

Conclusions on Iceland

(extract from the Communication from the Commission to the Council and the European Parliament "Enlargement Strategy and Main Challenges 2010-2011", COM(2010)660 final)

The first progress report on Iceland confirms the assessment of the Commission's Opinion of February 2010 that Iceland meets the political criteria. Iceland is a functioning democracy with strong institutions and deeply rooted traditions of representative democracy. The country's judicial system is well established and the judiciary is of a high standard. As regards human rights and the protection of minorities, Iceland continues to safeguard fundamental rights and to ensure a high level of cooperation with international mechanisms for the protection of human rights.

However, the Opinion also identified a number of shortcomings. The report confirms that Iceland has taken some measures to address them.

As far as the **political criteria** is concerned, the coalition government remained stable over the reporting period despite the difficult economic background and diverging views among the Icelandic political forces and population on the prospect of EU accession. However, support for the accession process has increased at the end of the reporting period with a majority in favour of conducting accession negotiations.

Some progress has been achieved in identifying those responsible actors for the collapse of the Icelandic banking system and in addressing its political and administrative consequences. This is a notable feature of the functioning of Icelandic democratic institutions. The report of the independent Special Investigation Commission, published in April 2010, led to a number of recommendations to stabilize the financial system and to increase its supervision. In parallel, the Office of the Special Prosecutor continued to conduct a number of investigations in the aftermath of the financial crisis.

Good progress was made to further improve the legal framework related to conflict of interests and the financing of political parties. The Judiciary Act was amended to change the rules on the appointment of judges with the aim of further strengthening the independence of the *judiciary*. Implementation of the Special Investigation Commission recommendations, the amended framework on conflict of interests as well as the revised procedures on judicial appointments is underway. The impact of these measures will need to be reviewed at a later stage.

Both *government* and *parliament* have continued to function well. The government took steps to further strengthen the public *administration*. The negotiating committees in charge of coordinating the overall accession process work smoothly.

The Council of Europe Framework Convention for the Protection of National Minorities remains to be ratified.

The **economy** of Iceland went into a deep and long recession and prospects for even a mild recovery remain uncertain. Unemployment has increased and public finances have suffered a marked deterioration with higher fiscal deficits and a significant rise in the already high public debt. On the other hand, inflation has been gradually and steadily coming down. A prudent macroeconomic policy mix focuses on exchange rate stabilisation and fiscal consolidation. A still dysfunctional financial sector and widespread private sector balance sheet imbalances as well as a very high external debt represent key challenges. The IMF programme has been on track.

As regards the **economic criteria**, Iceland can be considered a functioning market economy. However, financial sector weaknesses and capital movement restrictions still impede an efficient allocation of resources. Iceland could regain the capacity to cope with competitive pressures and market forces within the single market over the medium term, provided that it continues to address current structural weaknesses through appropriate macroeconomic policies and structural reforms.

The policy response has by and large been appropriate and supportive to re-establish a higher degree of macroeconomic stability, although prospects for a swift resumption of economic growth remain uncertain. Fiscal consolidation continued; fiscal deficits have started to decline and public debt has been restructured with a view to smoothing its profile and reducing exchange rate risks. Inflation has come down and key policy interest rates have been gradually lowered. A higher trade surplus has supported a slight appreciation of the domestic currency. Foreign exchange reserves have increased, however this was achieved largely on the basis of official external financing. The labour market remained flexible and participation rates relatively high. The country enjoys good basic infrastructure, abundant natural resources, and a well-educated population.

However, the economy is still struggling with the effects of the financial meltdown. Public finances remain confronted with the challenge to implement severe spending cuts and suffer from significant contingent liabilities related to financial sector distress, with a gross general government debt level of almost 90% of GDP. Despite real wage adjustments, unemployment has risen markedly. The reconstruction of the banking sector has progressed, but banks are still suffering from weak asset quality which undermines their ability to finance the economy. Widespread private sector balance sheet imbalances pose threats to financial stability. In addition, Supreme Court rulings declaring foreign exchange indexed loans illegal created uncertainty, notably on the treatment of corporate sector loans. This could further erode the financial situation of domestic banks as they would have to shoulder the additional burden instead of borrowers. The process of corporate sector debt restructuring has progressed slowly and the debt overhang is limiting the scope for new investment, holding back the recovery. Investment in large infrastructure projects is currently still under review because of political discussions and lack of funding. The business environment remained hampered by capital controls, relatively high interest rates and difficult access to financing, especially for SMEs.

