sup>98</sup> In other words, the *electronic herd* favours the countries that have rolled back the state<sup>99</sup>.

Unfortunately, there will always come a point when the electronic herd leaves. This point will come when either the government becomes unstable, the currency starts to lose its value for example because of too much consumption as was the case in Iceland, or if interest rates go down. As Waltz says:

The herd has no telephone number. When the herd decides to withdraw capital from a country, there is no one to complain to or to petition for relief. Decisions of the herd are collective ones. They are not made; they happen, and they happen because many investors individually make decisions simultaneously and on similar grounds to invest or to withdraw

---

<sup>97</sup> [http://en.wikipedia.org/wiki/United\\_States\\_public\\_debt](http://en.wikipedia.org/wiki/United_States_public_debt)

<sup>98</sup> Waltz, Kenneth N. (2008). Realism and International Politics. Routledge. New York. Pp: 231-232.

<sup>99</sup> Ibid.

their funds. Do what displeases the herd, and it will trample you into the ground. Globalization is shaped by markets, not by governments<sup>100</sup>

However, one can argue that the governments needs to clean up the mess when the market fails, and in that way this passage in fact summarises fairly well the effects of the credit crunch and the behaviour of electronic herd. The market fails because of laxness in regulation and the extreme freedom allowed currently in credit creation and the matter of fact is that the same thing can happen in every country with an overgrown banking system, a budgetary imbalance or political instability. In fact, Waltz argues that the money markets are the only aspect of the economic sector that has become truly globalised<sup>101</sup>. As a result the options of governments are limited in dealing with the electronic herd.

The Icelandic authorities are first and foremost guilty of conforming to what is already standard procedure within the EU and the United States. Strangely this argument can also be used for the reaction to the crises, in that Iceland necessarily needs to become a member of the EU in order to survive. Otherwise, it is claimed, Iceland will pay the price and become isolated.

In effect what happened was that Iceland got a vote of no confidence from the electronic herd and some maintain that the only way to re-establish confidence is by becoming a member of the EU, which would be the expected conformation.

It is on the other hand to a great extent the regulatory framework of the EU that is to blame for the mess Iceland is in. Strange commented on the supervision of banks:

The host authorities would make sure that its liquidity was sufficient and the parent that its solvency was secure. The trouble was that the difference between liquidity (the ability to find the cash to settle unforeseen liabilities) and solvency (the possession of assets adequate to cover liabilities) is clear conceptually but fuzzy in practise, for a failure of liquidity can soon lead to a failure in solvency.<sup>102</sup>

---

100 Waltz, Kenneth N. (2008). *Realism and International Politics*. Routledge. New York. Pp: 231-232.

101 Ibid.

102 Strange, Susan. (1994). *States and Market*. Pinter Publishers. London. P: 114.

Although the Icelandic banks had dug the hole they fell into themselves, through credit creation and intense debt, it can be argued that they were pushed in by the European banking regulations since the regulatory framework allowed the expansion of the banks, but without sufficient solvency. The solvency completely evaporated when the British government invoked the anti-terror legislation; the solvency already having been severely damaged after the fall of Lehman Brothers and the following closure of credit lines between Lehman Brothers and the Icelandic banks.

Although in terms of neo-liberal theory the aforementioned was indeed the result of the Washington Consensus the shift to what has been called the Post-Washington Consensus<sup>103</sup> may have come too late. Even though the Post-Washington Consensus has moved away from focussing mainly on economic growth to providing social safety nets and a market friendly economic system it can still be considered neo-liberal. Indeed it is argued here that the shift was merely the patching up of an already fragile system.

In other words, the social safety net is there to kick in when the economic system fails. The neo-liberal theories governing the economic system are too distant from the real economy and the social net and therefore it can be argued, and this view was supported by Chantal Mouffe, a Belgian political theorist in a lecture on June 13th in the University of Iceland<sup>104</sup>, that there is a growing gap between the two. There seems little sense in allowing creation of money through credit, what is in effect money printing, only to channel all the credit creation to various money products such as credit default swaps and what has now become sub-prime loans. The social safety net is there to protect the real economy in effect because the neo-liberal economy does not do that, as argued in Baker et al:

The assumed automatic and thereby near-mystical capacity of finance to create capital for “real” investment helps to endow finance with an

---

<sup>103</sup> Baker, Andrew, Hudson, David and Woodward, Richard eds. (2008). Governing Financial Globalization: International Political Economy and Multi-level Governance. Routledge/Ripe. New York. P: 42.

<sup>104</sup> Appendix: Chantal Mouffe 13th June Iceland\_1. Time: 37:30.

“unreal” set of characteristics. The pace of recent innovations in financial instruments, the transformation of finance into computerized information flows, and the sheer complexity of transactions would seem to justify the belief that finance is “unreal” and amazing. This is especially the case once finance is juxtaposed with the material “reality” of everyday economic life.<sup>105</sup>

The neo-liberal policies have opened up a system of credit creation that resulted in the Icelandic economy growing beyond the real economy very rapidly. As a result the Icelandic banks were forced to seek other means of funding when the credit markets closed, since they were “limited by their deposit and tax bases”<sup>106</sup> leading to the start of the Icesave accounts. The Icesave accounts, the subsequent fall of the banks and the burden of the Icelandic people are thus a direct result of decades of neo-liberal financial structuring and the marketisation of the financial system, especially the credit system. Both Marxist and Keynesian models of political economy support the view that through neo-liberal policies the current economic order has distanced itself too far away from what is generally known as the real economy<sup>107</sup>.

Another quote from Baker et al might offer an explanation of what happened next: “Of course, this process also involves losers from globalization, who still must be compensated through some sort of political process if stability – and even, if one dare say it, democracy – is to be maintained and extended.”<sup>108</sup> This may have been the case with Iceland as there is evidence that suggests Iceland was offered quick accession to European Membership if instead Iceland assumed responsibility of the Icesave accounts.

The aforementioned highlights how important it was for Iceland to accept the Icesave liabilities because distrust in one bank operating on the same basis as other banks within the EU would automatically destabilise the whole European banking network. The question remains what to do if another European bank

---

105 Baker, Andrew, Hudson, David and Woodward, Richard eds. (2008). Governing Financial Globalization: International Political Economy and Multi-level Governance. Routledge/Ripe. New York. P: 42.

106 Ibid. P. 45.

107 Ibid. P. 88.

108 Ibid. P. 47.

suffers the same fate as the Icelandic banks. It is likely that a paradigm shift is necessary to shift international finance away from the uniformity that poses systemic risks. One may argue that such a paradigm shift is already starting with nations trying to protect their own banking sectors; by increasing deposit guarantees and as well by opening up tax havens to scrutiny, what in itself could be considered a mercantilist move. The action taken is required to ensure that trust in the European banking sector remains.

In the aforementioned lecture on June 13th in the University of Iceland this assumption was supported by Chantal Mouffe, who argued, that the hegemony of the current economic order would be challenged<sup>109</sup> and replaced by a system of unity that respects diversity<sup>110</sup>. Mouffe also argued that the problems the global economy is facing today are the result of credit creation and the use of that credit for something other than real value creation<sup>111</sup>.

In relation to this it is an interesting perspective to note that the European economy is much more reliant on the banking sector than its counterpart in the United States. The European economy gets up to 90% of its financing from the banking sector while the United States economy gets only about 40% from banks<sup>112</sup>. Basically this means that while the American economy can still function rather well during a credit crunch the European economy will suffocate.

As concerns the effects of neo-liberal or mercantilist policies, Iceland's economy over the past two decades has many resemblances to the economy of the United States. For example, the effect of the move from mercantilism to neo-liberalism: In Underhill it is argued that there were two poles that highlighted the differences in mercantilist policies on one hand and neo-liberal on the other, that can be represented by Japan and the United States respectively<sup>113</sup>. Japan enforced a much more restraint monetary policy, with extreme savings and long-term interests as the main goal, while the United States fuelled consumption and

---

<sup>109</sup> Appendix: Chantal Mouffe 13th June Iceland\_1. Time: 28:10.

<sup>110</sup> Ibid. Time: 47:25.

<sup>111</sup> Ibid. Time: 28:10.

<sup>112</sup> <http://www.fxstreet.com/fundamental/analysis-reports/outside-the-box2/2009-06-05.html>

<sup>113</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P. 147.

increased credit with short-term interests in mind.

The United States was however the most active player in the global markets and under the leadership of the United States the growth in financial products was exponential. From \$15 billion in 1973 to \$1.4 trillion in 1998 the trade in foreign exchange markets managed to outnumber the trade in physical goods by 60-100 times<sup>114</sup>.

As a result it can be argued that the initial mercantilist policies of the Bretton Woods system where governments could manage the national economy, was undermined by increasingly unregulated markets as a result of the rise of neo-liberal policies in the late 20<sup>th</sup> century<sup>115</sup>. The aforementioned argument mirrors a popular view in Iceland today that unregulated markets cannot be trusted<sup>116</sup>. That may not be so surprising, given that Iceland went a route similar to the one the United States went, but with out the capability of printing such extravagant amounts of money without devaluating the currency massively.

Hence it has been argued here that neo-liberal policies have been instrumental in providing fertile grounds for the Icelandic meltdown. A system that initially was more based on mercantilist policies provided some limitations that may have managed to keep credit creation limited to value creation. It is argued here that such a system would have provided better stability in Iceland while liberalisation of the banking sector was carried out. The regulatory environment associated with the EEA agreement did however infringe the policy capacity of the Icelandic government since EU regulation is implemented to a great extent through the EEA agreement. However the governments over the last two decades in Iceland have pursued neo-liberal policies as well. Coupled with the speed of the Icelandic economy and the inherent regulatory slack, associated with neo-liberal ideology in Iceland, the regulatory authorities were a blunt instrument when it came to the growth of the banking sector.

When push came to shove last October the British authorities moved to safeguard their own interests. The next section will briefly examine the action

---

114 Ibid.

115 Ibid.

116 <http://www.marketoracle.co.uk/Article8728.html>



undertaken by the government of Gordon Brown, followed by a section that establishes the actions of the Icelandic government.

### ***The Actions of the British Government***

One of the main arguments of the Icelandic government concerning the reactions of the British government is that the meltdown could have been averted if Gordon Brown had not implemented the anti-terror legislation. The banks that had failed were Glitnir and primarily it was Landsbanki that caused concern in the UK because of the Icesave deposit accounts that had proved to be immensely popular. However, when the British government implemented the anti-terror legislation, it mainly hurt the strongest and only remaining bank, of the three big banks in Iceland; Kaupthing.

Kaupthing, in the UK, was fully supervised and guaranteed by the British regulatory authority and deposit guarantee scheme, because their businesses were subsidiaries rather than branches of the Icelandic parent company.

This occurred on October 8<sup>th</sup>, the day after Gordon Brown in effect described what had really happened when he said “we are freezing the assets of Icelandic companies in the U.K. where we can”<sup>117</sup>.

One can only imagine what effect such a statement has. Even though the very same thing happened when Lehman Brothers fell, it is unthinkable that Brown would have made the same statement about United States assets. The Icelandic ambassador to Britain Sverrir Gunnlaugsson, stated at the time that the statement was particularly damaging as Brown had by a single sentence turned all Icelandic businesses operating in the UK into rogue businesses or businesses non grata.

In fact the action of Brown underpinned the legal action the Icelandic government intended to take against the British authorities, but later dropped for no apparent reason. Gunnlaugsson said: “The Icelandic government believes that this was done without cause. If the bank had held, we would be in a far less

---

117 <http://www.bloomberg.com/apps/news?pid=20601102&sid=agEOsO.7RNdw&refer=uk>

dire situation than we are now. But the seizure led to the complete collapse of the parent bank”<sup>118</sup>. As a result, the already heavy blow to the Icelandic economy was followed through with another severe blow. The population was shocked to find that a friendly country would in effect kick a neighbouring country that was already down.

The action taken by the British was intended to safeguard interests of the UK. It was maintained by Darling and Brown that Iceland would not honour the deposit guarantees, although transcriptions of conversations between Darling and the Icelandic minister of finance showed otherwise<sup>119</sup>.

However, aside from that, it is interesting to note the reactions of the British government, which are typically realist, especially when considering they were dealing with what was at that moment, a maimed, fragile and small country. As an example, the British authorities themselves guaranteed local deposits only, just as the Icelandic authorities had done. This Britain did by guaranteeing deposits in the UK, but not on the Isle of Man where Kaupthing also had operations, supervised by the British FSA, financial regulatory authority, stating that they “are eligible for compensation neither from Britain nor from Iceland”<sup>120</sup>. The government on the Isle of Man blamed the British government for this and the action of the British government only goes to show that while the British government only guarantees UK deposits in full, they still claim it as unprecedented and illegal when Iceland does the very same thing<sup>121</sup>.

Gordon Brown himself should have considerable knowledge of the implications of such actions. Brown was British Chancellor of the Exchequer in the late 1990’s when he referred to “post-neoclassical endogenous growth theory”<sup>122</sup>. Currently holding the position is Alistair Darling; taking office in June 2007.

---

118 <http://www.indefence.is/lisalib/getfile.aspx?itemid=491>

119

[http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5005915.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5005915.ece)

120 <http://www.indefence.is/lisalib/getfile.aspx?itemid=491>

121 <http://www.theukgovernment.com/why-blame-the-uk-gov>

122 Baker, Andrew, Hudson, David and Woodward, Richard eds. (2008). Governing Financial Globalization: International Political Economy and Multi-level Governance. Routledge/Ripe. New York. P: 35.

Brown's experience as Chancellor of the Exchequer from 1997 to 2007 may have influenced his actions as Prime Minister in October 2008 as the Exchequer's role deals with all economic and financial matters of Britain. Testament to this may be the confusing communication of Darling and Brown with Icelandic authorities where Darling claimed that Icelandic authorities intended not to pay the deposit guarantees, contrary to what had been said by the Icelandic Minister of Finance as was documented in a leaked transcript of their conversation<sup>123</sup>. Indeed it seemed early on that Darling was acting on behalf of Brown rather than on his own although Darling was mostly criticised in a recent UK Parliament committee report on the incident<sup>124</sup>.

