Small States in Europe

Challenges and Opportunities

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Chapter 13

The Icelandic Crash and its Consequences: A Small State without Economic and Political Shelter

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The Icelandic economic miracle that began in the mid-1990s is over. The volatility of the small economy is once again evident. The collapse of the Icelandic financial sector and the króna (ISK) resulted in a swift turn from a blooming 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 (The 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. The tense relations that followed between the two countries, where to Iceland's dismay all member states of the European Union (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 guarantees of their citizen's savings, 'lost' in the branches of the Icelandic banks in these states, from the Icelandic government.

The International Monetary Fund (IMF) finally came to the rescue a few weeks into the crisis – after Iceland had accepted preconditions for settling the dispute with Britain, i.e. given in to Britain's demands. In May 2009, a new government put forward a bill to the Icelandic parliament, the Althingi, proposing that Iceland apply for membership of the European Union.

These events raise the question of whether the Icelandic government failed to guarantee its small economy and society sufficient economic and political shelter. This chapter examines Iceland's past shelters, particularly in the twentieth century, why Iceland has not followed its Nordic neighbours and applied for EU membership until now and whether, as has happened before, any powerful neighbour, or the EU, is likely to provide Iceland with shelter in order to cope with international economic downturns and guarantee its interests. The chapter also examines the consequences the economic crash has had on the views of political parties towards closer engagement in the European project.

Vulnerability of Small Economies

The economies of small states are considerably different from those of large states. Small states rely to a much greater extent on imports and exports than large states do due to the smallness of their domestic markets. This makes their economies more open and vulnerable to international economic fluctuations. Moreover, small states seek specialisation and economies of scale in export markets in order to be competitive internationally and thus often rely on one or two export products. Their exports are also more concentrated than large states' since most of their trade relies on a particular state or a specific market. Hence, small states are often the first to experience international economic crises: economic downturns may hit 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, in economic affairs – as in security affairs (cf. Jervis 1978: 172-3) – small states tend to have less influence over international events and a smaller margin of trial and error. This is one of the most important consequences of being the weaker part in an asymmetric relationship (cf. Chapter 1 in this volume).

The case of Iceland fits perfectly into this picture: 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 at eight times Iceland's GDP in 2007 (Gros 2008) 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. 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).

On the other hand, small states can be the first states to recover from international economic crises. This is because their small bureaucracies, with short distances between decision-makers and speedy decision-making, make them quicker to adapt to new circumstances. Thus, they may be faster and better able to adjust to global competition and other challenges (Kautto et al. 2001). In order to compensate for their economic vulnerability, small states seek protection from large neighbours and international organisations (Handel 1981). In the second half of the twentieth century, most small states sought multilateral economic shelter in international organisations, such as the EU, the IMF, the World Bank, the World Trade Organisation (WTO) and the Nordic Council rather than shelter

provided by a large neighbour under a bilateral agreement. 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, the World Bank and the Nordic Council, was mainly protected economically by its largest neighbour, the United States. 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. All other European small states have sought full participation in European integration, though some of them have been held back by their electorates. The 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; Chapter 1 in this volume). 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 (see, for instance, Vital 1967; Keohane 1969). Accordingly, international organisations provide small states with political shelter. The recent negotiations between Iceland and the US about the closure of the military base in Iceland, on the one hand, and between Iceland and Britain about British savers' deposits in the Icelandic banks, on the other, clearly demonstrate the superior position of the larger state (see, for instance, Ingimundarson 2008a; *The Economist* 2008a). While the small states (Latvia, Hungary and Romania) of the EU that were worst hit by the banking crisis were provided with rescue packs by the Union and given immediate help with arranging loans from the IMF (BBC 2009), Iceland was left defenceless and had to struggle to obtain IMF assistance.

Where has Iceland Sought Shelter?

One could argue that Iceland enjoyed shelter provided by its more powerful neighbours from the late thirteenth century down to the late twentieth century/early twenty-first century. Iceland became part of the Norwegian kingdom in 1262, one reason for this being the king's promise to guarantee annual supplies to the country (Lindal and Thorsteinsson 1978). In the following centuries, Iceland had some economic shelter from European sailors and merchants, which provided important trade links with Europe in times of a limited or non-existence of a domestic fleet. However, Iceland was part of the Danish Kingdom until the mid-twentieth century (after a merger of the Norwegian and Danish Kingdom in 1387). Iceland became a sovereign state in 1918 but still enjoyed a measure of cover by the Danish government. 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.

