ON ICELAND'S FINANCIAL CRISIS

by

Shaun Fantauzzo
B.A., University of Windsor, 2012

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Abstract

The global financial crisis has provoked a robust debate in international political economy literature. Existing studies afford readers with a thorough analysis of the impacts of neoliberalism and market fundamentalism, both of which are regarded as determinants of economic and political volatility. These studies identify a relationship between financialization and volatility that is encouraging as it permits for a more qualitative assessment of global phenomena, therefore facilitating a greater understanding of country-level experiences of the global financial crisis, of which there exists substantial and puzzling variation. Iceland's financial crisis is an example of this variation.

Though Iceland's financial liberalization occurred during an era of unprecedented international financialization, this does not explain why Iceland's government prohibited foreign competition, nor does it explain the rapid, astronomical growth of Iceland's banking sector between 2002 and 2008. Furthermore, Iceland's refusal and subsequent inability to honor foreign debt obligations represents a new development that merits addition consideration. These discrepancies provoke a number of questions regarding the impact that Iceland's institutional structure has on domestic and international developments, such as the liberalization of its financial sector and the financialization of the global economy. This suggests not that Iceland's financial crisis is a purely domestic phenomenon, but rather that domestic institutions played a unique role in exacerbating the impact of neoliberalism and market fundamentalism.

I develop a conceptual framework informed by Mancur Olson's theory of 'institutional sclerosis' to reveal the institutions that pre-dated Iceland's financial collapse and argue that Iceland's corporatist structure is conducive to capture, resulting in a disproportionately overextended banking sector. In addition, I summarize the events of Iceland's debt negotiations to provide a more comprehensive understanding of what influenced Iceland's politicians to provide continued support for honoring foreign debt obligations despite a clear 'no' mandate afforded by Icelanders in both referendums, as well as why Iceland honored foreign debt obligations altogether, allowing for proper conclusions to be drawn about Iceland's recovery model and its implications for existing theories in the fields of international political economy and global governance.

Preface

This thesis utilizes a process tracing qualitative methodology that sheds insight into Iceland's rapid, astronomical banking sector growth preceding its financial crisis in 2008. In addition to the literature already established on Iceland's financial crisis, I use primary sources to confirm the causal mechanism presented in this paper. For instance, I use internal reports from Iceland's central bank, debt reports from Landsbanki, statistics from OECD, IMF, and the World Bank, and court documents from The Court of Justice of the European Free Trade Association States, as well as numerous news sources from within Iceland and Europe during the time of its crisis.

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Dedication

To my late grandfather, Leonard. Everything is going to be okay.

Foreword

‘Suppose further that the message of this book was then passed on to the public through the educational system and the mass media, and that most people came to believe that the argument in this book was true. There would then be irresistible political support for policies to solve the problem that this book explains. A society with the consensus that has just been described might choose the most obvious and far-reaching remedy: it might simply repeal all special-interest legislation or regulation and at the same time apply rigorous anti-trust laws to every type of cartel or collusion that used its power to obtain prices or wages above competitive levels. A society could in this way keep distributional coalitions from doing any substantial damage. This remedy does not require any major expenditure of resources: intelligent and resolute public policies would by themselves bring great increases in prosperity and social performance.’ – Mancur Olson (1982) *The Rise and Decline of Nations*, p. 236

Introduction

The collapse of Iceland's financial system in 2008 constitutes a puzzle. Despite an average OECD asset-to-GDP ratio of 331% in 2008, Iceland's financiers amassed assets exceeding 900% of Iceland's economy.[1] Furthermore, Iceland's asset-to-GDP growth rate between 2002 and 2008 was 466% compared with an average OECD growth rate of 53%. What is responsible for Iceland's disproportionate banking sector growth and how is it different from other countries?[2] Unlike other countries, Iceland's banking sector growth was primarily generated within Iceland. At the time, Iceland's banks–Glitnir, Landsbanki, and Kaupthing–engaged primarily in securities lending with one another, unlike American and European financial institutions, which were lending beyond national borders. As a result, Iceland's banks were generating financial risk domestically rather than internationally, as was the case with many financial institutions preceding the financial crisis. For instance, in other countries–Ireland, Estonia, Latvia, Cyprus–banking sector growth, and the risk thereof, was internationalized. The banks in these countries were foreign-owned and engaged in securities lending that extended beyond their borders, not only increasing their exposure to foreign fluctuations, but also generating substantial systemic risk in the global economy. Iceland's banks, however, generated financial risk relatively independent of the global economy.[3] Furthermore, Iceland's financial crisis was largely insulated, with the exception of British and Dutch taxpayers who lost assets following Landsbanki's bankruptcy.

Following Lehman Brothers' collapse in September 2008 and the seizure of international credit flows, however, Iceland's banks found themselves unable to allocate capital needed to finance long-term liabilities, prompting their nationalization.[4] The situation escalated in 2008 after the Financial Supervisory Authority (FME), Iceland's financial regulator, declared that Iceland was incapable of honoring foreign debt obligations held in the United Kingdom and the Netherlands, a row known as the 'Icesave dispute.' Furthermore, just one day before the collapse of Landsbanki–which held British and Dutch assets–Iceland's parliament passed emergency legislation refusing to honor foreign debt obligations should Iceland's financial institutions become insolvent (a decision that prompted British authorities to act aggressively towards Iceland's government). In response, the FME separated domestic debt obligations from their foreign counterparts and shifted them into three newly capitalized banks–New Glitnir, New Landsbanki, and New Kaupthing–guaranteeing the deposits of Icelandic individuals. Foreign debt obligations, however, remained the responsibility of Iceland's former banks, the assets of which were eventually sold in an attempt to recover losses. The inability and subsequent refusal of Iceland's central bank to act as a lender of last resort resulted in the United Kingdom and the Netherlands taking legal action against Iceland's government, the result of which was a precedent-setting decision on the legal obligations of cross-border banking in the European Union.

The global financial crisis has provoked a robust debate in international political economy literature concerning the relationship between domestic and international institutions, the ability of central banks to act as a lender of last resort, and the political implications of financial crises. Existing studies afford readers with a thorough analysis of the impacts of neoliberalism and market fundamentalism, both of which are regarded as determinants of economic and political volatility. There is also a considerable amount of evidence that unprecedented international financialization amplified systemic risk.[5] For instance, in *Freefall: America, Free Markets, and the Sinking of the World Economy*, Stiglitz (2010) argues that the global financial crisis was triggered by decades of fiscal and monetary mismanagement promoted by the United States and the Federal Reserve under the guise of the efficient markets hypothesis. In *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*, Johnson and Kwak

(2010) discuss the political determinants of economic volatility by revealing the influence of a small elite of Wall Street bankers that successfully engineered the deregulation of the United States financial industry. These studies identify a relationship between financialization and volatility that is encouraging as it permits for a more qualitative assessment of global phenomena, therefore facilitating a greater understanding of country-level experiences of the global financial crisis, of which there exists substantial and puzzling variation.

Iceland's financial crisis is an example of this variation. Though Iceland's financial liberalization occurred during an era of unprecedented international financialization, this does not explain why Iceland's government prohibited foreign competition, nor does it explain the rapid, astronomical growth of Iceland's banking sector between 2002 and 2008. Furthermore, Iceland's refusal and subsequent inability to honor foreign debt obligations represents a new development that merits additional consideration.[6] These discrepancies provoke a number of questions regarding the impact that Iceland's institutional structure has on domestic and international developments, such as the liberalization of its financial sector and the financialization of the global economy. This suggests not that Iceland's financial crisis is a purely domestic phenomenon, but rather that domestic institutions played a unique role in exacerbating the impact of neoliberalism and market fundamentalism. Prior studies of Iceland's financial crisis (Sigurjonsson and Mixa 2011; Wade and Sigurgeirsdottir 2011; Wade and Sigurgeirsdottir 2012) focused on the failures of market fundamentalism and the consequences of financial exuberance, paying less attention to the institutional structures responsible for facilitating Iceland's disproportionate growth in the years preceding its financial collapse. Moreover, prevailing assumptions regarding Iceland's recovery model are premature and further research is necessary to determine whether or not it can serve as a model for other countries in crisis.

