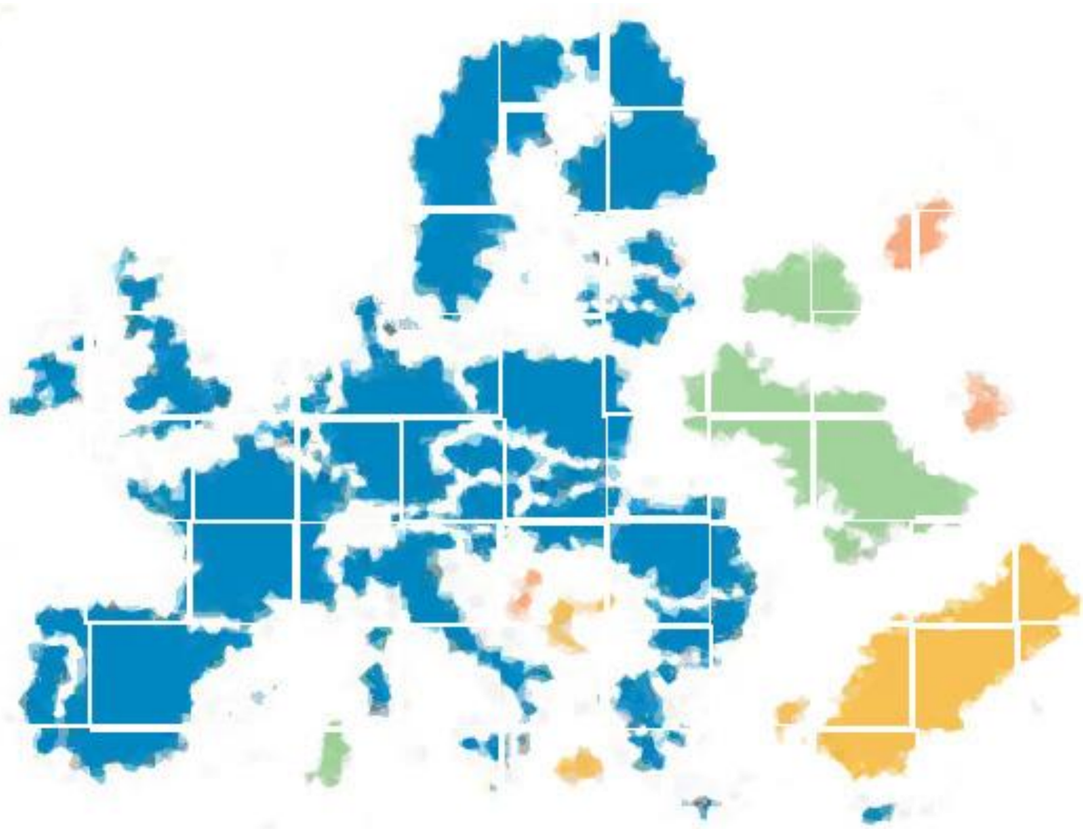
EU Frontiers

Student Paper Series

No Man is an Iceland: Undeniable Small-state Economics Favouring EU and Eurozone Accession

Hubert Jäger



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Located at Central European University in Budapest, the Center for EU Enlargement Studies (CENS) is dedicated to making recent and upcoming enlargements work, by contributing to the debate on the future of the EU and by exploring the results and lessons of previous EU enlargements. The research activities of the Center are not limited only to the analysis of previous enlargements, but also to the potential effects that a wider extension of the EU's sphere of influence may have on bordering regions. CENS disseminates its research findings and conclusions through publications and events such as conferences and public lectures. It serves as an international forum for discussing the road that lies ahead for Europe, and supports preparations for any coming accession by providing thorough analyses of pertinent topics. The Center provides policy advice addressed to the governments of countries in Europe and its larger neighborhood, keeps decision-makers in the European Parliament, the EU Commission, the Economic and Social Committee, the Committee of the Regions and other EU organs informed. It aims to achieve and maintain high academic excellence in all its research endeavors.

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Hubert Jäger

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Executive Summary

Iceland needs to resume EU accession talks for the exact reason that is now used for making the opposite case: economics. Following recent conclusions from the scholarly small-state debate, external sheltering is by far the most feasible option for Iceland to stay socio-economically competitive and be prepared for shocks on the medium and long run.

