



The Importance of Strategy

Iceland, Finland and Economic Security

Daði Rafnsson

Lokaverkefni til MA-gráðu í Alþjóðasamskiptum

Félagsvísindasvið

Október 2012



HÁSKÓLI ÍSLANDS

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Ritgerð þessi er lokaverkefni til MA-gráðu í alþjóðasamskiptum og er óheimilt að afrita ritgerðina á nokkurn hátt nema með leyfi rétthafa.

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Útdráttur

Tilgangur þessa lokaverkefnis er að velja því upp hvort Ísland eigi að móta sér öryggisstefnu á sviði efnahagsmála (economic security strategy). Og ef svo er hvort öryggisvæða eigi efnahagsmál? Til að byrja með er hugtakið efnahagslegt öryggi skilgreint og staða Íslands í kjölfar efnahagshruns árið 2008 er borin saman við stöðu og viðbrögð Finnlands sem glímdi við svipuð vandamál snemma á níunda áratug síðustu aldar.

Raunhyggja, frjálslyndisstefna og marxismi eru lykilkenningar í alþjóðasamskiptum og hjálpa til við að útskýra mismunandi nálgun hópa og ríkja á efnahagsmálum. Við samanburðinn við Finnland og niðurstöður er stuðst við kenningar um mannöryggi og mótunarhyggju, smáríki og hnattvæðingu.

Niðurstaðan er sú að mikilvægt er að Ísland móti sér þjóðaröryggisstefnu til langframa og nauðsynlegt sé að hún verði endurskoðuð reglulega til að bregðast við breytingum í alþjóðasamfélaginu. Íslendingar geta horft til reynslu Finna við mótun öryggisstefnu, enda er margt sameiginlegt með þessum tveimur löndum. Miklu máli skiptir að efnahagsmál fái veglegan sess í öryggisstefnu vegna áhrifa þeirra á mann- og samfélagsöryggi Íslendinga.

Ekki þykir ráðlegt að öryggisvæða efnahagsmál þjóðarinnar þar sem gagnrýnin umræða er nauðsynlegur hornsteinn þess að raunverulegs öryggis sé gætt í hvívetna. Breið samstaða þarf hinsvegar að nást í samfélaginu um mótun öryggisstefnu og eftirfylgni hennar, ásamt því að hlutverk séu skýr. Íslendingar geta jafnframt lært af reynslu Finna hvað varðar að nýta sér óhikað alþjóðastofnanir til að tryggja öryggi sitt og koma markmiðum sínum áleiðis.

Abstract

The purpose of this thesis is to ask whether Iceland should form an economic security strategy: and if so, whether economic affairs should be explicitly securitized. It begins by defining the term "economic security", and Iceland's situation in the wake of an economic crisis in 2008 is compared with the position and reaction of Finland which went through similar difficulties in the nineties.

Realism, liberalism and marxism are key theories in international relations and help explain the different approaches of groups and states when it comes to economic affairs. In this case, the comparison between Iceland and Finland is further illuminated by theories on human security and constructivism, small state theories and globalization.

The conclusion is that it is important for Iceland to form a long-term national security strategy and it must be reviewed regularly to account for changes in the international arena. Icelanders can look to Finland as an example of how they should do it, as these nations have many relevant features and challenges in common. Economic affairs must be an integral part of such a strategy because of their importance to the human and societal security of Iceland.

It is not advisable, however, to explicitly securitize the nation's economic affairs, as that could paralyse the critical debate which is a cornerstone of real security. Society must reach a broad bi-partisan consensus in the shaping and implementing of a national security strategy, and the roles of actors must be clear. Iceland can also learn from Finland how to use international organizations to strengthen its security and advance its interests.

Preface

My thesis corresponds to 30 ECTS credits and is written in the discipline of International Relations at the University of Iceland under the supervision of Alyson J. K. Bailes. The motivation comes from having studied towards a masters' degree in international relations at the University of Iceland and having noted how little attention is given to economic matters in the coursework and lectures. In fact, international relations academics seem content to leave them in the hands of economists and the odd political scientist.

Yet, the field of international relations has a lot to offer in economic discourse as is evident by the growing number of international political economy majors being offered by universities worldwide. For starters, international relations is nothing if not a study of power - what it is, who holds it, how they wield it and with what consequences.

The control of cabinets and parliaments grants ministers and MP's the possibility to determine how resources are allocated within the economy. Economic power can influence the outcome of elections, even in self-described cradles of democracy like France, United States, Greece and Iceland. It can influence what information is available to the public, as is evident by the recent News Corp scandal in the United Kingdom and the purchase of the biggest Icelandic daily newspaper, Morgunblaðið by a group from the fishing lobby.

In the wake of the economic crisis of 2008, Icelanders naturally asked themselves what had happened and whether something could have been done to prevent it. A comparison with Finland, a Nordic state with strong emphasis on strategy is therefore relevant to the discussion.

After completing a B.Sc. in Marketing from Barry University in Florida in 2002, I started work as a specialist in the sales and marketing division for the newly privatized KB Banki in August 2004. I remained at the bank and witnessed its extraordinary growth into

Kaupping, one of the world's 100 biggest banks until January 2008. I then landed the sales manager job at Humac, the Apple Computers reseller in Iceland where I experienced first hand the instability in the economy through the first half of the year. Both Kaupping and Humac were out of business by the end of 2008. In 2009 I started working towards a masters' degree in International Relations at the University of Iceland whilst simultaneously coaching football at Breiðablik and laying the foundations of a financial education company for young people called Fjármálaskólinn (School of Finance).

I would like to thank my advisor, Ms. Alyson Bailes for the invaluable assistance she has provided me with through my work on this thesis. Ms. Bailes has through her classes raised my awareness of the importance of economic security as an integral part of human security. She has also encouraged me greatly along the way as a great teacher does.

I am also grateful to Silja Bára Ómarsdóttir for lending an ear as well as valuable reading material in my search for a theoretical framework. I was very lucky to share my time at the University of Iceland with a group of ambitious and knowledgeable students who made it all so much more interesting and valuable. Rafn Haraldur Rafnsson and Ásgerður Krístrún Sigurðardóttir offered critical review and assistance which is greatly appreciated.

Last but not least I would like to thank my partner Thelma Hrönn Sigurdórsdóttir for all of her wonderful encouragement and support.

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1. Introduction

Many academics in the field of international relations, including Susan Strange, have expressed surprise and concern over the insufficient weight given to international political economy within the field. Strange (1998) herself claimed it necessary to acknowledge “a need to privilege the politics of the international financial system in the study of international relations: a discipline too long myopic in its focus on violent conflict and war between states at the expense of all else.”

It is perhaps understandable that the study of international relations should focus on violent conflicts as those have in most people’s minds traditionally posed the most severe threat to national security. Yet, behind the stories of war there is often a background story of the events that prompted heads of states to take up arms against others. Often turmoil, violence and warfare have underlying economic factors as instigators, such as the Irish famine, the French and American revolutions and markedly World War I and II.

In 2007 and 2008, tremors in global markets set off avalanches of economic troubles across the northern hemisphere, from the United States to Greece, Italy to Ireland and Portugal to Iceland. Many of the hardest hit countries had viewed themselves as rising global economic powers in the years preceding the crisis. Iceland’s Prime Minister had begun exploring how the nation could become a global financial center only two years before all of Iceland’s three big banks, and several small savings and loans organizations were wiped out on the back of one of the biggest asset bubbles in modern history. The results, beyond doubt or debate, struck at Iceland’s security interests as well as its international image and credibility in numerous fields.

Many nations, including Iceland realize the need for a national security strategy. In fact, the Ministry of Foreign Affairs had in 2007 commissioned a risk assessment report for

Iceland to be delivered by a committee in 2008. This had to be delayed just before publication as it became apparent that Iceland was facing grave economic threats, which the committee's work and drafting had failed to address appropriately. When the report was eventually released early in 2009, a hastily worked chapter on economic risks had been added. By then Iceland was facing the full blown consequences.

1.1. Purpose and research questions

This paper examines the importance of an economic security strategy for the nation of Iceland at a time when it no longer benefits from a 'special' relationship with a global superpower like the United States, and remains despite the subsequent EU application a half-hearted participant in the European project. The question is; do states need an economic security strategy and should economic affairs be securitized?

Economic security is a relatively modern concern, compared to traditional military or environmental risks, and belongs in the category of human and societal security. This paper examines how rapid globalization and increased economic and social embeddedness raises the need for nation states to have an economic security strategy in order to better protect their citizens and other stakeholders from economic risks. Risks and threats can certainly be external, or from within and in today's globalized world, few things are as free to roam the earth as money. There is therefore a problem of definition when assessing economic security. Who is supposed to be protected, by whom from whom? Global capitalism, the current international monetary system and the globalization of trade poses more complex challenges to national sovereignty that most would prefer to admit. Corruption, weak institutions and lack of preparedness can threaten states from within. Iceland fell victim to a combination of easy global access to credit, hot money flowing in and out of the country, local corruption and weak local and international surveillance. In such a scenario it is neither obvious who the enemy is nor where he resides.

A comparison is made with Finland, a Nordic nation and a small state that like Iceland has experienced a significant economic crisis in modern times, but unlike its cousin in the North Atlantic has a pro-active security strategy and a positive approach towards developments in the international arena. Using the tools of constructivism, the question of whether cultural norms and emphasis of elites are significant factors in explaining whether and how states approach security.

This paper argues that a democratic national government like Iceland's must ensure stability and promote prosperity for its citizens. But to do so it must adopt a proactive stance towards events and developments in the world at large, so it can better adjust its own situation towards such an end. This further demands political maturity and at least a minimum of cross-party consensus, as it means eschewing both the habits of a 'spoils system' and indulgence in short-term choices (of action or inaction) that court popularity at the expense of longer-term interests.

The Foreign Ministry of Iceland has begun work on a national security strategy. The last question which this paper seeks an answer to is whether a nation state should go as far as to securitize its economic affairs.

1.2. Methodological framework

1.2.1. Qualitative research methods

In this thesis the qualitative research method will be used for analysis. According to Denzin and Lincoln (2005) the word qualitative "implies an emphasis on qualities of entities and on processes and meanings that are not experimentally examined or measured (if measured at all) in term of quantity, intensity or frequency. Qualitative researchers stress the socially constructed nature of reality, the intimate relationship between the researcher and what is studied, and the situational constraints that shape inquiry".

By reviewing the relevant literature and using the available data to compare and analyze the different approaches of Iceland and Finland to security, this paper is able to explain why states should form a security strategy with an emphasis on economic issues, and offer suitable guidelines for a successful approach.

1.3. Gathering resources

Due to the economic events of Iceland having only recently occurred there has to be a careful selection of sources as there are plenty of politically motivated interpretations available. Guðni Th. Jóhannesson's book *Hrunið* and Alþingi's *Report of the Special Investigation Committee (SIC)* offer a reliable and consistent background.

For security strategy the Finnish Defense Ministry has proved to be an outstanding source. Much has been written on the Finnish crisis and the aftermath, both by Finnish academics and economist worldwide. The Foreign Ministry of Iceland, the Icelandic media and academics provide the sources for security in Iceland. Silja Bára Ómardóttir from the University of Iceland provided valuable material and insight on theories.

1.4. Limitations

The focus of the thesis is on whether Iceland should shape an economic security strategy. A comparison is made with Finland because it is also a small, Nordic state on the European periphery that faced its own serious economic crisis merely two decades ago.

The Icelandic crisis is still ongoing as the ideological, political and business landscape is still up in the air and the economy is dependent on the life-support of capital controls. Comparing the success of the reactions of the Icelandic and Finnish people and governments is therefore untimely and the emphasis is on whether a security strategy is helpful.

1.5. Structure of the thesis

The structure is made up of five different parts. Part 1 includes the theories that concern the subject. Part 2 comprises the bulk of the paper and discusses the situation in Iceland, and how the threats and instabilities originate from outside and within the system. Part 3 is on the Finnish crisis and how Finland's has responded with a comprehensive security strategy. Part 4 compares Iceland and Finland and the final and fifth part offers conclusions and recommendations.

2. Theoretical approach

For the purpose of this paper, the following more general theories will be consulted. Firstly we shall look at the United Nations Development Programme (UNDP) definition of economic security and then the effects that the three most dominant international relations theories of modern times - realism, liberalism and Marxism - can have on economic policy. Second are the relevant security theories, especially those of a holistic nature promoted by Barry Buzan and the Copenhagen School. Much of Buzan's work examines how securitization happens, and how the concept of societal security forces its adherents to look beyond classic security theories. Fourth, and relevant to both Iceland and Finland, are small state theories which seek to explain how relatively weaker powers act in the international community. Finally, no discussion on economic security sparked by a global financial crisis is complete without reviewing theories on globalization.

2.1. Economic security

Economic security has been defined by Christopher Dent (2007, p. 204) as “safeguarding the structural integrity and prosperity generating capabilities and interests of a politico-economic entity in the context of various externalized risks and threats that confront it in the international economic system”. The dyadic narrative of economic security analysis is divided into micro and macro levels. The former's concern is with local agents such as individuals, households and local communities, focusing on their safety. The latter concentrates on the behaviour of actors within the international economic system (Dent, 2007).

The UNDP report on human security from 1994 lists seven categories of human security; economic security, food security, health security, environmental security, personal security, community security and political security. According to the report economic security

requires an assured basic income either from remunerative work or a financed safety net. The importance of job creation is therefore important to states' economic security. Wage stability matters and the importance of real wages keeping their value. Income security is especially hard on minorities, fostering social problems and poverty with increased stress on states and their capabilities (UNDP, 1994).

Dent (2007) describes how the post-Cold War debate on economic security concentrated on a new tri-polar system (US, EU and Japan) replacing the bi-polar one. In Bill Clinton's second term as president the US begun emphasising a security strategy to boost economic prosperity. At the macro level, economic security must include ways to ensure economic stability and just distribution of wealth. The behavior of actors within the international system can certainly effect economic security of states. Barriers to trade and preferential policies affect production capabilities. Devaluing of currencies makes one nation competitive, possibly at cost of others. Non-state actors complicate things further, as the example of the Icelandic banks utilizing the benefits of the nation's situation as a member of the European Economic Area with the consequences severely affecting state and human security.

