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**THE GLOBAL FINANCIAL CRISIS
AND THE PROBLEM OF ICELAND'S MEMBERSHIP IN THE EUROPEAN UNION**

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Abstract

The article is an attempt of showing how the global economic crisis has influenced the Icelanders attitude towards the European Union membership. The possible consequences of the accession for Iceland and the European Union as well are also presented. It was until 2008 that the Icelanders had not considered the matter of European Union membership, the more so the prospect of adopting the euro. It turns out that the global economic crisis, which affected the Icelandic economy really badly, changed the government's and Icelandic society attitude towards integration with European Union to a large extent. In July 2009 Iceland officially applied for the membership in the European Union. However, it turned out quickly that the fears about securing the crucial sectors of Icelandic economy in the future accession treaty are beginning to dominate.

Keywords: global financial crisis, Icelandic financial crisis, Iceland's membership in the European Union, EU enlargement, EU internal market.

JEL Classification: F13, F14, F15, F42, F59.

Introduction

Although the Republic of Iceland has been a member of the European Economic Area (EEA) since 1994, taking advantage of the four EU internal market freedoms, it has been in political and economical relationship primarily with the countries of Scandinavia. At the beginning of the 21st century Iceland, thanks to developed over the years efficient economic system, extremely fast-developing banking and services sector, was one of the richest countries in Europe.

A closer look at the island located under the Arctic Circle is worthwhile for many reasons, as it has become world's „financial laboratory” and the crisis of the Icelandic banks in 2008 led this country to the verge of bankruptcy finally refuting the sceptical myth of capitalism among other things. It is also interesting that, even though the EU countries have been the most important economic partners, and the Iceland itself would not have any problems with fulfilling the EU membership criteria, the Icelanders had not considered the prospect of accession to the union.

The article is an attempt of showing how the global economic crisis has influenced the Icelanders attitude towards the EU membership. The possible consequences of the accession for Iceland and the EU as well are also presented.

1. Icelandic financial crisis and its consequences for its economy

Icelandic financial crisis continuing since autumn 2008 is a consequence of the slump in the global economy. The global slump resulted in collapsing of the whole financial system of this tiny island, and forcing the government to nationalise its own banking system. It was revealed that the Icelandic banking system has been built on very unstable basis of foreign debt.

Since the 90's of the 20th century the Iceland's state capitalism has based on pumping virtual money into global economy, invested in dot-coms' shares, real properties, currencies and bonds. The main goal was to keep constant economic growth stimulated by virtual means, which was easier than through increasing national production. In 2003 Icelandic banks started expansion on global scale. Foreign obligations of the four biggest Icelandic banks reached 140 bln euros in autumn 2008¹.

As a result of the crisis Iceland was forced to acquire quickly the three largest Icelandic banks. The first one – Glitnir Bank – was nationalised at the end of September 2008. The Government acquired 75% of shares for 600 mln euros². Next on 7th October 2008 Icelandic

financial supervisory authority – Fjármálaeftirlitið took control over Landsbank, and two days later Kaupthing – the biggest Iceland’s bank³.

The financial crisis caused (and it still does) negative consequences for Iceland’s economy. One of the consequences of the financial problems was drop in the value of the national currency. The drop in the value of the Icelandic króna was an effect of reducing the interest rates in the country. Over the period from October 2007 to October 2008, that is only one year, the exchange rate of the Icelandic króna dropped sharply by almost 70%. In early October 2008 the central bank of Iceland set the exchange rate of the króna in the ratio 197 to one euro. For comparison on the 1st October 2007 exchange rate to euro was 88 and six months later, that is on the 1st April 2008 – 120⁴. Until the early 2011 Króna has not made up the loss in value. The drop of currency exchange rate resulted in high inflation rate.

From the outbreak of the financial crisis in Iceland, the prices in shops have been changing daily, to catch up with the constantly increasing inflation (at the turn of the years 2008 and 2009 it crossed the level of 16 %) ⁵. Fortunately, in 2009 the prices started gradually falling, and the average inflation rate in the first half of 2011 stayed at the level of 2.8%⁶.

