

# Working Paper

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## **The EEA, Iceland and the international financial crisis**

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## 1. Executive Summary

By international standards, Iceland until recently disposed of an extremely large banking sector compared to the rest of its economy. As the country still clings to its own small currency, its Central Bank is not in the position to serve as a *credible lender of last resort*. This failing proved fatal as the financial crisis took hold of Iceland in Fall 2008, when two of the country's larger bank institutes were soon nationalized.

The financial turmoil in Iceland aroused reactions in other parts of the EEA as well. The UK and the Netherlands in particular were concerned about the safety of the deposits of their citizens in Icelandic banks. This anxiety came to a head when the UK applied the anti-terrorist act on a British subsidiary of the Kaupthing bank, thus forcing the otherwise solvent bank to be nationalized.

In sum, the three leading banks of Iceland are now under state control. The British act created tension between the two countries and is now to be examined by the European Court of Human Rights in Strasbourg. It also gives rise to the question whether the existing safeguard measures in the EEA are adequate in terms of serious financial crises.

The relevant safeguard-measures can be found in Arts. 43 and 112ff of the EEA Agreement. However, they do have little effect in practice since Article 56 para. 1 of the EC Treaty hinders the EU member states from restricting their capital markets. Consequently, limiting the access to national bail-out packages and deposit securances had and has to be managed on the political level. On the other hand, Iceland (not bound by the restrictions of the EC Treaty) has created rules in order to limit the capital flow in the country. However, it still remains unclear if the Icelandic measures are to be understood as safeguard-measures in the sense of the EEA Agreement.

On 28 November 2008, Iceland's Central Bank issued new Rules on Foreign Exchange based on the Foreign Exchange Act 1992. This policy aims at stabilizing the Icelandic Krona (ISK) by restricting the flow of foreign currency in the country. This measure accompanies the loan given to Iceland by the International Monetary Fund (IMF) and by a considerable number of European countries.

At a first glance, these actions restrict the effect of the EEA by restraining the free flow of capital in the Area's member states. But under closer scrutiny, the consequences may not only be negative. As Europe as a whole is suffering from the recent crisis, a temporary close may come as a relief.

What can be done to prevent Iceland falling again? As Iceland's rundown has apparently been caused by an inappropriate leverage-currency-ratio, the first option may be to reduce the size of the banking sector. The second option for (re-)gaining monetary security would be to join the EU, the EU's ERM and – in the long run - the Eurozone. Relief for Iceland's Central Bank would set in as soon as the Euro-accession process started – the European Central Bank (ECB) should give prompt backing.

In the short-run an adaptation of the EEA rules to the EC-Treaty provisions thus seems appropriate in order to abolish the existing inconsistencies and to rebuild confidence in times of financial turmoil. The abolishment of inconsistencies is highly likely, taking the form either of a re-adjustment of the EEA Treaty or by inviting the EEA countries to join the EU.

## 2. The relevant EEA regulations

The US subprime crisis – now a general financial crisis – continues to spread around the globe, one of its recent victims being Iceland, a state whose relations to the EU are mostly defined by the 1994 EEA Agreement. As this Agreement states in its opening Article, the EEA aims at promoting „a continuous and balanced strengthening of trade and economic relations between the Contracting Parties with equal conditions of competition, and the respect of the same rules, with a view to creating a homogeneous European Economic Area.“ In order to achieve those objectives, the four internal-market freedoms as well as the EC’s competition rules are to be applied among the members of the EEA Agreement. These regulations closely resemble those provided by the EC Treaty. However, the Agreement does not contain any provisions concerning its member states’ financial policy. This means that the international room for manoeuvre is limited.

As the financial crisis is likely to affect the internal market freedoms (and among those in particular the free movement of services and capital); the competition rules may be concerned as well as the EEA Chapter on state aid.

## 3. Anatomy of a crisis

Iceland intensified the deregulation of its banking system in the mid-1990s. This led to extraordinary growth amongst the Icelandic banks as well as to high interest rates on the ISK. Due to the high interest rates and the relatively strong Króna, Iceland’s citizens operated a considerable part of their consumption credits by foreign currencies. That and the alluring conditions of the Icelandic banks rendered the country’s economy highly leveraged – Iceland borrowed considerable sums of money from abroad.