2.2. Realism

Mercantilism is the realist, zero-sum approach towards managing the economy as a tool for the nation-state's (and/or its leaders') own gain. Its adherents believe the international system is anarchic and view competition between states as a natural law with the purpose of gaining advantage over others (Mingst, 2007)

Each state's interests mark the course of its economic policy and the international economy is ruled by the strongest actors seeking to maximize their own gains. Under the realist model, strong states act towards their ends by using pure coercion or mixed methods

such as carrot and sticks, i.e. promises of rewards for good behavior and punishment for bad (Greffenius and Gill, 1992). They may for instance bind supporters to them with economic incentives including aid, but also use force to intervene in or permanently conquer other territories whose economic resources (or strategic logistical advantages) they crave.

Even in the best of times it is a short run for most states and statesmen to the shelter of economic nationalism, and when times are dire the road to protectionism is especially appealing. The decision of the government of Iceland to let the three major banks default with their foreign creditors, while guaranteeing all local deposits, in 2008 led to an international dispute with the United Kingdom and the Netherlands and eventually a court case before the ESA court (EFTA, 2012). The current imposition of foreign exchange controls contravenes the free movement of capital which Iceland is obliged to guarantee as a member of the European Economic Area. Yet without such self-serving measures it seems more unlikely that Iceland could maintain the relative economic and social stability it has achieved since the fateful days of October 2008.

Realist theory, from the Melian Dialogue onwards, assumes that the strong states do as they can to the weak who suffer as they must (Thucydides, 2008). Charles Kindleberger's hegemonic stability theory assumes the leadership of one state as the most efficient way to control world financial markets and avoid financial crisis. In the final chapter of his book, *The World in Depression 1929-1939*, Kindleberger examines the Great Depression and arrives at the conclusion that the crisis was deepened and prolonged by British inability and U.S. unwillingness to assume responsibility for stabilizing it by discharging five functions (Kindleberger, 1986):

- 1) Maintaining a relatively open market for distress goods*
- 2) Providing countercyclical, or at least stable, long term lending*
- 3) Policing a relatively stable system of exchange rates*

4) Ensuring the coordination of macroeconomic policies

5) Acting as a lender of last resort by discounting or otherwise

providing liquidity in financial crisis

Kindleberger arrived at the conclusion that a single dominant actor on the world stage is best positioned to act because of its power. He argued that cooperation was not enough, leadership was needed. Without the USA's leadership, the success of the institutions and policies of the Bretton Woods organizations such as the IMF, World Bank, GATT/WTO would not have been possible (Kindleberger, 1986). The power of the hegemon is necessary to get things done. Kindleberger argues, "the most sensible proposals emanating from small countries are valueless if they lack the capacity to carry them out and fail to enlist the countries that do" (Kindleberger, 1986 p. 298). To make his point he argues that ideas were plentiful at the World Economic Conference of 1933, but USA, the single country able to provide leadership, did not aspire to such a role at the time.

Kindleberger's assertions describe the disparity in abilities to affect larger global concerns. According to Kindleberger, "small countries lack the power to affect the outcome of great events and are therefore privileged to look after the private national interest rather than concern themselves with the public good of stability in the world economy as a whole" (Kindleberger 1986, p. 300).

John J. Mearsheimer (1993) wrote about the false promise of international institutions where he noted a paradox of the world not working as the way institutionalist theories say it ought to, yet it holding a high degree of influence in academics and policy. From the realist standpoint, it is easy to be disillusioned by the apparent lack of power residing with international institutions. Realists in the financial sector have for example criticized the limitations of the Euro and the perceived inability of the European Union to deal with an economic crisis and hailed the quick recovery of Iceland as proof that the devaluation

capabilities of national currencies and the accompanying policy control of the government is a better alternative (Wolf, 2011).

2.3. Liberalism

Liberalism certainly considers politics and economics inseparable. It is the dominant theory of modern times, emphasizing capitalism in its various forms and a dynamic, globalized economy. Its modern conception has its origins in the European enlightenment where democracy challenged monarchy and Protestantism challenged catholic beliefs. The work of Scottish political philosopher Adam Smith, especially *An Inquiry into the Nature and Causes of the Wealth of Nations* contains arguably some of the most influential international political economy theories of modern times, such as the “invisible hand” (Smith, 1904).

The debate on Smith’s true message has long divided economists, political scientists and philosophers, with many seeking in it affirmation of their own ideas. Libertarians have especially claimed the invisible hand as justification for laissez-faire economics, although many Smith scholars find evidence against such drastic interpretations. Smith did not think an unregulated market would be ideal, and abhorred such by-products of capitalism as monopoly and powerful business interests working against the benefit of consumers (Smith, 1904).

In the international context, the goal of liberalism is to break down barriers of freedom and trade and maximize limited resources for the benefit of the global community. Proponents of liberal institutionalism maintain that international organizations can increase cooperation between states, making them more unlikely to compete aggressively, thereby reducing the likelihood of armed conflict. With globalization ascending at ever growing pace, interdependent states are better prepared to face threats and risks.

Faced with increased economic uncertainty in 2008, the government and Central Bank of Iceland turned towards friendly states in the international arena for help. From stronger actors in an international arena shaped by liberal institutions, most of the advice Iceland got pointed in the same direction - towards the International Monetary Fund (IMF). British economist John Maynard Keynes, the most influencing figure at Bretton Woods was instrumental in the forming of the World Bank and the IMF, the latter whose role it was to prevent economic malaise spreading from one country to another and act as a lender to nations unable to stimulate their own economies (Stiglitz, 2003). Instead of accepting bilateral assistance from a single state, with the accompanying carrots and sticks, Iceland's participation in an IMF program guaranteed financial assistance from several friendly states on consistent, institutionally regulated and essentially a-political conditions.

Where the realist Mearsheimer sees a paradox in the way states really act in their own interests and yet participate actively in international organizations, Kenneth W. Abbott and Duncan Snidal (2005) maintain that states actually take such institutions much more seriously than academics. Through participation, states are able to achieve goals they cannot on a decentralized basis. Small state studies would suggest that this especially skews the balance in the favor of weaker powers in the international arena. Finland's emphasis on proactive participation in international institutions displays a model liberal outlook towards the global community and the nation's role as an actor within it. Meanwhile Iceland could rather be described as reluctantly liberal, definitely participating, yet more wary of the games nations play within the agreed framework.

A global economic crisis confronts states with problems demanding action. The ideological background of each actor can influence whether the solutions he seeks to complex questions are of the realist, self-serving kind or of a liberal cooperative nature. The answers might not be straightforward, as Iceland has shown since the crisis with its decision to impose

capital controls and refuse the claims of foreign creditors, while nevertheless maintaining its EEA status and applying for full membership of the European Union.

2.4. Marxism

No discussion of international political economy is complete without making a mention of Marxism. Its relevance to this paper is not as important as the realist or liberal approach, yet it provides insight into the ideological conflict that comes with crisis and sheds a light on the different approaches by Iceland and Finland towards their economic security.

Karl Marx argued that because economics influence the social and political reality of states, they should organize their systems towards social goals of justice and equality. Conflicting with the general liberal idea of free markets, and more emphasis on the state's organization of its means of production and consumption, Marxism provides its ideological counterweight. Marx's ideas - like Adam Smith's - have been subject to different interpretations and he himself changed his mind on some aspects and never developed a systematic set of ideas on international relations (Gilpin, 1987).

Marxism's critical view on capitalism assumes that the state is the executive power of the ruling classes. They rule the state through which the wealthiest citizens control the economy. The international economy is manipulated by the strong to maximize their own gains. "Das Kapital" describes a reality of an uneven game of class conflict, and normatively Marxism promotes advancing the interests of the economically weak against the strong.

Marx maintained that the nation state system was organized by capitalist elites to keep people who had much in common from each other. With socialism triumphing in more nations he envisioned that borders would eventually be eliminated (Baradat, 2000). His theories were shaped by witnessing the abject conditions of British workers during the industrial revolution in comparison with the wealth of capital owners from the aristocracy.

Central to Marxist criticism, and relevant to modern discussion, is that while the individual capitalist is rational in his behavior, the system itself is irrational. Marx pointed out that self-interest would lead to accumulation, which would in turn affect the business cycle towards more stagnation, due to overproduction of goods, surplus capital and less incentive to investment (Gilpin, 1987, p. 37). Marxism spawned the ideological background of totalitarian Soviet communism, but married more happily with liberal ideas in the Nordic welfare states, including Finland.

Realism, liberal institutionalism and Marxism each contain their own form of ideology, but it is a rare nation that can be described as having a single theoretical allegiance. This paper maintains that the economic and security policies of the two different Nordic states of Iceland and Finland are partly shaped to the degree to which their political and economic elite embraces each strand compared with the others.

2.5. Security theories

As Michael Sheehan (2005) noted, the traditional relationship between economics and politics has seen the former positioned as a subordinate of the latter. Yet one is always present in the other. After the OPEC embargo of the 1970's and the publication of Robert Keohane and Joseph Nye's "Power and Interdependence", Western states increasingly woke up to the realization that the concept of state security had broader implications than merely of the traditional military kind, and in some instances involved more encompassing and complicated risks.

2.5.1. Classical theory

The study of international political economy (IPE) has certainly evolved at a rapid pace since Strange lamented its restricted influence in the eighties and nineties. According to Sheehan, academic research on economic security has been dominated by a neorealist agenda.

Sheehan (2005) claims there are four distinct ways in which economic security has been analyzed since the end of the Cold War. The first is a traditional, historical approach where economic strength is a condition for military power. Secondly comes a neo-Darwinist approach identifying threats and enemies in the competitive international economic arena. Then a focus on human security, where human welfare becomes a separate security issue; and lastly an emphasis on international interdependence and economic development as factors that, among other things, make war and conflict less desirable.

Moving past the traditional, military emphasis and into the realm of human security means that actors have to enter an ambiguous world of less visible enemies and complicated threats. Economic security is a broad term, overlapping with and mutually dependent with most other security concerns. Environmental threats affecting harvests and health can certainly affect economic power and therefore military capabilities. But effective defence of the national territory and assets is the most basic condition for economic success, also at the human level. As evident by the global financial crisis, international interdependence can pose a threat to national security - as both Greece and Iceland can testify. Free and open markets are susceptible to threats from outside national borders, as well as from within. But it is the price most nations have been willing to pay when making increased efforts for modernity and increased welfare for their citizens ever since the industrial revolution.

In a globalized and interdependent world, it appears that a focus on the security of states must increasingly and eventually be supplanted by a focus on the security of humans and societies. Policy hawks everywhere are sure to resist such a shift, but liberals will push the proposition that cooperation forces advanced states to settle disputes through negotiations instead of force (Keohane and Nye, 1997).

2.5.2. Human security

In the United Nations Development Programme from 1994, the case was made for a “profound transition in thinking – from nuclear security to human security” (UNDP, 1994: 22-26).

- *Human security is a universal concern. It is relevant to people everywhere, in rich nations and poor. There are many threats that are common to all people-such as unemployment, drugs, crime, pollution and human rights violations. Their intensity may differ from one part of the world to another, but all these threats to human security are real and growing.*
- *The components of human security are interdependent. When the security of people is endangered anywhere in the world, all nations are likely to get involved. Famine, disease, pollution, drug trafficking, terrorism, ethnic disputes and social disintegration are no longer isolated events, confined within national borders. Their consequences travel the globe.*
- *Human security is easier to ensure through early prevention than later intervention. It is less costly to meet these threats upstream than downstream. For example, the direct and indirect cost of HIV/AIDS (human immunodeficiency virus/acquired immune deficiency syndrome) was roughly \$240 billion during the 1980s. Even a few billion dollars invested in primary health care and family planning education could have helped contain the spread of this deadly disease.*
- *Human security is people-centred. It is concerned with how people live and breathe in a society, how freely they exercise their many choices, how much access they have to market and social opportunities and whether they live in conflict or in peace.*

The report makes a note of human security often being more easily understood by its absence instead of its presence and offers two definitions for clarity; safety from chronic threats such as hunger, disease and repression and protection from sudden and hurtful disruption in the pattern of daily life – whether in homes, in jobs or in communities. These kind of threats can permeate all layers of society and come about abruptly from natural courses through emergency or slowly and human-made through wrong policy choices. The report

makes a point of not confusing human security with human development, a process defined as widening humans' ranges of choices (UNDP, 1994: 23).

When the Cold War ended a host of Western academics were quick to proclaim a victory for the economic version of liberal democracy, including Francis Fukuyama who spoke of a philosophical end of history and victory for marketization which would decrease the likelihood of armed conflict between states (Fukuyama, 1989). Twenty odd years later, capitalism is still the dominant force shaping the international economy: but increasingly finds itself coming under the same kind of criticism which burst socialism's bubble, notably about whether it can alone ensure an efficient market, and whether it actually is a sufficiently able to create and distribute wealth for the benefit of societies and not merely elites.

The Cold War landscape offered policy makers clear lines to distinguish between good actors or bad. Such lines are not as easy to spot in the era of globalization; and actually most modern conflicts happen within states, with increasing threats from actors of the non-state kind. Human and societal security are both ideas that view the basic needs of individuals and societies as being more relevant than the needs of states. Robert Kennedy wrote that "there is another kind of violence in its way as destructive as the bullet or the bomb. This is the violence of institutions; indifference, inaction and slow decay. This is the violence that afflicts the poor...this is the slow destruction of a child by hunger and schools without books and homes without heat in the winter" (Sheehan, 2005, p. 77).

The crisis of globalized liberal capitalism is not least due to its inefficiency in moving wealth down the ladder to the poor and needy. Sheehan (2005) points out that parts of the world have experienced rapid economic development, fourteen million people die of hunger every year and a third of the population lives in dire poverty. Hunger and starvation is not due to lack of production, but failed distribution of food globally. With time the United

Nations has placed human security increasingly higher on its agenda, claiming it requires freedom from fear and freedom from want.

