

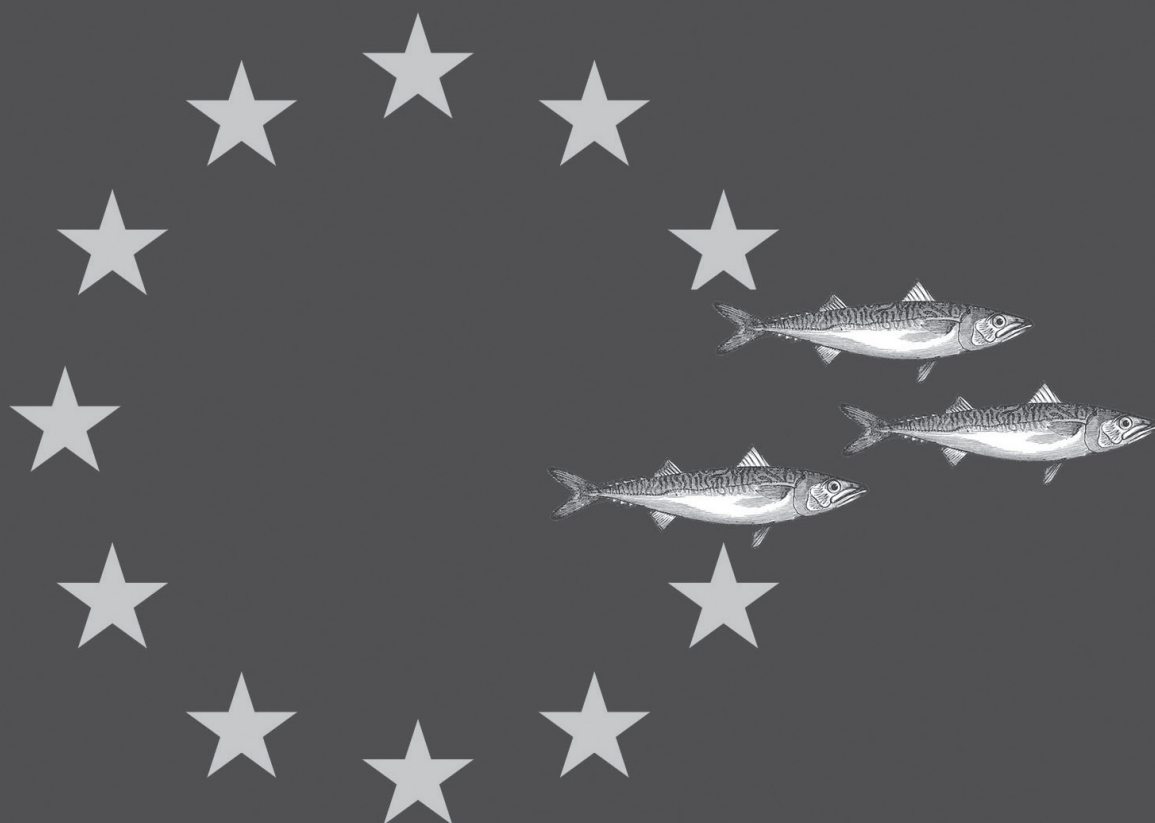
ICELAND AND EUROPE

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Alyson J.K. Bailes & Baldur Thorhallsson

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DRIFTING FURTHER APART?



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- Iceland applied for EU membership in 2009 at the height of the economic crisis. Four years later, a new government has put the application on hold: the majority of Icelanders are opposed to entry, but want to continue the accession process and put the results to a vote.
- Iceland's longer-standing problems with European integration stem from the issue of sovereignty in general, and maintaining control over fisheries and agriculture in particular.
- Since 2009, anti-European feelings have been stoked by the 'Icesave' dispute, while the prospective benefits of entry (including use of the euro) have been tarnished by witnessing the fate of other small states during the euro crisis.
- The new government proposes remaining a member of the EEA and developing relations with other world powers. But the US commitment to Iceland has weakened over the years, and 'rising' powers like China are unable, as yet, to solve the country's core problems.
- In terms of both its security and its standing within the global economy, Iceland is becoming more rather than less dependent on Europe over time. The question raised by the latest political turn is whether it will have to maintain that relationship from a distance, with limited control and with no guaranteed goodwill.

