The Icelandic economic collapse: Incompetence or the small size?

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Abstract

The paper applies small-states literature concerning the size of the economy and public administration to the case of Iceland and asks whether size has greater explanatory value than economic management and public administrative competence for understanding the Icelandic economic crash. The paper identifies a number of fundamental flaws concerning the government's economic handling and administrative working practices which contributed to the scale of the crash. At the same time, it argues that the authorities altogether failed to take account of the risk associated with the country's small size during the Icelandic 'outvasion'. It claims that small-state studies need to move back to the basics and consider the original small-states literature in order to fully understand the reasons for the Icelandic economic meltdown; we need to examine the small domestic market, reliance on external trade and the use of a small currency; also, we need to study the weaknesses associated with a small public administration, i.e. the fact that it cannot be expected to prepare for policy-making and legislation and to efficiently supervise domestic actors as decisively as a large bureaucracy. A small state needs to acknowledge its limitations and take appropriate measures to compensate for them. Good economic management and administrative competence, coupled with a shelter provided by regional and international organizations, is the key to success.

Keywords: Small states, economy, public administration, competence, Iceland, size, alliance

About the Author

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Introduction

Iceland's economic crash provides an ideal test case on whether *the size of the economy* and *public administration* is more relevant than factors associated with *economic management* and *administrative competence* for understanding how states are affected by, and respond to, global economic turmoil. Also, it provides an interesting insight into how a globalized small state outside the EU and Euro frameworks was exposed to the international financial crisis and whether this status limited or facilitated its responses to the crisis.

Iceland is the only state which experienced a collapse of almost its entire financial sector in connection with the 2008 financial crisis, (the three main banks, which collapsed, accounting for about 85 per cent of the sector) (OECD, 2009). Moreover, Iceland was the only OECD country to experience a currency crisis (South Korea was the only other medium-to-high income country to experience a currency crisis). In total, the Icelandic króna (ISK) depreciated by around 48 per cent between 2007 and 2009 (Ólafsson and Pétursson, 2010). In the autumn of 2008, the Icelandic Central Bank only provided foreign currency for the import of food, medicine and fuel (Central Bank of Iceland, 2008). Inflation rose from single figures to 18 per cent and unemployment rose, from full employment, to 8 per cent. Household and corporate debt sky-rocketed; many homes and businesses had borrowed in foreign currency (IMF, 2009). Immediately, the Icelandic government sought assistance from the International Monetary Fund (IMF). In 2009, GDP decreased by 6.8 per cent. This was the largest drop in GDP ever recorded since measurements began in 1945 (Statistics Iceland, 2010).

The economic crash soon created a political crisis, i.e. violent protests on the street of Reykjavik, a collapse of the coalition consisting of the conservative Independence Party and the Social Democratic Alliance (SDA), a parliamentary election and a creation of the country's first left of centre government. The Conservatives were thrown out of office after 18 years; for most of the time (1995-2007), they had been in a coalition with the centrist agrarian Progressive Party. Immediately, after gaining a parliamentary majority, the new government, consisting of the Left Green Movement and the SDA, applied for membership of the European Union (EU) in the summer of 2009. The Social Democrats insisted on a speedy accession process and the adoption of the euro. Their electoral success, despite the fact that they were partly blamed for the crash, had been achieved through these promises (Thorhallsson and Rebhan, 2011).

Iceland, an island on the European periphery in the North Atlantic, straddling the Mid-Atlantic Ridge, with about 315 thousand inhabitants, became the smallest state to apply for European Union membership. Previously, most politicians had argued that full participation in the European project would impose severe constraints on Iceland's economic and monetary policy, fisheries and agriculture. Membership of the European Economic Area (EEA) (1994) and the Schengen scheme (1996) was seen as serving Icelandic interests adequately (Thorhallsson, 2004). The EU application signalled a gradual geo-political transformation. Iceland had slowly been directed towards its Eurasian Plate side after it had been sited rather more on the North American Plate, politically speaking, during the Cold War – under US protection.

From the beginning, the focal points in small-states literature have been the variables associated with states' capabilities (Neumann and Gstöhl, 2004) in term of numbers of inhabitants, the size of the economy, military strength and territorial size (Vital, 1967; Archer and Nugent, 2002; Thorhallsson, 2006). Also, the influence of having a small central bureaucracy and small diplomatic corps was mentioned early in the development of the literature (Keohane, 1969; Vayrynen, 1971, Handel, 1981; Archer and Nugent, 2002) though this was never properly dealt with or taken fully into account.