The US government took over from the Danes early in the Second World War and provided not only defence in the form of a military presence in the country but also substantial economic and trade shelter until the late 1960s. This was not only a relief to Icelandic policy-makers due to the threat of a German invasion during the War, but also because some of them found it appealing that Iceland was not any longer on its own on the British North-Atlantic territory (Ingimundarson 2002). This later became evident in the Cod Wars with Britain (Confrontations in 1950s and 1970s regarding fishing rights). 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 (best terms) 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 Keflavik International Airport, paying the cost of running it and paying for the expensive military and civil radar surveillance systems 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). The visible political/military shelter provided by the United States lasted until 2006 when it closed the military base, to the indignation of the Icelandic government. However, the bilateral defence agreement between the two countries is still in place, providing Iceland with US protection in the event of a security crisis.

Iceland sought shelter in the European integration process in 1970 when it joined EFTA, ten 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. Already in the late 1950s, Iceland had taken part in negotiations, which came to nothing, on a free-trade area in Western Europe, and had considered EFTA membership but was not invited to the EFTA talks because at the time it was involved in a fishing dispute with Britain. In the early 1960s, the Icelandic government seriously considered applying for EEC membership, at the same time as some of its neighbouring states were seeking to join the EEC, in order to guarantee its future exports to the European market. In the end, the government decided to apply for associate membership – without knowing what exactly this would involve. The government concluded that its economy was not prepared for membership and was afraid of the consequences membership would have for its extensive trade with the Soviet Bloc. That said, all this came to nothing when Britain was denied entry into the EEC – Britain being Iceland's most important single trading partner (Thorhallsson and Vignisson 2004b).

Iceland sought further economic shelter within the EU framework through its joining the European Economic Area (EEA in 1994) – having encountered considerably higher import duties against its fish exports to Spain and Portugal after those countries joined the EEC (1986). EEA membership provided Iceland with tariff-free access for over 96 percent of its fish exports to the Common Market (Thorhallsson and Vignisson 2004c). 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 (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, was split on the EEA, and its leadership stifled all discussion of a possible application for EU membership in order to prevent an outright split of the party (Thorhallsson 2008a).

However, Iceland joined the Schengen scheme (2001), 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. Schengen accession was less controversial than the two previous European steps, though the Left-Greens opposed it, as did a few MPs of the Independence Party. The long-serving Prime Minister, David Oddsson (1991–2004), was also not enthusiastic about the membership and stated that Iceland was only taking part in Schengen in order to guarantee the continued free movement of Icelanders to the other Nordic states (Thorhallsson 2008a).

The Financial Crisis Hits

Iceland takes part in the four freedoms of the EU under the EEA Agreement. The Icelandic financial sector, after privatisation (the most decisive steps where taken in 2002 and 2003 when two State banks were privatised), made full use of the liberalisation of the sector and free movement of capital within the EEA. The sector rapidly outgrew the state's capacity to back it up and stabilise the free-floating Icelandic currency. In early 2008, the banking system had assets valued at eight times Iceland's GDP. Icelandic banks had massively borrowed 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 inward and outward FDI. In 1990 to 2000, average annual FDI flows were US$ 64 million inward and US$ 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 Iceland's GDP, inward FDI flows in 1990 were 2.3 percent of GDP and outward flows 1.2 percent of GDP. In 2007, FDI flows were 61.5 percent inward and 127.3 percent outward. In total, outward Iceland's FDI flows accounted for 0.6 percent of world total FDI flows in 2007. For a small country like Iceland, that was a relatively large share[1] and further accentuated the vulnerability of the small economy (Hagstofa Íslands 2008a and b).

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 (The Central Bank of Iceland 2008b). Underestimated risk of foreign currency shortage and later lack of access to foreign currency significantly contributed 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 (The 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 (The Central Bank of Iceland 2008d). In other words, the US no longer provided Iceland with economic shelter. This should have already been clear to the Icelandic decision-makers, since the US government had for decades been scaling down its assistance and operations in Iceland. In addition, the changed world order after the end of the Cold War and the 11 September 2001 terrorist attacks had fundamentally altered the strategic importance of Iceland. The Bush administration did not consider it of any importance to provide Iceland with political and economic shelter (see, for instance, the discussion in Ingimundarson 2008b). Therefore, the Americans simply expressed relief when 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). This finally struck Icelandic decision-makers, most coming from within the Independence Party, both within the government and the Central Bank, that the Americans had left Iceland on its own in the middle of the North Atlantic. However, many European states were very concerned about