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Iceland is not only one of Europe's smallest states (just 320,000 inhabitants), but also one of those worst hit by the financial crash of 2008. No other nation in the Nordic group suffered such trauma or underwent such major political upheavals as a result. One effect was to strengthen the hand of Icelanders who argued for taking shelter within the European Union (EU) and, ultimately, replacing the fragile Icelandic krona with the euro. Under an unprecedented left-of-centre coalition government comprising the Social Democratic Alliance (SDA) and the Left Green Movement (LGM), a parliamentary majority voted in summer 2009 to begin accession talks with Brussels.

Five years later, the elections of May 2013 served to swing Iceland back onto an opposite and more habitual track of Euroscepticism. The new coalition consists of the conservative Independence Party (IP) and the agrarian Centre-Right Progressive Party (PP), in both of which pro-Europeans are a minority. The latter's leader, Sigmundur Davíð Gunnlagsson, became prime minister – with IP leader Bjarni Benediktsson taking up the post of finance minister – mainly because the PP made much greater gains in the election. In their programme,¹ the new government leaders declared a 'pause' in the EU talks to allow an assessment to be made of the negotiations so far and the EU's own situation. This will be put before parliament and the people, and accession talks will not re-start 'except/unless after the holding of a national referendum'. The last, ambivalent phrase leaves it unclear whether the government is committed to putting the issue of continuing talks to the nation, or whether negative findings in the assessment process might suffice for a decision to discontinue them.

This paper addresses Iceland's recent dealings with Europe in the wider setting of its foreign policy and external strategy, and poses two main questions: What drivers have been at work, and what, if any, pointers can be found for the future? The paper will seek to critically explore the questions, rather than offer answers. Iceland's struggle to digest the issues raised in 2008 has clearly not ended, and it is too soon to say when or how it will.

1 *Stefnuyfirlýsing ríkisstjórnar Framsóknarflokksins og Sjálfstæðisflokksins*, 22 May 2013, available at <http://www.stjornarrad.is/Stefnuyfirlýsing/>.

A European outpost

Iceland's starting point is unusual in many ways.² Its tiny population inhabits a large island so remote from the European continent that Reykjavik is almost twice as far from London as it is from Greenland. Settled only in the 10th century, for centuries Iceland was linked to Europe only by sporadic sea traffic with sovereign masters (Norway and then Denmark) who themselves were located on the continent's western frontier. This helps explain how Iceland could emerge as a sovereign entity in 1918 and as a Republic in 1944 with its archaic variant of Nordic language and its idiosyncratic culture and lifestyle intact. Alone among the Nordic states, it has no armed forces and relies wholly on US protection, exercised bilaterally and through NATO. Its welfare system provides a broadly Nordic degree of cover but outsources some significant tasks to non-governmental and volunteer agencies, as does its internal emergency management.

Icelandic singularities extend to politics. The parties of the Centre-Right enjoyed a highly un-Nordic dominance in the decades after 1944, holding power for 51 of the last 69 years. Their leaders grew close to the USA not just in terms of strategic dependence, but also culturally and ideologically. American influence helped turn them from an initial *dirigisme* towards *laissez-faire*, free-market economic policies, followed by a more overtly Friedmanite programme of privatization.

Also untypically of a Nordic country, however, this strategy was imposed top-down rather than by building on a grass-roots consensus or a corporatist understanding. Icelandic politics are distinctly adversarial, personalized and polarized, making it hard to achieve compromise or even open-minded debate on any key issue. Thus the far Left virulently oppose the US/NATO connection, while the Social Democrats' long-term interest in European integration has been equally virulently opposed by the far Left and the Right.