Small states were said to be more economically vulnerable due to the size of their GDP, their small domestic markets, reliance on external trade and exposure to international

economic fluctuations (Katzenstein, 1984 and 1985; Papadakis and Starr, 1987; Griffiths, 2004). Small entities were even regarded as not being economically sustainable or viable (Commonwealth Secretariat, 1997; Commonwealth Consultative Group, 1985). The small size of their administrations posed constraints on their international behaviour, i.e. they had less capacity both to defend themselves diplomatically and to engage in international affairs (Keohane, 1969; Handel, 1981; Papadakis and Starr, 1987). Importantly, doubt was even cast on small states' ability to govern themselves, i.e. to run the necessary apparatus. It was argued that they had less capacity for exposure to risk due to the small size of their bureaucracy (Reid, 1974) and less margin for error, i.e. they are more vulnerable to absolute loss of manpower, territory or economic infrastructure than most larger states (Barston, 1973).

Small states were said to rely on larger states for their internal and external policy making. Moreover, they relied on their larger neighbours for basic survival and engagement with the outside world (Pace, 2001; Ólafsson, 1998; Archer and Nugent, 2002; Thorhallsson, 2006). Alliance formation was a must for their success (Keohane, 1969). Their domestic affairs and foreign policy were under a strong influence from their protectors. Accordingly, the smallest European states - Liechtenstein, Andorra, Monaco and San Marino - did not gain access to the United Nations (UN) and its predecessor, the League of Nations, until the early 1990s. Their foreign policies were not seen as being independent from those of their larger neighbouring states (Duursma, 1996; Hagalín, 2005).

After many of these hypotheses had been proved wrong (see, for instance, Magnússon, 2004; Katzenstein, 1984 and 1985), small states began to be seen as economically and administratively smart, salient, resilient and faster and more fit to adjust to global competition and other challenges (Browning, 2006; Briguglio, Cordina and Kisanga, 2006; Kautto, 2001). They were no longer seen as being constrained by their small administrations and the smallness of their economy. Instead, the informality and flexibility of their bureaucracy and the small domestic market – small community - were seen as providing them with opportunities, domestically and internationally (Rapaport, Muteba and Theratil, 1971; East, 1974; Thorhallsson, 2000). The economic success of small Western European states was found to be a result of their flexible democratic corporatism, based on the culture of consensus (Katzenstein, 1984 and 1985). The success of small states in regional and international organizations such as the UN and the EU has been seen as a result of their administrative working practices in terms of prioritization, informality, flexibility and the autonomy of their officials (Thorhallsson, 2000; Magnúsdóttir, 2009; Archer, 2003; Jakobsen, 2005). Small states were found to be notably influential in the multilateral arrangement of the international system.

Accordingly, the small-states literature gradually shifted its focus from the mere vulnerability consequences of the size of the economy and the central bureaucracy to opportunities associated with smallness. However, the question which remains unanswered is whether good economic management and administrative competence are more relevant than the opportunities and constraints associated with smallness. The aim of this paper is to examine whether a small state like Iceland encounters, purely or partly, structural problems associated with its smallness, in the international system: Does Iceland's small size in terms of its economy and bureaucracy provide a better understanding of the economic collapse and its responses to the crisis than do factors regarding economic management and administrative competence. Moreover, did the non-EU and Euro membership matter in the lead-up to the crisis, during the crisis itself and in cleaning up after the event? Are small states more or less in need of an external shelter (an ally or an alliance) in order to cope with the new globalized economy? The paper will address these concerns by examining a number of independent analyses conducted in order to understand the Icelandic economic collapse. The aim is to apply the literature on small states, concerning the economy and administration, to these

findings to explain whether or not the size of the economy and the public administration played a part in the crash.

Size of the economy versus economic management

In the years leading up to the crisis, there were several fundamental flaws in economic management in Iceland, according to the Special Investigation Commission (SIC) appointed to investigate the fall of the financial system (cf. for the following: Althingi, 2010a). The government kept lowering taxes, changed lending guidelines at the Housing Financing Fund and decided to build a massive power station during an economic expansion period. It did not restrain the budget and the Icelandic Central Bank was too late in raising interest rates. Accordingly, the government failed to address economic fluctuations, over-expansion and growing imbalance in the economy. This contributed significantly to the hard landing (see also: OECD, 2009).

