



Iceland's financial crisis

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The global financial crisis has been tumultuous for Iceland. Until recently considered a rich, successful and competitive nation, Iceland suffered a dramatic collapse of its economy and currency following the collapse of its banking sector in October 2008. It was forced to negotiate a loan from the IMF and further financial support from a number of countries, and saw the fall of its government. The crisis has led to renewed suggestions that Iceland may apply to join the EU and adopt the euro.

Following the Government's fall in January 2009, a caretaker Government took over in February and elections are expected on 25 April 2009. The major partner in the caretaker left-wing coalition, the Social Democratic Alliance, was a member of the previous administration and is strongly pro-EU, but its new partner, the Left Green Movement, has said it will continue to oppose EU membership.

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Contents

1	Financial crisis	3
1.1	Prelude to crisis, 2006-07	3
1.2	The 2008 crisis	3
2	The banking collapse	7
2.1	The growth of Icelandic banking	7
2.2	Landsbanki	8
2.3	Glitnir	9
2.4	Kaupthing	9
2.5	Kaupthing Edge	10
2.6	Comment on Iceland's economic liberalisation	11
2.7	Bank collapse and Treasury seizure of 'terrorist' assets	17
3	Iceland after the crash	22
3.1	Financial assistance from the IMF	22
3.2	Financial assistance from other countries	23
3.3	What's next? The economic outlook	24
4	Political fallout	25
4.1	Collapse of the Government	25
4.2	A caretaker government	27
5	Will Iceland join the EU?	28
5.1	Iceland's current links with the EU	28
5.2	Is an EU membership application imminent?	30
5.3	Conditions for joining	31
	Joining the EU	31
	Adopting the euro	32
5.4	Views on Iceland's membership	35
	Within Iceland	35
	From other candidate countries	36
	Inside the EU	36

1 Financial crisis

[by Ian Townsend, Economic Policy and Statistics Section]

1.1 Prelude to crisis, 2006-07

Iceland had previously seen a 'mini-crisis' after credit ratings agency Fitch, downgraded its sovereign rating from stable to negative,¹ citing the country's current account deficit, companies' debt levels and other factors which it said raised "questions about the activities and stability of Iceland's major banks and the state of the Icelandic economy."² Iceland then saw "a flight of hot-money by foreign funds",³ with falls in the stock market and its currency, the krona, which had knock-on effects on other markets and emerging market currencies. Iceland's problem's "snowballed across the globe, setting off an avalanche of sell orders in emerging markets from Brazil to Indonesia."⁴ This "contagion was primarily due to traders' need to liquidate profitable positions in order to fund their Icelandic losses."⁵

Amid rising inflation and a collapse of the krona, down by almost 20% from January to May 2007, Iceland then raised its interest rates by $\frac{3}{4}$ of a percentage point in March and again in May 2007, to 12.25% - their highest level for 15 years. As the *Financial Times* commented:⁶

The krona was one of the biggest beneficiaries of the global carry trade in which investors borrowed money in low-yielding currencies, such as the Japanese yen, to chase better returns in countries with higher interest rates.

But the carry trade has started to unwind due to rising global interest rates and tightening liquidity, hitting a number of currencies including the New Zealand dollar and Hungarian forint. Iceland, New Zealand and Hungary all have big current account deficits, with Iceland's reaching 16.5 per cent of gross domestic product last year.

The US State Department noted that the "market recovered as reforms were made in the banking sector."⁷ As investors retreated from risk, stocks and bonds in a range of countries including Iceland (along with Turkey, Hungary, and Latin America), a Lombard Street Research report "raised the risk of "an impending financial crisis" caused by excess credit and leverage across the global economy."⁸

1.2 The 2008 crisis

With an economy that had become increasingly dependent on financial services, the global financial crisis began to affect Iceland in 2007, despite the fact that Iceland's banks "had limited sub-prime mortgage market exposure".⁹

An August 2008 International Monetary Fund staff assessment noted that, as the global financial situation worsened, Iceland "faced severe financial turbulence in early 2008". It

¹ From AA- "stable" to "negative" ("Economists warn Iceland's economy is overheating", *Financial Times*, 24 February 2006, p9).

² US State Dept, [Iceland profile page](#), accessed 3 Mar 2009

³ 'Iceland raises rates to 12.25pc', *Daily Telegraph*, 19 May 2006, p1

⁴ 'Iceland's headline grabbing woes snowball across globe', *Financial Times*, 25 February 2006

⁵ *Ibid.*

⁶ 'Iceland central bank tries to cool economy with rate rise', *Financial Times*, 19 May 2006, p8

⁷ US State Dept, [Iceland profile page](#), accessed 3 Mar 2009

⁸ 'Markets prepare for more trouble Analysts warn of gathering storm as global currencies lurch sharply', *Daily Telegraph*, 15 May 2006, p1

⁹ US State Dept, [Iceland profile page](#), accessed 3 Mar 2009

considered that concerns over commercial bank debts had raised sovereign risk premiums significantly, which was probably “reflecting concerns about its potential liabilities in the event of banking problems”. Between December 2007 to March 2008 the krona depreciated by around 30% “with negative repercussions for already-high inflation.”¹⁰

A March 2008 *Financial Times* article reviewing Iceland’s economic situation acknowledged that there were problems, and warned of a potential crisis.¹¹ It noted that Iceland had the smallest economy in the 30-country Organisation for Economic Co-operation and Development (OECD), but the 6th-highest GDP per capita. It also noted recent “close scrutiny by international investors as they watched the country’s dramatic transformation from a fish-based oceanic backwater to a diversified and booming North Atlantic tiger economy”, and that:

Rapid growth has created imbalances in Iceland’s economy and the global credit crisis has exacerbated fears that the rapid expansion of the economy and the banking system may be a house of cards poised to topple. [...]

The core of Iceland’s trouble is its banking system, which has grown extremely quickly in recent years. Banking sector assets in Iceland have swelled from about 96 per cent of GDP in 2000 to about 800 per cent by the end of 2006 and are now probably 10 times GDP.¹²

The *Financial Times* noted that credit default swap¹³ spreads had widened, and cited the head of the Centre for Economic Policy and Research, Richard Portes, as saying that if these spreads “were an accurate estimate of probability of default, then Icelandic banks would be pronounced dead”. The *Financial Times* concluded

The uncomfortable fact for Iceland is that rumour and talk of a crisis could create the crisis. Thor Herbertsson, author of an influential report in 2006 on Iceland’s economy with Fredric Mishkin, a member of the US Federal Reserve board, said the situation was already “close to becoming self-fulfilling”.¹⁴

In an August 2008 staff assessment of Iceland, the International Monetary Fund had warned of the risks of the country’s economic imbalances:

The long expansion is coming to an end, exposing the economy’s overstretched private sector balance sheets, large macroeconomic imbalances, and high dependence on foreign financing. With external liquidity constraints binding, economic activity is expected to slow significantly from unsustainably high levels, inflation to remain well above target, and the current account to narrow. Uncertainty surrounding the outlook is unusually large, dominated by significant downside risks—both external and domestic. In the event of a prolonged external liquidity crunch, the economy could face severe financial strain, especially if domestic risks materialize simultaneously.¹⁵

The report said that the “long home-grown, foreign-funded boom led to large macroeconomic imbalances, overstretched private sector balance sheets, and high dependence on foreign

¹⁰ 'Iceland: 2008 Article IV Consultation—Staff Report', [IMF Country Report 08/367](#), December 2008, p3 (staff report completed August 2008)

¹¹ 'Whispers shake faith in boom', *Financial Times*, 26 March 2008, p2

¹² *ibid*

¹³ A “form of insurance against non-payment of corporate debt”.

¹⁴ 'Whispers shake faith in boom', *Financial Times*, 26 March 2008, p2

¹⁵ 'Iceland: 2008 Article IV Consultation—Staff Report', [IMF Country Report 08/367](#), December 2008, p1 (staff report completed August 2008)

financing”, citing a current account deficit of more than 15% of GDP, above target inflation, currency overvaluation, record growth of domestic credit, and a house price boom.¹⁶

The IMF staff’s view was that external liquidity risks were a “key concern [...] which could also trigger an unwinding of domestic vulnerabilities”, recommending that:

Monetary policy should continue to be tight, to return inflation to target and shore up confidence in the króna, given prevailing inflationary pressures and external vulnerabilities. The highly expansionary fiscal policy should be restrained to help support the central bank’s efforts to combat inflation and maintain confidence. Further actions to mitigate financial sector vulnerabilities should be pursued with vigor, as concerns about banks’ funding are at the core of the external liquidity risks. Contingency planning needs to continue in full force.¹⁷

The IMF reported that Iceland’s “authorities broadly agree with the staff’s diagnosis and recommendations”, although their focus was on “concerns about a deep domestic recession”, which gave “limited room to tighten monetary and fiscal policies.”¹⁸

In early October 2008 Iceland’s three largest banks collapsed. Iceland was in “*de facto* bankruptcy” and the country “effectively went bust”¹⁹, as one report summarised:

Between October 7 and 9, 2008, Iceland’s Financial Supervisory Authority (FSA), an independent state authority with responsibilities to regulate and supervise Iceland’s credit, insurance, securities, and pension markets, took control of, without actually nationalizing them, three of Iceland’s largest banks: Landsbanki, Glitnir Banki, and Kaupthing Bank.²⁰

The *Economist* noted that “the IMF calls the collapse of the banks the biggest banking failure in history”.²¹ Part [Error! Reference source not found.](#) of this note gives more detail on the bank collapse. Iceland was forced to negotiate assistance from other countries and the International Monetary Fund (IMF) (see parts [3.1](#) and [3.2](#)).

A US Congressional Research Service briefing summarises the factors behind the crisis as follows:

The demise of Iceland’s three largest banks is attributed to an array of events, but primarily stems from decisions by the banks themselves. Some observers argued that the collapse of Lehman Brothers set in motion the events that finally led to the collapse of the banks, but this conclusion is controversial. Some have argued that at the heart of Iceland’s banking crisis is a flawed banking model that is based on an internationally active banking sector that is large relative to the size of the home country’s GDP and to the fiscal capacity of the central bank. As a result, a disruption in liquidity threatens the viability of the banks and overwhelms the ability of the central bank to act as the lender of last resort, which undermines the solvency of the banking system.

¹⁶ *ibid.*, p3

¹⁷ *ibid.*, p3

¹⁸ *ibid.*, p3

¹⁹ ‘[Wall Street on the Tundra](#)’, *Vanity Fair*, April 2009 edition

²⁰ Congressional Research Service (Foreign Affairs, Defense & Trade Division), [Iceland’s Financial Crisis](#), November 2008, p4

²¹ ‘[Cracks in the crust](#)’, *Economist*, 11 Dec 2008

[...the] collapse in short-term borrowing meant that they found that it was increasingly difficult to finance debts in the interbank market.²²

In an interview for IMF Survey, the Fund's head of mission, Poul Thomsen, said in answer to a question on what had gone wrong:

Iceland allowed a very oversized banking system to develop—a banking system that significantly outstripped the authorities' ability to act as a lender of last resort when the system ran into trouble. Only a few years ago, Iceland had a banking system that was the normal size. But after the privatization of the banking sector was completed in 2003, the banks increased their assets from being worth slightly more than 100 percent of GDP to being worth close to 1,000 percent of GDP.

When confidence problems intensified this fall, Iceland was one of the first victims because the market realized that the banking system was far too big relative to the size of the economy. As investors started to pull out, it quickly spilled over into trouble for the Icelandic króna. Within a week the three banks collapsed, the króna's value dropped by more than 70 percent, and the stock market lost more than 80 percent of its value. For a small economy that is totally dependent on imports, this was a crisis of huge proportions.²³

The *Economist* saw “stark lessons from Iceland’s woes:

Iceland’s tale exemplifies why central banks around the world are spraying liquidity at the financial system to keep banks in business. When liquidity vanishes, banks quickly become insolvent. When that happens to foreign-currency loans and deposits, the central bank’s abilities as lender of last resort are tested, and Iceland shows how quickly a small country with a thinly traded currency can fail that test. [...]

Iceland found, to its peril, that its access to the leading currencies was not as sure as it had hoped. In fact, as troubles mounted, it succeeded only in securing swap lines worth €1.5 billion (\$2.3 billion) from three Nordic central banks in May, hardly enough to prevent a run on its banks. The Federal Reserve, the European Central Bank (ECB) and the Bank of England all rejected Iceland’s requests, stating, according to the Central Bank of Iceland, that the Icelandic financial system was too large relative to the size of the economy for plausible swap lines to be effective. They also wanted Iceland to talk to the IMF, which the authorities appear to have done only half-heartedly at first.