It is easy to agree with those who point at the failures of international institutions to rectify the problem of poverty. The IMF and World Bank's record, in the last three decades of the twentieth century, of lending the world's poorest nations money to achieve development on what have been named the Washington Consensus conditions of market liberalisation is notoriously poor. The policies of opening up underdeveloped markets in nations with weak infrastructure to foreign investment benefited Western capitalists and local elites, but were coupled with spending cuts on social welfare such as health care and education - with disastrous consequences for the poor (Stiglitz, 2003). Compared to the Cold War era, hegemonic control of international institutions appears on the wane: but with its reputation preceding it, the IMF's presence in Iceland in 2008 was widely met with suspicion and fear (Jóhannesson, 2009).

Human security begins where the basic material needs of people are met and any ambitious society actively pursues a high standard of quality of life for its citizens. Sheehan (2005) concludes that it is the liberal agenda of an international market which will dominate debates on economic security for the foreseeable future. It is agreed that the accompanying instability needs to be addressed as human security.

Professor Barry Buzan of the London School of Economics and the Copenhagen school of international relations has attempted to combine and modify the realist approach to security with a broader security concept and a constructivist view of aims and interests. He was the first to popularize the notion of 'societal' security, viewing the modern social collective as a middle term between the state and the individual, with its own security aims and resources. The Copenhagen School framework explores threats to referent objects and the securitization of these threats, whether non-military or military (Buzan, 1997).

According to Buzan and Ole Wæver, fellow authors of the Copenhagen School, securitization is a process whereby actors transform political, economic, social, military and environmental issues into security topics, thus allowing security logic - including exceptional measures if necessary - to be applied to them for public protection. The public perception of security and public support for related plans and actions, under this theory, thus depends on the emphasis of those in power (Buzan, 1997). While securitization theory normally warns against securitizing too many things, it may also be used to point to cases – arguably, including Iceland's - where the economy has not been securitized enough, or at least in too narrow and out-dated a manner.

Together with Buzan and Jaap De Wilde, Wæver identified five sectors where securitization could happen in their book *Security: A New Framework for Analysis* (1998:8):

- *Military*
- *Political*
- *Economic*
- *Society*
- *Environment*

In this framework economic security is defined by Buzan as concerning “access to the resources, finance and markets necessary to sustain acceptable levels of welfare and state power” (Sheehan, 2005:65).

Successful securitization must include an agent to make the move towards securitization; an object under threat which needs protection; and an audience which must be persuaded to accept the securitization. In recent times, the United States' decision to go to war against Iraq in the name of anti-terrorism and anti-proliferation has often been cited as an example of a successful securitization of an issue, by a powerful agent with a receptive audience (O'Reilly, 2008). The problem with securitization is that it transfers issues from the

critical debate of the political realm into an area of security where criticism is likely met with accusations of suspect motives.

A distinguishing feature of securitization is a rhetoric of threat, survival and immediacy. It is therefore a speech-act where the language itself is the act (Buzan, 1997). Securitization hardly happens in the economic sector as it is harder to spot referent objects and existential threats. But, during the IceSave debate in Iceland, much was made of supranational threats to sovereignty and the bleak future of Iceland's children if an agreement with the UK and the Netherlands would be signed (Jóhannesson, 2010). Those leading the speech act were non government organizations such as the InDefence pressure group and the opposition in Alþingi and it led to the extraordinary measures of a national referendum and rejection of the agreement.

2.5.3. Constructivism

Securitization is in fact one example of a constructivist act, whereas actors successfully convince an audience that something they perceive as a threat is real and something they value might require extraordinary measures for protection. From a constructive perspective Alexander Wendt (1992) maintains that threats and risks are what states make of them. It is not necessary for actors pushing for securitization to be states, they could also for example be the political Opposition or Non Governmental Organizations (NGO's).

Constructivists hold that state behavior is derived from elite beliefs, identities and social norms. The interests of the state are formed by the social identity of its individuals and actors. Constructivists add discursive terms of power to the material ones used by liberals and realists, and view ideas, speech and culture as powerful agents in society (Mingst, 2008). A constructivist approach can do much to explain differences in the behaviour and policies of two Nordic states that appear from afar to share a similar set of values. The history, culture,

imagery and language of Finland might explain why it values a pro-active approach towards international relations in comparison to Iceland, which has been shaped by different rocks in the ocean of time.

2.6. Small state theories

Examination of the role, capabilities and limitations of small states in the international arena usually begins with the question of definition. What exactly are the features of a small state? Measures of geography, population, GDP and military capabilities can paint a picture of any state, yet when viewed in isolation one feature can be perceived differently from another. Iver B. Neumann and Sieglinde Gstöhl (2006, p. 8) emphasise that “the distinction between small and great does not coincide with the distinction between strong and weak”. So it is that Iceland has a small population and cannot claim any military capabilities, but enjoys a relatively high GDP and considerably advantageous geographical features. Finland likewise has strong geographical features and an enviable GDP, but modest military capabilities and population numbers.

The relevance of small state theories to contemporary security approaches should not be underestimated. Most of the world’s roughly two hundred nation states would be considered small states and Iceland and Finland belong in that category. But for the sake of comparison, Keohane’s (2006) categorization of states offers four different classifications; system-determining where states have a dominating role in the system; system-influencing that have considerable influence without being determining on their own; system-affecting whose influence through small groups can be significant and at last system-ineffectual states whose influence is minimal and influence comes through participation in large groups. Arguably Iceland belongs in the last category but Finland’s position has wider shades of grey.

Morgenthau's definition of a great power is one which is able to impose its will against one which is not able to do so in return. But he concedes that small states can rise to the eminence of a great power, while a great power can sink to a lower level (Neumann and Gstöhl, 2006: p17). Whereas great nations have historically tended to draw their strength from their capabilities of inflicting violence against smaller nations, the latter have seen their powers increase with the rise of international institutions. Within international institutions all sovereign states stand equal before the law. While states realistically are not equal as far as material and power generating capabilities go, great powers tend to stay away from confrontation or intimidation with smaller states. The use or threat of violence is but one aspect of power in the international arena. Bargaining, negotiations and diplomacy increase the capabilities of small states and large. So Finland could be said to rise above its limitations through active participation in large and small groups and perhaps belong in Keohane's third category instead of the last.

Small states in particular can view diplomacy as the perfect tool to control their own fate. The difference in how Iceland and Finland approach their national security is linked to how these states view and use liberal appliances of diplomacy and international institutions as means to their own realist ends. Robert Rothstein defines a small state as one "which recognizes that it can not obtain security primarily by use of its own capabilities, and that it must rely fundamentally on the aid of other states, institutions, processes, or developments to do so; the Small Power's belief in its inability to rely on its own means must also be recognized by the other states involved in international politics" (Keohane, 2006: p. 56).

Small states have a greater dependency on exports and imports than large states due to the limitations of their small domestic markets. They are also more specialized and reliant on few economic pillars and are therefore more vulnerable to fluctuations in the international economy (Handel, 2006).

The European Union offers outstanding opportunities for research into state behavior. It is clear that small states do not have the administrative capabilities of their larger counterparts. They cannot realistically hope to exert their influence on the wide range of issues up for discussion in the European Union's forum. What small states tend to do according to Baldur Þórhallsson (2006) is to prioritize where they spend their energy and focus on the issues which concern them most. It is within this framework that the power of small states can surpass their expected abilities and their specialization can get them into a driver's seat.

In addition to the multi-lateral cooperation offered by international organizations, bi-lateral relationships with larger states can be useful for small ones. Iceland's special relationship with the United States kickstarted and aided its development from a rural farming economy into an developed and industrialized economy. Finding its feet, Iceland could count on Washington lending an ear and advice. But there is a downside to bi-lateral arrangements: that once the stronger actor no longer sees value in the relationship, it can abruptly end it. In this regard, international organizations allow states to strengthen their sovereignty by assuming their seats as legal equals where decisions are made. In turn they must step up to the table and take more responsibility for the destiny of their most important goals.

Despite all these general features of vulnerability and opportunity, and relevant policy options, which all small states in principle share, the actual security agenda and situation of each small state will vary depending on external and internal, historical and geographical factors, and also on its internal governance and skill in managing its own predicament. The most that can be said is that the security profile of a specific state in the developed world is likely to fall somewhere within the table set out below, which divides challenges according to their 'hard' or 'soft' nature but also in terms of their origin and the type of agency involved. Arguably, the most important task of strategy-forming in a small

state is not just to identify the challenges correctly, but to inter-connect and prioritize them, as a basis for finding the right combination of instruments to overcome the state's own limits and deficiencies and build security at acceptable cost.

An Academic Model for (Developed) Small States¹

A. Military, 'Hard Security' <i>(warlike threats, state response)</i>	B. 'New Threats' <i>(deliberate human, law+order response)</i>	C. Economic Security <i>(incidental risks of civil action, private sector important)</i>	D. 'Non-intentional' + natural hazards <i>(no-blame or long-term challenges, private+popular action important)</i>
State attack	Terrorism	General economic viability	Major accidents (inc. NBC* release)
Caught in crossfire	Violent/organized crime	Financial ditto	Infrastructure breakdown, key services
Subversion, sabotage	Smuggling of strategic goods	Security of supply (energy, other essentials)	Health challenges inc. pandemics
Internal (armed) conflict	Other 'asymmetric' attack inc. cyber-attack	Food security	Natural disasters
Transport + comms.	Environment damage	Severe civil unrest	Illegal migration, human trafficking
Climate change	Resource exhaustion		

**Nuclear, biological or chemical*

2.7. Globalization

People, ideas and goods have forever roamed the Earth. What is different about globalization since industrialization is the increased speed at which they travel, increasingly shrinking time and space between people across the globe. This has been aptly named respatialization by Jan Aart Scholte (2005) who claims that this term adds more meaning to redundant definitions of globalization, namely internationalization, liberalization, universalization and westernization. Keeping up with the speed of change and the shrinking of

¹ Taken (with permission) from the paper presented by Alyson JK Bailes at the ECPR International Conference of August 2011 on 'Non-Military Security for Small States'

distances between people poses a challenge for nation states, especially ones whose framework of security thinking is constrained within national and geographical borders.

In an embedded world, no nation is an island, even Iceland as far as the flow of money goes. Any discussion of economic security must include consideration for non-state actors that operate both within and above the state level. Although realists and liberals hold different beliefs on how the world turns, they unite around a democratic, capitalist agenda which has dominated world politics since the end of World War II, even claiming full ideological victory at the end of the Cold War. Globalization with free movement of goods, services, capital and in some cases people is an essential part of Western values.

Columbia professor and former head of the World Bank, Joseph Stiglitz (2003) has written extensively about the disruptive elements that have accompanied globalization since the birth of the Bretton Woods institutions. In the wake of the recent economic crisis, Stiglitz has reiterated his belief that globalization must be managed to a greater extent, to avoid severe shocks to states economies and ensure fairer distribution of wealth. In his book *Freefall* (2010), Stiglitz addresses the changing role of government and maintains that it should be about maintaining full employment and a stable economy; promote innovation, provide social protection and insurance and prevent exploitation. To this extent he encourages states to consider stronger global regulations and even a new global reserve system, as originally conceived by John Maynard Keynes for the original role of the International Monetary Fund.

Globalization in parts explains the threats faced by Iceland and Finland in their crisis – faulty policies and economies vulnerable to international events – but it also means that the solutions must come from cooperation on the international stage (Finland joining the EU and Iceland seeking the help of IMF). There are many challenges for small states within international organizations. Stiglitz (2007) has described how the democratic deficit of

unequal representation must be addressed, but he emphasises their importance as the critical venue where globalization can be made to work.

3. The Weak State of Iceland

“It is clear that economic weakness, contraction in the economy, lower living standards and budget cuts in different sectors of society will have a great impact on Icelandic security in the near future. The crisis spawned an international crisis between Iceland and the UK and the Netherlands because of Landsbankinn’s IceSave accounts and the British government decided to enact a terrorist law to freeze Icelandic assets in the UK. This debate caused great tension in the relationship between the nations and affected Iceland’s access to credit through the IMF and its neighbor countries. At first, the Icelandic government claimed that the deposit guarantees were limited to the assets of its Depositors’ Insurance Fund, but eventually it decided to solve the issue through negotiations. The case even had impact on Iceland’s operations within NATO, leading to the British Air Force abandoning its planned protection of Icelandic air space in December 2008. Last but not least, Iceland’s reputation abroad was severely damaged because of its banks’ going under, as it did not only affect foreign creditors, but hundreds of thousands of depositors.”

- Risk Assessment Report for Iceland (Útanríkisráðuneytið, 2009, pp. 13-14)

The small state of Iceland was hit by a severe economic crisis in October 2008. Following a politically disastrous privatisation of the state’s banks around the turn of the century, its banking sector had grown ninefold the size of its GNP, making it impossible to rescue (The Special Investigation Committee (SIC), 2010, p. 1). The result was a significant asset depreciation and collapse of its three main banks, an international relations crisis with the Netherlands and the United Kingdom due to Landsbankinn’s IceSave accounts, the consequent lowering of Iceland’s rating by the international ratings agencies, and a severe local political crisis where trust in society’s institutions fell to historic lows. On the individual level, record unemployment, massive private debt and record number of bankruptcies and financial uncertainty contributed to Icelanders taking to the streets in unprecedented protests.

In the years since the crisis there have been real, if generally masked, signs of social stress and health and welfare problems in some quarters (Sigmundsdóttir, 2010).

