
The Economic Situation in the Faroe Islands

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INTRODUCTION

In the early 1990s the Faroe Islands experienced an economic crisis with high unemployment, heavy debt and considerable emigration from the islands. 1995 saw the beginning of a period of significant progress. This article outlines the current economic situation in the Faroe Islands.¹

The Faroe Islands constitute a small economy with a population of approximately 48,000. The economy is highly dependent on the development in the fishing industries, as exports of goods mainly comprise fish products. Since practically all goods for consumption and investment must be imported, the price and quantity of fish determine the income of the Faroese population available for such purposes. Consequently fiscal policy does not affect the level of activity in the Faroe Islands to the same degree as in Denmark.

The Faroe Islands have home rule, and economic policy and economic legislation are primarily laid down by the Faroese authorities, i.e. the parliament (Løgting) and government (Landsstýri). The Faroe Islands are not a member of the EU.

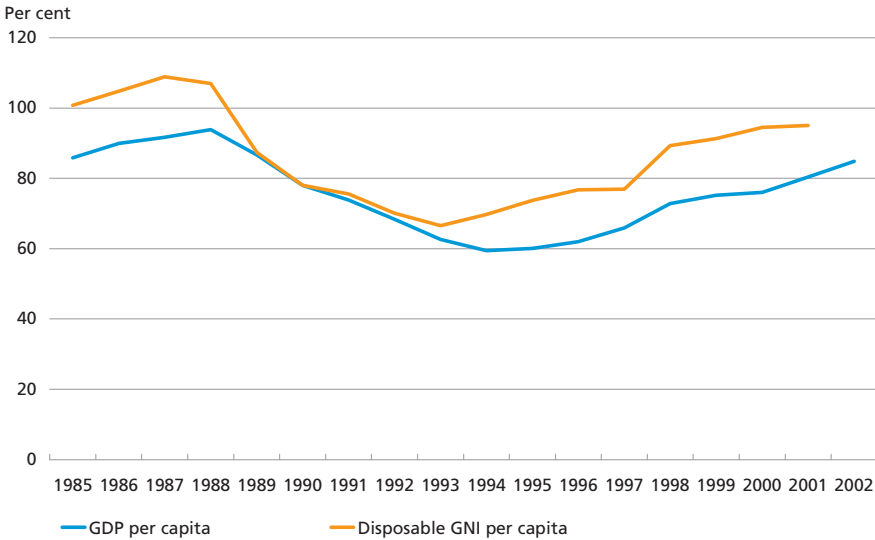
The Faroe Islands are part of the Danish currency area, since they use the Danish krone as their national currency. Among other things, this entails that the Faroese banks have full access to Danmarks Nationalbank's monetary-policy instruments and that Danmarks Nationalbank's monetary and foreign-exchange policy also applies to the Faroe Islands. The Faroe Islands have their own banknotes with the same denominations and formats as the Danish banknotes. The banknotes are printed at Danmarks Nationalbank, which supplies the Faroe Islands with banknotes via cash depots in Tórshavn in the same way as in Denmark. Danmarks Nationalbank exchanges the banknotes for Danish banknotes on a 1:1 basis and free of charge.

The statistical basis for assessing the Faroese economy is limited, and some of the statistics are subject to significant uncertainty.

¹ The article is, *inter alia*, based on a visit to the Faroe Islands in May 2003, during which we met with the High Commissioner's Office, the Faroese Ministry of Finance, the Faroese Economic Council, Landsbanki Føroya (the Governmental Bank of the Faroe Islands), business organisations, Føroya Sparikassi and Føroya Banki.

**GDP AND DISPOSABLE GROSS NATIONAL INCOME OF THE FAROE ISLANDS
COMPARED WITH DENMARK**

Chart 1



Note: Disposable GNI is calculated as GDP less interest, yields, wages, etc. to abroad (net), and current transfers to abroad (net).

Source: Hagstova Føroya, Landsbanki Føroya, the Faroese Ministry of Finance and Statistics Denmark.

