

EUROPEAN PARLIAMENT



Directorate-General External Policies

Policy Department

**INFORMATION NOTE
ON
THE POLITICAL AND ECONOMIC SITUATION OF
ICELAND
AND EU - ICELAND RELATIONS**

Abstract:

This note provides a background to the current political and economic situation in Iceland. Thereafter follows a review of historic agreements and recent developments influencing EU-Iceland relations. This survey includes a particular focus upon the question of potential Icelandic membership in the EU.

This note was requested by the European Parliament's Delegation for relations with Switzerland, Iceland and Norway, and is published in English.

Author: Jennifer ALLEN, under the authority of Stefan SCHULZ

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Copies can be obtained through:

E-mail: sschulz@europarl.eu.int

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For further information, please contact:

Jennifer Allen
DG External Policies, Policy Department

Tel: 02/283.10.25
Email: jallen@europarl.eu.int

COUNTRY PROFILE

Population: 296,737 (2005 est.)

Capital: Reykjavik; 113,288 residents (2003)

Ethnic Groups: homogeneous mixture of descendants of Norse and Celts 94%, population of foreign origin 6%.

Religions: Evangelical Lutheran 87.1%, other Protestant 4.1%, Roman Catholic 1.7%, other 7.1%

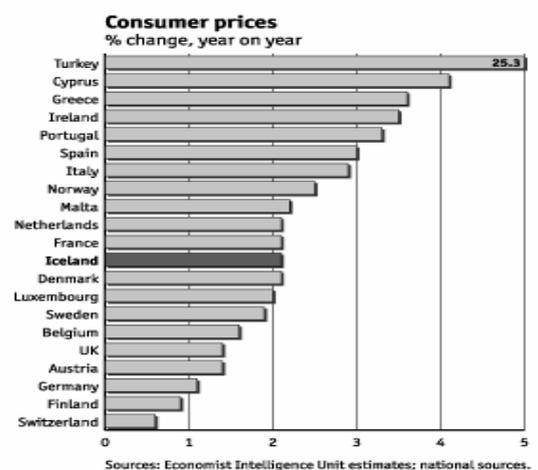
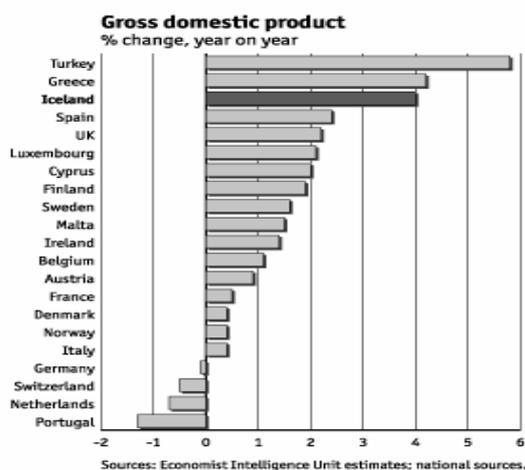
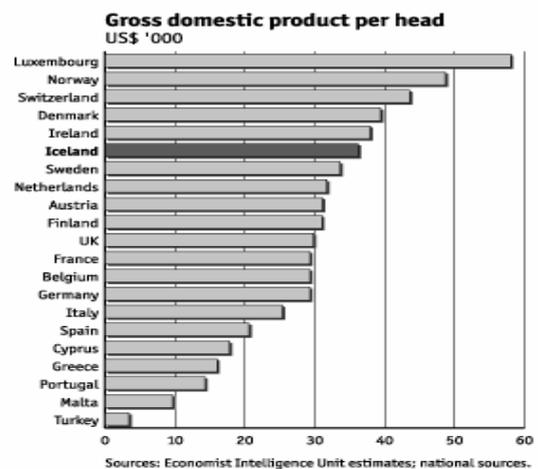
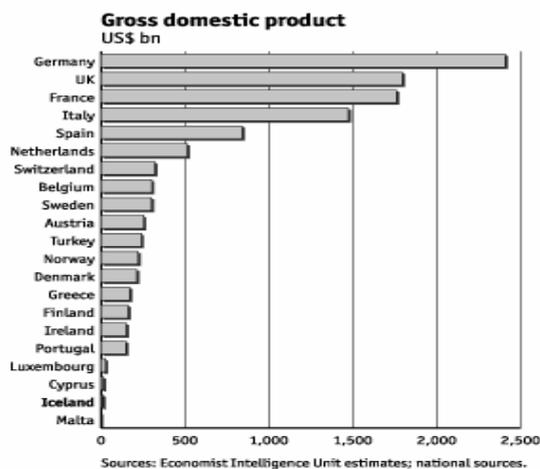
Economic growth, %: 5.2 (2004 est.)

