

IV. TRADE POLICIES BY SECTOR

(1) AGRICULTURE

(i) Features

1. Agriculture and forestry represented about 1.2% of GDP in 2011, up from 1% in 2006. In terms of employment, agriculture employed nearly 4,700 people in 2010; while this represents only about 2.9% of employment, it is an increase compared to 2008, when it was 4,400. Such an increase is unusual for a developed country and could be the result of the financial crises (Table IV.1).

Table IV.1
Overview of agriculture, 2006-11

	2006	2007	2008	2009	2010	2011
Contribution to GDP (%)	1.0	1.1	1.2	1.2	1.2	1.2
Number employed	.. ^a	.. ^a	4,400	4,300	4,700	4,800
			(ISK million)			
Value of production	17,612	18,607	20,335	20,524	21,192	26,623
<i>of which</i>						
Milk	5,419	5,925	7,457	9,106	9,230	9,618
Beef and veal	1,228	1,351	1,536	1,605	2,228	1,987
Sheep meat	2,688	2,820	3,340	3,322	3,613	4,509
Pigmeat	1,635	1,802	1,972	1,798	1,749	2,188
Poultry meat	1,717	2,051	2,184	2,244	2,251	2,650

a Statistics for employment in agriculture in 2006 and 2007 used a different methodology and are not comparable with later years.

Source: Statistics Iceland. Viewed at: <http://www.statice.is/>; and the Icelandic authorities.

2. Only about 1% of Iceland's land area of 103,022 km² is suitable for cultivation; about 25% is suitable for grazing, some of which can also be used to grow fodder crops. In 2009, there were about 3,045 farms, practically all family owned and operated.¹ Livestock and livestock products are the main farms activities and most crops are grown for animal fodder, although some vegetable production takes place both outdoors (potatoes and cabbages) and under glass using geothermal sources for heating. Most farms tend to be quite small with only 35 cows on the average dairy farm.

3. In addition to the harsh climate and lack of suitable land, the scope for increasing productivity in Iceland is also limited to some extent by the narrow genetic base: there is only one dairy breed, one sheep breed, and one horse breed. These breeds have developed in isolation from the rest of the world and are vulnerable to transmittable diseases, making it hard to safely introduce new genetic material.²

4. Agriculture in Iceland is heavily subsidized with most support provided through market price support measures, principally through high tariffs that help to maintain high domestic prices relative to world prices and, therefore lead to a large transfer from consumers to agriculture producers. The total value of support to agricultural producers was about ISK 14 billion in 2010, which is the equivalent of ISK 4.6 million per farm or ISK 2.9 million per person employed in agriculture.

¹ Ministry of Fisheries and Agriculture online information. Viewed at: http://eng.sjavarutvegsraduneyti.is/immigrants/icelandic_agriculture/ [July 2012].

² Jóhannesson (2010).

(ii) Trade

5. Iceland is a net importer of agriculture products.³ In 2011, exports were worth about US\$81.5 million and imports about US\$208 million. The main exports are lamb and sheep meat, water, live horses, food preparations, and raw fur skins (mostly mink). However, exports of some products vary considerably from one year to another: the value of sheep meat exports more than tripled from 2007 to 2010 and then fell back in 2011, while exports of fur skins fluctuated considerably during 2006-11 (Table IV.2).

6. Imports of agriculture products were spread over a wide range of products, with bakers' wares, coffee, prepared foods, and chocolate heading the list, although the top ten imports make up less than half of total imports. Total imports of agriculture products reflect the economic situation, with strong growth up to 2008, followed by a sharp decline in 2009 (Table IV.3).

Table IV.2
Exports of agriculture products, 2006-11
(US\$ million and '000 tonnes)

HS 02	Description		2006	2007	2008	2009	2010	2011
0204	Meat of sheep or goats	'000 tonnes	1.15	1.08	1.80	2.55	3.44	2.68
		US\$ million	5.01	5.32	9.74	11.37	17.37	17.14
4301	Raw fur skins	'000 tonnes	0.03	0.03	0.03	0.03	0.02	0.02
		US\$ million	8.62	9.63	12.28	7.57	5.29	10.48
2201	Waters, unsweetened	'000 tonnes	6.50	9.84	15.11	8.04	13.17	14.87
		US\$ million	3.51	5.51	8.29	4.58	7.52	8.29
0101	Live horses, asses, mules, and hinnies	'000 tonnes	0.44	0.45	0.69	0.50	0.43	0.37
		US\$ million	6.07	7.56	12.21	8.04	7.39	6.70
4102	Raw skins of sheep or lambs	'000 tonnes	2.22	0.94	1.04	2.72	2.56	1.67
		US\$ million	2.18	1.03	1.09	1.83	2.92	5.26
2309	Preparations of kind used in animal feeding	'000 tonnes	1.79	1.20	3.56	0.35	0.15	5.68
		US\$ million	2.21	2.01	5.01	1.17	0.69	4.67
2106	Food preparations nes	'000 tonnes	0.07	0.03	0.05	0.14	1.32	0.39
		US\$ million	1.02	0.86	1.51	2.23	5.30	3.70
	Other	US\$ million	15.65	17.97	20.81	15.07	20.46	25.22
	Total exports	US\$ million	44.27	49.90	70.95	51.86	66.95	81.47

Source: UNSD Comtrade database.

³ In reviewing Iceland's agriculture trade, all tariff lines for fish and fisheries products were excluded because exports of these products are much greater than exports of agriculture products. For the purposes of this section of the Report, the definition of agriculture product used is that set out in Annex 1 of the Agreement on Agriculture, where fish and fish products are taken to include HS headings 020840, 03, 051191, 1504, 1603, 1604, 1605, and 230120. Fisheries are addressed in section (2) below.

Table IV.3
Imports of agriculture products, 2006-11
(US\$ million and '000 tonnes)

HS 02	Description		2006	2007	2008	2009	2010	2011
1905	Bakers' wares	'000 tonnes	5.73	6.68	6.12	5.30	5.49	5.48
		US\$ million	21.22	27.55	27.35	20.37	20.50	22.71
0901	Coffee	'000 tonnes	2.22	2.37	2.20	2.44	2.29	2.15
		US\$ million	10.27	12.72	13.81	12.16	12.92	16.81
1904	Prepared foods (cereals)	'000 tonnes	2.54	2.63	2.56	2.58	2.48	2.60
		US\$ million	11.57	13.45	14.25	12.85	11.69	13.23
1001	Wheat and meslin	'000 tonnes	32.98	36.30	34.90	38.13	36.46	36.14
		US\$ million	6.63	11.08	13.56	8.65	9.02	13.12
1806	Chocolate	'000 tonnes	1.91	1.90	1.80	1.55	1.57	1.57
		US\$ million	11.86	12.78	13.33	10.30	10.15	12.02
1701	Sugar	'000 tonnes	10.09	10.89	10.79	10.87	10.98	10.77
		US\$ million	5.50	6.26	7.50	7.77	7.52	10.35
1901	Malt extract	'000 tonnes	2.67	2.67	2.42	2.16	2.26	2.35
		US\$ million	7.87	8.35	8.50	6.62	6.48	7.63
	Other	US\$ million	96.97	159.08	172.95	128.91	130.08	149.29
	Total	US\$ million	171.90	251.26	271.27	207.62	208.34	245.16

Source: UNSD Comtrade database.

(iii) Agriculture policies

7. The Ministry of Fisheries and Agriculture is responsible for agriculture policy, including trade policy. The Ministry was created in January 2008 when the separate Ministries of Fisheries and Agriculture were merged.⁴ On the same date, the Icelandic Food and Veterinary Authority (*Matvælastofnun* - MAST) was established as an inspection and administrative body with responsibilities that include: food safety; plant and livestock quality and health-related matters; feed, seed, and fertilizer services; administration of organic production; and monitoring of animal welfare.⁵ In September 2012, the Ministry of Fisheries and Agriculture it is to be merged with the Ministry of Industry, Energy and Tourism to form the Ministry of Industries and Innovation (Chapter II(2)). The Farmers' Association of Iceland represents farmers in discussions on agriculture policy and has been contracted by MAST to process direct payments to farmers.

8. The legal basis for agriculture policy is:

- Act No. 99/1993 on the Production, Pricing and Sale of Agricultural Products, which sets out the policy framework, the legal basis for production controls, provisions for slaughter and processing, pricing and support measures; and
- Act No. 70/1998 on Agriculture, which provides the legal basis for development projects, extension services, and livestock improvement.

9. Under these Acts, there are a number of regulations that apply to different sectors for specific periods, including:

⁴ Ministry of Fisheries and Agriculture online information. Viewed at: <http://eng.sjavarutvegsraduneyti.is/ministry/historical-overview/> [July 2012].

⁵ MAST online information. Viewed at: <http://www2.mast.is/index.aspx?GroupId=1258> [July 2012].

- Regulation No. 4/2011 on horticultural production, which has applied since 2002 and is to expire at the end of 2013;
- Regulation No. 913/2010 on dairy production, which has applied since 2004 and is to expire at the end of 2014; and
- Regulation No. 11/2008 on sheep production, which has applied since 2007 and is to expire at the end of 2015.

(a) Trade policies

10. Iceland has 1,793 tariff lines for agriculture products, at the eight-digit level (HS 2002). Although 1,000 of these lines are duty free, these relate to products not produced in Iceland, or that do not compete directly with production in Iceland. For other agricultural products, the tariff structure is complicated: most have compound tariffs with an *ad valorem* component of 30% and a specific duty component that varies from ISK 5/kg to ISK 1,462/kg. The average *ad valorem* equivalent of these compound tariffs varies considerably, although it has not been possible to calculate *ad valorem* equivalents. In addition, there are some tariff lines with simple *ad valorem* tariffs (normally of 30% or 55%), some simple specific duties, and some compound tariffs that have *ad valorem* components not equal to 30%. The tariff lines with the highest tariffs tend to cover meat and dairy products, and some vegetables (see Chapter III(iii)).

11. Iceland reserved the right to apply the special agricultural safeguard on 645 tariff lines but has never used it.⁶

12. Iceland notified the WTO Committee on Agriculture that it operates 87 tariff quotas covering a wide variety of products, some specified at the four-digit HS level and some at the eight-digit level. The quotas are specified as either "minimum access" quotas that relate to market-access opportunities created with the implementation of the results of the Uruguay, or "current access" quotas that represent market-access opportunities that existed before the results of the Uruguay Round were implemented. The Committee on Agriculture was also notified that tariff quotas for products under 66 four-digit HS headings were never opened because the applied MFN tariff has been less than or equal to the bound in-quota tariff.

