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**DIRECTORATE-GENERAL FOR EXTERNAL POLICIES OF THE UNION
DIRECTORATE B
- 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.

Any opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the official position of the European Parliament.

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Author: Matthew KLEIN,
under the authority of Stefan SCHULZ

Manuscript completed in May 2006.

Copies can be obtained through: E-mail: Cristina.Calvo@europarl.europa.eu

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COUNTRY PROFILE

Population: 299,388(July 2006 est.)

Capital: Reykjavik; 113,022 residents (2004)

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%

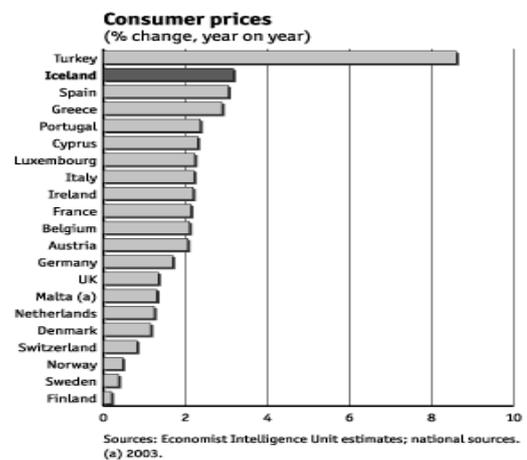
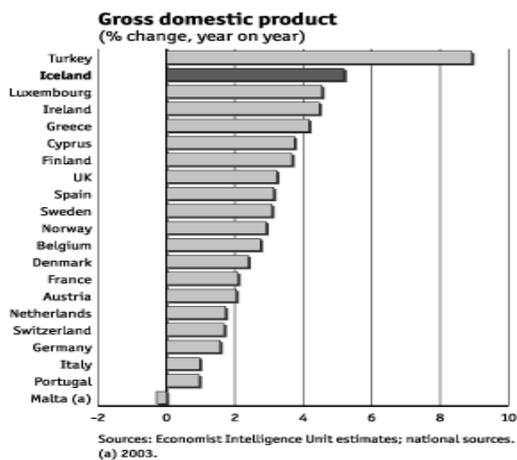
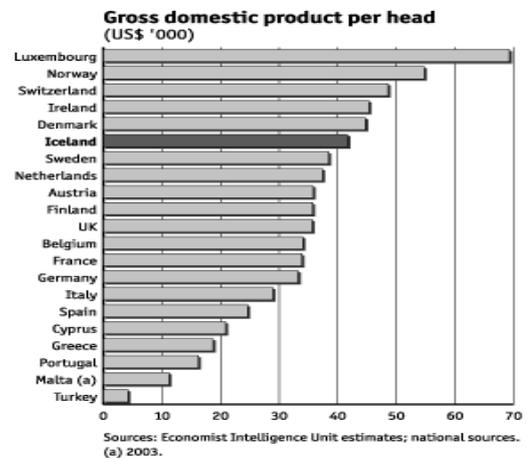
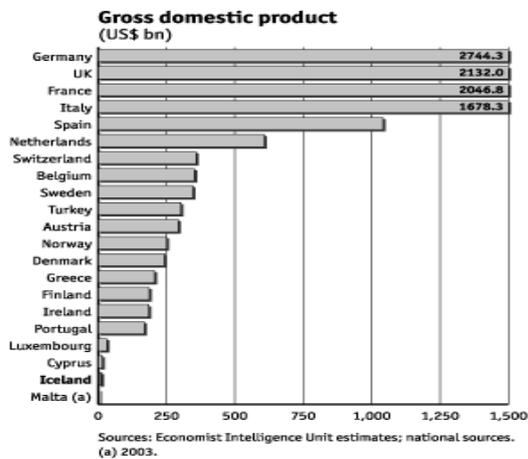
Economic growth, %: 6.5 (2005 est.)

GDP per capita: USD \$34,900 (2005 est.)

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, 2004



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. Amid rumours of dissatisfaction among PP members with the leadership and power struggles emerging within the party, the prime minister's once-high approval ratings have fallen back steadily over the past year.