GDP per capita: USD \$41,865 (2004)

Brief background: Iceland was settled by Norwegian and Celtic (Scottish and Irish) immigrants during the late 9th and 10th centuries A.D.. Independent for over 300 years, Iceland was subsequently ruled by Norway and Denmark. Limited home rule from Denmark was granted in 1874 and complete independence attained in 1944. Literacy, longevity, income, and social cohesion are first-rate by world standards.



Comparative economic indicators, 2003



POLITICS

Overview

Form: Constitutional Republic since independence in 1944.

Political party history: Typically been governed by two or more political parties in majority coalition governments.

Current majority coalition: Composed of the Independence Party (IP) and the Progressive Party (PP); centre-right; came to power in 1995. Dominated by the IP and re-elected for a third successive term at the general election on May 10th 2003.

Head of State

President: directly elected for a four-year term. Traditionally, an incumbent president who decides to stand for another term is either re-elected unopposed or without any serious challengers. The current Head of State is Ólafur Ragnar Grímsson, who replaced Vigdís Finnbogadóttir in August 1996. On June 26th 2004 he was elected for a third four-year term with a sizeable majority, receiving 68% of the vote.

The President's role is largely ceremonial and has little influence on day-to-day politics. However, bills passed by Parliament need the President's signature to be enacted. The President can refuse to sign a bill, in which case it would be put to a national referendum. In May 2004 Mr Grímsson refused to sign a controversial law on media ownership — the first time a presidential veto has been used in the republic's history.

Parliament

Chamber: Iceland has the **world's oldest functioning legislative assembly, the Althingi**, which was established in 930 AD. This unicameral assembly consists of 63 members elected for four-year terms.

Constituencies: According to a 2000 electoral law, 6 constituencies are established with 9 fixed seats for each constituency. Two supplementary seats are given to each of the three Reykjavik constituencies, while the North West, North East, and South constituencies are each given one supplementary seat.

Electoral system: Universal direct suffrage with proportional representation, where voters vote for party lists. The allocation of seats is made in two main stages. First, the nine fixed seats in each constituency are allocated independently by proportional representation, using closed party lists. At this stage, 54 of the 63 seats are allocated to lists with the highest allocation quotas. The remaining 9 seats are allocated to parties, according to the d'Hondt method, on the basis of national results. A party must obtain at least 5% of the national vote to be eligible for supplementary seats.

Major political parties: In May 2003, the body's most recent elections, the following political parties gained seats in parliament:

Independence Party (IP)	33.7% - 22 seats;
Social Democratic Alliance (Alliance)	31.0% - 20 seats;
Progressive Party (PP)	17.7% - 12 seats;
Left-Green Movement (LGM)	8.8% - 5 seats;
Liberal Party (Liberals)	7.4% - 4 seats.

Upcoming national elections: The next legislative election is scheduled to take place in May 2007, while the next presidential election is scheduled for June 2008.

Executive

Asgrimsson, viewed as both "safe" and "uninspiring": Mr Halldor Asgrimsson was appointed prime minister in September 2004, succeeding David Oddsson, who stood down to become foreign minister after 13 years in the post. This occurred as part of a deal brokered between the senior and junior IP-PP coalition partners. Mr Asgrimsson is a veteran of the Icelandic political scene, and while seen as a rather uninspiring successor, he was initially regarded as "a safe pair of hands".

High public approval lowered in wake of controversies: Since becoming prime minister Asgrimsson has had to preside over a number of controversial issues, including a long-running teachers' strike and vociferous debate over the government's support of the Iraq war, and his previously high approval ratings have slumped as a result.