13. The levels of in-quota imports vary considerably from one product to another and from one year to another. For example, the quota for pig meat is 64 tonnes while in-quota imports have varied from zero in 2004 to 378 tonnes in 2008. However, in most cases, average in-quota imports for the seven-year period ending 30 June 2010 exceeded the quota quantity and, for 29 tariff quotas, in-quota imports were more than three times the quota quantity. In some cases the high level of in-quota imports relative to the quota reflects the small size of the statutory quota, for example there are quotas for 900 kg of mushrooms, 1 tonne of palm oil, and 9.9 tonnes of pasta.⁷

14. Under its Uruguay Round Schedule, Iceland reserved the right to provide export subsidies for 1,797 tonnes of sheep meat up to a limit of SDR 9.3 million, and 3.16 million litres of milk up to a limit of SDR 2.6 million. However, according to the notifications made to the Committee on

⁶ WTO documents G/AG/N/ISL/27, 27 July 2009, G/AG/N/ISL/23, 29 July 2003, G/AG/N/ISL/21, 30 October 2002, G/AG/N/ISL/18, 23 February 2001, G/AG/N/ISL/13, 26 January 1999, G/AG/N/ISL/7, 15 July 1997, and G/AG/N/ISL/3, 17 October 1996.

⁷ WTO documents G/AG/N/ISL/30, 13 January 2011, G/AG/N/ISL/29, 30 July 2009, G/AG/N/ISL/25, 22 November 2005.

Agriculture, Iceland did not provide any export subsidies between 31 August 1998 and 31 August 2008.⁸ However, under Regulation No. 535/2003 on Price Equalization for Exports of Goods made from Agricultural Raw Materials, the Ministry for Fisheries and Agriculture may authorize the Customs Office to refund the exporter the difference between the cost of raw materials in the international and domestic markets. In 2011, ISK 2.7 million (about US\$23,274) was budgeted for the price compensation mechanism.⁹

(b) Domestic support

15. Under Regulation No. 913/2010 on dairy production, support is provided through production quotas, direct payments, and minimum producer prices. The national production quota is set each year by the Minister of Fisheries and Agriculture and is divided among producers based on historical production. Production in excess of quotas is permitted provided all such production is exported. Direct payments are based on the number of animals (headage payments) and the size of a producer's quota (support entitlements). Headage payments are provided for up to 100 cows, with full payment for each of the first 40 dairy cows then at a reducing rate for each additional cow.¹⁰ The average payment per cow in 2011 was ISK 22,000 (see Table IV.4 for total annual budgetary allocations.)

16. A new mechanism for transferring milk production quotas was adopted on 1 December 2011 under Regulations Nos. 190/2011 and 430/2010. A single market for quotas was established under the system: bids to purchase, giving the quantity sought and the maximum price offered must be accompanied by bank guarantees; and offers for sale, with the quantity available and the minimum price may be submitted to MAST twice a year (by 25 March and 25 October). A single clearing price equivalent to the intersection of the supply-demand curve is used; bids at lower prices and offers at higher prices are rejected.

17. The Agricultural Pricing Committee (made up of the Farmers' Association, the dairies, trade union, and the Ministry) sets minimum prices for milk delivered to dairies by producers. This minimum farm gate price applies throughout Iceland to milk produced within the production quota and is adjusted to take account of differences in quality. Minimum wholesale prices for several dairy products are also set by the Committee.

18. Dairy producers are required to pay a price transfer levy (to reduce the price of some dairy products) and a price equalization levy (to level production costs among dairies) on delivery of milk to dairies. In 2011, the total collected from these levies amounted to ISK 312 million and ISK 93 million respectively.¹¹

19. In addition to direct payments and minimum prices, dairy producers also benefit from indirect support for breeding, land cultivation, and development programmes.

20. Although suckler cows for some beef breeds are eligible for twice the headage payment of dairy cows, the beef sector in Iceland is essentially a by-product of the dairy industry.¹²

⁸ WTO documents G/AG/N/ISL/28, 27 July 2009, G/AG/N/ISL/ 22/Rev.1, 26 August 2003, G/AG/N/ISL/17, 28 February 2001, G/AG/N/ISL/ 15, 2 September 1999, and G/AG/N/ISL/15/Corr.1, 8 September 1999.

⁹ European Commission (2011), *Chapter 11 - Agriculture and Rural Development*, p. 5.

¹⁰ European Commission (2011), *Chapter 11 - Agriculture and Rural Development*, p. 7.

¹¹ European Commission (2011), *Chapter 11 - Agriculture and Rural Development*, p. 7.

¹² European Commission (2011), *Chapter 11 - Agriculture and Rural Development*, p. 7.

21. Under Regulation No.11/2008, sheep production is supported by direct payments that, unlike dairy production, are linked to historical rather than current production, along with aid for new entrants. In addition, direct payments are made to producers through the quality payment scheme, provided they meet environmental, animal health, and animal welfare requirements. A production control that provided higher farm-gate prices to producers was abolished at the beginning of 2008. This programme obliged participating farmers to export whenever domestic production exceeded domestic consumption.¹³ Consumer subsidies are also provided, at the wholesale level for purchasers of wool and to processors for marketing and storage costs of sheep meat. A levy collected at the wholesale level for marketing sheep meat amounted to ISK 13 million in 2010¹⁴ (see Table IV.3 for total annual budgetary allocations).

22. Under Regulation No. 4/2011, production of tomatoes, cucumbers and sweet peppers is also supported by direct payments linked to production as well as through electricity subsidies and marketing and research programmes (see Table IV.3 for total annual budgetary allocations).

(c) Support levels

23. The most recent notification from Iceland on domestic support to the WTO Committee on Agriculture was for the calendar years 2001, 2002, and 2003.¹⁵ However, supporting data for Iceland's application to accede to the EU provides information on budgetary support for agriculture in recent years (Table IV.3) and the OECD's annual monitoring and evaluation report and supporting database covers the period 1986 to 2010 (Table IV.4). While these sources are not in the same format as notifications to the WTO they do provide information on the levels and trends in support.

24. The OECD's main indicator of support to agriculture, the Producer Support Estimate (PSE), is "the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers, measured at the farm gate level, arising from policy measures that support agriculture, regardless of their nature, objectives or impacts on farm production or income." The Producer Single Commodity Transfer (producer SCT) is "the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers, measured at the farm gate level, arising from policy measures directly linked to the production of a single commodity such that the producer must produce the designated commodity in order to receive the transfer."¹⁶

Table IV.4
Spending on support measures to farmers, 2008-11
(ISK million)

	2008	2009	2010	2011
Dairy				
Direct payments				
Support entitlements	4,366	4,589	4,681	4,915
Headage payments	538	542	553	581
Breeding and development work	127	136	139	146
Payments not linked to prices or production	141	61	161	169
Contributions to farmers' pension fund	198	209	115	0

Table IV.4 (cont'd)

¹³ OECD (2009), p. 153.

¹⁴ European Commission (2011), *Chapter 11 - Agriculture and Rural Development*, p. 8.

¹⁵ WTO document G/AG/N/ISL/26, 16 December 2005.

¹⁶ OECD (2010).

	2008	2009	2010	2011
Sheep				
Direct payments				
Support entitlements	1,901	2,080	2,122	2,228
Quality payment scheme	1,039	1,088	1,110	1,165
Special regional support	49	52	53	56
Wool utilization	348	364	371	390
Marketing and storage	363	340	347	364
Support to new entrants and development	95	97	99	104
Horticulture				
Direct payments	246	247	228	239
Electricity subsidies	179	153	203	213
Programmes for marketing, research, education	28	31	29	31
Other				
Development projects	90	90	52	..
Extension services	351	381	359	302
Livestock breeding	100	107	110	86
Development projects	90	91	52	12
Agriculture Productivity Fund	160	159	148	15
Marketing projects	25	25	19	0

.. Not available.

Source: Ministry of Foreign Affairs (2011), *Iceland's application for membership of the EU: State Aid*. Viewed at: <http://esb.utn.is/media/ESB/samningskaflar/11/State-Aid.PDF> [January 2012].

25. According to the OECD, the PSE for Iceland declined in absolute terms from ISK 16.4 billion in 2006 to ISK 14.6 billion in 2010 and in relative terms from nearly 80% of total farm receipts in 1987 to 45% IN 2010. However, although there has been some reform of policy over the past few years, the main reason for the decline is the rise in international prices and the corresponding decline in consumer transfers that result from higher domestic prices relative to border prices. Support remains very high by OECD standards where the PSE is 18% for the OECD as a whole.

Table IV.5
Total producer support estimate and single commodity transfer values for selected commodities, 2004-10
(ISK million)

		2004	2005	2006	2007	2008	2009	2010
Total agriculture								
Value of production^a	ISK million	13,566	16,424	17,642	18,464	20,698	22,460	22,637
Producer Support Estimate^b	ISK million	13,628	15,965	16,390	14,721	15,606	15,428	14,609
	% of gross farm receipts	65.8	66.8	64.7	55.3	51.6	48.0	44.8
Milk								
Value of production	ISK million	5,120	5,020	5,419	5,941	7,245	8,891	8,663
Single Commodity Transfer ^b	ISK million	6,888	7,182	7,191	5,620	7,265	8,010	7,187
	% of gross farm receipts	75.4	78.2	74.2	53.2	59.2	56.9	51.2
Beef and veal								
Value of production	ISK million	943	1,113	1,170	1,314	1,514	1,677	1,879

Table IV.5 (cont'd)

		2004	2005	2006	2007	2008	2009	2010
Single Commodity Transfer ^b	ISK million	384	569	622	618	264	108	107
	% of gross farm receipts	40.7	51.1	48.5	43.1	16.1	6.0	5.3
Sheep meat								
Value of production	ISK million	1,898	2,290	2,688	2,820	3,340	3,322	3,497
Single Commodity Transfer ^b	ISK million	2,180	2,287	2,608	2,936	3,168	3,249	3,353
	% of gross farm receipts	52.9	49.4	50.9	55.1	48.1	48.8	48.4
Wool								
Value of production	ISK million	296	251	355	157	92	92	92
Single Commodity Transfer ^b	ISK million	134	129	243	95	-2	-2	-2
	% of gross farm receipts	45.3	51.5	68.4	60.7	-2.4	-2.5	-2.4
Pig meat								
Value of production	ISK million	1,164	1,307	1,635	1,802	1,972	1,766	1,774
Single Commodity Transfer ^b	ISK million	569	755	923	1,030	741	236	360
	% of gross farm receipts	48.8	57.8	56.4	57.1	37.6	13.4	20.3
Poultry meat								
Value of production	ISK million	1,235	1,630	1,716	2,051	2,184	2,244	2,189
Single Commodity Transfer ^b	ISK million	1,107	1,522	1,446	1,683	1,568	1,538	1,496
	% of gross farm receipts	84.0	86.2	84.3	82.1	71.8	68.5	68.3
Eggs								
Value of production	ISK million	600	696	752	742	742	752	752
Single Commodity Transfer ^b	ISK million	449	555	570	530	425	300	319
	% of gross farm receipts	74.8	79.7	75.8	71.4	57.3	39.9	42.5

a Value of production figures are from the OECD database and differ to those in Table IV.1, which were provided by the authorities.

b Gross farm receipts include the receipts from subsidies paid to producers as well as from sales and, therefore, may be greater than the value of production.