Why were the foreigners so tight-fisted? A big problem was the increasingly rickety business model of Iceland’s two largest banks, Landsbanki and Kaupthing Bank. Because Iceland is so small, the banks could attract only paltry sums in domestic deposits, which made them overly reliant on international capital markets. But in 2006, in what one of their chief executives describes as a stroke of genius, they hit upon the idea of creating internet accounts to attract foreign deposits, using the cost savings from online banking to offer higher interest rates to savers. Their strategy was so successful that soon they were sucking deposits away from bricks-and-mortar banks across Europe.

Financial officials in several countries say it became clear early this year that these online banks might pose a systemic threat across the region. Landsbanki, for example, had used Iceland’s membership of the European Economic Area (which gives countries access to the European single market without having to join the European Union) to develop its online banking presence. Under the EEA’s “passport” system, it

²² Congressional Research Service (Foreign Affairs, Defense & Trade Division), [Iceland's Financial Crisis](#), November 2008, p4

²³ ['Iceland Gets Help to Recover From Historic Crisis'](#), *IMF Survey Online*, 2 December 2008

could set up bank branches abroad that were supervised from Reykjavik, notably its internet operations in Britain and the Netherlands, called [Icesave](#).

But as Icesave grew, European authorities realised that Iceland's coffers were far too small to provide deposit insurance to savers, and that its central bank lacked reserves to act as a credible lender of last resort in the case of a run. The British authorities pressed Landsbanki to create a subsidiary in London that would be supervised by British banking authorities, as its compatriot, Kaupthing, had done. It never did. When Landsbanki collapsed in October, the country ended up owing \$8.2 billion to foreign internet depositors of its banks, an amount almost half the size of Iceland's entire economy.

At the time, other big cross-border banks, such as Fortis, a Benelux bank, and Dexia, a Belgo-Dutch bank, were in deep trouble, and there were growing concerns among European officials that a country could be overwhelmed if it was home to a big international bank that failed. Landsbanki made this fear into reality. Partly as a result of the Iceland fiasco, the British government has written to the European Commission seeking urgent consideration of improvements to legislation of cross-border banking in the EEA, including better ways of protecting depositors in branches of foreign banks.²⁴

The *Economist* also noted that by 2007 the loans made by Iceland's three main banks had grown to the equivalent of around nine times the size of GDP, increasing from around 200% of GDP after bank privatisation in 2003; of these loans only around a fifth were denominated in krona, the rest in foreign currencies.²⁵ The *Financial Times* suggested that that assets of Iceland's banking sector assets had increased from 96% of GDP in 2000 to around 800% by end-2006, and by March 2008 were "probably 10 times GDP".²⁶

2 The banking collapse

[by Tim Edmonds, Business and transport Section]

This section provides some background to the growth of the banking sector and looks at the events surrounding the collapse in Iceland and elsewhere.

2.1 The growth of Icelandic banking

Before 1999, the Icelandic banking system was largely state-owned and fractured on functional lines: commercial banking, mortgage finance, consumer credit banks, etc. In the late 1990s the decision was taken to modernise the financial services sector by first releasing it from state control. The first privatisation began in December 1999 when the Icelandic Treasury sold 15 per cent of its holdings in Landsbanki (National Bank of Iceland) and Búnaðarbanki (Agricultural Bank of Iceland), reducing the government's share in these banks to 72 and 73 per cent, respectively. The third bank associated with the 2008 collapse, Kaupthing, an investment bank, merged with Búnaðarbanki in 2003. It became the largest bank in Iceland.

Glitnir, the first bank of the Icelandic sector to fail in 2008, was created by the state-directed merger of the country's three privately-held banks - Alþýðubanki (Union Bank), Verzlunarbani (Bank of Commerce) and Iðnaðarbanki (Industrial Bank) - and one failing publicly-held bank - Útvegsbanki (Fisheries Bank) - to form Íslandsbanki (which later became Glitnir) in 1990. At the time, Íslandsbanki was the only major privately held commercial bank

²⁴ ['Cracks in the crust'](#), *Economist*, 11 Dec 2008

²⁵ *Ibid*

²⁶ 'Whispers shake faith in boom', *Financial Times*, 26 March 2008

in Iceland. It was publicly listed in 1993. Íslandsbanki subsequently merged with FBA Icelandic Investment Bank in 2000. Following the crisis the bank's name was changed back to the original Íslandsbanki.²⁷

The 1998 OECD *Iceland survey* described the background to the initial moves to deregulate the financial markets in general and the banking sector in particular:

The banking sector is currently dominated by the three commercial banks dealing with the public. Between 1930 and 1990, all the major banks were government-owned, as the only private bank closed in 1930 and was taken over by a new state-owned bank. At the end of the 1980s, most of the public-sector banks were making large losses. To deal with this problem, one insolvent public sector bank was sold to a number of small banks and became the nucleus of what is now the only private-sector commercial bank. In 1993, another was rescued through a series of loans and equity injections amounting to over 1 per cent of GDP. As a result, there remains only two banks in the public sector, accounting for 68 per cent of total bank assets. Until 1997, they were not constituted as joint stock companies subject to commercial law and benefited from government guarantees on their non-deposit liabilities.[...].²⁸

2002 was a key year in the development of the banking sector. In that year, the government shareholdings in the two commercial banks, Landsbanki and Búnaðarbanki, were nearly all sold; Kaupthing entered the commercial market – it had been a purely investment bank; and the existing Financial Supervisory Authority (FSA) was given considerably more power of oversight than previously it had held. For example, the budget of the FSA was raised 44 per cent between 2000 and 2002, and staffing levels were increased. Moreover, the creation of the Financial Stability Department at the Central Bank further improved oversight, and the parliament granted the FSA greater authority in late 2002.

Information in English about the commercial development and acquisitions history of the three banks is scarce, though there are relevant Wikipedia entries.

2.2 Landsbanki

The bank's major subsidiaries are:

- **Heritable Bank** (London) - Residential Development Finance, Mortgages, Specialty Finance
- **Landsbanki Securities (UK)** (London) - Corporate and Institutional Broking, Corporate Finance, Equity Research
- **Landsbanki Kepler** (Paris, Frankfurt, Amsterdam, Milan, Zürich, Geneva and Madrid) - Institutional Broking, Asset Management, Corporate Finance, Research
- **Landsbanki Luxembourg** (Luxembourg) – Private Banking, Asset Management
- **Merrion Landsbanki** (Dublin) - Corporate and Institutional Broking, Corporate Finance, Research

Landsbanki operated branches in London, Amsterdam, Oslo, Helsinki and Canada. Since 2006, it offered online savings in the UK, trading as Icesave, a service extended in 2008 to the Netherlands.

²⁷ Source: [wikipedia](#)

²⁸ OECD country survey Iceland 1998 (contact Section for copy stored in I/BTS/financial Services)

2.3 Glitnir

Most of the acquisitions of Glitnir were in its 'backyard' in Iceland and Norway. Glitnir considers Iceland and Norway its home markets. Since 2004, Glitnir acquired BNbank and Glitnir bank (previously Kredittbanken), Glitnir Securities (previously Norse Securities) and Glitnir Kapitalforvaltning, the factoring company Glitnir Factoring (previously FactoNor), and 50.1 percent of Union Gruppen in Norway. In addition, Glitnir's subsidiary BNbank acquired 45 per cent of the shares in Norsk Privatøkonomi ASA, an independent financial advisory company with 12 branches in key areas of Norway in July 2006.

2.4 Kaupthing

Kaupthing Bank previously operated in thirteen countries, including all the Nordic countries, much of Europe and the United States. It was the seventh-largest bank in the Nordic bloc in terms of market capitalization.

As of 31 December 2007, the bank had total assets of €58.3 billion. In 2006, it ranked number 1,006 in an annual ranking of top 2000 corporations in the world. The same year, it ranked number 177 (up by 34 places from 2005) on the list of the world's largest banks composed annually by the international finance magazine [The Banker](#).

In 2007, Kaupthing Bank had net earnings of €812 million, compared with €986 million in 2006. About 70% of its profit originated outside Iceland (33% in Iceland, 31% in the UK, 26% in Scandinavia, 8% in Luxembourg and 2% in other countries).

An acquisitions history is listed on [Wikipedia](#):

Acquisitions, mergers, subsidiaries

- 1930 Búnaðarbanki Íslands (English: Agricultural Bank of Iceland) founded in Iceland
- 1982 Kaupthing hf. founded in Iceland
- 1998 Kaupthing Luxembourg, S.A. opened
- 2000 Kaupthing Faroe Islands opened, Kaupthing New York opened, Kaupthing Stockholm opened
- 2001 Kaupthing Bank Copenhagen opened, Kaupthing Lausanne opened, Sofi acquired in Finland
- 2002 Aragon acquired in Sweden, JP Nordiska acquired in Sweden, Auðlind acquired in Iceland
- 2003 Kaupthing merges with Búnaðarbanki Íslands to form Kaupthing Bank, Tyren acquired in Norway, Norvestia acquired in Finland, Kaupthing Limited opened in the UK
- 2004 A. Sundvall acquired in Norway, FIH acquired in Denmark
- 2005 Singer & Friedlander acquired in the UK
- 2006 Kaupthing Limited merges with Singer & Friedlander to form Kaupthing Singer & Friedlander in the UK

- 2007 Kaupthing buys Dutch merchant bank NIBC for €3 billion, (as of late January 2008, Kaupthing decided to cancel the acquisition of NIBC)
- 2007 Kaupthing acquired a 20% stake in New Delhi-based Indian investment services company Finoble Advisors with in option to buy the remaining 80% in 5 year's time
- 2007 Kaupthing buys Belgian private banking and asset management operations of Robeco Bank, for an unspecified amount, further strengthening its position in the Benelux market.
- 2007 Kaupthing hf acquired Derbyshire Offshore, the Isle of Man subsidiary of Derbyshire Building Society, continuing Derbyshire Offshore's irrevocable and binding guarantee for all depositors funds in the new subsidiary, Kaupthing, Singer and Friedlander (Isle of Man) Ltd.
- 2007 - 2008 Kaupthing launches internet based Kaupthing Edge in the UK, Belgium, Norway, Germany, Finland, Sweden, Luxembourg, the Isle of Man, Austria and Switzerland.

2.5 Kaupthing Edge

Kaupthing Edge was a pan-European retail deposit taking brand. The purpose of the brand was to diversify liabilities on the Kaupthing balance sheet by currency, customer type (personal/retail) and country. Kaupthing Edge offered two deposit products: a savings account and a fixed term deposit account. Both were straightforward high-interest products. Kaupthing Edge savings and fixed term deposit accounts were managed over the Internet with the support of telephone call centres. Kaupthing Edge was available in eleven countries in Europe:

Finland - available since October 2007; liabilities taken over by the Finnish Financial Supervision Authority on 9 October 2008

Sweden - available since November 2007; accounts closed and all deposits repaid by 20 October 2008.

Norway - available since January 2008; liabilities taken over by the Norwegian government on 12 October 2008

Belgium - available since January 2008, all accounts were frozen on the 9th of October 2008. over 20,000 depositors funds still remains blocked as the bank is awaiting its takeover

United Kingdom - available since February 2008; accounts transferred to Dutch bank ING Direct on 8 October 2008

Germany - available since March 2008; agreement on repayment of 30,000 depositors reached 24 November with a loan of €308 million from Germany to the Icelandic Depositors' and Investors' Guarantee Fund¹

Luxembourg - available since April 2008

Isle of Man - available since April 2008; placed into receivership on 9 October 2008 due to Gordon Brown's UK Government forcing the sale of the UK branch to ING. Isle of Man branch had previously transferred £555M of unsecured funds into its UK sister branch. This left the IoM branch unable to function. Depositors abandoned by both UK and IoM Governments. Court hearing regarding DCS (Depositors Compensation

Scheme) or SoA (Scheme of Arrangement) put off until April 2009. [NOTE: this appears to be a rather partial account of the interplay between the British closure and the Isle of Man closure]

Switzerland - available since June 2008; in liquidation from 17 November 2008. Depositors partially repaid.