In that report the main reason for criticism is that it the legislation was used against Kaupthing, rather than the failing Landsbanki<sup>125</sup>. While Darling had to explain why the action was taken against Landsbanki, effectively demolishing the chances of the strongest Icelandic bank Kaupthing, Brown offered an explanation with a far broader base when he stated "We are freezing the assets of Icelandic companies in the UK where we can. We will take further action against the Icelandic authorities wherever that's necessary to recover the money"<sup>126</sup>.

The result was in effect the demise of Kaupthing bank, which had little to do with Landsbanki other than being Icelandic. This was in fact acknowledged by the Prime minister of Iceland Geir Haarde when he said: "This is very unfortunate, but this is something that happened partly as a result of action yesterday taken against Kaupthing by British authorities"<sup>127</sup>.

It is therefore clear that while the Icelandic Prime Minister and Brown did not differentiate between Landsbanki and other Icelandic firms as concerns the effects of the anti-terror legislation invoked, Darling did. This may be because

---

123

[http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5005915.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5005915.ece)

124

<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/402/40202.htm>

125

[http://blogs.telegraph.co.uk/daniel\\_hannan/blog/2008/10/24/gordon\\_brown\\_not\\_iceland\\_acted\\_like\\_a\\_terrorist](http://blogs.telegraph.co.uk/daniel_hannan/blog/2008/10/24/gordon_brown_not_iceland_acted_like_a_terrorist)

126 [http://news.bbc.co.uk/2/hi/uk\\_news/politics/7662027.stm](http://news.bbc.co.uk/2/hi/uk_news/politics/7662027.stm)

127 <http://www.telegraph.co.uk/finance/businesslatestnews/3167732/Financial-Crisis-Kaupthing-blames-collapse-on-British-Government.html>

Darling had been in talks with Iceland, the previous weeks before the collapse as he, and the Icelandic Minister of Finance, were trying to diffuse the volatile situation of the Icelandic banks operations in Britain<sup>128</sup>.

The fact that Darling knew the Icelandic banks were fragile weeks before the terrorist legislation was invoked supports the notion that Brown had in fact taken control of the situation from Darling, when all came tumbling down. This left Darling trying to explain why the anti-terror action was taken when he knew what was happening weeks before<sup>129</sup> – to which Darling answered that the Icelandic authorities had told him they intended not to honour the deposit guarantees. A statement that later turned out not to be true as was evident of the transcript that was leaked of Darling's and the Icelandic Minister of Finance conversation<sup>130</sup> as mentioned above.

It is easy to argue that the action of the British authorities is the source of realist policies. The main concern was with safeguarding the interests of the UK by cornering the Icelandic authorities, giving them little choice but to accept the terms of the British.

What prompted the actions were concerns over profits, competition and the survival of the British banking sector, which depended on trust in the deposit guarantee system. It can be argued that from a realist perspective the British government used economic coercion in order to safeguard its interests. At the point where this happened Iceland did not know that the British government itself would not honour deposit guarantees of accounts in the Isle of Man, in spite of the responsibility clearly being theirs according to their own arguments.

According to realist theorist Kenneth N. Waltz it is natural for governments to try to ensure equilibrium in relations to other countries<sup>131</sup>. The British government, it seems, did go beyond storing such equilibrium with unforeseen consequences

---

128 <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3263764/Financial-crisis-Alistair-Darling-suspected-Icelandic-banks-were-in-trouble-weeks-before-collapse.html>

129 Ibid.

130

[http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5005915.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5005915.ece)

131 Waltz, Kenneth N. (2008). Realism and International Politics. Routledge. New York. P: 73.

and with an interpretation of power that can only be to their own benefit. In other words, it is said by Waltz as pertains realism, that statesmen seek to have appropriate amounts of power in order to maintain the equilibrium<sup>132</sup> and as such that may have been the expectation of the Icelandic authorities. It was not the role of the Icelandic government to reach a compromise, as it is normally necessary for the greater power to give greater concessions<sup>133</sup>. This may be wishful thinking but strangely this still is what the population of Iceland expected from its allies and it probably reveals the political naivety of the Icelandic authorities more than anything else as regards the Icesave dispute. The Athenian speech from Thucydides<sup>134</sup> as quoted in Gilpin highlights the problems facing the *underdog* in international relations.

Until a state is pressed by others, it has little incentive to make concessions for the sake of peace; it gives highest priority to its own security and economic interests. However, once the challenging state is in a position to make its demands effective, it demands greater concessions than would have been deemed acceptable earlier; for its part, the challenged state now dares not meet these demands. Appeasement, it is feared, will only whet the appetite for still greater concessions. Perhaps the greatest task of the prudent and responsible statesman is to be able to judge when appeasement will and will not lead to peaceful resolution of disputes<sup>135</sup>.

A good example of this can be found during the days leading up to the crisis in Iceland when Britain's Financial Authority (FSA) is said to have offered to fast-track the Icesave accounts under FSA authority from the FME authority, by transforming the Icesave program into a subsidiary, for a payment of £200 million<sup>136</sup>. Although the claim was denied by the FSA there is evidence from a

---

<sup>132</sup> [http://books.google.is/books?id=eGqi\\_3X-8C8C&pg=PA55&lpg=PA55&dq=statesmen+seek+to+have+appropriate+amounts+of+power&source=bl&ots=fa\\_zhBTC7n&sig=eaJr57NHKjsnhKqy2O5HZBhljfo&hl=is&ei=JV5BSuOhCsr4-AbEjdm-CA&sa=X&oi=book\\_result&ct=result&resnum=1](http://books.google.is/books?id=eGqi_3X-8C8C&pg=PA55&lpg=PA55&dq=statesmen+seek+to+have+appropriate+amounts+of+power&source=bl&ots=fa_zhBTC7n&sig=eaJr57NHKjsnhKqy2O5HZBhljfo&hl=is&ei=JV5BSuOhCsr4-AbEjdm-CA&sa=X&oi=book_result&ct=result&resnum=1)

<sup>133</sup> Gilpin, Robert (1981). *War and Change in World Politics*. Cambridge University Press. New York. P: 207.

<sup>134</sup> Thucydides was one of the greatest Greek philosophers. He wrote the *History of the Peloponnesian War* where he analysed the political and ethical nature of war and peace.

<sup>135</sup> Gilpin, Robert (1981). *War and Change in World Politics*. Cambridge University Press. New York. P: 207.

<sup>136</sup> <http://icelandweatherreport.com/2009/03/british-fsa-denies-claims-by-former-landsbanki-owner-about-icesave-accounts-whats-the-deal.html>

transcript of a telephone call between the Icelandic and British finance ministers where the latter asks the first if Landsbanki received the liquidity required to move the deposits into a subsidiary to which the Icelandic ministers says they did not<sup>137</sup>. Interestingly one of the informants claimed in a conversation in March that it was the chairman of the Central Bank, Davíð Oddsson that denied the liquidity.

The aftermath is history. The British used anti-terror legislation to freeze the assets of the Icelandic banks, leading to the default of the largest Icelandic bank Kaupthing and the systemic crash of the Icelandic banking system. Afterwards Iceland had to make greater concessions, paying in full the Icesave accounts, an amount that is reputed to total from £2.32 to 4 billion<sup>138</sup>. In fact Gilpin agrees with the view of Thucydides as he claims that little has changed in the realms of international relations since Thucydides wrote his book, the fundamentals are still the same<sup>139</sup>.

In sum it has been argued that if the Icelandic government had been aware of realist tendencies the government would have been more likely to stand firm, thereby promoting the more self-centred power necessary to counter the British diplomatic machine.

A close examination of the Icelandic actions is therefore the next step of the analysis.

### ***The Actions of the Icelandic Government***

As has been argued in the previous pages the underpinnings of the Icelandic crisis were the result of two decades of neo-liberal policies that liberalised capital controls and privatised the banks, allowing for dramatic increase in credit creation that ultimately fuelled the following economic boom in Iceland. As a

---

137

<http://economictimes.indiatimes.com/News/International Business/Could Icelands crisis have been averted/articleshow/3718963.cms>

138 <http://www.ksfiomdepositors.org/category/tags/icesave>

139 Gilpin, Robert (1981). *War and Change in World Politics*. Cambridge University Press. New York. P: 7.

result the boom was the offspring of too much credit creation rather than creation of real value in the economy.

The neo-liberal economy concerns itself primarily with profits, dealing with competition and the subsequent survival of business. In Iceland it seems the regulatory authorities left the banks, the main catalyst of the Icelandic economy in the last decade, to their own devices. Consequently, the state was ineffective in providing the neo-liberal economy with the necessary restraints. In fact the Neo-Marxist Joachim Hirsch supported the state taking up an active role, as quoted in Baker, where he stated that the state is “the ideal collective capitalist”<sup>140</sup> and therefore the state is crucial in order for capitalism to function adequately.

Maybe this quote is one of the best in illustrating what many argue happened to the financial system in Iceland as well as globally. The state, failed in its role of providing economic coercion in order to make the system work efficiently. Undoubtedly, Hirsch’s argument would currently be met with little criticism in Iceland.

The many critics of the Icelandic model were mostly ignored during the build up of the banks. One of these critics was Robert Wade, Professor of Political Economy and Development at the London School of Economics and Political Science. In July 2008 he wrote an article for the Financial Times stating that Iceland would soon fall victim to its financial excess<sup>141</sup>. Wade wrote that the unwinding of the economy in Iceland was the “result of the excesses built up in this framework of light regulation – itself the product of hasty, though overdue, privatisation.”<sup>142</sup>

On the other hand prominent neo-liberal academics such as Professor Frederic Mishkin at Columbia Business school and Professor Richard Portes at London

---

140 Baker, Andrew, Hudson, David and Woodward, Richard eds. (2008). Governing Financial Globalization: International Political Economy and Multi-level Governance. Routledge/Ripe. New York. P: 32.

141 [http://www.ft.com/cms/s/0/061070b8-4781-11dd-93ca-000077b07658.html?nclick\\_check=1](http://www.ft.com/cms/s/0/061070b8-4781-11dd-93ca-000077b07658.html?nclick_check=1)

142 [http://www.ft.com/cms/s/0/061070b8-4781-11dd-93ca-000077b07658.html?nclick\\_check=1](http://www.ft.com/cms/s/0/061070b8-4781-11dd-93ca-000077b07658.html?nclick_check=1)

Business School were very supportive of the Icelandic model highlighting that after all the Icelandic banks had managed to avoid the sub-prime crises<sup>143, 144</sup>.

As concerns the actions of the Icelandic government to the crash and the reaction to the British government one must start with the overtaking of the banking sector in Iceland by the government and the financial authority (FME).

Iceland was facing a systemic failure of its banking system, something that is unheard of in a modern western economy. The failure of the economy is argued to have been the result of laxness in regulation due to liberalisation and privatisation.

When the banks failed the government was forced to take action in order to ensure the banks, and the economy, could still function. If no action would have been taken the credit system would have crashed and the population would have been forced to enter a barter economy.

The government has maintained that it was justifiable to guarantee deposits in Iceland only to the full in order to avoid a barter economy. The government has furthermore stated that the EU directive 94/19/EC on deposit guarantees is not intended to function in a systemic breakdown and this view has been countered by all the other parties of the dispute, going to such extremes as withholding the IMF program until Iceland acknowledged full responsibility and relinquished the right to take the dispute to the European Court of Justice. The directive clearly states the following:

Whereas this Directive may not result in the Member States' or their competent authorities' being made liable in respect of depositors if they have ensured that one or more schemes guaranteeing deposits or credit institutions themselves and ensuring the compensation or protection of depositors under the conditions prescribed in this Directive have been introduced and officially recognized.<sup>145</sup>

---

143

<http://www.vi.is/files/555877819Financial%20Stability%20in%20Iceland%20Screen%20Version.pdf>

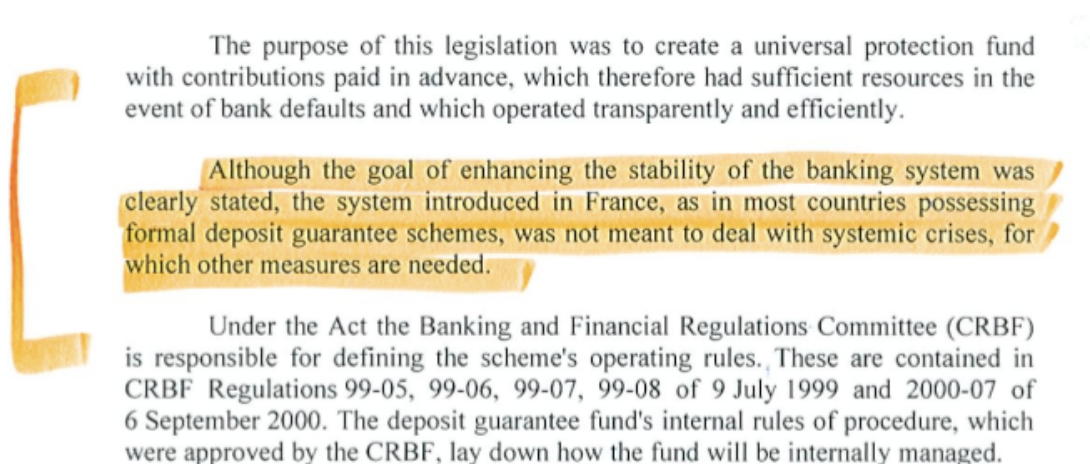
144 [http://chamber.is/news.asp?id=555&news\\_ID=603&type=one](http://chamber.is/news.asp?id=555&news_ID=603&type=one)

145 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML>



The deposit funds operate on a post-payment principle and therefore they are underfunded when deposits are growing rapidly. For this reason the Icelandic deposit guarantee fund did not have adequate assets to deal with the minimum guarantees. However, at the discretion of the government, it can step in and fulfil the minimum amount guaranteed of €20.887. If funding is not enough, there is no legal requirement for the government to cover the difference as the fund is privately funded and in this case guarantees privately owned banks.