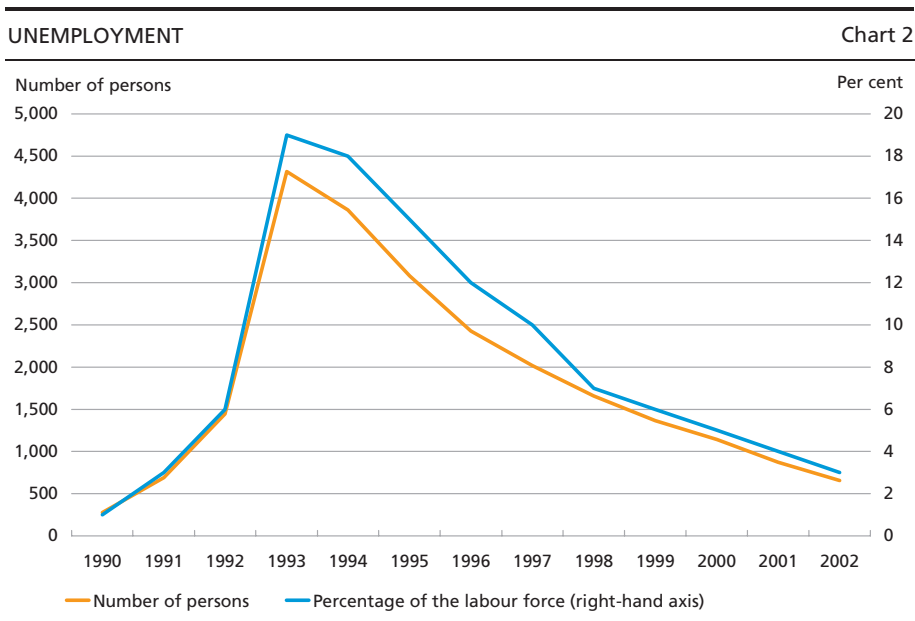
THE ECONOMIC UPSWING AFTER THE CRISIS

After the economic crisis in the early 1990s with heavy debt and high unemployment the trend reversed surprisingly fast. From 1995 to 2002 the Faroese economy saw a period of unusually high growth, mainly driven by catch volumes, high prices for fish, a prospering fish-farming industry and growing exports.

The Faroese gross domestic product (GDP) in current prices has shown an annual growth rate of 7-15 per cent over the last 5-6 years.¹ The Faroese Ministry of Finance estimates that this is equivalent to average real growth of 6-7 per cent per annum. After this growth period, the Faroese GDP per capita is once again more than 80 per cent of the level in Denmark, cf. Chart 1. The Faroe Islands' disposable gross national income (GNI) per capita, which includes the block grant from the Danish government, has exceeded 90 per cent of Denmark's GNI in recent years. Figures for 2002 are not available yet.

The favourable economic development means more jobs and considerably lower unemployment, cf. Chart 2. During the deep economic crisis more than 10 per cent of the Faroese population emigrated. The posi-

¹ Sources: the Faroese Ministry of Finance and Hagstova Føroya (Statistics Faroe Islands).



Source: Hagstova Føroya.

tive development since 1995 has led to the return of around 5 per cent of the population in total.

The last ten years have seen extensive consolidation of the public finances, as well as the finances of most households and business enterprises. There is thus no risk that a possible slowdown in the near future may develop into a crisis on the scale witnessed in the early 1990s.

THE CURRENT ECONOMIC SITUATION

Over the last 7-8 years the economy has followed an exceptionally favourable course, which is hardly likely to continue. In 2002 and particularly in the 1st half of 2003 there were indications that the economy is weakening.

Total payroll expenditures are often taken as an indicator of the general economic development. The annual growth rate for total payroll expenditures peaked in 2001 at 13.8 per cent, cf. Table 1. In 2002 payroll expenditures rose by 8.4 per cent. Payroll expenditures in the fishing industry depend on the value of the catches. Outside the fishing industry annual wage increases were 4-5 per cent, entailing a high rate of real output growth. Payroll expenditures in the first four months of 2003 increased by only 2.4 per cent against the same period in the preceding year. The lower increase indicates that the growth in the Faroese eco-