2 For more details on all the following points, see Baldur Thorhallsson, *Iceland's contested European Policy: The Footprint of the Past – A Small and Insular Society*, Occasional Paper 02/2013 of the University of Malta, at http://www.um.edu.mt/_data/assets/pdf_file/0004/185971/JM-BaldurPaper022013webv4.pdf.

Shaken, not stirred

This political landscape was shaken, rather than stirred into a significantly new mixture, by Iceland's tribulations, starting in 2006. That autumn, the US military base at Keflavik closed and all US forces withdrew, despite lengthy Icelandic pleadings for them to stay. US cover was re-framed as a reinforcement pledge under the still-extant bilateral defence treaty of 1951. The next two years saw speculative assaults on Iceland's small currency (the Icelandic krona), followed by the great crash of autumn 2008 which – among other things – halved the krona's value. At the same time, Iceland failed in its bid to win a rotating member seat on the UN Security Council.

This crisis, which in some nations might have drawn parties closer together, led in Iceland to an unprecedented double swing in political power. With the Right's former leaders discredited by the bust following the banking boom, the SDA and the more radical Left Greens took over the government provisionally in February and again after the elections in May 2009. It was a historic chance for the Social Democrats – who in earlier decades had driven Iceland's decisions to join EFTA and the European Economic Area (EEA) – to apply for full EU membership, and the normally anti-EU Left Greens complied as part of a coalition agreement. On the EU side, matters progressed unprecedentedly fast, and the green light was given in June 2010 for the negotiations that opened a month later.³

By early 2013, of 33 substantive negotiating chapters, 26 had been opened and 11 closed, with the fastest progress in areas where Iceland was already bound by EEA obligations.⁴ No real problems arose over foreign, security and defence policy either. But as the parties prepared for the 2013 election, agriculture, fisheries and some delicate financial issues remained to be addressed. While most opinion polls in 1998–2008 had shown a majority in favour of EU accession, since early 2009 the largest group

of respondents had expressed opposition to membership.⁵ Patently divided on the issue, the SDA and LGM had to agree in the election run-up to suspend efforts for progress in the accession talks. Iceland's default anti-European setting was reasserting itself, even before the right-of-centre parties won their victory with the help of anti-EU rhetoric. Aside from the historical generalities above, how can this be explained?

The most reluctant European?

Iceland's adjustment to the new Europe has, in fact, been problematic both in the medium and the near term. After 1944, the dominant themes were sovereignty and fish (notably, gaining control of the waters around the island). As the Independence Party's name suggests, the idea of 'standing alone' has had and continues to retain a powerful hold over Icelandic minds: combining a conviction that the Icelandic way is right with paranoia about its vulnerability to external dominance or deception.

For the political Right and Centre, the US relationship dating from the Second World War triggered no such fears because Washington gave both economic aid and strategic cover, and asked for little, except the Keflavik base, in return. 'Europe', however, was seen as a kind of greedy amoeba that would give Iceland a theoretical voice while in practice sapping its independent will and ingesting its resources. Tellingly, political agreement to join the EEA was reached in 1993 only after Icelandic negotiators reported that they had 'got everything for nothing'. Few outside the Social Democrat camp – which has never won more than thirty per cent of the nation's votes and was the smallest of the four main Icelandic political parties up to 1999 – have ever believed that Iceland could similarly outsmart the full power of the Union in the event of full integration.

As for fisheries, Iceland was willing to fight repeated 'wars' with Britain for exclusive control of its waters out to a distance of 200 nautical miles. Today, fish and related products still account for 40% of

3 Graham Avery, Alyson JK Bailes and Baldur Thorhallsson, 'Iceland's Application for European Union Membership', *Studia Diplomatica* Vol. LXIV-1, January 2011.