1 Outward FDI flows per country in percent of world FDI flow in 2007: Luxembourg accounted for 2.6 percent, Sweden 1.8 percent, Belgium 2.5 percent and Malta for 0.0009 percent; see more on www.unctad.org.

the potential Russian loan (Information from the British and French Embassies in Reykjavik 2009), particularly the other Nordic states, which promised further assistance – having been the only states that provided Iceland bilateral swap facility arrangements (*The Economist* 2008b). Poland also offered Iceland a considerable loan with the wish that Iceland would not accept the Russian loan (Rozhnov 2008).

The collapse of the banking system was severe. The Icelandic currency, the króna, depreciated more than most small states' currencies. The depreciation has 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 percent 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 percent in imports of goods and services, however, implied a much smaller reduction in total output, or 1.5 percent. 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 (The Central Bank of Iceland 2009a). Accordingly, unemployment rose to its highest level ever (since registration started in 1957) to over 9 percent in spring 2009 (Hagstofa Íslands 1997 and 2009b). The outlook remains grim, according to the Central Bank: 'As long as there is substantial uncertainty about the country's external debt, the status of public sector finances and the restructuring of the financial system, capital controls will remain a prerequisite for significant easing of monetary policy. … Consequently, unemployment will remain high. …The disinflation already underway will continue unabated' (The Central Bank of Iceland 2009b). In January 2009, the government announced that the Treasury's total liabilities would rise by just over ISK 400 billion in 2009. In addition, the Treasury guarantees the debt due to 'lost' savings in the Icelandic banks abroad and the loans from the IMF and others to the Central Bank of Iceland, in the amount of almost ISK 1,300 billion. It is estimated that the Treasury's debt will approach ISK 1,100 billion by the end of 2009. According to the National Budget for 2009, the Treasury deficit for 2009 will be ISK 150 billion (The Ministry of Finance 2009).

In November 2008, the IMF had approved a two-year Stand-By Arrangement for Iceland to support the country's programme to restore economic stability. According to the plan, Iceland will receive a loan of US$ 2.1 billion from the IMF, and supplementary loans totalling some US$ 3 billion from Denmark, Finland, Norway, Sweden, Russia, and Poland. In addition, the Faroese Government offered Iceland a loan of approximately US$ 50 million (International Monetary Fund 2008).

As stated above, Iceland did not seek EU membership at the same time as the other EFTA states in the early 1990s. The negotiations on the EEA, between the EFTA states, on the one hand, and the EU member states, on the other, were at their height when the Cold War ended and the Soviet Union collapsed, and the EFTA states started to look at the EEA Agreement as a temporary solution. They all sought full political and economic integration with the European Union – though the electorates in Norway and Switzerland prevented their political elite from joining the Union. Iceland, Norway and Switzerland and Liechtenstein became stranded within the EFTA and EEA (Switzerland did not join the EEA since the electorate refused to ratify the agreement and consequently the Swiss government froze its EU application). Accordingly, the Swiss government found it necessary to conclude a series of bilateral agreements with the EU and join the Schengen scheme. This can be explained by a combination of a pressure from the ongoing European integration process on a small state, a quest to benefit from it and a longing for a partial shelter in the European project. The decision by the Icelandic government not to apply for EU membership had, in fact, been a deliberate decision. This decision was repeated by all subsequent coalition governments until the spring of 2009. When the financial crisis hit the country – despite partial engagement in the European integration and having been protected economically by the American eagle for decades – the country was suddenly on its own without a proper American or European shelter.

Searching for Shelter

In spring 2008, the rapid fall of the 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). All political parties started to examine in greater depth the pros and cons of EU membership. The Progressive Party (the central agrarian party) adopted a pro-European policy, i.e. that Iceland should apply for membership under rigid conditions (Framsóknarflokkurinn 2009). The Social Democratic Alliance (SDP) emphasised, for the first time, strongly its pro-European stance in the election campaign in spring 2009 – focusing mainly on the potential economic benefits of membership and the euro. The EU and the euro became the main election issues, and the SDP gained ground in the election and got 29.8 percent of the vote, even though it had been in government at the time of the crash (since 2007) and was partly blamed for it. The SDP made a EU application a pre-condition for forming a government with the Left-Green Movement despite the outright opposition of the Left-Greens towards EU membership (Vinstrihreyfingin-Grænt framboð 2009). The SDP and the Left-Greens were bound to form a government after the election since, for the first time in Icelandic history, the left had a majority in parliament – after having been in a minority government for three months. The general election had been called at the beginning of the year after the collapse of the coalition government (Independence Party and the SDP), after weeks of violent protests (the most severe in Iceland's

history) and disputes within the government about how to tackle the economic crisis and political unrest.