Iceland wanted to become an international financial centre.<sup>1</sup> Alas, like today, it only disposed of a tiny domestic currency. The size of a currency is crucial for the effectiveness of the Central Bank as a lender of last resort. The Icelandic banks soon accumulated some assets, but also a considerable amount of liabilities in foreign currencies.

Things seemed to go well for Iceland until Fall 2008. In the course of the banking crisis, Lehman Brothers went bankrupt. Shortly after that, the Icelandic bank *Glitnir* was obliged to make a due payment of €600m. Due to the global financial crisis, interbank confidence and loans nearly came to a standstill. This also affected *Glitnir* which was unable to borrow sufficient foreign currency in order to fulfil its debt.

The *Glitnir* bank was illiquid, albeit still solvent. This is not an uncommon predicament among banks. Usually, the relevant central bank will then act as a lender of last resort and fill the gap by lending the money needed to the bank; the latter will repay the central bank at a given time.

However, a central bank can only accord unlimited money in its own domestic currency. If the bank's liabilities are to be met in foreign currencies, the central bank is forced to exchange its domestic currency on the market. This possibility is limited as the currency's value is linked to its availability.

<sup>1</sup> Domestically, the major industry is still fishing. Given that the entire country has a population of just 300,000, most of this fish is exported. As fish prices have soared in recent years, in response to tightened European Union fishing quotas, so the income of Iceland has soared. The average income per capita was (in 2008) the sixth-highest in the OECD countries.

Under the given circumstances, Iceland's Central Bank was not able to provide sufficient compensation for Glitnir's assets-liability deficit. The government was left with two possibilities: either lending Glitnir the required money or taking a stake in the bank. As the government feared further deficits upcoming to Glitnir, it decided in favour of a stake. This meant that the Icelandic Financial Supervisory Authority (FME) took Glitnir Bank over.

The market understood this act as a sign of extreme insecurity, and bank shares collapsed. Additionally, the rating agencies re-evaluated the status of Glitnir and Iceland's other banks as well as Iceland itself, and lowered their status. Accordingly, the Króna fell and the depositors – acting reasonably from their perspective –, started a run on the bank.

*Glitnir* was, however, still solvent at the time. A run on solvent banks under such conditions is rather unusual and was in this case mainly caused by the bankruptcy of Lehman Brothers as well as the absence of a reliable lender of last resort.

Due to the general financial problems, the second big actor in Iceland's bank business, *Landsbanki*, had to be nationalized as well.

In the course of these events, David Oddson, chairman of the Icelandic Central Bank, decreed that Iceland's depositors would be protected from losses. However, Iceland's banks had established a considerable client-base in the rest of the EEA zone. Its banks were particularly successful in the UK and the Netherlands; hence, the UK government feared that Oddson's remark meant that Iceland would only protect its own citizens and that its banks would therefore be unwilling to meet its obligations to its British clients.

During the consultation between the UK and Iceland the latter admitted that it would only assure the minimum of roughly €20,000 to foreign depositors. This amount had been specified in the EU Deposit Insurance Directive and its implementation had been extended to non-EU EEA states as well.

It is important to note that the Directive provides for access to a fund, albeit one unlikely to compensate all the losses of foreign customers. In its response to the run on its banks, Iceland referred solely to this fund, desisting from creating a solution specifically tailored to foreign investors. This left the UK insecure about the actual compensation for its citizens.

At this time, *Kaupthing*, another large Icelandic bank, was still intact and had not been subject to a run; Iceland even provided the bank with a loan. However, the UK began to worry about the solvency of *Kaupthing's* UK subsidiary and invoked anti-terrorism legislation to freeze the bank's UK-based assets. Under that law, British authorities were able to freeze the assets and to transfer them to the *ING Bank* located in the Netherlands. As this act ruined the reputation of *Kaupthing*, Iceland was forced to nationalize its third major bank as well.

Due to the pressure thus created, Iceland ensured a guarantee for depositors beyond the fund foreseen in the EEA regulations.

#### 4. The situation in Iceland today – being bailed out by neighbours

The nationalization of the three big Icelandic banks had been accompanied by an increasing discussion of the crisis in Iceland. The Icelandic people started to buy and hoard food while at the same time the ISK started to decrease dramatically. Although the Icelandic Central Bank disposes of a special fund for imports of food, Icelandic shops experienced problems while trying to buy food. Due to this development, the Central Bank issued new Rules on Foreign Exchange on November 28<sup>th</sup> 2008 in order to domesticize the capital flowing through the country. This measure will be covered in detail in the section on the safeguard measures.

