Full text of the lecture by Dr Ragnar Arnalds, member of the Board of Governors of the Central Bank of Iceland and former Finance Minister of that country, on "Iceland, the EU and the Euro" on Friday evening, 10 September, at the 22nd Desmond Greaves Summer School, held in the Ireland Institute, 27 Pearse Street. Dublin 2 .

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Mr Chairman, Ladies and Gentlemen,

It is a great pleasure for me to have the opportunity to visit your country, and to be with you to-day to discuss Iceland, the EU and the Euro.

As you know, the Icelandic people and the Irish have a lot in common.

Both are small nations, but the Icelandic one is twelve times smaller, just three hundred thousand people. In both countries the annual population growth is quite promising, and in fact outstanding by European standards, which means that we are not in the group of ageing nations.

A millennium ago both nations were independent, and both came under foreign rule, Ireland a little before the year 1200 and Iceland a little after. Both nations gained a limited independence after the First World War, and both became republics roughly two decades later, Iceland in 1944.

When Iceland was first settled, eleven centuries ago, quite a large number of people came to Iceland from Ireland and other Celtic regions according to the Icelandic sagas. Genetic research on blood types shows that as many as one-third of the settlers may have been the Celts, mostly women brought to Iceland by the Norse Vikings. Ever since Iceland acquired a written language in the 11th century, a strong literary tradition has been a dominant force, and a characteristic feature, in Icelandic cultural life. I am quite sure that this is in part a heritage from our Irish ancestors.

The geographical size of Iceland and Ireland is similar and their names differ by just one letter which often gives rise to misunderstanding in remote parts of the world.

But there are also obvious differences: Ireland is often named "the Green Island" while Iceland is mostly barren uplands. Only a small part of it is habitable and a mere one-fourth of the country is covered by vegetation. So agriculture in Iceland is rather small-scale in comparison to Ireland.
On the other hand, fishing is the most important industry in the country. The fishing grounds around Iceland are some of the richest in the world. The continental shelf, where warm and cold ocean currents meet, is very wide and creates an ideal environment for the growth of fish stocks.

Iceland is amongst the most active volcanic spots in the world. This is caused by the fact that the country is Nature's showcase of continental drift, where America is sailing away from the European continent and filling the empty space with volcanic lava. Therefore Iceland is growing a little bit every year.

Just under the middle of the country there is a pillar of fire and glowing lava, 60 miles wide. If it disappeared Iceland would sink into the gap in the Ocean formed by the tectonic plates.

Iceland's active volcanoes number in the hundreds. Ice is also a key characteristic of the country. Glaciers cover about 11% of land, lava fields a similar amount and barren volcanic sands even more.

Recently the people of Europe were reminded of the fact that Iceland is a country of ice and fire. The fact that a volcanic eruption in Iceland can stop air traffic throughout much of Europe is due to the volcano lying under a glacier like so many of the largest volcanoes in our country: deep down inside the crater the titanic battle of the ice-cap with molten magma led to massive explosions, pulverising the glowing lava and throwing hundreds of tonnes of lava and ash into the air every second.

Volcanic eruptions are often costly for Iceland - and for our neighbours. In a major eruption which started in the year 1783, approximately 20 % of the Icelandic population perished. At the same time the ash cloud in the atmosphere affected the climate of mainland Europe, leading to crop failures. French peasants faced starvation and many had to abandon their farms. The resulting social unrest culminated in the French revolution.

Through the centuries it was a common belief in Europe that the home of the Devil was under Iceland, and that one of its volcanoes, Mount Hekla, was the mouth of Hell.

Last winter the British were quite irritated with their neighbours in Iceland. It was not only that air travel was halted by the ash from Iceland. They had also lost several billions of pounds in the Icelandic bank collapse, and we heard them shouting over the Ocean: Please! We want cash - not ash!

But what has all this to do with the question of Iceland, the EU and the Euro?

Both the ice and the fire are enormous natural resources. The cold glaciers collect water vapour from the Atlantic Ocean and from them flow many mountain rivers which we use to generate electricity. Geothermal steam and hot water coming deep from underground are immeasurable and inexhaustible resources of energy which are now harnessed to heat more than 90 % of houses in Iceland. The steam is also our second source of energy for electrical production, which per capita is the highest in the world.

These natural resources are a public property, owned either by the state or by local communities for the benefit of the people. But it is quite clear that in the environment of the EU rules on free movement of capital, our natural resources could soon be bought up by multinational concerns.

