Iceland, economic integration and the European Union

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Abstract

Iceland is a small resource rich country in Europe that is highly dependent of foreign trade. According World Bank classifications Iceland is a high income economy, but with a population of little more than 300 thousand inhabitants, it is the smallest economy within the Organization for Economic Co-operation and Development (OECD). Iceland is highly dependent of foreign trade, especially to and from the European Union, where economic and political integration is evolving and the question about the most feasible level of participation is a future challenge for the country. Iceland is a member of the European Free Trade Association (EFTA), the European Economic Area (EEA) and Schengen and European Union (EU) candidate country until recently, when its government decided to withdrew its EU membership application. The EEA agreement currently ensures Iceland's access to the EU's common market.

Keywords: *Economic integration, small states, Iceland, global crisis, economic policy.*

JEL classification: F15, H12, E6.

Introduction

Iceland is a small resource rich country in Europe that is highly dependent of foreign trade. According to World Bank classifications Iceland is a high income economy, but with a population of little more than 300 thousand inhabitants, it is the smallest economy within the OECD. Iceland in highly dependent of foreign trade, especially to and from the European Union, where economic and political integration is evolving and the question about the most feasible and sustainable level of participation in this integration remains a challenge for the country. Iceland is a member of EFTA, EEA and Schengen and EU candidate country until recently when its government decided to withdrew its application. Should Iceland continue to rely on the current arrangement? Should it seek EU membership in the future and perhaps subsequently become part of the Euro area? What are the possible benefits and disadvantages for Iceland joining the EU and the Euro Area?

Iceland applied for EU membership in July 2009 and began accession negotiations just a year later. The current cabinet, that took office in May 2013

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decided to put the accession negotiations on a complete hold, to dissolve the negotiating structures, and to commission an assessment of the accession process as well as of developments in the EU (Ministry for Foreign Affairs, 2015). When the accession negotiations were put on hold 27 out of 33 chapters had been opened, out of which 11 have been provisionally closed. 6 chapters had not been opened, although negotiating positions was in place for two of them, i.e. the chapter on food safety, veterinary and phytosanitary policy and the chapter on justice, freedom and security. A negotiating position was not in place for four chapters, i.e. the chapters on agriculture, on fisheries, on the free movement of capital and on the right of establishment and freedom to provide services (Institute of Economic Studies at the University of Iceland, 2014).

Had negotiations resumed, Iceland would have faced contentious issues on fisheries policy which could potentially have derailed an agreement. The chapter on agriculture was also sensitive and challenging. Since those most difficult chapters were never opened it is hard to say what the changes of agreement between Iceland and the EU were. Also, if an agreement was reached, the accession treaty would still require ratification by every EU state and be subject to a national referendum in Iceland. Public support for EU accession measured by opinion polls has fluctuated, but is currently low.

1. Gains from trade, economic integration, multilateralism and small states – some theoretical considerations

Classical economic theory documents gains from international trade, demonstrating that nations can improve the welfare of their populations by engaging in cross-border trade with other nations. To this day this is one of the fundamental principles underlying arguments for all countries to strive to expand and to promote free world trade (e.g. Czinkota et.al 2009). The efficiencies derived from economics of scale are also a key argument for economic integration[2] and the creation of a common market that can benefit all participating countries. The level of economic integration varies. From least to most integrative, they are: the free trade area, the customs union, the common market and finally the economic union. EFTA, which Iceland is a member of since 1970 (see table 1), is a free trade area and represents the loosest form of economic integration where all barriers to trade among member countries are removed.

It does not have a common trade policy, such as a common external tariff, with respect to non-members, like customs union do. EFTA has three core tasks. The first is the liberalization of intra-EFTA trade. Second, the EFTA States have built networks of preferential trade relations in the world, currently consisting of 25 free trade agreements (FTAs) with 35 partners. Third, three of the four EFTA

[2] In addition to economic benefits to economic integration there can also be important political and security concerns that drive the integration process.

States – Iceland, Liechtenstein and Norway – are parties to the EEA Agreement,[3] which ensures their participation in the Internal Market of the European Union[4] (EFTA, 2014). As table 1 shows EFTA has lost most of its members who chose closer economic integration by joining the EU.

Table 1. European Free Trade Association (EFTA)[5] membership through the years

1960	Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom establish EFTA
1970	*Iceland becomes a member of EFTA*
1972	Denmark and the United Kingdom leave EFTA to join the European Economic Community (EEC)
1985	Portugal leaves EFTA to become a member of the European Economic Community (EEC)
1986	Finland becomes a full member of EFTA
1991	Liechtenstein becomes a member of EFTA
1995	Austria, Finland and Sweden leave EFTA to join the European Union (EU)

Source: EFTA, 2014

The EU is moving towards an Economic Union. This involves not only abolition of tariff and quotas among members (like in the case of a tree trade area such as EFTA), but also common tariff and quota system, abolition of restrictions of factor movements, as well as harmonization and unification of economic policies and institutions. The formation of an economic union requires nations to surrender a large measure of their national sovereignty to supranational authorities in union wide institutions.