According to Martti Hetemäki, undersecretary of Finland's finance ministry, the international aid package (cf. tables 1 and 2) now totals \$10.2 billion with \$ 5 billion coming from the UK, Germany and the Netherlands.

However, it is unlikely that even this relatively large sum will suffice to settle the ramifications of the Icelandic banking crisis. As the newspaper *Morgubladid* reported in January 2009, the Icelandic Central Bank has granted collateral loans to the now nationalized Banks *Glitnir*, *Landsbanki* and *Kaupthing*; these loans are now lost with a total debit expected to amount up to "tens or hundreds of billions" Króna. This loss will have to be borne solely by smaller banks and financial companies that granted the collateral loans. By 12<sup>th</sup> January 2009, it was still not clear how these debts will be settled.

The IMF granted a credit in order to stabilize Iceland's exchange rate in the near term and thus restore confidence in Iceland and its banks. The Central Bank of Iceland thus realised the Rules on the restriction of capital movements in the country<sup>2</sup> in order to restrain the flow of foreign currency.<sup>3</sup> The Rules are limited by a temporal clause to a time span of two years. They authorise the Icelandic Central Bank to impose rules prohibiting foreign exchange related to capital account transactions with the end to prevent excessive short term volatility in the domestic currency.

For its part, the aid package granted by the European states is not all that altruistic. Many of their citizens invested in Icelandic banks. The lending and aiding states aim at protecting their citizens by providing Iceland with enough money to cover the deposit losses of its now nationalized banks. For instance, the Dutch credit line had been increased by €0.2 billion as the losses of Ice-Save went higher.

<sup>2</sup> Based on Article 3 of the Act No. 87/1992 on Foreign Exchange.

<sup>3</sup> However, the Act No. 87/1992 on Foreign Exchange does also state in its Article 2 that foreign exchange transactions relating to the import and export of goods and services shall be unrestricted.

**Table 1**

<b>Donor</b>	<b>Date</b>	<b>Amount</b>	<b>Conditions</b>
International Monetary Fund (IMF)	November 19 <sup>th</sup> 2008	\$2.1 billion	Two year stand-by arrangement: \$827m. will be available immediately while the sum remaining will be disbursed in eight equal instalments of about \$155m. each (subject to quarterly reviews). The loan is due between 2012 and 2015.
Nordic Countries (Finland, Sweden, Denmark, Norway, Faroe Islands), Russia and Poland		\$3 billion	Conditions are fixed individually by each lender, cf. Table 2.
Netherlands, Germany, UK	November 20 <sup>th</sup> 2008	up to \$1.3 billion for IceSave depositors, up to \$5 billion in total	<p>The Dutch loan was granted only under the condition that the money is used for paying IceSave depositors. Additionally, the loan was dependent on the loan granted by the IMF.</p> <p>Furthermore, it is part of the \$5 billion loan package that the governments of NL, D, and the UK are about to grant Iceland. Arni Mathiesen, the Icelandic Minister of Finances and Dutch authorities had already come to an agreement for a loan of 1.1bn euro. This sum has now risen to €1.3bn (about 230bn ISK). This amount has risen because Iceland needs to pay IceSave depositors up to the first €20,887 in every depositor account.</p>

**Table 2: Bailing out Iceland – A detailed overview on some of the lending countries**

Donor	Date	Amount	Conditions
Sweden	January 16 <sup>th</sup> 2009	\$770 million	The Swedish government has submitted a parliamentary resolution to the Swedish parliament to grant the Icelandic state a loan worth up to \$770m. in connection with the International Monetary Fund's economic stabilization program.
Faroe Islands (autonomous province under Danish rule and one of Iceland's closest neighbours)	October 30 <sup>th</sup> 2008	\$53 million	According to the Faroese Minister of Finance, Iceland will not have to pay any interest rates.
Poland	November 17 <sup>th</sup> 2008	\$200 million	According to Poland's Ministry of Finance, "the support for Iceland will have the character of a loan whose detailed conditions will be decided between Iceland and the International Monetary Fund."
Finland, Sweden, Norway and Denmark	November 20 <sup>th</sup> 2008	\$2.5 billion	Following the IMF announcement, Finland, Sweden, Norway and Denmark said they would lend Iceland an additional \$2.5bn.