Similar to Peadar Kirby's (2010) treatment of the Irish financial crisis in *Lessons from the Irish Collapse: Taking an International Political Economy Approach*, this thesis seeks to shed light on the institutions that contributed to the scope of Iceland's financial crisis in 2008. I develop a conceptual framework informed by Mancur Olson's theory of 'institutional sclerosis' to reveal the institutions that pre-dated Iceland's financial collapse and argue that Iceland's corporatist structure is conducive to capture, resulting in a disproportionately overextended banking sector.[7] In addition, I summarize the events of Iceland's debt negotiations to provide a more comprehensive understanding of what influenced Iceland's politicians to provide continued support for honoring foreign debt obligations despite a clear 'no' mandate afforded by Icelanders in both referendums, as well as why Iceland honored foreign debt obligations altogether, allowing for proper conclusions to be drawn about Iceland's recovery model and its implications for existing theories in the fields of international political economy and global governance. This research will not only contribute to international political economy literature by providing a greater understanding of the interplay between Iceland's political structure and the global economy, but it will also provide a foundation for additional research on Iceland's financial crisis, as well as the Icesave debt negotiations by revealing how Iceland's institutional structure contributed to the rapid, astronomical banking sector expansion that preceded its financial crisis in 2008.

Glitnir, Landsbanki, and Kaupthing Collapse

The collapse of Iceland's banking industry in 2008 culminated in an economic crisis considered to be among the severest faced by any OECD country (Spruk 2010; Sigurjonsson and Mixa 2011). Despite favorable reviews of Iceland's economic performance prior to 2008 (Mishkin 2006; Laffer 2007), an investigative report published by Iceland's parliament (Alþingi 2010) shows that the relationship between Iceland's political elite and its financial industry facilitated a crony-corporatist environment that hampered Iceland's regulatory capacity, resulting in a grossly overextended banking sector.[8] For instance, Iceland's banks held combined assets in 2007 valued at 923% of GDP (IMF 2008, 11), placing them among the world's 300 largest banks.[9] The FME, however, staffed only 45 individuals–vastly outnumber by the cohort of financiers, lawyers, and businessmen representing Iceland's banks–most of whom resigned from their public duties to seek employment in the more lucrative private sector. Perhaps most discerning is that the level of liabilities denominated in foreign currencies grew eight times the level of Iceland's foreign currency reserve (Alþingi 2010, 3). Following the nationalization of Iceland's banks, the FME announced that Iceland would not be prepared to honor foreign debt obligations accrued by Landsbanki in the United Kingdom and the Netherlands, prompting an economic and political crisis that strained diplomatic ties with Europe and delaying the government's ability to refinance domestic financial institutions.

The collapse of Lehman Brothers in September 2008 sent Iceland into a severe economic recession. Real GDP growth dropped from 6% in 2007 to 1.3% in 2008, reaching a low of -6.8% in 2009 when Iceland began to show some signs of recovery. Inflation peaked at 12.7% in 2008 and remained steadily above 12% until 2009 during which the krona, Iceland's currency, depreciated nearly 100% against the dollar. In addition, unemployment rose from 3% in 2008 to 7.3% in 2009, rising even further to 7.6% in 2010.[10] Iceland's parliament responded by enacting the *Emergency Act*, permitting Iceland's central bank to implement strict capital controls and raise interest rates to 18% in an attempt to prevent capital flight and runaway inflation – both of which would have crippled Iceland's ability to stimulate domestic consumption and production. During the last days of October, the Nordic countries formed a joint committee with the International Monetary Fund (IMF) to discuss extending a structural adjustment loan to Iceland (Icelandic Chamber of Commerce 2012, 79). On 19 November 2008, Iceland received a joint $4.6 billion loan to stabilize the krona, recapitalize domestic financial institutions, and restore confidence in the economy.[11] Shortly after, Icelanders–disgruntled with the right-wing government that presided over Iceland's financial collapse–voted into power the Social Democrats and the Left-Greens, erecting Iceland's first left-wing government.

Debt negotiations with the United Kingdom and the Netherlands elicited two national referendums–held on 6 March 2010 and 9 April 2011–asking Icelanders to decide whether or not the government should honor foreign debt obligations owed to British and Dutch individuals accrued through Landsbanki's overseas operations. In both referendums–against the advice of Iceland's parliament–Icelanders strongly opposed honoring Iceland's foreign debt obligations, provoking an extensive legal battle between Iceland and the British and Dutch authorities that has only recently been settled by the Court of Justice of the European Free Trade Association States (EFTA) in Iceland's favor. In response, international credit rating agencies–Moody's, Fitch, and Standard and Poor–downgraded Iceland's sovereign debt from lower medium grade to non-investment grade, otherwise known as 'junk status.'[12] Nevertheless, Iceland's economy is showing signs of recovery, prompting the prepayment of debts to the IMF and the Nordic countries that extended loan support to Iceland in 2008. For instance, Iceland's GDP growth rate increased from -4% in 2010 to 3.1% in 2011 and the government deficit as a percentage of GDP decreased from a high of -13.5% in 2009 to a low of -4.4% in 2011. As a result, Iceland is frequently touted as a successor of the global financial crisis by academics and pundits, such as Krugman (2012, July 8th) and Stiglitz (2011, October 27th), both of whom have suggested using Iceland's recovery model in other financially troubled countries.

Applying Olson to Iceland

Mancur Olson's seminal works, *The Logic of Collective Action* and *The Rise and Decline of Nations*, offer a unique perspective of the institutional determinants of economic and political decay. Suggesting a negative relationship between the duration of a country's stability and economic growth, Olson theorizes that long-standing democracies are more likely to foster the proliferation of special-interest groups seeking protectionist legislation, resulting in economic and political stagnation. To support his theory, Olson (1982) outlines nine implications and conducts (among others) a comparative study of post-war economic growth in Britain, Germany, and Japan, arguing that special-interest groups in Britain are responsible for weak post-war economic growth compared with Germany and Japan: "In short, with age British society has acquired so many strong organizations and collusions that it suffers from an *institutional sclerosis* that slows its adaptation to changing circumstances and technologies" (78). In addition, Olson states that a country's culture will begin to change as special-interest groups persuade politicians and the electorate in their favor: "As time goes on, custom and habit play a larger role. The special-interest organizations use their resources to argue that what they do is what in justice ought to be done. The more often pushy entrants and nonconforming innovators are repressed, the rarer they become, and what is not customary is 'not done'" (86).[13]

In *The Logic of Collective Action*, Olson traces the formation of interest groups and stipulates that group size, behavior, and success depends heavily on whether or not the provided good is inclusive or exclusive. For instance, interest groups lobbying for an inclusive good–minimum wage–have an incentive to increase membership in order to pool resources. There is an additional incentive to increase membership since defecting members are able to free ride (a problem that prevents larger groups from being more efficacious than smaller groups). On the contrary, interest groups lobbying for an exclusive good–financial deregulation–have an incentive to limit membership, thereby increasing organizational aptitude and strengthening policing mechanisms. Larger groups, however, face coordination issues that smaller groups do not by virtue of having fewer members, allowing smaller groups to operate more efficiently: "In general, social pressure and social incentives operate only in groups of smaller size, in the groups so small that the members can have face-to-face contact with one another. In any large group, everyone cannot possibly know everyone else, and the group will *ipso facto* not be a friendship group; so a person will ordinarily not be affected socially if he fails to make sacrifices on behalf of his group's goals" (62).

Olson's theory of collective action and his rationalization for the stagnation of long-standing democracies permits for a greater understanding of the individuals, interest groups, firms, and institutions responsible for the rapid expansion of Iceland's banking sector preceding its financial collapse in 2008.[14] To begin with, Olson argues that the proliferation of *distributional coalitions*–narrow special interest groups intent on redistributing wealth among their membership–explains economic and political decay in long-standing democracies. Contrary to *encompassing coalitions*–larger groups interested in increasing economic growth and prosperity in society as a whole–distributional coalitions lobby for special treatment, such as subsidies, tax credits, deregulation, etc. The proliferation and cartelization of these groups redirects capital from productive means to non-productive means (i.e. from research and development to lobbying expenses), reducing innovation and competition, while increasing rent-seeking and wealth redistribution. As special interest groups gain political influence, the capacity for reform decreases and economic activity begins to stagnate (or decline). In addition, distributional coalitions will eventually seek to limit their membership even further, redistributing benefits to a much smaller group of individuals. This is precisely the case in Iceland, where financial interests persuaded politicians and the electorate to support the efficient markets hypothesis–reducing the FME's regulatory capacity–enabling Iceland's banking sector to expand well beyond its means.