The level of integration varies among countries within the EU as 19 out of 28 member states have adopted the euro (€) as their common currency and sole legal tender, see figure 1. The formation of a common currency area can bring benefits to the members of the currency union, particularly if there is a high degree of international trade among them (i.e. a high level of trade integration). This is primarily because of the reductions in transaction costs in trade and the reduction in exchange rate uncertainty. However, there are also costs of joining a currency

[3] The EEA Agreement does not include the following EU policies: Common Agriculture and Fisheries Policies; Customs Union; Common Trade Policy; Common Foreign and Security Policy; Justice and Home Affairs (the EFTA States are part of the Schengen area); Economic and Monetary Union (EMU).

[4] The EEA EFTA States do not have the right to participate in the political decision making within the EU institutions. The EEA Agreement does, however, provide the EEA EFTA State experts with the opportunity to contribute to the shaping of EU legislation (EFTA, 2014).

[5] The European Free Trade Association is an intergovernmental organization set up for the promotion of free trade and economic integration to the benefit of its Member States (today Iceland, Liechtenstein, Norway and Switzerland). (EFTA, 2014).

union, namely; the loss of independent monetary policy and the loss of the exchange rate as a means of macroeconomic adjustment.

In addition to economic theories on the gains from trade and economies of scale, as well as theories on economics of integrations, including common currency area, there are also theories on the behavior of small states within multilateral arrangements. Small states as well as large states have a choice to engage in bilateral negotiations and/or multilateral arrangements to address issues that cannot only be resolved within their borders. Bilateral negotiations are carried out between two nations focusing only on their interests. On the other hand, multilateralism is the international governance of the many, and in the case of the EU, 28 member states, large and small.

Multilateral negotiations open up the possibility for small states along with larger states to participate in international decision making. According to Thorhallsson, a leading scholar on small states, the small states literature generally claims that it is beneficial for small states to concentrate on multilateral relations within international organizations (Thorhallsson, 2005). When discussing multilateralism Kahler states that "Smaller, weaker states were believed to be disadvantaged by bilateralism..." and "[i]n their formal institutional design at least, most postwar multilateral institutions incorporated a larger role in decision making for states that were not great powers and could not aspire to be" (Kahler, 1992, p 681). When discussing small states as aid donors, Hoadley predicts high levels of participation by small states in multilateral agencies (Hoadley, 1980, p. 129). This would apply to the United Nations (UN) as well as multilateral development banks. More recently, Evans and Newnham argue that small states are said to have limited involvement in world affairs, favor intergovernmental organizations, are advocates of international law, shy away from the use of military force and in general have limited, mostly regional, foreign policy priorities (Evans and Newnham, 1998, p. 500–501). Finally, Maass states that "[m]embership and participation in international governmental organizations is not only a frequent priority of small states, but it has also been discussed as an indicator of independence, and as such as a secondary definitional requirement for small states in particular" (Maass, 2009, p. 69). A group of small states can also be influential as Ingebritsen argues, when discussing Scandinavian countries, that "these states exercise collective authority beyond their borders that exceed their military or economic might" (Ingebritsen, 2006, p. 1). She also argues that Scandinavians are likely to be found in groups that seek to strengthen international institutions. Scandinavian countries are indeed active participants in the UN and in multilateral development banks and among them Denmark, Finland and Sweden are EU members and give high priority to active participations within the EU institutional systems.

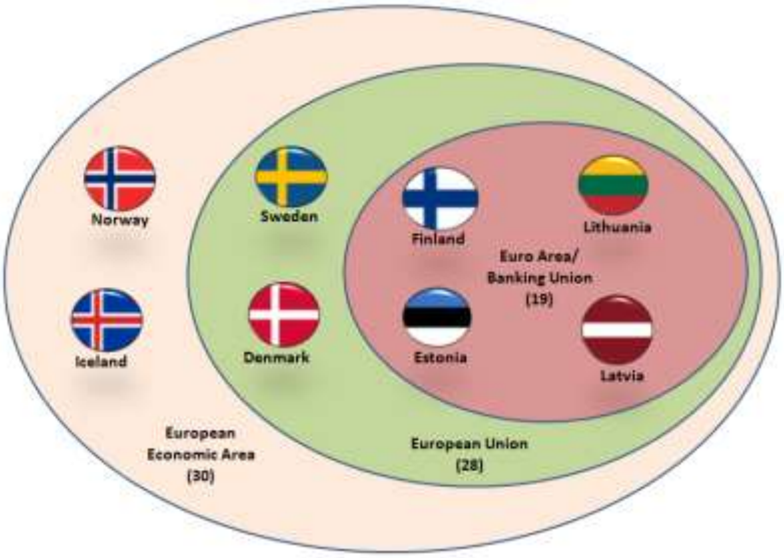
Keohane suggests that we focus on the systemic role that state leaders see their countries playing. This is critical to understand the impact countries can have on the international community. Keohane uses the following categories: System-determining when a state plays a critical role in shaping the international system; System-influencing are states that cannot expect individually to dominate the international system but may be able to influence it through unilateral or multilateral action; System-affecting states are those that cannot affect the international system if acting alone but can exert significant impact on the system if working through small groups or alliances or through universal or regional international organizations; and finally System-ineffectual states are those that can do little to influence the system-wide forces that affect them, except in groups which are so large that each state has minimal influence (Keohane, 1969, pp. 295-296).