No man is an Iceland: undeniable small-state economics favouring EU and Eurozone accession

"No man is an island, entire of itself. Every man is a piece of the continent, a part of the main." John Donne, 1624

Set Sails for Europe!

Standing alone means falling alone. Iceland was hit hard by the international financial crisis in 2007. After abandoning the U.S. security belt and keeping European integration within such boundaries that would leave Iceland with considerable economic flexibility, the boom and bust of the Icelandic economy in the 2000s was a clear warning about the nature of international financial markets. Today more than ever, small countries with open economies striving for competitiveness need external shelters whose task it is to minimise risk exposure on global markets. Given the halt in accession negotiations with the European Union in 2013, the recent change of mind in Iceland's overall strategy is justification enough to reiterate what is at stake for Iceland's socio-economic future if the island were to stay outside the Eurozone. This brief goes about the topic in three steps: first, past episodes of Iceland's orientation towards external powers will be revisited. The second section will embed the specific constellation of the Icelandic economic crunch in 2007/08 in the picture of small open economies (as many Eurozone members today are) and their options if they want to prevail. At last, I will lay out key arguments why Iceland's safe haven cannot be new sole adventures but further economic integration with mainland Europe. Eurozone members will serve as comparative cases to highlight the advantages of a shelter entity instead of a stand-alone strategy in times of crisis. As exemplified by the bailout cases of the European periphery, EU and Eurozone membership would hedge the risks of an economy such as Iceland's - specialised and with considerable financial exposure abroad.

This policy brief does not call for throwing core domestic Icelandic values translated over generations overboard that serve as the pillars of a proud and independent nation. Make no mistake: neither is it the claim of this paper to trivialise the challenges and crises of European integration themselves, nor are the considerable divides between Iceland and particular EU members before and after 2007 underestimated. The reasons for EU accession and the adoption of the single currency are of economic nature and should not be confused with social or security issues. Isn't it ironic? While economic doubts seem to make Iceland's path to the EU unfeasible, it is economics that make the most convincing case for joining forces with the European Union. The three key advantages of Eurozone membership are the easier creation of sustainable trade surpluses, preventive fiscal mechanisms safeguarding the home market and better chances to be bailed out by the community during a crisis - no matter what.

Previous Excursions in Foreign Waters

In security matters, Iceland's post-war orientation inclined heavily to the United States' interest sphere. Being a founding member of NATO, the island hosted a military base for the US Navy until 2006. The shift towards Europe occurred along a continuum stretching over the last 40 years (Steinmetz 2010). Iceland entered EFTA in 1970 and signed an association agreement with the EU in 1992, making it a member of the European Economic area. Other than common market access on both sides and participation in passport-free travel granted through the Schengen Agreement, the island state takes part in programmes covering educational and research purposes. Agriculture and fishery are explicitly excluded, since they are long-time areas of mutual debate. Internally, Iceland went through a change in their economic setup from the mid-1990s on: the financial system was liberalised and the two major banks privatised. Until the early 2000s, the country became integrated in international assets trading with offshore funds and investments of various kinds. The real-estate-fuelled upswing of the economy was regarded ambitious and successful, until a domino effect in the global banking network forced the government to renationalise its financial institutions and take on enormous amounts of foreign debt.

Fishing for Gold - and mostly: Fishing too Deep

The story of Iceland's financial crisis is the story of a crisis inflicted by turbo-capitalist over-engagement relative to the country's economic power. After a decade of booming development driven by globalised financialisation, Iceland's economic bubble burst in the course of an international financial crash. The country was hit early and hard for lack of viable safety nets designed to foresee, prevent and ease the effects of a domestic crisis of such measure. Since Iceland had refrained from maintaining or deepening its political bonds with reliable anchors before the crisis, there was no one around to bail the island state out when help was needed. Ireland and the Baltic states are important comparative cases in which many economic indicators were not all that different from Iceland's before the crisis: the foreign debt ratio was high and increasing, the capital base in the credit market was excessively leveraged and foreign direct investment was heated up as well. Would it not have been for political will of influential EU members and immediate action as the first symptoms of a downturn appeared, those countries' economies could have been hurt just as badly as Iceland's was.