Furthermore, a report from the year 2000 executed by French ministries, *Rapport de la Commission bancaire pour l'année 2000*, concluded that: "Although the goal of enhancing stability of the banking system was clearly stated, the system introduced in France, as in most countries possessing formal deposit guarantee schemes, was not meant to deal with systemic crises, for which other measures are needed."<sup>146</sup>



**Figure 2: English version of *Rapport de la Commission bancaire pour l'année 2000*.**

One of the findings of the French report is that under the circumstances of a systemic breakdown of the banking sector other measures are needed and therefore the deposit guarantee funds are not intended to cover all deposits in the same way as when one bank falls. The reason is simple. The deposit funds cannot do that since they are post-funded and privately run without state

---

146 See Appendix on CD: *skyrsla\_commission\_bancaire\_france\_bls\_185\_ensk\_utgafa*

backup. Furthermore it can be argued that the EU can be responsible for implementing the faulty directive.

It is also worth mentioning that the current president of the European Central Bank is Jean-Claude Trichet who was among the people that wrote the French report<sup>147</sup>. The European Central Bank was therefore well aware of the problem concerning the deposit guarantee system.

Nonetheless, Percy Westerlund, EU's ambassador towards Iceland and Norway wrote on his website in response to what he called a "profound misunderstanding" that:

One might add that the Icelandic government had the responsibility to compensate foreign Icesave depositors regardless of how you interpret the directive. This is because the Icelandic government announced it would offer domestic depositors guarantees for deposits in Icelandic banks. There is little doubt that there is then an obligation in principle to offer depositors in these banks' foreign branches equal treatment. Non-discrimination is a fundamental principle for the internal market, thus also for the EEA.<sup>148</sup>

Westerlund's argument is weak considering the actions of the British government as pertains deposit owners on the Isle of Man, as has been explained before but is explained in detail in the next paragraph, and especially so when the conclusion of the French report is kept in mind.

One of the main claims of the British authorities is that since the Icelandic government guaranteed all deposits in Iceland in full it should have done the same in the UK. This, the Dutch and British governments, have said, is discrimination, and illegal according to EU law in breach of the EEA agreement article 4. This view is supported by article 7 of the Treaty of Rome and can be seen in the consolidated version of the treaty establishing the European

---

<sup>147</sup> [http://en.wikipedia.org/wiki/European\\_Central\\_Bank](http://en.wikipedia.org/wiki/European_Central_Bank)

<sup>148</sup> <http://blogg.esb.is/?p=61>

Community where it says “any discrimination on grounds of nationality” is illegal<sup>149</sup>.

Iceland has denied such allegations pointing to the fact that this was done in order to save the economy and there was no discrimination by nationality although it could be argued that it was geographical. EU law demands that similar situations should be treated in the same way and therefore it is quite interesting to note that the government of Gordon Brown did exactly the same thing as the Icelandic government as regards the people on the Isle of Man as already explained before.

A closer examination reveals that Iceland did not discriminate on grounds of nationality, and neither did the UK with regard to the Isle of Man. Icelanders with deposits in the Icelandic banks operating in the UK lost money as well as the people of Britain on the banks failure. In addition foreigners with accounts in Iceland had their deposits guaranteed to the full, regardless of nationality. The effect is discrimination on the grounds of geography, carried out in order to avoid a total disaster in Iceland.

Darling has stated that deposit owners on the Isle of Man, are not covered by the British deposit guarantees<sup>150</sup> even though the Banks operating there were supervised by the FSA, as explained before. Therefore it could be argued that the objective of the British authorities was simply to minimise costs, whereas the objective of the Icelandic authorities was to enforce the legitimate objective of maintaining a functioning banking system, a much stronger argument in international law.

On 17<sup>th</sup> June, the national day of Iceland, news came of some details in the Icesave settlement with the British and Dutch governments. Three issues were highly controversial and show that Iceland has in fact been put against the wall, been pressured, by the withholding of vital foreign currency, to accept the following terms; a waiver of sovereign immunity, all disagreements as pertain

---

149 [http://eur-lex.europa.eu/en/treaties/dat/12002E/htm/C\\_2002325EN.003301.html](http://eur-lex.europa.eu/en/treaties/dat/12002E/htm/C_2002325EN.003301.html)

150 <http://news.bbc.co.uk/2/hi/business/7982277.stm>

the details of the settlement should be solved in British courts and finally that all assets of the state will be accessible to the creditors if Iceland fails to pay<sup>151</sup>.

The next section of the analysis will therefore deal with the role of the IMF in the dispute and the interactions between the IMF and the Icelandic government.

---

<sup>151</sup> <http://robertvidar.blog.is/blog/robertvidar/entry/898566/>

### ***Reforms and Politics: The Interactions Between the IMF and Iceland***

After examining the actions of the British and Icelandic governments during the financial crisis in Iceland it is necessary to examine more closely the role the IMF has had immediately after the crash and indeed after the IMF program was signed last autumn. Specifically it is worth investigating if the allegations directed at the IMF are unfounded or not as regards the IMF being the debt collector of global finance.

In Iceland, right from the start of IMF's involvement in the crisis, there has been loud criticism from the people of Iceland, many of which claim the IMF's only role is to rob the people and the country of its resources<sup>152, 153</sup>. Michael Hudson and John Perkins in fact claimed this in interviews in the Icelandic talk show *Silfur Egils* where they said that Iceland would be robbed of its natural resources because of the dictatorship of the IMF<sup>154, 155</sup>. Such claims arise despite Iceland having successfully paid off an IMF loan in the 1980's. Various other pressing issues that were addressed previously in the introduction and the following chapters will be dealt with here. The main theme though will concern pressure, either from the IMF directly or indirectly on the government of Iceland to accept the Icesave liabilities. Also if indeed the IMF has been pressured, and then why that pressure was applied and what does succumbing to the pressure mean as pertains the credibility of the IMF and the current economic order. Furthermore, it is crucial to examine how the government of Iceland reacted. Did it use the opportunity to further a EU accession agenda? Did the government give in, and indeed if it did, was that because of a political naivety, incompetence or something else?

---

<sup>152</sup> See interview (in appendix: *Silfur Egils\_John Perkins*) with John Perkins, the author of: *Confessions of an Economic Hit Man*.

<sup>153</sup> See interview (in appendix: *Silfur Egils\_Michael Hudson*) with Michael Hudson, an economist who has criticised, among other things, debt accumulation.

<sup>154</sup> See interview (in appendix: *Silfur Egils\_John Perkins*) with John Perkins, the author of: *Confessions of an Economic Hit Man*.

<sup>155</sup> See interview (in appendix: *Silfur Egils\_Michael Hudson*) with Michael Hudson, an economist who has criticised, among other things, debt accumulation.

### Has The IMF Been Reformed?

In Ngaire's book *The Globalizers* there is already some cause for alarm concerning the half of the Icelandic population that is sceptical of the intentions of the IMF. The book argues that; "the work of the Fund and Bank is affected by the preferences of their most powerful members, by their own bureaucratic motives, and by politics within countries with whom they work."<sup>156</sup> This is precisely what a number of politicians from the left and the right in Iceland have stated. As an example the current minister of finance, Steingrímur J. Sigfússon of the Left Green party, who at the time of the crash was a member of the parliamentary opposition, stated late in October that he was against the IMF being brought in. He has since suddenly changed his mind, after becoming minister of finance in the current coalition government, and has instead become one of the strongest advocates of Iceland accepting the Icesave liabilities and for cooperation with the IMF to dissolve the crisis<sup>157</sup>.

Moreover, the same applies to the politicians in the former ruling party, the Independence party. Most notably it has been the current chairman of the Independence party, Bjarni Benediktsson, who has criticised the Icesave agreement<sup>158</sup>. Benediktsson however realises that without an Icesave settlement the IMF is not likely to continue the IMF program and therefore it could be argued that he has shifted position as well as the Left Green chairman Sigfússon, to an opposite pole. Benediktsson is now critical of the agreement but was previously in favour.

Such concerns that IMF programs may be used to coerce debtor countries may not be unfounded, as Ngaire suggests there is little in the actual founding articles of the IMF that suggest the IMF is supposed to do other than help countries in distress.

A closer examination of the IMF reveals that there are three main parameters that define how the IMF works: First of all, particular agencies within powerful

---

<sup>156</sup> Woods, Ngaire. (2006). *The Globalizers: The IMF, the World Bank, and Their Borrowers*. Cornell University Press. New York. P: 179.

<sup>157</sup> <http://this.is/nei/?p=4534>

<sup>158</sup> <http://www.pressan.is/Vidskipti/Lesavidskiptafrettir/bjarni-ben-thingmenn-eru-ekki-ad-fara-stadfesta-samninginn>

nations, such as the US Treasury can influence policies since they are large contributors to the budget<sup>159</sup>. Secondly, economic and political ideology can influence IMF policies as is illustrated by the influence of the initial mercantilist Washington Consensus and the later more neo-liberal version of the Washington Consensus that preceded the Post-Washington Consensus<sup>160</sup>. Finally, the staff of the IMF may be influenced by office politics since it may require great conviction to develop a program that is location specific and therefore serves the needs of the aid receiving country fully<sup>161</sup>. In the last case it is probably far better for the staff of the IMF to replicate already used programs and thereby shift responsibility to the whole of the IMF instead of only the task force dealing with the recipient country<sup>162</sup>.

In other words, it is probably easier in terms of accountability for the IMF staff to reuse programs that have already been approved, rather than tailoring a new IMF program to every specific case, since that demands a much greater effort from the IMF staff and implicates the staff more in the result and accountability<sup>163</sup>.

To its own defence the IMF can however point out that each government enters an IMF agreement as collaboration between the two parties. In other words, the programs implemented are based on the cooperation of the IMF and the recipient country's government and intended to move the country in the right direction, away from financial distress. In relation to this there are two main forces at work:

On the other side of the work of the IMF and World Bank lie member governments with whom they must work. Developing, transition, and emerging economies all borrow from the institutions [...] Fund and Bank coerce or persuade able and willing interlocutors in these countries. In respect of needy governments, they have considerable bargaining power.

---

<sup>159</sup> Woods, Ngaire. (2006). The Globalizers: The IMF, the World Bank, and Their Borrowers. Cornell University Press. New York. P: 180.

<sup>160</sup> Ibid.

<sup>161</sup> Ibid.

<sup>162</sup> Ibid.

<sup>163</sup> Czempiel, Ernst-Otto and Rosenau, James N. (1989). Global Changes and Theoretical Challenges. Lexington Books. Massachusetts/Toronto. Pp: 179-181.

Each institution can lend or withhold resources, disburse or suspend payments, and impose various forms of conditions.<sup>164</sup>

The quote supports the criticism that has been directed at the IMF to a degree, in that the IMF has considerable leverage in persuading governments. The agreement itself however is based on a mutual agreement and the IMF can therefore usually point to that agreement and therefore share the accountability with the government involved. But once again, such methods on behalf of the IMF are still reminiscent to what the IMF has been criticised for in other IMF programs such as the same programs for all developing countries<sup>165</sup>.

But why should the IMF disburse or suspend payments on the basis of conditions? It could possibly be because the major countries that contribute to the IMF funds have much at stake in IMF programs being implemented successfully. This is one of the main reasons the IMF has been called the global debt collector<sup>166</sup>. A common view of the IMF is reflected in this statement:

The international monetary system is driven and energized by global capital markets. But those markets create externalities and sometimes fail in ways that produce systemic risks, irrational behaviour, contagion, spillovers from other countries' bad policies, and currency crises. All of these give governments strong reasons to cooperate in order to mitigate their vulnerability. This implies several roles for the IMF.<sup>167</sup>

Through countries that are net contributors to the IMF's funding the global capital markets may be the most instrumental in influencing the IMF in proposing structural amendment policies that may go against the founding articles of the IMF.

As concerns Iceland it seems the IMF was deliberately held back until negotiations had started regarding the Icesave accounts. The first part of the IMF loan was not handed over to the Icelandic authorities until the government had clearly stated that it intended to accept full responsibility for the Icesave

---

<sup>164</sup> Ibid. P. 181.

<sup>165</sup> <http://www.eurodad.org/whatsnew/articles.aspx?id=3261>

<sup>166</sup> <http://www.dollarsandsense.org/blog/2009/05/imf-as-big-banks-debt-collector.html>

<sup>167</sup> Czempiel, Ernst-Otto and Rosenau, James N. (1989). Global Changes and Theoretical Challenges. Lexington Books. Massachusetts/Toronto. P: 186.



accounts<sup>168,169</sup>. This meant the government needed to step in and finance the deposit guarantee fund in Iceland, even though there is no requirement for the state to do so in the EU legislation<sup>170</sup>. Otherwise the IMF loan would not have come through. It seems, as concerns Iceland's relations with Britain, Holland and Germany during the IMF negotiations, that the IMF program was indeed withheld during negotiations<sup>171</sup>. Iceland however was willing to put the dispute into the hands of the European Court of Justice<sup>172</sup> but that approach has been resolutely rejected by the members of the EU that are involved in the dispute. Interestingly, on June 24<sup>th</sup> it was revealed that in the initial stages of negotiations the disputing countries were willing to put the dispute to a court of arbitration<sup>173</sup>. This route was however ruled out later by the EU, as it would have jeopardized the stability of the European deposit guarantee system<sup>174</sup>. Clearly Iceland was sacrificed in order to maintain that stability.

In this dispute the IMF therefore does not seem to be acting any differently than in previous IMF agreements. It is still mainly the interests of the net contributors to the IMF that govern the IMF, and therefore by extension the recipient countries.

An interesting aspect of this argument is that it has been claimed that the IMF has reversed its policies from the 1980's, a period when it only assisted countries that had first paid off their debts to foreign creditors<sup>175</sup>. It can be argued, that in the case of Iceland this practice has been taken up again - if it was ever dropped that is - indeed putting the IMF in the role of a global debt-collector.

This is important since the Icesave deposit dispute will have grave consequences for Iceland, consequences that are on a par with the reparations of Germany

---

<sup>168</sup> <http://www.icenews.is/index.php/2008/11/11/imf-loan-to-iceland-turned-down/>

<sup>169</sup> <http://www.icenews.is/index.php/2008/11/07/iceland-awaits-imf-decision-on-monday/>

<sup>170</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML>

<sup>171</sup> <http://www.brettonwoodsproject.org/art-562981>

<sup>172</sup> <http://www.guardian.co.uk/commentisfree/2008/nov/11/iceland-creditcrunch>

<sup>173</sup> <http://eyjan.is/blog/2008/11/13/deilur-icesave-atti-ad-leysa-med-gerdardomi-embattismenn-esb-breyttu-forsendunum-einhlida/>

<sup>174</sup> Ibid.

