# Iceland crisis and causes led to the crisis

Countries

Iceland and the rest of the world reeling. In retrospect, Iceland was essentially operating like a firm with a highly unviable growth model. However, the political relationship between Iceland and Britain also greatly added to the economic downturn and financial crisis. Britain's use of anti-terrorismlaws, in an attempt to protect their economic investments in Iceland, essentially labeled Iceland as a terrorist state which only continued to stagnate the inflow of foreign capital.

Although without a doubt the primary cause of the Icelandic financial crisis was economic, political factors such as the relationship and interdependence between Iceland and Britain exacerbated the already dire situation. Iceland began as an isolated, fairly impoverished country whose survival was based largely on its fishing trade. 1 However, in recent years Iceland had been successful at establishing itself as a premier offshore banking hub. At one point Icelanders were ecstatic and celebrated the fact that their tiny country of about 300, 000 people had 3 banks in the worlds largest 300 banks.

The Icelandic government was able to entice foreign investors by setting interest rates very high, which encouraged foreigners to invest largely in financial assets. The large inflow of foreign capital associated with such mass foreign investment caused the krona to greatly appreciate. Since the krona was greatly overvalued it made all imports in both goods and services very inexpensive for Icelanders; the overvalued krona also made it a lot easier for Icelanders to borrowmoneyfrom abroad.

The high interest rates, gargantuan capital inflow, and an appreciated currency all aided in creating the economic boom that Iceland enjoyed for many years?

This economic boom encouraged Icelanders to borrow from abroad and many failed to foresee that such economic prosperity was limited and that a bust is inevitably going to follow a boom. The lack of government oversight on the banking system also was an economic factor that led to the financial crisis. One large problem with the Icelandic banking sector is that the banks became so large that the Icelandic government was unable to operate asa lender-of-last-resort simply because Iceland with its mere 300, 000 people has a very small tax base. 4 At the end of 2006 the total assets of its banks grew to be nine times as large as the countries GDP. It would have been less of a problem for the banks to be so large if they had not remained domiciled in Iceland. It was perhaps too large and ideal of a goal for such a small country like Iceland to become an international financial center. Iceland was essentially acting like a firm when indeed they should have been looking after the economic stability of their whole country. The Icelandic government simply lacked the ability to financially sustain their banks in times of economic crisis. If some of the banks in Iceland had foreign lenders-of-last-resort they might have been able to weather out the economic storm.

Iceland’s economic growth model was mainly built upon foreign investors being able and willing to keep on giving. However, due to the global economic crisis foreign capital ceased coming in and when it did the myriad of public and private debt became quite evident. ? 6 Some analysts argue that problems with the krona have prevented Iceland from being able to control the financial crisis. Since Iceland does not have an effective currency to manipulate they are largely unable to support the banks and have no practical ways to bring down the inflation and interest rates, which have been staying in the double digits. This is just one of the many economic situations currently affecting Iceland. Without a doubt the prime cause for Iceland’s financial crisis is largely the economic circumstances previously discussed. However, political factors such as Iceland's relationship with Britain also played a role in exacerbating the crisis and preventing Iceland from any chance it might have had of financial viability. Iceland and Britain once had a very mutually beneficialfriendship, which could be seen in that they were NATO allies and frequent trading partners.

However, as the global economic crisis began to take hold this friendship became tenuous at best. The problems between Iceland and Britain began in late 2008 when Britain, in an attempt to protect its financial assets in Iceland, invoke its 2008 anti-terrorism laws to freeze the British assets of a failing Icelandic bank. 8 Specifically Britain froze the assets of Landsbanki and seized the assetsof Kaupthing Singer & Friedlander. 9 The British seizure of Kaupthing Singer & Friedlander was followed shortly by the collapse of its parent bank, Kaupthing, which the Icelandic government had desperately been trying to keep viable.

In many Icelanderseyes and certainly in the eyes of the Icelandic government Kaupthing was the last of the Mohicans and its demise signaled the end of the Icelandic banking system? The political decision to invoke anti-terrorism legislation against Iceland essentially branded it as a terrorist state, which in the eyes of every Icelander was a thorough abuse of a small neighbor. Due to this one political action Iceland was listed on the British Treasury Department’s page with terrorist groups and states such as Al Qaeda, Sudan, and North Korea.

At this point in the crisis the foreign capital inflows into Iceland were already dismal but this British action triggered an immediate freeze on any remaining banking transactions between Iceland and abroad. Essentially no one wants to do business with a terrorist state. President Olafur Ragnar Grimsson stated that, “ It(Britain) was absolutely being a bully against a small country because I am absolutely certain that if it was the case of France and Germany, the British government would not have acted in the same way- absolutely not”. The Icelandic Prime Minister at the time, Geir H. Haarde, believed that Gordon Brown had “ sacrificed Iceland for his own short-term political gain thereby turning a grave situation into a national disaster”. 12 From the perspective of the Icelandic government their once cordial, neighborly relationship with Britain had been thoroughly abused to the point that a British foreign policy decision played an integral factor in the meltdown of the Icelandic financial sector Undoubtedly Britain’s political decisions affected the financial crisis in Iceland, yet, the Crisis in Iceland also greatly impacted Britain’s economic conditions.

Like the rest of the world, thanks to the downturn of the global economy Britain has been suffering its own financial woes. When foreign capital inflows ceased in Iceland this caused the krona’s value to fall, which led Icelandic banks to be unable tofinancetheir debts most of which are in foreign currency. This realization by all of the foreign investors who were once so eager to invest created a mad rush to get their money out of the failing Icelandic banks.

Unfortunately, Icelandic banks did not have proper reserves to cover the massive withdrawals leading all three of Iceland’s banks to be nationalized.

13 Regrettably many British universities, municipal governments, charities and hospitals had been lured in by the high interest rates to invest in Icelandic accounts. CambridgeUniversity had $20 million invested in Icelandic accounts while 15 British police forces have approximately $170 million frozen in Iceland.

Many groups that had invested in the Icelandic banking sector had done so in the convenience of their own home states through the use of online investing sites such as Icesave. co. uk. On their website Icesavenow displays the message that " We are not currently processing any deposits or withdrawal requests throughout Icesave Internet accounts. We apologize for any inconvenience this may cause our customers". 15 Certainly for large investors such as Cambridge University this is much more than a small inconvenience

At the center of Iceland's financial troubles is that their banking sector was highly dependent upon a continued inflow of foreign capital. In turn, Iceland's foreign investors were also very dependent upon Iceland's banks to maintain their viability. However, when the inflow of capital stopped the interdependence of Iceland and its investors became very clear. This is exemplified by the Icelandic-British relationship. British citizens and companies alike had been ensorcelled by the call of high interest rates in Iceland.

The viability of the banks was based largely on the ability to keep foreign capital coming into the country, which allowed the krona to appreciate. When the foreign credit market froze and investment decreased drastically the financial interdependence of Iceland and Britain manifested itself

Iceland’s main pitfall and cause of its financial crisis is that they essentially treated their country as a firm and allowed the banking sector to get far too huge considering, as we have seen, that it had no financial stronghold to back it up.

Although the blown-up banking sector and other economic factors created the financial crisis it was certainly exacerbated by the failed diplomatic relationship between Iceland and Britain. Britain’s use of its anti-terrorism legislation only made the economic woes of Icelandworse by essentially making it a pariah that should be avoided by the rest of the international community. In the end, Iceland’s financial practices had sown the seeds of their own destruction but the political actions of Britain ensured that it would be a long time before Iceland’s financial sector will germinate once more.