Despite the insights it offers, Olson's theory does not seamlessly explain Iceland's financial collapse. It is therefore necessary to modify it to account for new variables, such as the size of Iceland's population, the evolution of its corporatist structure, as well as the new parameters of a global economy characterized by unprecedented financial interdependence. The standard account of the global financial crisis–bad governance, ineffective regulation, overleveraging–does not explain why countries like Iceland, Ireland, and Luxembourg experienced more dramatic developments (i.e. disproportionate banking sector growth). These more extreme features of Iceland's economic behavior preceding its collapse present a puzzle that necessitates an explanation of why Iceland's institutions permitted such behavior. The remaining sections of this paper apply and alter Olson's theory, as set out in *The Rise and Decline of Nations*. Olson's assumptions will be tested against the narrative of Iceland's rise and decline and used to identify the determinants of Iceland's institutional development before and after its financial crisis. According to Olson (1995), "Economic policies are the result of causal forces. Thus, an explanation is needed of why Sweden and other Nordic and Teutonic economies (read: Iceland) first chose arrangements that brought impressive economic performance and then, as time went on, chose unsuccessful policies" (22).

Iceland's Institutional Sclerosis

In his seminal work, *Small States in World Markets*, Pater Katzenstein (1985) argues that small states generally have fewer resources, are heavily dependent on international trade, and appear vulnerable, compelling them to adopt a system of 'democratic corporatism' (30). Corporatism offers three things to small states: "… an ideology of social partnership, a centralized and concentrated system of economic interest groups, and an uninterrupted process of bargaining among all of the major political actors across different sectors of policy" (80). Iceland, following its independence in 1944, gradually adopted a variant of democratic corporatism that emphasized nationalism–'Þjóðernishyggja,' Icelandic for *nationmindedness*–and protectionism, affording domestic industry the advantage of operating without competition. Iceland's economic success is partly explained by its sociopolitical dynamics–cultural homogeneity, nationalistic pride, and party patronage–eliciting a more personal dialogue between Iceland's economic and political elites. For instance, Gellner (1983) and Campbell and Hall (2009) argue that small states with culturally homogenous populations are better coordinated and thus more likely to develop a stronger sense of national identity, conditions that are conducive to stability: "The willingness to sacrifice for the sake of the nation – often results from the sort of strong national identity found among people with a common culture. Thus, insofar as cooperation and sacrifice are beneficial for industrial societies, culture and homogeneity is an advantage" (552).

Katzenstein and Olsons' theories warrant a greater understanding of the interplay between Iceland's corporatist structure and its interest groups. Consistent with Katzenstein's framework for small states, Iceland emerged from Danish and Norwegian feudalism in the 1940s by embracing nationalism and adopting corporatism, resulting in strong alliances between government and industry. Contrary to Katzenstein, however, Iceland's corporatist evolution did not permit for equitable consensus building due to a number of structural constraints. For instance, Thorhallsson (2010) argues that Iceland's electoral design disproportionately benefitted agrarian and fishing interests located in Iceland's rural coastal areas. Although proportional representation electoral systems typically disperse political power, Iceland's agrarian and fishing lobbies–represented by Iceland's dominant right wing parties, the Independence Party and the Progressive Party–capitalized on this benefit, urging the government to implement protectionist measures that led to the rapid expansion of Iceland's fishing industry in the 1960s and 1970s.[15] These developments prompted a similar evolution of Iceland's manufacturing and financial interests, both of which enjoyed solidarity with Iceland's agrarian and fishing interests (379). The success of Iceland's special interest groups, however, cultivated an environment conducive to capture: "… when the Independence Party started to implement its neoliberal policies, it kept agrarian and fisheries interests intact by means of a sectoral corporatist structure and its compensation mechanism. The business-oriented sectoral corporatist structure, in fact, created an ideal framework for the neoliberal agenda" (379).[16]

The rapid expansion of Iceland's financial sector can therefore be explained considering the relationship between Iceland's governing parties and its industry. In the 1960s, following the brief collapse of Iceland's fishing industry, Iceland's government began liberalizing core tenets of the economy. By the 1970s, measures were taken to devalue the krona, reduce tariffs, raise interest rates, and abandon price-wage indexation, signaling to Icelanders and those abroad that Iceland had entered into an era of modernization. The business-oriented sectoral corporatist structure, however, prevented Iceland's government from implementing a competitive financial structure. Much like its industrial counterparts, Iceland's financial sector is heavily protected from foreign competition. For instance, following the implementation of Iceland's quota regime, fishing industry interests lobbied to exclude foreigners from obtaining shares of Iceland's total allowable catch (TAC).[17] Furthermore, Iceland's agrarian and fishing sectors are self-regulated

(Jónsson 1990; Hugason 2002), a key feature of Iceland's financial sector. Consistent with Olson's claim that symmetrical organization is unlikely between groups with common interest, Iceland's distributional coalitions–representing agricultural, fishing, manufacturing, and financial interests–have prevented more encompassing coalitions–i.e. the Financial Supervisory Authority, the Organization of the Disabled, and in general, Iceland's left-wing representatives–from gaining political traction. As a result, Iceland's distributional coalitions possess an *ipso facto* monopoly on political power that has persisted for almost seventy years.

Olson's theory suggests than any number of groups compete with one another and because some groups are more strategic than others, symmetrical organization–and thus optimal policymaking–is unattainable. There is little evidence, however, of a causal link between group symmetry and optimal policymaking (Cameron 1998, 569). Furthermore, it is not clear how Olson defines 'optimality' (569):

> It is not evident that the optimal outcomes, however defined, depend simply on the presence or absence of comprehensive bargaining. Nor is it evident that the latter depends, in turn, on the symmetry of group organization. Comprehensiveness of bargaining presumably depends on a rule or norm governing the inclusion or exclusion of groups from the bargaining process. But it is not evident that the rule or norm can be inferred simply from the degree of symmetry among groups.

Iceland's economic success between 1960 and 1989 provides evidence that group symmetry is not a necessary precondition for optimal policymaking. For instance, Iceland's fishing industry, although heavily protected by legislation influenced by Iceland's fishing lobby, has been tremendously profitable (and sustainable) since reform in the 1970s. Intra-lobby competition in Iceland is unnecessary as a result of Iceland's small population and size. Whereas interest groups in larger countries are compelled to bargain and compete with one another for government rents, norms and conventions formed in the years following Iceland's independence–consistent with Olson's second implication–have facilitated the cartelization of Iceland's interest groups instead of their rivalry. Furthermore, Iceland's more encompassing coalitions–labor, specifically–have been comparatively absent from the policymaking process. As a result, Iceland's interest groups operate relatively free of domestic and international competition. There are few reasons to suspect, however, that the cartelization of Iceland's interest groups has prevented optimal policymaking (aside from the rapid expansion of its banking sector preceding its financial collapse).[18]

Iceland's business-oriented sectoral corporatist structure–emphasizing discourse between government and industry rather than between government, industry, and the general public–explains the formation and consolidation of Iceland's interest groups (Kristinsson et al. 1992; Schmidt 2008; Thorhallsson and Kattel 2012). For instance, Thorhallsson and Kattel (2012) argue that, "Policymaking in Iceland has been characterized by centralization, the strong position of its political parties, and the considerable political weight of its rural regions and primary economic actors, and its substantial emphasis on political favoritism rather than general policymaking" (10). Furthermore, Iceland's institutional structure reduces the role of consensus building, compelling the government to build stronger alliances with party patronage (10). These conditions prompted the government to extend similar benefits to its manufacturing and financial sectors–both of which are constituents of Iceland's dominant parties–prompting their rapid expansion. On the contrary, Iceland's labor interests have historically been absent from the policymaking process (Óskardóttir 1997), resulting in distrust between Iceland's governing parties and their labor-market counterparts (Kristinsson 1993). The rapid expansion of Iceland's banking sector, however, is characteristically different from the growth of its agrarian and fishing sectors in the

1960s. For instance, systemic risk associated with the general euphoria of financial services is much less prominent in productive sectors, such as agriculture and fishing.[19]

Motivated by international developments–Reaganism in the United States, Thatcherism in the United Kingdom, and the proliferation of the 'Washington Consensus'–Iceland's financial liberalization featured core tenets of neoliberalism as promoted through the efficient markets hypothesis. Furthermore, a group of students from the University of Iceland–writing for the pro-market journal, *The Locomotive*–persuaded Icelanders of the benefits of 'modernization,' a term meant to symbolize Iceland's departure from the statism into the luxurious world of 'free markets.'[20] Unlike other countries, however, Iceland's government privatized state-owned enterprises almost exclusively to members of Iceland's economic and political elite, essentially prohibiting foreign competition.[21] For instance, Iceland's oligarchs–known collectively as 'The Octopus' and 'The Squid'–control a large portion of Iceland's wealth and are embedded within the political culture of Iceland's dominant parties: "The Octopus controlled the right-wing Independence Party, which dominated the media and decided on senior appointments in the civil service, police, and judiciary. The other right-wing party was the Centre Party, also known as the Progressive Party, based in the rural economy and controlled by its business arm (sometimes known as The Squid). These two parties provided most of the governments for the past 60 years [following independence]. They effectively ran the state-owned banks and prominent figures within them owned the two main daily newspapers" (Wade and Sigurgeirsdottir 2012, 132).

