CURRENT TRENDS IN THE FAROESE ECONOMY

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INTRODUCTION AND SUMMARY

The Faroese economy grew in 2013, following a couple of years characterised by stagnation. The nominal gross domestic product, GDP, increased by 5.1 per cent, while consumer prices fell by 0.6 per cent. Growth in nominal GDP was driven by fish exports, which rose as a result of larger catches of mackerel and herring and high salmon prices. Private sector demand is also picking up after a few years of household restraint. Employment is rising slightly, while unemployment is low and declining.

After political agreement had been reached between the EU and the Faroe Islands regarding herring catches, the EU in August 2014 lifted the trade sanctions against the Faroe Islands introduced in late August 2013. Furthermore, a 5-year agreement on mackerel quotas has been concluded with the other North Atlantic coastal countries. This reduces uncertainty in the fisheries sector and may boost earnings.

The economic recovery and increased revenue from resource taxes reduce the government deficit. This is a cyclical improvement, and the sustainability of public finances has not improved despite the lower deficit. Hence, measures to improve the underlying position of public finances are still required.

Facts about the Faroe Islands

Population (beginning of 2014)	48,219
of which in Tórshavn municipality	19,945
of which 18-66 years	29,067
Waged employment (full time, annual average, 2013)	23,703
Unemployment (full time, annual average, 2013)	1,214
Gross domestic product, GDP (kr. million, 2013)	14,344
GDP per capita (kr. 1,000, 2013)[1]	297.8
Gross national disposable income per capita (kr. 1,000, 2012)	318.6

Source: Hagstova Føroya.

1. By comparison, in 2013 GDP per capita in Denmark was kr. 330,900.

NATIONAL ACCOUNTS AND BALANCE OF TRADE

Nominal GDP rose by 5.1 per cent in 2013, up from 3 per cent the year before, cf. Table 1. Growth in the Faroese economy in recent years has been driven by fish exports, while domestic demand has been subdued. But in 2012 the level of investment rose sharply. This was mainly attributable to ships and aircraft, which are to a large extent imported and therefore have no immediate impact on activity.

The increase in fish exports meant that the value of exports, excluding ships and aircraft, rose by almost 15 per cent in 2013, cf. Table 2. Imports, excluding ships and aircraft, grew by nearly 2 per cent, primarily on account of increased imports of vehicles, as well as goods for households and for construction. Preliminary data shows that both

National accounts, nominal growth rates Table 1

Per cent, year-on-year	Share of GDP in 2012, per cent	2006	2007	2008	2009	2010	2011	2012	2013
Private consumption	55.2	8.0	5.8	-0.2	-1.4	-1.6	9.6	1.2	n.a.
Public consumption	30.9	3.3	8.2	10.5	1.8	3.7	1.9	0.9	n.a.
Total gross investment	28.9	42.1	28.4	-34.6	-17.4	20.7	-3.3	61.1	n.a.
Exports of goods and services	48.7	11.2	6.5	7.8	-11.0	15.2	12.9	2.2	n.a.
Final consumption equal to total addition	163.7	12.5	10.3	-3.0	-5.7	6.8	7.2	8.6	n.a.
Imports of goods and services	63.7	11.9	18.7	-6.8	-13.2	6.6	17.2	18.8	n.a.
Gross domestic product	100.0	12.9	5.9	-0.8	-1.7	7.0	2.4	3.0	5.1
Gross national disposable income	111.7	12.3	7.3	-5.1	-3.3	11.0	5.0	2.0	n.a.
Memo: Consumer prices		1.5	3.6	6.3	-1.0	0.4	2.3	2.2	-0.6

Note: Gross national disposable income is GDP plus wage and investment income, net, and transfers from abroad, net.
Source: Hagstova Føroya.

Trade balance and balance of payments Table 2

Kr. million	2011	2012	2013
Exports	5,407	5,515	6,085
Exports, excl. ships and aircraft	4,778	5,209	5,981
Imports	5,279	6,683	6,271
Imports, excl. ships and aircraft	4,556	5,355	5,446
Trade balance	128	-1,167	-186
Trade balance, excl. ships and aircraft	222	-145	535
Balance of payments	884	-447	n.a.