<sup>175</sup> Czempiel, Ernst-Otto and Rosenau, James N. (1989). *Global Changes and Theoretical Challenges*. Lexington Books. Massachusetts/Toronto. P: 186.

after the Versailles agreement after World War I<sup>176</sup>. Germany's reparations after World War I totalled 85% of GDP of Germany while only the Icesave settlement will exceed 100% of Iceland's GDP, and that is without other costs of the financial melt down<sup>177</sup>.

As a result it is quite controversial that it is supposedly the role of the IMF to promote general welfare of the recipient countries: "A further advisory role for the IMF in financial crises relates to the institution's duty to ensure that governments are not forced to take measures destructive of national prosperity (to quote the Articles of Agreement of the IMF)."<sup>178</sup> It seems clear that Iceland has suffered a very realist approach by the EU countries, executed with the help of the IMF, and that Iceland failed to react realistically itself and simply gave in, in order to secure the IMF loan.

### **Neo-liberalism, Mercantilism and Credibility**

Concerning the more economic aspects of the thesis' theory it is important to mention that the EU handled the credit crunch by reshuffling money from the state to the private sector in so called *bailouts*. Thus a bailout was provided for various European banks, starting with Northern Rock, HBOS, Royal Bank of Scotland, Bradford & Bingley<sup>179</sup>, Lloyds TSB<sup>180</sup>, German banks IKB and Sachsen LB<sup>181</sup>, as well as the Belgian Dexia bank and the Benelux bank Fortis<sup>182</sup>.

It can hardly be considered very neo-liberal to bailout failing banks. In fact the moves of individual European countries have proved to be highly controversial, criticised by the EU itself<sup>183</sup>, and generally thought to be a clear cut example of profits being privatised and the losses socialised which is obviously not the aim of neo-liberalism or even capitalism for that matter.

---

<sup>176</sup> <http://www.voxeu.org/index.php?q=node/2549>

<sup>177</sup> Ibid.

<sup>178</sup> Czempiel, Ernst-Otto and Rosenau, James N. (1989). *Global Changes and Theoretical Challenges*. Lexington Books. Massachusetts/Toronto. P: 187.

<sup>179</sup> <http://www.time.com/time/world/article/0,8599,1848243,00.html>

<sup>180</sup> <http://news.bbc.co.uk/2/hi/business/7666570.stm>

<sup>181</sup> <http://www.eurointelligence.com/Article3.1018+M5d6173a62e1.0.html>

<sup>182</sup> Ibid.

<sup>183</sup> <http://www.washingtonpost.com/wp-dyn/content/article/2009/03/01/AR2009030100389.html>

What happens in a bailout is that instead of investors and creditors losing their money as the neo-liberal financial sector supposedly wants, the money to be lost is transferred from the state, through various structural means such as a state backing of debt, direct funding or simply through taxes, to the private banking sector. This is what has been happening in the UK since the government took over the management of Northern Rock, and this has also happened in many other European countries such as Germany and France<sup>184</sup>. Whether the EU will devise a complete bailout plan for the union or not, has also been the subject of constant speculation.

In Iceland's case however the government ruling at the time of the crash decidedly refrained from any such measures stating clearly that the state would not bail out irresponsible bankers and their creditors. Nevertheless, what the start of the negotiations with the IMF entailed, is in effect that the IMF, and the European countries that had the greatest interests vested in the Icelandic banks, demanded that the state bailed out the creditors. Iceland continued in its neo-liberal response to the crisis, but was stopped and turned around completely.

The IMF therefore becomes the watchdog of Europe's transnational business elite and international finance<sup>185</sup>. In other words, while everything was going well the neo-liberals emphasised the free market principles, which were enthusiastically adopted by Icelandic coalition governments of from 1990 and the same applied to the EU, generally speaking.

Conversely, when things became troublesome European governments immediately shifted to more mercantilist policies, first and foremost trying to protect their own banks, such as Brown's government did in the case of Northern Rock. The credibility of the result of such actions is weak since the UK has been one of the most passionate followers of the removal of barriers to fuel its financial sector, the City of London. The actions taken by the bailout governments of Europe are often supported by arguments of necessity because

---

<sup>184</sup> <http://www.npr.org/templates/story/story.php?storyId=95408444>

<sup>185</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. Pp. 309-311.

of social consequences, in other words the banks have become what is typically cited as; *too large to be allowed to fail*<sup>186</sup>.

In fact, the efforts of Brown's government in the UK when trying to save the banks, prompted the following remark from Vince Cable, the economic spokesman for the Liberal Democrats: "Three of the five biggest banks in the world are British-based and protected. The UK is too small to save the banks, which are too big to fail. It is not too far from the truth to say we are facing "Reykjavik on the Thames" [...] The banks are making a private profit and a social loss."<sup>187</sup> Consequently the different responses of the Icelandic and British governments to failing banks are quite interesting as pertains the theory and even more so when the British government exercises its influence through the IMF to make the Icelandic government adopt the British way of dealing with crises.

When the actions of the British government are examined it becomes clear that they are motivated out of fear of the transnational business elite that has advocated the rolling back of the state. While according to the rulebook of neo-liberalism, businesses should simply go into bankruptcy if they are not run decently; they have become too large to be allowed to fail.

The root of this problem can be traced to the system of international finance, where the electronic heard quickly and efficiently moves into whatever country provides the best circumstances for money. Hence, if the British government does not bailout the business elite, it will simply go elsewhere, resulting in London literally becoming *Reykjavik on the Thames*.

As a result it can be argued that the current system, which is largely based on neo-liberal policies, as has been argued in previous sections, is not working adequately. Simply put, it works during the boom, but not during the bust. Consequently the whole financial system has credibility issues that will necessitate changes in the system; and if the crisis becomes serious enough on global scale it might even necessitate a paradigm shift.

---

<sup>186</sup> [http://www.politics.co.uk/news/economy-and-finance/banks-too-big-to-fail--\\$1265784.htm](http://www.politics.co.uk/news/economy-and-finance/banks-too-big-to-fail--$1265784.htm)

<sup>187</sup> Ibid.

Since the decline of mercantilism started in 1979<sup>188</sup> the global financial sector has been allowed to grow too large because the reforms that followed, were intended to pave the way for global finance and international banking. The move was supported by both the United States and the EU and the pressure Iceland suffers at the hand of the IMF is therefore rooted in mercantilist policies taking the back seat to neo-liberal policies. However it is the influence of realist theory that manipulates the actions of the governments as they face the choices of the electronic heard.

### **The Responses to IMF Pressure**

As the pressure exerted through the IMF has been examined above it is also imperative to observe the interactions of the British and the Icelandic governments with the IMF as the main point of friction.

The actions of the British can to a degree be explained by fundamental realist moves where the British try to maintain, or safeguard their interests and position. However there are indications that Brown miscalculated the situation and over reacted, as there are many implications that arise from invoking anti-terror legislation against a friendly nation. This applies not only as regards international relations but also economically.

It has been explained previously in the thesis that other European countries could easily suffer similar fate to Iceland and the UK must either not discriminate in its handling of a similar crisis, or face the consequences for have discriminated against Iceland. Waltz provides an interesting perspective on this:

Neorealists, rather than viewing power as an end in itself, see power as a possibly useful means, with states running risks if they have either too little or too much of it. Weakness may invite an attack that greater strength would dissuade an adversary for launching. Excessive strength may prompt other states to increase their arms and pool their efforts. Power is a possibly useful means, and sensible statesmen try to have an appropriate amount of it. In crucial situations, the ultimate concern of

---

<sup>188</sup> Baker, Andrew, Hudson, David and Woodward, Richard eds. (2008). Governing Financial Globalization: International Political Economy and Multi-level Governance. Routledge/Ripe. New York. P: 134.

states is not for power but for security. This is an important revision of realist theory.<sup>189</sup>

However there are indications that Brown's actions were not merely intended to provide security, but rather to divert some negative attention from him, as he has been immensely unpopular in the UK<sup>190</sup>. The actions, were in other words, designed to provide his own "Falklands moment"<sup>191</sup>. Undoubtedly Brown realises that even though the free market is supposed to take care of its own business, it will still be the state, or the government, that is held accountable when the economy falters and the currency depreciates - as has happened in both the UK and Iceland<sup>192</sup>.

A good case in point would be how the coalition government of the economic crash in Iceland was similarly blamed even though most evidence suggested that it was the banks that were working against the Icelandic economy and the currency the ISK. In other words, the government does what little it can to manage the exchange rate so it serves the interests of the nation but has limited resources in managing the financial sector, especially when it has outgrown the total economy. Therefore the financial sector can easily manipulate the currency and the government will still be blamed. This situation is exaggerated because of how difficult it is for governments to deal with international financial businesses. In the words of Strange: "In a nutshell, one may say that the markets are predominantly global, while the authorities are predominantly national."<sup>193</sup>

In relation to the pressure the IMF is exerting it is interesting to note that if Iceland were to deal with the crisis from the perspective of national interests it would go against the interests of the predominantly global markets. As a result Iceland would be considered coming close to an economic rogue state and as a result become more or less isolated in the international society.

---

<sup>189</sup> Waltz, Kenneth N. (2008). *Realism and International Politics*. Routledge. New York. P: 79.

<sup>190</sup> <http://www.dailymail.co.uk/news/article-1179918/Brown-unpopular-PM-polling-began-half-want-now.html>

<sup>191</sup>

[http://www.timesonline.co.uk/tol/comment/columnists/guest\\_contributors/article4943712.e](http://www.timesonline.co.uk/tol/comment/columnists/guest_contributors/article4943712.e)

<sup>192</sup> Strange, Susan. (1994). *States and Market*. Pinter Publishers. London. P:12.

<sup>193</sup> Ibid. P. 91.

Gordon Brown himself has even given evidence of the manipulation of the IMF in this case:

The first responsibility is for the Icelandic authorities to pay up – and that is why we are in negotiations with the IMF and other organisations about the rate at which Iceland can repay these losses that they are responsible for.<sup>194</sup>

The IMF in Iceland has however robustly denied that the IMF is collecting debts for the British government.

It is quite difficult to completely refute claims that the IMF is indeed mainly collecting debt for creditors, as there are various indications to this being the case, not only as concerns the IMF but also as concerns the EU - which of course is very influential in the IMF through the membership of the Union countries. As an example it suffices to mention that the turmoil in Eastern Europe has already prompted criticism towards the EU as well as the IMF as Michael Hudson writes on how loans are conditionalised, in this case by Joaquin Almunia of the European Commission in a letter to the Latvian government on 26<sup>th</sup> January:

Extended assistance is to be used to avoid a balance of payments crisis, which requires ... restoring confidence in the banking sector [now entirely foreign owned], and bolstering the foreign reserves of the Bank of Latvia [...] financial assistance is not meant to be used to originate new loans to businesses and households [...] it is important not to raise ungrounded expectations among the general public and the social partners, and, equally, to counter misunderstandings that may arise in this respect. Worryingly, we have witnessed some recent evidence in Latvian public debate of calls for part of the financial assistance to be used inter alia for promoting export industries or to stimulate the economy through increased spending at large. It is important actively to stem these misperceptions.<sup>195</sup>

If these are the conditions demanded by the EU it is not unreasonable to assume that similar conditions have been demanded by the European Countries that have interests in Iceland, with the help of the IMF. In the case above the interests involved are mainly those of Swedish banks so the situation is comparable, apart from the fact that Latvia is a member of the EU and Iceland is not.

---

<sup>194</sup>

[http://www.youtube.com/watch?v=ivmYGIFu\\_bg&eurl=http%3A%2F%2Fwww.eyjan.is%2Fsilfuregils%2F&feature=player\\_embedded](http://www.youtube.com/watch?v=ivmYGIFu_bg&eurl=http%3A%2F%2Fwww.eyjan.is%2Fsilfuregils%2F&feature=player_embedded)

<sup>195</sup> <http://www.globalresearch.ca/PrintArticle.php?articleId=13407>

However there are more factors at play as concerns the IMF dealings of Iceland. One of the major factors could be the aspirations the Social Democrats in Iceland have for EU membership. Some have argued that the Social Democrats have sided with the creditor countries, against the interests of Iceland, in order to promote its EU agenda.

Bjarni Benediktsson, the current leader of the Independence party maintains that the EU, as a whole, pressured Iceland into reaching an agreement with the UK over the Icesave deposits before the EU gave its consent for an IMF program in Iceland<sup>196</sup>. Moreover, he also stated that the EU would not take Iceland's application for EU membership seriously until Iceland has reached an agreement with the UK authorities and settled the accounts<sup>197</sup>. In other words he argues that it is very likely that the UK would oppose Iceland's membership if Iceland were not to accept responsibility for the Icesave accounts.

The hindrance posed by the EU, according to Bjarni Benediktsson, is therefore twofold; neither an IMF loan nor EU membership would be possible without an Icesave agreement. Given that other evidence seems to suggest that the social democrats in Iceland have used the opportunity to further its own EU membership agenda, it seems likely that Iceland will either be isolated in the international arena if the country denies responsibility of the accounts, or Iceland will pay a very hefty price for becoming a member of the EU. The price for the EU membership will be at least over half of GDP and could even outweigh the reparations paid by Germany after World War I<sup>198</sup> as previously mentioned.

To summarize it has been argued here that the IMF has indeed been used as tool of the European countries that have interests at stake in the Icelandic economy. Furthermore, this has been done by tying a satisfactory result, on behalf of the EU members, in the Icesave dispute with the payment of the IMF loans. The first half of the loan to Iceland was only paid out after many delays when the Icelandic authorities finally accepted the Icesave liabilities and started talks based on settling the dispute. The way the IMF has been used in the Icelandic case is

---

<sup>196</sup> <http://www.amx.is/stjornmal/7143/>

<sup>197</sup> Ibid.