These conditions provided a conduit for the privatization of Iceland's state-owned banks to party patronage in 1998: "Of the banks, Landsbanki was allocated to Independent Party grandees, Kaupthing to their counterparts in the Progressive Party, its coalition partner. *Foreign bidders were excluded* [italics added] … Later, Glitnir, a private bank formed from the merger of several smaller ones, joined the league" (Wade and Sigurgeirsdottir 2012, 135). Iceland's labor interests, on the other hand, were likely appeased by Scandinavian-style welfare policies, low unemployment rates, and rising incomes. For instance, Thorhallsson and Kattel (2012) argue that labor interests altered their approach in response to their earlier ineffectiveness:

> Considerable changes have taken place in the labor-market since the mid-1980s. These are reflected in a change of attitude, i.e. labor-market organizations prioritize the improvement of living standards, in general, instead of focusing only on wage bargaining. Furthermore, organizational restructuring has taken place on the labor-market. The structure of the labor-market organizations has become more centralized both on the employers' side and on that of the trade unions. … Trust was finally established between these competing actors. One could say that labor was finally included in the governmental decision-making process. Coordinative discourse among policy makers (the government, the employers and labor) became more significant than communicative discourse addressing the public (11).

Furthermore, party patronage extended beyond Iceland's dominant political parties: "Party membership was a standard part of a person's identity, together with parentage, occupation and schooling. The parties provided access to careers in both the public and private sectors. Political cleavages went right down to small units at the base, like firms, university departments and men's choirs. Ordinary people had to go through party functionaries to get loans to buy a car or foreign exchange to travel abroad" (Wade and Sigurgeirsdottir 2012, 132). The institutional structure of Iceland's political environment, therefore, facilitated patron-client relationships that were unlikely to be opposed by individuals from both ends of the political spectrum.

The remaining implications of Olson's theory provide insight into the political developments that occurred following Iceland's financial liberalization and more specifically into how Iceland's financiers amassed assets worth 900% of Iceland's GDP. Although international developments–neoliberalism in the 1980s, unfettered access to cheap credit in the 1990s, and the financialization of the global economy in the 2000s–contributed to the rapid expansion of Iceland's banking sector between 2003 and 2008 (Alþingi 2010), institutional structures within Iceland had the much more pervasive effect of facilitating its astronomical growth. To begin with, Iceland's business-oriented corporatist structure–in addition to its prolonged stability–facilitated the proliferation and cartelization of sectoral interest groups primarily motivated to redistribute wealth among their membership. As these groups gained political influence they began to limit membership, redistributing benefits to a much smaller group of individuals. For instance, Iceland's fishing industry–although profitable and sustainable–is designed to redistribute wealth, reduce aggregate income, and limit membership. In this case, however, these features are not necessarily damaging.[22] On the contrary, Iceland's financial industry expanded rapidly and grew astronomically–during which it offered benefits to all Icelanders in the form of loans, access to credit, and dividends–before limiting membership to a small group of elites primarily interested in growing their personal fortunes.

Consistent with Olson's theory, Iceland's sectoral interest groups have a limited membership, allowing for better coordination and greater organizational power. Furthermore, Iceland's business-oriented corporatist structure is much more accommodating toward industry interests compared with non-industry interests. As a result, Iceland's financial lobby–a distributional coalition consisting of former politicians and civil servants, private sector entrepreneurs, and wealthy individuals from The Octopus and The Squid–successfully persuaded the government to enact deregulatory legislation that not only permitted excessive behavior, but also insulated Iceland's financial industry from domestic inquiry: "The major shareholders of Landsbanki, Kaupthing, Glitnir, and their spin-offs reversed the earlier political dominance of finance: finance now dominated government policy" (Wade and Sigurgeirsdottir 2012, 135). In addition, Olson's theory stipulates that the accumulation and proliferation of distributional coalitions–*on balance*[23]–reduces efficiency and aggregative income in the societies in which they operate, as well as making political life more divisive. The evolution of Iceland's business-oriented corporatist structure, for example, reflects this assumption: "In the 2003 election campaign, the government started to promise and implement policies that went directly against economic stability. This included building a massive power plant and introducing tax decreases at a time of economic boom. These policies challenged social security and broke down the cooperation between the labor movement and the government" (Thorhallsson and Kattel 2012, 12).

The real implications of Iceland's banking expansion began at the turn of the century. Similar to the United States *Community Reinvestment Act, 1977*, Iceland's government in 2004 permitted banks to issue 90% loans, affording Icelanders access to cheap credit, prompting many to refinance their mortgages, travel abroad, purchase luxury cars, etc.: "It was largely a 'shop-window operation, justified by general euphoria and the efficient markets hypothesis" (Wade and Sigurgeirsdottir 2012, 135). Furthermore, Iceland's other sectors–agriculture, fishing, and manufacturing–benefitted from new access to capital, fueling an economic boom across the country. The patronage relationship between Iceland's dominant parties and its financial interests, however, forged new alliances that not only included the Independence Party and the Progressive Party, but also Iceland's left-wing parties (Kristinsson 1996). For instance, Thorhallsson and Kattel (2012) argue that Iceland's left-wing parties–what Olson refers to as the 'forgotten groups,' those that (historically) have 'suffered in silence'–became enthralled with Iceland's neoliberal agenda: "Sectoral corporatism created an ideal framework for the neo-liberal agenda. In 1991, the conservative Independence Party returned to office under a new leadership. Its coalition partners in government, the center-agrarian Progressive Party (1995–2007) and the Social Democrats (1991–1995 and 2007–2009), largely subscribed to its neo-liberal agenda" (11).

The economic benefits accrued from Iceland's financial boom, therefore, replaced the need for consensus building between Iceland's government and non-industry interest groups.

The transition to and heavy reliance on financial services can be explained by Iceland's historically staggered economic growth (McKinsey 2011). For instance, Iceland's four main sectors–agriculture, fishing, manufacturing, and finance–emerged in sequence, resulting in variable economic growth:

> There has been a historical tendency to pursue economic growth one sector at a time. The ebbs and flows of these sectors have created large fluctuations in overall economic activity. First, the fishing industry grew significantly in the 1980s, but faced price and volume declines from the late 1980s, contributing to a deep and lengthy recession into the early 1990s. This was followed by a significant build out of the energy-intensive industry in Iceland and in the 2000s the build out of the energy sector was accompanied by an expanding financial sector. High investment and consumption rates created unparalleled current account deficits, which in the end contributed to an economic collapse (McKinsey 2011).

Financial services, however, are characteristically different from other industries. Philippon (2008) argues that, "… the economic value added of one unit of financial services grows with the productivity of the agents who benefit from these services. As a result, the equilibrium size of the financial sector is independent of productivity in the non-financial sector" (9). The rapid expansion of the financial services industry–Iceland's economic engine between 2002 and 2008–reflects this observation: "International acquisitions and internal growth have swollen the banks' combined balance sheets" (Central Bank of Iceland 2008, 25).[24] For instance, Iceland's banking sector growth rate during this period averaged 466%, whereas per capita income growth averaged 1.3% (McKinsey 2011). By 2007, Iceland's financial services industry–consisting of banking, insurance, and real estate–accounted for 27.2% of Iceland's GDP. Furthermore, Iceland's government pursued measures–i.e. lowering the corporate tax rate–that drastically reduced Iceland's capacity to compensate during a financial crisis (Alþingi 2010). As a result, Iceland–enamored with the perceived benefits of financialization–became a financial haven that operated beyond its means, largely at the expense of taxpayers and foreign creditors.[25]

The euphoria of Iceland's perceived success–in addition to Icelanders complicity–reduced Iceland's capacity for oversight: "The supervisory institutions did not put any real pressure on the banks to downsize and public administrators and politicians were as lamed in the face of a far too powerful banking system and failed to respect their primary obligations. The prevailing social discourse about the unique success of the Icelandic bankers also facilitated the events" (Árnason et. al 2010, 1). In addition, the embeddedness of financial interests within Iceland's political structure resulted in conflicts of interest that contributed to Iceland's rapid, astronomical banking sector growth. For instance, Iceland's prime minister, the foreign minister, and the chairman of the FME, actively promoted and affirmed the salience of Iceland's banks (Alþingi 2010), despite clear indications that Iceland's financial sector was overheating: "At every turn, conflicts of interest were ignored. Indeed, conflicts of interest have been so endemic in the small Icelandic system that they are often not even recognized as such. Rather, they tend to be neutralized by being seen as mere 'coincidences of interest,' which, therefore, pose no societal problem" (Wade and Sigurgeirsdottir 2011, 695). The abolishment of the National Economic Institute–justified by the efficient markets hypothesis promoted by Iceland's financial sector–exacerbated this environment. Furthermore, the institutional structure of Iceland's government bureaus precluded accountability and regulatory proficiency (Alþingi 2010).[26]