The leadership of the Independence Party had initiated a detailed examination of the pros and cons of EU membership within the party after considerable pressure from the employers' wing (service and industrial sector) of the party and its coalition partner in government. However, at the special party conference, convened to review its EU policy, the EU opponents, rallied by the powerful forces of the fisheries and agrarian sectors, within the party managed to prevent a policy change. According to the party policy, a 'EU membership does not serve Icelandic interests', referring mainly to the fisheries and agricultural sectors and to the opposition to the transfer of sovereignty and to being bound by the 'flood' of regulations from Brussels (Sjálfstæðisflokkurinn 2009a and b). The firm opposition of the party to EU membership contributed to its election defeat – the worst defeat in its history – when it received only 23.7 percent of the vote, down from 36.6 percent two years earlier. The party remains split on the issue and faces a serious challenge every time it will try to find a common policy towards further European involvement (see discussion in details about the policy of the Independence Party in Thorhallsson 2008b).

The general election unexpectedly provided a majority for a EU application in parliament. The four new MPs of the Citizens' Movement, an offspring of the winter protests, announced that they would support a EU application in order to see what an accession agreement would entail. Thus, the SDP had a strong negotiating position for putting the EU issue on the agenda and for forming a coalition government with the Left Greens, who had won a decisive election victory, receiving 21.7 percent of the votes, up from 14.3 percent. The Progressive Party also advocated for EU membership. Together, the three pro-EU parties received 33 out of 63 seats in parliament. However, to complicate things, it is a known fact that a few of the Progressive MPs are not at all keen on a EU application, and few of the 16 Independence Party's MPs are in favour of an application.

The economic crisis clearly sparked the current debate on possible EU accession. Supporters of closer engagement in the European project have, in fact, always advocated and won approval by emphasising the economic benefits. This was the case for both EFTA and EEA membership. On the other hand, Eurosceptics have mainly emphasised the negative consequences of transferring sovereignty from Iceland to 'supranational' institutions and the negative effects which membership might have for the fisheries and agricultural sectors. Moreover, closer European engagement has been said to threaten the Icelandic way of life and limit Iceland's international room for manoeuvre, e.g. as regards entering into other free-trade agreements and adopting its own negotiating position within international organisations such as the WTO and regarding the Kyoto Protocol on climate change. Eurosceptics have also raised concerns about the costs involved in membership. Furthermore, Iceland's small size, combined with its lack of power resources to influence EU decisions, has been prominent in the arguments used by opponents of closer European integration. The small size of the Icelandic market and its profound reliance on marine exports, leading to substantial volatility of the economy, has also frequently been used as an argument for protectionism: all decisions concerning the economic and monetary policy must be taken in the country itself in order to respond speedily to economic swings. Retaining the Icelandic króna was seen as important in order to have a currency which would fluctuate according to the economy (see, for instance, Thorhallsson 2004d and 2008c).

However, the economic collapse led to a swift change of attitude towards the vulnerability of the economy and its small currency. The volatility of a small economy in the new globalised arena could not be illustrated more clearly. The collapse of the overgrown financial sector, which had sought expansion abroad within the EEA framework, led to economic downsizing on a scale rarely seen before. Iceland had liberalised its economy – particularly its financial sector – without securing the necessary economic and political shelter, e.g. from the European Central Bank and other EU institutes. Iceland, instead of being sheltered by the EU, encountered outright hindrance by its member states in its attempt to seek international assistance, due to the damage the Icelandic financial sector was causing within the Union.

Conclusion

Icelandic governments have reluctantly sought shelter within the framework of European integration in order to guarantee access to the European market and to respond to economic downturns. This was particularly the case in the heydays of Iceland's EFTA and EEA membership. Later, Iceland joined the Schengen scheme to assure the continuation of free movement to the other Nordic states and to enjoy the shelter of European police collaboration. Once again, the government is considering the European alternative, i.e. to join the EU and adopt the euro. A question mark has been put against the chances that Iceland could succeed in nurturing a sustainable economy without the shelter of the formal EU institutional framework and a more stable and reliable euro.