The financial crisis restrained the economic growth of Iceland. Gross domestic product of the country decreased from 20.4 bln \$ to 12.1 bln \$ in 2009⁷. According to the data published by Statistics Iceland Agency as many as 555 partnerships declared bankruptcy over the period between January and end of August 2009. In the corresponding period of 2008 470 companies declared bankruptcy. The number of bankrupting companies in 2009 rose by 17% in comparison to the previous year. Vast majority of the bankrupt Icelandic companies consisted of wholesale retail stores and companies from construction and automotive sectors⁸. The crisis contributed to a sudden increase of unemployment, which was almost nonexistent previously.

2. The influence of crisis on Iceland’s attitude towards integration with EU and adopting the euro

The payout of banker’s deposits, worth 5.5 bln British pounds in total, to British customers of the internet bank Icesave in Great Britain and the Netherlands was a problem that Icelandic Government has to face. When it occurred that the Icelandic bank was insolvent, the governments of those two countries laid out the money to pay the amount to their citizens, and Iceland was supposed to compensate British and Dutch expenses in the future⁹. Moreover, one of the consequences of the crisis was the increase of Icelandic public debt from over 50% GPD

in 2008 to as much as 90% GDP in 2009¹⁰. All of the above contributed to a fall of shares and indices stock.

After long negotiations the government of Iceland received a loan as financial support from International Monetary Fund and other countries (including Poland), estimated on amount of 2.1 bln \$¹¹. The financial aid package, which Iceland received from IMF and several European countries undoubtedly contributed significantly to reinforcement of the country's financial position, it stabilised Icelandic Króna and improved the situation of the nationalised banks.

It was until 2008 that the Icelanders had not considered the matter of The European Union membership, the more so the prospect of adopting the euro. The global economic crisis, which caused financial chaos in Iceland and affected the economy really badly, changed the government's and Icelandic society attitude towards integration with The European Union to a large extent.

The fall of banking system and general bad economical situation led to numerous anti-government demonstrations in the whole country, as well as political changes.

On the 25th April 2009 the early parliamentary election was organised, which was won by The Social Democratic Alliance party opting for deepening the integration with The European Union. After the victory the new Icelandic Prime Minister Jóhanna Sigurðardóttir stated that from that moment the most important task – except for fighting the crisis – would be applying for EU accession and adopting the euro¹².

The official application for Iceland's accession to The European Union was put forward on the 23rd July 2009¹³. Entering the group was perceived as a way out of the recession and protection from potential future economic crises. According to the Prime Minister of Iceland and pro EU groups instant adoption of the euro currency would advance the current struggle with the financial and economic crisis. The financial crisis with all its social consequences caused the increase in pro EU moods among the Icelanders, who until 2008 had not treat the possible integration with The European Union favourably. In the opinion poll carried out in Iceland on 30th July 2009, that is only three days after passing the application for the EU membership by the the Iceland's government, 51% of the respondents expressed their favour for the beginning of negotiations, whereas only 36% rejected the proposal¹⁴.

In spite of many protests and the fact that in relation to: GDP, private and public debts, currency exchange rate, stock indices the island was struck by devastating "turbocapitalism", *hrun*¹⁵ of the Icelandic economy, after some time, has been perceived as something as natural as volcanic eruption. The announced massive emmigration of the Icelanders has never happened. It seems that, the current financial crisis has not changed the Icelanders' everyday life diametrically,

especially among those, who have always believed that money can be obtained only by hard work and rejected living on credit promoted by banks

However, it turned out very quickly that the society is in no hurry to become a member of the European Union. This fact has been confirmed by the firm lack of support for this case in the opinion polls that have been carried out on a regular basis.

The results of the latest opinion poll carried out in March 2011 and published in Icelandic newspaper *Viðskiptablaðið* show that there has been a tremendous change in attitude of the Icelandic society towards the integration with the European Union: over 55% of the Icelanders were against, while only 30% supported the idea of Iceland's membership in the EU structures¹⁶.