## 5. The safeguard measures

Safeguard measures may in principle be applied by governments in the realm of the four internal-market freedoms and state aid. As far as the state aid is concerned, the EU Commission granted exceptional permission for a wide range of bail-out packages in the context of the financial crisis. However, the question remains if the states are eligible to limit their bail-outs to national companies – this may be discriminatory.

The legal basis for the application of safeguard measures is to be found in Art. 43, 112 and following of the EEA Agreement. Additionally, regulations on this matter are to be found in Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the EC Treaty. This Directive has been adjusted to meet the needs of the EEA. As such, measures concerning Article 2 of the Directive (liquidity of banks) have to be decided by the EEA Council. Article 3 of the Directive (special safeguard measures) requires a specific EEA related process as well.

The safeguard measure referred to in Article 3 of the Directive reads as follows:

“Article 3

(1) Where short-term capital movements of exceptional magnitude impose severe strains on foreign-exchange markets and lead to serious disturbances in the conduct of a Member State's monetary and exchange rate policies, being reflected in particular in substantial variations in domestic liquidity, the Commission may, after consulting the Monetary Committee and the Committee of Governors of the Central Banks, authorize that Member State to take, in respect of the capital movements listed in Annex II, protective measures the conditions and details of which the Commission shall determine.”

The application of safeguard measures creates a problem which can be examined from different angles.

- First, Iceland itself may resort to safeguard measures in order to restore its local economy – in fact, it has already done so.
- Second, the other EEA member states may stick to the safeguard clauses provided by the EEA in order to minimize the damage brought to their economies by the subsidiaries and branches of Icelandic banks – but are they eligible to do so?

### **5.1. The Icelandic safeguard measures**

Discussion of the crisis has been increasing every day in society and the media. Food shops encouraged people to hoard. On the other hand, the government argued that there will not be a lack of goods in the country, at least for the next eight or nine months, because of a special fund that the Central Bank keeps for food imports. Yet, Icelandic shops have had problems in buying food because of their lack of cash. The Icelandic Króna fell constantly and the currency was locked by the Central Bank, on permission of the prime minister's office.

As a reaction, an Emergency Law was set - "the most radical economic measures that have ever been taken in the country's history" (Iceland Review). The law enables the government to stage an extensive intervention in Iceland's financial system. At the same time the Icelandic Financial Supervisory Authority (FME) took over the board of Landsbanki Bank and Glitnir Bank.

The Central Bank of Iceland issued new Rules on Foreign Exchange on 28<sup>th</sup> November 2008; these rules were based on the Foreign Exchange Act 1992 and are part of the conditions required by the IMF.

The provisions issued by this order contained several restrictions on the free movement of capital. Thus their Art. 1 provides as follows:

#### "Article 1 - Investment and transactions

Investing in securities, unit share certificates in UCITS and investment funds, money market instruments, or other transferable financial instruments denominated in foreign currency is prohibited. However, parties that have invested in such financial instruments prior to the entry into force of these Rules are permitted to reinvest.

Sales proceeds in Icelandic krónur from transactions in financial instruments, according to Paragraph 1, that take place between domestic and foreign parties and are settled in Iceland must be deposited to the seller's account with a financial undertaking in Iceland.

It is prohibited to settle transactions with króna-denominated instruments according to Paragraph 1 in foreign currency.

Foreign exchange transactions related to cross-border movement of capital according to Paragraph 1 of the Temporary Provisions of the Foreign Exchange Act, with subsequent amendments, by means of withdrawals from króna-denominated bank accounts at domestic financial undertakings or the Central Bank of Iceland are prohibited.

It is prohibited to carry out movement of capital according to Paragraph 1 of the Temporary Provision of the Foreign Exchange Act, with subsequent amendments, in order to transfer or convey capital out of the country in connection with the sale of direct investments."

The further articles provide similar restrictions; they aim at garnering as much foreign currency as possible by constraining the exchange of the Króna and by establishing an obligation to submit foreign currency (Art. 8).

This whole act was driven by a need to re-stabilize the ISK. As the Central Bank tried to save the Icelandic Banks, it pumped a huge amount of ISK into the local market which consequently led to inflation. The Central Bank thus needed foreign currencies in order to restore its stock. By doing so, the Central Bank did not explicitly mention that this would be a safeguard measure in the sense of the EEA Agreement; its nature therefore remains unclear. The Icelandic authorities did not apparently comply with the process mentioned in Article 3 of the Directive on the Movement of Capital.