TOTAL PAYROLL EXPENDITURES Table 1

Kr. million	1999	2000	2001	2002	2002 Jan. - Apr.	2003 Jan. - Apr.
Primary sector	1,176	1,312	1,581	1,647	525	482
Manufacturing	917	1,046	1,176	1,307	402	430
Services	2,341	2,521	2,793	3,063	972	1,032
Total	4,434	4,879	5,550	6,017	1,898	1,943
Change in per cent against the preceding year	7.2	10.0	13.8	8.4	11.3	2.4

Note: Payroll expenditures comprise paid-out income taxed at source, as well as the tax deducted at source. Unemployment insurance and public disbursements such as social pensions, unemployment benefit and various subsidies have been deducted.

Source: Hagstova Føroya.

nomony is diminishing. This trend was reinforced by an extensive 4-week strike in the private labour market in May/June 2003.¹

The 2.4-per-cent increase in payroll expenditures covers considerable differences between the various sectors. For instance, payroll expenditures in the fishing industry declined by 11 per cent in the first four months of 2003 compared with the same period in 2002. On the other hand, payroll expenditures in the building and construction sector and the public sector increased by 7-9 per cent.

Employment

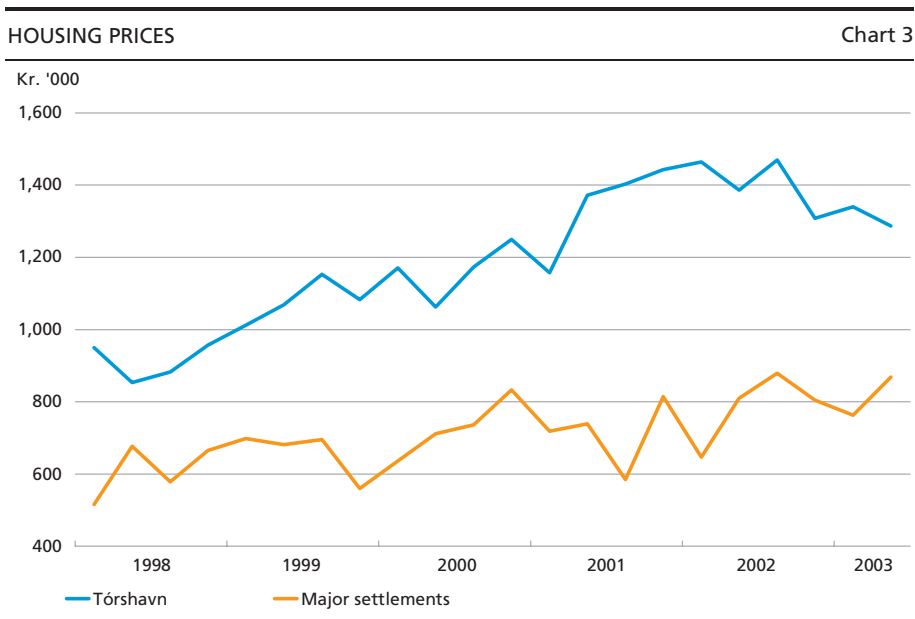
The Faroese economy is close to full employment, and unemployment is at around 3 per cent of the labour force. The level of activity in the building and construction sector has been relatively high, and in recent years it has been difficult for the building sector to recruit the necessary labour. Bottlenecks have exerted pressure on wages in the sector, cf. the strike in 2003. Imports for the building sector increased by 13 per cent in the 1st quarter of 2003 over the same period of 2002.

At times the fishing industry has been short of labour, and consequently foreign labour has been used to a limited extent.

The housing market

Housing prices in Tórshavn have been going up in recent years, cf. Chart 3. There has, however, been a slight tendency for housing prices to fall in the last quarters, which could be yet another indication of the onset of a slowdown in the Faroese economy.

¹ The strike is a major reason that payroll expenditures in the 1st half of 2003 only increased by 0.1 per cent over the 1st half of 2002.



Source: Føroya Sparikassi.

Oil

Since 2001 four test oil drillings have taken place, of which one has shown traces of oil and gas. It is as yet uncertain whether there is a basis for extraction, and further exploration drillings are required in the coming years to assess whether there is sufficient oil and gas in the area for commercial utilisation. If so, it will take a number of years before actual extraction can commence.