Icelandic Government (April 2006):

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	Sigridur Anna Thordardottir (IP)
Minister of Finance	Arni M Mathiesen (IP)
Minister of Foreign Affairs	Geir H Haarde (IP)
Minister of Fisheries	Einar Kristinn Gudfinnson (IP)
Minister of Health and Social Security	Siv Fridleifsdottir (PP)
Minister of Justice and Ecclesiastical Affairs	Bjorn Bjarnason (IP)
Minister of Social Affairs	Jon Kristjansson (PP)

Recent political developments

IP change-up: David Oddsson officially retired from politics in October 2005. His successor as IP leader is Geir Haarde, the minister of foreign affairs. Mr Haarde is a well respected and experienced politician, and his reputation for independence from the previous leadership is viewed favourably by voters, many of whom had become disillusioned in recent years with the governing parties. Support for the IP has risen since Mr Haarde's appointment, mainly at the expense of the main opposition Alliance, and the centre-right party will look to build on this encouraging trend in the run-up to next year's general election.

Cabinet reshuffle of Progressive Party ministers: On March 2nd the prime minister announced a modest cabinet reshuffle involving several members of his own Progressive Party (PP). The reshuffle is likely to have been motivated in part by growing criticism of the government over its management of the health care system, and also by the continuing poor performance of the PP in opinion polls. According to the latest Gallup poll in February, support for the PP stood at 10% (it has remained close to this level since early 2005), well below the level of 18% achieved by the party in the last two general elections.

Opposition politics: Ingibjorg Solrun Gisladdottir, the former mayor of Reykjavik, was elected as leader of the largest opposition party, the left-of-centre Alliance, in May 2005. Regarded as more politically astute than her predecessor, Ossur Skarphedinsson, the appointment of Ms Gisladdottir had been expected to lead to a rise in support for the party. This, however, has so far failed to materialise, and instead there have been signs of tensions developing within the Alliance. Her supporters maintain that she is the natural choice to be Iceland's next prime minister, but with the IP now performing strongly in the polls, the Alliance leader faces a testing period as she attempts to turn around the party's fortunes. Another prominent opposition figure is Steingrimur Sigfusson, head of the small Left-Green Movement (LGM). The LGM has enjoyed a steady rise in support in recent years, partly reflecting voters' concerns about the scale of heavy-industry projects in Iceland, and Mr Sigfusson's approval ratings have consistently been among the highest of any Icelandic politician. Ms Gisladdottir may attempt to attract the LGM to the centre-left umbrella of the Alliance ahead of the 2007 election.

Widespread criticism of healthcare policy: Recently appointed health minister, Siv Fridleifsdottir, stressed that she was inheriting a well-run ministry from her predecessor, but it is also one of the most challenging portfolios in government. The Ministry of Health is something of a poisoned chalice for the PP—the party's slide in the polls can be attributed, at least in part, to its failure to bring about visible improvements within the health sector during its period in office. In January the National Audit Office published a report in which it criticised the failure of the government to formulate an across-the-board strategy for the division of responsibilities within the Icelandic health care system.

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 held the presidency during 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: Though technically situated outside the Baltic, Iceland is a member of of the Council of Baltic Sea States (CBSS) and currently holds the presidency of that body until July 2006.

International cooperation

More proactive role in international cooperation sought: The government is now pursuing a more proactive role in international co-operation, as illustrated by Iceland's proposed candidacy for a non-permanent seat on the UN Security Council and the ongoing deployment of peacekeepers in Afghanistan and the western Balkans. Another stated aim of the government is to increase Iceland's contribution to development aid, which amounted to 0.21% of GDP in 2005 (well 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. A mission was deployed in 2004, when a 17-strong team were deployed at Kabul airport in Afghanistan. However, it ended with the unit being recalled ahead of schedule, after three members were injured in a bomb attack, which also resulted in two fatalities. It emerged, to the consternation of many critics at home, that the ICRU staff had been fully armed, which was seemingly in contradiction of their strictly civilian status. Despite this controversy, however, the ICRU has since been redeployed in Afghanistan and is also present in Sri Lanka and Kosovo.

