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Trade Policy Review Body

TRADE POLICY REVIEW

Report by the Secretariat

ICELAND

This report, prepared for the fourth Trade Policy Review of Iceland, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from Iceland on its trade policies and practices.

Any technical questions arising from this report may be addressed to Mr. John Finn (tel: 022 739 5081) and Mr. Usman Ali Khilji (tel: 022 739 6936).

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SUMMARY

1. Developments in Iceland over the past few years have been dominated by the collapse of the banking system in late 2008 that led to the liquidation of the main banks and the creation of three new banks to handle their domestic operations. As a result, the economy, which had already been slowing down, went into recession, the Icelandic krona fell against most other currencies, and unemployment increased.

2. Before the crises Iceland's economy had grown by an annual average of nearly 6% between 2003 and 2007, driven by private consumption and large investments in the power intensive industries. However, the growth also resulted in high levels of net external debt (both public and private) and gross international liabilities reached 625% of GDP in 2008 along with a high current account deficit and an appreciating currency. The collapse of the banking sector led to an average annual contraction in GDP of 5.4% in 2009-10. Despite the crisis, Iceland did not introduce any protectionist measures. Indeed, the recovery from the crises has been export led, with total merchandise trade as a proportion of GDP rising from 47% in 2005 to 70% in 2011, partly due to increased competitiveness due to the depreciation of the krona, and also due to the underlying strength of the fish, energy, and aluminium sectors.

3. In domestic currency terms, export and imports have already exceeded their pre-crises levels but this does not take into account the sharp fall in the foreign exchange rate for the Icelandic krona. In U.S. dollar terms, both export and imports fell sharply in 2009. Exports recovered quickly and in 2011 had almost reached pre-crises levels although the recovery in imports has not been as quick. Iceland's balance of trade in both goods and services has gone from a deficit equivalent to 5.7% of GDP in 2007 to a surplus equivalent to 12.3% of GDP in 2011.

4. Overall, the structure of trade in goods has not changed significantly over the past few years as the EU and other EFTA countries remain the main destination for exports and the main source of imports. Fish and fish products, and aluminium account for nearly all exports. Imports are more broadly based, although ores for processing, fuels, and machinery and transport equipment made up nearly 60% of total imports in 2011.

5. Iceland's trade policy is focused on its application to join the EU and its membership of EFTA and the EEA. Negotiations to join the EU have been under way since July 2009. Iceland has already adopted the *acquis communautaire* for those areas covered by the EEA. Furthermore, through the EFTA Convention, Iceland is already part of a free trade area covering industrial goods and fishery products while the EEA Agreement aims to establish an internal market for the free movement of goods, services, capital, and persons. However, neither EFTA nor the EEA establish a common external tariff and imports from other countries to Iceland are subject to Iceland's MFN tariff (unless covered by a regional trade agreement or under non-reciprocal trade arrangements).

6. The EFTA Surveillance Authority is responsible for ensuring that Iceland and the other EFTA countries in the EEA comply with the requirements of the EEA Agreement. The Authority can initiate investigations on its own behalf or accept complaints from individuals and enterprises that a state is not in compliance with its obligations under the EEA Agreement and issue a reasoned opinion. Depending on response of the country concerned, the authority can then move to the EFTA Court. Among the cases currently before the Court is a case against Iceland concerning state guarantees for banking depositors.

7. Overall, Iceland's MFN tariffs are quite low and over 70% of tariff lines are duty free. However, agricultural products are subject to tariffs which are often compound duties with an *ad valorem* component of 30% and a specific duty component that varies from ISK 5/kg to ISK 1,462/kg. The authorities were not able to provide the information necessary to calculate *ad valorem* equivalents for these tariff lines.

8. In terms of trade policies and practices, Iceland's import procedures are straightforward and are nearly always completed through electronic data interchange. Although the cost of importing and exporting is generally higher than in other OECD countries, this is due to the small size of the market which leads to higher costs for ports and terminal handling and internal transport.

9. The rate of business tax is relatively low at 20% despite an increase by 2 percentage points. However, some other taxes can be high, such as VAT which was increased to 25.5%, although a reduced rate of 7% is applied to some goods and services, including food and electricity. Excise duties are applied to a fairly narrow range of products, mainly fuels, tobacco, and alcoholic beverages. In addition to excise duties on fuels, motor vehicles are also subject to duties based on CO_2 emissions, to a semi-annual road tax, to a disposal charge, and to a weight/distance tax.