Icelandic Government (April 2005):

Prime Minister	Halldor Asgrimsson (PP)
Minister of Agriculture	Gudni Ágústsson (PP)
Minister of Industry and Commerce	Valgerdur Sverrisdóttir (PP)
Minister of Communications and Transport	Sturla Bödvarsson (IP)
Minister of Education, Science and Culture	Thorgerdur Katrin Gunnarsdóttir (IP)
Minister of Environment	Sigrídur Anna Thordardóttir (IP)
Minister of Finance	Geir H. Haarde (IP)
Minister of Foreign Affairs	David Oddsson (IP)
Minister of Fisheries	Árni M. Mathiesen (IP)
Minister of Health and Social Security	Jon Kristjansson (PP)
Minister of Justice and Ecclesiastical Affairs	Bjorn Bjarnason (IP)
Minister of Social Affairs	Arni Magnusson (PP)

Recent political developments

Continued domination of IP over PP expected: The ruling coalition, comprising the centre-right Independence Party (IP) and its junior coalition partner, the centrist Progressive Party (PP), is expected to remain in office over the next several years. Having been a junior partner in government for decades, the PP is likely to continue to cede most policymaking decisions to the IP, which remains the senior coalition partner, holding 22 of the 34 government seats in parliament.

Major figures: Asgrimsson and Oddsson, generally smooth interaction: They are, by some margin, the two most influential figures in Icelandic politics. During their time in government they have shown a remarkable ability to work together. At the same time, Mr Oddsson has long opposed Iceland joining the EU, while the prime minister has generally adopted a more favourable stance. The PP's announcement in February 2005 that it will seek to examine in more detail the possibility of future EU membership negotiations can be expected to lead to heightened debate on this issue.

Potential challengers to current Alliance leadership emerging: The popular former mayor of Reykjavik, Ingibjorg Solrun Gisladdottir, who resigned from her post in order to stand as the prime ministerial candidate for the main opposition Alliance party in the 2003 election, has long been regarded by many in her party as a leader-in-waiting, and at the party's congress on 21 May she challenged the current leader, Ossur Skarphedinsson, and was elected new leader of the Alliance with a comfortable majority. There is a risk that this could lead to tensions emerging within the party, although it may also boost the Alliance's standing in the polls. Steingrimur Sigfusson, head of the Left-Green Movement, is a potential challenger to the Alliance leader as the most prominent figure in the opposition bloc. His party has enjoyed an impressive rise in support in opinion polls over recent years, while his personal approval ratings have consistently been among the highest of any political figure in Iceland.

INTERNATIONAL RELATIONS

Regional affairs

EEA and Nordic Council membership: Iceland's regional status is largely determined by its membership of the European Economic Area (EEA). Furthermore, Iceland has maintained close relations with the Scandinavian countries through the Nordic Council - of which Iceland assumed the presidency at the beginning of 2004.

Traditionally Western focus turning Eastward: On the foreign policy front, Iceland has, as a small nation, traditionally focused on relations with the Western world. However, more recently there has been a determined attempt to open new markets in the east, with both the president and high-ranking ministers making state visits to the Far East and to the former Soviet bloc. Iceland's close relationship with Scandinavian countries is being extended to the Baltic region, as Iceland is due to take over the chair of the Council of Baltic Sea States (CBSS) in mid 2005.

International cooperation

More proactive role in international cooperation sought: Globally, Iceland's foreign policy interests are maintained within the UN system. Iceland's quest for a more proactive international role is illustrated by Iceland's proposed candidacy for a seat on the UN Security Council, and the current deployment of peacekeepers in Afghanistan, Sri Lanka and the western Balkans. Another stated aim of the government is to increase Iceland's contributions to development aid, which amounted to 0.19% of GDP in 2004 (slightly below the OECD average).

Icelandic Crisis Response Unit (ICRU): Over recent years Iceland has sought to make a more proactive contribution to the maintenance of international peace and security, primarily through the roles of civilian peacekeeping and monitoring missions. In 2001 the government founded the ICRU—a team of police officers, nurses, doctors and engineers—who could be deployed to potential trouble spots around the world at short notice. Its most recent mission occurred on June 1st 2004, when a 17-strong team were deployed at Kabul airport in Afghanistan.

Defence policy

National security maintained by external sources: As a remote island with a small population, Iceland has had to look abroad for its security. Without armed forces of its own, Iceland's security has been largely guaranteed by virtue of its membership of NATO and the 1951 bilateral defence agreement with the US, under which that country's navy maintains a base at Keflavik.

