SYMPOSIUM

domestic buffer versus external shelter: viability of small states in the new globalised economy

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Abstract
The article, written from a post-financial crisis vantage point, applies Katzenstein's democratic corporatist model to the case of Iceland, and asks if it overlooks an essential message from theory, namely that small states need an external protector in order to survive, economically and politically. The article claims that the model convincingly made the case for how small states can buffer from within but fails to grasp their need for external shelter to cope with risk. In a financialised world economy, small states need economic and political shelter in order to prevent risk from spiralling out of control and they need support in order to clean up after a crisis.

Keywords economic and political shelter; small states; corporatism; crisis; the European Union; alliance

INTRODUCTION

Katzenstein's domestic corporatism lays out how small European states have internally limited economic, political and social instability in order to respond to changes in the international economy (1984, 1985). The books narrow focus on domestic arrangement reflects the solidarity of the Bretton Woods' era geo-political system, which prevented existential military threats. They mirror the lingering effects of Bretton Woods' financial regulations which limited capital flows, so that financial crises were typically limited to a firm, a sector or at worse a currency, rather than being systemic, global and on a scale that threatened the entire economy. The experience of the neo-liberal international economy of today, characterised by free flow of capital, indicate that existential threats cannot be managed solely by democratic corporatism. European small states need external economical and political shelter that call into question Katzenstein's

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domestic focus and the degree of independence or autonomy that they can enjoy.

The case of Iceland, in the latest international economic crisis, demonstrates that though Katzenstein's thesis provided an important insight into how small states can compensate for their economic vulnerability; it lacks the original dimension whether small states can withstand external stress and are viable in the new turbulent international economy. Early in October 2008, *The New York Times* reported that Iceland was the first sovereign state to fall victim to the credit squeeze (Pfanner, 2008). Iceland was stranded on its own in the mid-North Atlantic without economic and political shelter. The Icelandic banking sector was the only banking sector that collapsed entirely and the county's quest for international assistance has been halted by its neighbouring states. On the other hand, an examination of the Baltic states indicates that they were provided with political and economic shelter by the European Union (EU) in order to cope with the economic crisis and its consequences.

Small states have a functionally given need to be open economically in order to facilitate growth because of the smallness of their domestic market and greater dependency on imports and exports than large states. Moreover, small states seek specialisation and economies of scale in export markets in order to be competitive internationally. Accordingly, they may rely on one or two export products, that is, such as Iceland and Norway. Their exports are also more concentrated than large states' since most of their trade relies on a particular state or a specific market (Katzenstein, 1984, 1985). This makes them more vulnerable to international economic fluctuations and structural change in the world economy. Economic downturns may hit small states swiftly and can become deeper than in large states, particularly if the narrow-based export industry is badly hit (Katzenstein, 1985; Handel, 1981; Ólafsson, 1998).

Thus, Katzenstein argues that small countries need two things: fast-paced change and flexible adaption (which is secured through short decision-making chains and corporatist, consensual decision-making); and a capacity to socialise risk by developing a comprehensive welfare state and active labour market policies (Katzenstein, 1984, 1985). Hence, small European states form a domestic buffer in order to ease constraints of the fluctuating international economy. *Small States in World Markets* (Katzenstein, 1985) convincingly made the case of how small states can buffer from within.

That said, does this domestic buffer serve as a sufficient shelter in a time of international economic crisis for states which are politically and economically more vulnerable than their neighbouring countries (markets)? Is it sufficient for small states, which expose themselves to shocks from without in order to raise their citizens' living standards, to buffer from within? Do small states need external shelter to cope with exposed risks?

For centuries, small states have sought economic and political protection from larger neighbours (see, for instance, Alesina and Spolaore, 2005) in order to compensate for their weaknesses (Handel, 1981). In the second half of the twentieth century, most small states sought multilateral shelter in international organisations such as the United Nations, the International Monetary Fund (IMF), the World Bank, the World Trade Organisation and small European states sought shelter in the Organization for Economic Co-operation (OEEC/OECD), the EU, the Organization for Security and Co-operation in Europe, NATO and the Nordic Council rather than shelter provided by a large neighbour under a bilateral arrangement.