Source: OECD statistical databases. Viewed at: <http://www.oecd.org/chile/producerandconsumersupportestimates/database.htm> [July 2012].

26. Despite the high level of support provided, agriculture continues to decline relative to the rest of the economy, the number of farmers continues to fall, productivity is low by international standards, and imports are rising compared with domestic production. Furthermore, policy continues to depend on market price support which, in most cases, is provided through high tariffs, resulting in large transfers from consumer to farmers. Although this has the advantage of not requiring any budgetary outlay from the Government, it is, according to the OECD, one of the least efficient and economically most expensive ways of supporting agriculture.¹⁷ However, the authorities stated that this does not take into account all the factors underlying agriculture policy in Iceland, such as food security, sustainable development, and rural development.

¹⁷ OECD (2002).

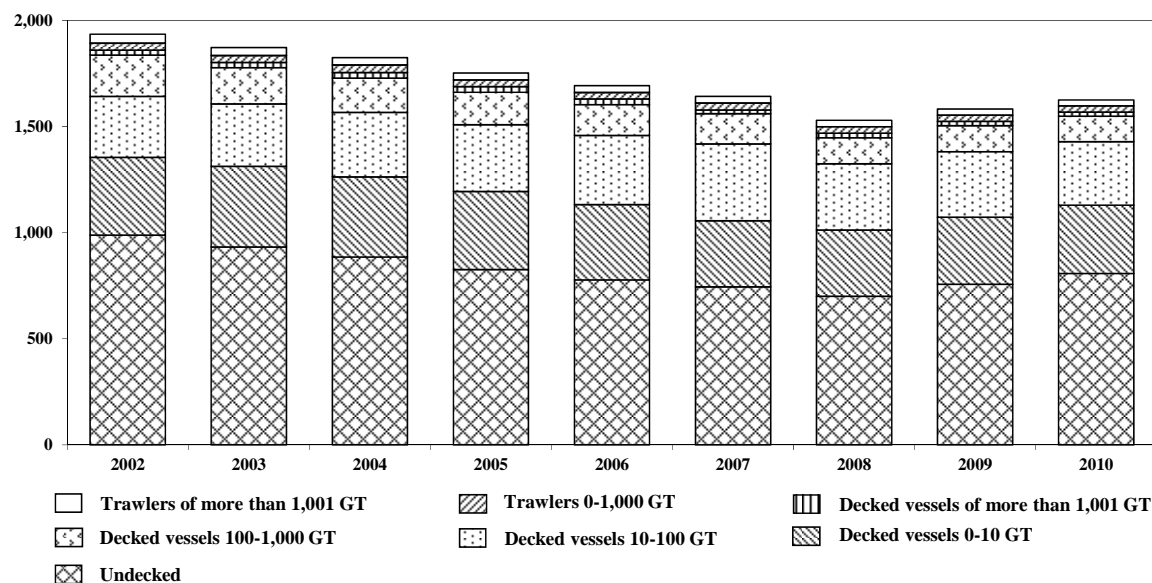
(2) FISHERIES**(i) Features**

27. Fisheries remains a very important part of Iceland's economy, representing 40% of merchandise exports in 2011 (down from 75% in the 1990s), and contributing about 9.7% to GDP (down from 14% in the 1990s). Iceland has a large trade surplus in fisheries with exports of US\$2,229 million in 2011 compared with imports of US\$136 million. Increasing capital investment and declining catches along with a more diversified economy have caused fisheries' share of total employment to fall steadily in recent years; employment fell from 5.7% in fisheries and 6.1% in fish processing in 1990 to 3% in fisheries and 2.2% in fish processing in 2010.

28. In 2010, Iceland had 1,625 fishing vessels with 152,401 gross tonnage (GT) plus 4 whaling vessels. The gross tonnage of the fleet has been declining since peaking at 191,222 GT in 2004. In recent years there has been an increase in the number of small vessels (undecked and decked vessels of 10 GT or less) while the number of larger vessels has continued to decline (Chart IV.1).¹⁸ Although the smaller vessels outnumber the larger ones, the latter represent by far the greatest share of catch and capacity (Chart IV.2).

Chart IV.1
Fishing fleet by size category, 2002-10

(Gross tonnes)

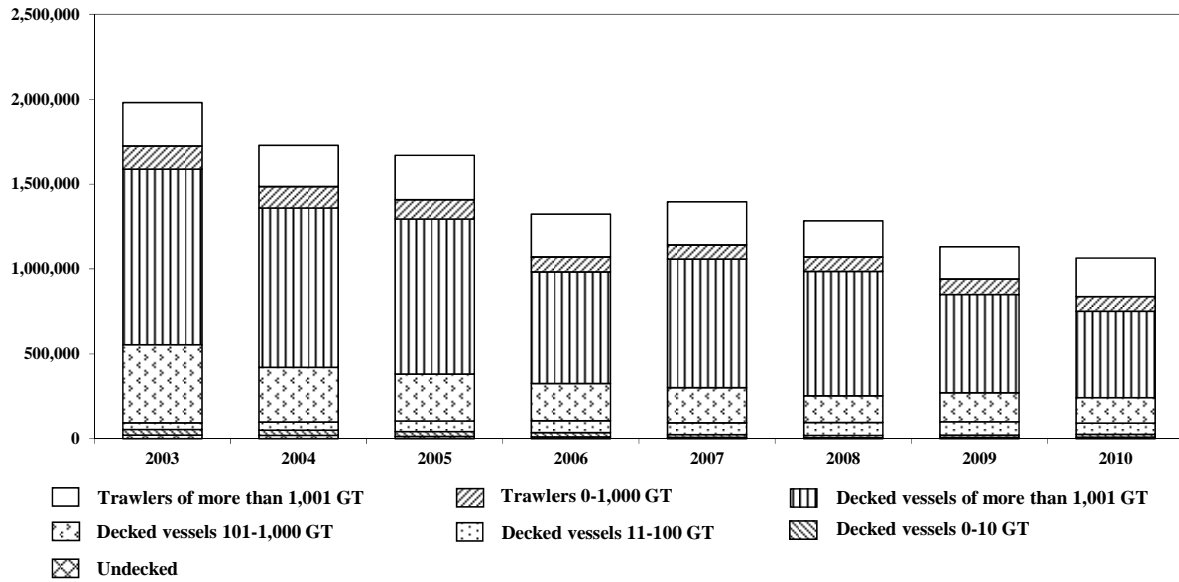


Source: Statistics Iceland online database. Viewed at: <http://www.statice.is/pages/916> [July 2012].

29. Although the total catch volume has been falling for some time, the value of catch has increased considerably since 2005 as unit prices have increased, even after inflation is taken into account (Chart IV.3).

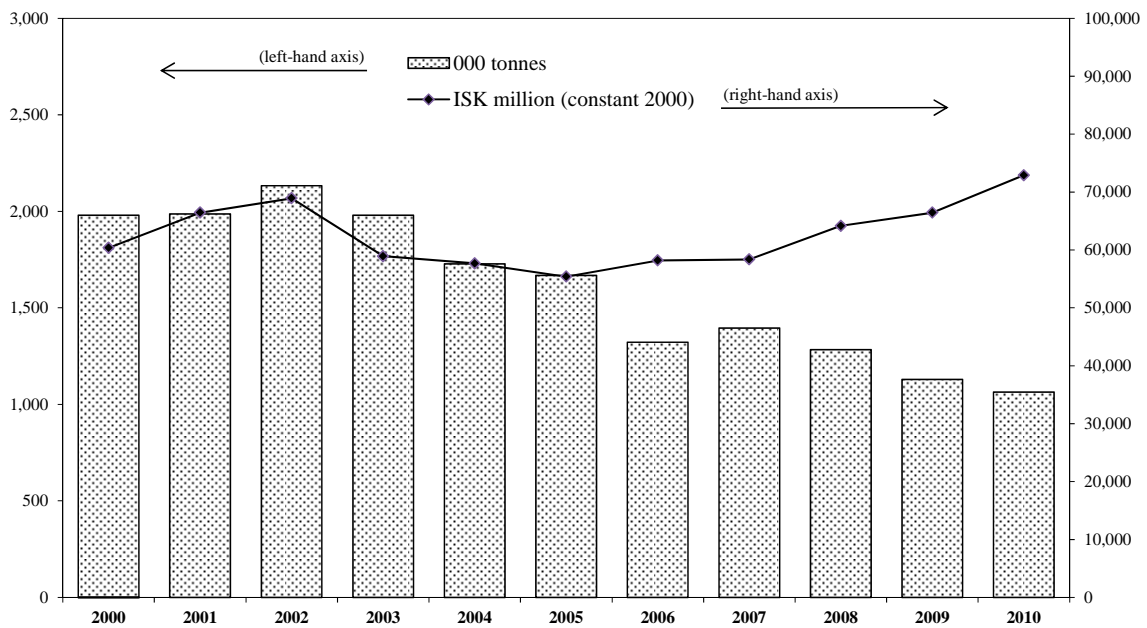
¹⁸ Statistics Iceland online database. Viewed at: <http://www.statice.is/pages/916> [July 2012].

Chart IV.2
Total catch by vessel size category, 2003-10
(Tonnes)



Source: Statistics Iceland online database. Viewed at: <http://www.statice.is/pages/916> [July 2012].

Chart IV.3
Total fisheries catch, 2000-10
(Tonnes and constant 2000 ISK million)



Source: Statistics Iceland online database. Viewed at: <http://www.statice.is/pages/916> [July 2012].

30. In terms of both value and quantity, cod is Iceland's most important catch as it made up over one third of the total catch value in 2010. Other demersal species include haddock, redfish, and saithe. Herring, blue whiting, mackerel and capelin are the most important pelagic species. Catches of different species vary from one year to another depending on stocks. For example, the catch of capelin was over 1 million tonnes in 2002 and 102,000 tonnes in 2009 as a result of declining stocks (Table IV.6). Most of the catch is taken in Iceland's fishing grounds but distant grounds are important for some species, particularly herring and blue whiting.