From the late 1990s to 2001 the hope of finding oil may have contributed to the favourable economic situation.

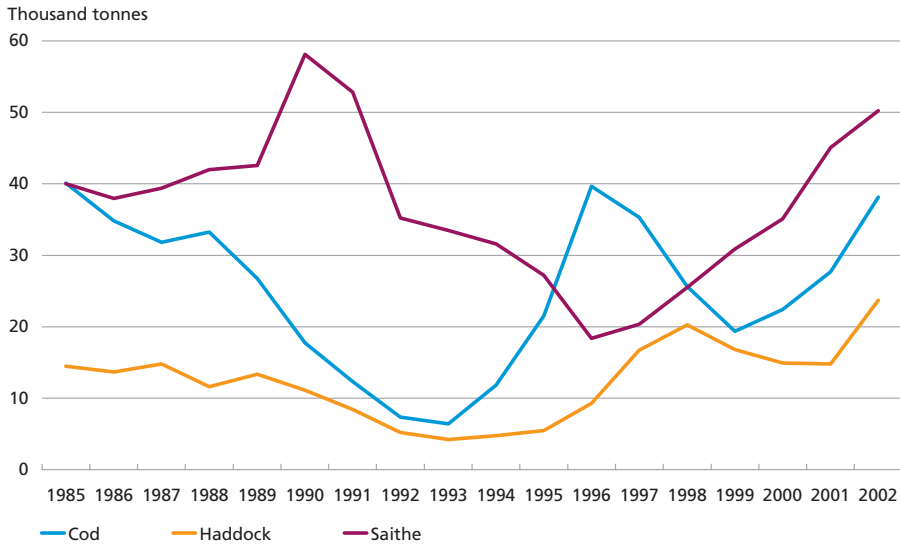
THE FISHING INDUSTRIES

Fisheries, fish processing and fish farming are the dominant industries in the Faroe Islands. Fishing products constitute approximately 75 per cent of the value of exports, and approximately 25 per cent of GDP stems from fisheries. Fishing takes place in Faroese territorial waters (up to 200 nautical miles from the Faroe Islands), and in external waters such as the Barents Sea. The value of catches in Faroese waters constitutes around 60 per cent of the value of total catches.

During the last 10-15 years fishing has been supplemented with salmon farming. Farming exports have amounted to approximately kr. 900 million a year in the last 4-5 years, equivalent to approximately 20

CATCHES OF COD, HADDOCK AND SAITHE IN FAROESE WATERS

Chart 4



Source: Hagstova Føroya.

per cent of Faroese exports of goods, and currently this is the second-largest export industry in the Faroe Islands.

Fishing

Catches in Faroese waters mainly comprise cod, haddock and saithe. For the major species, fishing is regulated in that each vessel is assigned a total number of fishing days per year. In other words, the catch effort is regulated, and there is no direct regulation of the quantities caught – as opposed to the EU scheme with quotas for each species.

The catch volumes of cod, haddock and saithe fluctuate considerably, cf. Chart 4. The volumes have increased in recent years and were at a high level in 2002.

World-market prices for the three species were generally high in 2000 and 2001. Combined with the large catch volumes this resulted in exceptionally high fishing income. In 2002 prices fell, but owing to the larger catch volumes, the catch value of these three species increased.

In the two first months of 2003 the catch volume of cod dropped by 19 per cent compared with the large catch volume in 2002. World-market prices for haddock and saithe have fallen in 2003, and the catch values declined considerably in the first two months of 2003.¹

Fishing in external waters mainly comprises herring, mackerel and blue whiting. These catches are regulated by international agreements and

¹ Hagstova Føroya.

quotas. In 2001 and 2002 the purse-seining fleet, which mainly fishes blue whiting, herring and mackerel, made a very good profit thanks to large catch volumes and relatively high world-market prices.

The economic situation of the Faroese shrimp-fishing industry, on the other hand, is very poor. A number of shrimp trawlers have gone into liquidation within the last year, partly as a result of low shrimp prices. The future of the shrimp fleet is uncertain.