How can this categorization contribute to the behavior of small states in international organizations? As Keohane observes, "...a major function of international organizations – perceived by many small and middle powers – is to allow these states acting collectively to help shape developing international attitudes, dogmas and codes of proper behavior" (Keohane, 1969, p. 297). For example, Iceland, acting alone or in partnership with a very large number of other countries, would have little impact and would be classified as system-ineffectual. Iceland could do little in most cases to influence system-wide forces. However, situations can exist, including international development cooperation, where small countries that work in partnership such as the Nordic-Baltic group could become system-affecting (see for example, Hilmarsson, 2011).

Iceland has in the past cooperated multilaterally with the Nordic countries and parliamentarians from those countries meet regularly in joint sessions. During the Cold War Iceland had strong bilateral relationship with the USA, a system-determining country, including a bilateral defense agreement. The political ties between the two countries could be critical in resolving disputes between Iceland and other countries most notably the dispute with the UK over fisheries territories. Post-cold war this relationship is weaker and does not provide the shelter it did in the past. Unlike Denmark, Finland and Sweden and the Baltic States, Iceland an EEA EFTA country (with Norway), in not an EU member and is not sheltered by EU institutions, see figure 1. There is a possibility, at least in theory, that the Nordic-Baltic countries could become system affecting states within the EU if the cooperate as a group.

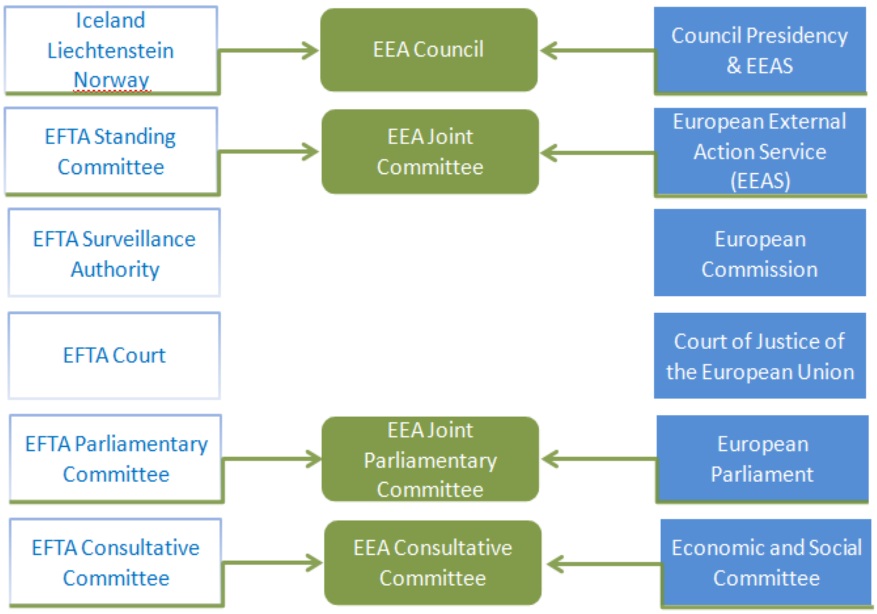
Although the three EEA EFTA states do not have the right to participate directly in the political decision making within the EU institutions, the EEA Agreement provide their experts with the opportunity to contribute to the shaping of EU legislation at the preparatory stage. This is done via participation in the European Commission's (EC) expert groups and committees. These groups advise the EC with the drafting of new laws, which the EU Council of Ministers and the European Parliament subsequently adopt. The participation of EEA EFTA experts and representatives in over 500 of these committees and groups is a valuable opportunity to acquire information and contribute to new legislative proposals at the earliest stages of policy formation (EFTA, 2014). This, however, means that the EEA EFTA states need to allocate sufficient human resources to take full advantage of this opportunity and this has been a challenge for Iceland. The EEA Agreement is supported with its own institutions and a formal cooperative mechanism vis-a-vis the EU institutions. The mechanism for decision shaping has thus been formalized and if used wisely can able the EEA EFTA states become system affecting in some cases, see figure 2.