The same goes for the marine resources around Iceland. Fish and fish products are of greater value for Iceland than any other nation in Europe. The exclusive economic zone around Iceland, inside the 200-nautical-mile limit is nearly 300. 000 sq. miles. That is more than seven times the size of the country.

Reflections and concerns about our natural resources are the most important factor in our debate on the EU.

Icelandic fishing policies have largely been a success in terms of sustainability, unlike the EU common fisheries policy which has led to overfishing and the severe depletion of stocks in Western Europe.
At the same time, the fact is that the transfer of power from the member states to Brussels is one of the main characteristics of the EU.

In the Lisbon Treaty, Article I-12, it is clearly stated that the Union shall have exclusive competence in the management of the fisheries and other marine biological resources under the common fisheries policy. We know for sure that the fishing grounds around Iceland are a tasty and tempting morsel, especially for the Spaniards.

It's also an invariable EU rule that the EU takes over the right of the member states to negotiate and make fishery settlements with other states, concerning the species that are not local but are caught in and outside the 200 nautical miles, for example herring, capelin, redfish and mackerel. The value of that catch is just about one-third of the total value of Iceland's fish products.

Therefore the transfer of the negotiating powers to Brussels would also be a very unfortunate step for the Icelandic fisheries.

In October 2008, Iceland's three largest banks collapsed almost overnight. During the run up to the collapse the exchange rate of the Icelandic krona fell dramatically, and the price of foreign currencies went up more than a hundred per cent.

Before we deal with the currency question and the Euro, it is appropriate to analyse the collapse of the financial system in Iceland and what can be learned from it.

The pro-EU -lobby used the collapse of the krona as the ultimate argument for Iceland to apply for membership of the EU. For a while, polls showed growing support for EU membership. The argument was that the Icelandic krona was to blame for the disaster, which would never have happened if Iceland had been a member of the EU.

In the summer of 2009 the Icelandic Parliament decided to apply for membership of the EU.

Is it really true that the Icelandic krona was the main cause of the devastating fall of the financial system? Of course not! It was the other way around. The collapse of the banks caused the fall of the currency. In course of time such propaganda proved to be far too idiotic for the Icelandic people, and is now hardly heard.

In the report of the Special Committee, appointed to investigate the collapse of the banks on behalf of the Icelandic Parliament, the national currency is not pinpointed as one of the causes.
So why did the banks collapse?

The Committee's report states that the explanation is "first and foremost to be found in the banks' rapid expansion and their subsequent size when they fell. Their balance sheets and lending portfolios expanded beyond the capacity of their own infrastructure. Management and supervision did not keep up with the rapid expansion of lending."

The three Icelandic banks were originally owned by the state. Their size was appropriate to the Icelandic economy, and their financial position was relatively stable.

When Iceland concluded the European Economic Area agreement with the EU, together with Norway and Sweden, Finland and Austria, Iceland became a part of the EU's internal market, undertaking to follow EU rules of free movement of capital across the borders in the EEA area. After that the banks were privatised, just after the turn of the century.

The new owners were three groups of Icelandic businessmen, who embarked on rapid expansion of the banks in the international market.

Only six years later, when the banks collapsed, the size of the banking system was approximately ten times larger than it had been before privatisation and it was nine times the size of Iceland's GDP.

Or in other words: three clumsy giants stood up in a tiny boat. That story had to come to a sticky end.

The summer of 2007 saw the onset of the international financial crisis. It hit in the wake of unusually low real interest rates and easy access to loans. These circumstances led to growing weaknesses in the international financial system. The major markets were rendered virtually inoperable and this proved especially difficult for the Icelandic banks, which were increasingly dependent on funding through international markets.

As the winter of 2007-2008 progressed, share prices fell. Foreign creditors made margin calls. The death march of the banks to their own grave had started.

In the autumn 2008 the Lehman Brothers Bank collapsed. It was the largest bankruptcy in the history of mankind and had a global catastrophic effect.

The collapse of the three Icelandic banks, which took place a month later, was of course much smaller, and did not have the same effect in the international market. Nevertheless the Icelandic catastrophe is ranked as the third largest bankruptcy, next after the Lehman Brothers Bank and Washington Mutual. Further down on the list we find WorldCom, General Motors, City Group and Enron.

This is hard to believe, bearing in mind that the Icelandic economy of 300 thousand inhabitants is one of the smallest in the world.

But why did international financial markets open their doors to the Icelandic banks?

There were mainly two reasons:

Firstly, they did it because of the banks' good credit rating, which the banks had inherited from the Icelandic state. The state didn't have a heavy burden to bear before the collapse but now it has lost its favourable rating.