Total fishing subsidies were reduced by approximately kr. 110 million from 1996 to kr. 40 million in 2002. The present scheme is primarily aimed at providing a minimum income for fishermen. In addition, a favourable income-tax scheme applies to fishermen.

Fish processing

Of the total catch, a proportion is exported directly as frozen or iced fish, while the remainder is sold to the Faroese fish-processing industry.

Key factors in this industry include capacity, Faroese wages, and the supply of fish. Output fell from 95,000 tonnes of fish in 2001 to 91,000 tonnes in 2002.

The strike in May/June 2003 meant that filleting activities came to a standstill and that fishermen could not unload their catches in Faroese ports. It is as yet too early to assess the impact of the strike on the filleting factories.

Fish farming

Fish farming, primarily salmon, has become a significant factor in the Faroese economy since the beginning of the 1990s. Farming takes place in the Faroese fiords and sounds. In addition, there are derived industries such as production of smolt and fish feed.

Whereas catch volumes fluctuate greatly, the quantities farmed are easier to plan. Moreover, slaughtering can to some extent be adapted to the expected sales price. Consequently fish farming can "iron out" some of the economic consequences of uncertainties and fluctuations in the fishing sector.

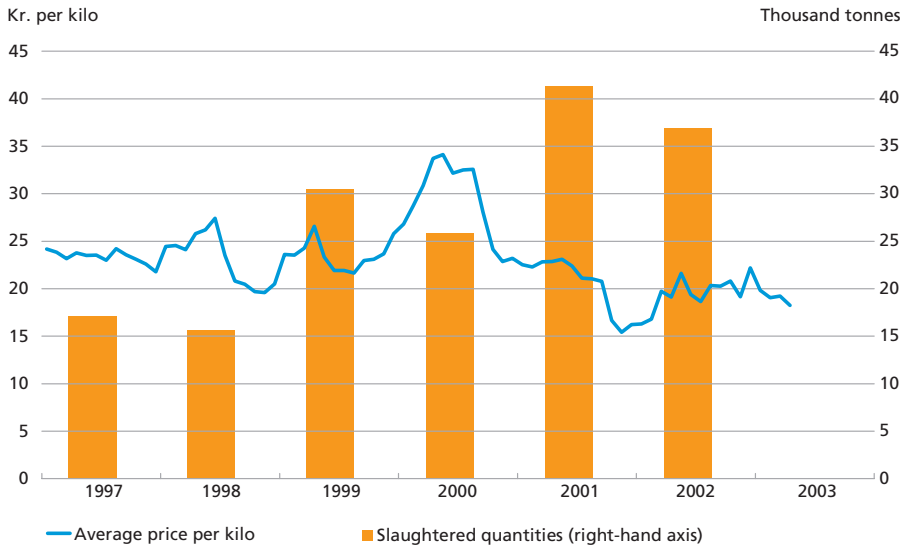
In 2000 the world-market price for salmon was unusually high, cf. Chart 5. With average production costs in the fish-farming industry of kr. 18-20 per kilo, profits were high. In the last two years the price for salmon has been low, and in the summer of 2003 production was not profitable.

Fish farming is also seriously affected by infectious salmon anaemia, ISA. This disease entails that salmon in infected areas must be slaughtered before they attain a suitable age and size.¹ Since normal produc-

¹ The infected fish are slaughtered, disinfected and incinerated. Subsequently the areas of the sea where ISA has been registered must lie fallow for 6 months before new smolt can be released.

SALMON FARMING

Chart 5



Source: Vinnuhúsið and Kontali Analyse.

tion time is 2-4 years, the consequence of these slaughters will be reduced output in the next few years.

Salmon production is capital intensive because the long production time requires financing. The low price for salmon and the outbreak of ISA have more or less halved the equity of the Faroese farming industry in one year¹. Another consequence is that it is difficult to attract new capital to the industry. In 2003 only just over half the normal volume of smolt has been released into the fiords.² The banks' accounts for the 1st half of 2003 show that the situation is critical for the industry, so at present the future of the farming industry is uncertain.