Figure 1. The Nordic and the Baltic States, all small countries, have chosen different levels of European integration. Norway and Iceland have the lowest level of integration but the Baltic States and Finland the higest level of integration



Source: Constructed by the author

Figure 2. Decision shaping under the Two-Pillar Structure under the EEA Agreement



The EEA Agreement established EEA EFTA bodies to match those on the EU side.
Source: EFTA, 2014

2. A brief literature survey on the economy of Iceland and its changing structure

As stated above, Iceland is an open economy that participates in major European cooperative projects, including EFTA, the EEA, and Schengen as well as in NATO. In addition to that it is an active participant in cooperation within the Nordic Region. The Icelandic economy is the smallest within the OECD. Its size is about 0.1 percent of the US economy, 4 percent of the Danish economy, and 25 percent of the economy of Luxembourg, while it is more than 50% larger than the economy of Malta (CBI, 2014).

Iceland is classified by the World Bank as a high income economy but the small size of its economy reflects the country's small population which was 329.100 on January 1, 2015. Iceland is considered to be a Nordic country and has the characteristics of a Nordic welfare state. Gross National Income (GNI) per capita measured in terms of Purchasing Power Parities (PPP), according to World Bank data, amounted to nearly 39 thousand US dollars in 2013, the twenty-second highest in the world and the thirteenth highest among the OECD countries. Iceland's GNI per capita is lower than that in Denmark, Norway, and Sweden but marginally higher than in Finland and slightly above the EU average (CIB, 2014).

Table 2. Iceland: General Information

Name	Iceland
Government	Constitutional republic
Head of State	President
Head of Government	Prime Minister
Official Language	Icelandic
Capital	Reykjavík
Area	103 000 Km2
Population	329.100 (January 1, 2015)
Population Density	3.1
Currency	Icelandic króna (ISK)

Sources: Official government websites

Historically, Iceland's prosperity has to a large extent been built on its comparative advantage in the marine and energy sectors (hydro and geothermal power), with investment and services as the main drivers of growth. Tourism has soared over the past few years and has become one of the main engines of export growth. In fact, tourism has established itself as the third pillar of the Icelandic economy (in addition to the fisheries and energy sectors), and as a result, Iceland's economy has become better diversified. Currently Iceland's largest trading partner countries are the Netherlands, Germany, Norway, the US, and the UK (CIB, 2014). The Euro area constitutes the largest trading area.

Over the past 10 years, the Icelandic labour market has had a participation rate consistently above 85 percent, one of the highest among OECD countries. In

2013, female participation was one of the highest in the OECD countries, with women accounting for 48 percent of the labour force. Participation rates among the young and the elderly have also been quite high (CIB, 2014). Unemployment is also low compared to EU member states and currently is about 4 percent.

While Iceland participates in European integration via EFTA and the EEA agreement, its history shows that it is skeptical about the benefits deriving from participation in international organizations and has not build a strong institutional capacity to cooperate on a multilateral basis. This in not only true if one considers EU membership skepticism. Iceland has also not sought membership in as many institutions that other Nordic countries actively participate in, including the regional development banks[6]. Iceland tends to favor more informal multilateral arrangements, bilateralism and sometimes unilateralism during times of crisis (e.g. Hilmarsson, 2014a and 2014b). This contradicts the small states theories discussed above.

3. The global crisis and recent economic performance

Iceland was among the hardest hit economies during the global economic and financial crisis that erupted in 2008. Prior to the crisis Iceland had experienced strong economic growth and unprecedented expansion in cross-border investments, especially in the financial sector (e.g. Hilmarsson, 2013a and 2013b). According to the IMF the consolidated assets of the three main Icelandic banks increased from 100 per cent of GDP in 2004 to 923 percent at the end 2007, reflecting expansion overseas. By the end of 2007, almost 50 percent of the three largest banks' assets were held abroad (IMF, 2008, p. 11). The banks had been privatized several years before the crisis with a light touch regulation and weak supervision in the spirit of *laissez-faire* policies. Before the crisis the government of Iceland publicly announced its ambition to turn Iceland into an international financial center.

The three largest banks, representing about 85 percent of the banking system, all collapsed in just a few days in October 2008. The whole economy was severely affected by this economic turbulence. The krona sharply depreciated, GDP fell, inflation and unemployment rose and the government ran large fiscal deficits in the aftermath of the crisis, see table 3. Unlike the fixed exchange rate regime and austerity programs implemented in some EU member states, the government sought to protect the welfare system resulting large fiscal deficit that it hoped would only be temporary. Sharp depreciation of the local currency was expected to boost exports and GDP growth like happened for example in Finland and Sweden in the early 1990s (e.g. Hilmarsson, 2014a).