Negotiations for reduction of US defense personnel in Iceland: Following the war in Iraq in early 2003, the US put forward proposals to alter its contract with the Icelandic government, possibly to the extent of relocating the naval base to continental Europe. Negotiations continue with little progress. The eventual outcome of these talks could lead to a reappraisal of defence and security policy, although Iceland is unlikely to go so far as to establish its own army.

ECONOMICS

Overview

Essentially prosperous capitalistic economic system: This Scandinavian-type economy contains an extensive welfare system (including generous housing subsidies), low unemployment, and remarkably even distribution of income.

Heavy fishing industry and import dependence: In the absence of other natural resources (except for abundant geothermal power), the economy depends heavily on the fishing industry, which provides 70% of export earnings and employs 8% of the work force. Thus the economy remains sensitive to declining fish stocks as well as to fluctuations in world prices for its main exports. The small economy is dependent upon imports of almost all categories of goods, and prices are sensitive to currency fluctuations.

Government policies include: reducing the budget and current account deficits, limiting foreign borrowing, containing inflation, revising agricultural and fishing policies, diversifying the economy, and privatizing state-owned industries.

Recent developments

Economic growth is expected to continue its rise: The Icelandic economy is estimated to have again expanded strongly in 2004. This followed a vigorous recovery in 2003, and was driven for a second successive year by robust private consumption growth and sustained capital spending in the energy-intensive and aluminium-producing industries. According to the Economist Intelligence Unit (EIU), this pattern of economic growth is expected to be repeated in both 2005 and 2006, as construction activity at the large-scale, foreign-investment-led projects reaches a peak. Overall, GDP growth is forecast to rise from an estimated 5.2% in 2004 to 5.9% in 2005, before slowing to 5% in 2006.

Iceland's trade balance has deteriorated sharply since 2002: This occurred in response to a fall in the value of marine exports and rapid growth of imports of consumer and investment goods. Healthy foreign demand is expected to lead to solid export growth over the next few years, but the import bill is forecast to rise at a significantly faster rate in response to robust domestic demand.

Fiscal policy

General government finances are in reasonable shape, despite repeated expenditure overruns in the past: This contributed to a deterioration of the public finances between 2001 and 2003, when the general government budget deficit amounted to 1.4% of GDP. Higher than anticipated unemployment and disability benefit payments, as well as rising hospital costs, again resulted in strong expenditure growth in 2004, although this was estimated to have been more than offset by a hike in tax revenue as a result of robust economic expansion.

Continuing public finance improvements anticipated: According to official figures, the general government budget balance recorded a small surplus of 0.2% of GDP last year. Given

the experience of recent years, some remain sceptical about the likely success of government efforts to control the growth of current expenditure, but with tax receipts projected to continue to rise sharply (despite the programme of tax cuts), reflecting strong domestic demand growth, further improvement in the public finances may be expected. The general government budget balance is forecast to record a surplus of 0.7% of GDP in 2005, rising to 1% of GDP in 2006.

Monetary policy

Strategy: "Inflation Targeting": The Central Bank of Iceland follows a policy of inflation targeting, based upon the CPI. The Bank possesses independence in setting interest rates, aiming to bring the rate of inflation close to its central target of 2.5%.

Rising inflationary pressures: Against a background of rising inflationary pressures in the economy, in late March the Central Bank warned of a deteriorating inflation outlook in light of continued strong domestic demand growth and soaring house prices. Inflation eased slightly in April 2005 to 4.3%, but this was still above the 4% upper limit of the Central Bank's tolerance band. With inflationary pressures forecast to remain strong over the next few years, the cycle of monetary policy tightening is expected to continue over the coming months.