Ólafsson's and Pétursson's (2010) analysis of 46 medium-to-high income countries indicate that the difference in the way individual states experienced the 2008 economic crisis had mainly to do with their economic management. States 'that, in the run up to the crisis, had higher inflation, larger current account deficits, a more leveraged private sector, greater output volatility, or a poorer fiscal position tended to experience some combination of a deeper or more protracted contraction in output or consumption, and were more likely to experience a systemic banking or currency crisis' (Ólafsson and Pétursson, 2010: 25).

The Special Investigation Commission claims that the reasons for the default of the banks 'are first and foremost to be found in their rapid expansion and their subsequent size. Their balance sheet and lending portfolios expanded beyond the capacity of their own infrastructure' (Althingi, 2010a: 1). The banks were suffering from a liquidity problem because they were suspected to be insolvent and no lender of last resort facilities could have saved them. Their wholesale funding had been very difficult from late 2006 and dried up completely in mid-2007 (Carey, 2011).

Nevertheless, there is a tendency to overlook the inability of the Icelandic state and its Central Bank to stand by its banks. It may have been a major mistake by the government to allow the massive expansion of the financial sector, but the fact that it had assets valued at over ten times Iceland's GDP in the autumn of 2008 (Central Bank of Iceland, 2010) made it impossible for the government to guarantee the payment of liabilities to foreign creditors (for comparison, the Irish banking assets were three times as big as GDP). It salvaged the domestic branches and their creditors, allowing their foreign operations to collapse and leaving their creditors without any more than a promise of minimum compensation (Althingi, 2008).

Already in early 2006, representatives of the Icelandic Central Bank 'had been "spanked'' at meetings with experts in London…, for risk-taking and the relative size of the Icelandic banking system. It is iterated that the banks were close to bankruptcy in the "mini-crisis'' in early 2006' (Althingi, 2010b: 4f.). Again, in the autumn of 2007, there were doubts about the capacity of the Central Bank of Iceland to be the lender of last resort for the banks. During the first months of 2008, it was clear, according to the Special Investigation Commission, 'that the enormous size of the Icelandic banking system relative to the Icelandic economic system and the associated risk for the entire Icelandic economy if the banks were to run into difficulties, was an especially urgent threat given the circumstances at the time' (Althingi, 2010b: 137). In the spring, the IMF, credit-rating agencies and foreign central banks concluded that the banks had become far too big relative to the size of the Icelandic economy and the capacity of the Icelandic government to rescue them. The other Nordic Central Banks made currency swap arrangements with the Icelandic Central Bank with the

condition that the Icelandic government would reduce the size of the banking system (Althingi, 2010b: 137f.). The Bank of England declined to make a currency swap agreement with Iceland but instead offered its assistance to scale down the financial sector. However, the Icelandic government did not take any measures to achieve this objective (Althingi, 2010b: 138).

The small size of the Icelandic economy made it impossible for it to stand by the financial sector. The government had no choice on whether or not to save the banks since it did not have access to external funds to back them up. The small national currency made matters worse. Its depreciation, earlier in the year, made foreign borrowing so expensive that the Icelandic authorities hesitated to borrow abroad in order to strengthen the currency reserve (Althingi, 2010a). The banks found it increasingly difficult to find counterparties willing to buy the króna in exchange for foreign currencies (Carey, 2011). Underestimated risk of foreign currency shortage, and later lack of access to foreign currency, significantly undermined the Central Bank's ability to stand by the banks (Guðmundsson, 2009). The Central Bank had not sufficiently bolstered its reserves despite the massive expansion of the banks (OECD, 2009). The banks' domestic operations and foreign branches lacked lender of last resort facilities for their foreign lending (Carey, 2011).