Icelandic governments have preferred the bilateral approach, which proved to be successful when gaining independence from Denmark and was portrayed as the successful method in the Cod Wars with Great Britain over fishing rights in the North Atlantic. The bilateral approach was also the base for the Nordic cooperation and Iceland's relations with the US (see the detailed study by Thorhallsson 2005 and 2006). The failure of this bilateral approach in the economic crash has altered the view of many politicians and interest groups on the feasibility of joining the supranational institutions of the EU. Iceland was left without any suitable bilateral relations or multilateral framework to help out. 'The American century' is clearly over – a period during which Iceland enjoyed the economic and political protection granted by its neighbouring superpower for over half a century. The Nordic cooperation, or Iceland's long-standing bi-lateral relations with its Nordic neighbours, did also not provide such a refuge: the Nordic states simply did not have the resources to come to Iceland's rescue on their own and, in fact, took a stance with their EU partners instead. The assistance provided by the IMF, after the economy came to a standstill, was restricted by British conditions. Thus, Icelanders are seriously considering to what extent the EU and its single currency can offer the country political and economic shelter.

The focus on the concept of sovereignty, the supremacy of fisheries and agricultural interests, an undeveloped economy and the shelter provided by America contributed to the continuation of Euroscepticism in Iceland. As a result, Icelandic policy-makers have neither sought the institutional shelter of the European Union, despite benefiting enormously from access to the common market. Nor have Icelandic politicians wanted to participate in EU policy-making, even though the EU's regulations are implemented in Iceland under the EEA. Although Icelandic governments have responded to the reality that the only way for a small state to have a say about international rules is to become actively engaged in international organisations, such as the WTO, the World Bank and the IMF, they have not taken up the option of becoming an active member of the EU. Thus, they were not able to influence EU regulations (e.g. in the financial sector), nor could they seek protection against domestic and international turmoil under the EU institutional framework. 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.

Regional and international organisations such as the EU, the WTO and the IMF provide small states with an opportunity to become actively engaged in a dialogue with larger powers. Were it not for the existence of these and other multilateral organisations, larger states would simply make rules and regulations on their own – and others would have to follow these due to the larger states' greater administrative, economic, political and military resources. For this reason, international organisations are of fundamental importance for small states. The fact that all small states in Europe have sought EU membership, except for the smallest four which have substantial defence and/or economic co-operation agreements with their larger neighbours (including authorisation to use the euro), indicates the importance of the Union. The EU not only provides access to the largest world market; it provides small states with shelter from economic downturns and a seat at the negotiating table. Access to the decision-making procedure may be as vital as the provided protection shield. This could be seen during Iceland's financial crises: a lack of access to the EU decision-making and contact network. Britain used its anti-terrorist legislation against Icelandic banks and was supported by all the EU member states, delaying the much-needed IMF assistance. Iceland was stuck in bilateral negotiations with Britain, and then later the EU itself, without the comfort of a multilateral framework.

The new globalised economy, particularly the globalised financial sector, makes small states more vulnerable than before to international economic crises, as was illustrated by the events of 2008. All states – including the large powers – sought first and foremost to save their own financial sectors and economies. The only actors that were willing to help individual countries with substantial loans were international organisations such as the EU, the IMF and the World Bank. These institutions rely, of course, on their members' willingness to give assistance, but they provide the framework for backing up the states that were worst hit by the crisis. The countries, which in the end, were willing to lend Iceland money did so under the conditions that the loans would be provided through the IMF framework (Jolly 2008). The EU is the only organisation that provides access to a single currency, support for it, in times of trouble and substantial aid to members in need in the short run as well as in the long run.

On the other side one has to see that European integration also poses several constraints on independent European small states. The common European market and the powerful euro may restrict small states' room of economic manoeuvre. They may find it increasingly more difficult to stand on their own, e.g. conducting their own economic and monetary policy. Thus, they may be pressured into taking full part in the project. On the other hand, small states do have a choice whether or not they want to join the EU as is indicated by the cases of Norway, Switzerland, Iceland, San Marino, Liechtenstein and Andorra. But, the decision not to take part in the European project requires arranging other forms of shelter, such as that provided by a large neighbour, or to be willing to pay the cost of staying out of the Union. The four smallest states have a neighbouring shelter; Norway and Switzerland could afford to stay outside. Iceland could not and paid the price.

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