3. The benefits and costs resulting from the membership in the European Union for Iceland and for the union

Many benefits as well as costs, considered mainly on the economic and political ground, are related to Iceland's membership in the European Union. The European Union also declares that Iceland's accession to the organisation will bring mutual, substantial benefits. The accession would decrease the impression of marginalization of this country in EEA thanks to possibilities of developing the union law, among other things. Even though, it may take years to introduce the whole union law, the most important thing is that Iceland as a rightful member of the union could fight for their rights in the crucial areas, as well as promote their priorities at the forum of the whole group. Thanks to the EU membership Iceland would have influence on modeling peace and providing security in Europe. Thereby the country would strengthen its position in Europe and in the world.

The Icelandic society would also benefit from the accession as the prices of products would fall. Within the Common Agricultural Policy the Icelandic farmers would receive direct subsidy and the citizens could benefit from the EU structural funds for the rural areas development. Undoubtedly the consumers would gain an access to many more commodities and wider range of services, offered in stronger market competition. After meeting the requirements of convergence Iceland could also reach the higher level of integration, that is economic and monetary union. By entering the monetary union Iceland would gain more benefits resulting from membership in uniform union market. Single currency would make it possible for the Icelandic companies to access foreign financial markets to a greater extent on much more favorable conditions than they have had so far. Elimination of the currency fluctuation reduces insecurity related to future

benefits of exporters and importers. The countries of the euro zone are Iceland's most important trade partners, so after adapting the euro currency the Icelandic export to the euro zone would increase. However, after accessing the European Union and adopting its currency Iceland would not be able to influence its own monetary policy, which results from the fact that monetary policy of the European Central Bank does not have to be favorable for the Icelandic economy. Furthermore, the fact of being a member of the European Union itself does not guarantee that, in case of another economic crisis or any other troubles, Iceland will receive any financial support from other members of the European Union. The present crisis revealed explicitly that there is no unity in the European Union. The countries struggling with the highest levels of deficit and public debts, that are on the verge of bankruptcy like for instance Greece, were basically left without any support. The eurosceptics' belief that Iceland's accession to the European Union would not protect it from another potential banking crisis may become true.

It is worth noticing that significant part of the Icelandic society changed their attitude towards the possible membership in the EU over the last year.

The fears that the country's interests in the crucial sectors of economy would not be secured are gradually dominating. The Icelanders claim that from the very first day of their membership their economic independence would be restrained, since the most important sectors of their economy – fishing and agriculture – are subordinated to the EU decisions. The fishermen, who fear the imposed by the Brussels fishing amounts, are the group that may lose the most on the EU membership and consequently all the consumers of the fish products.

Officially Iceland began the accession negotiations in July 2010 and over a year till June 2011 managed to settle about one third of the negotiation chapters¹⁷.

In the first report on the progress of Iceland's preparations to membership presented by European Parliament Foreign Affairs Committee on the 22nd of March 2011 the committee assessed the preparations positively and supported all the actions undertaken in this field.

The agreement, by the law of which Iceland committed itself to pay off the debts of the Icesave bank until the year 2016, was positively received by the EU members. Still the most arguable field of negotiations remains the case of whaling (banned by the union) and fishing. It is hard to predict whether both sides can reach satisfying compromise.

European Parliament Foreign Affairs Committee insists on taking up constant negotiations and calls for better informing the Icelanders about their results and the benefits of the European Union membership to gain higher support in the upcoming national referendum¹⁸.

Conclusions

In spite of the present economic crisis, Iceland remains modern and developing dynamically economy with young and well educated society. It has huge potential in such sectors as maritime management, renewable sources of energy, tourism and services. Investments in those fields, supported by rescue aid from IMF and possible EU membership give big hopes for economic stabilization in this country in the near future.

The economic predictions made by OECD experts show that, starting in 2011 the GDP in Iceland should be expected at the level of 2.2% and 2.9% in 2012¹⁹. Fitch rating agency also changed the rating of the sovereign creditworthiness from negative to stable in the opinion published on 16th May 2011. According to the experts the Icelandic economy begins stabilising²⁰. In spite of the crisis the Icelandic banks are still relatively flexible in their relations with their debtor, most of whom renegotiate paying off their debts.