Secondly the banks had access to European markets, on the basis of the EEA Agreement. Now, after the collapse, it is widely recognised that the EU rules on banking and bank accounts in foreign countries were quite faulty, especially the EU legislation on deposit guarantees, which gave rise to a complicated dispute over the Icesave bank deposits between the Icelandic government and those of the United Kingdom and the Netherlands.

The dispute is still unresolved, and last winter the Icelanders rejected in a referendum a payout plan that would have cost every household in Iceland around 45.000 Euros in the form of higher taxes.

The Committee's investigations also revealed that the operations of the banks were, in many ways, characterised by maximising the interests of the larger shareholders, who managed the banks, rather than running solid banks with the interests of all shareholders in mind. In all of the banks, their principal owners were among the largest borrowers, and had abnormally easy access to credit at the banks they owned.

In the legal proceedings which are now taking place that kind of behaviour has been called "robbing the banks from the inside."
It has also been disclosed that the banks purchased their own shares on a large scale in automatically matched trades in the Stock Exchange, attempting in this manner artificially to boost demand for their own shares. This was particularly the case after shares prices started to drop.

Now you may be inclined to ask whether the deteriorating situation of the banks could not have been foreseen by the authorities from the capital ratio of the banks?

The fact is that in the annual reports of the banks the capital ratio was always considerably above the statutory minimum. Half a year before the collapse the banks underwent classic stress tests, similar to those which were used last summer in Europe and attracted a lot of attention. The Icelandic banks received very good grades in these tests.

After the collapse the investigation showed that the banks had secretly invested their funds in their own shares. Therefore, the capital ratios did not reflect the real strength of the banks to withstand sudden setbacks. Generally it is impossible under such circumstances to estimate the real strength of a financial institution from the capital ratio.

On the other hand the Investigation Committee did point out that when the banking system had become far too big, relative to the size of the Icelandic economy, the public authorities didn't react. It would have been necessary to take action no later than two years before the crash, if there was to be any chance of averting the collapse of the banks.

But instead of focusing on the obvious problem, that the Icelandic financial system was far too large, the only thing the government did was to try to improve the image of the banking system by official statements abroad.

Both the parliament and the government lacked the political power and the courage which were needed to set reasonable limits to the financial system.

The main stream opinion in society was strongly in favour of the sacred EU rule of free movement of capital over the borders. All energies were directed at keeping the financial system going. It had grown so large that it seemed impossible to risk the collapse of even one part of it.

Or, to put it plainly: when the bubbles started bursting, and greed gave way to fears, there was no way to save the banks.

In the spring of 2008, the Icelandic government and the Central Bank tried to borrow quite a large sum abroad in order to save the banks. But only the Danish, Norwegian and Swedish central banks were willing to enter into currency swap agreements with the Central Bank of Iceland and the amount which they offered was just a fraction of what was needed. Today we Icelanders should be grateful, that our state was not able to undertake these gigantic loans in order to save the banks. A huge salvage loan would have ruined the Icelandic state finances for ever.

This year the Greeks have been in a similar situation. The difference is that the population of Greece is 35 times that of Iceland.

So what were the effects of the financial collapse?

Of course it's rare for the whole banking system of a country to crash completely. All business transactions with foreign companies and banks became extremely difficult. The Icelandic banks had branches in many countries, whose governments reacted in different ways.
To make things still more complicated for Iceland, Gordon Brown and Alistair Darling decided to put our oldest bank, Landsbanki, and the Central Bank of Iceland on the official British list of terrorist organisations. The key institutions of the Icelandic economy stayed on that list for months, together with Osama bin Laden and Al Qaida, the Taliban in Afghanistan, Sudan and Iran. These measures were especially hard to cope with. For a long time all foreign currency transactions were operated by a little group of people on one floor of the Central Bank of Iceland, and went through the international firm, J. P. Morgan.

In the middle of the crash the Icelandic Parliament passed emergency legislation which authorised the government to establish new banks, replacing the bankrupt ones, and to set up currency restrictions. These restrictions are still in force now nearly two years later.

I need not tell you that the emergency legislation is in conflict with the EEA Agreement and some basic principles of the EU. But the law has not yet been put to a juridical test.

I have spent a lot of your time giving an account of the Icelandic financial collapse, because it might be an interesting phenomenon for you here in Ireland and the serious banking problems you have to deal with.

The banking business is so complicated that most often the criminal side of it is not exposed, except in a case when a bank is declared bankrupt.

The Icelandic bankers were the disciples of their colleagues in other countries, and their behaviour discloses the huge insolence, greed and criminal activities which take place behind closed doors, not only in Iceland but certainly also in the modern banking world outside Iceland.