In this first progress report, Iceland's **ability to assume the obligations of membership** was assessed in light of its participation in the European Economic Area (EEA) and taking into account the exemptions granted under the EEA. The overall level of preparedness to meet EU *acquis* requirements remains good, in particular due to Iceland's participation in the European Economic Area.

The Icesave dispute remains unresolved. The bill authorizing a state guarantee on the loans granted by the governments of the UK and the Netherlands for the compensation they provided to their citizens holding saving accounts in Icesave was rejected by referendum in March 2010. The EFTA Surveillance Authority (ESA) send a letter of formal notice to the Iceland government in May 2010, hereby taking the first step in an infringement procedure against Iceland arguing that Iceland acted in breach of the Deposit Guarantee Scheme Directive by leaving the depositors in Icesave's Dutch and UK branches without the minimum guarantee. The European Commission shares the legal analysis of ESA. Negotiation efforts between the representatives of the three governments did not yield a result yet.

Preparations to take on the obligations of membership in the medium term continued in areas partly covered by the EEA as well as in chapters not covered by the EEA. Iceland continues to be largely aligned and applies a substantial part of the *acquis* in the fields covered by the

EEA such as free movement of goods, freedom of movement of workers, right of establishment and freedom to provide services, free movement of capital, public procurement, company law, intellectual property law, competition, financial services and information society and media.

However, efforts to further align with the EU *acquis*, in particular in areas not covered by the EEA, and to ensure its implementation and enforcement need to continue. It should also be noted that the following areas are likely to pose challenges in the accession process: financial services, agriculture and rural development, fisheries, free movement of capital as well as environment.

The government's efforts to address the fallout of the economic and financial crisis led to significant budgetary cuts. Attention is needed to ensure that resources remain available for the necessary preparations associated with the process of EU accession.

Iceland continues to be largely in line with the *acquis* in the area of *free movement of goods*. However, some elements are not yet fully in place as far as horizontal measures and the old approach product legislation are concerned.

A satisfactory level of alignment has been reached in the field of *free movement of workers*. Preparations for the coordination of social security systems remain to be completed. Legislation on the *right of establishment and freedom to provide services* is broadly in line with the exception of the services and postal directives.

Iceland applies the *acquis* on *free movement on capital*, with some exceptions. In close cooperation with the IMF, the Icelandic authorities have committed to gradually remove restrictions on capital movements and payments. Nevertheless, capital flow restrictions were meanwhile extended until August 2011; the maximum amount of foreign currency that can be bought for travel was reduced. Significant and sustained efforts are still needed to remove the existing restrictions on capital movements, including foreign investment in fisheries.

Iceland has implemented the main body of the *acquis* on *public procurement* and overall alignment is very good. However, the administrative capacity remains to be further enhanced to ensure proper implementation of public procurement policies.

Good progress was made on *company law*. However, full alignment with accounting standards is not achieved. Iceland continues to be largely in line with the *acquis* in the field of *intellectual property law* but a comprehensive enforcement policy is needed.

Iceland has reached a high level of alignment regarding the *competition acquis* and the relevant administrative structures are in place. The state aid measures taken in response to the financial crisis remain to be assessed.

Full implementation of the *acquis* on *financial services*, together with a reinforced supervisory framework, remains to be ensured. Implementation is not complete in some key areas including insurance and securities markets.

Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of the *information society and media*. However, the provisions of the telecom reform, the audiovisual media services directive and the policies derived from the recent adoption of the European Digital Agenda remain to be implemented.

Preparations in the field of *agriculture and rural development* have not started yet. The establishment of structures to address changes in the administration, in particular the setting-up of an EU-compliant paying agency and an integrated administration and control system (IACS) remains to be addressed.

Some progress has been made on *food safety, veterinary and phytosanitary policy*, in particular in transposing the legislation on general food safety. However, efforts are required to strengthen the administrative and laboratories' capacities. Substantial differences from the EU system remain as regards the hygiene package, plant protection products, novel food and genetically modified food.