Austria - available since September 2008; accounts frozen on 9 October, accounts transferred to other banks on 29 October

2.6 Comment on Iceland's economic liberalisation

An article from the *Financial Times* 8 July 2005 examined various aspects of the banking expansion story:

Iceland's banks have taken a lower-key route to expansion than entrepreneurs such as Jon Asgeir Johannesson but have been no less active. They are seen by some as the foundation of the country's recent economic transformation.

Set up as state banks to cater to the needs of a small, insular farming and fishing population, they took full advantage of financial sector deregulation in the early 1990s. "Before," says one Icelandic economist, "there was no equity market and no financial market."

Since gaining opportunities for diversification, Iceland's three main banks have funded many of the acquisitions made by Icelandic companies at home and abroad, both lending to and taking big stakes in companies. Kaupthing, the largest bank, has stakes in Baugur as well as Mosaic, the UK retailing company that was listed on the Icelandic stock exchange this year.

As the banks' investments have grown, so they have looked beyond Iceland's borders. Kaupthing had about Euros 3.5bn (Dollars 4.2bn) assets in 2001. By the end of the first quarter of 2005 it had grown to about Euros 25bn, having bought FIH, the Danish bank, and Singer & Friedlander in the UK. It prefers to be seen as a Nordic or north European bank than an Icelandic one, having won a place as one of the top 10 Nordic banks, largely as a result of acquisitions.

Kaupthing has been the most aggressive of Iceland's banks in expanding internationally, recognising the constraints of serving a population of less than 300,000. Landsbanki, its close rival, whose name greets passengers as they fly into Reykjavik, has been growing more slowly. In the past five years its assets have grown from IKr239bn (Dollars 3.6bn) to IKr730bn as it has bought up small banks in Luxembourg and London, and most recently Teather & Greenwood, the UK stockbroker. Yet it has ambitions to expand further and faster across northern Europe.

Islandsbanki, the third largest bank, was formed out of three fisheries and industrial funds. The bank, whose assets rose 50 per cent last year to IKr575bn, has also started to expand out of Iceland recently with acquisitions in Norway.

In many ways, the banks' recent history echoes what has happened in other Icelandic companies that are swiftly finding an international audience. They are headed by thirty somethings who left college just as deregulation was happening.

"We started to grab the opportunities," says one banker. Up to now, it has all gone their way, as the economy and companies have boomed. But the country's central bankers see signs of stress. Last year the central bank warned about a "flurry of leveraged buy-outs of listed and unlisted companies, which provide one explanation of the surge in lending by banks".

It went on: "These transactions have driven up equity prices of several listed companies, including financial companies, prompting the question of what the impact will be should share prices head back down."

The International Monetary Fund has urged the Financial Supervisory Authority in Iceland promptly to implement "stress tests to assess the risks to the financial sector arising from changes in interest rates and sharp movements in the exchange rate", adding: "This is becoming particularly important as banks intermediate a rapidly growing volume of foreign lending."

Moreover, says Nigel Myer, analyst at Dresdner Kleinwort Wasserstein, the banks' management teams, where the average age is under 40, "are untested in more challenging operating conditions".

This leaves the head of one bank unmoved, however: "Icelandic companies have done some of the biggest public to private transactions in the UK this year . . . None of that would have happened if we were novices."

The 2006 OECD survey included a complete chapter on the liberalisation of the Icelandic financial system and covers much of the period from 2002 onwards. Extensive, but edited, sections of this are shown below.²⁹

Iceland's financial sector has expanded considerably. Its share of output has risen from 4% of GDP in the mid-1970s to an average 5½ per cent in the 1990s to 7½ per cent recently. The sector is now a bigger part of the economy than high-profile industries such as fishing (5% of GDP), electricity (4%) or aluminium (1%). Real output of financial services is difficult to estimate, but simple measures of activity point to dramatic growth. For example, domestic lending of the credit system (assets, including portfolio investment, excluding those of foreign subsidiaries) has risen by an average of 15% a year since 1996 (compared with growth in nominal GDP of 8%). Much of this growth has occurred within the banking system, where domestic lending and securities has risen an average 25%. The last few years have been especially remarkable. Domestic lending and securities of the banking system grew by 37% in 2004 and 50% in 2005, while that of the credit system as a whole rose by 20% and 30%. Other measures of the quantity of financial services have also shown phenomenal growth. For example, the number of cheque, credit and debit card transactions has tripled since 1994.

[...]

[FINANCIAL DEVELOPMENT & GROWTH]

As discussed above, Iceland's financial sector has been growing strongly. In particular, firms and households have been borrowing increasingly heavily. As a result, Icelanders make relatively heavy use of financial services. One broad measure of this is the ratio of private sector loans and securities capitalisation to GDP. A narrower measure is the ratio of household debt to income. These are higher in Iceland than in most OECD countries. Several factors may help to explain this including large pension savings, the long duration of household mortgages, the young age of the population, and rapid productivity growth (Karlsdottir, 2005). A standard interpretation of these measures, consistent with the empirical literature (Levine, 2004), is that they indicate well developed financial markets and relatively easy access to finance.

However, on some other measures Iceland's financial sector is still under-developed. For example, it has few markets for derivatives. And trading in standard financial

²⁹ OECD country survey Iceland 2006 (contact Section for copy stored in I/BTS/financial Services)

products, like foreign exchange, bonds or equities, is often thin. These limitations seem to mainly reflect the small size of the economy, which impedes liquidity. They can be expected to be overcome with advances in time, income and technology.

Not just the quantity, but also the variety and sophistication of financial transactions have increased. The financial sector has expanded into many new lines of business, often quite recently. To give some examples, banking by internet and other forms of electronic transactions have exploded. Refinancing of home mortgages is now common; before 2004, this service was not offered. Banks now offer “one-stop shops” for home loans. Previously, borrowers took out different mortgages from different lenders, at different rates and conditions. (Housing finance is discussed in more detail below.) Large investment projects are now financed by domestic rather than foreign banks. In 1998 when the predecessors of Century aluminium financed their green field smelter, only one Icelandic bank (FBA, now part of Glitnir) participated in the syndication. Seven years later, the refinance and expansion financing were led by the Icelandic banks. New products are regularly being offered on the market. For example, Kaupthing Bank has recently announced that it will start issuing mortgage-backed securities. Similarly, in 2005 foreign borrowers started issuing bonds denominated in Icelandic krónur. Although targeted at small foreign investors, these affect domestic markets through adding liquidity and depth.

[THE EXPANSION OF THE BANKING SECTOR]

The expansion of Icelandic financial institutions into foreign markets has been especially dramatic. In the last few years, the three major banks have each made a number of substantial foreign acquisitions, particularly of banks in Nordic countries and the United Kingdom. Their foreign subsidiaries are now of similar size to their domestic assets (Table 4.1). Reflecting this expansion, the total assets of the commercial banks (plus the largest savings banks)¹ rose to 200% of Iceland's GDP in 2003 and 370% of GDP in 2004. As a result, the three major banks are now huge relative to the size of Iceland's financial markets. As of November 2005 they accounted for 55% of the total capitalisation of the Icelandic stock exchange (Table 4.1).

Table 4.1. The 3 major banks

	Kaupthing	Landsbanki	Glitnir
Market capitalisation (as of November 2005, ISK billion)	439	263	215
Share of Icelandic stock exchange	26%	16%	13%
Foreign subsidiaries as share of total assets (as of end-2005)	62%	22%	39%

Source: Iceland Stock Exchange, Central Bank.

The banks' strategy for foreign expansion *via* aggressive acquisitions has involved early identification of under-priced assets and using favourable credit ratings to lower the cost of borrowing to newly acquired firms. The positive image of Iceland in the target countries has also been an advantage. However, the explanation that market observers emphasise is that banking is simply something that Icelanders do well. The Icelandic bankers are young, outward-looking, educated and highly receptive to new technology.

Banking has a high status in the society. Assessing the importance of factors like these is difficult. But more objective performance measures are favourable. As measured by standard cost ratios the Icelandic banks are efficient by international standards. Fees charged by Icelandic banks tend to be substantially lower than those charged by counterparts in other Nordic countries (Baldursson and Jonsson, 2004).

The expansion of the banks abroad has been of clear, if perhaps somewhat narrow, benefit to Iceland. The main payoff has been a larger return to capital. The banks'

combined return on equity was 24% in 2003, 32% in 2004 and 42% in 2005. This has been an obvious boon to their shareholders, but also to the tax authorities, through swelling corporate tax receipts. Because the expansion has been through acquisitions rather than export of services it has involved relatively modest increases in employment within Iceland. However, headquarters, liquidity management and risk management have been concentrated in Reykjavik. Partly reflecting this, financial sector wages have risen strongly. The average salary paid by financial institutions rose by an average annual rate of 16% between 1999 and 2004, outstripping the economy-wide wage index, which rose only at a 7% rate. Most of this divergence has occurred in 2003 and 2004.

[RISK TO THE SYSTEM]

Other repercussions of the expansion have been favourable but relatively modest. Because the expansion largely reflects acquisitions rather than aggressive lending, it has broadened and diversified the banks' asset holdings. Because it has been financed by equity and subordinated debt it has not weakened capital adequacy. So the expansion has probably lowered systemic risk – even though the range of risks to which the Iceland banks are exposed has broadened.

[BROADER MARKET LIBERALISATION]

The growth of the financial market follows a wave of market-oriented policy changes. Over the past two decades Iceland's financial system has been transformed from one that was highly regulated by international standards to one where the authorities' role now tends to be supervisory, rather than managerial (with some exceptions, discussed below). Table below provides a chronology.

Financial market liberalisation in Iceland: key stages

Financial indexation permitted	1979
Liberalisation of domestic bank rates	1984-86
Iceland Stock Exchange established	1985
Interest Rate Act: interest rates fully liberalised	1987
Stepwise liberalisation of capital movement begins	1990
Treasury overdraft facility in the Central Bank closed	1992-3
New foreign exchange regulation marks the beginning of liberalisation of cross-border capital movements	1992
Interbank market for foreign exchange established	1993
Iceland becomes a founding member of the EEA	1994
Long-term capital movements fully liberalised	1994
Short-term capital movements fully liberalised	1995
Foreign direct investment liberalised in accordance with EEA agreement	1995
Interbank money market	1998
Interbank FX swap market	2001
Privatisation of state-owned banks completed	2003

Source: Central Bank of Iceland (2005a)

In general, the sector has been opened up to international capital; interest rates and other prices now reflect supply and demand; innovation is permitted and rewarded; and most institutions are now privately owned.

Of these numerous reforms, two are most often emphasised by market observers. First, Iceland joined the European Economic Area (EEA) in 1994. Membership has involved including within Icelandic law all existing and future EU directives in the field of financial services. These opened the country up to international capital directly while

facilitating trade through harmonisation and transparency. Second, government-owned commercial banks and investment funds were privatised between 1998 and 2003. This is widely perceived as having replaced a sluggish and inward-looking culture with a more entrepreneurial spirit. Furthermore, it enabled the banks to raise the equity that financed their expansion. This arguably would not have been possible under the previous structure of government ownership and control.

[...]

Liberalisation seems to have proceeded at a faster pace in Iceland than in other countries – in part because the starting point was more interventionist. Hence the more rapid growth of the Icelandic financial industry than those of other countries also suggests the important role of policy. The clearest evidence of this growth difference is that, while Icelandic banks have been growing abroad, foreign banks have not set up operations in Iceland (though they are welcome to do so).

[FINANCIAL PERFORMANCE]

One of the ways in which liberalisation contributes to economic performance is through raising financial sector efficiency. For example, this can occur through aligning incentives with outcomes, by a reduction in bureaucracy, or greater exposure to trade. Operating expenses have declined relative to net operating income, net interest margins have also declined dramatically. Average measures such as these are crude, and can be affected by many factors in addition to productivity. Nevertheless, market observers generally believe that the industry has become much more efficient following market liberalisation.³

[BANKING SECTOR STABILITY]

Relative to other countries, the Icelandic banking sector is extremely concentrated. Retail banking is dominated by the three main commercial banks. Of course, this reflects the small size of the Icelandic market. However, there is also a large fringe of small savings banks and pension funds that offer some financial services. Home loans are also provided by the Housing Financing Fund. Icelandic firms and governments have often gone overseas for investment banking services, though domestic banks are increasingly able to meet these demands. No foreign banks are located in Iceland. However, this does not reflect any policy impediment – to the contrary, their presence would be welcomed and their participation has been actively sought in the past (most recently, at the time of the bank privatisations). Foreign banks have long been active in lending to governments and large businesses. Overall, the banking sector may not appear to be competitive, but it is contestable.