THE FINANCIAL SECTOR

In 2002 the profit of the four Faroese banks totalled kr. 288 million, which was kr. 22 million lower than in 2001, cf. Table 2. Costs increased considerably more (by 22 per cent) than revenues (by 6.5 per cent), and operating income over operating expenses declined from 2.16 in 2001 to 1.89 in 2002.

On the income side, the banks' net interest income remained unchanged in 2002 compared with 2001. The falling level of interest rates in 2002 brought significant capital gains on securities, etc.

¹ Føroya Banki's annual accounts 2002.

² Vinnuhúsið.

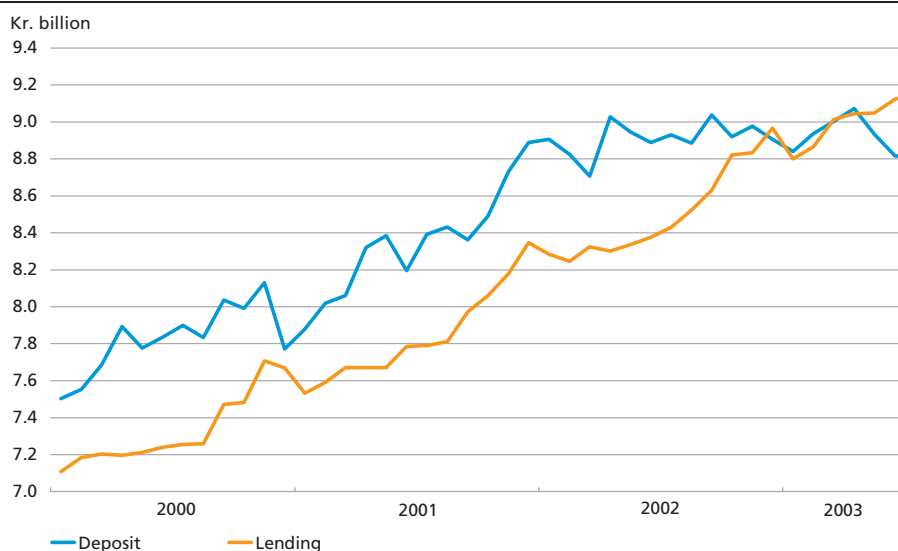
THE BANKS' FINANCIAL RESULTS					Table 2
Kr. million	1999	2000	2001	2002	1st half 2003
<i>Income</i>					
Net interest income	423.0	483.6	508.6	508.6	265.8
Net fee and commission income	19.2	24.9	31.0	37.3	24.6
Value adjustment of securities, etc.	-56.2	-1.9	19.0	44.7	15.5
Value adjustment of capital investments	0.2	-3.1	0.9	0.2	-2.2
Other ordinary income	13.0	23.0	16.6	22.6	20.0
<i>Costs</i>					
Operating expenses, etc.	260.3	266.6	272.2	301.9	151.0
Losses and provisions on debtors	-164.7	-154.0	-5.7	23.3	254.6
<i>Ordinary operating result</i>	303.7	413.8	309.6	288.1	-81.9

Source: Føroya Banki, Føroya Sparikassi, Suðuroyar Sparikassi, Norðoya Sparikassi and the Danish Financial Supervisory Authority.

The favourable economic situation in 1999-2001 led to reversal of previous provisions. In 2002 the banks' losses and provisions totalled kr. 23.3 million, equivalent to a ratio of losses and provisions to loans and guarantees of 0.3 per cent. Owing to the fish-farming problems, the two largest banks made significantly higher provisions for this industry in their accounts for the 1st half of 2003. This entails a loss on ordinary activities, but the solvency ratio of the banks remains high.

The banks' total lending increased considerably during 2002, while deposits remained fairly stable, cf. Chart 6.

THE BANKS' TOTAL DEPOSITS AND LENDING Chart 6



Source: Landsbanki Føroya.