Source: Hagstova Føroya.

exports and imports, excluding ships and aircraft, were higher in the 1st half of 2014 than in the same period of 2013.

The current account of the balance of payments has not yet been compiled for 2013. The trade deficit was kr. 186 million, corresponding to 1.3 per cent of GDP, and will be more than offset by wage earnings from people living in the Faroe Islands but working abroad. The current account surplus is expected to be around kr. 500 million in 2013.

MOST RECENT CYCLICAL TENDENCIES

Waged employment has risen a little since the spring of 2013, having been virtually flat in the preceding year, cf. Chart 1.[1] All the same, employment remains well below the level before the surge in 2006-08. The recent increase in waged employment is also reflected in total wage expenditures, which had increased by 5.3 per cent year-on-year in July 2014 after having risen only slightly more than consumer prices for some years.

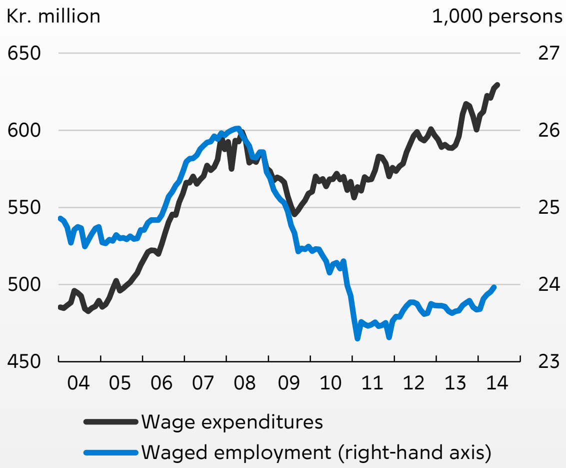
The rise in employment has taken place within the construction sector, among others, cf. Chart 2 (left). This is to a large extent attributable to the commencement of large public sector construction projects, but a few firms have also built new factories or offices. Employment in the construction sector is now at the same level as in 2002, i.e. before the boom with soaring house prices began in the Faroe Islands.

Following a couple of years of stagnation in the wake of considerable adjustment in 2009-10,

1 A limited range of statistics makes it difficult to assess the cyclical position of the Faroese economy. For example, GDP is compiled on a nominal annual basis only and with a considerable lag. Instead, other measures must be applied, e.g. wage expenditures and waged employment, which are compiled with a relatively short lag and usually provide a good indication of the development in the Faroese economy.

Wage expenditures and waged employment

Chart 1



Note: Seasonally adjusted monthly data. 3-month moving averages for wage expenditures. The most recent observation is from May 2014 for waged employment and July 2014 for wage expenditures.
Source: Hagstova Føroya.

waged employment in the private service sectors rose a little in 2013 and early 2014. This applies to firms within areas such as trade and maintenance as well as transport, especially sea freight. Hotels and restaurants have also taken on more staff, reflecting an emerging upturn in tourism. In contrast, the financial sector has continued to reduce its staffing, and employment within communications has also decreased.

Although the fisheries sector is flourishing, employment has fallen, cf. Chart 2 (right). Employment within fish processing has also fallen in spite of the increased catches. This is because most of the fish are exported without being processed. In the last couple of years, investments have been made in new factories for processing and freezing fish, but this has not been able to offset the general downward trend in employment in the sector.

Aquaculture, which has been very successful in recent years, has seen a rise in employment. However, this sector requires very little labour so the impact on overall employment is limited.