But the Icelandic disaster is also a crucial event in the context of Iceland and the EU, especially because of the profound impact it had on the Icelandic people's opinion of EU membership.

In the years before the collapse, many people were impressed by the achievements of the Icelandic businessmen and bankers and the fantastic growth of their firms. They were buying big companies all over Europe, mostly in the UK and France, in the Nordic countries, in Eastern Europe, the Balkans and Asia. They became large owners, not only in the banking sector, but also in the pharmaceutical sector, telecommunications, in many airline companies and in the food market. A number of well-known clothing stores on London's Oxford Street belonged to them, also toyshops and jewellery stores.

These fantastic investments contributed to a rapid rise of asset prices in Iceland, as witnessed by the fact that the Icelandic Stock Exchange index more than tripled in few years.

But parallel to this globalisation, the business community was crying out for EU membership and the Euro.

When the wind of change started blowing through the banking world and stock prices began to decline, the EU propaganda was intensified. People were told that the EU would save us from our problems and just the application alone would change everything for us.

Then the house of cards came tumbling down.

At the start the effect was a general despair among people and a political chaos. But shortly after the collapse of the banks the outcome of the opinion polls began to reflect substantial changes in people's attitudes towards the EU. And when Parliament decided to apply for membership we already had the paradoxical situation that the majority of the voters were opposed to joining the EU club.

These changes in opinion were in fact quite logical.

People were getting their feet back on the ground. The pseudo-world of the EU propaganda were no longer casting its spell and more and more people understood that the most important thing for us in Iceland was to build up and strengthen our own industrial production, in order to be able to scramble our way out of the burning wreckage.

This leads us directly to the question of our currency and the Euro.

Individuals and firms which had foreign debts were hardest hit by the dramatic fall in the exchange rate of our currency. On the other hand, a low rate of exchange is very helpful, and in fact a necessity for a nation which needs to be encouraged to save money and not to buy too many imported goods, but rather to produce and export.

Without the adjustment Iceland has achieved through its national currency, the country would certainly be in a crisis situation for a lot longer than is now the case.

To-day nearly everybody is admitting the fact that the weak currency is helping the economy of Iceland rise from the grave, just like a jeep inching its way up a steep slope in low gear. Of course it will be a slow process but we will make it, and get there in the end.

Those who want Iceland to adopt the Euro must also face the fact that a long time will pass, even decades, before our state can fulfil the conditions of the Maastricht treaty and be able to introduce the Euro, particularly because of the national debt.

Additionally, several factors point to the conclusion that the EU is not a practical monetary union, let alone a practical solution for Iceland. Economic circumstances in the member states are very different, but the interests and the needs of the largest states are given priority by the common monetary policies of the Euro area, while small states get into a vicious circle of too-high exchange rates and unemployment, especially in the remote areas.

The debate on Icelandic membership of the EU is nothing new in our country. When I started professionally in politics 50 years ago, I was already making speeches opposing Icelandic membership of the European Common Market, as its name was then.

Eight years ago we founded a cross-political NO-TO-EU organisation in Iceland. Its name in Icelandic is "Heimss_n," meaning "A View of the World," and until last year I was leading it. Besides the question of the natural resources and the currency, we have been emphasising how disastrous it would be for future generations, should we give away the rights and the powers associated with our independence.

The decision to join the EU cannot be made with short-term goals in mind, such as a temporary economic crisis or problems with the value of our currency, the krona. We must think decades ahead and remember that it was because of our very independence that our nation succeeded in improving its quality of life, from being one of the poorest countries in Europe a century ago to one of its richest at the start of the 21st century.

For the average Icelander the EU is so remote in space and time that many do not realise that the EU is not an ordinary international organisation but has been developing for the last six decades and has gained all the main attributes that define a state. Nothing indicates that this development has run its course.

It seems that the ultimate goal of inducing member states to hand over important aspects of their independence to Brussels is the building of a new Super state. The rights of the member states will in the end be similar to the states of the USA. They have autonomy in certain areas, but limited independence.

The fact is that the powers of small states in the EU are decreasing little by little, the powers of big states increasing.

The transfer of power to the EU would be more deeply felt in Iceland than in any other EU state, both because of the unused energy resources and because the fisheries are such a large part of the Icelandic economy. In the fullness of time Iceland could become like a small county in a super-state.

We also point out that the democratic deficit in the EU is enough reason, on its own, to reject membership. Devolution of power is what modern times call for, but the ever-growing concentration of power in the centralised institutions of the EU, which are barely answerable to the supervising power of voters, is weakening European democracy.