<sup>198</sup> <http://www.voxeu.org/index.php?q=node/2549>



damaging for the credibility of the IMF at a time it was supposed to be reformed and in a position to deal with a new economic environment in the world, a new purpose after the fall of the iron curtain.

The reactions of the Icelandic government were initially disbelief of what was happening and a political naivety in responses to the situation. To a degree this was down to half of the coalition government having an EU agenda and partly because the situation immediately after the crash seemed very serious, with impending lack of necessities and a complete meltdown of the economy. The government may therefore have felt it necessary to accept almost anything in order to secure an IMF loan. That however resulted in total neglect of realist perspectives, which may be put down to inexperience in international relations or even sheer incompetence.

The next section will therefore analyse the various complications that are involved with the whole affair, especially how the handling of Iceland could affect international relations as well as economic policy in the coming years. The next section will be the last section of the analysis and therefore the conclusion will follow immediately.

### ***The Wider Perspective – Implications and Complications***

From the perspective of international relations and economic theory the crisis in Iceland is an interesting case of how one calculated decision after another could lead to results that were very disproportionate to what was expected.

In 2007 when the boom was at its peak, the people of Iceland were oblivious to what was going to happen only a few months later. Few criticised the growth of the banks and the few who did could not predict that the consequences could be as dramatic as they have turned out to be.

In dealing with the consequences, the people of Iceland have rallied at demonstrations in numbers that have up until now been unheard of<sup>199</sup>. The people demanded action by the former government, and as of June 2009, there have also been demonstrations demanding action of the coalition government that recently took power. However while the demonstrations against the previous government, the coalition government of the Independence party and the Social Democrats under prime minister Geir Haarde, were mostly directed at what was perceived as the inability to deal with the meltdown and the lack of accountability by those responsible, the demonstrations against the current government have mostly been directed towards the handling of the Icesave dispute, but also towards lack of reaction to the crisis.

Few have been as resilient in their critique of the handling of the Icesave dispute as Ólafur Elíasson of the Indefence group<sup>200</sup> who has along with Indefence invested a lot of resources in bringing attention to what Indefence considers the unfair treatment of the Icelandic people when Brown and Darling invoked the anti-terror legislation against Iceland.

In an interview with Ólafur Elíasson<sup>201</sup> from the end of March Elíasson, who through his work in the Indefence group has become very knowledgeable about the Icesave affair, highlighted many of the key complications that can arise from the use of anti-terror legislation, as well as the political implications both locally and internationally.

---

<sup>199</sup> <http://www.youtube.com/watch?v=1e3arY-7PnY>

<sup>200</sup> <http://www.indefence.is/>

<sup>201</sup> See appendix on CD: Ólafur Elíasson



**Figure 3:** An image from the front page of the Indefence website. Hundreds of Icelanders sent in pictures of them protesting to the use of anti-terror legislation.



**Figure 4:** The images were widely used in a publicity campaign and as such they caught the eye of the international media.

To begin with Elíasson says he was shocked at how much apathy the government of Haarde had shown pertaining to the Icesave dispute. In October Elíasson had a conversation with Árni Páll Árnason, a member of the Social Democratic party and the coalition government at the time, who was involved in the Icesave dispute through his position as Member of the Committee on Foreign Affairs.

Elíasson expressed Indefence's concern that Iceland was not using what little bargaining power it had in resolving the dispute.

What the Indefence group has argued is that the Icelandic government has not firmly fought erroneous statements made by Alistair Darling and Gordon Brown. A short summary of arguments from the Indefence website is paraphrased and provided as follows<sup>202</sup>:

- Brown claimed that Iceland intended not to honour its obligations. The claim has since been resolutely denied and refuted. [A transcript of a conversation between the finance ministers of Iceland and the UK has been released confirming this.]
- The British government used anti-terror legislation, as no other law was available for such extreme measures. Although mainly directed at Landsbanki the measures in effect froze nearly all Icelandic assets.
- It has been claimed by the British government that only the security part of the anti-terror legislation (Crime and Security Act of 2001) was used and that Iceland was therefore not classified as a terrorist country. However Landsbanki of Iceland was put on a list of regimes subjected to financial sanctions on Her Majesty's Treasury website along with Al-Qaida and the Taliban<sup>203</sup>. Landsbanki was removed from the list eight hours after Indefence started a campaign to draw attention to the treatment of Iceland.
- Indefence also points out that it is likely that Brown acted out of short-term political gains. Brown did nothing when American banks failed with the same consequences.
- Furthermore Brown has claimed Iceland is bankrupt and will default on its obligations. This is not true. At the time of the crash the state had very little debt. However the statement has devalued Icelandic assets all over the world resulting in the short selling of most Icelandic assets.

---

<sup>202</sup> <http://www.indefence.is/QandA>

<sup>203</sup> See Appendix: HMTreasury\_211008\_2100

- Indefence points towards the consequences for Iceland of these actions; financial disaster, the freezing of Icelandic assets, Icelanders being harassed in foreign countries, students have had to abandon studies on top of pension funds, shares and deposits lost in the meltdown.
- The British government also has credibility issues after dealing with Iceland in such a way prompting concerns of lack of political restraint.
- The people of Iceland did overspend, as most other Western nations did.
- The people of Iceland have nothing to do with Icesave and most have lost large amounts of money during the crisis.
- It has been argued that the assets of Landsbanki are sufficient to cover the deposits, but the actions of the British government are damaging the assets, therefore decreasing their value

Late in October Elíasson and the Indefence group organised an action plan, depicting how Iceland should hold up defences against the British government. Elíasson says that it was evident early in the negotiation process that a soft route had been chosen<sup>204</sup> since little was happening on the Icelandic government's behalf. In a telephone conversation with Árnason of the Committee on Foreign Affairs in late October, Elíasson states that the government must act rapidly to have a better bargaining position. Elíasson was pointing to the anti-terror legislation as the main bargaining position as it demolished the chances of the Icelandic banking sector of surviving. Árnason answered that it had already been decided that the use of anti-terror legislation would not be used as a bargaining chip in the negotiations of the Icesave accounts<sup>205</sup> and that it was necessary to prepare the people of Iceland for a bad result from the negotiations<sup>206</sup>.

---

<sup>204</sup> See appendix on CD: Ólafur Elíasson, page: 1, line, 5.

<sup>205</sup> Ibid, page: 1, line, 9.

<sup>206</sup> Ibid, page: 1, line, 14.

At this point late in October it is likely that at least one half of the government coalition, the Social Democrats, was not willing to put up any resistance in order to minimize the damage from the Icesave dispute.

Only an hour later the same night Elíasson received a phone call from the chairman of the Progressive party, Sigmundur Davíð Gunnlaugsson, who had recently taken over the post and was one of the most vocal politicians in criticising the governments handling of the Icesave dispute. Gunnlaugsson told Elíasson that Árnason had called him about the conversation between himself and Elíasson, and that he did not want the public disoriented concerning the Icesave dispute<sup>207</sup>. In other words it seems that Árnason was concerned that the people of Iceland would not be happy with what the government had already decided to do in the Icesave dispute. However Árnason agreed that it was necessary not to rule out future lawsuits against the British government for invoking the anti-terror legislation.

A little later the same night in late October Elíasson received another phone call from a lawyer who had been hired by Kaupthing bank to prepare legal action on behalf of the bank. The lawyer told Elíasson that after three months the chance to sue the British government will expire, on the 7<sup>th</sup> of January<sup>208</sup> and that as of yet no action had been taken by the Icelandic government.

According to Elíasson this prompted the Indefence group to go to the media and the result was that a few weeks later the Icelandic government approved to set aside funds for the litigation process of the banks<sup>209</sup>. The cost of the litigation was expected to total at around €1.1 million while the total cost of the Icesave liabilities is considered to be in excess of €3.6 billion. Elíasson says it never occurred to the government that Iceland could achieve a better settlement and that what happened was simply that the British “figured they had a poor bargaining position, dealing with a bit shaky Icelandic banks and having already burnt themselves on the fall of Lehman Brothers, they simply decided to look

---

<sup>207</sup> Ibid, page: 1, line, 15.

<sup>208</sup> Ibid, page: 1, line, 22.

<sup>209</sup> Ibid, page: 1, line, 24.

after their own interests just like they did during the Falklands war.”<sup>210</sup> Elíasson continues: “They have good people in the Foreign Service and they start designing a strategic response. They realise that this needs to be done in a way that will not cause concerns with the Icelandic government and therefore they start spreading rumours that Iceland was fortunate to have the British act so swiftly in stopping the Icelandic banks.”<sup>211</sup>

Furthermore Elíasson says that it seems the British Foreign Service sought refuge with the Social Democrats in Iceland and promised the support of the UK to Iceland’s EU membership if the Icesave accounts could be settled on good terms<sup>212</sup>. Elíasson who attended meetings with the British Foreign Service says that Andrew Dalglish, head of Europe Strategy Group, stated very clearly that if Iceland would quickly settle the Icesave dispute then the UK would make sure that Iceland would get a quick accession into the EU instead<sup>213</sup>.

### **A Hidden EU Agenda?**

From a realists perspective this claim is quite interesting. It has been the main agenda of the Social Democratic party in Iceland to apply for EU membership but the party has been isolated in its view, until the meltdown of the Icelandic economy. The crash in October mobilised a large part of the population behind a decision to apply for EU membership. In March 2009 64.2% of the population was in favour of applying for EU membership as opposed to only 50% three years ago<sup>214</sup>. It seems warranted that the Social Democratic party could have given up a better bargaining position for quick EU membership.

Most would argue that it is not in the best interest of the country and the realist approach would have been to play hardball. Furthermore it is interesting to note if indeed the Social Democrats can be considered to be acting politically.

Morgenthau argued that: “Nations at times may act aside considerations of power. When they do, Morgenthau insists, their actions are not “of a political

---

<sup>210</sup> Ibid, page: 1, lines, 42-45.

<sup>211</sup> Ibid, page: 1, lines, 45-50.

<sup>212</sup> Ibid, page: 1, lines, 50-56.

<sup>213</sup> Ibid.

<sup>214</sup> <http://www.si.is/malaflokkar/althjodlegt-samstarf/evropumal/skodanakannanir/>

nature.”<sup>215</sup> The three major political parties in Iceland have all been accused of having too much interests vested in the success of business blocks in the country and hence it may be possible that the Social Democrats indeed did act out of something other than political nature. The Social Democrats have for a long time been thought to be under the influence of the most powerful businessman in Iceland, who owns a majority of the free media<sup>216</sup>.

However, there is broad support for EU membership in Iceland and supporters can be found in large numbers in all political parties except the Left Green. EU membership is by some seen as the solution to the problems Iceland is facing and therefore the possibility of EU membership is one of the main implications of the economic meltdown. Whether Iceland’s problem will be solved by EU membership or not there are certain positive points linked to EU membership that have been used as the main arguments in the EU debate in Iceland.

Þorvaldur Gylfason, an economist who has been associated with the position of central bank manager, has mainly cited that food prices and interest rates would be lower, competition more effective and a more stable currency as the most attractive results of EU membership<sup>217</sup>. In a strong economy, Gylfason argues, there is less need for membership than in a weak one<sup>218</sup>.

Gylfason has argued that the quickest way to resurrect the Icelandic economy is to apply for EU membership<sup>219</sup>. By doing so the government would send the signal that it intends to deal with the crisis effectively and quickly. Critics of the EU have however claimed that the EU has put pressure on the IMF to enforce extreme fiscal austerity in Iceland, hoping that the following permafrost of the economy would push the people in favour of EU membership. The reasons the EU would do this are said to be the EU’s need for resources, mainly fish, which has been heavily exploited almost to the brink of extinction in the EU<sup>220</sup> and

---

<sup>215</sup> Waltz, Kenneth N. (2008). Realism and International Politics. Routledge. New York. P: 79.

<sup>216</sup> [http://www.mbl.is/mm/frettir/innlent/2009/06/04/samfylking\\_baugur\\_og\\_stod\\_2/](http://www.mbl.is/mm/frettir/innlent/2009/06/04/samfylking_baugur_og_stod_2/)

<sup>217</sup> <http://icelandweatherreport.com/2009/01/an-interview-with-thorvaldur-gylfason.html>

<sup>218</sup> Ibid.

<sup>219</sup> Ibid.

<sup>220</sup> <http://www.independent.ie/world-news/europe/eu-admits-its-unsure-of-fish-stock-levels-1736866.html>



cheap green energy that is plentiful in Iceland<sup>221</sup>. Furthermore it has been argued that the EU is enthusiastic regarding Iceland's membership because that would increase the pressure on Norway, which is also an EEA member. Olli Rehn, European Commissioner for Enlargement, confirmed such speculations in a speech from 11th May 2009 where he said "And who knows, maybe over time, this might provide a stimulus to Norway as well."<sup>222</sup>

Whatever reasons the EU might have for Iceland's membership it seems clear the price will be high if the aforementioned is the case. The result of the Social Democrats seemingly caving in and giving up 650 billion ISK over the Icesave deposits, in return for a speedy accession to the EU, is ironically that the total debt of the Icelandic authorities doubles, thereby lifting Iceland far above the limits stipulated in the Maastricht Treaty for Euro membership.

In fact it can be argued that the population is more likely to support EU accession if the economy remains weak than if the economy recovers. There is little incentive for the population to opt for EU membership if the Icelandic Krona strengthens and people can deal with the economic aspects of the crash. However if the Krona weakens, and it has weakened considerably since the new coalition government took office, it is very likely that support for EU membership will increase even further. There are some indications that this is already happening. The Social Democrats in Iceland have continuously maintained that the Icelandic Krona is finished<sup>223</sup>. Such statements are of course not likely to help matters.

As pertains the actions of the EU member countries and the IMF one might argue that Iceland has been held as collateral for the safety of the European banking system and to alleviate the discomfort from that, a quick accession to the EU could be on the table instead.

---

<sup>221</sup> <http://morgunbladid.blog.is/blog/morgunbladid/entry/643822/>

<sup>222</sup> <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/245&format=HTML&aged=0&language=EN&guiLanguage=en>

<sup>223</sup> [http://mbl.is/mm/gagnasafn/grein.html?grein\\_id=1243105](http://mbl.is/mm/gagnasafn/grein.html?grein_id=1243105)

However, the primary concern of most people in Iceland at this point is a stable currency and therefore many look towards EU membership and thereafter the Euro. As has been argued before on the other hand, Iceland is far from fulfilling the Maastricht agreement for fiscal standards.