Authorities in neighboring states, and the market, lost trust in the Icelandic banks and the ability of the state to defend them. Moreover, Britain used its anti-terrorist laws to seize assets of the Icelandic banks in London which led to the closure of the only functioning bank (Donaldson and Vina, 2008). Iceland encountered a collapse of its entire financial sector, a currency crisis and a currency shortage. The economic landing was hard. A modest improvement only began two years later (IMF, 2011; OECD, 2010; Danske Markets, 2011). That said, currency restrictions will remain the fact of life for Icelanders until 2015, according to the Icelandic Central Bank's plan to ease currency controls (Central Bank of Iceland, 2011). Three years after the depreciation, the ISK is still undervalued by about 25 per cent versus the euro, despite strict controls (Danske Markets, 2011). There are still considerable uncertainties concerning the Icelandic funding situation (Danske Markets, 2011; IMF, 2011). Forecasts differ on whether unemployment will fall or rise; the IMF (2011) expects it to decline gradually to just over 3 per cent in 2014; Danske Markets (2011) claims that it will remain close to 10 per cent until 2013 (i.e. to the end of its forecast period). There has been only a moderate increase in total exports despite the obvious benefits of a favourable exchange rate for the export industries. Export increases are hampered by limited aluminium production capacity and fish stocks. On the positive side, predictions have been made of two to four percent GDP growth and low inflation (about or below 2.5 per cent) in the coming four years (IMF, 2011; Danske Markets, 2011), a large trade surplus, a largely balanced current account and stabilization of the public finance situation (IMF, 2011; Danske Bank, 2011), much lower interest rates offered by the Central Bank than in the previous years and the complete reorganization of the financial sector.

EU and euro membership might not have hindered the collapse of the Icelandic banks and the economic downturn associated with it (Carey, 2011). On the other hand, Iceland would not have experienced the currency crisis which has substantially increased inflation and mortgages and other loans taken in foreign currency and also loans in ISK due to their being price-indexed. For instance, food prices rose by nearly 40 per cent in the two-year period from early 2009 (Icelandic National Broadcasting Service, 2011). Also, Icelanders would not either have been faced with currency controls, which severely hamper the business community and foreign investment (Fréttablaðið, 2010). Moreover, Iceland would have been assigned rescue packages just like other EU and Euro members in economic difficulties. There would have been fewer concerns about Iceland's future funding situation due to the back-up from the European Central Bank. Iceland would have had access to the EU's Structural Funds and the

European Investment Bank (the latter has on refused or hesitated to loan Iceland since the crash) which, for instance, have provided important support for the Baltic states during the recession (Malkin, 2009).

Accordingly, Iceland, as part of an alliance (the European Union), would have been sheltered by its institutional framework. Iceland's problems would have become the EU's problems and the Union would have been compelled to come to its rescue. Iceland, like other hard-hit small European states, had to seek external assistance in dealing with the crisis and in cleaning up after the event. The IMF was Iceland's only alternative, while beleaguered countries in the Union received joint EU and IMF rescue packages. In fact, Iceland's IMF assistance was, on several occasions, delayed by IMF members, particularly Britain and the Netherlands, due to the unresolved Icesave dispute (Strauss-Kahn, 2009).

Iceland's economic outlook is improving but several uncertainties stand in the way of full recovery. Membership of the EU and the adoption of the euro would ease the way forwards (Carey, 2011; Ólafsson and Pétursson, 2010), particularly as regards currency and funding difficulties. A small state's economy is restricted due to the limited state back-up. These restrictions, identified in the literature, may be overcome by a decisive back-up from a more powerful ally or alliance formation, such as the European Union. Iceland was protected politically and economically by the USA during the cold war, prior to which it had been part of the Danish Kingdom for centuries (Thorhallsson, 2004). In the early 1990s, the Icelandic government failed to adapt to the new international environment and seek much-needed external shelter within the EU.

To summarise, economic mismanagement in the years prior to the crisis made Iceland particularly vulnerable to the 2008 international financial crisis and resulted in a very hard landing. The government's unwillingness to scale down the overgrown financial sector and the banks' expansion beyond their own infrastructure made it impossible for the Icelandic authorities to defend the financial sector. The limited capacity of the government and its Central Bank to defend the banks was altogether overlooked and led to an overnight economic collapse. A small state's economy is restrained by the smallness of its domestic market and the state's financial resources. This was recognized in the original small-states literature, but it was overlooked in Iceland in the prosperous years of the late 20th century and the early 21st century. Businesses in a small state may engage in massive 'outvasion' and create enormous wealth, but this is a very risky tactic, since greater economic vulnerability is bound to follow. It ought to be a part of good economic management to take account of the limitations imposed by a small domestic economy in order to find a balance between sustainable growth and risk taking. This awareness was altogether lacking in Iceland's case.