## **5.2. Safeguard measures operated by other EEA member states**

In order to restrain the access to the national bail-out packages, safeguard measures may be brought on by other EEA members as well. As far as the EU member states are concerned, problems arise when it comes to the applicability of the safeguards provided by the EEA.

The EEA regulates these exceptions primarily in its Art. 43 (capital movements) and in Art. 112 ff. (safeguards in general) respectively.

However, EU member states are also bound by the EC Treaty, since Union members are obliged to liberalize their capital markets vis-à-vis all states (*erga omnes* obligation, cf. Art. 56 para. 1 TEC). The question arises whether this provision is applicable vis-à-vis the EEA member states. This would be the case if the EEA prevailed over the EC Treaty in this special constellation. As the European Court of Justice stated in its opinion EEA 1/91, the EEA constitutes ordinary public international law whereas the Treaty establishing the European Community has to be classified as a legal system in its own right (a constitutional charter) and is thus a legal system *sui generis*. According to this hierarchy of law, common international law is placed beneath EC primary law; as such, it is inevitable that EC law will prevail in cases of overlap.

Nevertheless, this classification throws the EU member states into a predicament. The EU-27 are bound by a treaty obligation to open their capital markets, meaning the safeguard measures provided by the EEA do not come into effect. The position of the EU member states compared to the other EEA member states without such a restriction seems to be impaired: if a measure put in place by an EU member exceeds the measures allowed by the EC Treaty, a breach of the latter is the consequence. On the other hand, restricting a safeguard measure on the relations with non-EU-member states is discrimination in the sense of Arts. 4, 40 and 42 EEA.

This puzzle may be solved by adapting the EEA Treaty to the EC Treaty. This may be accomplished by a change according to Art. 118 EEA. The change itself could be the introduction of the principle of reciprocity in the EEA Treaty, and, as a consequence, the elimination of the Treaty's safeguards measures.

At the moment, the primary concern of the EU member states is the protection of their own economy by supporting it with fresh money:<sup>4</sup> huge bail-out packages have already been released and there are still more to come. The branches and subsidiaries of foreign banks – such as the Icelandic ones – yearn for that support as well. As after all, it fits two of their most pressing needs: it provides the banks with fresh money and their Central Bank with foreign currencies needed to stabilize the domestic currency.

<sup>4</sup> If the access to fresh money is a reasonable solution to the crisis is left to discussion but beyond the range of this paper.

Nevertheless, as the extent of the crisis in each national economy still remains unclear, the authorities of all EEA states are reluctant to support foreign banks and thus foreign economies. The strict rules of non-discrimination provided in the EEA Agreement and the EC Treaty leave but little room for manoeuvre in favour of home companies. In the absence of a political solution, the Icelandic subsidiaries and branches are therefore legally eligible to other states' bail-out packages.

If no other solution is found, political tensions may thus arise between Iceland and other EEA member states.

In the long run, this situation can only be avoided by abolishing the existing imbalance concerning the application of safeguard measures in the EEA Agreement and the EC treaty.

## **6. If Iceland were to join the EU**

What would change if Iceland joined the EU and the Euro area? Even today, the country lacks a Central Bank capable of directing the huge financial transactions occurring within Iceland. Moreover, the small population creates social pressure which tends to make the authorities shy away from criticism.

Accession to the EU would provide a suitable means to solve these issues; in fact, this move would not even affect Iceland's monetary policy, as its market is already open to the Euro. The relief for Iceland's Central Bank is likely to apply immediately at the same time as the accession process starts because the ECB may then grant further support to the Icelandic Central Bank.

If Iceland refuses EU membership the only viable solution seems to be the re-establishment of a national control mechanism with regard to foreign capital moving into the country. However, this alternative is likely to damage the economy of the state and would in turn lead to an exodus of the younger generation.

## **7. Outlook and Recommendations**

On January 20<sup>th</sup> 2009, Iceland's Ministry of Finance published a new economic forecast. It states that the adjustment of the Icelandic economy to the financial crisis is not complete, meaning that the forecasts for the two years to follow are rather gloomy. Economic growth, figuring in 2008 at -0.1 per cent, is about to decrease further with the real GDP being forecast to decline by 9.6 per cent in 2009, unchanged in 2010. The unemployment rate is forecast to increase dramatically from 1.7 per cent in 2008 to 7.8 per cent in 2009 and even 8.6 per cent in 2010. In fact, the financial crisis already took hold of the labour market in 2008, and it is only due to the periods of notice that the unemployment rate could be kept low last year. The deterioration of the labour market may increase the exodus of Icelanders in search of work in other EEA member states.