Coincidentally it is the Euro that could prove to be dangerous for the Icelandic economy if and when Iceland adopts the Euro.

A country adopting another country's currency loses its lender of last resort – the institution capable of rescuing its banks if their depositors lose confidence in them and try to withdraw their funds. A “run” can start because of fears about the soundness of a single bank, but it can spread to other banks if the first bank is unable to repay its depositors.<sup>224</sup>

Furthermore the institution, for example in the case of Iceland the Central Bank, may not be in a position to serve as a lender of last resort if the banking sector has grown far beyond the capabilities of the bank. This however can also be the case with banks from Switzerland, Luxembourg and even Britain. Therefore a crisis can spark a run on banks that normally should be solvent and basically sound, for example as a result of credit drying up in interbank lending markets as happened in the Icelandic case. From a purely realist perspective such prospects are less than ideal. Iceland would be at the mercy of a supranational power in every decision concerning monetary policy.

An implication related to this is that regulation coming from the EU would be difficult to merge with the interests of both small and large European countries. As an example the raising of deposit guarantees, which has in fact already been done after the crash of the Icelandic banks, will favour larger countries and basically restrict smaller countries in conducting international banking. The Icelandic bank crash has already had an effect on the EU as the minimum threshold on deposit guarantees was raised from €20 thousand to €50 thousand as of June 30<sup>th</sup> 2009 and the minimum will be raised to €100 thousand by January 1<sup>st</sup> 2010<sup>225</sup>. As early as October 7<sup>th</sup> 2008 did the EU announce that deposit guarantees would be raised to a €50 thousand minimum, thereby

---

<sup>224</sup> Kenen, Peter B. and Meade, Ellen E. (2008). Regional Monetary Integration. Cambridge University Press. New York. P: 39.

<sup>225</sup> <http://www.state.gov/e/eeb/rls/othr/ics/2009/117665.htm>

responding immediately to boost confidence at the same time as the FME<sup>226</sup> dealt with the financial chaos in Iceland.

This arguably interferes with the four freedoms of the EU, the cornerstone of EU cooperation. The larger member countries are naturally looking after their own interests in times of crises and this hurts the prospects of the smaller countries. With a deposit scheme as will be effective from the beginning of 2010, it will be too costly for small countries to conduct banking in countries that are much larger. What the EU is basically doing is limiting international banking to the larger nations, with smaller nations only being able to conduct national banking. This reduces the risks of the EU of another crisis such as the Icelandic one but is not in line with the four freedoms.

One does not need a vivid imagination to see the implications, what would happen if Switzerland or Luxembourg were in the same position as Iceland?

Neo-liberal theory has resulted in a fundamental restructuring of the European financial system and the relations between society and the economy as there has been a tendency to distance the market from the strong institutions that arose after the second world war, with the Keynesian welfare state as its focus<sup>227</sup>. The balance has therefore shifted from the more mercantilist system of the post war period that favoured the public and sought to secure national interests to a more neo-liberal approach favouring the market and hence the private and more global *electronic herd*<sup>228</sup>. Such circumstances are unlikely to serve the best interests of smaller countries like Iceland.

One of the main arguments so far is that the national interests of Iceland were sacrificed in order to safeguard the supranational interests of the EU. This might seem contradictory to the above mentioned but is rather an argument on a different level. In other words the actions taken by the initiative of the UK government was intended not only to safeguard the interests of the UK but also

---

<sup>226</sup> [http://www.eitb24.com/new/en/B24\\_113418/Business/ECOFIN-EU-raises-minimum-bank-deposit-guarantee-to-50000/](http://www.eitb24.com/new/en/B24_113418/Business/ECOFIN-EU-raises-minimum-bank-deposit-guarantee-to-50000/)

<sup>227</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P. 306.

<sup>228</sup> Ibid.

to keep the EU's banking system from imploding. Evidence has been produced that a bank run had already started on banks operating in the largest EU countries but with headquarters in smaller member states<sup>229</sup>. This was to great extent because deposit owners had lost trust in their money being safe. In order to re-establish trust in the system, Iceland needed to announce that all deposits would be fully guaranteed, otherwise the general public would have no reason to expect anything other than more money being lost when the next bank would collapse and that could be a bank from any of the crises stricken economies in Europe. The Irish government realises this as can be seen from the announcements that deposits in Irish banks would be fully guaranteed<sup>230</sup>. The EU has also realised this and therefore the increased deposit guarantee has been introduced that will take effect in the beginning of 2010.

It is on the other hand contradictory to use anti-terror legislation in order to freeze the assets of Icelandic banks and in effect the assets of many Icelandic businesses that had nothing to do with the banking collapse in Iceland. The contradiction lies in the risk of another bank failure, e.g. of a bank from another European country that has an overgrown banking system. The UK government will be forced to follow its previous precedent or else face legal action from Iceland for discriminatory treatment as stated previously, if it were to handle another bank crisis differently.

As a result the EU is pushed for common policies for the sector, which will be difficult to implement if the four freedoms are not to be violated.

Arguably it could be stated that the EU's banking system was saved for the time being but a lot of new problems arose with the chosen solution as regards discrimination and the four freedoms. One way of solving these problems is by allowing Iceland a quick accession to the EU. That way Iceland will become a part of the EU and be fully backed by the European central bank and the UK government will have no need to treat another EU members in the same way as Iceland if another bank from a small EU country falls victim to the credit crunch.

---

<sup>229</sup> [http://www.thisismoney.co.uk/news/article.html?in\\_article\\_id=470349&in\\_page\\_id=2](http://www.thisismoney.co.uk/news/article.html?in_article_id=470349&in_page_id=2)

<sup>230</sup> <http://www.cashquestions.com/all-irish-bank-deposits-fully-guaranteed.html>

It will however always leave Iceland at the mercy of a monetary policy that takes account of the larger EU members, rather than the small ones.

Theoretically speaking though, it is in strong contrast to what one would have expected in a realist world to accept such a result as pertains to Icelandic interests. States normally want to protect national interests and according to Underhill it is only when it serves the states interest when co-operation is chosen<sup>231</sup>. The only possible explanation is that the social democrats truly believe that Iceland is better off in the EU but this however was a view that was not shared by the other coalition party in Iceland at the time of the crash, the Independence party, and in fact no other party in Iceland has a history of wanting EU member ship apart from the Social Democrats.

Moreover it is intriguing that the relative bargaining power of states normally decides the outcome of negotiations between states and hence there can be serious doubts about the result of the Icesave negotiations. The same goes for the possible EU accession talks, being favourable for Iceland as the bargaining position of Iceland is extremely weak at present and it was given away, some argue, as a bargaining chip during the Icesave negotiations. Because of this, if Iceland will become a member of the EU, there will always be serious doubt as to the reasons behind the membership and a general consensus is unlikely to be reached among the population that EU membership was necessary and good.

In other words, the crisis in Iceland has already changed the rules of the game. Some changes were necessary in order to make the neo-liberal economic model function properly but the actions that have been taken are possibly too reliant on realist perspectives of the supranational EU. As Strange puts it the necessary changes will have to include:

These would include issues like the rules of the game in trade, the terms on which investments are made across national frontiers, the ways in which currencies adjust to one another and balance of payments deficits

---

<sup>231</sup> Stubbs, Richard and Underhill, Geoffrey R. D. (2006). Political Economy and the Changing Global Order. Oxford University Press. Ontario. P. 307.

are financed, and the ways in which credit is made available through international capital markets and by international banks.<sup>232</sup>

The changes will be the result of the current economic hegemony since the EU, as the main influence in policy making, is a product of history as Rosenau and Czempiel argue<sup>233</sup>. Rosenau and Czempiel mention that there are two elements that quite clearly explain how the changes will happen. One is that the actors, such as heads of states, and their interactions, such as through the Icesave dispute, will base their actions on motivations and expected results of their actions<sup>234</sup>. The second is that the motivations and the actions are inherently linked to the environment the actors are formed in<sup>235</sup>, “they are products of history”<sup>236</sup>.

The first quote elaborates upon the explanatory value of realist theory. The dispute between Iceland, Britain and the EU is not merely a dispute about money but of credibility, accountability and fairness. The individual actors do not agree on the course that should be taken and the moves are explained by their motives. Even though it could be argued that the actions of the British government were short sighted it can still be argued that the motive of Gordon Brown was to shift some of the pressure on himself elsewhere and Iceland was a convenient scapegoat, but also a matter that had to be dealt with literally within hours if confidence in the European banking system was not to evaporate.

The second quote explains the environment that has shaped the actions of the British government, in other words the environment is a product of, initially mercantilist theory, and ultimately neo-liberal theory and as a result it is imperative to introduce the theories in order to be able to explain the motivations and the origins of the motivations that lie behind maintaining the function of the European banking system.

---

<sup>232</sup> Strange, Susan. (1994). States and Market. Pinter Publishers. London. P:12.

<sup>233</sup> Czempiel, Ernst-Otto and Rosenau, James N. (1989). Global Changes and Theoretical Challenges. Lexington Books. Massachusetts/Toronto. P. 37.

<sup>234</sup> Ibid.

<sup>235</sup> Ibid.

<sup>236</sup> Ibid.

Another important aspect of examining the crisis with political theory rather than economic theory lies in the very meaning of the word crisis. "The use of the term "crisis" implies something more than one of the cyclical downturns of capitalist economy; it implies that recovery will require structural changes to be made in the economy."<sup>237</sup> In other words what is happening is something that requires fundamental political action in order to re-shape the structure of the economy. As a result it is more appropriate to analyse what is happening with political theories as the economic theories can explain what is happening and why, but are less useful in explaining what will happen next or will have to be done next. In the minds of the population this is crystallised in the shift from a centre-right wing government to a left wing government as was the case in Iceland in the beginning of May, and as vice versa as will probably be the case in the next elections in Britain.

As regards the structural elements of the political theory it is mainly *agents*, *systems* and *structures* that are relevant pertaining to realist, mercantilist and the neo-liberal theories. Agents can for example be governments or states that willingly or unwillingly have influence on other agents and the accumulated experience gathered through such action will further influence future action<sup>238</sup>. This is relevant as it highlights the implications of any given course of action, for example the risks that may be involved for Britain itself in using terrorist legislation against an ally. The risks are both political and economic.

---

<sup>237</sup> Ibid. P. 45

<sup>238</sup> Ibid. P. 59.

## Conclusion

During the research work for this thesis there have been constant updates in the investigations on the issue. Even as late as June 24th, barely a week before the deadline of the assignment new information was added. The analysis is therefore based on the freshest information possible and as a result, the greatest effort has been on writing a thesis that is current and up to date and answers vital questions that are relevant to a much wider population than just the population of Iceland.

The crisis was very destructive in terms of finances, but it still remains to be seen whether that destruction can be "creative" as the capitalists typically claim.

Concerning that point the people of Iceland would argue that the outlook could be better but some changes are already underway that are meant to prevent the repetition of the events as well as to deal with what happened.

It has been argued that what happened in the systemic bank crash in Iceland was triggered by the implementation of neo-liberal policies that were carried out by coalition governments, lead by the Independence party of Iceland. However, the policy changes that were implemented in Iceland over the last couple of decades were little different from what other Western European economies have gone through before Iceland. Of course, they followed to a great extent the neo-liberal route as well.

The changes in the economy promoted deregulation and general laxness in economic regulatory control that resulted in an environment, which favoured the creation of credit. The opportunity to create credit in Iceland released a force that promoted rapid growth in the economy for over a decade – however as the credit was used to a very limited extent on creating real value, the growth was unsustainable. This situation was exacerbated by the privatisation of the former state banks. They ended up in the hands of unscrupulous investors that relied on high interest rates in Iceland in order to draw enormous amounts of capital to Iceland. This was the business of carry trade. The capital was used to buy up businesses in the UK, Denmark and other European countries and the growth of



the Icelandic banks was brisk. The global economy followed the same model and grew concurrently, albeit at a slightly slower rate. These circumstances are a classic example of a bubble economy. The inflow of capital raised real estate prices, strengthened the currency and therefore fuelled even more consumption. Under such circumstances it is only a matter of time before the bubble bursts. The bust was indeed hidden in the boom.

What happened next is that the global economy, basically following similar economic policies started to inflate. Iceland, which had probably benefitted more than most other economies from the economic growth of the last decade, became the victim of what has been called the electronic herd. Since the growth was unsustainable the currency started to depreciate and after that there was no turning back. The global financial elite soon lost its confidence in the Icelandic economy and capital started flowing out of the country. As a result Iceland faced a currency crisis, which meant that the privatised banks could not pay off their loans.

The situation was to a great extent the result of EU regulation that allowed the banks to grow rapidly under these circumstances, under supervision only from the home country. With such massive sums of capital, the regulatory authorities in Iceland were powerless in terms of controlling the banks. There was also political and social consensus concerning their expansionary policies.

The EU regulation is also to blame though. It did not account for a systemic crisis since it would infringe on the four freedoms of the EU that are the cornerstone of the Union. In a systemic crisis a privately post-funded deposit guarantee fund cannot under any circumstances pay back in full deposits of banks that have been expanding. Iceland therefore became a victim of circumstance, rendered powerless after the liberalisation of neo-liberal policies.

The Icelandic banks fell and suddenly the European banking system was facing a crisis of credibility. In the eyes of EU countries governments it was inconceivable that deposits would not be honoured because that would erode all confidence in the credit system, immediately resulting in a run on banks originating from the smaller members of the EU.

It was vital for the health of the EU's economy that Iceland would honour the deposit guarantees. It was especially important for the UK, the most exposed of all of the EU states to the Icelandic meltdown. Britain's leader, Gordon Brown therefore resorted to extreme realist measures and froze all assets of the Icelandic banks with the use of anti-terror legislation. His decision ruined what was left of the Icelandic banks. At first the Icelandic government complained but very soon it became apparent that a soft solution had been chosen. Iceland had not been treated as an equal, but accepted the treatment, probably either out of shame for what happened or simply because of incompetence and lack of experience in international politics.