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However, the case of the smallest states in Europe indicates that not all small states conform to a single pattern in this respect. Iceland, despite being a member of most of the international organisations created after the Second World War, and receiving some direct economic benefit from membership, particularly from the IMF and the World Bank, was mainly protected economically and politically by its largest neighbour, the US. This was also the case of the smallest states in Europe – Andorra, Monaco, Liechtenstein and San Marino – which turned to their larger neighbours for economic and political shelter, that is, they all have substantial economic and defence arrangements with their larger neighbours. Most other European small states have sought full participation in European integration, though some of them have been held back by their electorates, in order to ease European and German constraints (Katzenstein, 1997).

The small states' literature generally claims that small states have a stronger negotiating position within multilateral organisations than in bilateral negotiations with a large state (Vital, 1967; Neumann and Gstöhl, 2004). Small states benefit from clear procedures, rules and regulations within international organisations – making it more difficult for large states to use their greater power resources, such as a larger administration, economic and military power, to press their interests single-handedly (for instance, see Vital, 1967; Keohane, 1969; Handel, 1981). Accordingly, international organisations provide small states not only with economic shelter but also more secure political shelter.

Vital (1967) argues the strength and weakness of a state, and its long-term viability, must be examined by its capacity to withstand stress and its ability to pursue a policy of its own devising. The actual state of political reality is what

'For centuries, small states have sought economic and political protection from larger neighbours'.

matters, rather than the legal or formal commitments, domestically and externally, when evaluating a state's viability. The ability of states to protect themselves from being attached, bullied or pressed heavily from international or domestic actors (such as states, intergovernmental organizations, lobbyist, terrorists, multinational companies) is of prime importance if they are to provide their citizens with economic growth and political stability.

According to Katzenstein's thesis, small states can use domestic arrangements to limit external economic risks associated with economic openness. That said, might not the new globalised economy, characterised by free movement of capital, create the possibility of large sudden shocks that put at risk the viability of a state's whole economy – if not the state itself? Domestic compensations within a corporatist state and the welfare state may ease rapid economic downturn but may be of little long-term use, if the foundations of the economy crack overnight. Does the functioning of the neoliberal economy, demonstrated so clearly in the latest financial crisis, not lead us towards Vital's key concern: whether states can withstand stress in order to survive? Hence, are we not faced with the original question of the small state literature from the 1960s and 1970s, whether or not small states can function without an ally?

The importance of economic and political shelter for small states, due to their more limited resources and means to withstand stress compared to larger states, is related to three inter-related features: reduction of risk before the

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crisis event; assistance in absorbing shocks when risk goes bad; and help in cleaning up after the event. Furthermore, there is a need to distinguish between economic and political shelter. The former may be in the form of direct economic assistance, a currency union, help from an external Central Bank, beneficial loans, favourable market access, common market etc provided by a more powerful country or an international organisation. Political shelter refers to direct and visible diplomatic or military backing in any given need by another state or an international organisational (such as organisational rules and norms).

According to Vital, the ideal case study to analyse whether or not a state can withstand stress and formulate its own policy is 'when the state is *alone* – *n*ot necessary in all its affairs, but at least in the great and crucial ones – and is thrown back on its own resources that the limitations and, indeed, the possibilities inherent in its condition are best seen' (Vital, 1967: 79). Iceland provides an excellent case in this respect and the Baltic states an excellent comparative study. That said, the Icelandic domestic structure of decision-making does not entirely fit Katzenstein's cases presented in *Small States in World Markets* (see Thorhallsson, 2001, 2010). The aim of this article is to examine the external dimension of small states' vulnerability and raise the question whether *Small States in World Markets* overlooks the essential part of international relations theory that small states need an external protector in order to survive, economically and politically.

