

**Excerpt from a report by the Minister for Foreign Affairs, Össur Skarphéðinsson,
on foreign and international affairs**

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INTRODUCTION

Foreign policy in a time of crisis

The international financial crisis impacted Iceland earlier and more severely than other countries. The effects were magnified here, particularly because of the small size of the economy relative to that of the financial sector and the difficulties experienced by a small nation trying to maintain an independent currency in a globalised world. Under these circumstances, all of the basic structures of society have come under great strain, as has Iceland's position in relation to the rest of the world.

The crisis has taken root in the international economy and spread throughout the world. As a result, its impact can only be dealt with through concerted effort, in which the strength of individual nations and confederations of states will be decisive. In a globalised system, measures taken in one country have consequences in others, and decisions taken in international forums impact the daily lives of people everywhere in the world.

One year ago, Iceland enjoyed international respect and attention for the outstanding success this small nation had achieved on an international scale, but since then the country's status has changed dramatically. The spotlight trained by other nations and the international media on Iceland has produced a much more negative image of the country than Icelanders had become accustomed to seeing, and the country's reputation has suffered greatly. But this situation also presents many opportunities which, if properly exploited, could lead Iceland out of the crisis sooner than other nations.

Iceland is rich in human and natural resources. Few nations have as strong a foundation on which to base their efforts to overcome the crisis. The renewable sources that supply 80 percent of the country's energy needs, including 100 percent of its electrical energy requirements, are the envy of other states. There is considerable international demand for Icelandic expertise in the exploitation of renewable energy and fisheries resources. The fisheries sector has major opportunities, because marine research data now presents a more positive picture of this resource than it has at various times in the past. Other foreign-exchange earning sectors, such as tourism and exports of innovative technology also see new opportunities. Furthermore, the age distribution of the Icelandic population is much more favourable for economic recovery than it is in countries where the average age is much higher. The immediate future will be difficult, but the recovery effort will succeed.

The European Union is currently the focus of intense debate in Iceland, as relations with the EU will be vitally important in overcoming the country's current economic difficulties. EU member states account for the preponderant share, approximately 75%, of Iceland's foreign trade, which illustrates the necessity of Iceland taking a decision on the country's future status in relation to the EU and the common currency. A carefully considered assessment of national interest, based on the most convincing and reasonable argumentation, must prevail in this debate.

The democratic will of the Icelandic people will determine the country's future relationship with the EU. The Foreign Service has acquired extensive knowledge of the

workings of the European Union and gained valuable experience from interaction with that organisation. The Foreign Service is therefore well prepared to engage in accession negotiations and to safeguard Iceland's interests in such talks, should there be a decision to launch an application process.

At the same time, the Ministry for Foreign Affairs continues to look after Iceland's national interests in a wider context. Every effort is being made to restore Iceland's reputation in the international community through active and responsible participation in the work of international organisations. The Ministry will now have to do this work on a smaller budget than it had in recent years, and the informal networks forged through both bilateral and multilateral contracts will prove invaluable.

The inevitable funding cutbacks will require that clear priorities be set for the work of the Foreign Service. But Iceland will continue to represent the values it has advocated in the past on the international stage, such as human rights and democratic governance, sustainable development and environmental protection, conservation of the marine environment, the eradication of poverty, and the peaceful resolution of conflicts. The Icelandic Government is also determined to combat climate change. Iceland's position in the High North will also be stressed, in view of increasing interest in the natural resources found in the Arctic, and the new navigation routes opening up in the region. We must look to the future in the High North and assess both the risks and opportunities resulting from global climate change.

The present general foreign-policy report by the Minister for Foreign Affairs concentrates on European affairs, as well as reviewing other important international concerns. In this context, it is appropriate to point out that last year, the Minister for Foreign Affairs presented two reports to the Alþingi, one on foreign and international affairs, and the other on European affairs. Here, they will be combined in view of present circumstances and the brief period of time the Alþingi had to finish its work before the election.

The Foreign Service's Response to the Banking Collapse

The Foreign Service's role in the Icelandic Government's response to the banking collapse has consisted chiefly of communication with other governments and international organisations. Icelandic diplomatic representations abroad have explained this country's view of the crisis to foreign governments, interest groups, enterprises, local authorities, the general public, and the media in the countries involved.