Table IV.6
Total catch and catch of main fish species, 2002-10
(ISK million and '000 tonnes)

		2002	2003	2004	2005	2006	2007	2008	2009	2010
Total catch	ISK million	68,935	58,931	57,689	55,399	58,189	58,378	64,158	66,444	72,908
	'000 tonnes	2,133	1,980	1,728	1,669	1,323	1,396	1,283	1,130	1,063
Cod	ISK million	25,629	22,820	23,746	20,329	21,078	21,521	20,858	21,320	24,439
	'000 tonnes	213	206	227	212	199	174	151	189	179
Haddock	ISK million	6,363	5,136	6,501	7,244	8,723	10,575	9,786	8,892	8,352
	'000 tonnes	50	60	85	97	97	109	102	82	65
Redfish	ISK million	5,293	4,122	3,156	4,459	4,995	4,226	5,963	5,784	6,587
	'000 tonnes	66	63	48	62	58	55	70	58	56
Saithe	ISK million	2,243	2,180	2,357	2,517	3,579	3,101	4,194	4,514	4,649
	'000 tonnes	42	52	63	68	75	64	70	61	54
Greenland halibut	ISK million	3,448	3,559	3,308	2,476	2,295	1,543	2,671	4,127	3,663
	'000 tonnes	19	20	15	13	12	10	12	16	13
Norwegian spring-spawning herring	ISK million	2,282	1,674	1,855	4,210	3,019	2,602	4,874	5,273	4,375
	'000 tonnes	127	118	103	162	160	176	200	229	188
Blue whiting	ISK million	2,094	3,015	2,393	1,215	2,739	2,198	1,759	1,564	1,790
	'000 tonnes	286	502	422	266	315	235	164	120	87
Herring	ISK million	1,581	1,538	2,007	1,622	1,830	1,544	2,969	2,104	1,600
	'000 tonnes	97	132	122	103	132	144	171	102	67
Capelin	ISK million	7,681	4,272	3,423	4,103	1,666	3,090	1,194	238	1,446
	'000 tonnes	1,079	676	516	595	178	294	138	14	102

Source: Statistics Iceland. Viewed at: <http://www.statice.is/pages/916> [January 2012].

31. Compared with the catch industry, aquaculture is small, with total production of about 5,100 tonnes in 2008. Cod and arctic char are the main species.¹⁹

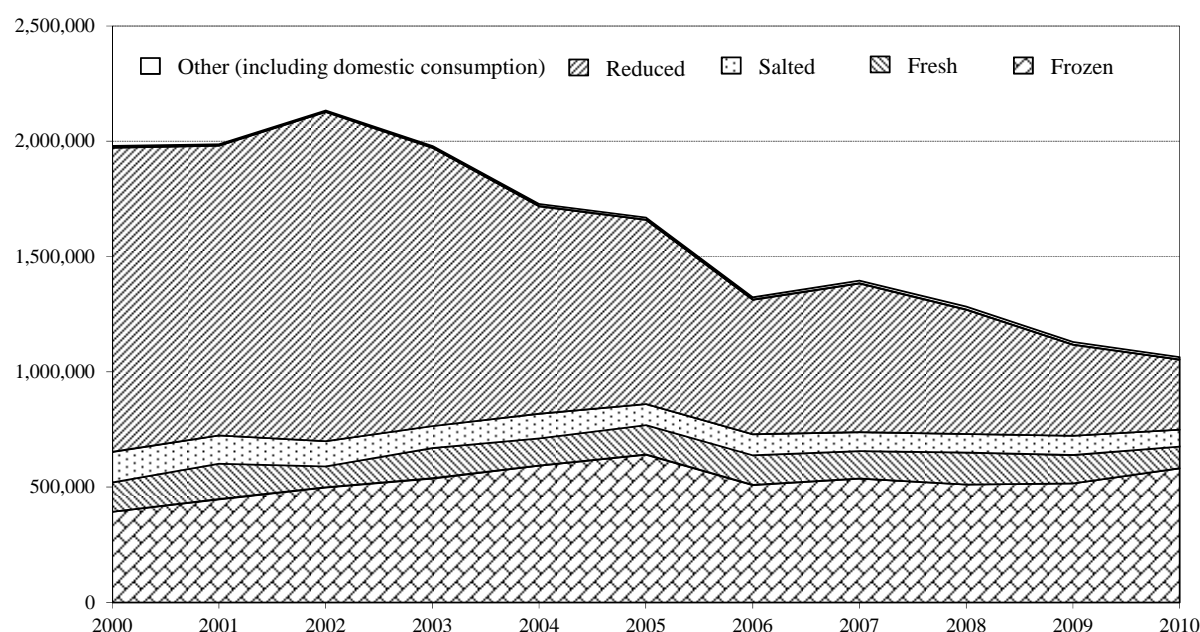
32. Fish processing remains important to Iceland's economy although employment in the sector has declined. An increasing proportion of the catch is being exported fresh or frozen on board and less is being reduced into oil and meal production. In 2000, a major part of the pelagic catch was reduced to oil and fat and less than one fifth was frozen, in 2010 less than one third was reduced and over half was frozen (Chart IV.4).

¹⁹ FAO (2010).

33. Based on UN Comtrade data, Iceland's trade in fish products has fluctuated in recent years: it increased steadily in value to over US\$2 billion in 2007, fell to US\$1.7 billion in 2009, and increased to US\$2.2 billion in 2011.²⁰ Imports of fish and fish products amounted to US\$136 million in 2010, after falling to US\$78 million in 2009. However, under the HS, SITC or BEC product classification systems available from UN Comtrade, data on trade in fish products by species can be misleading, as some categories, such as HS 030420 (fish fillets, frozen) includes fillets from different species. Therefore, data from Statistics Iceland using the national classification system have been used in this section of the review.

Chart IV.4
Fish processing, 2000-10

(Tonnes)



Source: Statistics Iceland online database. Viewed at: <http://www.statice.is/pages916> [July 2012].

34. For many years, Iceland's main fish export has been cod, (Table IV.7) although its importance relative to the total value of fish exports declined from nearly 40% in 2005 to just over 30% in 2011. Over the past few years the exports of mackerel have increased from nothing to over US\$200 million while exports of other species have fluctuated depending on catch (which depends on the Total Allowable Catch (see below) and prices. Although the quantity exported has remained fairly constant, at about 650,000 tonnes since 2005, the value of exports has increased alongside fish prices. Furthermore, the structure of exports has changed with an increasing proportion of frozen fish and fish fillets and a declining portion as meal and oil (Chart IV.4).

35. Iceland's main export markets for fish products are other EEA countries, which take nearly three quarters of total exports of marine products; the United Kingdom and Spain are the main destinations. Outside the EEA, Russia and Japan are the main markets.

²⁰ For the purposes of this Review, fish products are defined as HS headings 020840, 03, 051191, 1504, 1603, 1604, 1605, and 230120.

36. Frozen shrimps accounted for over half of Iceland's imports of fish and fish products in 2011, most of which is imported for processing and re-export. The applied tariff on imports of all fish and fisheries products is zero, except for imports of meat of whales and other cetaceans, which are subject to an applied tariff of 30% plus ISK 363/kg.

Table IV.7
Exports of fish products, 2005-11
(US\$ million and '000 tonnes)

Description		2005	2006	2007	2008	2009	2010	2011
Cod	'000 tonnes	114	109	101	88	109	96	95
	US\$ million	668	688	776	717	611	583	665
Mackerel	'000 tonnes	0	0	0	4	13	54	110
	US\$ million	0	0	0	7	20	68	208
Herring	'000 tonnes	99	133	140	184	209	160	130
	US\$ million	115	141	144	226	208	167	208
Redfish	'000 tonnes	44	45	44	47	45	42	38
	US\$ million	126	144	128	141	129	133	167
Capelin	'000 tonnes	177	104	104	76	18	57	100
	US\$ million	148	91	155	124	24	100	158
Haddock	'000 tonnes	44	42	48	53	42	31	23
	US\$ million	187	192	259	239	164	154	139
Saithe	'000 tonnes	30	33	30	30	30	27	24
	US\$ million	74	94	95	107	98	101	108
Shrimp	'000 tonnes	23	20	16	18	13	15	12
	US\$ million	126	107	100	110	79	91	98
Greenland halibut	'000 tonnes	9	9	8	9	12	10	10
	US\$ million	49	45	39	47	66	58	69
Other demersal	'000 tonnes	14	14	15	13	19	18	24
	US\$ million	38	50	52	48	33	36	56
Catfish	'000 tonnes	7	7	8	8	8	7	6
	US\$ million	25	28	30	45	42	40	43
Lobster	'000 tonnes	1	1	1	1	1	2	2
	US\$ million	20	17	21	24	22	28	27
Other	US\$ million	177	187	198	227	192	214	222
Total	US\$ million	1,754	1,785	1,997	2,064	1,688	1,773	2,169

Source: Statistics Iceland online database. Viewed at: <http://www.statice.is/pages/916> [July 2012].

(ii) Policies

37. The Ministry of Fisheries and Agriculture is responsible for fisheries policies, laws and their implementation. (In September 2012, the Ministry of Fisheries and Agriculture it is to be merged with the Ministry of Industry, Energy and Tourism to form the Ministry of Industries and Innovation (see Chapter II(2)(i)). The main legislation remains the Fisheries Management Act of 1990, which established the legal basis for the annual establishment of a Total Allowable Catch (TAC) for each species and its allocation among holders of vessel quotas. In August 2006, the Fisheries Management Act was consolidated to include all amendments up to that date and re-issued as Act No. 116/2006.²¹

²¹ The Fisheries Management Act No. 116 dated 10 August 2006 (in English). Viewed at: <http://www.fisheries.is/management/fisheries-management/the-fisheries-management-act/> [July 2012].

38. The Directorate of Fisheries, under the Ministry of Fisheries and Agriculture, is responsible for implementing government policy, monitoring fishing activities and collecting data, and imposing penalties for illegal catches. The Fisheries Association of Iceland represents the fisheries and processing industries in policy discussions with the Ministry. In 2007, along with the Ministry, the Marine Research Institute (MRI), and the Directorate of Fisheries, it issued a Statement on Responsible Fisheries in Iceland that emphasized the importance of catch limits based on scientific grounds, the enforcement of these limits, and the importance of research.²²

39. TACs are established by the Ministry of Fisheries and Agriculture based on MRI assessments of the state of fish stocks, which are evaluated by the relevant working groups and advisory committees of the International Council for the Exploration of the Sea (ICES). Under a Government decision, since 2005, the TAC for cod is based on a harvest control rule, with the target harvest equivalent to 25% of the estimated biomass; the rule was revised to 20% with effect from fishing year 2007/08.