The FME–engrossed in moral hazard–was not only unprepared to manage Iceland's banking sector, but also unresponsive: "The FME had the power to require increased equity of financial institutions, i.e. in case of increased operational risk. This power, however, was never exercised".[27] The behavior of the FME's chairman reflects the extent of Iceland's moral hazard: "The government's PR road shows and the chairman's granting of [interviews] for PR purposes, illustrates the regulatory capture that was endemic in Iceland's system of financial management" (Wade and Sigurgeirsdottir 2011, 691). In addition, Davíð Oddsson–Iceland's right-wing prime minister from 1991 to 2004–refused to resign from his post as the chairman of Iceland's central bank, despite presiding over Iceland's financial liberalization and subsequent collapse. These conditions prompted Iceland's Special Investigation Commission to conclude that, "both the parliament and the government lacked the power and the courage to set reasonable limits to the financial system. All the energy seems to have been directed at keeping the financial system going. It had grown so large that it was impossible to risk that even one part of it would collapse".[28] Iceland's *Report on the Special Investigations Commission* reveals that Iceland's financiers benefitted tremendously from the expansion of their respective institutions, as predicted by Olson's theory.[29] Furthermore, the success of Iceland's financial lobby reduced Iceland's capacity to reallocate resources in response to changing conditions (read: rapid, astronomical banking sector growth), resulting in Iceland's institutional sclerosis.[30]

Explaining the Icesave Debt Negotiations

The conventional account of Iceland's debt negotiations suggests that the government refused to honor foreign debt obligations by letting its banks fail, prompting commentators to characterize Iceland's recovery model as 'experimental' and implying that its response was churlish and hasty. Upon closer consideration, however, it becomes evident that Iceland responded both rationally and strategically to its foreign creditors. Consistent with Olson's theory, Iceland's financial crisis destabilized the stronghold of its interest groups–challenging the environment cultivated by its business-oriented corporatist structure–resulting in a series of developments that can be directly explained using insights from Olson's theory applied to Iceland's political history.[31] Following the collapse of Lehman Brothers in 2008, Iceland's parliament enacted emergency legislation guaranteeing domestic deposits and affording the FME explicit control of the country's financial sector.[32] Within days, the FME assumed control of Glitnir, Landsbanki, and Kaupthing and Iceland's central bank announced its intention to peg the krona to the euro, a proposal that was ultimately abandoned. In addition, Iceland entered into loan negotiations with Russia, the IMF, and the Nordic countries and held bilateral talks with British and Dutch delegations over foreign debt obgliations accrued through Landsbanki's overseas operations, *Icesave*. Negotiations with the United Kingdom and the Netherlands, however, failed to mitigate tensions amassed over Landsbanki's collapse, prompting Britain's treasury to freeze Landsbanki's assets under the United Kingdom's *Anti-Terrorism Crime and Security Act*.[33]

On 19 November 2008, Iceland accepted a $4.6 billion loan from the IMF and the Nordic countries meant to, "support the country's program to restore confidence and stabilize the economy" (Iceland Chamber of Commerce 2012, 79). In the following months–lasting until January 2013–Iceland entered into debt repayment negotiations with the United Kingdom, the Netherlands, and the European Union. The British and Dutch authorities initially stipulated that Iceland's government compensates 18% of Landsbanki's total liabilities–$22.2 billion–prompting the enactment of Act 96/2009 (colloquially known as *Icesave Bill 1*). Under the terms of *Icesave Bill 1*, the United Kingdom and the Netherlands would extend to Iceland €4 billion (with a 5.5% annual interest rate) in the form of temporary loan assistance.[34] *Icesave Bill 1*, however, was ultimately rejected by the United Kingdom and the Netherlands–despite support from Iceland's parliament and president–over a dispute regarding Iceland's repayment terms. During Iceland's parliamentary debate, members that opposed the bill argued that it was not Iceland's responsibility to honor foreign debt obligations accrued through Landsbanki's overseas operations (The Economist 2009, August 13th). Supporters of *Icesave Bill 1*, however, warned that failure to pass would jeopardize Iceland's pending loan from the IMF and the Nordic countries (The Economist 2009, August 13th).[35] As a result, the final version of the bill included a clause that limited Iceland's repayment term to 2024.

Following the rejection of *Icesave Bill 1*, Iceland began renegotiating its repayment terms with the United Kingdom and the Netherlands. Under the terms of Act 1/2010 (*Icesave Bill 2*), Iceland would compensate the British and Dutch governments the full amounts covered by their respective minimum deposit guarantee schemes over a period of fourteen years. On 30 December 2009–following a series of heated debates–Iceland's parliament enacted *Icesave Bill 2*. Pending presidential assent, however, Justice Ragnar Hall–a member of Iceland's Supreme Court–cited a number of design flaws built into the legislation, subsequently advising Iceland's president to consider rejecting the bill. Justice Hall criticized the bills priority claims, arguing that its enactment would require Iceland to compensate more than the minimum deposit guarantee.[36] In response, Icelanders petitioned the president to veto the bill (BBC News 2010, January 2nd), prompting Grímmson to announce a referendum set for 6 March 2010 (BBC News 2010, January 5th). In the months following the referendums announcement, Iceland continued negotiating repayment terms with the British and Dutch delegations. Both countries, however, rejected Iceland's renegotiated terms and on 6 March 2010 Icelanders voted overwhelmingly against honoring foreign debt obligations. The results signaled to parliament that Icelanders were not only unsatisfied with Iceland's debt negotiations, but also that they were unwilling to support honoring foreign debt obligations altogether.

Despite a clear 'no' mandate from its electorate–as well as losing support from the president–Iceland's parliament enacted Act 13/2011 (*Icesave Bill 3*). Iceland's president, however, rejected the new bill–responding to strong public dissent–stating that it was imperative that Icelanders "exercised legislative power in the Icesave dispute" (Valdimarsson 2011, February 20th). On 9 April 2011 Icelanders–once again–voted against honoring foreign debt obligations, prompting the European Free Trade Associated Surveillance Authority (ESA) to release a statement requiring Iceland to clarify whether or not it would honor foreign debt obligations pursuant to European Economic Area (EEA) regulations.[37] Iceland's Ministry of Economic Affairs–on 2 May 2011–issued a response indicating that "it is not in breach of its obligations under Directive 94/19/EC and under Article 4 of the EEA Agreement. It disagrees with the statements made by the Authority and urges the Authority to conclude this matter without any further action" (ESA 2011, June 10th). ESA, however, issued a reasoned opinion on 10 June 2011 stating that, "Pursuant to the second paragraph of Article 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice, the EFTA Surveillance Authority requires Iceland to take the measures necessary to comply with this reason opinion within three months following notification thereof" (ESA 2011, June 10th).

Iceland's Ministry of Economic Affairs, however, rejected ESA's reasoned opinion and on 14 December 2011 ESA launched legal action against Iceland: "The case will now be brought before the Court of Justice of the European Free Trade Association States (EFTA Court). Iceland will have the opportunity to present its position. If the EFTA Court finds that there is a breach, Iceland will be required to take immediate actions to comply with that judgment" (ESA 2011, December 14th). On 28 January 2013–following twenty-five months of deliberations between Iceland, the United Kingdom, the Netherlands, Liechtenstein, Norway, and the European Commission–the EFTA court ruled in Iceland's favor: "The Court holds that, by failing to ensure payment of the minimum amount of compensation to Icesave depositors in the Netherlands and the United Kingdom within the time limits laid down, Iceland has not failed to comply with the obligations" (EFTA Court 2013, January 28th). Furthermore, the EFTA Court opined that, "… the Directive does not lay down an obligation on the State and its authorities to ensure compensation if a deposit-guarantee scheme is unable to cope with its obligations in the event of a systemic crisis" (EFTA Court 2013, January 28th). The Supreme Court of Iceland, however, affirmed that priority claims attached to the Landsbanki receivership would be repaid in full pending the liquidation of Landsbanki's assets (Landsbanki Íslands hf 2011, October 28th).