[6] Those are the African Development Bank, the Asian Development Bank and the Inter-American Development Bank.

Table 3. Iceland: Selected Economic Indicators 2007 to 2014
(Percent change)

	2007	2008	2009	2010	2011	2012	2013	2014
Gross domestic product 1/	6,0	1,3	-6,8	-4,0	2,1	1,1	3,5	2,0
Unemployment rate 2/	1,0	1,6	8,0	8,1	7,1	6,0	5,4	5,0
Consumer price index (average)	5,0	12,4	12,0	5,4	4,0	5,2	3,9	2,0
(Percent of GDP)								
General government balance 3/	5,4	-0,5	-8,6	-6,4	-5,6	-3,7	-1,7	-0,1
Current account balance	-15,7	-28,4	-11,8	-8,4	-5,2	-4,2	5,5	3,7
1/ Constant prices, 2/ In percent of labor force, 3/ National account basis, e/ Estimate.								

Source: IMF 2010, 2012, 2015a, 2015b, World Economic Outlook Database

After almost seven years since the crisis hit, Iceland has reached a relatively strong macroeconomic position with good growth prospects, see Tables 3 and 4. Fiscal and external balances are now in surplus and economic activity will according to the IMF surpass its pre-crisis peak in 2015. According to the Central Bank of Iceland the post-crisis contraction in GDP has reversed in full (CBI, 2015). Public debt is on a downward sustainable path. Unemployment continues to trend down, now at 4 percent. Growth slowed last year but is expected to pick up to around 3 percent over 2015–17**,** supported by robust domestic demand and tourism. Consumption has been boosted by household debt relief and—together with net trade—have benefited from favorable commodity prices (IMF, 2015). According to the IMF GDP growth was 4,0 percent in 2015 (see Table 4).

There are increasing concerns that economic stability may be threatened with the current demand of salary increases well beyond the current growth rate. Large salary increase could undermine economic recovery and the competitive position of the economy, and lead to a reduction in employment (CIB, 2015). The government has been criticized for granting debt relief to households that to a large extent could have serviced their debt without such relief. This effort is also seen as discriminatory against those households who chose to rent their housing and socially vulnerable families who may be in greater need of assistance than homeowners. Amid low unemployment, wage pressures are building. There is a risk that the hard earned macro stability post-crisis may be lost if increases in salaries go out of control, with rising inflation, like has repeatedly happened in Iceland over the decades.

Table 4. Iceland: Selected Economic Indicators 2014 to 2016
Estimate and Projections (Percent change)

	2014	2015	2016 p
Gross domestic product 1/	2,0	4,0	3,2
Unemployment rate 2/	5,0	4,0	4,0
Consumer price index (average)	2,0	1,6	2,1

	2014	2015	2016 p
(Percent of GDP)			
General government balance 3/	-0,1	0,7	0,1
Current account balance	3,7	4,2	4,7
1/ Constant prices, 2/ In percent of labor force, 3/ National account basis, p/ Projections			

Source: IMF 2015a, 2015b and World Economic Outlook Database

According to the IMF "the outlook for growth is positive. The economy will grow at around 3 percent during 2015–17 under baseline assumptions of large energy-intensive investment projects, robust growth in private consumption boosted by household debt relief, and further expansion of the tourism sector. Terms of trade, consumption, and growth in 2015 will benefit from a sharp decline in oil prices. Investment will be funded by FDI, retained earnings, and, increasingly over time, borrowing. Inflation is expected to stay below 1 percent this year and rise gradually to target by the end of 2016, as the effects from imported deflation and currency appreciation dissipate and pressures from wages and a closing output gap mount" (IMF, 2015, p. 7). The Central Bank of Iceland projects even stronger GDP growth rate than the IMF 4,5 percent in 2015 and 3,5 percent in 2016 (CIB, 2015).

The Icelandic economy is still vulnerable, but better diversification, including in sectors generating foreign exchange helps maintain stability. In its discussions with the IMF the government has expressed deep concerns about the upcoming collective wage bargaining round and implications for stability. Price stability is still within Central Bank of Iceland target and is helped by disinflation in key trading partners, particularly the euro area, a slump in oil prices, and an appreciating currency in the context of high exchange rate pass-through. This could change quickly as discussed above.

Iceland has been under capital controls for almost seven years. Strong macroeconomic fundamentals and healthy financial sector is among the keys for successful capital account liberalization. As the IMF has recently stated "Liberalization of the capital account under a revised strategy could pick up pace, boosting confidence and private investment and raising long-term growth—but missteps could lead to a disorderly unwinding or even prolonged controls. Wage demands in the upcoming round of collective bargaining could lead to further strikes, and resulting wage hikes could increase inflation and weaken competitiveness" (IMF, 2015b). The question remains if Icelanders have learned anything from the past – or if the economy will return to the boom and bust scenario yet again as it has for decades and most recently during the 2008 crisis.