3.1. What is special about Iceland?

This chapter comprises the core of the present paper. It attempts to describe how Iceland's economic crisis came about through self-inflicted systemic weaknesses, was ignited by external factors beyond its control and compounded by both internal and external factors. Hence the chapter's title - the weak state of Iceland - indicates that as a small nation, Iceland is both vulnerable towards global economic fluctuations (availability of cheap credit fuelled a boom, US mortgage crisis unleashed an avalanche on the Icelandic economy); and exposed, because of its limited capabilities and small population, to being manipulated from within for the gain of a few (monopolies, strong production sector-influence on politics, corrupt privatization of state assets, nepotism). Arguably, because of those limitations, Iceland more than most nations needs to be on its guard regarding state and human security, in the economic sphere as much as or even more than in others.

Iceland is a small state. Homogenous. Isolated. In the EEA but not the EU. It is exposed to regular instability due to the size of individual companies or individuals and openness of society. As is typical of small states, Iceland is highly dependent on imports and its export sector is dominated by fish and aluminum production.

The fishing industry is accountable for 40% of Iceland's export earnings at over 12% of GDP, while employing just 7% of the work force (CIA, 2012). The economy is vulnerable to global market conditions in the fishing and aluminum industries. Increased diversification into manufacturing and service industries has seen the advent of strong companies in technology and tourism. All are affected by the Icelandic Krona (ISK), the tiny local currency. Its volatile history led to consumer loans being fixed to the consumer price

index in the late seventies to combat the effects of inflation. A considerable number of individuals and businesses seeking lower interest rates were attracted to foreign currency loans in the beginning of the 21st century with disastrous effects when the ISK lost half its value (SIC, 2010, pp. 46-47).

Iceland is special because it is a developed western nation whose whole banking sector collapsed. It sent its foreign creditors packing. It imposed currency restrictions. Its public sector debt levels are historic. What happened is a story of a successful development aid recipient outgrowing its boots.

Iceland's name first appears on a currency with the names of Greenland and the Faroe Islands in 1771, on a Danish coin called pjaester. From 1815 the Danish State Bank held the rights to issue currency in Iceland, but with the formation of a state treasury in 1871, Iceland's finances were separated from Denmark's. In 1885 the country's government was granted permission to issue currency on the treasury's behalf and this laid the foundations of the country's first financial institution, Landsbankinn ('national bank'), which opened on July 1, 1886. Its role was to support and encourage monetary transactions and help the developing country's industries (Myntrit, 2002).

Iceland's financial sector grew rapidly alongside the calls for separation from Denmark. On December 1st, 1918 Iceland and Denmark agreed on the Act of the Union, valid for twenty-five years and recognizing Iceland as a fully sovereign state in personal union with the King of Denmark. Iceland's movement for independence had first and foremost revolved around the issue of self-rule, and Denmark was asked to continue implementing the nation's foreign policy (Thorarensen, 2007).

When Denmark fell under Nazi occupation in 1940, the Alþingi (Icelandic Parliament) announced it would take over the responsibilities that Denmark had performed on its behalf, including foreign policy. In May that year, the British Army occupied Iceland to

prevent Nazi expansion in the North Atlantic and a year later the United States Army accepted Iceland's invitation to assume its defenses. On June 17, 1944, Iceland became a republic.

Companies like Landsbankinn in the financial sector and Eimskip in the transportation sector became an integral part of Iceland's twentieth century push from an agricultural society to modernization. In 1927 Landsbankinn's part in the independence movement was cemented by its assuming the role of a central bank with the exclusive rights to print official currency, a role which it held until 1961 with the formation of the Central Bank of Iceland (Seðlabanki Íslands, 2005). In a young nation, politics and business were hard to separate. Reflecting the balance of power in Icelandic politics, the banks executive boards were appointed by the political parties (Landsbankinn, 2012).

After World War II, Iceland's strategic position between Moscow and Washington DC. led to a fruitful alliance with the United States. Iceland was one of the largest benefactors of the United States in the post-war period, in spite of no war damages to speak of. The United States provided Iceland with the political and defensive shelter it needed to build its industries and infrastructure; in turn, the military base outside Keflavik granted the US a strategic location in the Cold War (Thorhallsson, 2009). Iceland was also a dependable ally for the United States at the newly formed international organizations, the United Nations, NATO and the Bretton Woods institutions.

The arrival of the US armed forces and the construction and maintenance of the NATO base in Keflavik became a source of wealth and power for industrious Icelanders. Political lines were drawn amongst what became known as the *four parties*: the Independence Party on the right, the Centre Party which had its origins in the agricultural and co-operative circles, the social democrats of the People's Party and the left wing People's Alliance. Soon the so-called half-and-half shares (*helmingaskipti*) of Icelandic politics became commonplace. The tightly controlled economy and the business environment was ruled and divided by the

parties in power at each time. Ministers would hire bank managers favorable to their party and sit on the boards of important companies (RNA (8), 2010).

3.2. Libertarian influence

In the 1970's Iceland was a relatively closed society with a tightly controlled economy, and as late as 1977 it was classified as a developing country in a UN report. A few young men - including three future Prime Ministers, a Supreme Court Justice and several high-ranking members of society - influenced by libertarian views wanted the Independence Party to lead the fight in abolishing the government's control. Together they published the magazine 'The Locomotive' from 1972-1975. The American economist Milton Friedman, who became a personal friend of the future political science professor Hannes Hólmsteinn Gissurarson, in part influenced the Locomotive members. His visit to Iceland in 1984 aroused great interest in Icelandic politic circles (Guðmundsson, 2002). Friedrich Hayek, James M. Buchanan, Ronald Reagan and Margaret Thatcher also shaped the political minds of the young libertarians as they ascended to positions of power in the 1980's.

The Locomotive's members were a natural offspring of their inhibited society and quite critical of their own party. Egalitarian Iceland, with no beer, no television on Thursdays or the whole month of July, state-run media, and little to separate the private and public sectors would obviously provoke opposition from the youngsters influenced by Friedman and Margaret Thatcher. Davíð Oddson was elected to the city council of Reykjavik in 1974 for the Independence Party and in 1982 he became the mayor. By the nineties, he had outgrown his position and in 1989 was elected the vice-chairman of his party; and in 1991 he accepted his party's leadership position. In the Alþingi elections that year the party bounced back to be able to form a new government with the People's Party on the platform of Iceland's becoming a member of the EEA, which it did in 1994. In 1995, the coalition broke and Oddson formed a new one with the agrarian Centre Party.

3.3. Privatization

Originally the state's banks were supposed to be privatized into a spread ownership to prevent them landing in the hands of few businessmen or conglomerates. As described in the Rannsóknarskýrsla Alþingis (RNA (1), 2010, p. 227-241) the state had privatized FBA, an investment bank, in 1998 and a couple of years later decided it was time to let go completely of the rest. No single investor was supposed to end up with a dominant share so that the banks would be as independent as possible towards the industries of Iceland: but a power struggle behind the scenes of the coalition government of the Independence Party and the Centre Party changed all that.

As the money-men who wielded considerable influence behind the scenes pushed for their shares of the spoils, the traditional half-and-half rule between the parties reared its ugly head. The committee on privatization intended to sell the state's remaining shares in Búnaðarbankinn and Landsbankinn in 2002, but advances from Björgólfur Guðmundsson to Davíð Oddson was to propel 45.8% of the latter into the hands of his holding company Samson, which he owned with his father and their business partner. Independence Party CEO, and former Locomotive member Kjartan Gunnarsson was guaranteed a position on the board (RNA (1), 2010).

Búnaðarbankinn was sold to the S-Group, a Centre Party group of investors close to and including Finnur Ingólfsson - a Centre Party finance minister who introduced the government's plan for privatization in 1998, resigned from his post as minister a year later, made a short stop in the Central Bank as one of its governors and then popped up on the other side with a newly privatized bank in his pocket. The chairman of the privatization committee, Steingrímur Ari Arason, resigned before the decisions were finalized stating that he had never before witnessed such unprofessionalism (RNA (1), 2010, p. 266).

The S-group bought 45,8% in Búnaðarbankinn for 11.9 billion ISK, after having claimed it was working with a renowned international financial institution whose name was not to be revealed. Believed to be Société Générale by many, it turned out to be provincial German private bank Hauck & Aufhauser (RNA (8), 2010, p. 28-30). That did not deter the minister of commerce from the Centre Party from signing the deal. After the economic collapse of 2008, it was revealed that Samson and the S-Group had borrowed parts of the fee at the very banks that each other were acquiring from the government. The libertarian privatization of the Independence Party and the Locomotive team was turning Iceland into a Russian-style oligarchy. The banks were simply privatized into the hands of the biggest financial supporters of the Independence Party and the Centre Party.

3.4. Expanding economy

Iceland had joined the European Economic Area in 1994 to gain access to European markets. But despite boundless opportunities now being available for Icelandic businesses, economic policy and fiscal management at home ultimately proved a task beyond local control. Iceland adapted EU directives and regulations regarding its financial markets without much in the way of review, when it could perhaps have adapted them more towards its local and special circumstances. The Financial Authority and the anti-trust authorities were undermanned and lacked the resources to deal with the explosive growth of the banks (RNA (5), 2012, p. 140). Then again, why worry when Transparency International claimed Iceland was the least corrupt nation in the world? (RNA (8), 2012, p. 133)

Oddson had declared the Independence Party as the winner in the ideological war in 1993, and his government had implemented a social experiment where their dream was for Iceland to be the freest country on the planet (Stephensen and Sigurgeirsson, 1993). In 2004-2007 it certainly appeared that Iceland was reaping the benefits of the Independence and Centre Parties policies. In 2005, Centre Party leader Halldór Ásgrímsson restated Oddson's

dream of Iceland becoming an international financial center and appointed a committee charged to such end that was met with the support of the banks' executives (RNA (8), 2012, p. 91-93).

The Icelandic Chamber of Commerce, which prided itself of the government adopting 90% of its suggestions into law, envisioned a future where Iceland would be the most free nation on earth in 2015, with as little regulation as possible standing in the way of Icelandic businesses. The Chamber also proposed that Iceland should stop comparing itself to its Nordic neighbors, as "we are above them in most areas anyways" (Viðskiptaráð, 2006, p. 22).

In May 2003, Búnaðarbankinn was merged with Kaupping, Iceland's premier brokerage enterprise. Kaupping went through mergers and acquisitions to double in size every year during the decade until it was amongst the 800 biggest companies in the world in 2007 (Mbl.is, 2007). No Icelandic bank had been amongst the one thousand biggest banks in the world before, but now all three were gunning for the top one hundred (Vb.is, 2007).

Even though the state was almost free of foreign debt, the Central Bank and the state treasury were weak. In the first decade of the 21st century interest rates kept rising and foreign capital flowed freely into Iceland, exalting the krona but creating an illusory purchasing power. The tangled web of cross-ownership by three major blocks in the business sector revolved around controlling ownership in the banks. Icelandic politicians benefitted handsomely themselves, receiving larger donations than had been previously imaginable. In 2006, FL Group donated 30 million ISK to the Independence Party just days before new laws on campaign financing were due to take effect. Landsbankinn also chipped in with 25 million ISK (RNA (8), 2012, p. 78 and 164-165).

The banks' executives borrowed money to buy stocks in the banks themselves and Icelandic businessmen invested heavily abroad with borrowed money from the banks they

controlled. Five of Kaupping's riskiest loans in Luxembourg involved large owners of the bank. Little or no collateral of value was behind a large number of the loans, sometimes just the stock itself. Jón Ásgeir Jóhannesson, his immediate family and their companies became too big to fail in a literal sense through their debts to the banks at the end of 2008 (RNA (9), 2012, p. 55-56). The same could be said of the largest shareholders of Landsbankinn and Kaupping. If the banks had called in their loans then it would have had disastrous consequences. The controlling position of such individuals was immense and they effectively ran the bank on some major decisions. Members of the press also owed the banks a good deal of money and the line between the press, the politicians and the businessmen was often blurred, hindering critical debate. Icelandic companies paid their owners dividends of 463 billion ISK from 2003-2009. Scores of businesses paid out those dividends despite losses and negative equity (RNA (9), 2012, p. 62-68).

3.5. Warnings

As early as 2001 Joseph Stiglitz had expressed concerns about the possibility of a sharp inflation and that the Icelandic economy might be over-heated, which could end in a market contraction (Stiglitz, 2001). In spite of these warnings the governments of Iceland still went ahead with the privatization of the two banks, and ordered work to begin on the largest construction project in the nation's history at Kárahnjúkar Dam in the east of Iceland, which would provide the power for a new aluminum smelter in Reyðarfjörður. It also lowered the qualification bar for mortgages by introducing 90% home loans, and it lowered finance and income taxes well below the average in the Nordic countries and most of Europe. The Special Investigation Committee after the economic crash concluded that the two parties in government had attempted to fulfill all their campaign promises at once, even against their own better judgment - as the then Prime Minister Geir Haarde later admitted (RNA (8), 2012, p. 180).

In 2006, The International Monetary Fund (2006, p. 24) expressed concern about the Icelandic financial system, citing international markets' worries that the quick growth of the Icelandic banks' balance sheets had over-exposed the nation. "Potential vulnerabilities include considerable near-term refinancing needs, credit quality, the long term sustainability of the banks' presence in the domestic mortgage market and the crossholdings of equity".

But what would the situation have been if it the warning signs of the Geyser Crisis report in 2006 had been heeded? Danske Bank's (2006) report described Iceland's economy as the most overheated in the OECD area, and predicted a recession in 2006-2007 with a dip in GDP of 5-10% and inflation surging above 10% with the depreciation of the Icelandic Krona. Danske Bank was not alone in ringing the warning bells, as it pointed out. The IMF and OECD had both published reports on the impending situation; so had Barclays, Merrill-Lynch, Credit Sights and Fitch Ratings, while a Financial Stability report prepared in 2005 by the Icelandic Central Bank had also been wary of the rapid growth (Seðlabanki Íslands, 2005).

In Iceland, however, all such criticism was overwhelmingly rejected with accusations of envy or lack of understanding or both. The Chamber of Commerce commissioned a report by then chairman of the Economic Institute at the University of Iceland, Tryggvi Þór Herbertsson, and Columbia University professor Frederic Mishkin. Titled *'Financial Stability in Iceland'*. The report was used as counterweight against the negative criticism pounding upon Iceland's shores. It claimed that Iceland's fundamentals were strong and there was no need to panic. Herbertsson got 2 million ISK for his part of the report while Mishkin was paid 135.000 USD (RNA (8), 2010).