It is therefore evident that Iceland did not simply 'let its banks fail.' Less evident, however, is what influenced Iceland's politicians to provide continued support for honoring foreign debt obligations despite a clear 'no' mandate afforded by Icelanders in both referendums. Furthermore, it is not clear why Iceland–absolved of legal responsibility following EFTA Court's ruling in January 2013–honored foreign debt obligations altogether. The redistribution of power within Iceland's political sphere following the collapse of its financial sector–as predicted by Olson–explains Iceland's inability to build a consensus regarding its obligation to foreign creditors. To begin with, the success of Iceland's left-wing bloc in the 2009 parliamentary election facilitated a number of structural reforms that disrupted the consensus established in the 1990s by Iceland's neoliberal engineers. For instance, the FME's nationalization of Iceland's banking sector ran counter to the status quo–i.e. efficient markets hypothesis–cultivated by

Iceland's financial lobby following Iceland's banking sector liberalization in 1998. In addition, Icelanders felt that they were victims of the financial crisis–rather than contributors–and therefore strongly opposed honoring foreign debt obligations accrued through Landsbanki's overseas operations in the United Kingdom and the Netherlands. Remnants of Iceland's business-oriented corporatist structure remained, however, as expressed by the refusal of Iceland's left-wing bloc to support public opinion during their tenure.[38]

There are two strategic environments to consider when analyzing Iceland's debt negotiations: 1) discourse between Iceland, its foreign creditors, and a variety of international institutions and actors and 2) discourse between Iceland's president, parliament, and electorate. The initial refusal of Iceland's deposit guarantee to foreign creditors prompted Britain's decision to freeze Landsbanki's assets, signaling that it was fully committed to holding Iceland's government accountable for Landsbanki's collapse. Furthermore, worries over Iceland's ability to secure IMF loan assistance–although unmerited–prompted Iceland's parliament to begin negotiating whether or not Iceland was responsible (and capable) of honoring foreign debt obligations. Justice Hall's criticism, however, instigated widespread public dissent that sidetracked parliament's initiative to build a consensus regarding Iceland's debt position. In response, Iceland's president announced a referendum on the issue, further weakening Iceland's parliamentary coalition. Not only did Iceland's referendum signal to parliament that Icelanders strongly opposed honoring foreign debt obligations, but also it set a precedent that bound Iceland's president during *Icesave Bill 3* negotiations. Grímmson's decision to relinquish legislative authority to Iceland's electorate–coupled with the fact that Icelanders voted so strongly in the first referendum–meant that future decisions regarding Iceland's foreign debt obligations would require a plebiscite (or some form of consultation with the public).

For instance, following the enactment of *Icesave Bill 3*, Iceland's president announced that Icelanders would vote on the issue in a second referendum scheduled for 9 April 2011. Despite pleas from Iceland's parliament, the president was bound by precedent to turn the issue over to the public. The second referendum results, however, were much less threatening than Iceland's first referendum results, signaling that Icelanders were becoming more willing to accept their country's debt obligations. Furthermore, Iceland's refusal to reconsider the results of its referenda signaled that Iceland was strengthening its bargaining position.[39] There are three hypothetical explanations for these developments: 1) Iceland's economy recovery relieved tension in Iceland, 2) the IMF's announcement that Iceland's loan conditions were not linked to Icesave's resolve relieved exogenous pressure, and 3) the Supreme Court of Iceland's ruling that Landsbanki's receivership–despite EFTA Court's decision–was legally required to compensate the United Kindom and the Netherlands trumped parliamentary debate (as well as Iceland's referenda results). In addition, ESA's decision to pursue legal action against Iceland transferred the power of authority from Iceland and its foreign creditors to the EFTA Court. EFTA Court's ruling, however, absolved Iceland of any legal responsibility regarding minimum deposit guarantees in the United Kingdom and the Netherlands, affording Iceland leverage: "The EFTA Court has now ruled out any prospect of the United Kingdom suing Iceland for the interest cost, and clarified that governments are not liable to cover the cross-border depositor obligations of their banks" (Aldrick 2013, January 29th).

Despite EFTA Court's decision on 28 January 2013, the Supreme Court of Iceland ruled on 28 October 2011 that the government was legally required to honor retail priority claims owed to the United Kingdom and the Netherlands pending the liquidation of Landsbanki's assets. The courts ruling precluded three years of parliamentary debate and trumped the results of Iceland's referenda by dictating that Iceland was–irrespective of parliament and the electorate–legally bound by Icelandic law to honor foreign debt obligations accrued through Landsbanki's overseas operations. Following the courts decision, negotiations between Iceland and its foreign counterparts shifted from bilateral talks to legal proceedings. Although EFTA Court's decision absolved Iceland of legal responsibility, the Supreme Court's decision persisted, prompting Iceland's government to liquidate Landsbanki's assets to compensate the British and Dutch governments. Internal reports from Landsbanki's receivership–as of 13 September 2013–indicate that over 50% of priority claims owed to the United Kingdom and the Netherlands have been repaid (Landsbanki Íslands hf, September 13th). Further analysis, therefore, reveals that Iceland did not simply 'let its banks fail.' Iceland's parliament–despite limitations imposed by the president, the Supreme Court, and the electorate–labored effortlessly to negotiate settlement terms that could be agreed upon by Iceland's president and electorate, as well as its British and Dutch counterparts. The court's ruling, however, rendered debate (and referenda) needless, providing an explanation of why Iceland honored foreign debt obligations altogether.

Additional insight into the parameters of Iceland's debt negotiations contributes to an already robust literature on the global financial crisis, providing a more comprehensive understanding of the interplay between Iceland and its foreign creditors. In addition, this section delivers a summary of events that establishes a foundation for additional research on Iceland's financial crisis, as well as the Icesave debt negotiations. This section concludes by arguing that Iceland and its foreign creditors responded rationally and strategically considering the uncertainty of the Icesave debt negotiations. For instance, despite Iceland's initial refusal to insure foreign deposits, Britain signaled that it was prepared to pursue whatever action necessary to recover losses incurred as a consequence of Landsbanki's collapse, prompting Iceland's parliament to initiate negotiations regarding its responsibility to foreign creditors. Iceland's referenda analogously signaled to the British and Dutch authorities that debt negotiations were failing to produce tangible results and that it was necessary to pursue legal action. Furthermore, the Supreme Court of Iceland's ruling in 2011 gestured to Iceland's president and its electorate that honoring foreign debt obligations was not a matter of public opinion, but rather domestic and international law. Conventional accounts of the Icesave debt negotiations, therefore, mistake Iceland's inability to honor foreign debt obligations for utter refusal, overlooking efforts taken by Iceland's parliament to negotiate a settlement, as well as the Supreme Court of Iceland's ruling that Iceland–regardless of EFTA Court's decision–would remunerate the British and Dutch governments for losses tied to Landsbanki's collapse.

Concluding Remarks

Using a theoretical framework inspired by Mancur Olson, as well as literature on small states and corporatism, this thesis argues that Iceland's institutional structure contributed to its rapid, astronomical banking sector growth between 2002 and 2008, culminating in the collapse of its financial industry. Consistent with Olson's theory of collective action and economic stagnation, Iceland's business-oriented corporatist structure fortified relationships between Iceland's government and its financial elite, changing the course of Iceland's sociopolitical evolution. In addition, Iceland's corporatist evolution precluded equitable consensus building due to a number of structural constraints. For instance, Iceland's proportional representation system afforded additional political representation to Iceland's sparsely populated coastal regions, enabling agrarian and fishing interests to influence policymaking much more effectively than individuals and interest groups from Iceland's urban core. Although proportional representation electoral systems typically disperse political power, Iceland's agrarian and fishing lobbies–represented by Iceland's monopolist right-wing bloc, the Independent Party and the Progressive Party–capitalized on this benefit, urging the government to implement protectionist measures that led to the rapid expansion of Iceland's fishing industry in the 1960s and 1970s. These relationships facilitated an environment that set a precedent for Iceland's financial interests in the 1990s. The rapid, astronomical expansion of Iceland's financial sector can therefore be explained considering the relationship between Iceland's government parties and industry established by Iceland's agrarian and fishing lobbies following its independence in 1994, resulting in Iceland's institutional sclerosis.