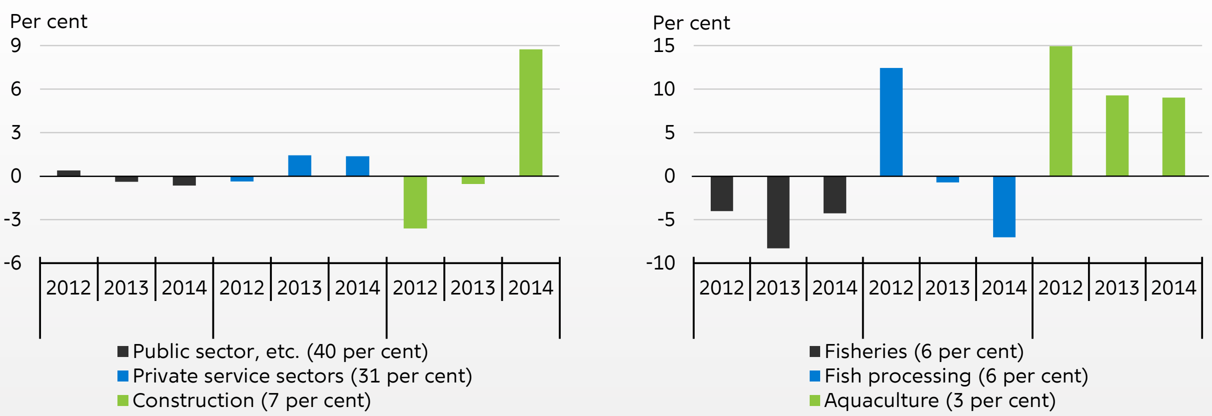
The biannual confidence indicators show that both firms and consumers are fairly optimistic about the economy. Both indicators are well into positive territory and at the same good levels as in 2007, before the economic downturn.

Compared with previous surveys, households now take a more favourable view of their own finances and the Faroese economy relative to one year earlier, and they have more positive expectations for the future. This could point to a rise in private consumption after several years' stagnation as households have consolidated. Higher VAT payments and imports of consumer goods in the 1st half of 2014, as well as a marked increase in imports of passenger cars, also point to growing private consumption.

The housing market is buoyed up by falling interest rates, and over the last year the banks have reduced their interest margins. Trading

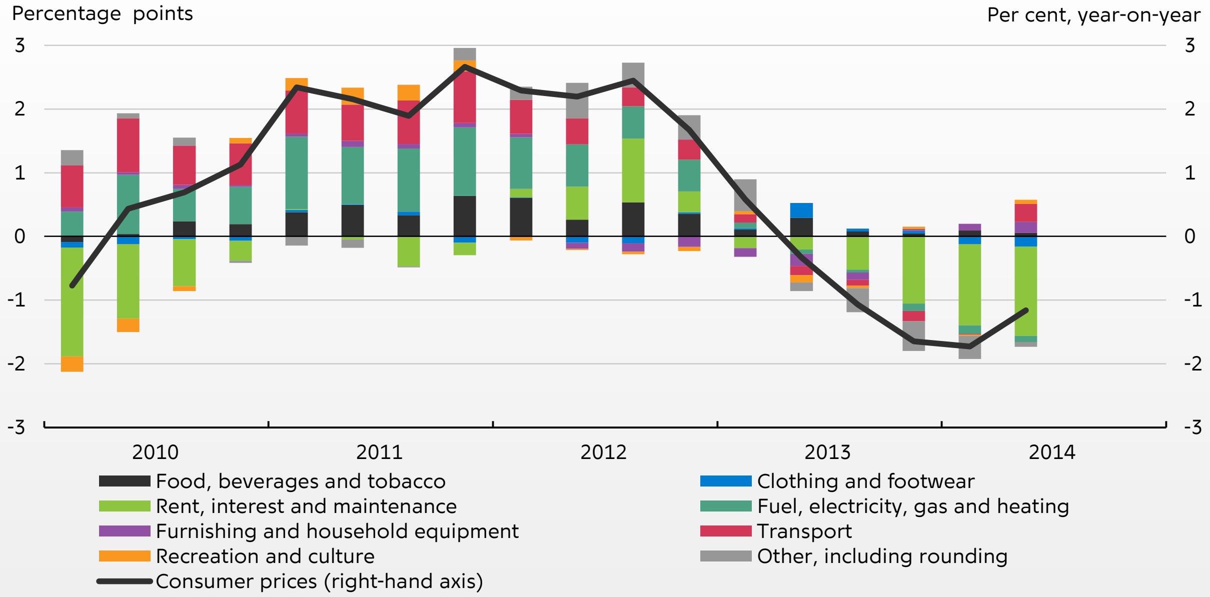
Changes in waged employment in selected sectors

Chart 2



Note: Data for 2014 shows the change in the period January-June 2014 in relation to the same period of 2013. Figures in brackets in the legend indicate the sectors' shares of total waged employment in 2013.
Source: Hagstova Føroya.