10. Most import restrictions in Iceland are applied for safety reasons, such as licences required to import radioactive goods, firearms and ammunition, and toxic chemicals. In addition, imports of live animals are prohibited and imports of fresh meat require the permission of the Minister of Industries and Innovation.

11. To aid recovery after the financial crises that started in 2008, new legislation was enacted in 2010 on incentives for initial investment in Iceland. The law provides for financial aid for training, investment and research and development as well as regional aid for projects outside the Reykjavik area. This regional aid can be as high as 35% for small, 25% for medium-sized, or 15% for larger enterprises. In addition, there are several tax incentives for investment outside the Reykjavik area. The law is to be reviewed before the end of 2013, although, should it expire, investment agreements made before its expiration will remain in force.

12. Iceland has not made any notifications to the TBT or SPS Committees since 2006. However, most EU standards have been transposed into Iceland. On SPS issues, as a member of the EEA, Iceland has applied EU legislation on SPS matters, with the exception of veterinary issues, which were exempt from the EEA Agreement. Since November 2011, the exemption has been limited to trade in live animals and animal germplasm while Iceland also continues restrictive import policies on fresh meat, raw eggs, and animal products not for human consumption. The strict control of imports of animals and animal products is justified on the grounds that Iceland's livestock breeds have developed in isolation for several centuries and are susceptible to transmittable diseases. Furthermore, domestic production of animals and animal products are also subject to strict controls.

13. Agriculture in Iceland faces several constraints including the climate, lack of suitably land, and the relatively small size of the farm businesses. Although it represents only a small part of the economy and employment, it is considered important for cultural and other reasons, including maintaining a rural population in the sparsely populated countryside. Milk and sheep meat make up over half of the value of production. Agriculture production is directly protected from competition through relatively high tariffs and indirectly through strict SPS-related measures. It is also supported through direct payments to producers and, for dairy, minimum prices. Total support to producers, as measured by the OECD's producer support estimate, at 45% of gross farm receipts, is one of the highest in the OECD.

14. The fishing industry has traditionally been one of the pillars of the economy and it remains very important as it accounts for 40% of exports and nearly 10% of GDP. The focus of policy has, for some decades now, been on managing resources with total allowable catches set for each species that are then allocated to fishing vessels each of which receives an individual transferable quota based on its historical share of the catch. These individual quotas are fairly freely transferrable, with limits on the total amount of quota any individual or company can hold. Foreign ownership of fishing operations and primary fish processing is limited to 25% direct and 49% combined direct and indirect ownership. In certain circumstances, direct foreign ownership of up to 33% may be permitted. Compared to other OECD countries, government transfers to fishing are relatively low: in 2007 they were the equivalent of 4% of the value of the landed catch versus 20% for the OECD as a whole.

15. Relatively cheap energy prices due to the abundance of hydro and thermal power has resulted in the establishment of energy intensive industries such as aluminium smelters. These have become an important sector of the economy and source of foreign exchange. Furthermore, the authorities have identified energy intensive industries, along with land intensive industries, knowledge based industries and tourism as sectors where Iceland has a competitive advantage and future avenues for growth. However, the current restriction whereby investment and/or ownership of energy exploitation rights and the production and distribution of energy are limited to EEA and EFTA residents, which would hinder investment in the sector.

16. In the aftermath of the global financial crisis in 2008, the banking system collapsed. Domestic banks found themselves heavily indebted to domestic and foreign depositors and lenders with little hope of repaying their liabilities. As a result, the domestic and foreign operations were separated, the banks were liquidated and new banks created to run domestic operations. The recapitalization of these institutions resulted in a significant fiscal outlay on the part of government. The economic effects were severe as the exchange rate depreciating by more than 70%, an IMF sponsored programme was implemented and capital controls introduced. Since then, the banking sector has recovered although the size of the sector has decreased considerably. However, risks remain mainly in the form of a high number of non-performing loans.

17. Although Iceland is recovering from the crises, the recovery is fragile and risks remain. It is important that Iceland reduce public debt and put public finances on a sustainable track and continue with debt restructuring so that the large overhang of non-performing loans be reduced so that banks can resume their core lending activities. Although, the authorities have identified certain sectors where they feel that Iceland has a competitive advantage, investor confidence needs to be restored in order to attract investment.