THE FINANCIAL CRISIS HITS ICELAND

The case of Iceland fits perfectly into the picture of a vulnerable small economy: the economy having undergone distinct cycles depending on the success of the fishing industry at any given time (Jónsson, 2002). Moreover, the dramatic rise of the banking sector in the first decade of the twenty-first century – which had assets valued of over ten times Iceland's GDP in autumn 2008 (Central Bank of Iceland, 2010) and, for the first time, contributed more to GDP than the fishing industry in 2007 (Hagstofa Íslands, 2009a) – made Iceland even more exposed to the fortunes of the international economy.

The collapse of the Icelandic financial sector and the króna resulted in a swift turn from a booming economy to an economic crash in early October 2008. The Icelandic government was defenceless against the economic turmoil that ensued when the small economy was hit by the international financial crisis. It had been unable to seek substantial external assistance from neighbouring countries and international organisations prior to the crisis in order to strengthen the foundation of the economy, particularly the overgrown financial sector.

Moreover, the government had severe difficulties in guaranteeing external assistance when the financial crisis hit the country with full force. Iceland's economy came to a standstill and the Icelandic Central Bank only provided foreign currency for the import of food, medicine and petrol (Central Bank of Iceland, 2008a). The British government used its anti-terrorist rules to take control of assets held in Britain by the beleaguered Icelandic banks (Donaldson and Vina, 2008) and demanded full payback from the Icelandic government to British account holders. Tense relations followed between the two countries. To Iceland's dismay all member states of the EU, including the Nordic states, stood by Britain, delaying much-needed external assistance (Morgunblaðið, 2008). Iceland faced challenges on all fronts since the governments of Germany, the Netherlands and Luxembourg also demanded full

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guarantees of their citizen's savings, lost in the branches of the Icelandic banks in these states, from the Icelandic government.

The IMF finally came to the rescue, a few weeks into the crisis – after Iceland had accepted preconditions for settling the dispute with Britain and the Netherlands, that is, given in to their demands. However, this so-called Icesave dispute[1] dragged on and the IMF did not initiate a 2-year Stand-By Arrangement for Iceland to support the country's programme to restore economic stability until November 2009 – over a year after the crisis hit – until Iceland had finalised a deal with Britain and the Netherlands. According to the plan, Iceland will receive a loan of US$2.1 billion from the IMF, and supplementary loans totalling some $3 billion from Denmark, Finland, Norway, Sweden and Poland. In addition, the Faroese Government offered Iceland a loan of approximately $50 million (IMF, 2008a). According to the IMF, its member states, including the long-term friends and closest neighbours of Iceland, the Nordic states, refused to lend Iceland money until the dispute had been settled (Strauss-Kahn, 2009). Hence, the IMF could not initiate its assistance since their loans were part of the IMF's rescue package. Moreover, in January 2010, Britain, the Netherlands and the Nordic states yet again blocked the IMF assistance after the President of Iceland placed the Icesave deal, which the government had stuck with Britain and the Netherlands and the Icelandic parliament (the Althingi) had narrowly approved, on the ballot as a referendum. These events raise the question of whether the Icelandic government failed to guarantee its citizens sufficient economic and political shelter in order to prevent the economic crash, get assistance after the crisis hit, and clean up after the event.

The Icelandic financial sector made full use of the liberalisation of the sector and free movement of capital within the European Economic Area (EEA) after privatisation. The most decisive steps were taken in 2002 and 2003 when two state banks were privatised. The sector rapidly outgrew the state's capacity to back it up and stabilise the free-floating Icelandic currency. Icelandic banks had borrowed massively abroad in order to buy foreign banking assets, leveraging their capital base several times over. Also, Iceland's extremely high net foreign debt ratio added to its vulnerability (Gros, 2008). The rise of the financial sector resulted in a multiplication of the size of inward and outward foreign direct investment (FDI) (UNCTAD, 2008).[2]