The Icelandic society is currently involved in heated discussion about possible accession to the European Union. Unfortunately the xenophobic moods rose, and people are afraid of multinational companies influence as well as negative effects of accession to the European Union. At the same time it is worth mentioning that, after three years from the financial crisis outbreak Iceland is handling pretty well, reducing its foreign debt, raising banking flow, creating new streams of foreign trade and supporting national ventures.

Andrim Snaer Magnason states that proper use of the potential of Iceland based on renewable energy and constantly developing tourism should guarantee constant economic growth in the future and high standard of living for its citizens. Making the country dependent on great foreign corporations is not necessary, as many small independent companies are appearing on the high-tech market, and the membership in the European Union will not contribute significantly to the increase of national wealth and dynamic economic growth²¹.

Iceland's membership in the European Union structures means many immeasurable benefits for the group and for the country itself. What is more Iceland meets almost all the requirements crucial to become one of the members of the European Union. The European Parliament expressed an opinion, in a resolution published in the early April 2011²², that Iceland "has reached the advanced stage in meeting the requirements of ten negotiation chapters and partly meets the requirements of another eleven negotiation chapters". Nevertheless, as Pawel Frankowski²³ points out, Iceland is a country, which can be characterised by strong feeling of national identity, as well as affiliation with the Nordic countries which shun from entire integration with other european countries. For this reason, that is other, independent character

of foreign policy and lack of conformity as to many union priorities, despite the fact that there are many potential benefits following deeper integration, Iceland may suspend the ongoing membership negotiations. Also the question of society's support for the negotiations with the European Union remains unanswered, and the people are those whose voice will be deciding in case of their future membership in the European Union.

Notes

- ¹ Sutkowski (2010), p. 136, 138.
- ² *Iceland's State acquiries 75 percent in Glitnir Bank*, http://icelandreview.com/icelandreview/daily_news/?cat_id=16539&ew_0_a_id=312851.
- ³ Guðmundsson, M., *The financial crisis in Iceland: causes, consequences, policy responses and recovery*, Central Bank of Iceland, s. 3, <http://www.sedlabanki.is/?PageID=287&NewsID=2298>.
- ⁴ *Statistics: Euro foreign exchange reference rates*, European Central Bank, <http://www.ecb.int/stats/exchange/eurofxref/html/eurofxref-graph-isk.en.html>.
- ⁵ *Inflation – comparison with MB 2011/1*, Central Bank of Iceland, <http://www.sedlabanki.is/?PageID=202>.
- ⁶ *Price developments*, Central Bank of Iceland, <http://www.sedlabanki.is/?PageID=201>.
- ⁷ *Iceland – GDP (current USD)*, The World Bank, <http://data.worldbank.org/indicator/NY.GDP.MKTP.CD>.
- ⁸ *Bankruptcy rates slowly decreasing in Iceland*, <http://www.icenews.is/index.php/2009/09/29/bankruptcy-rates-slowly-decreasing-in-iceland/>.
- ⁹ Bowers (2010).
- ¹⁰ *Iceland: Economy*, <https://www.cia.gov/library/publications/the-world-factbook/geos/ic.html>.
- ¹¹ *Iceland set for \$2. bn IMF help*, <http://news.bbc.co.uk/2/hi/business/7689633.stm>.
- ¹² Totaro (2009).
- ¹³ *Press release: Iceland submits its formal application in Stockholm* (2009).
- ¹⁴ *Riflegur meirihluti styður ESB – viðraeður* (2009).
- ¹⁵ isl. crisis, crash.
- ¹⁶ Guðmundsson, H.J. (2011).
- ¹⁷ *Iceland 2010 Progress Report* (2010), p. 5.
- ¹⁸ *MEPs welcome Iceland's progress towards EU membership* (2011).
- ¹⁹ *Iceland – Economic forecast summary*, OECD.
- ²⁰ *Positiva tecken för Island*, Svenska Dagbladet.
- ²¹ Magnason (2010), p. 164–170.
- ²² Rezolucja Parlamentu Europejskiego z 7 kwietnia 2011 r. (2011).
- ²³ Frankowski (2011).

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