Many concerns have recently been expressed about the stability of the Icelandic banking system. Examples include Fitch Ratings (2006), Merrill Lynch (2006) and Danske Bank (2006). These and other observers have worried about high levels of debt and large exposures of financial institutions to house prices, share prices and the exchange rate, all of which have been at elevated levels. In response to these concerns and other factors, such as unwinding of the international carry trade, Icelandic capital markets have been highly volatile. Between mid-February and early May, the Icelandic krona depreciated by around 20%, while share prices fell by a similar amount. These realignments will have serious macroeconomic implications. For example, as discussed in Chapter 2, the exchange rate depreciation means that the Central Bank is unlikely to approach its inflation target in the absence of large interest rate increases. How far-reaching the effects will be on the financial system is not clear. Interest margins for the three main banks have increased considerably which, at the least, will slow their expansion. Representatives of leading financial institutions have

suggested that the changes to date can be easily absorbed, although a substantial contraction of the economy would make things more difficult.

The stability of the financial system seems likely to remain an issue for some time. Iceland's high current account deficit, its rapid credit growth and the volatility of the economy will always make foreign investors somewhat nervous. However, these risks are offset by several positive factors.

The balance sheets of financial institutions seem healthy. In particular, the major banks are well capitalised and their assets are increasingly diversified. Much of their rapid expansion, both in Iceland and abroad, has been financed by equity and subordinated debt. Both borrowers and lenders are aware of the risks being taken and have approached them prudently. The Financial Supervisory Authority has recently strengthened its stress testing, a welcome development. This indicates the banks could comfortably handle a simultaneous 35% fall in domestic stock prices; a 25% fall in foreign stock prices; 20% loan default losses; a 7% fall in bond prices; and a 20% depreciation of the króna. More recent stress testing has indicated robust capacity to handle large debt write-downs. Overall, the guarded assessment of financial supervisors, credit rating agencies and the IMF is that the system is broadly sound. Some market commentary is more sceptical.

Detailed assessments of the state of the financial system are now published by the Central Bank in its annual *Financial Stability* reports. Because foreign investors' concerns dictate the terms at which Icelanders borrow, continued reassurance about the stability of the financial system will be necessary. If anything, one might wonder whether the position of some financial institutions is too secure. The government of Iceland explicitly guarantees the debt of the Housing Finance Fund and guarantees the major banks implicitly. The government has never given any assurances that it would guarantee the major banks. Nor however has it denied that it would do so. Accordingly, the markets believe there is a positive probability of government support. Credit rating agencies Moody's and Fitch both justify their favourable ratings of the banks on this basis. These guarantees have been important in the growth of these institutions. However, they expose the public to a large potential liability, they skew the distribution of capital away from less-favoured institutions and they encourage excessive risk-taking. The guarantee of HFF debt is discussed in the following section. The implicit guarantee of the banks is an issue that will probably grow in importance, particularly if their operations extend further abroad. Whereas the banks used to be considered "too big to fail", if their current growth continues, they may soon become "too big for the government of Iceland to rescue". Accordingly, the government should consider making an explicit statement that there is no unconditional government guarantee of bank lending. It may be that the current deposit insurance system (Asgeirsson, 2005) and lender-of-last-resort facilities are sufficient to protect small deposit holders and prevent bank runs.

Like just about everywhere else in the world and every other informed opinion maker, the OECD clearly did not see the collapse of the Icelandic banking system coming. In its February 2008 Survey it wrote "most criteria suggest that the Icelandic banks are sound".³⁰ It noted that "all of them have recently passed a comprehensive stress test by the Icelandic Supervisory Authority...At the same time Moody's has placed the ratings for Icelandic banks on review, while pointing to their growing reliance of foreign deposits as a possible source of fragility".³¹

³⁰ OECD country survey *Iceland*, February 2008, p30

³¹ *Ibid*

2.7 Bank collapse and Treasury seizure of 'terrorist' assets

An issue which caused considerable irritation in Iceland and provoked some comment in the UK was the use of Section 4 of the *Anti-terrorism, Crime and Security Act 2001* to seize funds that could be used to compensate UK depositors, announced by the Treasury on 9 October 2008.³² Section 4 is shown below:

Power to make order

- (1) The Treasury may make a freezing order if the following two conditions are satisfied.
- (2) The first condition is that the Treasury reasonably believe that—
 - (a) action to the detriment of the United Kingdom's economy (or part of it) has been or is likely to be taken by a person or persons, or
 - (b) action constituting a threat to the life or property of one or more nationals of the United Kingdom or residents of the United Kingdom has been or is likely to be taken by a person or persons.
- (3) If one person is believed to have taken or to be likely to take the action the second condition is that the person is—
 - (a) the government of a country or territory outside the United Kingdom, or
 - (b) a resident of a country or territory outside the United Kingdom.

The Chancellor explained his choice of course of action (the legislative base for this was the power to seize assets from terrorists etc) in a statement to the House:

I have to tell the House that getting information out of Iceland is proving to be quite difficult. That country obviously has severe difficulties, and that is why I decided that I had to intervene. It would have been quite wrong to say to people covered by the Icelandic scheme, "Sorry, you've got to go to Reykjavik and try to get your money there." That is especially true when it is not clear to me whether the Icelandic scheme can be funded. So we have taken steps to freeze the assets of the bank involved, and I hope that we will be able to recover some of those assets in order to offset the money that we will have to provide to help people in the meantime.³³

The Chancellor made further comments during an oral evidence session of the Treasury Committee hearing

Q47 Mr Breed: Thank you. Chancellor, turning to something quite different, why was it necessary for the Government to use anti-terrorism laws for the purpose of freezing the assets of the Icelandic banks? Were the existing laws relating to insolvency not sufficient to cover this situation?

Mr Darling: No, they were not and actually the legislation we used, although it does cover terrorism also covers the powers that we have to protect the country's general economic interest. Interestingly, when you look back at what happened when the legislation went through Parliament, there was an amendment laid in the House of Lords to try and confine these powers to be used in the case of terrorism and that amendment was voted down. I think it was contemplated at the time that those powers might be used more widely. Indeed, in my statement, I think on 15 October, when I said that we were using the powers under that Act, I did make it clear that these were

³² HM Treasury press notice 103/08, 9 October 2008

³³ HC Deb 8 October c282

general powers which are available to the Government. Can I just say - this is also important - you need to understand why we were doing this. We still have a situation now, five weeks later, where we have stepped in to guarantee the retail depositors in the Landsbanki subsidiary and as of today we still do not have an agreement from the Icelandic government that they will cover us for it so we did need to step in to protect the interested British taxpayers.³⁴

The exchange in the Lords committee stage of the *Anti-terrorism, Crime and Security Bill* referred to by the Chancellor was in November 2001.

The amendment mentioned was one to clause 4 of the Bill and was moved by Lord Goodhart on the grounds, he said, that the Bill as it stood broadened considerably the then existing power to freeze assets which derived from the *Emergency Laws (Re-Enactments and Repeals) Act 1964*. The long title of the Bill opens with “Amend the Terrorism Act 2000; to make further provision about terrorism and security; to provide for the freezing of assets”, their Lordships debated whether ‘freezing of assets’ was a separate issue or whether it was implicitly connected to terrorist events. Moving his amendment Lord Goodhart said:

The noble Lord said: This is a probing amendment. Clause 4 as drafted allows a freezing order to be made if a foreign government or resident is likely to take,

“action to the detriment of the United Kingdom's economy (or part of it)”.

That expression is extraordinarily wide. Perhaps I may give an example. A Japanese company is considering whether to build a new car manufacturing plant in the United Kingdom or in Switzerland. The Swiss Government offer the company a financial inducement to build its plant in Switzerland—something in the nature of, say, a tax holiday.

That is plainly action to the detriment of the United Kingdom economy. The result is that, at least in theory, the Treasury could make a freezing order stopping anyone in the United Kingdom, or United Kingdom nationals resident abroad, from making payments to the Swiss Government. Some people might say that that was quite right, but I am sure that it was not the intention. I want to probe why such a wide-ranging clause has been adopted.³⁵

Lord Hylton called for the amendment to be defeated since he wanted it to be applied to the funds of African dictators currently deposited in London. Although the desirability of such a power was not questioned by him, Lord Onslow, amongst others, expressed the view that this was extending the scope of the Bill too far. Agreeing, Lord Elton said “Perhaps the Minister will reply to the specific point that what he wants to achieve relates to terrorism”.³⁶

Replying, the Government minister, Lord McIntosh, gave as an example of the use Clause 4 the case of “Abu Qatada, described as Osama bin Laden's key contact in Britain, [who] today launched a legally aided High Court bid to be paid social security benefits”.³⁷ He appeared to accept the very generality of the power granted under the Order but highlighted the restraints on the use of the Orders and the non-terrorist circumstances where they could be used. Both sections reveal the imagined scope and operation of the Orders.

³⁴ [Treasury committee, uncorrected evidence HC 1167-i](#)

³⁵ HL Deb 28 November 2001 c348

³⁶ *Ibid*, c351

³⁷ *Ibid* c 354

There are unavoidable and desirable constraints on the use of that power. Before we exercise it, we have to consider whether it is compatible with European Community obligations. It could not be used as a means of arbitrary discrimination or as a disguised restriction on the free movement of capital. International law, in particular the World Trade Organisation, would prevent the power being used as an illegitimate tool to protect UK businesses. The European Convention on Human Rights also imposes significant restrictions on the exercise of the power. We can freeze assets only when it is necessary in the general interest and where it is a proportionate interference with the rights of individuals.

The power is just one part of the sanctions regime. If a decision to impose sanctions is taken at European Community level or under a United Nations Security Council resolution, it would not be appropriate to use the power. There are safeguards in the power.

[...]

The problem is that the power is intended to provide wide-ranging protection against threats to national security. One reason for these provisions is to counter the new risk of terrorism, but it is also important to cover such situations as wars or civil unrest affecting United Kingdom nationals and their property. The sanctions have been available for many years to counter actions that threaten UK economic interest, wherever that threat comes from.³⁸

In a later exchange he was invited to say that the legislation was terrorist-based:

Lord Elton: I do not wish to be a bore on this subject, but I think that I am likely to become so. Can we establish at the beginning that this is emergency legislation directed at an emergency? When the Minister—or my noble friend Lord Renton—starts saying that it would be very useful and desirable to prevent other things happening which are not the product of the emergency, it seems to me that the parliamentary process that we are now using is not appropriate. I am merely picking up on what my noble friend Lord Onslow said a moment ago. The House generally feels that emergency legislation must restrict itself to dealing with the events of the emergency.

Lord McIntosh of Haringey: I did not use the phrase “very useful” but I do not dissent broadly from what the noble Lord, Lord Elton, said. If we included the word “terrorism”, we would, in effect, restrict quick and urgent action that was necessary to prevent certain things that cannot be shown at an early stage of an investigation to be terrorism. That will be true for a number of aspects of Parts 2 and 3 of the Bill. We shall resist moves to restrict the powers given under the Bill on, for example, disclosure of information for criminal investigations and proceedings, which is wider than the existing provisions because at the time when it is necessary to allow such disclosure, it will not be possible to know whether such disclosure would be beneficial in dealing with terrorist threats. That is the problem throughout these parts of the Bill.³⁹

It might be telling that, when pushed, the Minister’s argument against restricting action to terrorist activity was that it may “restrict quick and urgent action that was necessary to prevent certain things that cannot be shown *at an early stage of an investigation* to be terrorism” rather than things which were clearly and obviously not terrorist-sponsored. He continued in the same vein:

³⁸ [HL Deb 21 November c354](#)

³⁹ Ibid c354

Amendment No. 37 would restrict the use of Clause 4 in a way that could be damaging to terrorist investigations. Amendments Nos. 38, 39 and 40 go in the other direction. I have already said that the measure will ensure that the powers that were originally intended for use in war time are broad enough to cover the threat of terrorist attacks. To achieve that, we need a broad and flexible power to cover a range of different circumstances. We appreciate that these are serious measures for use only in emergencies and in defence of national security.⁴⁰

Banking crises appear not to have been uppermost in anyone's mind at the time.