The financial meltdown last October was followed by a currency crisis. Iceland received unprecedented attention from foreign governments and the international media as the negative effects of the banking collapse were felt around the world. It soon became clear that Iceland had to make a concerted effort to promote an understanding of its position among other nations and international organisations and to gain support for Iceland's perspective on the situation.

The Minister for Foreign Affairs stressed holding bilateral meetings and consultations with foreign ministers in order to seek their support for Iceland's views. Consultations of this kind were held with the foreign ministers of the other Nordic countries, the United Kingdom, the

United States, France, Germany, the Netherlands, Spain, and several other nations, and there were also talks with other government ministers and high-level officials as required. This effort was necessary in order to protect Icelandic interests and protest the United Kingdom's use of anti-terrorist legislation against Iceland, and they were also essential for obtaining loans from the International Monetary Fund and friendly countries.

The Ministry for Foreign Affairs asked ambassadors and consular officials to liaise with government officials at the highest possible levels in the countries where they were posted, in order to explain Iceland's views of the situation. Icelandic ambassadors have held numerous meetings with foreign government and ministry officials, interest groups, and media representatives in order to explain Iceland's position, secure support for this country, correct misunderstandings, and prevent the banking collapse in Iceland and its impact in other countries from damaging relations between Iceland and other nations.

The Foreign Service also represented Iceland's interests in relation to international organisations and supplied information on the situation in this country to the European Union, the Organisation for Security and Co-Operation in Europe, and the North Atlantic Treaty Organisation. Iceland's permanent representative to NATO strongly protested the United Kingdom's use of anti-terrorism legislation against Iceland at a conference held by that organisation in October.

In contacts with the British Government, the Icelandic Government has strongly emphasised the political aspects of the Icesave issue: that it involves both fundamental Icelandic interests and bilateral relations between the two countries, and that it is therefore impossible to see the matter in terms of a conventional wind-up of a bankruptcy estate. At the end of February/beginning of March, Icelandic Ministry for Foreign Affairs officials met high-ranking representatives of the British Prime Minister's and Foreign Offices for talks on the Icesave question and found much greater understanding of Iceland's position on this issue than they had experienced previously.

After the financial shock, Icelandic Embassies and the Ministry's Consular Service provided general information and handled various problems for Icelandic citizens abroad. Icelandic embassies and consulates also provided financial assistance to citizens who met specific requirements. Following media reports that Icelandic citizens had been subjected to unfair treatment abroad, the Ministry for Foreign Affairs requested corroborated accounts of such incidents. Icelandic embassies have also held regular information meetings with associations of Icelandic citizens resident abroad.

The Ministry for Foreign Affairs has also maintained contacts with Icelandic enterprises and associated interest groups in order to assist them in dealing with the negative effects of the financial crisis. The Ministry and Icelandic embassies have provided enterprises with various kinds of assistance, including help with funds transfers and payment guarantees, as well as aiding enterprises that have experienced difficulties due to negative media reporting and lack of confidence in Icelandic business. Foreign Service commercial attachés have contacted Icelandic firms in the countries where they are posted in order to gain an overview of the situation there and their client's needs, so that they can provide as much assistance as possible.

The Foreign Service will continue to represent Icelandic interests abroad in an effort to ensure that the effects of the economic collapse have as little impact as possible on this country's citizens. There will also be ongoing efforts, in co-operation with other ministries, to resolve issues pertaining to Iceland's international trade and other relations.

1 EUROPEAN AFFAIRS

1.1 Introduction

In January 2008, the Minister for Foreign Affairs presented a special report to the Alþingi on Iceland's position in the European internal market, and this was followed by useful discussion of European affairs. In view of the extensive impact that EU legislation has on Iceland, it is reasonable that the Alþingi should discuss Iceland's position in European co-operation at regular intervals. In recent months, the Alþingi has worked on establishing new regulations for the handling of European Economic Area issues, which demonstrates that the Alþingi intends to play a greater role in these matters and take a more direct part in decision-making in the EEA than it has done in the past. This year, the report on European affairs is part of the Minister's regular report to the Alþingi on foreign affairs.

European affairs are also discussed in this context due to their importance for Icelandic political and economic affairs. It is essential for informed political debate that the specialist knowledge acquired by the Ministry of Foreign Affairs be presented to members of the Alþingi, and that members be cognizant of the current status of EU monetary affairs, EU agricultural and fisheries policies, and EU members' influence on Icelandic interests.