40. Some fish stocks are managed by international and/or bilateral agreements, under which Iceland receives a quota allocation:

- the Northeast Atlantic Fisheries Commission (NEAFC) administers stocks in the international area in the Northeast Atlantic, and the catch by Icelandic vessels is limited for blue whiting, Atlantic mackerel, Norwegian spring-spawning herring, and oceanic redfish;
- Icelandic ships are permitted to fish for cod within the EEZs of Norway and Russia in the Barents Sea, subject to a TAC;
- the International Commission for the Conservation of Atlantic Tuna (ICCAT) allocates a fishing quota to Iceland for blue fin tuna for the East Atlantic and Mediterranean; and
- the Northwest Atlantic Fisheries Organization (NAFO) administers stocks in the international area of the Northwest Atlantic, and the catch by Icelandic vessels is limited for northern shrimp.²³

41. The TAC for each species that is subject to quota limits (both the TACs set by the Ministry of Agriculture and Fisheries for fisheries within Iceland's EEZ, and those represented by quota allocations under the international and/or bilateral agreements) is divided among fishing vessels, each of which receives an individual transferrable quota (ITQ) based on its historical share of the catch. ITQs are "fairly freely transferable" but upper limits are set for quota shares for the major fishable stocks that can be held by any single company or group of companies linked by common ownership. Conversely, a vessel will lose its ITQ if it catches less than 50% of its total quota for two consecutive years. A separate quota system is applied to boats of less than 15 gross tonnes.

42. In addition to the TAC and ITQ system, the Ministry of Fisheries and Agriculture, the MRI, and the Directorate of Fisheries operate a number of supporting measures including: permanent closure of nursery areas; closure of spawning areas for cod during the spawning period; temporary closure of areas with excess juveniles; a 12-mile exclusion limit for large trawlers; and mesh-size limits and other equipment-related measures to reduce by-catch and catch of juveniles.

²² Ministry of Fisheries and Agriculture (2007).

²³ For the total allowable catches for all stocks subject to such limits (in English), see Ministry of Fisheries and Agriculture online information (in English). Viewed at: <http://www.fisheries.is/management/total-allowable-catch/> [July 2012].

43. Fishing companies have to pay a fishing fee based on the total value of catch landed in each year less allowances for salaries (fixed at 39.8% of the value of the catch), oil, and other running costs (index linked to the average cost in 2000). The fee was 6% in 2004 and gradually increased to 9.5% in 2009.²⁴

44. Foreign ownership of fishing operations and primary fish processing (defined as salting, freezing, drying, and other processing to protect from decay, and the production of fish-oil or fish meal) is limited to no more than 25% direct and 49% combined direct and indirect ownership. In certain circumstances, direct foreign ownership of up to 33% may be permitted.²⁵

45. Government support to the fisheries sector includes: the Fisheries Project Fund created in 2003²⁶ (this includes the assets of the Fisheries Development Fund, disbanded in October 2005); the Research Fund to Increase the Value of Sea Produce; grants to enhance scientific knowledge in marine aquaculture²⁷; and state aid to domestic fish-processing companies to support vocational training in the fishing industry. According to one report, "Icelandic subsidies have been substantially lower than those of the other countries" and "[t]he Icelandic fisheries, although encouraged by Government policy, have largely had to stand financially on their own."²⁸

46. Another report put the total value of government financial transfers to marine capture fisheries in Iceland at US\$47 million in 2007, of which US\$13 million was classed as cost-reducing transfers and the rest was for general services (research and management/enforcement less fees). The total value of government transfers in 2008 was the equivalent of 4% of the total landed value, compared with 20% of the total landed value for the OECD as a whole US\$23,199 million.²⁹

(3) ENERGY

47. Iceland is unique in terms of its geography and its natural terrain, which, in-turn, gives it an unusual energy profile. Approximately 85.4% of the primary energy supply comes from renewable sources (hydropower and geothermal), while the remainder comprises imported fossil fuels (refined oil) (Chart IV.5). The fossil fuels are used almost entirely for transport and fisheries.

48. Three quarters of the electricity generated is used for the aluminium industry; other industries use a further 10%, while residential consumption is only 5%. Hydro-power is responsible for 74% of electricity generation and the remainder is produced from geothermal sources. Direct geothermal energy is also responsible for most of the space heating in Iceland.

49. The electricity sector is dominated by companies owned by the State or by local governments. The National Power Company (*Landsvirkjun*), which is owned by the State of Iceland, accounted for about 76% of the electricity generated in 2011. The National Power Company is also the main stakeholder in IceGrid (Landsnet), which operates the transmission grid and is responsible for the delivery of electricity to the entire country through various state and regional distributors.

²⁴ FAO (2010); and Ministry of Fisheries and Agriculture online information. Viewed at: <http://www.fisheries.is/management> [July 2012].

²⁵ Central Bank of Iceland (2010), Box 3.1.

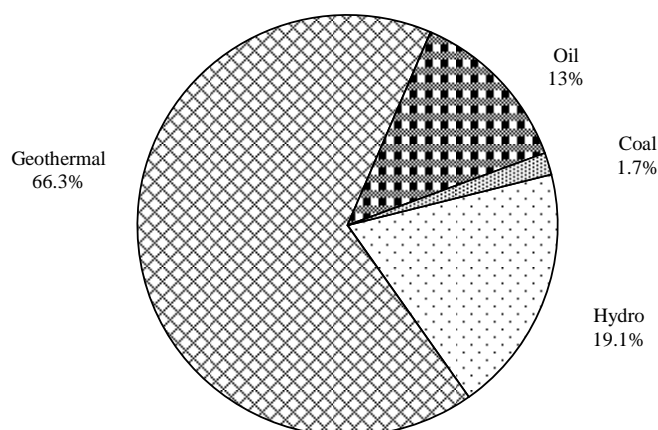
²⁶ Act No. 146/2003.

²⁷ WTO document G/SCM/N/123/ISL, 16 November 2005.

²⁸ Schrank (2003).

²⁹ OECD (2012b).

Chart IV.5
Primary energy sources



Source: Iceland National Energy Authority online information. Viewed at: <http://www.nea.is>.

50. Iceland's energy market is open, and foreign companies already operate in the market. Iceland has implemented the first and second electricity directives of the EU³⁰, and the generation and distribution segments of the market are open to competition from companies in the EEA.³¹ Under the provisions of Electricity Act No. 65/2003, third-party access was allowed for transmission and distribution networks. Power companies determine the price of electricity that they sell, while transmission and distribution fees are set by the industry regulator (National Energy Authority).³² Iceland also operates a policy of equalization of energy prices. Under this policy, homes that are heated by oil and electricity (where no other means of heating are available) are subsidized by the State. These subsidies amounted to ISK 1.1 billion in 2010.

51. The legislation covering the energy sector in Iceland is set out in Act No. 57/1998 on Survey and Utilization of Ground Resources, and Act No. 65/2003 on Electricity. Both Acts are administered by the National Energy Authority. Under these laws, investment and/or ownership of energy exploitation rights and the production and distribution of energy are limited to EEA and EFTA residents. Act No. 57/1998 stipulates that resources within the ground belong to the owner of the land. However, a licence from the National Energy Authority is required to survey or prospect on the land³³; additionally a compensation agreement with the landowner is required.

52. As per the provisions of the Electricity Act, licences for the construction and operation of electric power plants are granted by the Minister of Industry, Energy and Tourism (from September 2012, the Ministry of Industries and Innovation). The Act also stipulates that only one

³⁰ Information provided by the authorities.

³¹ One of the three largest electricity producers is majority owned by Magma Energy of Sweden (information provided by the authorities).

³² Electricity prices in Iceland have declined in real terms since 2007 and are significantly lower than those in other Scandinavian countries.

³³ As of August 2008, the National Energy Authority may grant licences on behalf of the Minister of Industry, Energy and Tourism.

company may provide electricity transmission services in the country (IceGrid) and this company also has the exclusive right to construct new transmission infrastructure. However, the National Energy Authority sets an upper limit on IceGrid's income, and IceGrid's profits are bound by an upper limit under the Act. These measures indirectly control the tariff that IceGrid may charge.

53. Under the provisions of the Electricity Act, transmission and distribution need to be separated from production and sales. Furthermore, the Act allows consumers to choose their supplier.

54. The authorities stated that, as part of its accession process to the EU, Iceland had accepted the *acquis* regarding energy and did not expect any difficulties in implementing it by accession. Furthermore, the authorities are in the process of preparing a comprehensive energy strategy for 2020 that is to be released in 2012. The salient features of the strategy are:

- replacing fossil fuels with renewable energy;
- following an environmentally protective and precautionary approach in hydroelectric and geothermal energy production;
- to support diversified industry with an emphasis on ecologically beneficial high-tech industry;
- sustainable utilization of all energy sources; and
- encouraging better energy utilization.

(4) SERVICES

(i) Financial sector

(a) Banking

Crisis and restructuring

55. Iceland was one of the countries worst affected by the 2008 financial crisis; nearly the entire banking system collapsed. The Government had to intervene through emergency measures, which included, *inter alia*, capital controls and the establishment of three new commercial banks by the State, which took over the domestic operations of the three largest commercial banks, to prevent a complete meltdown of the system.

56. Following its liberalization in 2003, the banking sector in Iceland, which comprises commercial banks and savings banks, pursued an aggressive growth strategy; consequently, it grew exponentially, with assets rising from less than twice the level of GDP to a peak of nearly 11 times GDP in 2008.³⁴ The growth was initially funded not through deposit mobilization but much higher risk borrowing in international capital markets. These funds were used by the banks to make loans to, *inter alia*: the banks owners and related parties, who in turn invested in foreign firms and overseas real estate.³⁵

57. Credit rating agencies assigned high ratings to the largest commercial banks in Iceland, enabling the banks to access global bond markets. The banks relied to a large extent on short-term

³⁴ OECD (2011); and Ministry of Economic Affairs (2012).

³⁵ OECD (2011).

market funding, which created a significant refinancing need for the banks. While global interest rates were low and international asset prices were rising, this was a profitable strategy and banks' returns on assets rose from 1.3% in 2003 to 2.6% in 2008.³⁶ In 2008, nearly 60% of the banks' lending was to non-residents and 66% of deposits were denominated in a foreign currency.³⁷ Furthermore, the aggressive pursuit of growth also raised questions about loan quality, as these were perceived to be made to the banks' owners and related parties, through holding companies. Indeed, in 2008, loans to holding companies accounted for approximately one third of banks' loans to Icelandic firms.

58. Rising interest rates in some countries and falling asset prices, along with an increase in non-performing loans changed the risk perception of the lenders to Iceland's banks. As a result credit default swap (CDS)³⁸ rates on Icelandic banks' debt increased many fold, which for all practical purposes meant that Icelandic banks were shut out of international bond markets.³⁹ In order to meet their refinancing needs, the banks started to mobilize deposits, particularly in overseas markets, through online accounts by offering relatively high returns (over 6%, which were among the highest offered by online banks).