Size of the public administration versus administrative competence

A small public administration, like Iceland's, cannot be expected to prepare for policy-making and legislation as decisively as larger bureaucracies or to have the manpower to efficiently supervise large financial institutions engaging in massive foreign expansion. For instance, in 2008, there were only 56 people working in the Icelandic Financial Supervisory Authority (FME) (IMF, 2008) compared with 246 employees in the Financial Supervisory Authority in Norway in 2010 (Norwegian Ministry of Finance, 2010) and 1,830 in Germany in 2011 (German Federal Financial Supervisory Authority, 2011). Interestingly, the IMF in August 2008 still welcomed that 'the budget and the staff of the FME have increased significantly over the last years' and that 'all stakeholders, including the government and the supervised parties recognize the need for the FME to grow in line with the expansion of financial undertakings' (IMF, 2008: 27). Moreover, in 2001, 150 people were employed in the

Foreign Service in Iceland, compared with 1,150 in Norway, 1,642 in Finland and 5,500 in Britain (Foreign Ministers of Iceland, Norway, Finland and Britain, 2001).

The substantial lack of supervision of the banks, the inability to deal with their expansion, the passive response to candid criticism of their behaviour and the chaotic reaction to the crisis event significantly contributed to economic crash (Althingi, 2010a). These factors can in turn be explained by the small staff complements and lack of expertise in the financial sector and the demanding tasks associated with it. At the same time, the need for administrative competence and the background political reality, i.e. the unwillingness of the government to curb the financial sector and its firm belief in the neo-liberal agenda, have to be taken into account in evaluating the cause of the crisis.

The criticisms raised by the Special Investigation Commission and the independent committee of experts appointed by the Prime Minister to address the implications of the commission's conclusions for the public administration point to a fundamental failure by the bureaucracy regarding policy-making and supervision. They identify a lack of professional competence due to political interference, small staff size, reliance on personal connections and limited emphasis on best practice. The smallness of the administration and its lack of expertise not only made it unable to supervise the financial sector properly; it permitted 'the bankers largely to regulate themselves' (Althingi, 2010c). The banks were thought to be less closely supervised than other banks in the EU/EEA (OECD, 2009). Although financial regulations were mostly transposed through the EEA, 'Iceland's supervisors were unable to keep up with the complexity and size of the system as it grew rapidly and applied rules in an excessively legalistic manner' (OECD, 2009: 11). Also, the fact that the number of departments in the Icelandic central public administration was one-third of that in the Norwegian administration affected its behaviour. Icelandic departments have broader responsibilities and specialization (Lægreid, Steinthorsson and Thorhallsson, 2004). At the same time, they are forced to prioritize in order to cope with their burden. Officials are granted official autonomy and flexibility. For instance, Icelandic officials have greater autonomy in dealing with EU/EEA cases than their counterparts in the other Nordic states (Thorhallsson and Ellertsdóttir, 2004; Lægreid, Steinthorsson and Thorhallsson, 2004). Also, responsibility for handling EEA/EU relations in Iceland is mainly in the hands of public servants (not politicians), due to the structure of the EEA agreement. This absence of domestic politicians within the EEA decision-making processes has created a reactive approach in implementing the EEA rules, i.e. the Icelandic authorities simple apply the rules without taken any notice of the domestic reality such as the county's small size.

Historically, the administration has outsourced its policy-making in the important fisheries and agrarian sectors. This is in line with the sectoral corporatism that exists in the country and was later extended to the aluminium industry and the financial sector (Thorhallsson, 2010). Outsourcing of projects has further weakened the administration's capacity to build up knowledge and engage in decisive policy-making. Moreover, it has made the small bureaucracy particularly vulnerable to powerful pressure groups (Prime Minister's Office, 2010; Thorhallsson, 2010). This was the case in the relations between the administration and banks (Althingi, 2010a).