What can be considered a troublesome state of crisis in large economies, can be an outright disaster in small ones. It used to be common practice in small economies, which participated in global trade and finance, to hedge the risks of a crisis through a comprehensive internal safety net. Defining the theory of domestic corporatism, Peter Katzenstein (1984) describes how countries without a large-scale internal domestic market can prevail competitive as open economies focussing on select key industries. Essentially, it is argued that the triangle of political, economic and social relations within a country are to be kept in balance to offset external challenges. According to the theory of domestic corporatism, this is achieved through two factors: flexible policy-production in a swift manner and the minimisation of risks posed by the international post-war economy by socialising them with an advanced welfare state and proactive labor market policies. After the financial crisis of 2007 and 2008, Baldur Thorhallson (2011) concludes that this mechanism is not enough to prevail in modern capitalist crises - and calls for proactive economic sheltering with the European Union.

Anchors Down: Why to Settle with the European Union

Supposing that Iceland will want to continue playing a significant role in international markets apart from its fishing industry, the decision to continue negotiations with the EU should be based on socio-economic considerations that take future crises into account. Essentially, the prospect of EU membership accompanied by the adoption of the Euro offers three key advantages over the status quo with regard to the ability to withstand external shocks: facilitation of balance-of-payments and balance-of-trade surpluses through increased competitiveness; improvements in fiscal standards and preventive shelter from speculation; access to solidary community bail outs in case of a domestically unmanageable financial turmoil.

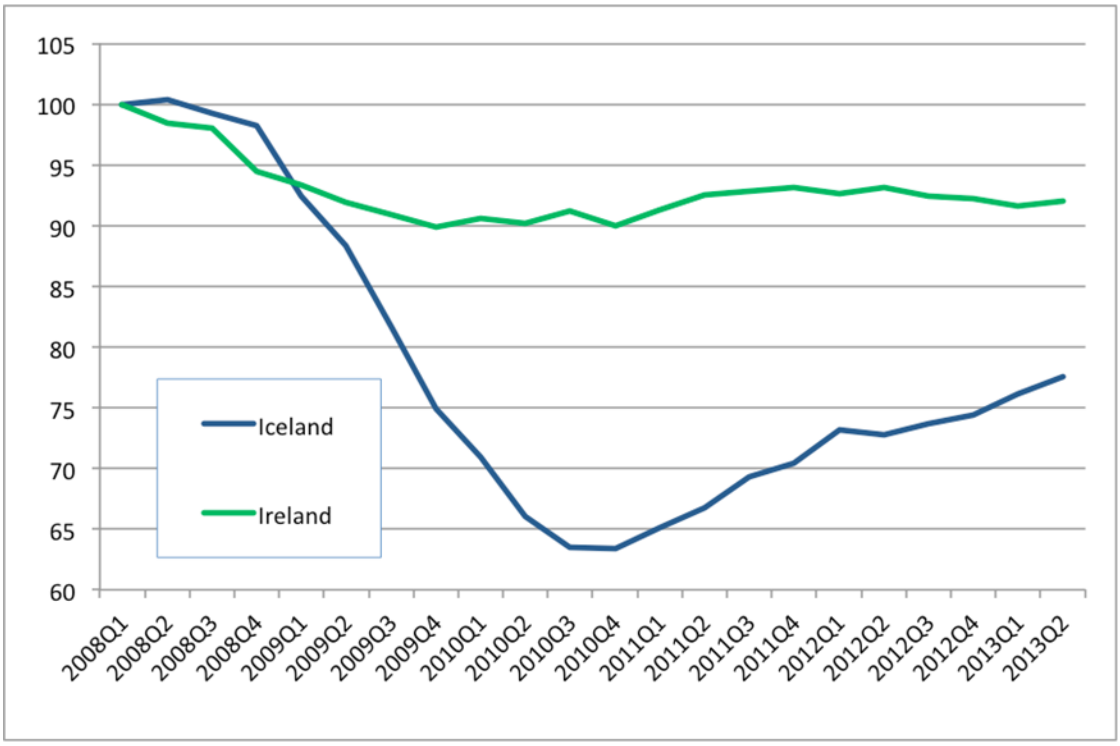
Competitiveness: Eurozone membership would boost Iceland's position as an international creditor. Admittedly, it would rank within the Top 5 EU members according to GDP per capita, making it foreseeable that the country would be left a net payer position within the Union. Still, it pays off to take a look at existing net payers before drawing premature conclusions: As the frontrunner of all export-oriented economies within the Eurozone, Germany has benefitted enormously from its position: not only have interest rates for German sovereign bonds reached record-lows in the aftermath of the current crises, but their unit labor costs have been decreasing ever since the Euro replaced the Deutschmark. This increase in competitiveness translates into trade surpluses that can be invested in less fortunate parts of Europe at higher yields - comfortably in the same currency. Small Eurozone economies such as Austria, Finland, the Netherlands or Sweden have experienced similar developments, making the picture of benign and benevolent bailouts for the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) a lot less likely. Well-off Eurozone members rescue weaker counterparts less for altruism than for serving their own needs and benefits. While Iceland currently runs considerable trade and payment surpluses, there are risks posed by investing them in foreign currencies (and their Krona is by no means an international reserve currency) - which led to the crisis that struck Iceland by so much surprise (Schwartz 2011). Eurozone membership could end this vicious circle and enable sustained prosperity without attaching it to economic bubbles.