Iceland had expected a political solution; after all it was hardly fair to let a small country carry the burden of saving the entire EU's banking system. Instead Iceland got an economic solution and became just another number on a balance sheet. Strangely Iceland accepted this treatment. A complete lack of a realist political perspective is a likely reason for that acceptance.

It is argued that the current economic order will always have bubbles bursting and when that happens states will act in a realist manner, guarding their interests, disregarding their friends. It is also argued that a more mercantilist system would have been more stable.

In order to coerce Iceland into accepting the immense liabilities of the Icesave accounts, it looks as if the nations with the most at stake made sure the IMF would withhold the IMF package until Iceland accepted to finance the difference of what was available in the limited deposit guarantee fund and what was needed.

Even the Scandinavian countries supported this way of resolving the Icesave dispute.

It can be said that for a number of reasons this was first and foremost unfair as well as irresponsible. The system is still the same and will require major changes in order to restore trust in the EU's banking system. That trust is vital as the EU's economy is very dependent on financing from banks.

The implications are manifold. The UK's actions will force the UK to deal in the same manner with a comparable bank crash or else face being charged for discriminating against Iceland. The UK furthermore has a weakened cause as the UK did exactly the same as Iceland did against the deposit owners in the Isle of Man. In order to restore trust in the system the deposit guarantees have been raised and this will make it very difficult for banks originating in smaller economies to operate across borders. In fact, all countries with an overgrown banking sector are at risk when the changes go through because the electronic herd will leave immediately for a safer economy. This includes the UK, Switzerland and Luxembourg, to name a few.

As for Iceland it has been put forth that there are no legal requirements for Iceland to honour the deposits beyond the funds available through the deposit scheme. There are ethical requirements, but since it was the entire banking sector of the EU that was at stake it was the duty of the more powerful countries to make the greater concessions and besides Iceland had a legitimate objective.

For some reason the Icelandic authorities finally ended up neglecting the interests of Iceland. It has been argued that the Social Democratic party desired EU membership and therefore saw an opportunity to further its EU agenda. There is evidence that shows that Iceland was offered a quick accession to the EU in exchange for saving the EU's banking system. Iceland paid a hefty price if that is the case. Only the following months will show if this was the case.

As concerns the IMF its credibility is also damaged. It has been argued that the IMF indeed functions as a global collector of debt and that it has not changed its policies or been reformed as has been claimed. Iceland furthermore will have to enforce extreme fiscal austerity in order to be able to pay back the Icesave deposits, which in itself is a requirement for getting the IMF package and as such the EU and the Scandinavian countries support the action. It seems likely that the IMF imposed conditions concerning the Icesave deposits when one looks at the conditions imposed by the EU on Latvia.

Iceland is probably one of the few countries that tried to avoid bailing out its banking sector. It has however through an unbelievable turn of events been

forced to do exactly that, pay the creditors back what private banks owed them. This is being done because of realist actions of the countries that have the most interests and is a classical shift from the neo-liberal policies that have been useful in the boom, to more mercantilist policies that seem more fitting in the bust. The IMF has therefore become the watchdog of the global financial elite.

To summarize the point has been made that the economic crisis was brought about by deregulation as a result of neo-liberal policies and that Iceland was the victim of realist international relations at the hands of the UK and the EU primarily. Instead of fighting the Icelandic authorities gave in. This was done partly because of lack of a realist perspective, political naivety and the longing of the Social Democrats for Iceland to become a member of the EU. The actions of the British government will have implications for a long time and will probably result in a more mercantilist environment in Europe for the time being.

The main answer to the research question however is that Iceland was pressured into accepting the Icesave liabilities in order to save the EU's banking system and in order to maintain trust in a dysfunctional economic order that will always have bubbles bursting. A crisis such as this is so serious as to demand changes of this system that up until now has been influenced by neo-liberal policies. In terms of changes it is therefore argued that it is likely that Iceland will have quick accession to EU membership in order to alleviate the damage from accepting the Icesave deposits – and that it is likely that the EU will be forced to regulate the economic sector more efficiently, a move that could lead to more mercantilist behaviour.

Iceland fought the so-called cod wars twice with the British and won twice. At that time the government of Iceland acted in a distinctly realist way. This time however the British won by such a margin that previous victories seem trivial.

## Bibliography

### *Litterature*

- Baker, Andrew, Hudson, David and Woodward, Richard (2008). *Governing Financial Globalization: International Political Economy and Multi-Level Governance*. Routledge. New York.
- Baylis, John and Smith, Steve. (2007). *The Globalisation of World Politics: An Introduction to International Relations*. Oxford University Press. Oxford.
- Czempiel, Ernst-Otto and Rosenau, James N. (1989). *Global Changes and Theoretical Challenges*. Lexington Books. Massachusetts/Toronto.
- Czempiel, Ernst-Otto and Rosenau, James. N. (1992). *Governance Without Government: Order and Change in World Politics*. Cambridge University Press. Cambridge.
- Dijkstra, Anneke Geske. (2007). *The Impact of International Debt Relief*. Routledge. New York.
- Fischer, Stanley. (2004). *IMF Essays from a Time of Crisis: The International Financial System, Stabilization, and Development*. The MIT Press. Cambridge.
- Gilpin, Robert (1981). *War and Change in World Politics*. Cambridge University Press. New York.
- Gilpin, Robert. (2001). *Global Political Economy: Understanding the International Economic Order..* Princeton University Press. New Jersey.
- Andersen, Ib and Kvale, Steinar. (2006). *Dataindsamlinger og spørgeteknikker – i projektarbejder inden for samfundsvidenskaberne*. Forlaget Samfundslitteratur. Frederiksberg.
- Andersen, Ib and Kvale, Steinar. (2002). *Interview - En Introduktion Til Det Kvalitative Forskningsinterview*. Forlaget Samfundslitteratur. Frederiksberg.
- Kenen, Peter B. and Meade, Ellen E. (2008). *Regional Monetary Integration*. Cambridge University Press. New York.
- Keohane, Robert O. (1989). *International Institutions and State Power: Essays in International Relations Theory*. Westview Press. Boulder.
- Ravenhill, John. (2005). *Global Political Economy*. Oxford University Press. Oxford.
- Rosser, Barkley J. Jr. and Rosser, Marina V. (2004). *Comparative Economics in a Transforming World Economy*. The MIT Press. Cambridge.
- Strange, Susan. (1994). *States and Market*. Pinter Publishers. London

Strange, Susan. (1997). *Casino Capitalism*. Manchester University Press. Manchester.

Strange, Susan. (1998). *Mad Money*. Manchester University Press. Manchester.

Stubbs, Richard and Underhill, Geoffrey R. D. (2006). *Political Economy and the Changing Global Order*. Oxford University Press. Ontario.

Vreeland, James Raymond. (2007). *The International Monetary Fund: Politics of conditional lending*. Routledge. New York.

Waltz, Kenneth N. (2008). *Realism and International Politics*. Routledge. New York.

Woods, Ngaire. (2006). *The Globalizers: The IMF, the World Bank, and Their Borrowers*. Cornell University Press. New York.

### ***Electronic Sources***

<http://bernardrooney.blogspot.com/2009/04/real-issue-is-icelands-economic.html>

<http://blogg.esb.is/?p=61>

[http://blogs.telegraph.co.uk/daniel\\_hannan/blog/2008/10/24/gordon\\_brown\\_not\\_iceland\\_acted\\_like\\_a\\_terrorist](http://blogs.telegraph.co.uk/daniel_hannan/blog/2008/10/24/gordon_brown_not_iceland_acted_like_a_terrorist)

[http://books.google.com/books?id=0C2\\_Qs8bP04C&printsec=frontcover&dq=mad+money#PPA15,M1](http://books.google.com/books?id=0C2_Qs8bP04C&printsec=frontcover&dq=mad+money#PPA15,M1)

[http://books.google.dk/books?id=lexwc-iBDs4C&dq=rosenau&printsec=frontcover&source=bl&ots=wLmIBSY57s&sig=neb0ussf56613Ualdw8Mvr3JFC8&hl=en&ei=V60WSoaiBtfPjAet\\_oHkDA&sa=X&oi=book\\_result&ct=result&resnum=2#PPP1,M1](http://books.google.dk/books?id=lexwc-iBDs4C&dq=rosenau&printsec=frontcover&source=bl&ots=wLmIBSY57s&sig=neb0ussf56613Ualdw8Mvr3JFC8&hl=en&ei=V60WSoaiBtfPjAet_oHkDA&sa=X&oi=book_result&ct=result&resnum=2#PPP1,M1)

[http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5005915.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5005915.ece)

[http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5005915.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5005915.ece)

[http://chamber.is/news.asp?id=555&news\\_ID=603&type=one](http://chamber.is/news.asp?id=555&news_ID=603&type=one)

[http://danskeanalyse.danskebank.dk/link/FokusAndreIceland21032006/\\$file/GeyserCrises.pdf](http://danskeanalyse.danskebank.dk/link/FokusAndreIceland21032006/$file/GeyserCrises.pdf)

[http://economictimes.indiatimes.com/News/International\\_Business/Could\\_Iceland\\_crisis\\_have\\_been\\_averted/articleshow/3718963.cms](http://economictimes.indiatimes.com/News/International_Business/Could_Iceland_crisis_have_been_averted/articleshow/3718963.cms)

<http://en.sff.is/news/spotlight/nr/165>

[http://en.wikipedia.org/wiki/Four\\_Freedoms\\_\(European\\_Union\)](http://en.wikipedia.org/wiki/Four_Freedoms_(European_Union))

[http://en.wikipedia.org/wiki/Hannes\\_H%C3%B3lmsteinn\\_Gissurarson](http://en.wikipedia.org/wiki/Hannes_H%C3%B3lmsteinn_Gissurarson)

[http://en.wikipedia.org/wiki/James\\_N.\\_Rosenau](http://en.wikipedia.org/wiki/James_N._Rosenau)

[http://eur-lex.europa.eu/en/treaties/dat/12002E/htm/C\\_2002325EN.003301.html](http://eur-lex.europa.eu/en/treaties/dat/12002E/htm/C_2002325EN.003301.html)

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML>

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31994L0019:EN:HTML>

<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/245&format=HTML&aged=0&language=EN&guiLanguage=en>

<http://eyjan.is/silfuregils/files/2009/05/merrill-lynch-2006-07-21.pdf>

<http://hdr.undp.org/en/statistics/>

<http://icelandweatherreport.com/2009/01/an-interview-with-thorvaldur-gylfason.html>

<http://icelandweatherreport.com/2009/01/an-interview-with-thorvaldur-gylfason.html>

<http://icelandweatherreport.com/2009/01/an-interview-with-thorvaldur-gylfason.html>

<http://icelandweatherreport.com/2009/03/british-fsa-denies-claims-by-former-landsbanki-owner-about-icesave-accounts-whats-the-deal.html>

<http://larahanna.blog.is/blog/larahanna/entry/871136/>

[http://mbl.is/mm/frettir/innlent/2009/05/22/husleit\\_gerd\\_a\\_10\\_stodum/?ref=fphelst](http://mbl.is/mm/frettir/innlent/2009/05/22/husleit_gerd_a_10_stodum/?ref=fphelst)

[http://mbl.is/mm/gagnasafn/grein.html?grein\\_id=1243105](http://mbl.is/mm/gagnasafn/grein.html?grein_id=1243105)

<http://news.bbc.co.uk/2/hi/business/3768971.stm>

<http://news.bbc.co.uk/2/hi/business/7666570.stm>

<http://news.bbc.co.uk/2/hi/business/7982277.stm>

<http://news.bbc.co.uk/2/hi/europe/8017927.stm>

[http://news.bbc.co.uk/2/hi/uk\\_news/politics/7662027.stm](http://news.bbc.co.uk/2/hi/uk_news/politics/7662027.stm)

<http://this.is/nei/?p=4534>

[http://www.acus.org/atlantic\\_update/new-irish-bank-deposit-guarantees-stir-eu-controversy](http://www.acus.org/atlantic_update/new-irish-bank-deposit-guarantees-stir-eu-controversy)

[http://www.acus.org/atlantic\\_update/new-irish-bank-deposit-guarantees-stir-eu-controversy](http://www.acus.org/atlantic_update/new-irish-bank-deposit-guarantees-stir-eu-controversy)

<http://www.amx.is/stjornmal/7143/>

<http://www.bloomberg.com/apps/news?pid=20601102&sid=agEOsO.7RNdw&refer=uk>

<http://www.brettonwoodsproject.org/art-562981>

<http://www.cashquestions.com/all-irish-bank-deposits-fully-guaranteed.html>

<http://www.cepr.org/GEI/GEI9SS.htm>

<http://www.cid.harvard.edu/cidtrade/issues/washington.html>

<http://www.dailymail.co.uk/news/article-1179918/Brown-unpopular-PM-polling-began--half-want-now.html>

<http://www.dollarsandsense.org/blog/2009/05/imf-as-big-banks-debt-collector.html>

[http://www.economist.com/world/europe/displayStory.cfm?story\\_id=12762027](http://www.economist.com/world/europe/displayStory.cfm?story_id=12762027)

[http://www.eitb24.com/new/en/B24\\_113418/Business/ECOFIN-EU-raises-minimum-bank-deposit-guarantee-to-50000/](http://www.eitb24.com/new/en/B24_113418/Business/ECOFIN-EU-raises-minimum-bank-deposit-guarantee-to-50000/)

<http://www.euractiv.com/en/trade/eu-us-banana-dispute-resolved/article-113506>

<http://www.eurointelligence.com/Article3.1018+M5d6173a62e1.0.html>

<http://www.facebook.com/group.php?gid=113280451146&ref=mf>

[http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari\\_2009.pdf](http://www.forsaetisraduneyti.is/media/frettir/KaarloJannari_2009.pdf)

[http://www.ft.com/cms/s/0/061070b8-4781-11dd-93ca-000077b07658.html?nclick\\_check=1](http://www.ft.com/cms/s/0/061070b8-4781-11dd-93ca-000077b07658.html?nclick_check=1)

<http://www.ft.com/cms/s/0/c67abb90-dc48-11dd-b07e-000077b07658.html>

<http://www.fxstreet.com/fundamental/analysis-reports/outside-the-box2/2009-06-05.html>