But the banks also said they would take the criticism seriously, especially the need for more traditional financing. In the summer of 2006, all three major banks in Iceland started major marketing and sales campaigns encouraging their customers to invest their money in their savings accounts and money market funds (RNA (8), 2010). These campaigns were a

roaring success at all the banks, who began proclaiming later in the year that they had responded responsibly to the Geyser Crisis warnings by changing the way they financed themselves, improving and increasing their information flow, and decreasing their exposure to risk. By then, online savings accounts had become popular with UK customers. Less overhead for the banks theoretically meant they could offer higher rates. The Dutch bank ING Direct had taken the lead in this market with great success, and Landsbanki saw an opportunity to lessen its dependence on the fickle financial markets. Thus IceSave was born. In February 2007 with 220 billion ISK accumulated in IceSave alone, Landsbanki CEO Sigurjón Þ. Árnason proclaimed the online account “pure genius” (Aðalsteinsson, 2007, p. 13).

Robert Z. Aliber, professor of economics from the University of Chicago, told Icelanders on a visit in the summer of 2007 that he gave them one year until the bubble would burst. The legend goes that Aliber counted the building cranes in Reykjavik and drew the conclusion that Iceland was in trouble. A journalist who interviewed Aliber was accused of treason and the organizers from the University of Iceland were told by their sponsors not to expect any more funding. One year later Aliber did make another visit and pronounced the big three banks all virtually dead, a sentiment echoed by Robert Wade of the London School of Economics. Both were met with either accusations of senility or being enemies of the state (RNA (8), 2012).

3.6. Collapse

When Lehman Brothers collapsed on September 15, there were still fundamental flaws unresolved in the system. The interconnected make-up of the business sector in Iceland was still vulnerable to shocks, which could trigger a domino effect and bring the whole house down. The banks, especially Glitnir, were still dependent on the financial markets, which were offering increasingly shorter-term and more unfavorable credit rates (RNA (7), 2010).

In the beginning of 2008 when the total assets of IceSave had reached the amount of 4.9 billion pounds sterling, the Central Bank had begun realizing that it could not act as a lender of last resort for the bank. Early in 2008, discussions within Landsbankinn began revolving around transforming IceSave from its London branch into a local subsidiary as a reaction to negative media publicity the Icelandic banks were receiving in the UK (RNA (5), 2010).

On February 8, the bank told the Central Bank that it was considering these options. Davið Oddson, who had by then assumed the position of Central Bank Governor had just arrived from meetings in London with the ratings agencies, which warned about the situation in Iceland. In early March, Oddson and fellow Central Bank governor Ingimundur Friðriksson had a meeting with Bank of England governor Mervyn King. Oddson told King that the “situation of the banks is pretty good” (RNA (6), 2010, p. 12). Discussions on further co-operation between the banks ensued including talks on a bilateral currency swap agreement.

It turned out that the Central Bank was facing a crisis itself. The krona was in free fall from its strong position of the previous couple of years and the bank was facing a situation similar to the Icelandic banks where financial markets were closing their doors (RNA (7), 2010).

During the spring Central Bank representatives met with Nordic Central Bank representatives. At the meeting the Icelandic government was encouraged to act to balance its economy. The Swedish Central Bank governor had noted that the Icelanders did not seem to realize fully the risks at hand (RNA (6), 2010, p. 276). In another meeting with the Bank of England, Mervyn King expressed his grave concerns, “It is clear that the balance sheet of your three banks combined has risen to the level where it would be extremely difficult for you to

act as a lender of last resort. International financial markets are becoming more aware of this position and increasingly concerned about it“ (RNA (6), 2010, p. 167).

Timothy F. Geithner of the US Treasury expressed concerns over Iceland's liquidity and said that the amount it needed would have to be very high and that he had heard these concerns from other governors as well. On April 15, Oddson sent a formal request to the Central Banks of Europe, UK, Sweden, Denmark and Norway where he asked for help in order to stabilize the situation (RNA (6), 2010, p. 163-164). He argued that this would be precautionary as shortage of liquidity was not yet a serious issue for the Icelandic banks.

King had replied with an offer of assistance towards downsizing the banking system, but only received an iteration of currency swaps (RNA (7), 2010, p. 277). At the end of April the Central Bank then forgot to extend a credit line with the Bank of International Settlements to the amount of 500 million EUR (RNA (6), 2010, p. 148). When the mistake was discovered, the BIS was asked to extend it nonetheless, but to no avail. On May 14, Prime Minister Geir Haarde received a phone call from Oddson who was at the meeting of Nordic Central Bank governors in Oslo. Stefan Ingves wanted Haarde to make a statement on the behalf of the government that Iceland's fiscal policy would pursue a more responsible path. Without such an announcement there would be no assistance forthcoming. The Icelandic government promptly responded with an appropriate announcement (RNA (6), 2010, p. 176).

But the markets were in effect closed for Iceland in the summer. The Central Bank suddenly competing for the same available financing as the Icelandic banks, managed to secure a loan of 300 million Euros at Bayerische Landesbank in Germany in the beginning of September (RNA (7), 2010, p:8). Then at the end of September a currency swap was announced between the US Treasury and the Central Banks of Sweden, Norway and Denmark. Oddson contacted Geithner. A day later the two spoke on the phone and Oddson

asked for a similar deal to that provided by the other Nordic countries. It was rejected the next day but the possibility still remained open.

By the end of September Glitnir was in serious trouble. Huge repayments were due in 2009 - 1.500 million euros in the first quarter alone - and great uncertainty prevailed over how the bank would manage this. On Saturday September 27, the bank's representatives met with the three Central Bank governors, the Prime Minister and high ranked bureaucrats. Although the Social Democrats were members of the coalition government, no-one present represented that Party and the Minister of Commerce only found out about the meeting later. What was not common knowledge was that the Central Bank governor and the Minister of Commerce - who was the minister officially responsible for the banking system - had hardly spoken for a year because of differences of opinion on Iceland's advances towards the EU (RNA (7), 2010).

Geithner had promised to look into the possibility of a currency swap. The Central Bank sent the US Treasury a letter saying that a deal would support Iceland's currency reserves and increase trust. On October 3, the US Treasury finally responded that an agreement would not be possible. The reason given was the size of the Icelandic financial system: for a currency swap agreement to work, it would have to be bigger than the Treasury could provide. If Iceland sought the help of the IMF, then it would consider being part of a solution, especially if the European Central Bank would also be included but an IMF adjustment package would be a precondition for any participation (RNA (1), 2010). On October 24, Iceland struck an agreement with the IMF. By then, all three banks had collapsed, the stock exchange had been wiped out and God himself had been asked to bless Iceland (Jóhannesson, 2009).

At the government's meeting on September 30, Oddson said that he believed that this was the time for a coalition government with the participation of all the parties in Alþingi.

This was a highly unusual request from a bureaucrat, but most of the people present interpreted Oddson's idea to be that he should lead such a government. This was like pouring oil on the flames and Geir Haarde was told in no uncertain terms that there was no way that the Social Democrats would agree with Oddson leading the government in these times. Þorgerður Katrín Gunnarsdóttir, Independence Party minister of education, suggested that the Central Bank governor should concern himself with his job only, but leave the running of the country to the elected officials (Jóhannesson, 2009).

On October 1, the Icelandic krona had depreciated more than any other currency in the world, apart from the Zimbabwean Dollar and the Manat in Turkmenistan. Inflation surpassed 16% in October. Icelanders who had borrowed mortgages and car loans in foreign currencies in the previous years were hurting as their payments soared.

More than 300.000 Britons with 5 billion pounds in IceSave had become alert to the situation in Iceland and the money begun flowing out as customers became nervous. The same was happening in the Netherlands where 140.000 Dutch citizens had savings worth 1.7 billion Euros. At one point it was made impossible to withdraw from IceSave and the British media reacted immediately. Geir Haarde took a call from Gordon Brown who encouraged him to seek help at the IMF: Iceland's problems were systemic and could not be solved without the fund's help. Brown also told Haarde that one of the Icelandic banks had transferred one and a half billion pounds from the UK to Iceland. A similar occurrence happened before Lehman Brothers went bankrupt, when eight billion disappeared across the Atlantic (Jóhannesson, 2009).

UK authorities were meanwhile talking to Landsbankinn's management and offering them to fast-track the change of IceSave's status to a subsidiary under UK jurisdiction in less than four days. But as they waited impatiently for an answer from the state on whether it would support the move with the 200 million pounds they needed, the

government was already meeting with foreign experts from J.P. Morgan and others who had told them that it was looking like it was game over (Jóhannesson, 2009).

On Monday October 6, the Icelandic government announced its plan to guarantee all savings and loans in Iceland and assume control of the banks if needed. The plan was to defend Icelandic households and businesses at home to prevent a total systematic failure. New banks would be created for domestic assets. The old banks would absorb the foreign debt, and the banks' creditors abroad were supposed to take the hit (Jóhannesson, 2009). The Icelandic banks had certainly outgrown their shoes by a mile, or around nine times larger than the GDP of Iceland. The subsequent asset depreciation amounting to 280 percent of nominal GDP was five times larger than the second biggest in history, Indonesia in 1999 (Jónsson, 2010). At a seminar at the University of Iceland in May 2010,

The cruel face of globalization exposed itself to Icelanders in the first months of the crisis. Capital restrictions halted currency outflow but meant that Icelandic companies that do any sort of business internationally were affected by closed credit lines and lost business. The drop in the currency meant that all plans went out the window. McDonalds even closed shop in Iceland (Valdimarsson, 2009). Students abroad could not access their accounts and had to rely on the kindness of their schools, neighbors and landlords (Visir.is, 2008). The bankers and businessmen who had been applauded by their own staff and their own media were now accused of treason. If Kaupping had been an American company, its bankruptcy would have been the fifth biggest in US history, even larger than Enron. All three Icelandic banks would have made it onto the list of the top twelve bankruptcies in US history (Bibler, 2010).

The calls for the government's resignation started immediately in October (Jóhannesson, 2009). An organized grassroots movement soon attracted crowds to weekly protests in downtown Reykjavik and regular citizens' meetings soon outgrew their locations.

The banking system had collapsed, Iceland's reputation abroad lay in ruins and there was no alternative to approaching the IMF. The International Monetary Fund's role is to secure financial stability inter alia by helping those countries that have hit the wall. No developed western state had sought its assistance since 1976, and – as noted above - the Fund's reputation in the developing world had been less than favorable since it began approaching problems with the libertarian mantra of stabilizing, privatizing and liberalizing. Iceland had already been through the latter two with disastrous consequences. Many begun questioning what would be the price of asking the Fund for its help (Mbl.is, 2008)?

By appointing a Special Investigation Committee to investigate the causes of the economic collapse and creating the office of Special Prosecutor, the government responded to calls for action (Visir.is, 2009). Yet it was facing approval ratings in the low thirties and sinking fast. An attempt to float the currency failed in merely days. The hastily imposed exchange control restrictions would not be lifted in 2008 or in the next four years at least. The Independence Party eventually relented in January 2009 and conceded power. The subsequent general election produced the first left majority coalition in the history of Iceland, made up of the Social Democrats and Left Greens. Alþingi commissioned a special investigation report into the causes of the collapse of the Icelandic banks that was damning in its verdict of reckless politicians and the business sector (RNA, 2010).

3.7. Risk Assessment Report

In March 2009, The Foreign Ministry of Iceland published a report titled *Risk Assessment Report for Iceland – Global, Social and Military Aspects*. It had been commissioned by Ingibjörg Sólrún Gísladóttir, the then Foreign Minister, in 2007 and had been intended for publication in 2008. Its original commissioning brief stated that a new era had arrived in Iceland's security and defense affairs, and even though agreements with the United States and NATO were in place to protect the nation in times of war, the term security

had broader implications that needed to be addressed. The committee responsible for the report included academics, politicians, reporters, bureaucrats and ambassadors. The lack of economists or experts on finance on the committee is noteworthy given that the report was commissioned when the Icelandic banks were all about to break onto the list of the top 100 banks in the world. The group did however consult with economics professors and top bank executives.

Interestingly, the report's delivery was delayed on the eve of one of the most severe financial crises any nation had endured in modern times, yet earlier versions had barely contained any mention of economic security risks. The eventual report, perhaps influenced by being composed in the middle of the storm, put economic challenges high up in its analysis but was vague on specific solutions, concentrating on describing in broad strokes what had happened, and pointing out the obvious and gaping holes in the Icelandic system.

3.7.1. A wider concept

The report began by explaining how the traditional security concept must be broadened to include new threats, including global, transnational, social and human risks. In spite of being without a military, Iceland's strategy must have a similar basis to those of other Western nations, emphasizing sovereignty, citizens' safety, protection of government and the fundamentals of society, and making use of cooperation both bi-laterally with other states and multilaterally through alliances and membership of international organizations, including NATO, EEA, Schengen, the Organization for Security and Co-operation in Europe and the United Nations. The committee defined three analytical fields: national security with an emphasis on threats from other states or alliances, societal/civil security with an emphasis on individual security and identities and values, and global/transnational risks like organized crime (Utanríkisráðuneytið, 2009). The table below, borrowed from Alyson Bailes shows

the theoretical division made in the report between the different types of threat, and then the sequence in which policy aspects for Iceland were addressed in the text.