As for inflation, it is forecast to rise to 13.1 per cent in 2009 due to the rapid inflation experienced in the latter half of 2008. However, a decline is expected in the course of the year 2009 meaning that the rate is likely to reach the 2.5 per-cent inflation target of the Icelandic Central Bank by 2010.

The prognosis given by the IMF generally overlaps with the forecast given by the Icelandic Ministry of Finance. Due to the leverage and the dependency of the private sector of foreign currency, a recession is about to rise by 2009 to 2010. However, the IMF believes that an anticipated and large import-compression may lead to a rapid swing of the current account into a surplus. Hence,

as soon as confidence in the economy is regained, the Icelandic domestic demand may be up again by 2011.

The following recommendations may be drawn from the situation sketched out in this paper.

- First, an adjustment of the EEA safeguard clauses as described seems to be necessary. This basically entails maintaining the measures for now but abolishing them in the long run through an adaptation to the exigencies of the EC Treaty. However, as Iceland may join the EU in the next couple of years, any extension of the safeguard measures is likely to have an effect only in the short run.
- Second, a strengthening of common funds for deposit security seems to be appropriate. Thereby conflicts such as the one between the UK and Iceland on the assurance of foreign deposits can be avoided in the future.

Iceland's new Social Democratic Prime Minister Jóhanna Sigurðardóttir is now leading a coalition government with the left-green party, with external support from another small Progressive Party, which is expected to seek a mandate for EU membership in a General Election in May 2009. Meanwhile, the European Commission seems to be preparing itself for a membership bid. An application would be viewed very favourably in Brussels, and the negotiations would be fast-tracked to make Iceland the EU's 28th or 29th member in record time, probably by 2012. Olli Rehn, Commissioner in charge of enlargement, recently said: "The EU prefers two countries joining at the same time rather than individually. If Iceland applies shortly and the negotiations are rapid, Croatia and Iceland could join the EU in parallel. On Iceland, I hope I will be busier. It is one of the oldest democracies in the world and its strategic and economic positions would be an asset to the EU." EU membership will certainly be a central theme of the election campaign, with the social democrats pushing to join the EU as soon as possible.

The financial disaster in Iceland has triggered extreme volatility among the country's voters. While there is support for joining the Euro as a currency safe-haven to protect Iceland from a battering by the markets, there is less enthusiasm for full EU membership, particularly among those in the vital fishing sector. A poll of 18<sup>th</sup> October 2008 published by the Reykjavik daily *Frettabladid* showed that 70 percent of Icelanders would like to see a referendum on future EU membership. 49 percent said they would vote in favour of accession, with 27 percent rejecting it.

One of the main sticking points up until now has been the question of the fishing industry which comprises 30 percent of Iceland's exports and 5 percent of its GDP. In its EEA membership, Iceland has an exclusion for agriculture and fisheries policies. The country has slowly expanded its exclusive fishery zones from the original 4 nautical miles (nm) to 12 nm in 1958, 50 nm in 1972 and 200 nm in 1975. Defending this expansion precipitated three political conflicts with the United Kingdom, the so-called "Cod Wars".<sup>5</sup> The key concern of Iceland therefore is that it would lose control over its fishery resources if it has to adopt the Common Fisheries Policy (CFP) of the EU. If the EU wants Iceland as a full member, a reform of the CFP will therefore be pivotal. Iceland would either need an exemption from the CFP or a special Icelandic regime within the CFP.

<sup>5</sup> Iceland finally "won" the conflict when it threatened to close the crucial NATO air base at Keflavik, from which the United States kept a close watch on the Greenland-Iceland-United Kingdom (GIUK) gap, a strategic waterway vital for access to the North Atlantic.

The EU should be ready to offer full membership very soon: the banking sector has collapsed and is unlikely to recover, yet Iceland's "real economy" in the fisheries, tourism and higher education sector is healthy and sustainable. Moreover, Iceland can provide the EU with energy resources (geothermal power that could either be exported if the technology gets developed or be used in situ by energy intensive industries of other EU member states), as well as with additional access, expertise and reputation in the Arctic area. By incorporating Iceland, the EU would gain a stable country that, apart from its most recent foray into commercial banking, has been very well-run economically.