Increases in consumer prices and contributions from subcomponents Chart 3



Source: Hagstova Føroya and own calculations.

activity is rising and is now more or less at the same level as in the mid-2000s. In Tórshavn, there are indications that the price of houses traded is rising, while the trend is virtually flat for the Faroe Islands overall.

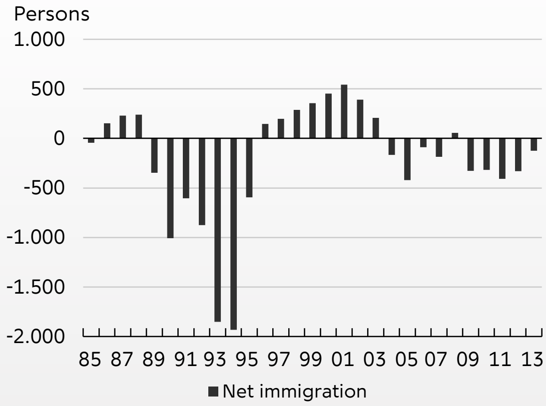
Homeowners' interest payments are included in the index of consumer prices. The lower interest payments on loans for owner-occupied homes pull down the index, and since the spring of 2013 the consumer price index has fallen, cf. Chart 3. In the 2nd quarter of 2014, consumer prices were 1.2 per cent lower than in the same quarter of 2013, but if interest payments on owner-occupied homes are eliminated, inflation was 0.4 per cent. The low rises in consumer prices supports households' real income and hence private consumption. In nominal terms, wage expenditures rose by just under 4 per cent in the first seven months of 2014.

THE LABOUR MARKET

Unemployment has decreased steadily since early 2011, standing at 3.9 per cent of the labour force (seasonally adjusted) in July 2014, cf. Chart 4 (left). That is the same level as in 2004-05. Comparison with other countries is difficult, in that the Faroese population is very mobile and responds to high unemployment. Only a small share of the fall in unemployment is attributable to higher employment. Instead, there has been net emigration, as also seen in previous periods of relatively high unemployment, cf. Chart 4 (right). Net emigration in 2009-12 masked a small demographic rise in both the population overall and the number of people of working age. In addition, still more people living in the Faroe Islands have found work abroad, mainly within shipping, fisheries, offshore activities and construction.

The large number of Faroese people working abroad shows that the labour force is highly skilled and very mobile. This is positive, but also increases the risk of a shortage of labour in the Faroe Islands. This is currently a problem in the construction sector, as many skilled workers, especially electricians, have found work in Norway, where wages are higher, not least after tax. So there are signs of bottlenecks in the Faroe Islands. As a result, new legislation introduced in July 2014 has made it easier to employ foreign labour in the construction sector. This is particularly important since several large construction projects have been planned for the coming years.