4. Benefits from joining the EU

Among the key benefits of joining the EU is that access to the common market. Iceland already enjoys this benefit via the EEA agreement, i.e., free flow of goods, services, capital and people across national borders. Iceland was also able to avoid the collapse of the Nordic Passport Union via its membership in Schengen. It thus has enjoys many of the benefits (some would say most) of economic integration without EU membership and can thus to some degree both eat the cake and keep it.

In the future there could be questions about EEA sustainability. Will the EU still respect the EEA agreement in coming decades or is it only a temporary arrangement. Here partnership with Norway in EEA EFTA is critical. Should Norway become a member of the EU, Iceland would hardly have the capacity to engage in negotiations with the EU alone with Lichtenstein. Being a member of the EU Iceland could be more confident that the benefits of access to the single market would be in place in the longer term. Membership would also ensure regular consultations and participation in EU decision making instead of continuing to receive instructions via email from Brussels. Regular consultations could help a small country with limited institutional capacity increase professionalism.

EU membership could possible shield Iceland during times of crisis, economically and in terms of security. There is greater need for outside support/shield given weaker ties with the USA post-cold war. Closer cooperation with EU member states and support from EU institutions could contribute to stability as Iceland has a history of economic boom and bust.

The risks associated with small population, including close ties between individuals, that can result in corruption and rent seeking could be reduced. During the 2008 crisis there was certain loss of confidence in the Icelandic political and institutional system. General elections took place in the spring 2009 and an EU application followed three months later. This is hardly a coincidence.

EU membership would mean that Iceland could possible after two years of membership join the Euro area. Currently Iceland does not participate in EU's monetary system and cannot adopt the euro and also remain in good standing with the EU. The adoption of the euro unilaterally does not seem like a viable option (e.g. Buiter, 2000 and ECB, 2008). The exchange rate of the local currency has fluctuated greatly in the past and during the 2008 capital controls where introduced as a temporary measure. Capital controls are still in place almost seven years after the crisis but the government has recently announced plans to abolish those controls.

5. Disadvantages from joining the EU

In Iceland there is a concern about EU's Common Fisheries Policy (CFP) and Common Agriculture Policy (CAP). These potentially most difficult chapters, on the CAP and CFP, were not opened during accession negotiations so it is impossible to say if a compromise could have been reached and at what cost to Iceland. The nation is divided in its support. Membership of the EU has stronger support by employers outside the fishing industry and agriculture. The political importance of agriculture sector in Iceland is much greater than its economic contribution would suggest. By staying out of the EU Iceland avoids implementing the CFP and CAP of the EU.

If Iceland becomes a member of the EU, its influence within such a large institutional structure would be minimal. In fact, given its small size influence via membership would be a token benefit only. Iceland would also have a tiny weight in the Euro area economy should it adopt the euro. A common currency would have limited Iceland's possibilities to respond to the 2008 crisis when depreciation of the króna played an important role in bringing about adjustment of Iceland's trade deficit.

Small states have experienced difficulties in dealing with the larger EU states and EU institutions and this became clear during the 2008 crisis. Large EU states, supported by the EU institutions, do not hesitate to use strong arm tactics against small states. An example of this is EU's handling of the crisis in Ireland and Latvia. The UK and the Netherlands, supported by the EU also used strong arm tactics against Iceland during the so called Icesave dispute. The Icesave dispute had negative effects on the sentiments in Iceland towards the EU and European nations, including the Nordic countries (who supported the Netherlands and UK in its dispute with Iceland during the crisis).

When discussing Iceland's response to the crisis the European Central Bank comments as follows: "When Iceland's policy response in the wake of the crisis is compared with that of other affected countries, there are two measures that stand out most. First, Iceland introduced capital controls to protect itself from the worst repercussions of the sudden reversal of capital flows that it faced at the end of 2008, a strategy that has possibly aided its subsequent recovery. However, as time goes by, evidence is mounting regarding the distortive and often detrimental effects that these restrictions are having on the decision-making of economic agents and the difficulties that Iceland's authorities face in decisively reducing the substantial stock of krónur that continues to be held offshore and returning to a fully liberalized capital account in the near future. Second, Iceland decided not to nationalize the debts of its oversized banking sector, instead opting to inflict losses on its financial institutions' creditors and foreign depositors. Although this saved the government from assuming liabilities that would potentially have been beyond its debt-servicing capacity, it also opened the door to a series of legal challenges (with final decisions still pending in some instances), thereby introducing a significant degree of uncertainty for authorities, businesses, foreign investors and the general public" (ECB 2012, p. 97).