I. CATEGORIES IN ICELAND'S 2009 RISK ASSESSMENT

i) Threat and Risk Analysis

National [military] security	Societal/civil security	Transnational (globally-Induced) risks
Sovereignty	Crime and terrorism	Environment
Territory	Natural disasters	Pandemics
Threats from states	Threats to groups, values, identity	Climate Change
	Infrastructure safety	Terrorism
		Human Trafficking
		WMD

ii) Policy Sectors

Financial systems	Immigration
Military defence	Maritime safety
Health and epidemics	Civil air safety
International terrorism	Road safety
WMD	Food and water supplies
Organized crime inc trafficking	Energy security
Cyber-security	Communications and infrastructure

3.7.2. Economic security

The report put threats to economic security in the category of global/transnational risks, much like natural disasters and global epidemics. However – and for obvious reasons – it departed from the logical sequence in order to put a special chapter on the security of the financial system right at the start of its analysis (Utanríkisráðuneytið, 2009, p. 33-40). In this lengthy section it noted that the increasingly complicated nature of financial instruments made risk assessment difficult, and private institutions that were trusted to provide ratings had recently failed. It was remarkable that the Icelandic banks had been hardly involved in the sub-prime markets, yet could not withstand a global financial crisis that had severe impact on their ability to finance themselves in international bond markets. Those risks were external in

origin but internal risks had left the Icelandic foundations weak. The authors of the report expressed concern about how unaware and unprepared Icelanders had been for the impending catastrophe, in spite of several warnings.

The emergency law protecting local deposits prevented a bank-run and kept society operational as the storm hit the shores. But it led to a foreign assault on Icelandic debtors as a result of their blocking foreign creditors from making their claims against the banks. This led to massive distrust in the Icelandic legal and justice systems, and to a foreign government's invocation of a terrorist law to freeze the banks' UK assets.

The authors concluded that it was likely that the whole banking system would have collapsed whether there was a global crisis or not, due to excessive risk taking and cross-ownership undermining the foundations of the Icelandic economy. The government and surveillance institutions did not provide enough checks and balances on the major actors. This resulted in a major threat to societal security, economic and political stability, foreign trade and Iceland's reputation abroad (Utanríkisráðuneytið, 2009).

Because of Iceland's membership in the EEA, the Icelandic banks could operate, borrow and invest in the common market. Iceland had implemented European regulations but left the supervision in the hands of resource-starved and undermanned local surveillance authorities. The report was critical of the fact that people in the surveillance sector and the banks tended to be too familiar with one another. A small Central Bank could not control the inflow of hot money taking advantage of high interest rates and in return bolstering the currency. The Icelandic depositors' fund was also expected to guarantee the savings of individuals in much larger societies.

The report addressed the paradox of financial institutions operating in a free market but with government bailout guarantees, a combination that could lead to excessive risk taking. The banks' size relative to the economy meant that their influence on the

economy was too great. The privatization and introduction of international accounting standards contributed to an asset bubble where equity was greatly overestimated and risk severely underestimated. With a crisis looming, the Icelandic government did not accept the offers of help from stronger neighbor states to move the banks abroad. The crisis response overall made clear that there was no official strategy in place to deal with economic risks and threats to society. The ability of the Icelandic judicial system and its courts to deal with the aftermath also came under question.

Even as trust in society's institutions was at a historic low, the report stressed the need to improve relations with foreign banks to prevent the economy from becoming even more dependent on fishing and aluminum and less diversified in the long run. Otherwise Iceland would run the risk of an exodus of talent. Globalization of finances, goods and services demanded the globalization of society's institutions.

The economic crisis had a massive impact on Iceland's reputation abroad, which the report defined as a security issue in itself. Access to markets is based on trust, a valuable commodity in the global community. Iceland did not only have a banking crisis, but also a currency crisis that demanded a review and strengthening of the nation's monetary affairs. Joining the European Union and adopting the Euro was named in the report as a possibility, although the drafters might have reached a different conclusion had it been written three years later. The point remains valid that a stronger, more stable currency would be beneficial to Icelandic businesses that would benefit from a stronger economy, more price stability, lower interest rates and the elimination of consumer price indexation.

The report concluded that economic stability would best be secured with strong and transparent economic governance, a strong Central Bank and an active surveillance authority. It claimed that better laws on financial institutions were needed as well as increased financial know-how within the offices of the Special Prosecutor and surveillance authorities.

The capabilities of those offices and the Central Bank to interrupt the operations of financial institutions that threatened the economy and financial stability must increase. Retail banks must be restricted in doing business with complex financial instruments and risky ventures, and the separation of investment from retail banking was encouraged. Cross-ownership of financial institutions must be limited. The report did not offer further specific proposals for action in such areas, but left the details open for political debate.

4. Finland – The importance of strategy

Since the end of the Cold War, most Western states have worked on redefining their security approach to reflect the changing natures of risks and threats (Dent, 2007). The bi-polar world of the competing hegemon, United States and Soviet Union, placed the focus on traditional realist approaches for most states. When the risks are easily defined, borders are clearly drawn, and the enemies are absolute, it is easy to concentrate on seeking balance or superiority in an arms race, optimizing military capabilities and making alliances in international organizations.

The value of security strategy is not lost on most states and international organizations. The European Common Security and Defense Policy offers a European Union benchmark for its member states. Large nations such as the United States, France, Russia and the UK are amongst those nations who have a long-term strategy assigned with short-term reviews. Smaller states tend to differ according to their unique position, hence the different approach and importance assigned to the issue in Iceland and Finland.

The world after the Berlin Wall has become increasingly complex. The 'war on terror' was triggered by actions of non-state actors, yet led to an armed invasion by the United States and a coalition of willing states into Iraq. A subprime crisis in the United States spread quickly through Europe, affecting global economic and social security for several years. The European integration drive picked up unexpected speed after the end of the Cold War, causing imbalances where the aims of a supranational system clashed with the ambition of national actors. The current and still unresolved Euro-crisis shows the combined fateful influence of both these factors.

4.1. Small state in crisis

In some ways, the Finnish economic crisis in the 1990's bears notable similarities to Iceland in 2008 and onwards. Like Iceland, Finland has traditionally relied on a production resource based economy and forestry and metal mining are still important, but the country has seen a remarkable change in its make-up in the last few decades. It is now a highly industrialized, free-market economy with exports contributing a third of the GDP in recent years. Highly competitive in manufacturing and excelling in high tech exports, Finland experienced a significant contraction during the recent global economic crisis through less demand worldwide. Finland's budget surplus turned into a deficit but its banks and financial markets largely avoided any serious consequences and there has been marginal recovery in economic growth since 2010 (CIA, 2012).

Finland had, like Iceland, been a founding member of the Bretton Woods institutions and for decades pegged the markka to the US dollar. The Finnish economy was characterized by controlled monetary policy which subsidized important sectors of the economy with low interest rates and easily available credit, capital account controls, high taxes, strong trade unions and low unemployment. It did however come at the cost of regular devaluations in the markka. When Sweden devalued its krona in the early 1980's, Finland followed suit to protect the competitiveness of its economy and its export sectors. During the decade, pressure for deregulation in the financial markets saw the liberalization of capital movements and interest rates controls gradually disappeared. Foreign capital inflows and borrowing in foreign currency became easily available. Finns responded to the newfound credit by assuming much greater private debt than before, contributing to an asset bubble. Calls for liberalization of other aspects of the economy grew louder and were answered in greater detail during the boom years (Jonung, L., Kiander, J. and Vartia, P., 2009).

It was too good to be true, and did not last. The suicide of SKOP-Bank CEO Matti Ali-Melkkila in 1989 heralded the beginning of the end (Jonung, Kiander and Vartia, 2009). Finland went through a tough economic crisis in the early nineties with unemployment rising from 3% to almost 20% in the span of a couple of years and GDP falling by around 14% in the same period, not recovering to the same levels until 1996. Just as in Iceland, risks and threats to economic and societal security came from external sources as well as internal. Turmoil in the Soviet Union, Finland's biggest trade partner, led to a 70% decline in Russian trade (Honkapohja and Koskela, 1999). Coupled with fluctuations in the OECD area and the effects of German unification on European interest rates, the external effects on GDP were significant. But Finland's own inadequate financial regulations and high levels of private debt made it unprepared and less able to prevent the crisis from making a significant impact.

Finnish lessons similar to Iceland's included the dire effects of deregulation in the financial markets and ineffective reactions to large capital inflows and currency attacks. Defending the Finnish currency meant that the nominal and real interest rates were kept prohibitively high and short rates volatile. This eventually led to loss of credibility and depreciation of the markka (Honkapohja and Koskela, 1999).

Honkapohja and Koskela describe how deregulation pushed Finnish markets onto a merry-go round that was hard to halt (1999, p. 402): "Domestic interest rate regulation is lifted and the private sector is allowed to borrow freely abroad. At the same time, the authorities signal their intention of sticking with the fixed exchange rate regime previously in place. As domestic and foreign investors perceive little likelihood of a loss from exchange rate movements, the story next features a lending boom both domestically and from abroad, often in foreign currency. Having built up large debts in domestic and foreign currency, the private sector is very vulnerable to changes in domestic interest rates and in the exchange rate. Meanwhile, the lending boom shows features of an unsustainable bubble, so, sooner or later, a

turnaround happens and financial capital flows out. At this stage, the alternatives available to the authorities are all bad. If they want to defend the value of the currency, the authorities have to raise domestic interest rates, which hurts the highly indebted private sector. If they want to improve the weakened competitiveness of the export sector, a devalued exchange rate hurts those who have borrowed abroad. In the end, either a tightening of monetary policy or a depreciation leads to bankruptcies and rising unemployment.”

In 1991 the new Centre-Right government of Esko Aho heeded the calls from the Central Bank to not devalue the markka but peg it to the ECU (the EU's common currency denominator of that time and fore-runner of the Euro). The decision was hotly contested within both the government and the Central Bank but a strong majority in the parliament approved. The government was forced to face the labor unions and seek to negotiate an “inner devaluation” with lowering of wages and pension contributions, which was unanimously rejected. The peg could not last long and the exchange rate dropped rapidly, and even drastic hikes up to 50% in the Bank of Finland’s exchange rates could not halt the outflow of capital. The end result was a 14% devaluation of the markka in November 1991. When the markka eventually was allowed to float in September 1992, it dropped by one-third in the next few months. Recovery led by a rise in exports begun in at the end of 1993 and the economy grew by 4.5% annually through the decade (Jonung, Kiander and Vartia, 2009).

Tales of Finland’s underlying problems reveal similar weaknesses to those that Iceland faced, as a small state overwhelmed when confronted with turmoil in global financial markets. The push for open and free markets has been one of the main characteristics of the liberal democratic values shaping the Western developed world since World War II. The two Nordic nations were handed difficult tests of their abilities, but their response so far has differed.

4.2. Will to defend

As the conditions for a successful export industry became more favorable with devaluation and agreements between the government and the labor market parties, Finland transformed itself in the last two decades of the twentieth century, from relying on heavy resource based industries to knowledge-based industries. By the turn of the century, the electronics sector, spearheaded by global mobile phone manufacturer Nokia, had outgrown the traditional sectors of metal, paper, pulp etc.

Jonung, Kiander and Vartia (2009, p. 47) make the point that Finland experienced a “fundamental Schumpeterian restructuring” in its economy. Inefficient factors were eliminated while efficiency and productivity grew in existing firms and industries, thanks to a combination of structural changes and creative destruction.

A key factor in Finland’s recovery was its decision to apply for full European Union membership. Participation in the common market was deemed as important for Finnish industry; access to a larger regulatory system enhanced Finland’s reputation and capabilities domestically and abroad; and there was significant value to be gained in increased political and existential as well as economic security through full participation - especially given the turmoil in Russia. Security motives were far more important, and to a degree explicit, in the process of Finland's EU entry compared with the simultaneous applications of Sweden and Norway although all saw the benefits of the access to markets (Arter, 1995).

4.3. Location, location, location

Finland’s location affects its culture and world-view much as it does in Iceland. Whereas the latter is an isolated island with few visible ever-present neighbors, relations with larger and more powerful states on each side, especially in the East, have shaped the former. Tarja Cronberg (2006) has compared the ‘will to defend’ between Finland, Norway, Sweden

and Denmark and found that while the Nordic countries exhibit a generally positive attitude towards defense, the Finns are markedly more inclined to participate in the defending of their country, even with arms and an uncertain outcome. In the other three countries the view of general conscription has changed towards its being an opening to a professional army career, combined with expectations of peacekeeping missions, while Finns - perhaps influenced by their location between Europe and Russia - still have a view of the army as a defender of the nation. This generates the view that more people have a role to play in its defense. Not surprisingly the 91 percent level of trust in the Finnish army is considerably higher than the European average (Cronberg, 2007, p. 317).

Finland was a part of Sweden from the 12th century until 1809 when it became an autonomous duchy in the Russian empire. Its declaration of independence in 1917 was followed by intermittent armed struggles against the Russians until the end of the World War II. Just as the building of national identity, borrowed in part from the sagas, entered a decisive phase in the 19th century in Iceland, the publication of the Kalevala poems by Elias Lönnrot inspired Finns' self-confidence and bolstered their aspirations for their country (Vento, 1992). In the 20th century, the new small state followed the traditional path of independence by joining international organizations like the United Nations and the Bretton Woods institutions, but remained outside of NATO so as not to aggravate its Communist neighbors.

For Finland, the lessons of World War II were that the nation had to be serious about security in a wide-reaching way. General conscription means every Finnish male has a role to play, to this day, in defending his country. The business sector also has an active role to play in times of emergency and is consulted on security policy. The widening of the security concept and strategic planning makes for better preparedness. Participating proactively and entering strongly binding relationships on the global stage has been a strategy playing a clear and major role in enhancing Finnish strengths and capabilities. The decision to

enter the European Union was beneficial to Finnish industries in a similar way to Sweden, but with Russia tearing itself apart at the time, the security logic (as noted) was also strong. The Ministry for Foreign Affairs of Finland (2012) states that its “foreign and security policy is based on good bilateral and international relations, a strong role in the EU's Common Foreign and Security Policy (CFSP) of the EU, effective multilateral cooperation and credible national defense.”