This thesis also provides evidence that Iceland's financial crisis has domestic corporatist roots that are much more causally responsible for its rapid, astronomical banking sector growth rather than being solely the result of global contagion, as is the case in many other countries. Whereas banks in other countries–Ireland, Estonia, Latvia, and Cyprus–were foreign-owned and engaged primarily in international securities lending, Iceland's business-oriented corporatist structured prompted the government to prohibit foreign competition–instead privatizing the banks to Iceland's oligarchic elites–and its banks lent primarily to one another, insulating systemic risk within Iceland (with the exception of Landsbanki). In addition, this thesis demonstrates how relatively well-functioning proportional representation consensus building can generate institutional decay when other variables, such as small size and corporatism, are present. Iceland's electoral system–like all proportional representation systems–is intended to disperse political power. The dominance of Iceland's right-wing bloc, however, facilitated consensus building between two parties with identical platforms and similar interests, precluding Iceland's ability to build consensus among non-dominant interests, such as labor. The success of Iceland's special interest groups, therefore, cultivated an environment conducive to regulatory capture that facilitated Iceland's rapid, astronomical banking sector growth between 2002 and 2008. These developments allowed financial interests to lobby for deregulation, allowing unfettered access to global capital markets, resulting in the expansion and subsequent collapse of Iceland's financial institutions in 2008.

Furthermore, this thesis provides a comprehensive analysis of Iceland's debt negotiations with the United Kingdom and the Netherlands, affording readers with a greater understanding of what influenced Iceland's politicians to provide continued support for honoring foreign debt obligations despite a clear 'no' mandate, as well as why Iceland honored foreign debt obligations altogether, allowing for proper conclusions to be drawn about Iceland's recovery model and its implications for existing theories in the fields of international political economy and global governance. In the case of Iceland, the financial crisis destabilized the foundation of the financial lobby, allowing for the emergence of new actors, as well as reform of Iceland's regulatory structure. Following the collapse, the Supreme Court of Iceland, the president, the public, and EFTA Court, emerged from the wreckage, bringing about reforms that were unlikely to have been achieved before Iceland's financial crisis. This is consistent with Olson's theory and provides insight into how post-crisis Iceland was able to successfully reform institutions that were previously decayed as a result of decades of interest group formation that preceded Iceland's financial crisis. This thesis, therefore, not only contributes to international political economy literature by providing a greater understanding of the interplay between Iceland's political structure and the global economy, but it also provides a foundation for additional research on Iceland's financial crisis, as well as the Icesave debt negotiations.

Endnotes

[1]Iceland's experience is not exclusively puzzling: Ireland and Luxembourg's asset-to-GDP ratios were 650% and 2,200%, respectively. There has been a considerable amount of attention paid to Ireland's experience and additional case studies focusing on Iceland, Luxembourg and other countries with overextended banking sectors will increase the robustness of this literature.

[2]I am not suggesting that other countries experienced *normal* banking sector growth. I am merely demonstrating that Iceland's asset-to-GDP growth was disproportionately larger than other OECD countries (with the exception of Ireland and Luxembourg – both of which are also interesting case studies).

[3]The prolonged survival of Glitnir, Landsbanki, and Kaupthing was undoubtedly dependent on the international financial system. This does not, however, explain the protectionist behavior of Iceland's banks.

[4]This is yet another distinction of Iceland's banking sector collapse. Whereas many financial institutions in other countries held toxic assets on their balance sheets, Iceland's banks were simply overleveraged. Presumably, Iceland's banking sector expansion could have continued infinitely provided international credit markets remained salient.

[5]"Financialization can be defined as the long-run shift in the center of gravity of the capitalist economy from production to finance. This change has been reflected in every aspect of the economy, including: (1) increasing financial profits as a share of total profits; (2) rising debt relative to GDP; (3) the growth of FIRE (finance, insurance, and real estate) as a share of national income; (4) the proliferation of exotic and opaque financial instruments; and (5) the expanding role of financial bubbles." (Bellamy 2010)

[6]The EFTA Court decision on Iceland's foreign debt obligations was precedent setting.

[7]Perhaps a brief foreword from Douglass North's (1991) article, *Institutions*, is necessary: "Institutions are the humanly devised constraints that structure political, economic, and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct) and formal rules (constitutions, laws, property rights). Throughout history, institutions have been devised by human beings to create order and reduce uncertainty in exchange. They evolve incrementally, connecting the past with the present and the future; history in consequence is largely a story of institutional evolution in which the historical performance of economics can only be understood as a part of a sequential story. Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline" (97).

[8]For an insightful analysis of Iceland's corporatist regime, see Roger Boyes' *Meltdown Iceland: How the Global Financial Crisis Bankrupted an Entire Country*. In addition, Charles Ferguson's documentary, *Inside Job*, details the reciprocal relationship between Iceland's political and financial elites. Both accounts are verified in the *Special Investigative Report* (2010) commissioned by Iceland's parliament, the Alþingi.

[9]This is particularly staggering for three reasons: 1) combined bank assets in 2004 were roughly 100% of Iceland's GDP, 2) bank assets in the United States and other advanced industrial economies ranged from 50% to 450%, and 3) the majority of Iceland's assets were securities loans denominated in foreign currencies, increasing Iceland's exposure to exchange rate fluctuations.

[10]Iceland's population growth stagnated and briefly declined during the financial crisis, exacerbating the effect of unemployment. This is important when considering the consequences of financial crises, as out-migration is often overlooked when evaluating economic recoveries. For instance, Latvia post-crisis employment growth in frequently heralded as a success (much like Iceland), despite a large portion of Latvia's workforce migrating to neighboring countries in Europe, increasing the appeal of unemployment figures.

[11]The IMF contributed $2.1 billion and the remaining $2.5 billion was a combination of loans and currency swaps from Norway, Finland, Sweden, and Denmark. For a short period of time, Iceland and Russia entered into bailout negotiations, however, the Russian government reneged due to domestic economic turmoil.

[12]International credit rating agencies blatantly failed to properly assess credit volatility in the years preceding the global financial crisis. A more elaborate critique of these agencies can be found in Ryan (2013): "Credit Rating Agencies: Are they Credible?" Notwithstanding, credit rating agencies remain influential in determining whether or not countries are credit-worthy.

[13]For instance, the FME gradually lost its regulatory powers as Iceland began to liberalize, during which proponents of greater regulatory oversight were shunned in favor of the 'efficient markets hypothesis.'

[14]Despite the prominence of Olson's earlier works, this paper is informed mostly by Olson's 1990 and 1995 articles on Scandinavian economic development, "How Bright are the Northern Lights: Some Questions about Sweden" and "The Devolution of the Nordic and Teutonic Economies."

[15]Typical proportional representation systems afford political power to a multitude of political parties. Iceland's small size, however, does not permit for party competition as theorized by proportional representation scholars. For instance, although the Independence Party and Progressive Party are regarded as two different parties, they represent the same interests and have very similar platforms. By representing Iceland's rural regions–which were afforded more political power under Iceland's institutional structure–these parties were able to secure a political monopoly in Iceland.

[16]This framework was reinforced by the Independence Party's promotion of class solidarity: "The Independence Party's successful slogan, 'solidarity of classes,' dates back to the economic structures of the 1930s and refers to the essence of societal consensus. It is these norms that contributed to the party's broad popularity among voters of all classes. The idea of class solidarity (and the universal appeal of the party to the traditional classes) has made it difficult for the party leadership to break ranks with what are, historically, the core economic sectors of Icelandic society and, in fact, the core backers of the party: the agricultural and fisheries sectors. The solidarity of Iceland's economic sectors and, actually, the solidarity of the party itself, would be threatened by breaking ranks with its protectionist policies in the agricultural and fishing sectors" (Thorhallsson 2010, 379).

[17]In addition to its corporatist structure, tension between Iceland and the United Kingdom over territorial control of its Atlantic fisheries undoubtedly facilitated skepticism toward foreign competitors.

[18]Iceland is regularly praised for its economic and political developments following independence, giving the impression to both domestic and international interests that Iceland's sectoral corporatist structure was profitable. Unjustified praise, however, often results in unjustified behavior. Iceland's inability to see the forest for the trees, therefore, arguably contributed to the rapid expansion of its financial industry in the 1990s, regardless of whether or not it was 'optimal.'

[19]Iceland's agrarian and fishing sectors produce tangible goods, whereas financial services – in general – produce intangible goods that are often artificially inflated, creating systemic risk.

[20]Several accounts of Iceland's 'modernization' discuss how Icelanders were introduced to fine dining, luxury cars, cheap credit, etc., all of which was financed by the expansion of Iceland's newly privatized financial sector. I place quotations around 'free markets' to demonstrate that this was not truly the case. Iceland's privatization was largely uncompetitive and therefore anti-capitalistic. Wade and Sigurgeirsdottir (2012) provide a summary of this group's intentions: "Their aim was not just to promote free-market policies but also to open career opportunities for themselves, rather than wait for Octopus patronage. At the end of the Cold War their position strengthened materially and ideologically, as 'statism' and left-wing parties lost public support. Over the decades the Locomotive members took senior positions in politics, law, the judiciary, business and academia" (132).