59. However, the inflow of retail deposits was not enough to cover the outflows and the banks had to borrow from the Central Bank of Iceland and the European Central Bank, using claims on other Icelandic banks and fisheries companies as collateral.

60. The collapse of Lehman Brothers in the United States compounded the already acute liquidity position of Icelandic banks, with interbank markets ceasing to function. As a consequence Glitnir (an Icelandic Bank), which was to finance the repayment of a maturing bond through the sale of a subsidiary, was facing default. This had a ripple effect: the value of Glitnir shares plummeted, exposing Landsbanki (Icelandic Bank) to large losses and failure as it had accepted large amounts of Glitnir shares as collateral for loans extended to the owners of Glitnir Bank. Credit rating agencies downgraded both Icelandic banks and the Republic of Iceland, resulting in increased margin calls and a run on the banks by depositors. Furthermore, due to the large size of the banking system relative to the economy of Iceland, the authorities were unable to issue blanket or even higher deposit guarantees.

61. To prevent a complete collapse of the banking system, the Parliament of Iceland passed an "Emergency Act" on 6 October 2008 (Act No. 125/2008) under which:

- the Minister of Finance on behalf of the Treasury may provide capital to an existing financial institution and/or takeover completely or partly an existing financial institution;
- the Minister of Finance on behalf of the Treasury is also authorized to inject capital into a savings bank. Such a capital injection should not exceed 20% of the savings bank's own funds. The implication being that the Treasury is allowed by law to strengthen the capital ratio of savings banks;

³⁶ IMF *Country Reports*, 12/89, 12/90, 12/91, 08/367, 08/368 and 09/306. Viewed at: <http://www.imf.org/external/country/ISL>.

³⁷ Central Bank of Iceland (2009).

³⁸ A credit default swap (CDS) is a financial swap agreement whereby the seller of the CDS will compensate the buyer in the event of a loan default. The buyer of the CDS makes a series of payments (the CDS "fee" or "spread") to the seller and, in exchange, receives a payoff if the loan defaults. Credit default swap pricing is used as a gauge of the riskiness of corporate and sovereign borrowers.

³⁹ For example CDS rates rose by over 800 basis points in 2008.

- the Financial Supervisory Authority (FME) may call a meeting of the shareholders or guarantee capital owners. The FME is to preside over such meetings and has the right to take the floor and present proposals, which may include limiting the decision-making powers of the board of directors, dismissing the board of directors, taking over the assets, rights, and obligations of the financial entity, and selling or merging the financial entity. Where the FME dismisses the board of directors, the FME may appoint a five-member board, which would enjoy the same powers as the previous board;
- the FME may restrict or prohibit the sale of a financial entity's capital and assets. In such circumstances, the FME is permitted to take custody of the assets, and have them evaluated and sold as necessary for the payment of accrued claims. The FME is also authorized to nullify asset sales that took place up to one month before special action was taken; and
- depositor protection is enhanced. Previously deposits in financial undertakings had the same priority as other unsecured claims for repayment purposes during bankruptcy proceedings. Deposits now enjoy a higher priority as they are part of an eight item list of claims that are to take priority during bankruptcy proceedings.

62. The Government also announced a guarantee of domestic deposits to forestall a run on banks and to ensure that the intermediation function of the banking system continued. The guarantee was not a part of the legislation but only an announcement from relevant ministers.

63. Under the powers conferred on it by the Emergency Act, the FME took over the operations of three commercial banks (Landsbanki, Glitnir, and Kaupthing), which were placed in a moratorium under the control of the Resolutions Committee. The domestic assets of these banks were discounted by 60% and transferred to the new banks that had been created by the Government (Table IV.8). Creditors of the taken-over banks were to be compensated up to the value of assets in excess of liabilities transferred to the new banks.

Table IV.8
New banks

	Total equity	State equity	State holding	Subordinated loans from the State	Total state financing
	ISK/billion		% of total equity	ISK/billion	
Landsbankinn	72	9	13	24	33
Arion	65	3	5	25	28
Islandsbanki	150	122	81	0	122

Source: OECD Economic Surveys Iceland, June 2011.

64. The new banks were capitalized in 2009, after agreements were reached with the creditors of the old banks regarding compensation for the net assets that had been transferred to the new banks. The creditors of Glitnir and Kaupthing accepted majority stakes in the newly formed Arionbanki and Islandsbanki respectively, while the creditors of Landbanki accepted a minority equity stake in the new bank (Landsbankinn) and a ten-year bond worth ISK 260 billion issued by the new bank.⁴⁰ Additionally, the Government injected capital into Landsbankinn so as to capitalize the bank to required levels, by virtue of which the Government acquired a majority stake in the bank (Table IV.8). The capital adequacy ratio was also revised significantly upward to 16% by the FME. Currently all

⁴⁰ The value of the bond could rise by ISK 90 billion if a review of the value of assets transferred reveals that they are worth more than their transfer value.

restructured banks are above this ratio (Table IV.9). The much larger foreign operations of these banks went into receivership. The Government of Iceland agreed a reimbursement package with the United Kingdom and the Netherlands, whereby Iceland would repay 4% and 2% of GDP between 2017-23 to resolve the dispute with the UK and Dutch creditors respectively. However, this arrangement and a later one were rejected in two referenda.

Table IV.9
Financial sector, 2009-11

	Total assets						
	2009		2010		2011		2011 CAR
	ISK/billion	% of GDP	ISK/billion	% of GDP	ISK/billion	% of GDP	%
Commercial banks	2592	173	2804	182	2677	162	24
Landsbankinn	1061	71	1081	70	1124	68	24
Arion	757	51	813	53	823	50	22
Islandsbanki	717	48	683	44	679	41	28
MP bank	57	4	62	4	51	3	21
Savings banks	143	10	135	9	59	4	13
Non-banks	308	21	270	18	231	14	29
Housing Finance Fund	795	53	836	54	859	52	2

Source: IMF, Country Report 12/89.

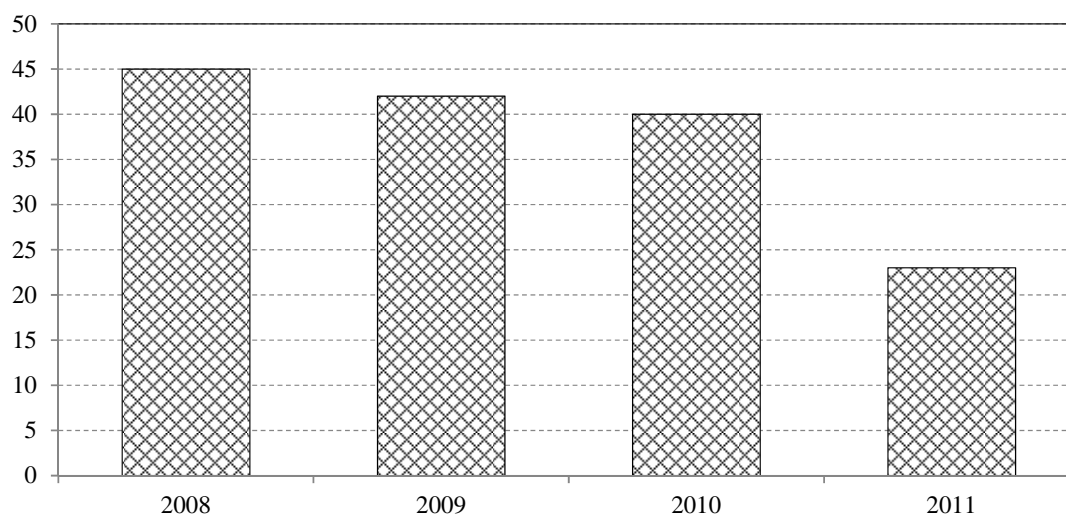
65. The savings banks were also severely affected by the crisis. In April 2009, the authorities took control of five savings banks and negotiated the restructuring of the others, resulting in the Government having a majority stake in six savings banks. As of June 2011, all savings banks had been restructured and met the required capital adequacy ratio. As a result of the restructuring, the number of savings banks operating in Iceland has been halved to ten.

66. The Government also needed to inject funds to recapitalize the Housing Finance Fund, which has a 50% share approximately of the housing mortgage market in Iceland. However, the restructuring of HFF has still not been completed.

67. The continued functioning of the banking system also required the restructuring of private sector debt. In the run-up to the crisis, private-sector debt had reached over 450% of GDP (in 2008) and, as the crisis took hold, non-performing loans peaked at 45% of total loans. The restructuring process has encompassed, voluntary out-of court settlements, increasing the coverage of debt distressed individuals, reducing the conflict of interest between creditors, and reducing asymmetry of information between debtors and creditors. Furthermore, in December 2010, the authorities agreed a comprehensive set of measures with lenders as well as a restructuring offer to SMEs by mid-2011. As a result, loans equivalent to approximately 12% of GDP have been written off for households and 50% of GDP for corporations. Consequently, NPLs have nearly halved to 23% of total loans (Chart IV.6). The Supreme Court ruling in February 2012⁴¹, which deemed foreign currency loans illegal, is likely to cause delays in the restructuring process.

⁴¹ Islandsbanki online information. Viewed at <http://www.islandsbanki.is/english/about-islandsbanki/news/news-item/2012/02/15/Supreme-Court-ruling/>.

Chart IV.6
Non-performing loans, 2008-11
(% of book value)



Source: IMF, Country Report 12/89 and OECD (2011), *Economic Survey*, June.

68. As a result of the restructuring, the number of banks (commercial and savings) declined from 22 in 2008 to 14 in 2012, while the total assets of these banks declined from 1,000% of GDP to approximately 165% of GDP. On the other hand bank profitability and capital adequacy have improved significantly. Return on assets rose from -0.3% in 2009 to 3% in 2011, while capital adequacy ratios nearly doubled, to 24%.⁴²

69. The authorities took other measures to contain the impact of the crisis on the Icelandic economy. In the immediate aftermath of the crisis, questions about the banks' credit quality, appropriate exchange-rate level, and the oversupply of ISK in the market led to cessation of any activity on the foreign exchange market, which in turn impeded economic activity and international trade. To get economic activity going again, the Central Bank issued foreign exchange regulations on 10 October 2008, which stipulated that foreign exchange could only be used to finance priority imports and not fund capital outflows. On 15 October 2008, a temporary system of daily foreign-exchange auctions was set up, whereby the exchange rate was determined by market conditions. In November 2008, an amendment to the foreign exchange law was enacted, under which movement of capital to and from Iceland without a licence from the Central Bank was banned, and Icelandic residents had to deposit any new foreign currency they received with an Icelandic bank. The domestic interbank foreign exchange market reopened in December 2008, since then the ISK has stabilized. However, capital controls remain in place.