In the first half of 2008, the vulnerability of the Icelandic financial sector and the inability of the state (as the lender of last resort, to save the banks, should write-downs in the value of foreign assets place them in difficulty) became more evident (Central Bank of Iceland, 2008b). Underestimated risk of foreign currency shortage and later lack of access to foreign currency contributed significantly to the financial crisis in Iceland. This was further enhanced by a much too narrow focus on the risk involved in operations of individual banks, rather than a much wider attention which should have been given to the risk involved in the operation of the financial sector as a whole (Guðmundsson, 2009). However, the Icelandic Central Bank sought assistance from the European Central Bank and the member states' central banks, but found their doors closed (Central Bank of Iceland, 2008c). Also, to Icelandic decision-makers' surprise, the US government and its Central Bank was not willing to help out – despite providing the other Nordic states with swap facility arrangements that they could draw upon if necessary (Central Bank of Iceland, 2008d). In other words, the US no longer provided Iceland with economic shelter. Therefore, the Americans simply expressed relief when

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the Russian government hinted that it was willing to bail Iceland out with a substantial loan after the crisis hit (information from the US Embassy in Reykjavik, 2009).[3]

The collapse of the banking system was severe. The Icelandic currency, the króna, depreciated more than most small states' currencies. The depreciation substantially increased the debt burden borne by those households and firms – many of which were already bankrupt – that had borrowed in foreign currency. The depreciation had substantial inflationary effects, with inflation peaking at nearly 19 per cent in January 2008. Consumption and investment fell by almost one-fourth, year-on-year in the fourth quarter of 2008. A contraction of close to 50 per cent in imports of goods and services, however, implied a much smaller reduction in total output, or 1.5 per cent. The surplus on external trade has not provided the króna with the expected support, which has made it more difficult for monetary policy to facilitate the reconstruction of private sector balance sheets (Central Bank of Iceland, 2009a). Accordingly, unemployment rose to its highest level ever (since registration started in 1957) to over 9 per cent in the spring of 2009 (Hagstofa Íslands, 1997, 2009b).

The case of Iceland indicates that small states are as ever, if not more than ever, bound to the fortress of the international economy. This seems specially the case due to the instability of the international financial sector. Small states have learned to live with price variations of their export industry and sudden shortness of resources as *Small States in World Markets* convincingly indicates. However, a domestic buffer cannot prevent economic catastrophes which may happen overnight in financial markets. In the twentieth century, Iceland slowly but steadily found out how to cope with traditional economic risk, that is, fall of fish catches and the price of marine products.[4] Iceland made it to the top ten list of the OECD countries according to Gross National Income in the economic boom (Central Bank of Iceland, 2007) and was top out of 177 countries on the 2007/2008 Human Development Index (UN Development Programme, 2007/2008). This was achieved despite the continuation of traditional risks hitting the country on a regular basis.

On the other hand, the international financial risk to the country not only brought an overnight economic crash, but (even more dramatically) it also set off weeks of violent protests in the street of Reykjavik (for the first time in Iceland's history) and a collapse of the government and general election. The unexpected and swift crash created a deep wound to the core function of the state and society, with confidence in politicians, political parties, the government and the state's national bureaucracy, and the media falling dramatically (Capacent, 2009). The Icelandic welfare state, centralised bargaining and its sectoral corporatist structure has without doubt eased the economic shock, by protecting the most vulnerable in the society, prevented many companies from bankruptcy, avoiding massive unemployment and skyrocketing inflation, etc. This is all in accordance with Katzenstein's thesis. However, a question mark has been put on the viability of the small state to withstand external stress and its core domestic and international functioning.

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WHERE HAS ICELAND SOUGHT SHELTER?

One could argue that Iceland enjoyed a shelter provided by its more powerful neighbours from the late thirteenth century down to the early twenty-first century. Iceland became part of the Norwegian kingdom in 1262. One reason for this was the king's promise to

guarantee annual supplies to the country (Líndal and Thorsteinsson, 1978). In the following centuries, Iceland had some economic shelter from European sailors and merchants, who provided important trade links with Europe in times of a limited or non-existent domestic fleet. However, Iceland was part of the Danish Kingdom until the mid-twentieth century (after a merger of the Norwegian and Danish Kingdoms in 1387). Iceland became a sovereign state in 1918 but still enjoyed a measure of cover by the Danish government.[5]