Fiscal prudence: Entering a closely related economic association such as the European Monetary Union comes at the price and/or benefit of lower political independence. Mutual vigilance about budgetary restraints as stipulated in the Maastricht criteria may be perceived bothersome, but helped build up a framework to push socio-economic convergence (IMF 2011). Even if free riding occurred, overall discipline in national policies outweigh the side cost of imperfection in an unfinished political project as the EU. Greece being an exception of over-consumption, i.e. living on future expenses leveraged by the availability of cheap credit, all other EU members that faced troubles of their own either stumbled over imported banking crises or the subsequent issues with their sovereign debt.

Solidarity Union: Small countries can, but do not have to be better off as a part of a political association providing economic shelter. Until now, each and every Eurozone member could count on life support directed by Brussels and carried out in cooperation with supranational financial organisations, most notably the IMF. Eurozone countries that were politically sheltered by stronger neighbours within the European Union were at significant advantage when tunnelling through the crisis. Greece, Ireland, Portugal, Spain and Cyprus all successfully negotiated for international bailouts with substantial backing and financial engagement by the European Union. In contrast, Iceland's past and present external relations played a key role in the evolution of the country's financial crisis and its (non-)solution (European Commission 2012). As the Króna depreciated, public debt burden and inflation rose unhaltedly. As a consequence, Iceland wooed for international support but was turned down by both the US Federal Reserve and the ECB. Quite adversely, the Dutch and British governments even impaired Reykjavik's position by forcing creditors' guarantees to be reimbursed. Ultimately, only a package borne by the IMF in cooperation with fellow Nordic countries came to Iceland's rescue - with a 2-years delay (Althingi 2010). In sharp contrast, EU members were being helped in a better, faster and stronger fashion.

Ireland's Celtic Tiger Crisis is a special comparative case inside the European Union that shows the already mentioned advantages of Eurozone members in practice: both countries experienced booms of their financial systems, feature highly qualified labor forces and were hurt badly in the aftermath of the US financial shock (Howden 2013). As Thorhallson (2012) describes, the lack of European shelter in political and economic terms escalated and prolonged Iceland's crisis, with the only exception being the possibility of internal devaluation of the Krona to ease the pain. In comparison with the Irish case, international isolation of Iceland and the loss of trust for the future are hard to be estimated and will keep Reykjavik's international standing behind its potential for a significant time.

Graph 1: Real GDP development throughout the crisis. In comparison, Ireland fared better in terms of cleaned GDP. (Howden 2013)



As a consequence, European integration should not stay stuck - especially since Reykjavik is already half-way there. Specifically, Iceland is a founding member of OECD and OSCE and actively contributes to the Council of Europe and the Council of Baltic Sea States, among others. With a high level of integration just short of full EU membership, Iceland's legislative framework is in many regards in close accordance with the acquis communitaire of the Union, which enabled a swift start into the negotiation process in 2010. Of the 33 chapters to be completed before accession, 27 could be opened and 11 completed in record time. As the initial screening of the European Commission pointed out, only seven chapters were to be considered obstacles on the negotiation path, namely Financial Contol, Statistics, Taxation, Monetary Policy, Fisheries, Agriculture and Free Movement of Capital. According to officials of both sides of the neootiation table (Skarphéðinsson 2012, Rehn 2009), none of these chapters are unsurmountable - if public opinion is won.