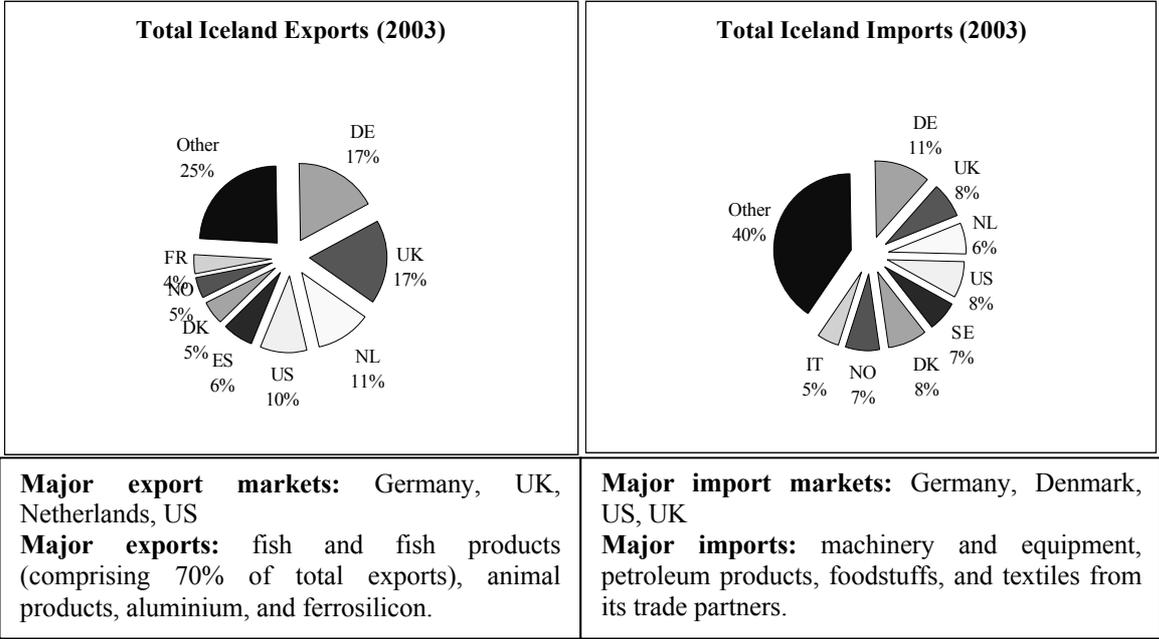
RELATIONS WITH THE EU

Overview

Relations with Iceland, through EEA co-operation as well as bilaterally, are close and generally smooth.

Trade

The EU is by far Iceland's most important trading partner. In 2003, 72.5% of exports went to the EU and 57.5% of imports came therefrom.



Agreements governing Iceland-EU relations

Schengen Acquis:

The original arrangement of 1996 was aimed at combining the free movement of persons within the Schengen countries with the Nordic Passport Union, established in 1957 between Denmark, Finland, Iceland, Norway, and Sweden, but it left Iceland and Norway without voting rights on the Schengen Executive Committee. **The new Cooperation Agreement of March 2001 entirely integrates Iceland** and Norway into the full implementation, application, and development of the Schengen protocol as annexed to the Amsterdam Treaty, with the following key features:

- **Joint Committee established:** The agreement establishes a Joint Committee outside the institutional framework of the EU, composed of representatives of the governments of Iceland and Norway and members of the Council and the Commission.
- **Supplemental arrangements confirmed:** The agreement was supplemented by two other Council decisions, one adopted on 17 May on certain arrangements for the application of the Agreement and the other adopted on 20 May concerning the Joint

Supervisory Authority, set up under Article 115 of the convention applying the Schengen Agreement.

- **Schengen Information System integrated:** The provisions of the Schengen acquis relating to the SIS (the Schengen Information System) came into force on 1 January 2001. Evaluation visits have been carried out in all the Nordic states (Denmark, Finland, Sweden, Iceland, and Norway) in order to check whether the SIS functions were applied correctly.

An accompanying agreement between the EU, Iceland and Norway **established these countries' rights and obligations vis-a-vis Ireland and the United Kingdom** in the areas of the Schengen acquis.

The Dublin Convention:

In 2001, Iceland also **signed on to the Dublin Convention on asylum applications, thereby assuming the obligation to co-finance Eurodac**. The Council authorised the Commission in May 2000 to negotiate an agreement with Norway and Iceland concerning the criteria and mechanisms for establishing the State responsible for examining a request for asylum lodged in a Member State or Iceland or Norway, which basically reproduces the obligations and rights contained in the Dublin Convention and the EURODAC Regulation. The conclusion of this agreement is a precondition for the abolition of border controls between the Schengen countries and the countries of the Nordic Passport Union. The agreement was signed on 28 November 2000. The European Parliament gave its opinion on the draft decision concerning the conclusion of the Agreement on 14 February 2001.