Talking about "a series of legal challenges" and "a significant degree of uncertainty for authorities" could be viewed as comment or advice from the EU, but one could also view this comment as a threat. A small nation that does not yield to the EU and its larger member states will sooner or later suffer the consequences. The case of Latvia and Ireland comes into mind. Such comments or threats are not likely to increase confidence in the EU in Iceland.

Eventually the Icesave dispute went to the EFTA Court[7] were Iceland came out as the winning party. After receiving the court ruling the Icelandic Ministry for Foreign Affairs commented as follows: "The EFTA Court ruling on Icesave

[7] The EFTA Court, based in Luxembourg, corresponds to the Court of Justice of the European Union in matters relating to the EEA EFTA States (EFTA, 2014).

rejected all claims by the EFTA Surveillance Authority that Iceland should be declared in breach of the EEA Agreement. The Court rejected the claim that Iceland has breached the Deposit Guarantee Directive or has discriminated against depositors contrary to EEA law. It is a considerable satisfaction that Iceland´s defence has won the day in the Icesave case; the EFTA Court ruling brings to a close an important stage in a long saga" (Ministry for Foreign Affairs, 2013). Had Iceland yielded to EU demands this could have brought its debts to an unsustainable level.

Several scholars have commented on the damaging effect the Icesave dispute had on Iceland's sentiments towards the EU. Professor Gylfi Magnússon, who served as a Minister for Economic Affairs in the government coalition after the crisis hit, commented as follows: „The governments of Britain and the Netherlands have not directly linked the dispute about Icesave to Iceland's application for membership of the EU, but individual politicians in these countries, especially the Netherlands, have done so, e.g. encouraged their countries to oppose the progression of the application unless Iceland accedes to their demands. Understandably, such threats are very hard for Icelanders to swallow and they have undermined support for EU membership in Iceland. The Icesave dispute has undoubtedly had a very negative effect on many Icelanders' attitudes to other European nations and the EU and has fueled nationalism and isolationism" (Magnusson, 2010). Thorhallsson and Rebhan comment as follows: „...while Iceland struggled to obtain assistance from the International Monetary Fund (IMF), Britain and the Netherlands allegedly blocked such assistance on a number of occasions, with the formal and informal approval of other European states." (Thorhallsson and Rebhan, 2011)

It is hard to be impressed with EU's handling of its post crisis problems. Currently one can say that the EU is faced with three crises: (i) a financial crisis, including a banking and a debt crisis), (ii) an economic policy crisis, including austerity programs, cutting welfare programs and increasing taxes, and (iii) a political crisis, where market forces compete against democracy. Post crisis economic performance in the EU is characterized by slow economic growth and long term employment (especially among the youth) and increasing income inequality. It is unlikely that Iceland will want to join during this current period of uncertainty.

6. The consequence of small economic size experienced by Iceland

It is clear that outside the EU a country like Iceland can be vulnerable because of small size, small institutions with limited institutional capacity and corruption. The government has not build strong capacity to work with large multilateral organizations and favors small multilateral structures such as EFTA, Nordic cooperation, and bilateralism if possible, and sometimes unilateralism during crisis (see, for example, Hilmarsson, 2014a).

Iceland is vulnerable when larger nations, including EU and EU member states use strong arm tactics to resolve disputes. There is a tendency within the EU to exercise authority with unilateral force, sanctions and threats. This was the case with Icesave as well as when Iceland has had disputes with the EU on the utilization of fisheries sources. This strong arm tactic are unlikely to impress Icelanders.

Nordic cooperation is important for Iceland and Iceland cooperates closely with Nordic countries and the Baltic States in multilateral institutions such as the World Bank, IMF and EBRD. The 2008 crisis showed that Nordic countries are unreliable partners when under pressure from larger EU states. Dispute with larger EU member states supported by the EU, especially during the crisis, has severely damaged EU's image in Iceland.

Conclusions

The Icelandic economy is recovering from the 2008 global economic and financial crisis and is according to the IMF expected to surpass pre-crisis GDP levels in 2015. According to the Central Bank of Iceland this has already happened. Current economic growth is healthy and unemployment is low compared with high income EU countries. The economy is now better diversified than it was a decade ago. In terms of foreign exchange revenues, it is based mainly on three main pillars, (i) the traditional fisheries sector, (ii) aluminum production using domestic clean energy sources and (iii) a flourishing tourism sector. Challenges remain; including the removal of capital controls imposed during the crisis and salary increases that could result in inflation above Central bank of Iceland inflation target.

After the 2008 crisis hit there was certain loss in confidence in the Icelandic institutional systems leading to EU application submitted by the government in July 2009. One can argue that this included the recognition that Iceland needs to be shielded by stronger, more competent and less corrupt institutions and that EU membership could provide that shield and increased professionalism.