Finland's first white paper on defense was adopted by the parliament in the early seventies. In 1997 a report on *The European Security Developments and Finnish Defense* was submitted to the Finnish Parliament by the government. Mapping the European security environment and its impact on Finland, it provided definitions of the principles for developing a comprehensive security policy. It proposed regular reviews of structural changes and the building of a long-term strategic plan no later than 2005 (Ministry of Defence, 2012). Subsequent defense white papers in 2001, 2004 and 2009 were worked on by experts, debated in government and approved by parliament.

The review in 2004 found that the EU and NATO enlargements, a deeper integration in the EU and stability in Russia contributed to a more stable environment in the areas surrounding Finland (Prime Minister's Office, 2004). But now globalization and international affairs appeared as bigger threats to Finland's internal and external security than seven years earlier. The war on terror's impact on the analysis became apparent with proliferation and weapons of mass destructions mentioned as threats not to be taken lightly. Among other things, this reflected how the development of Finland's strategy was increasingly influenced by the threats and security concepts that came with being such an active and engaged part of the international community. Despite certain influences of US origin, however, the 2004 white paper stated clearly “the most important point for Finland in this context is the capability and influence of the European Union” (Ministry of Defence,

2004, p. 5). In this perspective, economic security in Finland has clearly and consciously included being part of the Eurozone and the European Central Bank since 1995.

The Finnish method of revising strategy publicly and with relatively short periods between reviews is remarkable, and each document included important additions. Tanner, Al-Rodhani and Chandiramani explain how the white paper of 2009 attempted to answer these core questions (2009, p. 30):

1. What sort of world are we living in?
2. What are the challenges and opportunities?
3. Who are the key actors in the world that impact Finnish security?
4. How do we go about formulating military security in the world that emerges from the other three questions?

As a new addition to the strategy forming process – and particularly relevant for economic security - *The Strategy for security the functions vital to society* was drafted by the Ministry of Defence and published after government and parliamentary approval in November 2006. It was updated as *The Resolution on the Security Strategy for Society*, in December 2010. This document provides guidelines for government and local administrations and is based on a comprehensive concept of security, with emphasis on safeguarding national sovereignty and territorial integrity, the population's well being and a functioning society.

The following are defined (Ministry of Defence, 2010, p:3):

- *the functions vital to society and their desired end states*
- *the threat scenarios that jeopardize vital functions, including the possible disturbances within each scenario*
- *the strategic tasks of the ministries to secure and guarantee the continuation of the functions*

- *the criteria for crisis management as required by the management of disturbances*
- *the principles of the monitoring and development of the strategy's implementation*
- *the principles of exercises in preparedness and crisis management*

4.4. The Finnish Approach

As seen in *Security Strategy for Society 2010*:

1) Threats and risks are set out by nature rather than origin, as the effects are often the same regardless of who causes them. A distinction is made, however, between whether they take transnational (global?), national, or local form, as this will affect the method of response. Note that military attack comes last!

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| - <i>serious disturbances in the power supply</i> | - <i>serious disturbances in the health and</i> |
| - <i>serious disturbances in the</i> | - <i>welfare of the population</i> |
| - <i>telecommunications and information</i> | - <i>major accidents, extreme natural</i> |
| - <i>systems; cyber threats</i> | - <i>phenomena and environmental threats</i> |
| - <i>serious disturbances in transport</i> | - <i>terrorism and other criminality that</i> |
| - <i>logistics</i> | - <i>endangers social order</i> |
| - <i>serious disruptions in public utilities</i> | - <i>serious disturbances in border security</i> |
| - <i>serious disturbances in food supply</i> | - <i>political, economic or military pressure</i> |
| - <i>serious disturbances in the financial</i> | - <i>the use of military force</i> |
| - <i>and payment systems</i> | |
| - <i>disruptions in the availability of public</i> | |
| - <i>funding</i> | |

2) *As a basis for preparing to avoid, minimize and handle these threats, the positive needs and goals of society are set out under the following headings:*

Management of Government affairs

International activity (including protection of national interests, multilateral commitments, and aid)

Finland's defense capability

Internal security: protection under the law, public order, border and immigration control, anti-crime and anti-terrorism, emergency response by land and sea (to human actions, accidents and natural events)

Functioning of the economy and infrastructure: financial assets and transfers, insurance, energy supply and distribution, ICT security inc. functioning of official communications, warning and alert systems; transport, food and water supply/distribution, critical industries and services, housing, labour market, education, environmental management and waste treatment

The population's income security and capability to function: income security, social services, welfare and health including medical supplies, pandemic readiness, response to nuclear emergencies and chemical or bio-attack.

Psychological resilience in crisis

The above categorization provided by Alyson Bailes from a class on security in Europe at the University of Iceland. The Finnish government is in principle required to provide the guidelines for the strategy but also to harmonize preparedness and implement its goals. The strategy also requires input from different actors and stakeholders in society, including the business community.

Economic security aspects of the strategy stretch and overlap across the security spectrum but are summed up in the following passage from the Security in Society webpage (2012):

In a well-functioning economic system the basic needs of the population and the business community are met. The state, too, can finance its operations. In exceptional conditions the authorities must control the economy with more powerful measures than usual to guarantee the well being of citizens. This is achieved by decisions regarding state revenue

and expenditure and the financial and insurance markets. If necessary, workforce is directed on a temporary basis to help in the aftermath of a major accident.

When faced with crisis, Icelanders invariably utter the national catchphrase “things will manage” (þetta reddast) to remind themselves to keep calm and carry on. In comparison, Finns appear to have managed considerable preparations for difficult times. The recent reports of Finland’s government actively preparing for an exit from the Eurozone by a hard-hit member such as Greece should not come as surprise. Finland’s foreign minister Erkki Tuomioja told the Daily Telegraph in August 2012 that Finnish officials had prepared with an “operational plan for any eventuality” and that “it is not something that anybody – even the True Finns - are advocating in Finland, let alone the government”. But the Finnish have to be prepared according to Tuomioja, “The break up of the euro does not mean the end of the European Union. It could make the EU function better” (Evans-Pritchard, 2012). Even if it does not happen, at least it will not catch the Finnish government unaware if it does.

5. Comparison

In the short life of the republic, Iceland had in many ways been an egalitarian society, but after 1995 it saw a marked rise in income inequality. From 2004 when the Gini-coefficient was introduced as a tool of measurement, the gap between the wealthiest Icelanders and the rest increased dramatically (Hagstofan, 2012). This caused a huge imbalance in the traditional social contract until 2008 when it appeared broken.

The isolated Icelanders did not experience the two World Wars in the same way as their European brethren had. With miniscule war damage, the country's importance on the world stage due to the Cold War, and its generous treatment under the Marshall Plan, Iceland could even claim to have benefited from the wars. Against this background, historian Guðmundur Jónsson has tellingly described the economic crisis of 2008 as Iceland's wartime (Jónsson, 2010).

5.1. Without a Shelter

A persistent question has haunted Icelandic academics and politicians since 2008. Why did the modern, democratic, industrialized, European nation have so few friends to turn to in these dark times? Iceland's neighbors in the south, the Faroe Islands, had been the only nation willing to help out at the height of the crisis with 45 million euros (Forsætisráðuneytið, 2008). The Nordics were surprisingly hesitant to come to the rescue. With its tail between its legs, the Icelandic government finally turned towards the IMF in October 2008 and requested a two-year Stand-By Arrangement from the Fund in the amount of SDR 1.4 billion (Special Drawing Rights, IMF currency), around 1190 percent of its quota (International Monetary Fund, 2008). With the IMF on board, the Nordics pledged an additional aid package. Baldur Þórhallsson suggests that the answer might be found in Iceland's lack of security shelter. States, especially small ones, need shelter from the threats and risks that surround them. This

they get by making bi-lateral agreements with larger nations and/or through international institutions. When the economic disaster hit Iceland, the government had neglected to provide its nation with such a shelter (Thorhallsson, 2010).

Historically, Icelanders had benefited from the shelter provided by being a part of the Norwegian and then Danish kingdom since 1262. Many Icelanders view these times as eras of oppression, as the myths of the subsequent independence battle were constructed to have them believe so (Hálfðánarson, 2004). The hard truth is that without assimilation by its stronger neighbors in the Nordics, life in the harsh climate and isolation in Iceland would have been much more difficult. European seafarers in the North Atlantic also provided Iceland with shelter in the form of trade and transport (Thorhallsson, 2009). And in later times, the formation of the Icelandic republic and the accompanying industrialization would have been much harder without the support of the United States. Without this relationship - the shelter provided by the US - Iceland might have found the conclusion to the Cod Wars with Britain in the 60's and 70's somewhat different.

The problem with bi-lateral relationships is that the stronger party holds all the cards. It can up and leave when it no longer finds the relationship beneficial, and this is what the US became increasingly likely to do when the Cold War had ended and its focus moved from Europe to other parts in the world. Davíð Oddson's governments tried to talk the US out of departing, even paying the price by adding Iceland to the notorious Coalition of the Willing states that approved of the US invasion in Iraq - a wildly unpopular decision in Iceland (Fréttablaðið, 2003). In 2006, the last US fighter planes departed from the base close to Keflavik and Iceland's special relationship with the US had lost an important pillar. Iceland has since then not replaced the void with a permanent, adequate shelter (Thorhallsson, 2009).

The obstacles to effective action lay not only in a lack of direct substitutes for the US, and Iceland's relatively limited experience and understanding of what NATO could bring

from non-US sources, but also in national division and confusion on the EU front. Iceland's relationship with the European integration drive has been an uneasy one. Twentieth-century Icelanders were brought up to believe strongly in Iceland's sovereignty being sacred, and the events in Europe made many people uneasy about losing what they had just gained. The sovereignty issue has been central to Icelandic politics: and when Iceland joined the EFTA in 1970 during a recession when fishing stocks had collapsed, it was with hesitations offset only by the country's need to be able to access the markets in Europe (Thorhallson and Vignisson, 2004, p. 21-37). Similarly, the access to markets was the most important issue that decided Iceland's membership in the European Economic Area in 1993 (Thorhallson and Vignisson, 2004, p. 38-49). Since the time of NATO entry and previous to IceSave, nothing had promoted such heated debates in the halls of Alþingi as the vote on EEA membership.

Once EEA membership was agreed on, the government soon decided that it had gotten "everything for nothing", and further EU ascension was deemed unnecessary. This quote, which then Foreign minister Jón Baldvin Hannibalsson claimed was falsely attributed to him sums up the benefits the EEA agreement in the eyes of many Icelanders (Dagur, 1991). The single biggest issue keeping Iceland at a safe distance from Europe was the common fisheries policy. Fishing is the most integral part of the country's economy and any thought of losing control over fishery resources to foreigners is unacceptable in Icelanders' eyes. With EEA membership, Iceland got everything it wanted, notably access to the European market, with minimal concessions and full control over its fishing. Oddson was vehemently against the European Union, to the point of describing possible membership as betrayal of Jón Sigurðsson, Iceland's foremost hero in the push for independence (Björnsson, 2010, p. 219). So without the bi-lateral shelter of the US and without full European Union membership, Iceland found itself at the start of 2009 alone in the world: an island without shelter in so many ways.

5.2. Iceland vs. Europe

The free transfer of capital and the permission obtained by Icelandic banks to operate branches in other countries within the EEA enabled them to borrow from other banks and accept savings in foreign currencies and therefore experience a rapid growth. But all supervision was in the hands of domestic entities. – (Útanríkisráðuneytið, 2009, p. 34)

As constructivism explains, culture, social norms, history and elite influence are powerful forces shaping states's foreign policy and approach to security. Finland, shaped by the proximity of mighty neighbors and centuries of having been ruled by them, has embraced a proactive approach to strategy that includes a large and visible citizens' defence, strategic planning and pro-active participation in multi-lateral organizations like the European Union. The republic of Iceland, which gained independence as a modern state 40 years after Finland, which has just recently joined the ranks of developed countries, and until 2006 enjoyed the bi-lateral security shelter of the United States, appears less aware of its potential and seems therefore not as confident in its own capabilities. Manifesting itself in Iceland's hesitant relationship with international institution and the European merger, this analysis might help to explain its more reactive and disaggregated, approach as compared with Finland's.

The handling of the IceSave dispute with the United Kingdom and the Netherlands emphasized this uneasy relationship. By October 2008, British customers had trusted Landsbankinn with around 5 billion pounds of their savings through IceSave. Dutch customers had deposited close to 2 billion Euros (Jóhannesson, 2009). According to European Union directives an Icelandic deposit insurance fund was supposed to guarantee each and every individual 20,887 Euros. While the British government stepped in to completely guarantee all deposits made by individual investors, the Dutch government did so as well up to the limit of 200,000 Euros. The two nations would now turn towards the Icelandic

government to claim that it should pay its due share of the compensation, the 20,887 Euros per account. This would mean a total bill of 3.91 billion Euros for the bankrupt country of Iceland, an obligation of 48,000 Euros per inhabitant for a nation of 317,000 people, or fifty percent of GDP. In a nutshell, the argument since revolved around each side's concept of fairness. By guaranteeing local deposits but not those in branches abroad, the British and the Dutch claimed that Iceland had discriminated unlawfully according to the EU directive 94/19/EB, which was the basis of law no. 98/1999 in Iceland. To stop any further withdrawal of deposited funds from Icelandic bank branches in Britain, the government in London froze relevant holdings under a little-known provision of the UK Anti-terrorism Crime and Security Act (RNA (7), 2010).

This legislation had never been invoked against a Western state before and the Icelandic reaction to its application was indignant. The Act had not only frozen the assets of the banks, but also created problems for Icelandic individuals and businesses doing normal and legal business all across the continent, as scores of European banks refused to process their payments and Icelandic banks in the midst of reconstruction had to accommodate to life under capital restrictions. Kaupthing, which had until then seemed likely to survive, crumbled under the Anti-terrorism Act (Jóhannesson, 2009).

Prime Minister Haarde thanked the British government for guaranteeing the IceSave deposits. He pointed out how changes in the laws regarding depositors' insurance made them able to post priority claims in the bankruptcy proceedings. He said he was hopeful that the assets of Landsbanki would cover most of the deposits in the UK. The government would support the depositors' insurance fund and was determined not to let the matter cast a shadow over the long-term friendship of Iceland and the UK (Jóhannesson, 2009, p. 187).