Defence policy

US to end permanent military presence in Iceland: On March 15th the US government unexpectedly announced that it would end the permanent presence of US military personnel and aircraft at the Keflavik military base in south-west Iceland by the end of September. Following this date, there will be no significant permanent US military presence in Iceland. The US military has been present in Iceland since 1951, under the terms of a long-standing bilateral defence agreement between the two countries (which, along with NATO membership, forms the cornerstone of Iceland's security policy). What is likely to rankle the Icelandic government most

is the suddenness of the announcement and the relatively short time period before US forces depart. The US government has pledged that it will continue to honour the terms of the 1951 defence agreement, although it remains to be seen how this can be achieved. The Icelandic government has begun discussions with NATO officials over its need "to retain a credible defence capability".

The base has long been the major employer on the Reykjanes peninsula, and the 900 Icelandic employees at Keflavik will all be dismissed. Another concern is the impact on the operations of the Icelandic coastguard. US aircraft and helicopters have historically lent their support to maritime search and rescue missions. After US capacity was downsized in 1995, Iceland acquired two of its own helicopters. However, without the back-up of the US, domestic rescue services can at present only patrol 150 of the 670 nautical miles of its patrol area. The purchase of new helicopters is therefore likely to be a top priority for the government in the coming months.

ECONOMICS

Overview

Essentially prosperous 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 attractive to aluminium producers), 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

Turbulent period in Iceland following Fitch downgrade: Over recent months the Icelandic economy has attracted a considerable level of interest from international financial analysts and media, focusing on the scale of the country's economic imbalances and the soundness of the banking sector. An international ratings agency, Fitch, set the ball rolling in mid-February, when it downgraded Iceland's long-term sovereign credit outlook from "stable" to "negative"—although the actual rating remained unchanged at a favourable AA-. Fitch stated that while signs of overheating and imbalance in the economy – rising inflation, rapid credit growth, buoyant asset prices, a steep current-account deficit and escalating external indebtedness – had been evident for some time, the revision had been triggered by a faster-than-anticipated deterioration

in several of the indicators, primarily the current-account deficit and private-sector external debt.

Following the release of the Fitch report, the value of the krona and share prices on the Icelandic Stock Exchange fell back quite sharply. The financial markets then recovered to some extent, as two other international ratings agencies, Moody's and Standard & Poor's, reaffirmed their sovereign credit ratings on Iceland. However, during March and early April both the krona and equity prices resumed their downward trend, as Merrill Lynch, a global financial management company, and Danske Bank, the second-largest bank in the Nordic area, published negative reports on the Icelandic economy. The spate of negative reports on Iceland prompted the governor of the Central Bank, former prime minister David Oddsson, to describe some of the media coverage as "misinformed, rash, and even sometime hostile".

Mixed messages over position of banking sector: Some rather confusing messages have appeared in recent months regarding the stability and soundness of the banking sector in Iceland. On the one hand, the picture presented by the commercial banks themselves and, to a lesser degree, by the Central Bank, is that the financial sector is in a reasonably strong position. At the same time, however, there is no denying that the level of private-sector external debt has ballooned in recent years, and that the banks remain heavily dependent on foreign funding and also highly exposed to changes in foreign investors' risk appetite.

The Central Bank, and indeed the commercial banks themselves, have recognised that wider foreign institutional ownership of Icelandic equities would help to alleviate some of the domestic leverage concerns and help to calm fears that their equity bases are built on domestic capital gains. Equally encouraging is evidence that the banks and Icelandic companies in general are now accepting the fact that the pace of asset and funding growth needs to slow.

Fiscal policy

Government finances may move into the red: Government expenditure has risen sharply in recent years, but this has been more than offset by a sharp increase in tax revenue as a result of the robust economic expansion. After moving into the black in 2004, the Economist Intelligence Unit (EIU) estimates that the general government budget surplus increased sharply in 2005 to around 3.1% of GDP. At the start of 2006 the government implemented the second stage of its three-year (2005-07) programme of tax cuts. The largest phase of the tax reform is projected to take effect next year, when the current large-scale investment projects will be nearing completion. The general government surplus is forecast to fall back slightly this year, to around 2.8% of GDP. A projected slowdown of the economy, together with the impact of tax cuts and the start of an extensive programme of public-works projects, will result in a deterioration in the public finances in 2007, with the general government budget balance forecast to record a deficit of around 0.7% of GDP. The ratio of general government debt to GDP is low, at around 30% of GDP in 2005, and is forecast to decline in 2006-07.