4 For details, see the website of the EU Information Office in Reykjavik (Evrópustofa) at <http://eu.mfa.is/negotiations/status-of-talks/nr/7109>.

5 See p. 7 of the digest of poll results 2000–2013 from Capacent Gallup (published by the Federation of Icelandic Industries) at http://www.si.is/media/althjodlegt-samstarf/4022801_Samtok_Idnadarins_210213.pdf.

Iceland's exports, although the general switch to large hi-tech vessels makes their impact on employment far smaller. Iceland's insistence on freedom of exploitation is reflected both in its pursuance of commercial whaling, and the recent dispute with Norway and the EU over the right to catch migrating mackerel.⁶

At its simplest, the popular fear about Europe is that 'the EU (or large members like Britain and Spain) will take our fish'. In actuality, Icelandic 'historic rights' to a share of the catch would be respected in the event of membership, and the latest new guidelines announced for the EU fisheries policy⁷ have moved it nearer to the kind of ecological calculations and local control that Iceland's own fishery management is based upon. However, opening up ownership in the Icelandic industry is still a potential deal-breaker given the sector's strategic role in the national economy, and the political influence of big fishing enterprises, which enjoy close ties with the new government. It must also be said that to Icelandic eyes, the EU's style of negotiating in specific disputes (most recently on mackerel) can appear both rigid and doctrinaire, to a degree that merely inflames the concern about a small interlocutor being bullied and pushed aside. Such perceptions are shared among many Icelanders and the people of the Faroe Islands and Greenland, who have rejected any institutional relationship with the Union at all.

Added short-term disincentives to integration may again be summed up in the following words: Icesave and the euro crisis. The Icesave dispute was pursued up to 2012 by the UK and the Netherlands rather than the EU, and was finally adjudicated (in Iceland's favour) in the EFTA Court. But the two claimant countries based their claims for reimbursement⁸

on EU/EEA regulations about official guarantees for bank deposits, and the demand for Iceland to treat other EU/EEA account-holders like its own citizens.

The left-of-centre government's difficult negotiations with the two states could too easily be seen as another case of innocent little Iceland being bullied by large Europeans, using legalistic European arguments. Resentment swelled over the UK's use of anti-terrorist legislation to freeze Icelandic bank holdings, and again when it became clear (in 2009) that the UK and the Netherlands were holding up post-crisis IMF assistance to Iceland pending a payback guarantee. Conversely, the insistence of Progressive Party leaders that Iceland should and could win a legal case against the Icesave claims – implicitly backed by President Ólafur Ragnar Grímsson when he called national referendums to strike down two successive Iceland/UK/Netherlands agreements – played a major role in the former's landslide election victory of May 2013.

As for the euro crisis, Icelandic attention has focused on what it means for the euro as such, and the fates of small EU members. A key argument of Icelandic pro-Europeans is that the country needs a stronger international currency if it is to engage safely in globalized trade without tight exchange controls. (Such controls were imposed after the crash with IMF complaisance and are still in place, though contrary to EEA rules.)

The (false) perception that the Europe-wide crisis has been about the strength of the euro has weakened this case, though other mooted solutions such as resorting to unilateral adoption of the euro, or a currency union with Norway or Canada, are even less plausible. The new government has simply declared that the Icelandic krona will be the national currency for the foreseeable future. As for other small states, the average Icelandic sees Ireland and Cyprus not only as suffering more dictation and unfair treatment due to their EU/euro membership, but as having found worse solutions than Iceland's, specifically for their banking debts.⁹

6 The Icelandic side of this story can be found at <http://eng.atvinnuvegaraduneyti.is/subjects/mackerel-fishing-dispute/nr/6903>.

7 European Commission, *Landmark agreement on Common Fisheries Policy reform*, at http://ec.europa.eu/information_society/newsroom/cf/mare/itemdetail.cfm?item_id=10888&subweb=343&lang=en.