The government was banking on the European directives regarding depositors' insurance funds not being valid in case of a total system collapse. Iceland's whole banking

system had gone under and surely no nation could be expected to shoulder the burdens of such a disaster? The situation in Iceland was chaotic, the Icelandic government had tried to assure its British counterparts that they did intend to try their best to minimize their citizens' losses, and there were hundreds if not thousands of Icelandic companies and individuals doing regular, honest business with the UK who were now suffering. The problem the countries needed to solve in unison was that those who saved with IceSave had to get their money back, just like those who saved with Northern Rock in the UK, Washington Mutual in the US and the Icelandic banks in Iceland. Otherwise public trust in the financial sector could be severely shaken, increasing the depth of the crisis.

On November 14 2008, the Icelandic government announced that it had agreed to admit its obligations for the IceSave deposits, given that the Landsbanki assets would cover most of the 600 billion ISK outlay. The news was met with dismay in Iceland (Jóhannesson, 2012). The confused public, having seen their country enter humiliated into an agreement with the IMF, were further indignant at having to foot the bill for what was now agreed to be a corrupt bank's operations in the UK. In two subsequent national referendums the people of Iceland refused to honor repayment agreements negotiated with the Dutch and British governments, and eventually the case went before the ESA Court with a verdict due in late 2012. The delay had affected Iceland's reputation and relationship with other nations, and contributed to a divided nation at home. Aside from stealing precious time from a government that sorely needed to attend to its own economy and a nation in crisis, the repeated negotiation and rejection of the IceSave agreements succeeded in delaying the phased disbursement of Iceland's assistance from the IMF (Vb.is, 2009).

It is worth questioning with hindsight whether the Icelandic and British governments could have tackled the crisis more calmly and cooperatively. Iceland's government probably lacked the necessary diplomatic skills and understanding of the finer

details of international relations to get their points sufficiently across. They showed limited understanding and sometimes naivety in grasping the feelings and likely reactions of other parties, just as in the Keflavik affair before 2006. The British government for its part, under fire and fighting fires at home, probably did not understand the Icelandic situation fully and clutched at the opportunity to show a strong stance domestically.

Apart from nationalist rhetoric and recent development history, leading sector influence helps explain the different approaches of Finland and Iceland. The former's raw materials and manufacturing industries saw the clear value in integration. The latter's fishing industry meanwhile traditionally leads the movement against. Icelandic discussion on its part in Europe tends to focus on economic matters. Security is hardly ever mentioned. In comparison, the Finnish government saw the European security cooperation as a better long-term guarantee of safety, when the multipolar system replaced the bi-polar one. Joining the European Community required a significant change in course, away from neutrality and into an alliance of states. Once in, Finland became an observer in the WEU, its organization for military cooperation (Ingebrigtsen, 1998).

6. Conclusion

In a globalized, embedded world it is safe to recommend that each nation state should form a comprehensive security strategy. For small states it is even more important than for larger ones: and they need especially to focus on human security and active participation in international organizations, as their relative might does not allow them to compete in terms of material and military might or to impose their will unilaterally. For Iceland, successful progress down this path would include learning from the Finns about their pro-active approach to security and their pragmatic, instrumental and well-prioritized approach to participation in international organizations.

As history has shown, a small state like Iceland is vulnerable to fluctuations in the international economy. It makes sense for such a state's national economic security strategy to make full use of all national strengths and internal actors, to pay close and wide attention to micro-level human security, and to include active, many-streamed participation in international organizations.

The first of these goals – as well as a coherent external image, and consistency in strategy over time - is only possible with increased bi-partisan cooperation. Yet the Icelandic political and business elite tends to be competition driven, dominated by the ideas of Friedmanites, libertarian and perfectly realist. Such an approach claims superiority over other ideas, with a Nietzschean will to power taking precedent over survival or adaption. This explains the supposedly pro-business right-wing party's preference for a weak currency and capital controls, and also the story of the left-wing MP who opposed any relations with the IMF - before becoming its poster child after assuming the post of financial minister (Vb.is, 2012).

It remains to be seen whether the rise of new parties and novice politicians has been a false dawn, or a beacon of hope. The Best Party's surprisingly convincing victory in the Reykjavik municipality elections in 2010 ushered in a new generation, shaped outside the party system, into the political landscape. Even more surprisingly, they managed to address such ticking time bombs as the dire financial straits of the Reykjavik Energy corporation, where the more conventional politicians had previously failed to act, and in some cases acted dangerously for the common good (Mbl.is, 2012).

Success in the last aim, correctly instrumentalizing international organizations, requires a change of mindset. Operating pro-actively within the framework of international organizations could only strengthen the economic defenses of Iceland. Yet as we have seen, Icelanders are historically wary of international organizations, for reasons relating to their culture of being a relatively new independent republic and coming late to development compared to other European states. Many Icelandic politicians have tended to play into the cultural suspicion towards foreign rule, constructing threats from the outside if it suits their agenda. They inadvertently become part of the problem themselves in doing so.

A comparison with another Nordic nation exposes greater differences than most would probably expect. While Finland on the one hand appears as a role model for small nations beyond the Nordics and Europe, Icelandic academics and the Alþingi's Special Investigation Report paint a convincing picture of Iceland as a weak state. It is weak towards outside threats because of failure to plan ahead and organize an appropriate shelter. It is weak towards threats from the inside because its institutions are easily manipulated by elites. Nepotism and lack of bureaucratic expertise in the system make it vulnerable and less able to spot and deal with foreseeable risks. Suspicion and a competitive, almost antagonistic attitude between parties, branches and actors foster a spirit of uncooperativeness and secrecy, where cooperation and transparency is needed. A media sector wholly dependent on business elites

for profits and political elites for goodwill cannot be expected to rock boats and blow whistles.

Meanwhile Finland's business and political elites have adopted a more cooperative stance within and outside of its borders. Finland is a larger nation than Iceland but one that must still live with risks beyond its direct power to control, notably because of its Eastern neighbour. But it has a proactive national security strategy with an emphasis on participation and adaptation. Finland faced more adversity in the earlier stages of its independence and had to learn the lessons of diplomacy at an earlier stage than Iceland. Since taking over the reins of its own destiny, Finland has become increasingly more security minded. It attempts to gain benefits from existing systems and understand its own actions and consequences.

In trying to address the gap between these two nations' approaches, whether anything would be gained by the explicit securitization of economic strategy is another question altogether. Iceland has failed in prioritizing economic security, yet it came close to full securitization with the enactment of the emergency law in October 2011. At the time, Icelandic politicians agreed on extraordinary measures, in lieu of alternatives but the calm did not last long. A major problem that contributed considerably to the financial crisis in Iceland was the absence of public and critical debate about the development of the economy and the goals and behavior of its main actors. This included lawmakers, politicians and the media. Thereby, Icelandic society unconsciously conspired to create an aura of securitization around local economic affairs – in the sense of removing them from normal political discourse, debate and democratic control - in the years between the privatization of the banks and their eventual collapse. At the height of the era, the Finance minister scolded an opposition member of Alþingi for such criticism. “Boys, can you not see the feast?” (Alþingi, 2007). Throughout the time of the bubble, the President of Iceland was speaking at home and abroad of the miracles of Icelandic businessmen and their superior qualities (Grímsson, Ó, 2005).

Finland itself has not securitized its economic affairs and financial sector, either in the sense of placing them under military-strategic control – indeed the role of armed forces in its internal security has been steadily cut back since 1990 – or in the sense just discussed of suppressing debate. Instead it gains security from participating in the European market, in the Euro and the European Central Bank; policies on which internal debate has been continuous and sometime lively, despite a fairly stable majority consensus. Such participation certainly means that a state becomes a stakeholder in the problems of others, but it also means it becomes a partner in the solution. While realists circle the wagons, liberals mesh their own destinies with those others. Like risks and threats in an embedded world, human security transcends borders. Such are the perils and opportunities of globalization.

In spite of relative success in matters concerning ocean management and fishing law, Iceland is ill suited to play zero-sum games in the international arena, especially when it comes to economic affairs. It is neither sensible, nor sophisticated, for small states such as Iceland and Finland to pose or behave as big powers. While Iceland blows off course with the slightest winds, Finland can float in many storms because it has a strategy. In that sense it is still in control of its own destiny while Iceland is not.

7. Discussion

On intricate matters of economic security there is plenty of room for further research including the effects of tax havens on Iceland's economy, what sort of foreign investment is drawn to Iceland under capital controls, what lessons the IMF learned from the case of Iceland, and so forth. In conclusion the paper offers some points for consideration on how Iceland should approach the construction of an economic security strategy:

Build a realistic long-term strategy emphasizing human security, with frequent short-term review

The Foreign Minister of Iceland has already put the wheels in motion towards Iceland shaping its own security strategy. Such strategy must have a long-term vision, yet be due for mandatory review on a regular basis. Following the example of Finland, Iceland has to ask itself what its actual position in the world is and what the real challenges are. Iceland's sovereignty and prosperity is not going to be protected through military efforts. Iceland is a vulnerable, system-ineffectual state that can not expect to gain much in a realist world. In fact the latter is explicitly not a world a small state should want to be in. On the other hand it can benefit from active participation in a liberal world with an emphasis on modern, human security safeguards. It must work out an appropriate strategy, where economic security should be amongst the key factors in Iceland's national defence.

Assignment of responsibilities and broad engagement

A strategy based on wishful thinking and influenced by partisan ideology is unlikely to be of much use. Therefore it must be shaped by a broad consensus of government and opposition parties, as well as business, labour, social and academic representatives, all of whom must be assigned appropriate roles in safeguarding the nation of Iceland and defending its population.

Bi-partisan effort

Broad engagement calls for a greater bi-partisan effort than has hitherto been known in Icelandic politics. Yet it is neither unrealistic nor without examples, considering the preparedness, togetherness and response Icelanders display when faced with natural disasters. With economic affairs, the perception of the threat is different. It is more complicated and less obvious and therefore Icelandic society would for example do well by emphasizing financial education from a young age.

Increased diversification

The economy's dependence on fish exports can only be countered by diversifying towards a knowledge- and service-based economy. As the expansion of the banks showed, a growing sector can rapidly overtake the traditional ones on several fronts. Finland transformed its economy from production-based to knowledge-based in roughly a decade, so the example is there.

Iceland can also benefit from diversification in its population to fill jobs in different sectors and keep the workforce at a desirable age. While many have the image of foreign workers building dams and working menial jobs in the fishing industry, there are also computer programmers, pharmaceutical executives and musicians to be found contributing to Iceland's economy.

Long term currency strategy

The Icelandic krona has been hailed as a saviour in times of crisis but its contribution towards the collapse must not be ignored. By floating a tiny currency on the rough waters of international markets, Iceland attracted a volatile short-term capital influx which in turn fuelled a false boom. As far as its impact on human security goes, the krona effectively turns households and individuals into hedge funds when planning for the future. Whether purchasing a home, pursuing an education or planning a family, Icelanders must

reckon with greater uncertainties and more volatility than individuals in nations with more currency stability.

Iceland appears to have three choices. The first is to keep the krona and accept that keeping it stable comes at a price of less economic freedom than elsewhere in the developed world. It can also gain stability by adopting another currency through a bi-lateral agreement with another state, thereby surrendering a great part of its economic autonomy. Lastly it can join the European Union and adopt the Euro, which would mean sharing its economic autonomy with other nations. The first option has hardly any long-term viability as the effects of globalization and embeddedness with the outside world are hardly to be reversed in Iceland. The other options will test Icelanders' view of what constitutes sovereignty and require them to answer the same questions most states have to deal with on a regular basis: is their autonomy deflated or enhanced by sharing?

Active participation in international organizations

A system-ineffectual state, Iceland has in the past found success where it mattered, inter alia by approaching international relations concerning the laws of the ocean with a pro-active mindset, and gained considerably from it. Yet it is hesitant towards bringing the same attitude to other areas in the international arena, perhaps due to limited capabilities, lack of self-confidence or pressure from interest groups. Finland is an active member of the European Union while Iceland perennially remains a reluctant participant in the European project. Icelanders tend to concentrate on monetary costs or loss of autonomy associated with membership in international organizations and ignore the gains of association with more capable partners. A half-hearted approach towards the European project through the EEA has been deemed a fiasco for Norway's sovereignty (Aale, 2012) and Iceland is in the same position, or even worse as Norway's presence in Brussels is much greater.

Participation in the EU would mean active ownership not only in the region's troubles, but also in its solutions such as better regulation, a stronger currency despite its ups and downs, and more access to the corridors of power. Given Iceland's vulnerability from internal risks, full membership in the European Union might actually enhance Icelandic sovereignty by providing external safeguards from internal threats including poor governance and elite misbehaviour. When the Hungarian government attempted to restrict the freedom of the press in its own country, the Hungarian people found it had an ally in the framework of the European Union. Icelanders already have no qualms about seeking the protection of European courts in cases of human rights.

As the Finnish have learned, in the European Union a small European state can get many things done in one place should it so require and desire. The EU is indeed not the only international organization where Iceland could play a more active role. It could do so at the United Nations, NATO, the IMF and the World Bank to name only a few. As Europe deals with an unprecedented crisis, it might not appear as attractive as before and no matter what path Iceland may choose, the onus is on the state and the nation itself to get its own things in order the best it can. This includes strategic thinking and action when it comes to the security of its own citizens.

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List of abbreviations

EC	European Community
EEA	European Economic Area
EFTA	European Free Trade Agreement
EU	European Union
EUR	Euro
FME	Fjármálaeftirlitið
IMF	International Monetary Fund
ISK	Icelandic Krona
NATO	North Atlantic Treaty Organization
OECD	Organisation for Economic Co-operation and Development
RNA	Rannsóknarskýrsla Alþingis
SDR	Special Drawing Rights
UN	United Nations
USD	United States Dollar
WEU	Western European Union