The sharp depreciation of the domestic currency, króna, during the crisis and its historic fluctuations and loss of value over the decades due to monetary mismanagement also called for the adoption of a new currency where the euro would be the most likely option. However, euro adoption would require EU membership and a two-year period demonstrating sound economic management according to EU criteria. While unilateral adoption of the euro is possible in theory, it seems unrealistic politically and is strongly opposed by the EU. Furthermore, a common currency would have limited Iceland's possibilities to respond to the 2008 crisis when depreciation of the króna played an important role in bringing about adjustment of Iceland's trade deficit.

The so-called Icesave dispute with the UK and the Netherlands appears to have had damaging effect on how Icelanders view the European Union. Perceived

EU backing of claims from the UK and the Netherlands has changed the way Icelanders view the EU and European countries and public support for EU membership is low post crisis. The government that took office in May 2013 has withdrawn the EU application and informed the EU that Iceland should no longer be considered an EU candidate country. National support for EU accession remains low according to recent public opinion polls.

Low economic growth, high unemployment and dysfunctional EU institutional systems, including vulnerable euro also makes the EU less attractive. There are also issues related to cohesion and stability within the EU with the southern Europe performing poorly compared to the northern Europe.

The chapters on agriculture and fisheries policy were not opened during the EU accession negotiations with Iceland hence the most challenging issues related to accession where not even discussed and it remains unknown if acceptable solution can be found and how it would look.

Iceland clearly benefits from the access to the EU common market via the EEA agreement, enjoying gains from trade and economies of scale. This is possible as long as the EU is willing to respect the EEA agreement and as long as Norway is part in the EEA agreement. Without Norway, Iceland would not have institutional capacity to cooperate with the EU under the agreement and given the small size of Iceland and Lichtenstein it is doubtful if the EU would be interested in such cooperation.

Should Iceland become a member of the EU it is clear that the union would only give a small weight to Iceland in its decision making given its small population and economic size. This would also apply to the ECB should Iceland eventually become a member of the Euro area. According to Keohane's theory, Iceland as an EU member would fall under "system-ineffectual states" category, i.e. those states that can do little to influence the system-wide forces that affect them, except in groups which are so large that each state has minimal influence. Iceland could strive to become a "system-affecting state" i.e. among those states that cannot affect the international system if acting alone, but could exert some impact on the system by working through small groups or alliances. Cooperation with like-minded nations, especially the Scandinavian countries, and to some extent the Baltic States could be an option to consider. Those countries for example cooperate within the World Bank, the IMF and the EBRD (e.g. Hilmarsson, 2011). However, during times of crisis, experience shows that Iceland cannot rely on support from those small states that are more likely to follow their own interest or that of larger more powerful EU member states. This became clear during the 2008 crisis and the Nordic countries also did not support Iceland strongly during the in its fisheries disputes with the UK.

Iceland has always been reluctant to participate in international organizations unless benefits from such participation are clear, such as in NATO that also involved a bilateral defense agreement with the USA with both security and economic benefits attached. Unlike the other Nordic countries, the government has not build strong capacity to cooperate with international organizations and has preferred less formal structures and lower level of economic and political integration by being a member of EFTA and the EEA agreement.

One can argue that a small country like Iceland needs a shield post crisis when it no longer benefits from strong bilateral relations with the USA, a system determining country. History shows that Iceland has preferred to use bilateral relations in solving its problems in the past and during crisis sometimes makes unilateral moves. In crisis situations Iceland has not hesitated to take actions against larger nations or group of nations including during the so called Cod Wars and during the 2008 global crisis. These unilateral actions have been successful. This contradicts the small states literature that generally claims that it is beneficial for small states to concentrate on multilateral relations within international organizations. The Icesave dispute also shows that an EU shield could come at a high cost when the EU supports the claim of larger EU nations like during the Icesave dispute. Furthermore, the experience of Latvia and Ireland during the 2008 crisis further confirms that EU shield can come at a high cost.

The question remains what the most feasible arrangement is for long term prosperity of Iceland? This depends in part on whether access to the common market remains via the EEA agreement. The slow growth, high unemployment and ongoing crisis in some EU member states do not make EU membership attractive at least in the short term. Joining the Euro area would hardly be feasible unilaterally and adoption of the euro would be unlikely to take place until about two years after EU accession.

EFTA membership and the EEA agreement appear to be the best arrangement for Iceland at present. The EEA agreement decision shaping under the two-pillar structure of EEA EFTA bodies that match those on the EU side has so far served well. The three EEA countries have some modest influence under this system and this arrangement ensures access to the internal EU market. This can change in the medium or long-term and the decision made by the government of Iceland that Iceland should not be considered a candidate or a potential EU candidate country was unwise. Iceland should not burn any bridges given how quickly the global environment can change.

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