8 Specifically, the governments sought repayment with interest of sums they advanced to their own citizens when cash in the latters' deposit accounts with two Icelandic banks disappeared during the crash. For the Icelandic side of the argument, see <http://www.mfa.is/tasks/icesave/q--a/>.

9 In essence, Iceland froze the old 'bad' banks, rather than letting bankruptcy take its course or bailing out their external debts, while creating new banks where domestic accounts were preserved. Settlement of major old bank debts began in 2012, including substantial payouts to Icesave depositors.

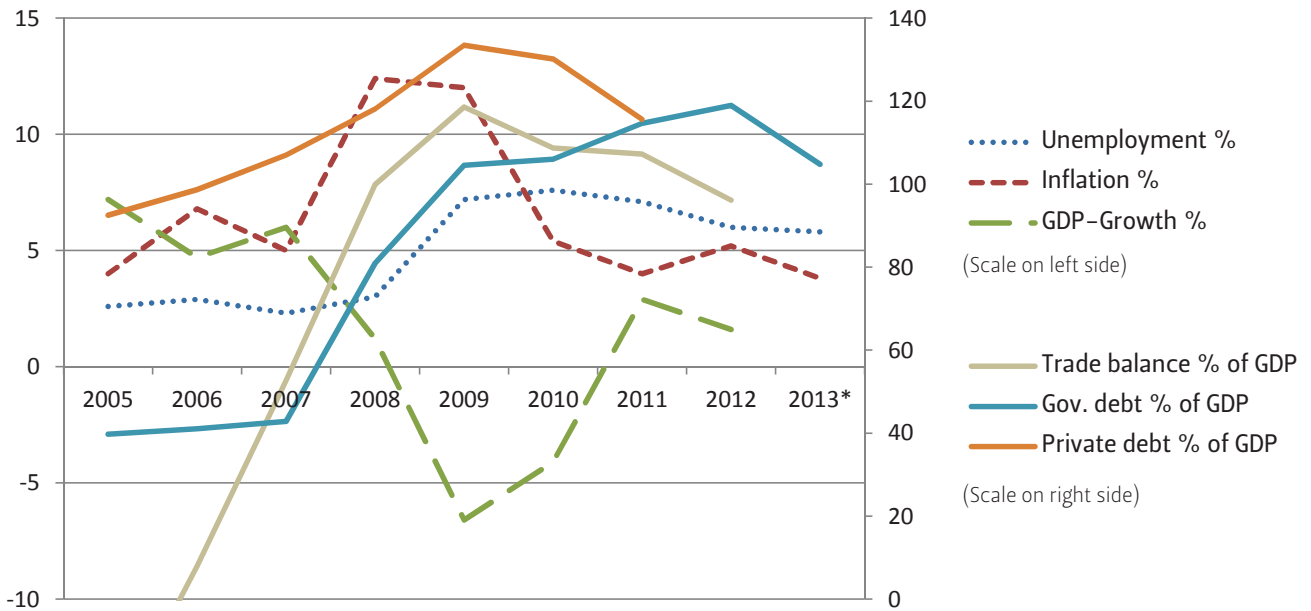


Figure 1: Iceland's Main Economic Indicators 2005–2013. Most indicators show a recovery since 2009–10 but official and household debt remains a major headache, as does continuing reliance on exchange controls.

Table by Viktor Orri Valgerðsson; 2013 figures are latest estimates. Source: Statistics Iceland, www.statistics.is.

What next?

The new government aims to reinvigorate Iceland's economy from the top – for example through lower company taxes and relaxation of environmental curbs – to the bottom, through relieving household debt. As the country's wealth depends so heavily on external trade, tourism and investment, and as over 80% of trade goes to EU/EEA members, the new leaders do appreciate the need for access to the Single Market through the EEA.