INCOME AND EXPENSES OF THE EXCHEQUER						Table 3
Kr. million	1998	1999	2000	2001	2002	2003
Tax revenues	1,043	1,234	1,310	1,566	1,675	1,796
Customs and duties	989	1,042	1,117	1,148	1,239	1,268
Other income	142	117	88	91	58	54
Block grants	920	945	973	995	629	630
Total income	3,094	3,338	3,488	3,800	3,602	3,747
Operating costs	2,292	2,557	2,713	2,923	3,171	3,224
Capital investments	83	133	174	180	240	283
Interest costs	249	156	127	76	24	66
Total expenses	2,624	2,690	2,887	3,103	3,411	3,507
Surplus	470	648	602	697	191	240

Note: Exchequer accounts 1998-2002 and budget for 2003.

Source: High Commissioner's report 2003 and the Faroese Ministry of Finance.

PUBLIC FINANCES AND GOVERNMENT DEBT

The economic progress since 1995 and the low level of interest rates have contributed to improving public finances. The Exchequer's surplus was kr. 191 million in 2002, against kr. 697 million in 2001 and kr. 602 million in 2000, cf. Table 3. The drop in the Exchequer's surplus in 2002 compared with 2001 is mainly attributable to a reduction in the block grant from Denmark by 1/3 to kr. 630 million annually.

Government spending increased by 30 per cent from 1998 to 2002, equivalent to average annual growth of 7 per cent, while the annual increase in wages in the public sector was 4-5 per cent.

The increase in government spending from 1998 to 2002 comprises higher operating costs and capital investments, as well as lower interest costs. On the income side, tax revenues are affected by tax cuts, e.g. in connection with a tax reform in 1997 and changed tax brackets in 2001 and 2002.

The budget for 2003 operated with a surplus of kr. 240 million. Subsequent tax cuts totalling kr. 123 million over two years have been adopted, i.e. kr. 52 million in 2003 and kr. 71 million in 2004. The budget for 2003 included an increase in revenues from direct and indirect taxes of 5-6 per cent, but in the first seven months of 2003 such revenues were approximately 1 per cent lower than in the same period of 2002. The fall in revenues from direct and indirect taxes during the first seven months of 2003 reflects the lower economic growth, but also the effect of the strike in the early summer.

Government debt

The government surpluses have made it possible to increase the liquidity of the public sector and reduce government debt considerably. The gross debt of the Exchequer has been reduced from kr. 6.9 billion at end-1996 to kr. 5 billion at end-2002, and liquidity was kr. 2.4 billion at end-2002.

In addition, the public sector has considerable assets. These include the public sector's share of the Financing Fund of 1992 (particularly Føroya Banki) and other public enterprises and foundations. The possible privatisation of parts of these enterprises is a current issue in the Faroese debate.

FOREIGN TRADE AND EXTERNAL DEBT

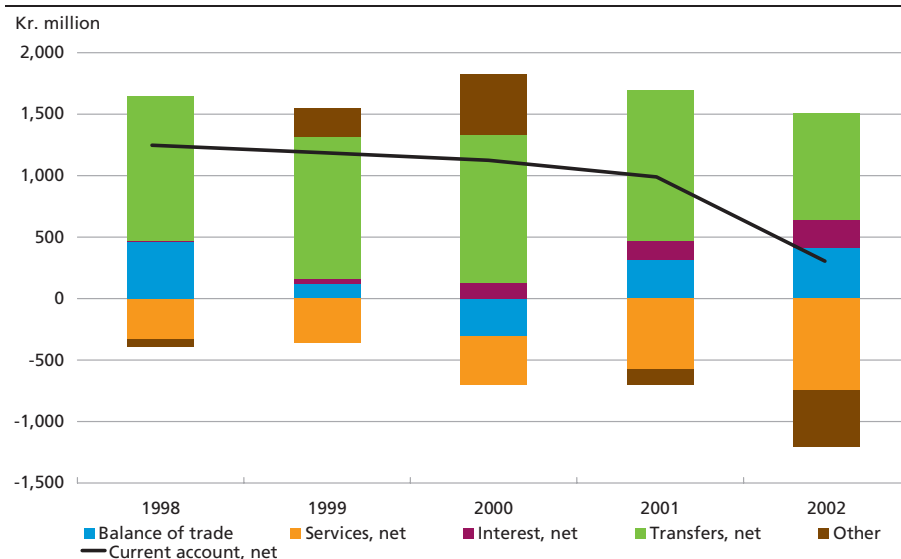
The balance of trade for the Faroe Islands showed a surplus of kr. 381 million (excluding ships) in 2002, against kr. 284 million in 2001. The increase covers a fall in exports of kr. 120 million, which was more than offset by a fall in total imports of kr. 216 million.