Replying to the debate Lord Goodhart said:

I end by not being satisfied with the Government's response. As regards the drafting, the Minister did not attempt to dispute my interpretation; that is, that it is within the wording of the Bill as it now stands that it should cover the competitive bidding for overseas investment that I was describing. I specifically chose the example of Switzerland because I wished to choose a state which was not part of the European Union.

It is certainly unsatisfactory if we have to rely for the restriction on the extreme width of Clause 4 on international obligations, the rules of the World Trade Organisation and so forth. It would be better if on the face of the Bill some limitation could be imposed on the width of Clause 4. I entirely accept that Clause 4 is not intended to be limited to terrorism and that my amendment is therefore inappropriate. But that gives rise to the wider problem raised by the noble Lord, Lord Elton, and the noble Earl, Lord Onslow, and it again discloses a problem dealt with by many speakers yesterday, including myself. This is a wholly inappropriate use of emergency legislation because it goes well beyond the emergency. Having said that, I cannot redraft the legislation for the Government. It is unsatisfactory. Nevertheless, I beg leave to withdraw the amendment.⁴¹

A further issue is whether, by its actions announced on 8 October, the UK government put undue pressure on, and hastened the demise of, the Kaupthing bank which had until then survived. It is not asserted that the UK government brought down the whole Icelandic banking sector: there were clear signs of difficulty in Iceland before 8 October.

On 29 September 2008, the Icelandic regulator (FME) had taken a 75 per cent share in Iceland's third largest bank, Glitnir, an action taken after an agreement whereby the Government of Iceland provided the bank with new equity amounting to 600 million Euros.

On 6 October Iceland's parliament, the Althing, passed emergency legislation enabling the government to intervene extensively in Iceland's financial system - the most radical economic measure ever taken in the country's history. On the same day, shares in all of the Icelandic banks were suspended on the domestic stock market. The following day the FME used this emergency legislation to take over Landsbanki and Glitnir.

At this point there is a dispute as to what happened next. Alistair Darling and Mr. Arni Mathiesen, the Icelandic Chancellor, had a telephone conversation. Mr Darling's version was that "I was in no doubt...that the Icelandic government was not going to be able to help British depositors".⁴² On 8 October he said on radio, referring to the conversation, "The

⁴⁰ Ibid

⁴¹ Ibid c357-8

⁴² Channel 4 News interview, reported *Financial Times* 25 October 2008

Icelandic government, believe it or not, have told me yesterday they have no intention of honouring their obligations here”.

This version was disputed by the Icelandic Government. It released a transcript of parts of the conversation, including the following exchange:

AD: "What about the depositors you've got who've got deposits in London branches?"

ÁM: "We have the [deposit] insurance fund according to the Directive and how that works is explained in this letter (to the UK) and the pledge of support from the government to the fund."

AD: "So the entitlements the people have which I think is about £16,000, they will be paid that?"

ÁM: "Well, I hope that will be the case. I cannot state that or guarantee that now but we are certainly working to solve this issue. This is something we really don't want to have hanging over us."⁴³

In the UK there has been criticism too of the Government's actions, particularly by people with deposits in the Kaupthing banks on the Isle of Man and Guernsey, neither of whom will benefit from the UK compensation scheme, but see the freezing of funds as directly contributing to a diminution of their available compensation pot.

The issue of whether Iceland originally intended to compensate UK depositors or whether it was not able to compensate them through lack of funds may never be known. It was not until after the arrangement of its IMF loan that the Icelandic authorities were able to announce that they would be paying their tranche of compensation. The negotiations for the loan were complex, with more than a suggestion that Britain and others exercised what influence they had to ensure that the loan was conditional upon Iceland meeting its European Economic Area (EEA) compensation obligations. An article from the Times outlines the end of the saga:

The \$2billion (£1.3billion) IMF loan, part of a \$6billion package that Iceland needs to help it to rebuild its tattered economy, hit the buffers last week after the Netherlands, Germany and Britain demanded that the rescue package be conditional on Iceland giving some financial guarantees to foreign depositors.

Announcing the agreement, Geir Haarde, Iceland's Prime Minister, said: "It became increasingly clear that we were not just up against two countries but all twenty-seven in the European Union."

Mr Haarde, in a statement with Ingibjorg Solrun Gisladdottir, the Foreign Minister, said that "the way had now been opened for a loan from the IMF", which is to address Iceland's request on Wednesday. The ministers said: "According to the agreed guidelines, the Government of Iceland will cover deposits of insured depositors in the Icesave accounts in accordance with EEA (European Economic Area) law."

The EEA agreement states that the Government must repay about the first £18,000 in British savers' accounts.⁴⁴

⁴³ *Financial Times* 24 October 2008

⁴⁴ 'Refund for UK savers as Iceland seeks IMF rescue', *Times* 17 November 2008

For more information, a convenient summary can be found in the debates on the *Landsbanki Freezing Order* in the proceedings of the [Delegated Legislation Committee](#)⁴⁵ and in the House of Lords Merits of Statutory Instruments Committee.⁴⁶

More information concerning ongoing compensation arrangements for depositors in failed Icelandic banks, both in the UK and in the Isle of Man and Guernsey can be found in Library Standard Note 4864, *Icelandic Bank Default*.

3 Iceland after the crash

[by Ian Townsend, Economic Policy and Statistics Section]

3.1 Financial assistance from the IMF

On 24 October, in the immediate aftermath of the bank collapse, Iceland agreed a \$2.1 billion rescue package with the International Monetary Fund (IMF), later formally approved on 19 November 2008.⁴⁷ The two-year Stand-By Arrangement, approved under the IMF's fast-track emergency financing mechanism, made \$827 million available immediately with the rest to be released in eight tranches of \$155 million, subject to quarterly reviews.⁴⁸

The IMF outlined the program's three main objectives as:

- **Preventing further sharp króna depreciation** by maintaining an appropriately tight monetary policy in the context of a flexible exchange rate policy. Restrictions on capital outflows will remain in the near term.
- **Developing a comprehensive and collaborative strategy for bank restructuring** by (i) putting in place an efficient organizational structure to facilitate the restructuring process, (ii) proceeding promptly with the valuation of banks' assets, (iii) maximizing asset recovery in the old banks, (iv) ensuring the fair and equitable treatment of depositors and creditors of the intervened banks, and (v) strengthening supervisory practices and the insolvency framework.
- **Ensuring medium-term fiscal sustainability.** While automatic fiscal stabilizers will be allowed to work in full during 2009, the program includes the development of a strong medium-term fiscal consolidation plan to be launched in 2010. This effort is needed to deal with the very substantial increase in public sector debt that is likely as a result of the budgetary cost of recapitalizing the banking system fulfilling the deposit insurance obligations to depositors in foreign branches of Icelandic banks.⁴⁹

The IMF noted that *de facto* capital controls had been in place in Iceland since the bank collapse, with “only payments for priority imports and other current account transactions” allowed since. The IMF-sponsored program intends to remove restrictions and revert to a freely-convertible krona:

But to prevent large capital outflows from causing a further sharp drop in the króna, existing capital account restrictions will remain in place in the near future. With this in mind, the authorities legally formalized the existing *de facto* regime during the last

⁴⁵ *Landsbanki Freezing Order 2008* (SI 2008/2668) and *Landsbanki Freezing (Amendment) Order 2008* (SI 2008/2766). Considered by Delegated Legislation Committee. [Minutes of proceedings at UP 7 2007-08](#).

⁴⁶ HL Merits of Statutory Instruments Select Committee, 29th Report 2007/8

⁴⁷ ['IMF Executive Board Approves US\\$2.1 Billion Stand-By Arrangement for Iceland'](#), *IMF Press Release* 08/296, 19 November 2008

⁴⁸ The first quarterly review is at <http://www.imf.org/external/pubs/ft/scr/2009/cr0952.pdf>

⁴⁹ ['Iceland Gets Help to Recover From Historic Crisis'](#) *IMF Survey* (online), 2 December 2008

week of November to make it more effective, rules-based, and transparent. It is an important goal under the IMF-supported program to lift all capital controls during the program period, as confidence improves.⁵⁰

Asked what success would look like in Iceland, Deputy Director of the IMF's European Department, Poul Thomsen, said:

within the next couple of months, the government succeeds in stabilizing the króna and normalizing the country's foreign exchange operations so that all companies that export and import have access to the foreign exchange market.

Once the currency has stabilized, the government should be able to gradually reduce interest rates in 2009, gradually lift the capital controls, and begin to tackle the fiscal problems.

The potential for success is very good because the economy is so flexible. I expect that by the end of the two-year program, Iceland's economy will be growing again.⁵¹

3.2 Financial assistance from other countries

Under Iceland's economic program the \$2.1 billion IMF loan will cover 42% of the financing needed in 2008-2010. The other 58% (\$3 billion) was to be provided bilaterally from other countries⁵² (and a further \$5 billion "in cash").⁵³

A request for an EU loan from the then Prime Minister of Iceland in mid-October 2008⁵⁴ was rejected, apparently because the EU could not find the right instrument for such a loan.⁵⁵ Support from the EU non-member partner countries in Eastern Europe has also been relatively limited.

There was a delay in formally agreeing the IMF package, reportedly due to disagreement over Iceland's compensation of foreign depositors.⁵⁶ There was also the issue of a \$500 million shortfall in the funds to be raised from international donors: bilateral loans were broadly contingent on official IMF approval of its loan and the country's economic recovery plan. The *Financial Times* noted "deep suspicions in Iceland that the UK government has put pressure on the IMF to delay the loan until a dispute over the compensation Iceland owes savers in Icesave, one of its collapsed banks, is resolved."⁵⁷ However, it cited a UK government spokesman stating that it had "in no way blocked the IMF's loan to Iceland. In fact the UK government fully supports the IMF's loan and looks forward to a swift resolution of this issue".⁵⁸

A press release from the Swedish Government's Finance Ministry on the same day that the IMF approved its package for Iceland states that Denmark, Finland, Norway and Sweden had "jointly decided to supplement the IMF financing of US\$2.1 billion with additional loans of

⁵⁰ ['Iceland Gets Help to Recover From Historic Crisis'](#) *IMF Survey* (online), 2 December 2008, citing Paul Thomsen, Deputy Director, IMF European Department.

⁵¹ *Ibid*

⁵² [Iceland: Letter of Intent and Technical Memorandum of Understanding](#), 15 November 2008 states that the IMF loans would amount to "about \$2 billion", with the "residual need" for \$3 billion (para 24).

⁵³ OECD, *Economic Outlook 84*, December 2008, pp148-9 (via www.sourceoecd.org – intranet only)

⁵⁴ Dick Leonard, ['Opposition in Iceland to EU membership begins to thaw'](#), *European Voice* 20 November 2008

⁵⁵ Daniel Korski, ['The EU is not an island that can ignore the plight of Iceland'](#), *European Voice*, 23 October 2008

⁵⁶ 'Iceland rescue held up by call for guarantees over deposits', *The Times*, 13 November 2008, p64

⁵⁷ 'Iceland's rescue package flounders', *Financial Times*, 12 November 2008, p8

⁵⁸ *Ibid*

US\$2.5 billion.”⁵⁹ An Iceland Government press release notes that “loans of up to \$3 billion have been secured from Denmark, Finland, Norway, Sweden, Russia and Poland. The Faroe Islands also announced that they would lend Iceland \$50 million.”⁶⁰ Iceland also reportedly “agreed to borrow £2.2bn from the UK government and €1.3bn from the Netherlands government”, to compensate depositors in the country’s collapsed banks.⁶¹

The quarterly review of the IMF programme noted that the cost of the bank collapse is now “expected to be lower”:

To date \$5.8 billion in insured foreign deposits from the United Kingdom, Netherlands, and Germany have been identified in the overseas branches of Icelandic banks. This is lower than the initial estimate of \$8.2 billion, in part because ring-fencing of branches in other countries has made it possible to cover deposits through recovered assets.⁶²

The IMF review document also notes that while the “program remains fully financed”, “negotiations with bilateral creditors on the terms are not yet complete”:

Negotiations over deposit insurance loans, now expected to be \$2.4 billion less [...] will resume in early-January.