The problem, for Iceland as for other EEA members, is that non-EU participants have only a minimal say in the reams of Single Market legislation that they are obliged to implement as the price of their market access: and they have no control at all over new EU policy decisions that may affect their economic fortunes more profoundly. Current examples of EU initiatives with strong, partly alarming implications for Iceland are the various proposals for more centralized banking controls and the proposed EU-USA Free Trade Agreement. But how much influence can Icelanders expect *vis-à-vis* the EU on such issues, if they break off the accession process while still hanging tough on mackerel and similar disputes?

It may be premature to expect a new government to master such challenges, but they will get no easier

over time. The new leaders' credibility is tied above all to their economic performance, which came under critical scrutiny even in their first weeks. The nexus of issues around relieving debt, maintaining stability for banks and large enterprises, and boosting external confidence – crucial both for any hope of lifting exchange controls and for future investment – seems especially intractable. And as soon as anything goes wrong, the scope for splits both between and within the parties is hardly less than under the last coalition.

Meanwhile, Iceland's always-volatile public opinion may be hedging even on the EU issue itself. There is concern that important internal reforms will be jeopardized by losing the 'IPA' grants promised by Brussels for pre-accession adjustment of Icelandic systems. Opinion polls show a majority generally¹⁰ in favour of completing the membership talks so that the people could accept or reject the terms by referendum, which helps explain the new government's hesitation over calling a referendum

10 Some polls in 2011–12 showed a negative balance, but by early 2013 the average poll finding was back to over 50% for continuing talks and around 30% definitely against. A clear majority in June 2013 also wanted to be able to address the issue in a referendum.

on the negotiations issue itself. What if the result was a Yes for continuing talks, while key government ministers – including the foreign minister – have already said that will never happen on their watch?

Alternatives to Europe?

It might be easier to guess how the new leaders will solve these conundrums if the general prospects for Iceland's external strategy were clearer. Normally, a small state exploits more than one source of shelter and protection and, if skilled, can play off one large partner against another. For Iceland, the events since 2006 have generated new debates and uncertainties in this context as well.

Firstly, trust in Washington has been gravely shaken by the military withdrawal, the US origins of the 2008 economic collapse, and the lack of US aid thereafter. One effect has been to make Icelandic policy-makers take more interest in NATO as an institution, seeking to diversify military relations, and signing bilateral defence MOUs with several Nordic and other neighbours. NATO's agreement to hold periodic airspace patrolling exercises over Iceland, involving allies as distant as Poland, is seen as a success for these new tactics by all except the Icelandic far Left.

However, NATO's future value to Iceland has two great limitations. Its protective power is doomed to wane, as is the direct US engagement in Europe; no other ally would venture west to help Iceland in a general crisis, while defence cuts are further sapping the ability to do so. Secondly, NATO is irrelevant to Iceland's real existential challenges, which lie in the economic and 'soft' security fields.¹¹ That became

11 This would not have been obvious in the past as the dominant Right had a narrow, military concept of security. Since 2006, however, broader definitions have come into currency that take greater account of natural disasters, infrastructure and supply, and economic/financial hazards. An independent 'risk assessment' along these lines was published in March 2009 and at the time of the 2013 election, a parliamentary cross-party group was drafting policy recommendations with a similar multi-dimensional approach. It remains to be seen whether the new government will follow through with these materials and/or develop an official security strategy.

clear enough when Iceland used NATO fora to complain about the UK's use of 'anti-terrorist' measures during the Icesave dispute, with less than no effect.

Even during the Cold War, Iceland traded profitably with the Soviet Union, so it is no stranger to the idea of balancing one super power against others. The idea of turning to Moscow resurfaced in the early days after the 2008 crash, when a delegation was sent (fruitlessly) to enquire about a Russian loan. More recently, President Grímsson has argued for exploring the new strength of China, the only top world power with still-robust growth, and one with growing global reach demonstrated not least by its exploration of Arctic trade routes (see more below). Indian investors meanwhile have committed *inter alia* to building two new luxury hotels in Iceland. The new government has duly signalled a wish to explore all these new power relationships with a view to their serving (at least) as a supplement to the basic Euro-Atlantic orientation.