[21]On the contrary, other countries allowed foreign competition. For instance, Estonia and Latvia, both of which are often compared to Iceland, opened their industries to foreign firms from Sweden, Norway, and Denmark.

[22]Wealth redistribution, reduced aggregate income, and limited membership ensures the long-term viability of Iceland's fish stock.

[23]Although Iceland's financialization initially increased efficiency and aggregate income, the financial crisis, *on balance*, reversed this trend.

[24]For instance, "Iceland's small banking elite was driving through mergers and acquisitions at home and abroad, competing and cooperating with each other. Using their shares as collateral, some took our large loans from their banks and bought more shares in their own or related banks, inflating share prices. It worked like this: Bank A lent to shareholders in Bank B, who bought more shares in B using shares as collateral, raising B's share price. Bank B returned the favor. The share prices of both banks rose without new money coming in. The banks not only grew bigger, they grew more and more interconnected" (Wade and Sigurgeirsdottir 2012, 135).

[25]Much of the 'technological innovation' that occurred in the 1980s onwards is misleading. Financiers often argue that complex investment vehicles–mortgage-backed securities, reverse convertibles, collateralized debt obligations–decrease systemic risk by increasing liquidity, but this is repeatedly shown to be false in practice. The global financial crisis was a crisis of liquidity and credit and it occurred at the height of these investment practices. As a result, these tools can hardly be regarded as 'innovative' in the sense that they increase productivity and liquidity. In fact, as the crisis shows, much of their use was non-innovative and destructive. In the words of Krugman (2009, April 9th): "Much of the seeming success of the financial industry has now been revealed as an illusion. Worse yet, the collapse of the financial house of cards has wreaked havoc with the rest of the economy, with world trade and industrial output actually falling faster than they did in the Great Depression. And the catastrophe has led to calls for more regulation of the financial industry. But my sense is that policymakers are still thinking mainly about rearranging the boxes on the bank supervisory organization chart. They're not at all ready to do what needs to be done – which is to make banking boring again. Part of the problem is that boring banking would mean poorer bankers, and the financial industry still has a lot of friends in high places. But it's also a matter of ideology: despite everything that has happened, most people in positions of power still associate fancy finance with economic progress."

[26]Wade and Sigurgeirsdottir (2011) summarize the conclusions of Iceland's Special Investigations Commission: "The civil service is established in such a way that each department has little dependence from the minister. The permanent secretary is selected by the minister, often on the basis of one-on-one interviews with no one else present, sometimes from a short-list prepared by an outside consulting firm. There is no civil service commission to ensure merit recruitment. The permanent secretaries, in effect, have lifetime jobs at that rank and the system is populated by people who once made a good deal with a minister. In this context, one can understand what happened when in 2007 the inner circle of government could no longer ignore the evidence that the balance sheets of the banks might be cans of worms. The relevant ministers established a coordination committee of senior civil servants to monitor the situation and plan for a crisis. But the committee members, led by the permanent secretary of the prime minister's office, had no idea how to do such planning and they did not even try. The Special Investigation Commission determined that they never reported to ministers in a way that could be verified, thus allowing the latter to deny that they knew how serious the situation was becoming and escape legal responsibility" (695).

[27] This is quoted from a summary of the Special Investigation Committee's report (page 5), http://www.rna.is/media/skjol//RNAvefKafli2Enska.pdf. The report additionally states that, "The FME was not well enough equipped to sufficiently monitor the financial institutions when they collapsed in the autumn of 2008. Considering the operating expenses of the FME and its budget up to 2006, it is clear that the growth of the FME did not keep pace with the rapid growth of the Icelandic financial system, more complicated ownership links within the financial market, and increased activity of regulated entities abroad, and it was not consistent with the growing and increasingly complicated tasks entrusted to it pursuant to law during the preceding years" (16).

[28]This is quoted on page 17 of the Special Investigation Committee's report summary. The report also indicates that, "In replies made by administrators of governmental institutions who reported to the SIC, the statement was frequently encountered that it did not fall under the functional area of the person concerned, or his institution, to address or take responsibility for the project in question. It was also repeatedly stated, that other institutions or officials were responsible for such issues or tasks. Based on these answers, it may be assumed that the representatives and administrators of those governmental institutions, that had the role of monitoring operations in the financial markets and the effects of those operations on state economics were, in various cases, unaware of who was meant to carry out and take responsibility for certain aspects of these affairs in the government's daily activities" (18).

[29]Olson's eighth implication is that, "distributional coalitions, once big enough to succeed, are exclusive and seek to limit the diversity of incomes and values of their membership."

[30]Olson's seventh implication is that, "distributional coalitions slow down a society's capacity to adopt new technologies and to reallocate resources in response to changing conditions, thereby reducing the rate of economic growth." Where Olson's theory needs alteration, however, is the distinction between institutional decay and regulatory capture. As stated above, Iceland's institutional decay and subsequent rapid, astronomical banking expansion could have presumably continued infinitely had it not been for the collapse of Lehman Brothers. This thesis, however, demonstrates how institutional decay where the financial industry becomes dominant can generate systemic risk and a non-linear disjuncture. Institutional decay combined with financialization, therefore, can quickly result in systemic risk and eventual collapse, as was the case in Iceland between 1998 and 2008.

[31]For instance, Olson argues crises, such as war (or in Iceland's case, financial collapse), destabilize the foundation of special interest groups. In Germany and Japan, the devastating loss of the Second World War resulted in the destabilization of special interest groups that Olson argues are conducive to institutional sclerosis. In the case of Iceland, the financial crisis destabilized the foundation of the financial lobby, allowing for the emergence of new actors, as well as reform of Iceland's regulatory structure. Following the collapse, the Supreme Court of Iceland, the president, the public, and EFTA Court, emerged from the wreckage, bringing about reforms that were unlikely to have been achieved before Iceland's financial crisis. This is consistent with Olson's theory and provides insight into how post-crisis Iceland was able to successfully reform institutions that were previously decayed as a result of decades of interest group formation that preceded Iceland's financial crisis.

[32]Iceland's parliament enacted this legislation just one day before Landsbanki's default, signaling to the United Kingdom and the Netherlands that in the event that Iceland's financial institutions collapsed, the government would only secure the deposits of Icelanders, retrospectively creating tension between Iceland and its foreign creditors.

[33]Within months of invoking terrorist legislation against Iceland, the United Kingdom's Secretary of State for Defense, Liam Fox, published an apology in Norway's newspaper, *Aftenposten*. Britain's reaction, nevertheless, highlights the intensity of Iceland's debt-obligations, as well as the intensity of the global financial crisis.

[34]In this scenario, British and Dutch depositors would have been compensated by their respective governments and Iceland would be required to reimburse the principal amount plus interest.

[35]From The Economist (2009, August 13th): "Ms. Sigurdardottir calls the Icesave debate 'the most important issue that any Icelandic parliament has been required to address.' The government argues that most of the debt will eventually be covered by the sale of Landsbanki assets. It also insists that the deal is an essential part of clearing up Iceland's financial mess. Loans from the IMF and Iceland's Nordic neighbors, worth some $ billion, are on hold pending its approval. If debate drags on for too long, Iceland's credit rating, already close to junk, could be downgraded again and tht would threaten the chances of a recovery. It was later revealed by the IMF's mission to Reykjavík, Mark Flanagan, that resolving Icesave was never a formal condition (The Independent 2010, January 10th).

[36]The debate over priority claims is an appendage of an existing debate on whether or not Iceland was required to honor foreign debt obligations at all.

[37]The statement indicated that, "The Authority has taken note of the outcome of the Icelandic referendum concerning the Icesave issue. We not expect a swift answer from the Icelandic government to our Letter of Formal Notice of May last year.[37] We will assess the government's reply before we take further steps in the case. Unless the letter from the government contains arguments that alter our preliminary conclusions in the case, the next formal step would be to send Iceland a final warning, a Reasoned Opinion. This final warning will give Iceland two months to rectify their breach of the EEA Agreement. If Iceland continues to be in breach of the agreement, the case will be sent to the EFTA court" (EFTASA 2011, April 11th).

[38]Iceland's left-wing coalition adamantly supported honoring foreign debt obligations, despite widespread public dissent.

[39]It is additionally possible that this reflects growing distrust regarding Iceland's foreign debt negotiations.

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