The authorities indicated that they would soon begin negotiating the terms of the committed bilateral loans with the Nordic countries, and would be contacting the Russian and Polish authorities to begin similar negotiations. They, together with the Faroe Islands, have committed a total of \$3.2 billion. Most of the financing was programmed to be available in the fourth quarter of 2008, but is now expected to be delayed until early 2009.⁶³

3.3 What’s next? The economic outlook

In October 2008, the IMF was predicting a contraction of real GDP 3.1% in 2009, after growth of just 0.3% in 2008. Growth of 0.5% was expected in 2010, and then 2.1% in 2011.⁶⁴

While the IMF expects inflation to remain high in 2009 (11.2%) it is expected to fall in 2010 to 7.6% then 6.5% in 2011. Unemployment as a share of the labour force is expected to rise from 1% in 2007, through 2.2% in 2008 to hit 3.9% in 2010. Iceland’s current account deficit is expected to be 13.7% in 2009, down from 18.2% in 2008, before falling to 10.6% in 2010.

In November 2008, revised GDP growth projections from the IMF suggested a fall in GDP of 9.6%, and an unemployment rate of 5.7% in 2009.⁶⁵

The OECD’s December 2008 forecasts also suggest a large economic contraction. Real GDP is expected to fall by 9.3% in 2009, and a further 0.7% in 2010.⁶⁶ The OECD also expects “unemployment to soar over the next two years,” rising to 7.4% of the labour force in

⁵⁹ [‘Joint statement from the Ministers of Finance in Denmark, Finland, Norway and Sweden regarding help to Iceland’](#) Regeringskansliet: Finansdepartementet (Government Offices of Sweden: Finance Department) press release, 19 November 2008

⁶⁰ [‘International Monetary Fund approves Iceland’s request for a two year stand-by arrangement’](#), Iceland Government press release, 20 November 2008

⁶¹ ‘Reykjavik borrows \$10bn to stave off economic collapse’, *Financial Times*, 21 November 2008, p3

⁶² [‘Iceland: Stand-By Arrangement—Interim Review Under the Emergency Financing Mechanism’](#), IMF Country Report 09/52, February 2009, para 5, p3

⁶³ *ibid.*, para 17, p7

⁶⁴ IMF, [World Economic Outlook database](#), October 2008.

⁶⁵ [‘IMF Executive Board Approves US\\$2.1 Billion Stand-By Arrangement for Iceland’](#), IMF Press Release 08/296, 19 November 2008

⁶⁶ OECD, *Economic Outlook 84*, December 2008, Annex table 1 (via www.sourceoecd.org – intranet only)

2009 and then 8.6% in 2010, and the current account deficit to “decline markedly.”⁶⁷ The OECD also highlights the uncertainties around these projections, notably exchange rate volatility and wage increases, which could “prove higher than projected, pushing up inflation and reducing the gain in cost competitiveness from currency depreciation.”⁶⁸

A March 2009 review of Iceland’s IMF support programme stated that:

The crisis has led to a sharp drop in economic activity, but a late-year turnaround remains within reach. Meanwhile, the króna has stabilized and inflation appears to have peaked—indicating that the program is delivering results.⁶⁹

On 19 March Iceland was able to lower interest rates for the first time since the IMF package, from a record high of 18% to 17%.⁷⁰

4 Political fallout

[by Arabella Thorp, International Affairs and Defence Section]

4.1 Collapse of the Government

On 26 January 2009, Iceland’s conservative Government collapsed, the first government to fall as a result of the global financial crisis.

The conservative Independence Party (IP) had dominated politics since Iceland declared full independence from Denmark in 1944. It had often ruled in coalition with other parties; from 1995 to 2007 its coalition partner was the centrist Progressive Party (PP). Davíð Oddsson, who had been at its head since 1991 (and who until recently was the unpopular chairman of the board of governors of the Central Bank of Iceland, bearing the brunt of the blame for failing to stop the country’s financial institutions from accumulating excessive levels of bad debt)⁷¹ was Prime Minister until he relinquished the position to PP leader Halldór Ásgrímsson in 2004. In June 2006 Ásgrímsson resigned as Prime Minister, following the PP’s poor performance in municipal elections, and was succeeded by Geir Haarde who had been leader of the IP since Oddsson left politics in 2005.

The IP-PP coalition held onto its majority with only a single seat in the May 2007 parliamentary elections, but the PP’s poor showing led it to leave the coalition. Subsequent negotiations led to a ‘grand coalition’ between the IP and the left-wing Social Democratic Alliance (SDA). Geir Haarde remained as Prime Minister and the SDA’s leader, Ingibjörg Sólrún Gísladóttir, became Foreign Minister. The new Government initially had a strong majority and wanted to concentrate on issues surrounding children, the elderly and the environment. Iceland’s political stability contributed to its coming top of the UN’s Human Development Index in 2007 and top of the [Global Peace Index](#) in 2008.⁷² Even in October 2008 Geir Haarde was not under pressure to step down, and when such calls did begin and opposition parties tabled a motion of no confidence in his government in November, he ruled out resignation.

⁶⁷ *ibid.*, p147 and annex table 13

⁶⁸ *ibid.*, p149

⁶⁹ [‘Statement by the IMF Mission to Iceland’](#), *IMF Press Release 09/76*, 13 March 2009

⁷⁰ [‘Iceland interest rates cut to 17%’](#), *BBC News Online*, 19 March 2009

⁷¹ [‘Iceland’s central bank chief David Oddsson is forced out’](#), *Times*, 27 February 2009

⁷² The Global Peace Index is drawn up by the Institute for Economics and Peace, an independent think-tank, together with the UK-based Economist Intelligence Unit. It tests each nation against 24 “peacefulness” criteria, including a nation’s relations with its neighbours, arms sales and foreign troop deployments.

However, the Government could not withstand the effects of the financial crisis for long. Since October 2008, there had been peaceful weekly protests about its handling of the situation, but at the end of January the demonstrations turned violent, leading to 22 arrests and the worst civilian unrest since Iceland joined NATO in 1949:

Iceland's government was last night scrambling to avoid becoming the first administration to be ousted by the global financial crisis, as ministers huddled to try and hold together a coalition in the face of some of the biggest protests the country has seen for 60 years.

Protesters who have mounted vocal demonstrations in recent weeks against the collapse of the economy squared up to police, spattered parliament with eggs and paint, and at one point surrounded the prime minister's car as he tried to leave his office.

They pelted Geir Haarde's car with eggs and banged on the windows, shouting "resign", in a sign of mounting exasperation at the government's failure to prevent the economy from imploding under a mountain of billions of dollars of debt.

"These men bankrupted Iceland. It's ridiculous that they continue as if nothing happened," the writer Hallgrimur Helgason said. "I want the government to resign and an emergency government to be proclaimed, preferably made up of women. They can't do worse than men."

Haarde's press secretary said some demonstrators "came quite close to him and they didn't look all that peaceful".

Last night, the government's supposed political ally, the Alliance party, was meeting to discuss the future of the coalition. Options on the table included a motion calling for early elections, or even a vote of no confidence in the government.

After fleeing the government building, Haarde went to a meeting of Independence party MPs at their headquarters. He later emerged to insist that he could hold the coalition together.

Protesters have been rallying outside the parliament since October, when the credit crunch ripped the heart out of Iceland's financial system.

The protesters have begun referring to their daily attempt to oust the government as a "fleece revolution", because of the sweaters worn.

After a midwinter hiatus, several hundred protesters returned en masse on Tuesday, as parliament was preparing to return from recess. Some clashed with police who used pepper spray and batons to drive them back.

"The USA is getting rid of Bush today, we want to get rid of you" and "Yes, we can" were among banners carried by thousands of protesters.

The protesters banged pots and pans, wheelbarrows and a drum set. "We are protesting against useless ministers," said one of three ladies who were beating teapots with spoons. They, like many others, had taken time off from work. "We are taking a long lunch break," they said.

The latest protest rally is thought to be the biggest since 1949, when Iceland joined Nato. On Tuesday night, the crowds lit a bonfire and once it ran out of fuel, the Christmas tree in the town square was torn down and used as firewood. Nearby benches were also thrown into the pyre.

Iceland's financial collapse was triggered when a huge housing and consumer bubble burst last year under the weight of foreign debts that at one point amounted to 10 times the country's GDP.

The economy is expected to contract sharply this year and unemployment is soaring.⁷³

After sixteen weeks of protests over the handling of the financial crisis, Prime Minister Geir Haarde announced his resignation on 23 January 2009, citing medical reasons (a medical examination had revealed that he had a malignant tumour of the oesophagus requiring surgery).⁷⁴ On 26 January he tendered his Government's resignation to the President of Iceland, Ólafur Ragnar Grímsson. He still hoped to build a national coalition government comprising all parties in Parliament to rule until May, but this plan collapsed. Ingibjörg Sólrún Gísladóttir, leader of the IP's coalition partner the SDA, ruled out standing for Prime Minister because she was still recovering from brain surgery.⁷⁵

4.2 A caretaker government

On 1 February a new caretaker coalition government took office, in which the IP is not represented. The coalition comprises the centre-left SDA (which had been the minority partner in the previous administration) and the hard-left Left Green Movement, with backing from the centrist PP (which had governed in coalition with the IP from 1995 to 2007). The new Prime Minister is the SDA's Jóhanna Sigurðardóttir, a popular politician who had been Iceland's Minister of Social Affairs and Social Security in the previous administration and who is Iceland's longest-serving MP. She is a former air hostess, and the first openly gay head of government in the modern world.

The new Government, in which half the members of the Cabinet are women, has been described as part of a gender revolution, in which women are also taking top positions in the banks and other bodies:

"You can see what is happening," says Katrin Olafsdóttir, Associate Professor of Economics and a member of the board of New Glitnir, which is trying to devise a new mission for the crippled bank. "The men went out there and took these incredibly irrational risks - and getting loads of money for doing it, feeling really good about it — and then the women have to come in to clean it up."⁷⁶

The coalition has been clear that it will adhere to the programme agreed between the IMF and the outgoing administration, and "base itself on a very prudent and responsible policy in economic and fiscal matters". Nevertheless, its left-wing credentials remain: it "will, at the same time, prioritise social values, the principles of sustainable development, women's rights, equality and justice".⁷⁷

A general election is expected on 25 April 2009, with EU membership as a central theme of the election campaign. The outcome is far from certain, as the financial crisis has produced uncharacteristic volatility in Iceland's voters. The IP, which only last July was still ahead in the polls (33% of respondents said they would vote for it in the next parliamentary

⁷³ Valur Gunnarsson, 'Iceland's coalition struggles to survive protests: PM's car pelted with eggs as debt-hit economy sinks; Demonstration estimated to be biggest since 1949', *Guardian* 22 January 2009

⁷⁴ David Ibbison, 'Iceland's ill PM resigns and calls May poll', *Financial Times* 24 January 2009

⁷⁵ David Ibbison, 'Iceland in turmoil as coalition collapses', *Financial Times* 27 January 2009

⁷⁶ Roger Boyes, 'Women take over as Age of Testosterone drags country to the verge of bankruptcy; Iceland "Men take risks, get drunk and don't give back the money"', *Times* 7 February 2009

⁷⁷ Leigh Phillips, 'No EU referendum in Iceland under new government', *EUobserver* 2 February 2009

elections),⁷⁸ was overtaken first by the SDA⁷⁹ and then in January 2009 by the Left Green Movement:

A recent opinion poll revealed the Left-Green Movement would emerge victorious if elections were held today with 28.5 per cent of the vote, compared with 24.3 per cent for Mr Haarde's Independence party and 17 per cent for the Social Democrats.

The Left-Greens, who are anti-big business and proenvironment, have benefited from a dramatic rise in anti-capitalist sentiment following the crisis as people expressed disgust at prominent and flashy young businessmen known as the "Viking raiders".

These entrepreneurs led Iceland's overseas corporate expansion, lived a high life and are seen as a symbol of the ways in which Iceland lost touch with its more modest economic past.

Mr Haarde's right-wing Independence party introduced the policies that allowed these free marketeers to prosper, alongside large parts of the rest of the population, who got rich speculating in property.

The Left-Green party's manifesto says that "all natural resources shall be public property and utilised without reducing them".

The party would "fight for an independent Icelandic foreign policy that maintains the sovereignty of Iceland" and "opposes participation in military organisations such as Nato".

It also "rejects further building of power plants for the use of polluting large scale industry and demands conservation of the highland". This would spell an end to Iceland's aluminium smelting industry, an important source of revenues.