<http://www.globalresearch.ca/PrintArticle.php?articleId=13407>

<http://www.guardian.co.uk/commentisfree/2008/nov/11/iceland-creditcrunch>

<http://www.guardian.co.uk/world/2009/feb/22/iceland-women>

[http://www.huffingtonpost.com/dr-drew-pinsky/narcissism-and-the-econom\\_b\\_178541.html](http://www.huffingtonpost.com/dr-drew-pinsky/narcissism-and-the-econom_b_178541.html)

<http://www.icenews.is/index.php/2008/11/07/iceland-awaits-imf-decision-on-monday/>

<http://www.icenews.is/index.php/2008/11/11/imf-loan-to-iceland-turned->



down/

<http://www.indefence.is/>

<http://www.indefence.is/lisalib/getfile.aspx?itemid=491>

<http://www.indefence.is/QandA>

<http://www.independent.ie/world-news/europe/eu-admits-its-unsure-of-fish-stock-levels-1736866.html>

<http://www.ksfiomdepositors.org/category/tags/icesave>

<http://www.marketoracle.co.uk/Article8728.html>

[http://www.mbl.is/mm/frettir/esb/skodun.html?art\\_id=68386](http://www.mbl.is/mm/frettir/esb/skodun.html?art_id=68386)

[http://www.mbl.is/mm/frettir/innlent/2008/10/07/emergency\\_law/](http://www.mbl.is/mm/frettir/innlent/2008/10/07/emergency_law/)

[http://www.mbl.is/mm/frettir/innlent/2009/01/08/raudir\\_i\\_framan\\_af\\_reidi/](http://www.mbl.is/mm/frettir/innlent/2009/01/08/raudir_i_framan_af_reidi/)

[http://www.mbl.is/mm/frettir/innlent/2009/06/04/samfylking\\_baugur\\_og\\_sto\\_d\\_2/](http://www.mbl.is/mm/frettir/innlent/2009/06/04/samfylking_baugur_og_sto_d_2/)

[http://www.mbl.is/mm/frettir/kosningar/2009/03/26/mistok\\_gerd\\_vid\\_einka\\_vaedingu/](http://www.mbl.is/mm/frettir/kosningar/2009/03/26/mistok_gerd_vid_einka_vaedingu/)

<http://www.npr.org/templates/story/story.php?storyId=95408444>

[http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?\\_r=1&scp=3&sq=how%20risk%20models%20started%20the%20crises&st=cse](http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?_r=1&scp=3&sq=how%20risk%20models%20started%20the%20crises&st=cse)

<http://www.petersoninstitute.org/publications/papers/paper.cfm?ResearchID=307>

[http://www.politics.co.uk/news/economy-and-finance/banks-too-big-to-fail--\\$1265784.htm](http://www.politics.co.uk/news/economy-and-finance/banks-too-big-to-fail--$1265784.htm)

[http://www.politics.co.uk/news/economy-and-finance/banks-too-big-to-fail--\\$1265784.htm](http://www.politics.co.uk/news/economy-and-finance/banks-too-big-to-fail--$1265784.htm)

<http://www.pressan.is/Vidskipti/Lesavidskiptafrettir/bjarni-ben-thingmenn-eru-ekki-ad-fara-stadfesta-samninginn>

<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/402/40202.htm>

<http://www.ruv.is/heim/vefir/pistlar/sigrund/eldri/store807/item258441/>

<http://www.sedlabanki.is/uploads/files/Wp8.PDF>

<http://www.si.is/malaflokkar/althjodlegt-samstarf/evropumal/skodanakannanir/>

<http://www.socialresearchmethods.net/kb/sampron.php>

<http://www.state.gov/e/eeb/rls/othr/ics/2009/117665.htm>

<http://www.telegraph.co.uk/finance/businesslatestnews/3167732/Financial-Crisis-Kaupthing-blames-collapse-on-British-Government.html>

<http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3263764/Financial-crisis-Alistair-Darling-suspected-Icelandic-banks-were-in-trouble-weeks-before-collapse.html>

<http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3263764/Financial-crisis-Alistair-Darling-suspected-Icelandic-banks-were-in-trouble-weeks-before-collapse.html>

<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5231082/Former-Iceland-bank-governor-David-Oddsson-defends-role-in-meltdown.html>

[http://www.thisismoney.co.uk/news/article.html?in\\_article\\_id=470349&in\\_page\\_id=2](http://www.thisismoney.co.uk/news/article.html?in_article_id=470349&in_page_id=2)

<http://www.time.com/time/world/article/0,8599,1848243,00.html>

[http://www.timesonline.co.uk/tol/comment/columnists/guest\\_contributors/article4943712.ece](http://www.timesonline.co.uk/tol/comment/columnists/guest_contributors/article4943712.ece)

[http://www.unc.edu/depts/diplomat/AD\\_Issues/amdipl\\_13/yarmolinsky.html](http://www.unc.edu/depts/diplomat/AD_Issues/amdipl_13/yarmolinsky.html)

<http://www.vanityfair.com/politics/features/2009/04/iceland200904>

<http://www.vb.is/frett/1/46179/>

<http://www.vb.is/frett/1/49194/>

<http://www.vb.is/frett/34/53902/geir-h--haarde-bidst-afsokunar-a-mistokum-vid-einkavaedingu-bankanna>

<http://www.vi.is/files/555877819Financial%20Stability%20in%20Iceland%20Screen%20Version.pdf>

<http://www.visir.is/article/20090425/FRETTIR01/167991999/1288>

<http://www.voxeu.org/index.php?q=node/2549>

<http://www.voxeu.org/index.php?q=node/748>

<http://www.washingtonpost.com/wp-dyn/content/article/2009/03/01/AR2009030100389.html>

<http://www.washingtonpost.com/wp-dyn/content/article/2009/04/09/AR2009040903241.html>

[http://www.youtube.com/watch?v=ivmYGlFu\\_bg&eurl=http%3A%2F%2Fwww.eyjan.is%2Fsilfuregils%2F&feature=player\\_embedded](http://www.youtube.com/watch?v=ivmYGlFu_bg&eurl=http%3A%2F%2Fwww.eyjan.is%2Fsilfuregils%2F&feature=player_embedded)

<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/402/40202.htm>

## Appendix

### ***Timeline of Events***

2006 – The Icelandic banking sector becomes headlines material on 21st March as the Danske Bank in Denmark criticises the Icelandic economy citing that: “On most measures, the small Icelandic economy is the most overheated in the OECD area.”<sup>239</sup>

2006 – Icelandic banks respond strongly and launch a campaign to avert what was mainly seen as an image crisis. Some structural changes are made to alleviate risks.

2006 – The Icesave online savings program was launched in the UK partly in response to criticism from Danske Bank. The strategy was to ensure a broader base for financing the Landsbanki by offering over 6% interest rates. At the time financing through other means was becoming more and more expensive for the Icelandic banks. Icesave was opened in the Netherlands and Germany as well. The Icesave deposit accounts are a branch of Landsbanki meaning that the supervision and responsibility of the accounts is with the Icelandic regulatory authorities.

2007 – The Icelandic economy reaches new heights. Concerns grow rapidly as wages, real estate prices and consumption accelerates. The Economy reaches its peak in late 2007.

2007 – Kaupthing opens the Kaupthing Edge accounts that are similar to the Icesave accounts of Landsbanki. However Kaupthing's deposit accounts are opened in a subsidiary and hence they were covered by local regulatory authorities in each country. Kaupthing opens in the UK, Finland, Sweden, Norway, Belgium, Germany, Luxembourg, Isle of Man, Switzerland and Austria.

---

<sup>239</sup>

[http://danskeanalyse.danskebank.dk/link/FokusAndreIceland21032006/\\$file/GeyserCrises.pdf](http://danskeanalyse.danskebank.dk/link/FokusAndreIceland21032006/$file/GeyserCrises.pdf)

2008 - Iceland's economic difficulties become clear during the autumn of 2008 as the credit becomes hard to come by. The credit crunch is around the corner with unforeseen consequences for Iceland and the global economy.

2008 – Late in the year Icelandic banks that have grown to six times the GDP of Iceland are suffering dramatically because of the credit crunch. When Lehman Brothers in the United States falls important credit lines to the Icelandic banks evaporate leaving the banks unable to refinance themselves.

2008 – On 29th September the first Icelandic bank hits deep waters. The Icelandic government takes a 75% stake of Glitnir, the third largest bank, after it faces short-term funding problems because of Lehman Brothers.

2008 - On 6th October trading in the stock exchange is suspended on a number of firms. The government offers an unlimited guarantee for banks operating in Iceland and Iceland's parliament passes emergency legislation giving the government the power to intervene in Iceland's financial system to avoid a total crash leading to a barter economy.

2008 – On 7th October the government of Iceland takes control of the country's second and third largest banks, Landsbanki and Glitnir.

2008 – On 8th October the government of Iceland takes control of its biggest bank, Kaupthing, after hoping it would survive the turmoil. However the decision of the British government to invoke anti-terrorism legislation to freeze all the banks UK-based assets Kaupthing automatically moves the bank into technical default. The British government gives the control of the Kaupthing Edge accounts to ING Direct.

2008 – On 9th October Geir Haarde the Icelandic Prime Minister criticises the British government, stating he was upset and shocked that it had invoked "hostile" anti-terror legislation to freeze Icelandic banks' assets in the UK.

2008 – On 10th October Gordon Brown the British Prime Minister criticises Iceland's handling of the collapse of its banks and its failure to guarantee British savers' deposits stating policies were "effectively illegal" and "completely unacceptable".

2008 – On 15th October the central bank of Iceland lowers the country's interest rate by 3.5% from a record high of 15.5%. A law firm based in the UK is hired by the Icelandic government to prepare a lawsuit against the British authorities for invoking anti-terrorism legislation that effectively froze all Icelandic assets in the UK.

2008 – On 20th October Iceland's financial authorities, the FME, formally announces the establishment of *new* Glitnir, Landsbanki and Kaupthing banks effectively leaving bad assets in the old banks and starting up new banks in order to ensure an ongoing credit and monetary system in Iceland.

2008 – On 28th October the central bank of Iceland raises its key interest rate to 18% from 12% after alleged pressure from the International Monetary Fund.

2008 – On 20th November the International Monetary Fund finally approves a \$2.1 billion loan for Iceland. Iceland is the first Western European nation to get an IMF loan since the UK in 1976.

2008 – Late in November inflation hits new highs with an annual rate of inflation of 17.1%. The effect on households is extreme since almost all real estate loans are inflation indexed.

2008 – On 16th December Geir Haarde tells the BBC he is preparing to take legal action against the British government over the collapse of the bank, Kaupthing.

2008 – On 18th December the International Monetary Fund says Iceland is making the transition into stabilising the economy. The primary target is stable currency, which basically means severe capital controls, currency limitations and a high interest rate. At this point there is little credit circulation in the country and Icelandic businesses are already suffocating from high interests even though inflation is almost non-existent after a dramatic fall in imports.

2009 – On 20th January the Icelandic finance ministry predicts the economy is likely to shrink by almost 10% in 2009 and that it will see no growth in 2010.

2009 – On 21st January massive protests are underway in the city of Reykjavík. At this point the prime minister, financial minister and the central bank

chairman, David Oddsson have bodyguards for their protection, a first in the formerly peaceful country of Iceland.

2009 – On 23rd January Prime Minister Haarde succumbs to the pressure and calls for a general election on 9th May two years before the next election should have taken place. He also announces he will not run since he has been diagnosed with throat cancer.

2009 – On 26th January Geir Haarde announces the resignation of the government after the other coalition party the Social Democrats feel there is little point in continuing the coalition.

2009 – On 31st January the former opposition Left-Green Movement and the former partners of the Independence Party in the outgoing coalition, the Social Democrats, say they have secured the necessary backing to form an interim government ahead of a general election planned on 25th April.

2009 – On 1st February the New Prime Minister Johanna Sigurdardottir announces a plan for the next days until the elections. The main priority is to replace the board of the central bank - among them is David Oddsson. She also states that the country should look towards EU membership.

2009 – On 11th May, after a very long gestation period, the coalition government of the Social Democrats and the Left-Green Movement announces a hundred day plan to resurrect the economy. Among the plans of the government is; EU membership, refinancing of the new banks, some intentions to alleviate debt burden of families, the reducing of currency controls, lowering of government wages and massive cuts in government spending.

2009 – On 8th June the leader of a negotiation team whose role was to settle the Icesave dispute, Svavar Gestsson who is a former left wing politician and a former minister, announces that a deal has been struck with Dutch and British authorities. Iceland will carry a burden of almost €4 billion with an interest rate of 5.55%.

2009 – On the following days in June the whole dispute of the Icesave accounts

starts all over again in Iceland. Members of the parliament have not seen the settlement but are still intended to vote on it. The pressure from the UK seems intense and the Icelandic government seems to have little time to look into the legal entanglements of the settlement. It is claimed that the settlement will remove the right of Iceland to fight the dispute according to international law, and instead move the dispute to a private case that would be settled in the UK if a disagreement arises again.

Protests immediately start again with protester claiming the settlement will ruin Iceland and enslave the population.

2009 – On 17th of June, the day celebrating the independence of Iceland since 1944, over 32 thousand have supported a facebook group against the signing of the Icesave settlement<sup>240</sup>. The situation is intriguing since the President of Iceland, Ólafur Ragnar Grímsson had on 2nd June 2004 refused to sign a law into effect since he claimed the law was against the will of the people and that the people needed an opportunity to vote on the matter<sup>241</sup>. This had never happened before in the entire history of the republic. The law in question was intended to ensure that no one party could gain control over a majority of the news media in Iceland. Coincidentally his refusing to sign the law is thought to have allowed the bankers and money men in Iceland to buy up the media and silence all criticism directed at them.

The Icesave dispute is still ongoing and unresolved when the thesis goes to print.

---

<sup>240</sup> <http://www.facebook.com/group.php?gid=113280451146&ref=mf>

<sup>241</sup> If the president does not confirm a law with his signature the parliament can either change the law and send again to the president or the parliament will announce elections where the bill of law will be put to the vote of the people.