Monetary policy

Strategy of "Inflation Targeting" under pressure: The main objective of the Central Bank of Iceland's monetary stance is price stability, defined as a 12-month rise in the consumer price index of 2.5%. This framework is currently facing a severe test. Against a background of strong

inflationary pressure in the economy, the Bank has raised its main intervention rate, the repo rate, on 13 occasions since May 2004, by a total of 620 basis points, to the current 11.5%. The most recent increase, of 75 basis points, occurred in late March, following a turbulent period in Iceland's financial markets.

Although the febrile housing market has continued to show signs of cooling, the inflation outlook has deteriorated significantly in recent months, because of a sharp depreciation in the krona, evidence of a larger than expected output gap, and rapidly rising wage costs. The Central Bank has described the inflation outlook as unacceptable, and in its most recent Monetary Bulletin stated that interest rates will have to be raised "substantially" from the current level if inflation is to return to target within an acceptable period.

With inflationary pressures forecast to remain strong over the outlook period, particularly with the krona projected to weaken further this year, the Economist Intelligence Unit (EIU) expects the Central Bank to raise its policy rate by 50-75 basis points at each of its next two meetings in May and July. The EIU baseline forecast is that the repo rate will then remain on hold until early 2007, when the Bank will begin to loosen monetary policy as the pace of economic growth slows.

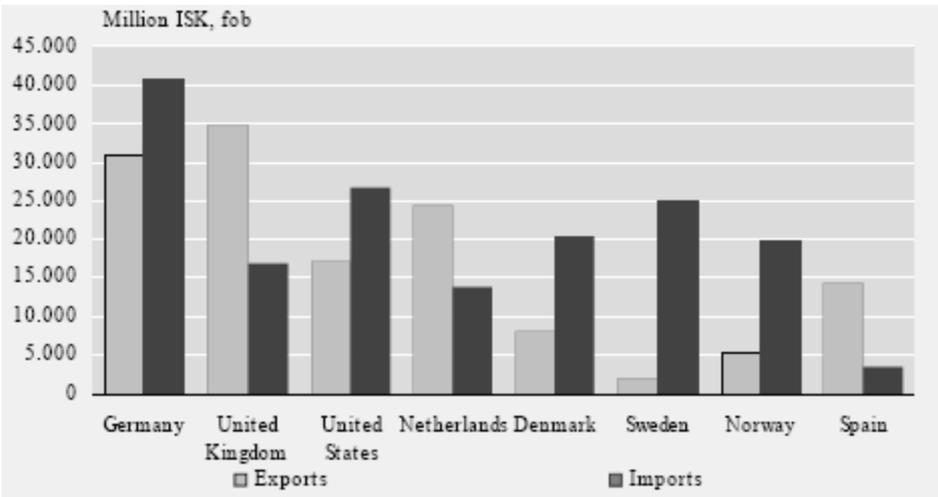
RELATIONS WITH THE EU

Overview

The European Union's relations with Iceland, through EEA co-operation as well as bilaterally, are close and generally smooth.

Trade

The EEA is by far Iceland's most important trading partner. In 2005, 77% of exports went to the EEA and 69% of imports came from there.



Exports and imports by main trading countries in 2005

Largest export markets: United Kingdom, Germany, Netherlands	Largest importing partners: Germany, United States, Sweden
Highest value exports: Marine products, Agricultural products, Manufacturing products	Highest value imports: Food and beverages, Industrial supplies, Fuels and lubricants

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: Iceland has been largely 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 shift within PP: 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. 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 Gallup poll, conducted in August 2005 (after the rejection of the proposed European Constitution in France and the Netherlands), indicated that 43% of Icelanders were in favour of joining the EU, while a higher percentage (55%) supported the start of EU membership negotiations.¹

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.

¹ poll results: <http://www.si.is/malaflokkar/althjodlegt-samstarf/frettir-og-greinar-um-althjodamal/nr/2191>

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