With regard to European affairs, this report deals with matters pertaining to EEA and Schengen co-operation, as well as to matters that fall outside these agreements and would have to be taken up in potential accession negotiations with the EU. The latter discussion is based on the work of committees appointed by the Minister for Foreign Affairs to investigate specific areas, including issues relating to fisheries, agriculture, and regional policy. These three areas would be very important for Iceland if accession negotiations were to be initiated with the EU.

In addition to these committees, there is also a panel working on behalf of the Prime Minister's Office, which includes members of all the political parties represented in the Alþingi, along with representatives of business and industry, which has been asked to submit its conclusions soon on the relationship between Icelandic interests and the EU membership issue.

1.2 Iceland and Europe

Iceland has been an active participant in European co-operation for decades. This participation has been developed primarily on the basis of three fundamental agreements made at specific junctures during this period: the EFTA treaty in 1970, the EEA agreement in 1994, and the Schengen agreements of 1996 and 1999. Bearing in mind that two-thirds of Iceland's foreign trade takes place with EU member states, six percent with other EFTA countries, and two percent with other states with whom Iceland has made bilateral free-trade agreements, it is obvious that the bulk of Iceland's foreign trade is covered by the agreements cited above.

Foreign trade is a fundamental precondition for prosperity in this country, as it amounts to 35 percent of gross national product, and this percentage is likely to increase over the next few years. This involves not only the export of conventional goods; trade in services has also accounted for a larger share of Iceland's foreign trade in recent years, although this sector is

expected to contract in the immediate future. In the longer perspective, the key factor in the creation of economic value will be greater exports of goods and services, and it will be necessary to obtain even more value from the country's natural resources. In this respect, wider market access, particularly for fully finished goods, is an essential factor in enabling greater creation of value in key economic sectors in this country.

All of these factors highlight the importance of the trade agreements concluded with the EU in recent years. Furthermore, Iceland's national security arrangements will now be based to an increasing degree on co-operation with this organisation. Iceland has taken a cautious approach in foreign affairs, proceeding one step at a time. Now, 15 years after the EEA agreement entered into force, it would be reasonable to consider whether full membership in the EU might be the best option in the long term. It is essential to consider whether Iceland's national interests would be best served by deeper economic integration with the EU. It is clear that further progress in this area cannot be made through special agreements with the EU, but rather through membership in the Union.

There is also the question of the risks involved in participating in the EU Single Internal Market without full membership in European currency co-operation, because Iceland would not have access to the safety net and the economic support that the euro and EU membership provide.

In this context, it is appropriate to highlight the difference between interest rates and conditions in Iceland compared to those in the EU. Under the present circumstances, every fraction of a percentage that interest rates rise or fall has vital importance for Icelandic households and enterprises.

In light of the overall debt situation confronting the Icelandic economy in the coming months and years, EU membership would save the Treasury billions, possibly even tens of billions of krónur, in the form of more favourable credit terms. An Icelandic application for EU membership would also be seen internationally as an important step along the way to regaining stability and credibility at this stage in the country's history.

Even though several Balkan states are expected to join the EU within the next few years or decades, as noted earlier in this report, it is also obvious that some "enlargement fatigue" is now being felt in the EU. This is particularly obvious from criticism that some of the twelve states that joined in 2004 and 2007 were not fully prepared for accession, as well as in the calls for stricter requirements for incorporating and implementing EU legislation for the present applicant countries.

There seems to be a consensus among experts on EU development that following the accession of Croatia, which will probably join the EU in 2012, new members will not be admitted to the EU before 2015. Olli Rehn, the present member of the EU Commission for Enlargement, said recently that Iceland had an opportunity to join the EU at the same time as Croatia. However, it can be assumed that this possibility will diminish with every passing month.