The first mistake was to hand over the state-run banks to political favourites who did not have any experience in running financial institutions and had major expansion plans (OECD, 2009: 11). The government did not follow the Icelandic Financial Supervisory Authority's (FME) advice in the privatization process and the authority was given insufficient resources to carry out its duties (Althingi, 2010a). Also, politicians were suspicious of the administration's effort to regulate the banks since it might constrain their expansion. Politicians praised the bankers for massive expansions; they were regarded as the new Viking explorers who new how to take risks and succeed. This was due to the natural talent of the

Viking race and informal and flexible decision-making (President of Iceland, 2006; Althingi, 2010b). The Icelandic 'outvasion' seemed a great success. The administration was expected to engage in informal and flexible decision-making in order to make things easy for the bankers. Comprehensive policy making has always been sidelined by emphases on informality and flexibility within the administration (Prime Minister's Office, 2010). Politicians reacted fiercely to external criticism of the banks and did not take any measures to scale down their expansion plans; Icelandic banks were expected to base their headquarters at home and were, in fact, praised for doing so (Althingi, 2010a) – despite the massive risk for the Icelandic state and the economy associated with their operations abroad.

The committee of independent experts argues that the ability of the Icelandic administration to prepare legislation is inevitably limited due to its small size (Prime Minister's Office, 2010). Accordingly, it is unrealistic to assume that preparation for policy-making and legislation can always be as detailed as in the neighbouring states. The small size of the bureaucracy is a fundamental fact and cannot be changed. On the other hand, there is a considerable room for improvement within the administration, since there is little emphasis on comprehensive policy-making processes within the administration itself and by politicians. The smallness creates particular challenges for the administration. These are related to the organizational structure and working practices, on the one hand, and emphases concerning relations with domestic and external actors on the other.

First, close personal connections (characterised either by friendly or antagonistic relations), due to the small community size, had considerable influence on the scenario leading to the crisis and the crisis response. These connections did not lead to efficient policy-making; instead, they created suspicion and conflict. Close personal connections may also have played a part in the failure to supervise the financial institutions. The committee recommended that these weaknesses be met by measures such as highlighting comprehensive policy-making processes, closer coordination between different actors, the creation of larger units and institutions, clearer accountability and unitary leadership of senior executives (Prime Minister's Office, 2010)

Second, despite its smallness and closeness to the other Nordic states, Iceland's political system is not characterized by consensus politics, but rather by conflict and debates in which the truth of statements has little value (Althingi, 2010c). There is a strong tradition of majority rule. This could be modified by adopting the small European states' corporatism, which is characterized by consensual decision-making by all the main actors in society (Prime Minister's Office, 2010).

Third, Iceland's foreign policy needs to take account of the smallness of the country. Globalization and close engagement with external actors (e.g. through the EEA Agreement) poses several challenges for a small entity. The Icelandic authorities did not use the flexibility of the EEA Agreement to implement regulations concerning the financial sector according to the small size of its economy (Prime Minister's Office, 2010). They could have adopted measures to hinder the banks' expansion abroad, despite the fact that the EEA regulatory framework makes no distinction between whether a financial instate in a small country is opening branches in a small or large market/country and makes the small entity responsible to investors without adequate guarantees (Althingi 2010d: 132). The Icelandic authorities made no move to limit the risk associated with the opportunities which the financial sector was granted by membership of the EEA (Prime Minister's Office, 2010).

Compared with larger states, small states have to tackle difficulties associated with their more limited resources concerning information gathering and comprehensive policy-making (Prime Minister's Office, 2010: 48f.). A small state has to acknowledge its limitations and accept that it may not have sufficient manpower to engage in decisive policy-making concerning the financial sector and the supervision of international banks. Hence, it may have

to relinquish its right to take independent decisions, domestically, and join regional or international organizations in order to limit the vulnerability associated with the new globalized economy.

Small states can defend their interests and become influential within the European Union. However, they have to prioritize and make the most of the characteristics associated with their small bureaucracy, such as informality, flexibility and the autonomy granted officials in dealing with the Union's demands (Thorhallsson, 2000; Magnúsdóttir, 2009). However, this may not be at the cost of a lack of supervision, and careful notice has to be taken of the characteristics of a small community, such as personal connections, small units and the small domestic economy.

To summarize, although staff sizes and limited administrative competence played an important part in limiting Iceland's ability to deal with the massive financial sector, the political situation and political culture played a part as well. For instance, while the Working Group on Ethics, which was part of the Special Investigation Commission, blamed the crash partly on weak public institutions, it argued the most important lessons to draw from these events also concerned weak social structures and weakness in the political culture. It concluded that 'although several individuals, in the financial, administrative, political and the public sphere, showed negligence and sometimes reprehensible action… actions in the financial and administrative sector need to be explained by relating them to the wider social context, such as the prevailing political ideology and social values, and the poor performance of the media' (Althingi, 2010c: 1).