No new development can be reported in aligning with the EU common *fisheries* policy. Particular attention needs to be paid to the internal market *acquis* regarding the right of establishment, the freedom to provide services as well as the free movement of capital in the fisheries production and processing sectors where the restrictions in place are not in line with the *acquis*. Mechanisms for implementing and controlling Community support measures have yet to be set up.

On *transport*, the restrictions to foreign investment in air and maritime transport remain in force. Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of *energy*. Alignment with the *acquis* in the areas of oil stocks, independence of regulatory authority and energy efficiency is moderately advanced.

No legislative developments can be reported in the area of *taxation*. Iceland has already achieved a good level of administrative capacity. Nevertheless, liaison offices and IT interconnectivity are still to be established.

Iceland is already highly in line with the *acquis* in *economic and monetary policy*. However, several shortcomings still exist, in particular regarding full independence of the central bank and the prohibition of monetary financing of the public sector.

As regards *statistics*, the availability of statistical data in line with EU methodology needs to be improved in particular in business, macroeconomic and agriculture statistics. The implementation of major planned statistical operations such as the farm structure survey and the population and housing census is not guaranteed as human and financial resources have been further cut down.

Iceland already implements substantial parts of the *acquis* related to *social policy and employment*. However, a comprehensive employment strategy remains to be elaborated.

Against the difficult economic background, preparations in the area of *enterprise and industrial policy* are well on track. Better access to finance for SMEs is an issue. Alignment with EU standards on *trans-European networks* is high.

As regards *regional policy and coordination of structural instruments*, Iceland is at an early stage of preparations for the implementation of the cohesion policy instruments. An appropriate needs analysis, including the identification of the institutions responsible for the implementation of the cohesion policy, remains to be performed.

Iceland's *judiciary* is of a high standard and Iceland provides for a high level of protection on *fundamental rights*. Iceland has taken some measures to address the shortcomings identified in the February 2010 Opinion in particular as regards the procedure of judicial appointments and conflict of interest. However, implementation of these recommendations needs to be further assessed. The legislation on citizens' rights and data protection is not yet in line with the *acquis*.

Iceland applies the Schengen Agreement and has reached an advanced level of alignment with the *acquis* in the field of *justice, freedom and security*. The legislation in some areas remains to be brought fully in line with the *acquis* and relevant international instruments need to be signed or ratified.

Iceland is well advanced for EU accession and integration into the European *Research Area*. Alignment with EU standards in the field of *education and culture* is high. Iceland continued to participate actively in the Open Method of Coordination in education as well as in community programmes including Lifelong Learning, Youth in Action and Erasmus Mundus programmes.

Environmental policy in Iceland is, to a large extent, aligned with the EU *acquis* through the EEA agreement and further progress can be reported in the areas of air quality and sustainable development. However, compliance with the climate change as well as the nature protection *acquis* in particular as regards protection of whales, seals and wild birds as well as conservation of natural habitats and of wild fauna and flora remains to be achieved. The ratification of key multilateral environmental agreements is pending.

Iceland has already implemented a significant part of the *acquis* in the field of *consumer and health protection*. However, the transposition of new *acquis* in the area of consumer protection remains to be completed and the processing of RAPEX notifications needs further streamlining.

The *customs* legislation of Iceland is, to a large extent, in line with the *acquis*. Significant further approximation is needed in duty-free legislation and practices. Interconnectivity with the EU IT systems remains to be ensured.

Some progress has been made in the field of *external relations*. Iceland started preparations to assess its obligations relating to the need to amend or renounce its international agreements; it also began preparations related to the common commercial policy. Measures remain to be taken to ensure that Iceland's Official Development Assistance does not decline further. Iceland has made good progress and reached an overall good level of alignment in the area of *foreign, security and defence policy*.

As regards *financial control*, a gap assessment needs to be carried out in the areas of financial management and control systems and internal and external audit to take into account internationally accepted standards in force in the EU. Preparations regarding the protection of the EU's financial interests remain to be enhanced. There has been some progress in the area of *financial and budgetary provisions* as Iceland has started to identify the required alignment with the *acquis*.