In many respects, it would be a major step for Iceland to seek accession to the EU, but it should be kept in mind that on the basis of the agreements cited above, Iceland, along with Norway and Liechtenstein, is the country that has made the most progress in adjusting its regulatory and treaty environments to the EU. In these areas, the EFTA countries that belong to the EEA are far ahead of the states that are now engaged in accession negotiations with the Union. It is interesting, in this context, to recall the survey quoted in last year's report by the Minister for Foreign Affairs. It showed that Iceland has actually already adopted most of the EU regulations contained in the majority of the 35 chapters of EU law on which agreement must be reached in accession negotiations with the Union. The survey was presented in order to show how deeply involved Iceland actually is in European integration, without being an EU member state. It should be kept in mind that the survey does not state that each of the subject areas in question is completely subsumed under the EEA agreement or other treaties. But it is, nevertheless, an important indication of Iceland's EU-readiness. The report also discusses areas that are not covered by the EEA agreement, which would have to be given particular attention during accession negotiation with the EU.

1.3 EU Enlargement

Further enlargement of the EU is now taking place in three stages. As a first tier, formal accession negotiations are currently underway with Croatia and Turkey. Next in line is FYROM (Former Yugoslav Republic of Macedonia), which has received EU recognition as a potential member state, but accession negotiations have not yet been launched. And a third group consisting of other states in the Balkans except for Kosovo, has entered the process as well, after concluding partnership agreements with the EU.

The EU Commission issues annual reports on the status of affairs in these countries, which attempt to evaluate how far they have progressed in meeting the criteria established for accession and to decide, on that basis, what measures still need to be taken. Iceland has an obvious interest in this process, due to the mandatory enlargement of the EEA that follows in the wake of EU enlargement. It is therefore essential for the EFTA states that belong to the EEA to closely monitor this process, particularly in light of the obligations which the EU has demanded that EFTA countries take on in connection with this process.

At the beginning of November last year, the European Commission published a report assessing the status of those countries aiming for EU membership. The report of the Minister for Foreign Affairs in 2008 devoted extensive discussion to these matters, and this report will therefore mention only the recent developments in connection with the EU Commission's assessment.

Looking first at *Turkey*, there has been some tension in relations between Turkey and the EU in recent months, due to circumstances discussed in the 2008 report by the Minister for Foreign Affairs. There have also been internal political tensions in Turkey in recent years, among other things because the country's chief public prosecutor demanded that the ruling Justice and Development Party be banned, because it was trying to impose Islamic law in this secularist state. The charges were dismissed, but the government party was still required to pay a fine. Further progress in accession negotiations between Turkey and the EU will depend, on the one

hand, on domestic developments in Turkey, and on the other, on a solution being found to the dispute over the division of Cyprus. Some progress has been made on in the first area, as certain amendments have been made to the constitution, although some observers question whether they will actually be implemented. The most recent constitutional amendments relate to freedom of speech and the rights of minority religions. Further action is clearly needed in order to strengthen democratic change and human rights in Turkey and to develop this society further in the direction of EU legal standards. Particular concerns include the status of political parties, constitutional amendments, freedom of speech, and the rights of women. Turkey has launched negotiations on 10 of the 35 mandatory chapters and completed talks on one. Further reforms in several fundamental areas are still pending. It will also be necessary to resolve the Cyprus dispute if Turkey wants to make progress in its accession negotiations. The EU has decreed that negotiations will not commence on specific chapters until this dispute has been resolved and Turkey has fully complied with its obligations toward Cyprus an EU member state. It is hoped that progress will be made on resolving the dispute this year, as conditions now seem more favourable toward the development of mutual trust between the two states.

Accession negotiations with *Croatia* seem to be going well, despite recent complications arising from an unresolved border dispute with Slovenia. Potential solutions to that dispute are now being discussed. So far, Croatia has opened discussion on 22 chapters, concluded the process with regard to seven chapters, and has made considerable progress on meeting the criteria for closing the negotiations on several others. The requirements have been met for opening talks on most of the outstanding chapters. The European Commission considers it possible to complete the negotiations this year and has presented definite timetables for the process. These plans could be upset due to the dispute with Slovenia, which has blocked negotiations on some chapters and prevented closure on others due to the dispute between the two countries. But if the negotiations proceed according to plan, it can be assumed that Croatia will become a full member of the Union in 2011.

It was a great disappointment to FYROM that the European Commission did not recommend launching accession negotiations with that country in report published by the Commission last autumn. This decision was due mainly to the violence that marred the recent FYROM elections, and the conclusion that certain fundamental rules had not been observed during the voting. The Commission has deemed that the general conditions for launching accession negotiations have yet been fulfilled, even though progress has been made in some areas, such as domestic affairs and the justice system.