Conclusion

Iceland's economic management had fundamental flaws which contributed to the scale of the downturn. The government fuelled the economic boom instead of addressing its overheating; it failed to curb the massive expansion of the banks which further exposed the small economy to high risk. The Icelandic authorities did not take any notice of the possible danger connected with closer engagement in the international financial system. The small economy has always been vulnerable to fluctuations in the international economy due to its predominant reliance on marine product exports. Nevertheless, participation in the free movement of capital within the EEA, without attention given to the consequences for the small economy and the state's liability for its banks operating within the common market, made the country more than ever exposed to external risk. The government's firm belief in the free market and limited interference it its operations – including those of the banks – was manifested in politicians' official and unofficial pressure not to restrain the 'outvasion'. Hence, the public administration was given insufficient resources to deal with the demanding task of supervising the banks. Moreover, the absence of Icelandic politicians from the EEA/EU decision-making processes concerning financial rules left them unaware of their implications for the small economy and capacity of the small state entity. Furthermore, traditional features of the administration, such as little emphasis on long term policy-making, a general lack of professionalism, outsourcing of projects and political interference, led to insouciance about the threat pose by the 'outvasion' to state and society. The entire focus, by most politicians, public servants, researchers and the media, was on how to further boost the 'outvasion'. Virtually the entire society became engaged with the on-going non-negotiable 'outvasion culture'.

On the other hand, our findings also indicate that we need to consider the original small-states literature regarding the small size of the public administration and the economy in order to understand fully the reasons for the Icelandic economic meltdown.

First, Iceland’s small administration did not have the resources needed to engage fully in comprehensive policy-making and legislation concerning the financial sector. Also, the size of staff and lack of expertise within the administration led to a fundamental lack of supervision of the financial sector and assessment of the risks entailed in its expansion for the small community. The small bureaucracy was unable to deal properly with the complexity of the massive expansion by the banks; their operations in the new globalized international economy were too demanding. A small administration cannot be expected to engage in policy formation in as decisive a manner as larger administrations. Icelandic policy makers need to take account of the fact that the scope of the Icelandic administration will always be more limited than that of most other administrations in Europe. This has to be compensated for by seeking advice and assistance from the others and by close engagement with supervisory bodies such as the EFTA Surveillance Authority (ESA) and its sister organization, the European Commission. Instead of expressing annoyance over alleged interference by ESA, Icelandic politicians and public bodies should have welcomed its efforts at supervision.

Second, the small domestic market, the small state budget and the small national currency could not sustain the Iceland ‘outvasion’. The financial sector outgrew the domestic market’s ability to defend it. The Icelandic authorities did not have any unrestricted external back-up such as they had enjoyed during the cold war and, previously, under the Danish umbrella. Economic size did not pose any constraints during the economic boom; however, size constraints gradually emerged as the warning signals about the state’s capacity to stand by its banks started to pile up. The market lost trust in the economic system and the banks and the state did not have access to overseas loans or other forms of assistance. The fall in the exchange rate and, later, the currency shortage, further weakened the system, i.e. the ability of the banks to continue their operations and the ability of the state to respond to their difficulties. The whole economy collapsed when the international financial crisis hit with full force. Again, Iceland was without an ally in responding to the crisis event, and in the midst of the crisis it was faced with Britain’s closure of an overseas branch of its only functioning bank. Moreover, it had great difficulty in obtaining IMF assistance. One of the most important lessons to be learned from the crash is the restricted scope of small economies to engage in the international global economy without a proper ally. We are back to the established observation in the small state literature that a small state needs an ally in order to limit the risk exposure involved in engagement with the international community. The case of Iceland indicates that the importance of shelter has never been as salient as at present, with the growing reliance of small states on the international financial system.

Small states can overcome many of the obstacles associated with the small size of their economy and public administration. The key to success is sound economic management and administrative competence. Small states need to acknowledge their limitations and take notice of it in their economic planning and the structuring of their public administration. Constraints imposed by having limited personnel and small domestic markets may be compensated for by closer engagement with relevant international and regional organizations. These may provide not only a larger market with its potential economic benefits, but also an important economic and administrative shelter. Having an ally will not systematically limit risks posed by reliance on international trade, and economic crises will continue to occur; however, having recourse to protection may ease economic burdens and provide important economic and political assistance in times of need.

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