In the past, government officials have expressed deep concerns that a victory for the Left-Green party would result in a disastrous government at this critical juncture in Iceland's history.⁸⁰

5 Will Iceland join the EU?

[by Arabella Thorp and Ian Townsend]

5.1 Iceland's current links with the EU

Iceland's financial and political turmoil has led to renewed suggestions that it increase its already strong links with Europe. Iceland has historically been active in international co-operation: it is a member of the Nordic Council, which includes Denmark, Sweden, Norway and Finland, and of the Nordic Council of Ministers; it was a founding member of the North Atlantic Treaty Organisation (NATO) (even though it has no armed forces); it joined the United Nations (UN) in 1946 and the Council of Europe in 1950; and it has been a member of the Organization for Security and Co-operation in Europe (OSCE) since its inception in 1975.

Iceland has been a member of the EU's Schengen border-free area since 2001, by virtue of its membership of the Nordic passport union.

Along with Liechtenstein, Norway and Switzerland, Iceland is a member of the [European Free Trade Association \(EFTA\)](#), having joined in 1970. The original 1960 agreement was

⁷⁸ ['Iceland's Independence Party Leads All'](#), *Angus Reid Global Monitor*, 20 July 2008

⁷⁹ ['Social Alliance Leads Rivals in Iceland'](#), *Angus Reid Global Monitor*, 1 December 2008

⁸⁰ David Ivison, 'Iceland's ill PM resigns and calls May poll', *Financial Times* 24 January 2009

reached between countries that sought the benefits of trade with the then EEC without full membership, but many former EFTA members (including the UK) are now members of the EU. EFTA is a free-trade area or common market, rather than a customs union like the EU: member countries can set their own tariffs, and can reach their own free trade agreements (FTAs) with third countries. In 1972, individual EFTA countries signed free-trade agreements with the EEC with the aim of abolishing import duties on industrial products

These arrangements were superseded by the [European Economic Area \(EEA\)](#) Agreement between the EU and Iceland, Norway and Liechtenstein, effective since January 1994 (the fourth EFTA member, Switzerland, has negotiated separate bilateral agreements with the EU). The EEA extends the EU's internal market – and its ‘four freedoms’, of goods, services, people and capital – to these countries. For Iceland, this includes generally tariff-free access for its marine exports as well as partial access to EU waters, in return for a quota of catch by EU fishing vessels in Icelandic waters. The EEA also gives citizens of Iceland the right to live and work in all other EEA countries (and vice versa) and to work for EU agencies, and also gives Iceland the right to participate in various EU activities and programmes covering enterprise, environment, education and research expert groups.

EFTA countries have no official voting rights in the EU, and their influence on European affairs is more indirect, for example through taking part in the Justice and Home Affairs ‘Mixed Committee’. However, all EEA countries have to comply with the EU's internal market legislation, which makes up roughly two thirds of the body of European legislation and case-law known as the *acquis communautaire*. Iceland's laws therefore already comply with most of the *acquis*, but the EEA's relationship with the EU does not include the customs union (although it “tries to maintain parallelism”), the Common Agricultural and Fisheries Policies, the Common Foreign and Security Policy or Justice and Home Affairs.

There is an EEA Joint Committee that works to extend EU regulations and directives to the non-EU members of the EEA (with the EU represented by the European Commission). The EEA Council – the members of the Council of Ministers (in its General Affairs and External Relations formation) and one representative each for the EFTA EEA country governments – meets twice a year.

The three EFTA EEA countries also make financial contributions to the EEA through the ‘EEA Financial Mechanism’. For 2004-2009 their total joint financial contribution is €600 million, in annual tranches of €120 million. This money is to contribute to the reduction of economic and social disparities in the EEA through grants to investment and development projects covering environmental protection, sustainable development, conservation of European cultural heritage, human resource development, health and childcare, in the following countries:

- Czech Republic
- Estonia
- Greece
- Spain
- Cyprus
- Latvia
- Lithuania
- Hungary
- Malta
- Poland

- Portugal
- Slovenia
- Slovakia
- Bulgaria
- Romania⁸¹

Norway also provides additional money through the Norwegian Financial Mechanism.

In terms of the current economic relationship between Iceland and the EU, in 2007 Iceland accounted for 0.2% of EU imports, ranking it 61st among import sources, while it accounts for 0.3% of EU exports (ranking it the EU's 54th largest export destination). The EU is overwhelmingly Iceland's biggest trading partner, accounting for 61% of Iceland's imports and 75% of its exports, ahead of the US (14% of imports and 7% of exports), China (for imports) and Japan (for exports), and Norway.⁸²

Although Iceland did not apply for EU membership prior to the largely Scandinavian round of enlargement in 1995, the question of eventual EU accession has stood in the political background. As far back as 1992 there was strong public support for beginning negotiations for full EU membership. This was prompted partly by dissatisfaction with the limitations of the EEA, including the fact that the EFTA members must adopt most of the *acquis communautaire* without having any real influence on its formulation.⁸³

In early 1995 the SDA became the first Icelandic political party to endorse an application to join the Union. The IP had broadly opposed EU membership but became more open to the idea latterly. After the 2007 election, the then Prime Minister Gier Haarde set up a commission to consider the possibility of EU membership, declaring that his country could start EU talks under the right circumstances.⁸⁴

5.2 Is an EU membership application imminent?

Since Iceland began to realise the extent of its financial crisis, it has been mooted that part of its solution may be to seek EU membership. In October 2008, Ingibjörg Sólrún Gísladóttir, leader of the SDA and (at that time) Foreign Minister, was reported as saying:

In the short term, our defence is co-operation with the International Monetary Fund and in the long term EU membership, adoption of the euro and backup from the European Central Bank.⁸⁵

Even the then Fisheries Minister, the IP's Einar Guðfinnsson, said in October that the time was ripe to rethink the country's relationship with the EU.

The caretaker Government has established a parliamentary committee to examine the question of joining the EU and adopting the euro. The committee is due to report on 15 April 2009.

⁸¹ [EEA Agreement, Protocol 38A](#), inserted by the 2004 EEA Enlargement Agreement (OJ No L 130, 29.4.2004, p. 3 and EEA Supplement No 23, 29.4.2004, p. 1), e.i.f. 1.5.2004, and subsequently amended.

⁸² European Commission, [Iceland trade statistics](#)

⁸³ ['Iceland come in from the cold?'](#), *Centre for European Policy Studies*, March 2002

⁸⁴ ['Iceland, Montenegro preparing EU entry bids'](#), *EurActiv.com*, 12 December 2008

⁸⁵ Steve Hawkes and Roger Boyes, 'Iceland considers joining EU after Pounds 100m aid to Landsbanki', *Times* 14 October 2008

However, an application is unlikely to appear until after the Parliamentary elections. The SDA's new partner in the caretaker Government, the Left Green Movement, is opposed to EU membership. It has rejected the idea of a referendum on EU membership during the caretaker administration or in tandem with the general election. It is open to two referenda after the election, one on whether to begin membership negotiations and another on whether to accept membership once negotiations have ended, but has said that it will fight on the 'no' side in any campaign.⁸⁶

5.3 Conditions for joining

Joining the EU

According to Articles 6 and 49 of the [Treaty on European Union \(TEU\)](#), any European state which respects the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law may apply to become a member of the EU. More detailed political and economic criteria for membership are contained in the so-called 'Copenhagen criteria', which were set out by the European Council in Copenhagen in June 1993:

Accession will take place as soon as an associated country is able to assume the obligations of membership by satisfying the economic and political conditions required.

Membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union.

Membership presupposes the candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.

The Union's capacity to absorb new members, while maintaining the momentum of European integration, is also an important consideration in the general interest of both the Union and the candidate countries.⁸⁷

The reference to the 'obligations of membership' in the third paragraph includes the implementation of the full *acquis communautaire*.

The accession process is both complex and extended. First, applicant countries must be accepted as potential candidate countries, which have to meet basic standards before reaching a bilateral agreement with the EU. Then they may be granted candidate country status. Once the Copenhagen criteria and the specific requirements of its bilateral agreements are judged to be sufficiently met, and the EU's 'absorption capacity' is judged to be sufficient, substantive negotiations will be opened. These detailed negotiations are the cornerstone of the accession process, and begin with a 'screening' of compatibility with each 'chapter' of the *acquis communautaire*, continuing with progress towards the opening and closing 'benchmarks' for each chapter. The *acquis* itself is not open to negotiations and the EU does not grant opt-outs to new candidates similar to those the UK has secured on the euro or EU social legislation.⁸⁸

⁸⁶ Leigh Phillips, 'No EU referendum in Iceland under new government', *EUobserver* 2 February 2009

⁸⁷ Copenhagen European Council, June 1993, [Presidency Conclusions](#), para. 7A(iii)

⁸⁸ House of Lords European Union Committee, 53rd report of 2005-06, [Further Enlargement of the European Union: threat or opportunity?](#), HL 273, 23 November 2006, Chapter 1 Box 3

If the negotiations are successfully concluded, the results are incorporated in a draft Accession Treaty, which is submitted to the Council for approval and to the European Parliament for assent. After signature, the accession treaty is submitted to the Member States and to the candidate country for ratification according to their respective national procedures, which may require a referendum. When the treaty takes effect, the candidate becomes a Member State. The ratification process alone can take up to two years.⁸⁹ Throughout the process, the Commission monitors progress in annual reports.

Adopting the euro

An October 2008 Centre for Economic Policy Research paper argues that:

if Iceland wishes to maintain an internationally active banking sector domiciled in Iceland that is as large as the current one, relative to the Icelandic economy, it is only sensible for it to join the euro area. This is the only way to guarantee a permanent foreign-currency lender of last resort.⁹⁰

While Iceland could unilaterally adopt the euro as its currency, in order to become a formal member it would have to first become a member of the EU and then work to join the eurozone.

A number of countries outside of the eurozone use the euro, either informally and unilaterally, or with a bilateral agreement with the EU.

Those with bilateral agreements with the EU include the French overseas territories in the Pacific, countries in West and Central Africa with historical links with France, the Comoros and Cape Verde Islands (with links with France and Portugal respectively). However, the eurozone “has no obligation to support the exchange rate” in any of these cases.⁹¹

Monaco, San Marino and the Vatican City had previously used the national currencies of France or Italy and have signed “monetary agreements with the EU and use the euro. Under the agreements, they can also produce limited quantities of euro coins with their own design on the national sides, but cannot issue euro banknotes”.⁹²

Other countries link their national currencies with the euro, by:

supporting an exchange rate against the euro that is only allowed to fluctuate within defined limits. The third countries’ monetary authorities support this exchange-rate peg on their own by intervening in currency markets. The euro area has no agreements or obligations to support these currencies.⁹³

In the Balkans, for example, this includes Croatia, the former Yugoslav Republic of Macedonia and Serbia. Also, Bosnia and Herzegovina has a euro-based ‘currency board’ which is “in charge of supporting the fixed foreign exchange rate, to which the normal objectives of central banks are subordinated.”⁹⁴ The currency of Bosnia and Herzegovina, the convertible mark (KM), previously pegged to the German mark, is now fixed to the euro at an official rate of 1.95KM:€1. In addition, both Kosovo and Montenegro “use the euro as a

⁸⁹ European Commission [press release on enlargement](#)

⁹⁰ W Buiter and A Sibert, ‘The Icelandic banking crisis and what to do about it: The lender of last resort theory of optimal currency areas’, [CEPR Policy Insight 26](#), October 2008, p12

⁹¹ See European Commission, [The euro: Links to other currencies](#) page

⁹² *Ibid*

⁹³ *Ibid*

⁹⁴ *ibid.*

domestic currency without any agreements with the EU, following the tradition of the German mark which had previously been the de facto currency in these areas”.⁹⁵

While Iceland has relatively large economy compared with some of the countries and territories referred to above, it is smaller than that of Serbia or Tunisia (which also links its currency to the euro).⁹⁶

Even if it did not join the EU adopting the euro could increase boost trade and investment by reducing the transaction costs involved, and give Iceland access to larger capital markets; however, Iceland would effectively surrender control of monetary policy. Decisions would be taken by the European Central Bank (ECB), which controls the eurozone monetary policy), that would affect Iceland’s economy without it being able to contribute to them. Adopting the euro in this way would also mean settling on an exchange rate ‘peg’. Given the current economic situation in Iceland, it is unlikely that current exchange rates would be considered a basis upon which to set a long-term currency peg with eurozone countries.