In the first four months of 2003 the value of exports (excluding ships) was kr. 1,310 million, compared with kr. 1,386 million in the same period of 2002. The decline is mainly attributable to falling prices for frozen/iced whole fish (except salmon and trout).

The current account has shown a surplus since 1993. The current account deteriorated considerably in 2002 compared with 2001, cf. Chart 7. A

BALANCE OF PAYMENTS

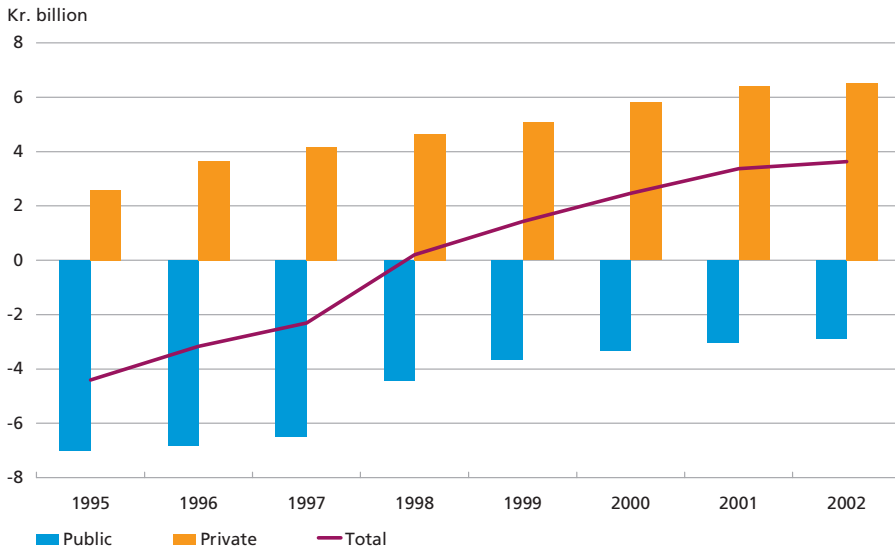
Chart 7



Source: Landsbanki Føroya.

THE FAROE ISLANDS' NET EXTERNAL ASSETS

Chart 8



Source: Landsbanki Føroya.

major reason for this fall is a reduction in the transfers from the Danish government by kr. 366 million in 2002.

The Faroese Islands' net external assets

In the early 1990s the Faroese Islands' net external debt totalled kr. 8 billion, but by 2002 this had been transformed into net external assets of kr. 3.6 billion, cf. Chart 8.

The substantial fall in the net debt is primarily attributable to the large current-account surpluses. The debt reduction is, however, also a result of a write-down of the Faroese debt to the Danish government by kr. 900 million under an agreement between the Danish and Faroese governments in 1998.

The net external position of the Faroese Islands covers large variations between public and private net external debt, cf. Chart 8. At end-2002 the private sector had net external assets totalling kr. 6.5 billion, whereas the public sector had a net debt of kr. 2.9 billion.

CONCLUSION

After a period of 7-8 years with favourable cyclical development in the Faroese Islands, several factors now indicate a slowdown in the Faroese economy. The increase in payroll expenditures diminished in 2002, and this trend strengthened in the 1st half of 2003. Exports and imports have

declined. The catch values of fish, which were very high particularly in 2001 and 2002, dropped at the beginning of 2003. Fish farming is under financial pressure owing to disease and low world-market prices for salmon, which also has a negative impact on the banks.

However, the foundations of the Faroese economy are considerably more solid in 2003 than in the late 1980s after the boom during the 1980s. Public finances are relatively sound, and the Faroese net external debt has been transformed into significant net external assets. In addition, the fishing industry is geared to compete on market terms to a much higher degree than previously. Consequently, the Faroese economy is much better prepared to cope with a possible recession.