Apart from technicalities, the only milestone out of sight is the support of Icelandic voters who seem reluctant to back further talks given internal and external changes. First, Iceland's recovery has been accomplished due to remarkable efforts of the country's business community. Thus, common sentiment in Iceland has fallen victim to the illusion that no outside help would be required to cope with past and future challenges to be encountered. Secondly, EU members that were affected most from Iceland's recklessness in getting rid of toxic assets abroad have not forgotten about the egotism of the Icelandic constituency: UK and Dutch investors who had lost most of their savings with Icesave, one of Iceland's leading offshore institutions, were dismissed in a 2011 Icelandic referendum on whether to repay for the damage caused by the bank - or not. Letting investors in Britain and the Netherlands default on their savings was clearly no sign of approximation to a European community spirit (Sigmundsdóttir 2010). In a domino effect, those bills helped revive long-forgotten rivalries between Nordic Sea neighbours over unrelated questions regarding fishing quotas that dominated the negotiation climate from then on. The 2013 elections mirrored the declining euphoria about EU membership and the momentum continues to grow on the side of eurosceptics. Hesitance to decide between suspension and eventual termination of EU accession talks resembles the thin ice on which both parties are balancing their interests. Gladly, not all strings have been broken: in case Icelandic political elites manage to convince a broader audience of the inevitability of the economic stance of the debate, a turnaround is possible - especially given the long-time lead in pro-EU opinion in many of the pre-2011 polls. If a clear case is made to explain why small states involved in a globalised economy need external shelters for their own good, understanding can be expected.

SOS! It's the Economy, Once Again.

While ancient wisdom has not exactly helped Greece to avoid their current misery, Greek mythology is worth a glimpse when dealing with the case of Iceland: after its departure into international financial capitalism, flying too low would have made Iceland's growth model unsustainable. On the other hand, flying too close to the sun and getting blown away by the wind set the final seal on Iceland's economic demise - just the way it stopped Icarus' flight. If Iceland believes its economic fortunes to be found in a highly international financial environment again - which is not an unthinkable conclusion at all - it will be better off with a big brother at its side to watch over dangers approaching from the outside. Domestic corporatism as a model to set off the effects of external shocks has proven insufficient in global markets based on casino capitalism: neither Reykjavik's generous welfare state nor its flexibility and swiftness in economic policies could stop the subprime crisis of 2007 to spill over from the U.S. to Iceland - a country that enjoyed top-tier credit rating and which was widely believed to be prepared to manage a full-fledged crisis (Stiglitz 2001).

The advantages of the EU as an external shelter are beyond doubt given the unprecedented level of cooperation, peace and prosperity among its participants. Apart from fishery, whale hunting and energy political obstacles, which lie between Iceland's remaining political independence and full EU membership, the island state should be more than cautious not to commit the same mistakes of the last decade again. If Iceland wants to continue its integration path into transnational markets and participate in global finance to reestablish wealth and opportunities its citizenry, accession to a monetary union is the measure of choice in order to best guarantee stability.

Ironically, economic considerations happen to stand in the way of the negotiations towards Iceland's European future. Fishing rights and minimised monetary freedom, which are the long-time favourites of critical voices, were starting points of governmental changes and the suspension of accession talks in 2013. This policy brief intends to send out a warning to the respective authorities, pointing at the long-term costs of this short-sighted agenda. Serving populist interest thus worshiping election day is a risky endeavour in times of leveraged finance: Iceland got away with both eyes in bruises after its recent crisis that left thousands out of their job - and out of their houses. Denying the need for strategic partnership in monetary matters is hazardous, as it will also leave these people without opportunity. While the island in the middle of the Northern Atlantic will have a hard time digesting its last fiscal slump created by opportunism, it certainly cannot afford another crisis of this size anytime soon. Next time will be different - and Eurozone accession is a window of opportunity that should not be missed. The winds of the international economy might have calmed now. But new turbulences may be just around the corner - and any good sailor would advise to take caution. For a new storm will rise.

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