The very small participation in elections to the European parliament shows how distant the commissioners of Brussels are to them. In Iceland the voters can throw out a government they don't like, but in the EU they would have no effect on who would be the new bosses of our citizens.

Iceland's distance from the power centres of the EU, and the EU bureaucrats' lack of knowledge of Icelandic circumstances, remind us how ridiculous it would be for Iceland to be governed from a distance of 1,200 miles (2,000 kilometres). Important decisions regarding Icelandic issues could mill around in the system for long periods and that could cause the nation a great deal of harm, for example in the fisheries sector where there is often a need for quick decisions and flexibility.

A lot of EU regulations do not suit Iceland at all, because it is such a small society where circumstances are in many ways unusual. The latest and worst example is that a group of businessmen could operate private banks overseas under the aegis of EU/EEA regulations.

These regulations were made in harmony with the circumstances in states 20 to 50 times larger than the Icelandic state, and proved to be highly toxic for our small nation and its taxpayers. It is of the greatest importance for Iceland that laws and regulations for our country takes into account the smallness of the population.

Far away to the southwest in the Atlantic there is another small nation which also has a lot in common with the people of Iceland. That is Newfoundland. In many ways I think its story is noteworthy.

Newfoundland was a British colony, which in the last century gained sovereign status in the Commonwealth, but got into severe financial troubles in the Great Depression and choose to enter the Canadian Union after the Second World War.

Through the centuries the most important industry in Newfoundland was fishing. They had some of the world's finest and most extensive fishing grounds which were also visited by European and American ships. In the sixties, seventies and the eighties hundreds of big trawlers from twenty to thirty countries fished there.

Iceland used its power as an independent state to protect its fishing grounds by extending the territorial fishing limit, first to 4 nautical miles, then to 12 miles, then 50 miles and finally to 200 miles. Canada was nearly a decade later than Iceland in this development and when Canada at last proclaimed a wider territorial fishing limit around Newfoundland, the fish was disappearing. In a period of few years the catch fell from around 800 000 tonnes of cod down to zero. The foreign fleet of modern factory trawlers had totally depleted the fishing grounds, just like a vacuum cleaner.

In many other sectors the loss of sovereignty also had a negative effect on employment in Newfoundland. Fresh initiative declined and many companies in commerce, banking and communications became branches from large enterprises in Canada. In recent decades unemployment in Newfoundland has been very high.

The gravest consequences of an economic depression are the situation when the economy gets into a vicious circle of protracted unemployment and low economic growth. The smallness of the Icelandic society makes it relatively simple to take rapid action, and the rate of exchange of a small currency is also quick to adapt to new circumstances. Therefore the whole economy has a flexibility which helps it to find the right way out of difficulties.

Every disaster, every misfortune, has its positive side and can be turned to our benefit. We in Iceland have learned our lesson. The first thing we had to admit was that terrible mistakes had been made.

But it could have been worse. The state could have been submerged in debts. Now, two years after the collapse, we are gradually getting to our feet.

Unemployment in Iceland is on its way down, and at the moment the rate is around seven, eight per cent, lower than both in the US and the average of the EU, where unemployment in many member states has been around 20 per cent in recent months.

But the situation is complicated and we face a lot of problems.

The worst problem is the huge debt burden which fell on the state.

But Iceland is not the only European state with a troubled economy.

A massive transfer of debt from the banking sector onto the balance sheets of nation states has taken place in Europe.

A wave of draconic austerity measures is sweeping over the continent, while everywhere the lords of the financial markets are stealing away from their responsibility.

The EU-lobby in Iceland quite regularly reiterates that Iceland is in need of the protection of the EU. It is true that we have no armed forces, a weak currency and the remains of economic chaos and instability after the worst financial crash we have seen in the last two centuries. Nevertheless the Icelandic people are still saying No to EU membership.

A year ago the Icelandic government knocked on the door of the EU.

Since then opposition against membership has been constantly growing and is now around two against one, which is to say between 60 and 70 per cent.

Of course it's a waste of energy and money to negotiate for years when you know that nothing will come of it. When people are asked in the polls if they want the EU application to be scrapped and withdrawn completely, the overwhelming answer is Yes.

Everyone in this hall is familiar with the game played by naughty children, who ring the neighbour's doorbell. When he opens the door they hide and laugh.

When the Commission in Brussels opens the door, the Icelandic people will not be hiding. They will give a clear answer. But inevitably it will sound to the ears of the Commissioners like a door-bell prank.