European Police College (CEPOL):

Iceland is an associated member of CEPOL, established by a decision of the Council on 22 December 2000. CEPOL looks to **help train senior police officers**, and to **develop a European approach to the main problems facing Member States** in their fight against crime, crime prevention, and the maintenance of law and order and public security. CEPOL also offers its infrastructure to senior police officers of applicant countries, as well as those of Iceland and Norway. It cooperates with the national police training institutes of these countries, and with relevant training bodies in Europe, such as the Nordic Baltic Police Academy (NBPA).

EU-Iceland Fisheries policy

History of little fishing rights compromise: For the more part, Iceland has been uncompromising in negotiations on mutual fishing rights. As an exception, under the terms of the 1992 Exchange of Letters Agreement with Iceland, which was negotiated in parallel with the EEA Agreement, the Community is given a quota of 3 000 tonnes of redfish to be fished in Icelandic waters in exchange for which the Community gives Iceland a quota of 30 000 tonnes capelin. This agreement was renewed in October of 2003, to begin in 2004 and expire in 2009. The main beneficiary EU member states of this agreement are the UK and Germany.

November 2003 EEA-EU Agreement re-negotiations: Iceland's interests centered upon **continued market access of fish products to Central and East European (CEE) markets** after EU enlargement. Enlargement brought to an end the bilateral free trade treaties between the CEE countries and Iceland, spurring Reykjavik's intense interest in post-enlargement market access. Under the terms negotiated, **Iceland received compensation for its loss of free access**

to CEE markets. This stands in the form of an annual duty-free quota of 950 tonnes of frozen herring, Iceland's main export to the region. The quota came into force in May 2004 and is due to be reviewed after five years.

Additional terms established in the 2003 EEA-EU Agreement re-negotiations

Structural Fund contribution increase: A significant increase in the size of Iceland's contribution to the EU's Structural Funds was negotiated. The three EFTA members of the EEA agreed to provide a total contribution of 600 million euros (equivalent to a fivefold increase) over five years to the EU's Structural Funds, of which Iceland's share will be 50 million euros.

Potential EU membership

The issue has divided Iceland for years: Both the governing coalition and the electorate remain divided over the issue of Iceland's possible future membership of the EU. The former prime minister, Mr Oddsson, had long adopted a decisive stance against joining, citing insurmountable differences over fisheries policy and fears of a potential loss of sovereignty. Iceland's position has been expected to soften to some extent, with the appointment of the more pro-EU Mr Asgrimsson as prime minister, but no significant change of policy with regard to EU membership is generally expected in 2005-06.

Slight pro-EU PP shift: In February, the Progressive Party's annual conference saw a strengthening of the group's pro-European stance. This coincided with the reelection of Mr Asgrimsson as leader of the Progressives at their annual congress, receiving the support of 82% of PP members (down from 92% in 2003).

PP study of EU-feasibility begun: Following a proposal by some PP members that Iceland should commence EU membership negotiations in the next electoral term, which starts in 2007, a formal decision was taken by the party to establish a working group to examine the feasibility of a future application. The group's findings are due to be presented at the PP's next congress in two years' time.

Continuing divide; no plans for negotiations: The prime minister was keen to stress, however, that at present there were "no plans" for Iceland to start EU membership talks, conscious of the fact that the PP's senior partner in government, the IP, is strongly divided over the issue and that the IP leader and minister of foreign affairs, Mr Oddsson, remains resolutely opposed to joining the EU. Nevertheless, the PP appears keen to encourage debate over the issue in Iceland.

Inconsistent public opinion:

More positive toward starting negotiations than joining: Public opinion towards the EU has tended to fluctuate from one poll to the next, although the most recent, conducted in September 2004, indicated that 53% of Icelanders were in favour of joining the EU, while a higher percentage (71%) supported the start of EU membership negotiations.

Concern over loss of fishing resource control: This apparent inconsistency can probably be attributed to concerns in Iceland that the country would lose control over its vital fisheries resource if it had to adopt the Common Fisheries Policy (CFP) of the EU. Should any

future membership negotiations offer the possibility of a suitable compromise being reached over the fisheries issue, it is likely that public opinion in Iceland would shift more in favour of EU membership. Any decision on whether Iceland eventually joins the EU will almost certainly be determined by a referendum.

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