The US government took over from the Danes early in the Second World War and provided substantial economic and trade shelter until the late 1960s and defence in the form of a military presence in the country until 2006. The US government, from the beginning, provided Iceland with considerable aid (much higher than other European states received, per capita), beneficial loans, monetary donations and favourable trade (most favoured nation) deals with US companies and guaranteed Iceland's exports by buying up unsold fish stockpiles. Moreover, the US built up Iceland's infrastructure, such as Keflavík International Airport, paid the cost of running it and for the expensive military and civil radar surveillance system until 2006. Its military presence also contributed considerably to Iceland's GDP and provided much-needed foreign currency earnings (Thorhallsson and Vignisson, 2004a).

The political shelter provided by the US was also a decisive factor in Iceland's successes in extending its exclusive economic zone to 200 nautical miles. Britain and other European fishing nations hesitated to use their full force against Iceland's rigorous extensions of its economic zone due to the US government's and NATO's concerns about the future of the military base in the country (Ingimundarson, 2003).

Iceland sought shelter in the European integration process in 1970 when it joined EFTA, 10 years after its creation, as a policy response to an economic downturn (the collapse of its important herring stock) and due to the fact its economy was better prepared for membership than before (having been undeveloped and heavily held back by trade barriers). In addition, it was clear that the US government would no longer provide the country with direct economic assistance. EFTA membership also paved the way for a bilateral free trade agreement with the European Economic Community (EEC), signed in 1972.

Iceland sought further economic shelter within the EU framework through its joining the EEA in 1994 – having encountered considerably higher import duties against its fish exports to Spain and Portugal once those countries joined the EEC. EEA membership provided Iceland with tariff-free access for over 96 per cent of its fish exports to the Common Market (Thorhallsson and Vignisson, 2004b). The Icelandic government still did not consider EU membership as did the other EFTA states, the reason being that EEA membership was seen as being highly beneficial to the economy and, in fact, more beneficial than outright EU membership. EU membership was seen, by nearly all politicians, as entailing considerable strain on the fishing and agricultural sectors. The leadership of the Independence Party (the Icelandic conservative party), which had taken the decision not to apply for EU membership in 1992, also disapproved of transferring decision-making concerning monetary policy and free-trade agreements from Reykjavik to Brussels. The EEA Agreement had already been very controversial in the country – the political discourse being on the transfer of sovereignty that the agreement entailed. The Independence Party, the largest party leading all governments from 1991 until 2004 and in office until January 2009, was split on the EEA, and its leadership stifled all discussion of a

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possible application for EU membership in order to prevent an outright split of the party (Thorhallsson, 2008a).

However, Iceland joined the Schengen scheme in 1996, along with Norway, after the Nordic EU member states made it a precondition for keeping the Nordic Passport Union functioning. Membership of Schengen has provided Iceland with a more important shelter than was anticipated at the beginning due to the importance of police collaboration as increased international crime has affected the country (Thorhallsson, 2008a).

In Spring 2008, the rapid fall of the Icelandic króna had already sparked a heated debate about the feasibility of EU membership and adopting the euro. The entire business community demanded a currency change – the fishing industry insisting on a currency change without joining the EU. Employers' associations, except for the fisheries and agricultural organisations, requested an immediate EU application, as did the main labour union (Thorhallsson, 2008b). In July 2009, the new Icelandic government applied for membership of the EU referring repeatedly to the need for Iceland to join the Economic and Monetary Union and adopt the euro.