70. The authorities also negotiated a standby agreement with the IMF, which enabled Iceland to receive emergency funds to deal with the crisis, as well as access to funds from other sources (countries and institutions). However, the terms of the agreement required Iceland to implement and achieve many quantitative criteria.

⁴² IMF, Country Report 12/89.

Cost of restructuring

71. The steps taken by the authorities to deal with the crises left shareholders and unsecured creditors to absorb losses associated with the failed banks. For the three failed commercial banks, losses amounted to approximately €1 billion, of which the creditors are expected to recoup about €10 billion.⁴³

72. In order to recapitalize the new banks, the Government injected funds equivalent to 22% of GDP, and in return gained assets and equity stakes resulting in a net outlay of 3.8% of GDP by the Government. The cost of recapitalizing HFF was an additional 2.1% of GDP.

73. Defaults on Central Bank loans to the failed banks, which were collateralized by claims on other Icelandic banks (which also failed) resulted in losses equivalent to 13% of GDP. Furthermore, Central Bank loan guarantees amounting to approximately 1.5% of GDP were also called in. Thus the total direct fiscal costs of the crisis amounted to about 20% of GDP.

74. As part of the conditions of the IMF programme, the regulatory framework and supervisory practices in Iceland were to be assessed and recommendations made.⁴⁴ The recommendations included: strengthening the discretionary powers of the FME; establishing a national credit agency at the FME; making provisions on large exposures, connected lending, and related-party loans more stringent; toughening the fit-and-proper requirements for owners; and improving the cooperation between the FME and external auditors.⁴⁵ These recommendations were adopted as a part of the amendment to the Act on Financial Undertakings approved in June 2010. Additionally, a bill that would have revised the deposit insurance legislation in line with the European legislation went to parliament. However, this bill has since been revised and a new Act promulgated. The Act amends the scheme to react to changes in the European scheme. Financial institutions will pay into the fund in accordance with amounts deposited (general fee) and a risk indicator fee. As noted in the *travaux préparatoires*⁴⁶, the EU has not yet decided upon a final scheme regarding its deposit guarantee. Thus, according to the authorities, it is not the right time for Iceland to introduce its own comprehensive scheme, although it is important to have cohesion.

(ii) Telecommunications

(a) Structure

75. The share of the information and communications sector in GDP declined from 5.5% in 2005 to 4% in 2010, while total revenue increased from ISK 29 billion to ISK 43 billion. Annual investment in the sector declined from over ISK 8 billion in 2008 to a little more than ISK 5 billion in 2010. The decline can be attributed to the overall decline in the economy brought about by the collapse of the financial system. On the other hand, total telecommunication subscriptions continued to rise during the review period, due entirely to growth of mobile subscriptions (Chart IV.7). The telecommunications penetration rate rose from about 144% in 2006 to 163% in 2010.

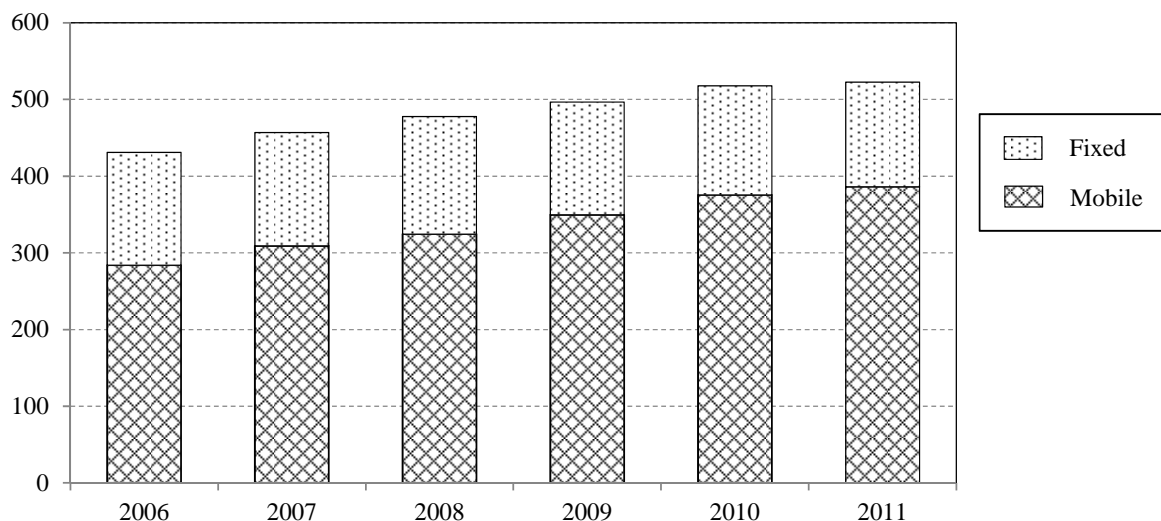
⁴³ OECD (2011).

⁴⁴ The retired Director General of the Finnish Financial Supervisory Authority Kaarlo Jannari was engaged to carry out the assessment.

⁴⁵ Jannari (2009).

⁴⁶ Information provided by the authorities.

Chart IV.7
Telephone subscriptions, 2006-11
(‘000)



Source: Iceland Post and Telecom Administration online information. Viewed at: <http://www.pfs.is>.

Fixed-line telephony

76. The fixed-line segment has been in decline over the past few years. Total subscribers declined from nearly 147,000 in 2006 to around 142,500 in 2010, while total traffic declined from 860,000 minutes to 618,000 minutes. Fixed-line telephony accounted for over 30% of total revenue in the electronic communications industry in 2010, up from 23% in 2006, on account of internet television subscriptions. Following the consolidation and restructuring during the previous review period, there are currently four service providers in the fixed line segment: Siminn, Vodafone, Tal, and Simafelagid. The latter entered the market in 2010. Despite losing market share, Siminn continues to dominate, with 74% of the market followed by Vodafone, with nearly 17%. Both providers are classified as having "significant market power" in certain service markets and hence may be subject to various obligations, imposed by the Post and Telecom Administration (PTA) with respect to access to infrastructure, interconnection, and carrier selection and pre-selection.

Mobile telephony

77. The mobile communications market grew significantly during the review period: total subscriptions rose from 284,000 in 2006 to over 341,000 in 2010. Traffic also increased markedly from 450,000 minutes to nearly 750,000 minutes. Growth was driven by increased subscriptions and usage by the younger segment of the population. In terms of revenue generated, the mobile industry accounted for over 34% of total revenue in electronic communications in 2010, making it the largest sub-sector. In 2007, Nova started mobile voice call operations, in 2008 Tal and Sko merged, while Alterna commenced operations in 2010. As a result there are five companies operating in the mobile communications sector. Despite losing market share since 2006, Siminn continues to be the main supplier with a 42% share in 2010. Vodafone and Nova were the next largest with a 31% and 22% share of the market, respectively.

Internet

78. In 2010, the internet sector accounted for nearly 17% of total revenue in the electronic communications sector. Between 2006 and 2010, total internet subscribers rose from nearly 88,000 to 109,000. Four companies operate in the market, with Siminn controlling over 50% of the market in 2010; its market share remained more or less constant during the review period. Vodafone, the other major internet service provider, controlled over 30% of the market in 2010.

(b) Regulations

79. The main laws governing Iceland's telecommunications sector are Postal and Telecommunications Administration Act No. 69/2003 and Electronic Communications Act No. 81/2003. The Postal and Telecom Administration (PTA) which is part of the Ministry of the Interior is responsible for administering the Acts and serves as the regulatory authority for the sector.

80. The PTA is responsible for, *inter alia*, implementing the Electronic Communications Act and supervising electronic communications as provided for in the Act; encouraging competition in postal and electronic communications services and preventing unfair business practices; participating in developing the market for electronic communications and information technology; safeguarding public interest; advising the authorities and ministries and ensuring that Iceland fulfils its international obligations as well as making recommendations, if necessary, for amendments to acts and regulations; and participating in cooperation resulting from international obligations.

81. Under the Electronic Communications Act, natural persons and legal entities established within the EEA and within WTO Member states have a general authorization, and therefore do not need a licence, to start operations, unless specific frequencies are involved. All operators are required to register with the PTA. An individual licence is required for all frequencies except open spectrum. In most cases the procedure is simple and frequencies are assigned by the PTA within six weeks of receipt of application.

82. The Act also addresses transparency and non-discrimination; rules on number portability, and on carrier selection and pre-selection; and provisions relating to competition within the sector. The right to interconnection is established in Chapter VII of the Act, and the PTA is expected to "ensure access and interconnection and interoperability of services in a satisfactory and efficient manner" (Article 25) and may, *inter alia*, impose obligations with respect to open and non-discriminatory access and price control.

83. All users are entitled to universal service at the same tariff rate throughout the country under the provisions of the Act. The universal service obligation relates to basic telephony, data (128 Kb connection), and some other services. To ensure this obligation is met, the PTA may place obligations on electronic communications providers and set minimum quality requirements; according to the authorities, minimum quality requirements have been issued by the PTA. The PTA also operates the equalization fund, which provides funding for universal service operations that are either unprofitable or run at a loss.

84. Violations of the provisions of the Electronic Communications Act or the Act on the Post and Telecom Administration must be rectified within a month of their notification by the PTA. If violations are not rectified, the PTA has authority to subject providers to daily fines, and to cancel the right to use numbers or the general authorization to operate. Serious or repeated violations may result in imprisonment. Rulings by the PTA may be referred to the Rulings Committee for electronic

communications and postal affairs, and to the courts. However, according to the authorities there were no significant breaches during the review period.

85. Recent amendments to the Electronic Communications Act have increased communications security and consumer protection; implemented EU regulations on roaming on public mobile telephone networks; and ensured smoother and quicker number portability. The Act was amended in 2007 with regard to the universal service fund (equalization fund), which is financed by a fee levied on the turnover of all electronic communications providers; this fee was increased from 0.12% to 0.65%. The contribution was reduced to 0.1% in 2009 as the universal service provider did not use the available funds.

(iii) Transport

(a) Air transport

86. The air transport sector in Iceland comprises passenger and cargo airlines, airports, and associated services. The sector's contribution to GDP was 6.6% in 2010 up from 5% in 2004.

87. Between 2006-11, total passenger traffic was static, at around 3 million passengers. Passenger composition changed slightly over the period as international passenger traffic grew from 2.1 million passengers to 2.2 million while domestic passenger traffic declined. The decline was due to the financial crisis, which reduced the spending power of the local population, and to improved road infrastructure. Icelandic airlines became a more financially viable choice for international travellers due to the financial crisis.

88. Total cargo and mail also declined from approximately 65 tonnes in 2006 to about 40 tonnes in 2011. Both international and domestic cargo declined as there was a shift from air freight to road and sea cargo transport, due to lower prices and increased efficiency.