The ECB has signalled its opposition to countries adopting the euro by themselves. In a February 2008 speech a Member of the ECB’s Executive Board, Jürgen Stark, said on “unilateral euroisation” being considered in Iceland at that time:

I would like to emphasise that the ECB, in line with the official position outlined above and consistent with our mandate, would neither encourage nor facilitate such a move. Countries which unilaterally introduce the euro would do so in their responsibility and at their own risk, without committing the EU or the ECB. The ECB would thus pursue a policy of non-engagement and non-support towards these countries.⁹⁷

In summary, Mr Stark said, the ECB “would like to welcome the newcomers through the front entrance, and not via the backdoor.”⁹⁸ He went on to outline the generic economic costs and benefits of unilateral euroisation in detail:

[...] euroisation could bring some potential benefits for the country concerned.

- Most notably, the country would import the ECB’s credibility, which could possibly lead to a lower inflation rate.
- Euroisation would also eliminate exchange rate risk. In turn, the country in question may benefit from lower interest rates.
- On the micro-economic side, euroisation would lead to lower transaction costs, and might provide a boost to trade and financial integration.

These benefits can, however, not be taken for granted. Most of these benefits can indeed only be reaped if they are supported by sound economic policies.

- For instance, inflation may still be running high in case of pro-cyclical fiscal and wage policies. Accordingly, euroisation cannot be a substitute for stability-oriented policies.

⁹⁵ [‘Euro used as legal tender in non-EU nations’](#), Associated Press via International Herald Tribune website, 1 January 2007

⁹⁶ Iceland was the 93rd in 2007 (with GDP of £19.5 billion), compared Croatia (62nd, \$51.3 billion), Serbia excluding Kosovo (69th, \$41.6 billion) and Tunisia (with 75th with \$35.0 billion) [Source: World Bank [2007 GDP rankings](#)]

⁹⁷ [‘The adoption of the euro: principles, procedures and criteria’](#), Speech by Jürgen Stark, Member of the Executive Board of the ECB at the Icelandic Chamber of Commerce, Reykjavik, 13 February 2008

⁹⁸ *ibid.*

- Again, this underlines the importance of having in place a stability-oriented macro-economic framework, such as the one established at EU level.

What are the possible costs and risks of euroisation?

- First of all, the country in question may face an inappropriate monetary policy stance in case of diverging business cycles. The loss of an independent monetary policy and the exchange rate instrument may make it more difficult for the country in question to respond to idiosyncratic shocks, or to correct a loss of competitiveness.
- The country in question could also run into logistical difficulties, since it would exclusively depend upon private arrangements with credit institutions for a number of key services, such as banknote handling and the execution of high-value payments. It would also render it more difficult to extend the lender of last resort function to its own credit institutions.

Finally, the country would also lose seigniorage revenues.

In short, unilateral euroisation is not a panacea. Its benefits are uncertain, whereas the costs are real, and the risks serious. In particular, it should be stressed that euroisation is not a 'quick-fix' for structural problems or external pressures. Admittedly, euroisation would provide some shelter against adverse winds coming from the outside.

In a way, the euro can be likened to the armours worn by knights during the Middle Ages. Of course, an armour provides a shield against external hits. However, an armour can also limit the freedom of action and restrain flexibility. It can give a false sense of security.

The effects of euroisation are similar. It can attenuate external pressures in the short run. But it does not solve the problems underlying these external pressures. If no action is taken to solve these problems, the pressures will be building up.⁹⁹

EU Enlargement Commissioner Olli Rehn has also spoken against Iceland adopting the euro without joining the EU:

The EU's stand is very clear. We do not support and would not accept a unilateral adoption of the euro. For a normal developed state in Europe, which might be aiming for EU membership, only the conventional way is possible, which is fulfilling the Maastricht Treaty.¹⁰⁰

If Iceland were to join the EU, it would commit to euro membership. Prior to this, as part of the convergence process, countries must join the Exchange Rate Mechanism (ERM II), "a system designed to avoid excessive exchange-rate fluctuations between the participating currencies and the euro that might disrupt economic stability within the single market."¹⁰¹ They must successfully participate in ERM II for at least two years before moving to the single currency. This effectively sets a minimum timeframe between EU and euro membership.

Iceland would also have to meet the Maastricht criteria, notably a ceiling of 60% ratio of debt to GDP, a budget deficit ceiling of 3% and exchange rate stability (fluctuations within a 15% band either side of a specific rate over two years). In current circumstances, Iceland is

⁹⁹ *Ibid*

¹⁰⁰ 'Majority in Iceland Wants Currency Change', *Angus Reid Global Monitor*, 12 January 2009

¹⁰¹ http://ec.europa.eu/economy_finance/the_euro/the_euro6480_en.htm

unlikely to meet these criteria, but it is possible that it could, following an economic recovery.¹⁰²

Iceland would join the euro area once it fulfils all the convergence criteria. At that point, the Central Bank of Iceland would become part of the Eurosystem, its governor would have a seat at the table of the ECB's Governing Council, and Iceland's economy would be considered in taking monetary policy decisions for the enlarged euro area as a whole.

While there have been some calls to loosen the rules for joining the single currency due to the financial crisis, including from Hungary, EU leaders have reaffirmed the existing rules, with "broad agreement it would be an error to change the rules of the game at the moment" according to the Prime Minister of the Czech republic, the current holders of the EU presidency.¹⁰³ However, there were calls at the same meeting for the exchange rate stability criterion to be re-examined.

Iceland's economic impact on the EU would be likely to be small. Its economy is smaller than all current EU member states apart from Malta,¹⁰⁴ and so "unlikely to prove a destabilising force", while in budgetary terms Iceland is also unlikely to significantly affect EU finances.¹⁰⁵ As noted above, Iceland already contributes financially to the EU through European Economic Area arrangements.

5.4 Views on Iceland's membership

Within Iceland

One of Iceland's major objections to EU membership in the past was its strong objection to the Common Fisheries Policy when fishing dominated its economy. Many are concerned that Iceland would have to surrender management of its unsubsidised but highly successful and sustainable fisheries to Brussels.¹⁰⁶ Iceland is reluctant to interfere with its successful management system to allow fish stocks to recover, introduced after a period of over-fishing in the 1980s. Recent restructuring of the Icelandic economy has seen fish and related products decline from over 50% of exports in 2002 to 37% by 2007,¹⁰⁷ but in the current situation fishing may once again be the most vital sector of the Icelandic economy both economically and politically.

Another issue for Iceland is workers' rights. A spokesman for the Left Green Movement has voiced their "concern about recent European Court of Justice decisions that could prevent unions from taking action to defend these rights, and on the general neo-liberal direction of policies. The party has also cited the EU's "democratic deficit" and "lack of transparency" as reasons for opposing membership.¹⁰⁸

Iceland's population has long been opposed to EU membership. This opposition had appeared to be lessening: an opinion poll published in a major Icelandic newspaper, *Fréttablaðið*, on 18 October 2008 suggested that 70% of Icelandic people wanted a

¹⁰² "[The adoption of the euro: principles, procedures and criteria](#)", Speech by Jürgen Stark, Member of the Executive Board of the ECB at the Icelandic Chamber of Commerce, Reykjavik, 13 February 2008

¹⁰³ "[No change to euro entry rules now, maybe later-EU leaders](#)", *Reuters*, 1 March 2009

¹⁰⁴ World Bank 2007 GDP rankings; <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf>

¹⁰⁵ "Iceland to be fast-tracked into the EU", *The Guardian*, 30 January 2009

¹⁰⁶ Leigh Phillips, 'No EU referendum in Iceland under new government', *EUobserver.com* 2 February 2009

¹⁰⁷ Fish and related products accounted for 53% of total goods exports in 2002, falling to 37.3% by 2007 (Statistics Iceland, [External Trade statistics](#) (SITC (rev 3) class 03 "Fish, crustaceans, molluscs etc."))

¹⁰⁸ Leigh Phillips, 'No EU referendum in Iceland under new government', *EUobserver* 2 February 2009

referendum on whether to join the EU, with 49% saying they would vote in favour and 27% against.¹⁰⁹ However, the *Financial Times* reported in early March 2009 that enthusiasm for EU membership appears to be diminishing again:

The latest polls reveal less than 40 per cent now back an application to join the bloc, compared with a mid-crisis high of nearly 80 per cent.

The reasons for the fall-off are mixed. Fissures inside the eurozone between large members, such as Germany and France, and small ones, such as Greece and Ireland, are undermining the zone's attractiveness to a tiny country. Icelanders see little point in enduring one currency crisis only to get embroiled in another.

"We are watching developments within the eurozone closely," said Steingrímur Sigfússon, minister of finance, in an interview. "What will happen to the euro? We will take that into the picture."

Others argue that, as Iceland has already undergone a crisis, there is little protection to be derived from joining the eurozone.

"If we had had the euro it would have made the collapse less spectacular," said Gylfi Magnússon, minister for business affairs. "On the other hand, people point out that having a currency that has collapsed will help recovery in terms of exports."

Politicians are also wary of public disquiet over implications for the island's fishing industry, a valuable sector that is closely associated with the national heritage - as testified by the "cod war" against the UK in the 1970s.¹¹⁰

There is more public support for adopting the euro than for becoming part of the EU as a whole: a poll in January 2009 found that 56% of respondents supported adopting a foreign currency, whereas only 22% would keep the krona.¹¹¹

From other candidate countries

Other potential accession countries could be annoyed if Iceland leapfrogs ahead of them to EU membership. Of the current 'candidate countries', Croatia has been given a timetable for completing membership negotiations by the end of 2009; Turkey's long-running membership ambitions are still many years from being achieved and the (former Yugoslav) Republic of Macedonia has yet to start formal membership negotiations. There are also five 'potential candidate countries' waiting in the wings.¹¹²

Inside the EU

Support for Iceland's membership of the EU is strong amongst European officials. Olli Rehn, the EU's Enlargement Commissioner, is reported as saying Iceland could join at the same time as Croatia:

The EU prefers two countries joining at the same time rather than individually. If Iceland applies shortly and the negotiations are rapid, Croatia and Iceland could join the EU in parallel. On Iceland, I hope I will be busier. It is one of the oldest

¹⁰⁹ See Dick Leonard, '[Opposition in Iceland to EU membership begins to thaw](#)', *European Voice* 20 November 2008

¹¹⁰ David Ibbison, 'Icelandic ardour for Europe's club cools', *Financial Times* 4 March 2009

¹¹¹ '[Majority in Iceland Wants Currency Change](#)', *Angus Reid Global Monitor*, 12 January 2009

¹¹² See Library Standard Note SN/IA/4918, '[Progress on EU Enlargement at a Glance: 2008](#)', 19 December 2008

democracies in the world and its strategic and economic positions would be an asset to the EU.¹¹³

Rehn does not consider Iceland's fast-track to EU membership to be jeopardised by its financial situation:

"It has serious difficulties, but it has plenty of national wealth, and it is without any doubt a democratic European country, with very strong democratic roots. If Iceland were to apply for EU membership, I would expect that the accession negotiations would not take terribly long. Iceland is already a member of the European Economic Area, which covers roughly two thirds of the *acquis communautaire*. I usually say to my friends in South Eastern Europe that there is no shortcut to EU membership, and that is true. But in the case of Iceland, this EEA agreement serves as a shortcut in the negotiations," said Rehn.¹¹⁴

However, the whole enlargement project is intricately bound up in the travails of the Lisbon Treaty. While EU Member States remain uncertain about the direction of the European project and about their own roles within Europe, any further expansion is uncertain. As long as the Lisbon Treaty remains unratified, therefore, the admission of any new Member State could well be problematic. Rehn's offer to Iceland of a fast track to EU Membership was criticised by the President of the European Parliament, Hans-Gert Pöttering, who said that now was the wrong time to even think about enlargement.¹¹⁵ On the other hand, it has been suggested that Iceland's early membership could help with ratification of the Lisbon Treaty, as an accession treaty could provide a vehicle for amendments to the Lisbon Treaty.¹¹⁶

¹¹³ Ian Traynor, 'Iceland to be fast-tracked into the EU', *Guardian*, 30 January 2009

¹¹⁴ ['EU to play Iceland card to prop up Lisbon Treaty'](#), *EurActiv.com*, 30 January 2009

¹¹⁵ ['Parliament chief lectures Rehn over 'badly timed' Iceland remarks'](#), *EurActiv.com*, 5 February 2009

¹¹⁶ ['EU to play Iceland card to prop up Lisbon Treaty'](#), *EurActiv.com*, 30 January 2009