THE BALTIC STATES' EU SHELTER

A number of small EU member states are also facing deep recessions and the question arises whether the Union failed to provide them with political and economic shelter. An examination of the Baltic states provides an interesting insight into their capacity, in the EU context, to withstand the international financial stress of 2008. Engagement in the European project, including free movement of capital, made both the Baltic states and Iceland particularly vulnerable in the financial crisis. The

'In July 2009, the new Icelandic government applied for membership of the EU ...'

imbalances of the Baltic states' economies were driven by massive inflow of FDI and immense domestic household borrowing. EU membership and the measures these states have taken with a view to adopt the euro intensified the inflow of capital. These facts, combined with foreign ownership in the banking sector, made the countries more exposed to the international economy. That said, foreign ownership in the Baltic states had a stabilising factor by stemming the reversals of cross-border capital flow when the crisis hit. Kattel (2010) concludes that this aspect seems to have saved the Baltic economies from outright default and a run on their banks and currencies. Also, the European Central Bank came to the rescue by providing Swedish banks with special liquidity support in order for them to deal with 'their' banking crisis in the Baltic states (Jochem, 2010). Iceland's banking sector – which was mostly owned by Icelanders – was the only banking sector which collapsed entirely.

Also of importance is the fact that as soon as the economic crisis hit member states of the Union, the crisis became an EU crisis. The EU itself had to respond to events and try to limit the consequences of the crisis for its members. For instance, Latvia – along with Hungary and Romania – has received financial assistance provided under a joint IMF/EU programme (IMF, 2008b; BBC, 2009). The total financial package for Latvia amounts to 7.5 billion euros – over 40 per cent is provided by the EU, the rest being financed by the IMF, the World Bank and the European Bank for Reconstruction and Development, and a number of

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countries in Northern and Eastern Europe (IMF, 2008b). Contrary to the case of Iceland where IMF assistance was frozen for a long time, Latvia's IMF programme has gone relatively smoothly. Hence, while Iceland faced outright hindrance (from Britain, the Netherlands and the EU) within the IMF by their blocking of approval of the financial package due to the Icesave dispute – the EU provided a framework for Latvia in which IMF assistance was approved. Accordingly, the EU not only provided Latvia with direct financial assistance, but it also paved the way for its international assistance.

Furthermore, the enormous annual fiscal transfer to the Baltic states from the EU Structural Funds not only made them better equipped to deal with the crisis, but it also made them better capable of dealing with its aftermath. Without these transfers, the Baltic states would have faced public deficit figures close to double digits and far worse unemployment. For instance, Lithuania will receive more than 6.6 billion euros in assistance from the Structural Funds in the period 2007–2013. Nearly half of the money is allocated to the Operational Programme for Economic Growth and 40 per cent to the Operational Programme for Promotion of Cohesion (Malkin, 2009). Iceland does not have access to any such assistance through its membership of the EEA or any other international organisation. Also, Estonia fulfilled the economic criteria to adopt the euro during its deep recession and adopted the euro on 1 January 2011 (for instance, see Andersen, 2009).

On the other hand, the Baltic states have restrained their policy options by their currency boards, resistance to devalue their currency and aim to join the eurozone. This is likely to mean higher unemployment figures, even emigration, and high public debt (Kattel, 2010). Iceland is also facing a record high unemployment figure – though it may not be as high as in many of the EU member states – and an enormous public deficit. Moreover, while Iceland found itself stranded in the middle of the North Atlantic Ocean without any shelter, the Baltic countries received immediate political and economic assistance from the Union in order to cope with the crisis and its consequences, domestically and internationally.

To conclude, it is obvious that membership of the Union did not prevent the economic crisis from hitting the Baltic states, as well as the other EU members. On the other hand, the Baltic states were better equipped to respond initially to the crisis and start on the road to recovery because of the EU's political and economic shelter – though there are also some drawbacks due to their engagement with the Union.

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CONCLUSION

Small states may be the first states to recover from international economic crises due to their small bureaucracies: short distances between decision-makers and speedy decision-making, which makes them quicker to adapt to new circumstances. Thus, they may be faster and better able to adjust to global competition (Kautto *et al*, 2001). According to Katzenstein, many European small states have also created a feasible and successful system of domestic decision-making, including an extensive welfare state, in order to cope with the fluctuation of the international economy. Domestic arrangements are significant in determining exposure to international strains.