For applicant countries, the first step in accession negotiations with the EU is the conclusion of a so-called association agreement with the European Union. The objective of this agreement is to formalise interaction between the EU and the country concerned and encourage progress on the reforms required to meet the criteria for membership in the Union. Among other things, this involves adapting national legislation to EU law. Assessments of progress in implementing the association agreement are an essential aspect of the EU Commission's evaluation of a country's readiness to launch formal accession negotiations.

Montenegro has now formally applied for membership in the European Union and applications can be expected from several other Balkan nations in the near future. The progress

of these applications will be evaluated on the basis of how well the countries in question have done in fulfilling various provisions of their association agreements with the EU. The Commission will assess applications at the request of the Council of Ministers, but several years will probably pass before accession negotiations can begin. It can be assumed, for example, that accession negotiations will begin with FYROM sooner than with Montenegro. By the same token, there is every reason to assume that Iceland would be even closer to the head of the queue.

A partnership agreement has been signed with *Bosnia and Herzegovina*, and an interim agreement on its implementation has entered force. Political circumstances have made the process very cumbersome in Bosnia, due to the lack of co-operation among the ethnic groups living in the country. Closer co-operation is necessary in order to achieve the objectives of the partnership agreement. There is obviously still a long way to go before that country reaches the threshold of accession negotiations.

Serbia has signed a partnership agreement with the EU and an interim agreement on its implementation. But its entry into force depends on the consent of all EU states, and not all of them are willing to grant this as long as war criminals remain at large. In other respects, Serbia is considered well prepared to launch accession negotiations and make further adjustment to the EU legal framework. If there is compliance with the demand to arrest war criminals this year, the European Commission sees no obstacle to granting Serbia the same status as FYROM, i.e. that of candidate for membership, which is the last step in the direction of formal accession negotiations.

Kosovo has also been promised consideration as a potential candidate country. This was last confirmed by EU leaders in June of last year. The Union is urging that the necessary reforms be made in Kosovo with a view to fulfilling the criteria for future membership in the EU.

The EEA agreement contains a special provision that comes into play when there are new parties to the agreement, either through accession to the EU or EFTA. This provision has been invoked twice within a short period of time, when a total of 12 new states became party to the EEA agreement through accession to the EU in 2004 and 2007. Negotiations for these two enlargements of the EEA area resulted in the EFTA states within the EEA agreeing to contribute a total of 672 million euro to the poorest EU member states. The so-called EFTA Development Fund was created, which is open to all new EU member states, as well as Spain, Portugal, and Greece. Norway also contributed more than 600 million euro for the same purpose, but this contribution could only be used to assist new EU member states. At the same time, the EU approved unrestricted free trade in herring filets and larger duty-free quotas for certain other fishery products, particularly lobster and redfish. Even though there is no time limit on EU enlargement as such, the agreements made concerning financial contributions by the EFTA countries within the EEA and those concerning larger import quotas for fishery products to the EU will remain in force only until the end of April 2009. Negotiations are currently underway with the EU concerning the future of these funds and the duty-free quotas.

1.4 *The Treaty of Lisbon*

Last year's report by the Minister for Foreign Affairs contained a detailed discussion of the Treaty of Lisbon, so there is no need to repeat that here. But one EU member state, Ireland, has now rejected the treaty in a referendum, and it is therefore uncertain whether it will enter into force. This report will therefore deal with the present situation rather than the changes the Lisbon treaty would entail, unless specifically stated otherwise.

A total of 24 member states have now ratified the treaty, and it has been approved by the national parliaments of two other others. But the question of how to deal with the treaty in relation to Ireland remains open. There have been attempts to arrange matters in such a way that the treaty can still enter into force. EU member states appear to have agreed that they will make certain changes in the treaty as soon as possible, if it enters into force. Another referendum on the treaty is expected to take place later this year in Ireland, and that vote will likely determine the treaty's fate. The most significant change that member states have agreed to make regarding the Lisbon treaty is to ensure that each member state will still have a member of the European Commission, which means that there will still be 27 Commissioners, and that their number will increase with further EU enlargement. It is also assumed that there will be additional guarantees that the treaty will not change limits on EU authority regarding taxation, and that the Union will not influence individual member states' security and defence policies, including those of states that have chosen to remain nonaligned. And finally, it is assumed that the EU will not interfere with the provisions of national constitutions concerning family issues.