Even setting aside questions about such partners' values and sincerity, however, none of them can give Iceland the broad strategic cover it needs, or provide more than minor help in boosting its economy in the near term. Nor do they provide as clear an alternative to Europe as their advocates might wish. Would China and India want to invest in an Iceland that no longer formed part of a 500-million-strong Single Market? China's keenness to conclude a Free Trade Agreement with Iceland (signed May 2013) was certainly linked to the country's EEA status. And if Iceland wants a level playing field and protective international rules when engaging with such huge partners, it must look first and foremost to the EU's policies, partnerships, and global clout to secure them.

The Arctic and Nordic dimensions offer perhaps the strongest card in Iceland's post-crisis policy hand. During the Cold War, Iceland's position in the Atlantic gateway to the High North guaranteed US/NATO protection. Now in the context of climate change and potential Arctic opening, it is again attracting the interest of all large powers, and not necessarily in a hostile or competitive way. Iceland can reasonably hope for longer-term benefits both direct (agriculture, tourism), and indirect, for example through the demand for its cheaply-generated energy and for services to shipping. Like other small players, however, it needs a peaceful Arctic

setting, respect for the environment, and rules of economic fair play to secure sustainable profits. Since experts predict a relatively slow build-up of investment and activity, Iceland also needs good, low-cost ways to meet imminent challenges such as more frequent accidents, natural disasters and infrastructure break-downs. All this explains the new government's statement that Iceland must be a leading player in the Arctic and will also foster 'West Nordic' cooperation.

'Leading' in the Arctic makes sense if it means Iceland should be heard and successfully push its interests. As an Arctic Council (AC) member it has already helped win arguments over strengthening the Council's mechanisms and admitting new observers (including China in May 2013). It hosted the working groups that finalized the texts of two binding AC agreements on search and rescue and anti-oilspill cooperation, both crucial for addressing gaps in Iceland's own capacities.¹² Further, Iceland has managed to focus Nordic security cooperation increasingly on its own plight and the Arctic, among other things by securing a Nordic 'solidarity' pledge in 2011 for all non-military emergencies, and persuading Sweden and Finland to join monitoring flights over its territory.

'West Nordic' cooperation is a network that links parliamentarians in Iceland, Greenland and the Faroes, but is also gaining ground among academics, officials and firms. All three small entities have potential large gains in view of Arctic development (for example from their own sub-sea oil and gas), but may struggle to avoid being overwhelmed or exploited. Ironically, Iceland is the only one with direct access to EU norms and potential solutions through the EEA, and its Arctic policy aims are almost identical to the EU's. Should Greenland and/or the Faroes seek full independence, Reykjavik would offer them a bridge to Europe in a more meaningful sense than Copenhagen.

Last words: back to the future?

Iceland's latest swing to the Right raises more questions than it answers. The nation's de facto reliance on Europe, including Europe's success in

surmounting the euro crisis, is no less than it ever was: arguably greater, given the EU's growing importance in 'soft' security contexts and Iceland's need for friends in the Arctic. The bleakest interpretation of current politics is that by renouncing full membership, the Icelandic elite will doom themselves to remain dependent on the EU in these and other ways without shared control; possibly – given mackerel and the like, and the limits of flexibility and comprehension on the EU side – with no guaranteed goodwill either.

As we have seen, however, there is no convincing 'better hole to go to', and even the more constructive Nordic/Arctic dimensions of Iceland's strategy rely to some degree on its preserving a European anchorage. Meanwhile, the pro-European forces can regroup and speak more freely in opposition. Whatever happens in the next year or so, it may prove only a brief stopping point in the longer Icelandic saga.

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¹² Details at www.arctic-council.org.