The problem that small states encounter in the new globalised world is not purely structural. Their governments do have a choice whether or not they adopt a cautious policymaking, for instance, build on Katzenstein's European small states model or sign up for the *laissez-faire* agenda, which magnified the risk of being

small in the case of Iceland. The Icelandic government's quest for the neo-liberal agenda from the early 1990s made the Icelandic economy and society extremely vulnerable. However, small states need economic and political shelter to prevent risk from emerging and spiralling into catastrophe. Katzenstein's domestic flexible adaption may be of little use if a state cannot withstand external stress.

'... small states need economic and political shelter to prevent risk from emerging and spiralling into catastrophe'.

Icelandic governments have sought shelter within the framework of European integration in order to guarantee access to the European market and to respond to economic downturns. Iceland took full part in the liberalisation of its financial sector though the EEA Agreement, but failed to seek the shelter needed to protect the foundation of the sector itself in time of crisis, and so, in fact, the foundation of its own economy. The EEA gave Iceland nearly tariff-free market access to its most important market and Iceland reaped economic gain from this. At the same time, the EEA exposed Iceland to economic instability, i.e. it created the conditions for the economic boom from the mid-1990s, the overvaluation of the króna and the economic collapse. The EEA is a lopsided multilateral agreement. It increases growth and risk exposure in new ways and is not the kind of multilateral agreement which provides economic shelter such as currency stability and backup for a small Central Bank. In other words, Icelandic businessmen found it easier to assume risk abroad and used the Agreement advantages to the utmost. At the same time, the Icelandic governments failed to seek the shelter needed to deal with this new and unknown exposure.

Moreover, when Iceland became bullied by Britain and the Netherlands, the EU and all its member states, including the Nordic states, stood by them by interpreting EEA rules in their favour, that is, concerning reimbursement for creditors' guarantees. Furthermore, Iceland was faced with bilateral talks instead of having the political shelter of the EU multilateral framework. The EU member states allied with Britain and the Netherlands in hindering Iceland from enjoying the IMF shelter and assistance from the EU and Norway in order to force Iceland to surrender. Not being a member of the EU club, and without the US shelter, Iceland became an outsider in the international community. For instance, Britain never used full military and diplomatic force against Iceland during the Cod Wars, despite all the temptations, because of Iceland's shelter from the US and NATO. Nowadays, Britain does not hesitate to use anti-terrorist law against Iceland, prevent international economic assistance and thus cause un-measurable damage to the Icelandic economy. Also, the case of Iceland stands in sharp contrast with the case of the Baltic states. The EU provided them with political, as well as economic shelter. Thus, we might wonder if Iceland can succeed in nurturing a sustainable economy without economic and political shelter of the formal EU institutional framework and a more stable and reliable currency.

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Notes

1 The dispute is centred on the retail creditors of the Icelandic bank, Landsbanki which offered online savings accounts under the Icesave brand in Britain and the Netherlands. Landsbanki was placed into

receivership by the Icelandic government early in October 2008. As a result, more than 400,000 depositors with Icesave accounts were unable to access their money for at least 6–8 weeks, that is, until the governments of Britain and the Netherlands guaranteed them access to their money. On the other hand, deposits in Iceland were guaranteed by the Icelandic government from the beginning and generally available.

2 In 1990–2000, average annual FDI flows were US$ 64 million inward and 75 million outward. In 2007, these figures had become US$ 3,078 million and US$ 12,127 million, respectively (UNCTAD, 2008). As a percentage of Island’s GDP, inward FDI flows in 1990 were 2.3 per cent of GDP and outward flows 1.2 per cent of GDP. In 2007, FDI flows were 61.5 per cent inward and 127.3 per cent outward. In total, outward Iceland’s FDI flows accounted for 0.6 per cent of world total FDI flows in 2007.

3 On the other hand, a number of European states formally made their concerns about the potential Russian influence in Iceland known to the Icelandic government. This was at least the case of France, Poland and all the other Nordic states.

4 Marine products in total export of goods accounted for 57 per cent in 2005, 75 per cent in 1980 and 91 per cent in 1960.

5 For instance, the Danish Foreign Service handled Iceland’s external relations until 1940 – despite foreign affairs being in the hands of the Icelandic government – due to the non-existence of a foreign service in Iceland.

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