89. Currently, there are 16 foreign passenger transport operators in Iceland: 13 have an Icelandic Operation Licence and 7 operate scheduled air services. Four international and nine domestic airports operate scheduled flights in Iceland. All airports (except Reykjavik airport) are owned and operated by Isavia, a wholly government-owned entity under the Ministry of the Interior. In 2011, over 85% of international traffic was through Keflavik airport, while Reykjavik airport accounted for nearly 50% of domestic traffic. Ground handling is done by the airlines, under EU rules.

90. Procedures and fees are the same for domestic and international airline companies. However, the Government subsidizes scheduled air transport to a number of domestic destinations that have not proven economically viable. Contracts are awarded to airlines via an open tender. In 2011, the subsidy was nearly ISK 215 million, up from ISK 137 million in 2006.

91. Act No. 60/1998 on Aviation is the main legislation governing the air transport sector. The Act is administered by the Ministry of the Interior through the Iceland Civil Aviation Authority. According to the authorities, the Act mirrors European legislation, making Iceland compliant with European rules on licensing, access to the airline and ground handling, competition, slot allocation, airport charges, and aviation safety and security. Furthermore, under the provisions of the Act, EEA

operators are allowed to engage in cabotage, while non-EEA operators are only allowed to engage in cabotage if specified in a bilateral agreement.⁴⁷

92. In accordance with European rules, Iceland operates under a "Single European Sky". In addition, Iceland has bilateral aviation agreements with Armenia, Azerbaijan, Bahrain, Barbados, Brazil, Canada, Chile, China, Columbia, Croatia, Denmark, Dominican Republic, Egypt, Finland, Germany, Ghana, Hong Kong, China, India, Indonesia, Jamaica, Jordan, Kuwait, Laos, Lebanon, Luxembourg, Macau, China, Malaysia, Mongolia, Netherlands, Norway, Oman, Paraguay, Qatar, Russian Federation, Rwanda, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Syria, Thailand, Turkey, Turkmenistan, United Kingdom, Viet Nam, and Zambia. Iceland is also party to the EU-USA Open Skies Agreement, which is the only open skies agreement that Iceland has in place.

93. Under the provisions of Act No. 34/1991 on Foreign Investment in Companies, foreign ownership in Icelandic companies involved in airline operations may not exceed 49%. This limitation does not apply to nationals of the EEA, who are treated as Icelandic nationals. Additionally, no entity may be granted an operating licence unless it is effectively controlled by EEA nationals. There are no limitations on foreign participation in auxiliary services.

94. A major change during the review period was the division of the Icelandic Civil Aviation Administration into a new Icelandic Civil Aviation Administration (ICAA) and Isavia. The new ICAA is responsible for regulation and aviation safety, and thus for the issuance of licences for pilots, air traffic controllers, and air mechanics. The ICAA also issues air worthiness certificates, air operator certificates, and certificates for air navigation services and operations of aerodromes. Communications and interaction with international civil aviation organizations is also the responsibility of the ICAA.

95. In addition to handling operations and developments of all airports in Iceland (except Reykjavik Airport), Isavia is responsible for air navigation services in the Icelandic control area.

(b) Maritime transport

96. On account of Iceland's geographical position and dependence on international trade, maritime transport remains very important for the country. Indeed nearly all merchandise trade is conducted by sea. Although 1,216 open boats and 1,050 decked vessels are registered in Iceland, only one tanker and one dry cargo ship are domestically flagged.

97. The volume of goods transported by sea increased from nearly 5 million tonnes in 2003 to around 6 million tonnes in 2010; a third were exports and the rest imports. The growth came about due to new aluminium smelters coming online.

98. Currently, there are about 60 harbours in Iceland; the number decreased during the review period due to mergers between small municipalities and the establishment of port associations. Harbours and coastal protection structures are owned and operated by the municipalities.

99. Fifteen ports have appreciable cargo activities, four of which can handle ships up to 40,000 DWT.⁴⁸ The rest are essentially fishing ports but are able to receive larger merchant vessels for exports of fish-based products. Good natural harbours are available for development in parts of the

⁴⁷ As per the provisions of their bilateral agreements, operators from Greenland, Paraguay, and Chile are allowed to engage in cabotage.

⁴⁸ Iceland Export Directory online information. Viewed at: <http://www.icelandexport.is>.

country earmarked for industrial development. Associated Icelandic Ports, formed in 2004 through the merger of Reykjavík and adjacent ports (Akranes and Grundartangi), serve as the principal import and export points, and accounted for 47% of total cargo in Iceland in 2010.

100. The main legislation governing the maritime sector is the Icelandic Maritime Administration Act of 1996, administered by the Iceland Maritime Administration (IMA), under the Ministry of the Interior. Under the provisions of the Act, all Icelandic flagged vessels greater than six metres in length must be registered with the IMA, which maintains a ships register. A registration fee is charged based on the ship's tonnage. Other responsibilities of the IMA include: port state control of foreign merchant vessels in Icelandic ports; seamen's certification and crew issues; implementation of the international Convention on Standards of Training, Certification and Watchkeeping for Seafarers (STCW); issuing professional diving and pilots' certificates; and maritime traffic services and security. The IMA is also responsible for preparing and publicizing the adoption of new maritime legislation. It publishes marine-safety training materials and promotes training in other ways. Iceland's maritime legislation is fully aligned with EU regulations on freedom to provide services, transfer of cargo and passenger ships between registers, action to safeguard free access to cargoes in ocean trades, and maritime cabotage. With respect to cabotage Iceland is the only WTO Member that has scheduled a binding commitment on cabotage.

101. With respect to harbour administration, the IMA is responsible for coastal protection and harbour projects, research, and planning for the development of coastal protections and harbours. The State is responsible for conducting basic research pertaining to harbour projects as well as provision of financial support for new harbour projects. The IMA develops a revolving four-year harbour development plan and submits it to Parliament for approval. In recent years new development projects have been conducted in 20-30 harbours a year, for an average of ISK 300-500 million annually. Most harbour projects are tendered out. The IMA monitors the technical and financial aspects of state-sponsored projects and reports on them annually to the Ministry and Parliament. The IMA also monitors the construction of coastal protections. The financing of these projects is through the Harbour Development Fund, which is run by the IMA and funded through the state budget and harbour fees.

102. In January 2011, Iceland introduced a new port state control system in accordance with the EU directive on port state control. Under the new system, called the New Inspection Regime (NIR), random checks have been abolished, and inspections will be targeted according to a Ship Risk Profile so that "risky" ships are inspected frequently, while "good" ships are inspected less frequently. A ship's risk profile is determined according to, *inter alia*, age, flag, type, and company.

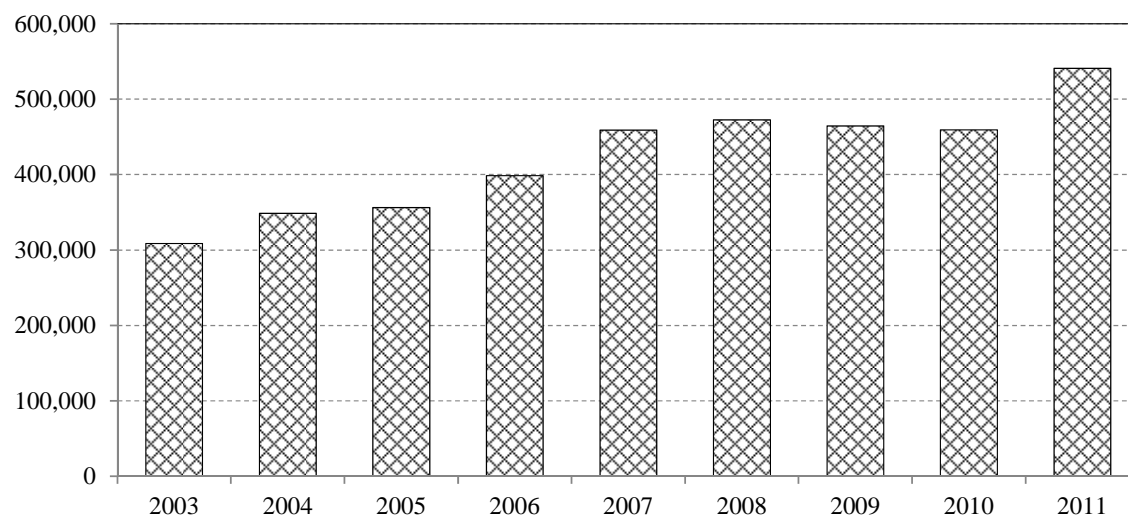
103. Iceland has ratified and incorporated into its laws and regulations, most of the conventions and instruments adopted by the International Maritime Organisation (IMO), such as: the International Convention for the Safety of Life at Sea (SOLAS); International Convention on Standards of Training, Certification and Watch keeping for Seafarers (STCW); International Convention on Standards of Training, Certification and Watch keeping for Fishing Vessel Personnel (STCW-F); Load Lines; the International Convention for the Prevention of Pollution from ships (MARPOL); Convention on the International Regulations for Preventing Collisions at Sea (COLREG); International Convention on Maritime Search and Rescue (SAR); and Convention for the Suppression of Unlawful Acts against the Safety of Maritime Navigation (SUA).

(5) TOURISM

104. The share of tourism in Iceland's GDP was 5.6% in 2009 and the sector employed 5.2% of the workforce. Furthermore, between 2005-10 the sector accounted for nearly 17% of Iceland's export receipts.

105. However, due to the nature of the industry, which is cyclical and income elastic, growth was variable during the review period. Tourist arrivals, which had tapered off after 2008, increased significantly in 2011 to over 565,000 visitors (growth of over 16% over 2010) (Chart IV.8). The recent growth can be attributed to a number of factors: Iceland is a more affordable destination due to the exchange rate depreciation; better and more frequent flight connections; and increased marketing (including inadvertently, through the eruption of Eyjafjallajökull in 2010 and Grímsvötn in 2011).

Chart IV.8
Passenger traffic through Keflavik airport, 2003-11
(Number)



Source: Information provided by the authorities.

106. Under the Government's new growth plan, the authorities have identified tourism as a focus sector. In this regard, a new public strategy for tourism in Iceland was approved by parliament in 2011. Salient features of the new strategy are to:

- maintain Iceland's unique nature with focused and strong emphasis on strengthening destinations;
- improve the quality, professionalism, and environmental consciousness of the tourism industry;
- promote increased profitability, and respect for the industry; and
- extend the tourist season, decrease seasonal fluctuation, and promote a better distribution of tourists around the country.

107. With regard to the latter; over 50% of tourists visiting Iceland do so in the summer. To avoid seasonal fluctuations the authorities are trying to promote Iceland as a year round destination by marketing unique natural phenomena such as northern lights and winter festivals.

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