Unemployment and net immigration Chart 4

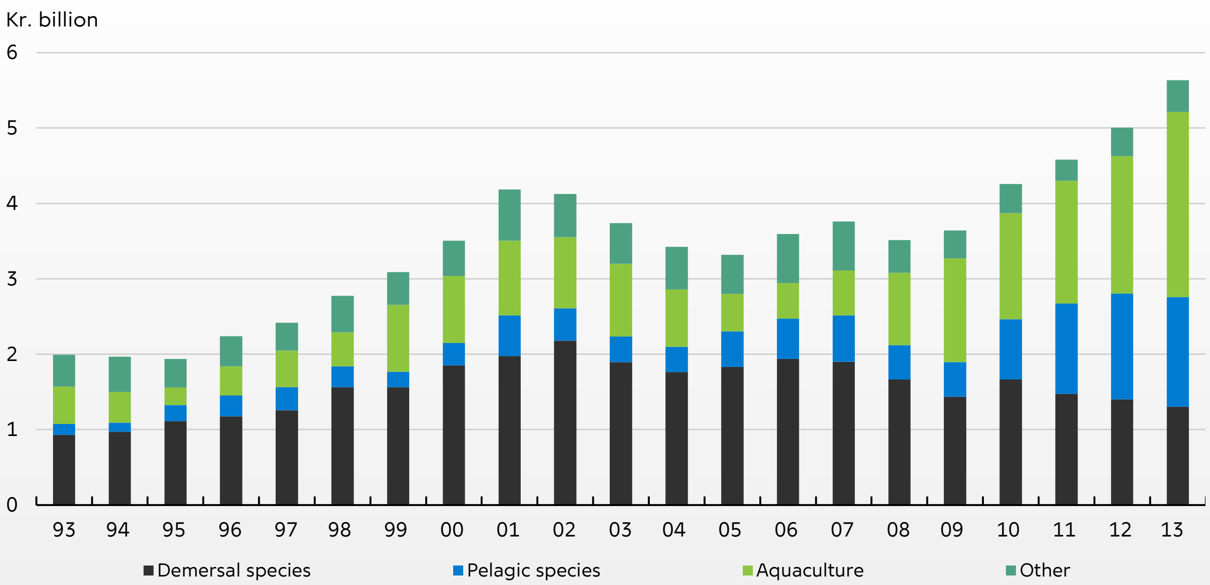


Note: Seasonally adjusted monthly data for the unemployment rate.
Source: Hagstova Føroya.

FISHERIES AND AQUACULTURE

In recent years, fish have accounted for almost one sixth of total gross value added in the Faroe Islands and approximately 95 per cent of exports of goods, excluding ships and aircraft. This means that the Faroese economy is highly dependent on developments in catch volumes and fish prices. Both fluctuate considerably over time, but not necessarily in the same direction for all species. Since earnings over the past years have increasingly been diversified across species, cf. Chart 5, the vulnerability of the economy overall is reduced.

Value of fish exports Chart 5



Note: Pelagic species live in open waters, not near the sea bed or in coastal waters. These species are mackerel, herring, whiting, capelin and sprat, among others. Demersal species include cod, saithe and haddock. Aquaculture comprises salmon and trout. Other is shellfish, etc.
Source: Hagstova Føroya.

In recent years, earnings from fish have risen substantially. Growth drivers have been aquaculture and pelagic fishing around the Faroe Islands, especially for herring and mackerel. Conversely, traditional local demersal fishing, comprising cod, saithe and haddock, has been financially weak.

Aquaculture continued to increase its revenues in 2013, accounting for 44 per cent of total exports of fish. The main species farmed is salmon, for which prices have been high in recent years. The Faroe Islands still have access to the Russian market after Russia's trade embargo on certain food products from the EU. This provides an opportunity to sell salmon to the Russian market at high prices, whereas prices have fallen considerably in the European market. Hence, the overall impact on the Faroese economy is not clear. The volume of aquaculture production is high and close to the capacity limit if disease epidemics and resultant high costs are to be avoided.

Earnings from pelagic fishing have also risen substantially in recent years. This is primarily attributable to increased catches, reflecting factors such as the Faroe Islands' unilateral fixing of its mackerel quotas in 2010-13 following fruitless negotiations with the EU, Norway and Iceland on the distribution of the overall quota. In 2013, the Faroe Islands also fixed their own quota for Atlanto-Scandian herring. The quotas were 158,000 tonnes for mackerel and 105,000 tonnes for Atlanto-Scandian herring. Under the former agreements, the quotas would have been approximately 30,000 tonnes for each species.

In March 2014, the Faroe Islands, Norway and the EU concluded a 5-year agreement on mackerel quotas, allowing Faroese mackerel catches this year to remain more or less on a level with last year's. In June 2014, the Faroe Islands and the EU concluded a political agreement to end their herring dispute. Against that background, the Faroe Islands have fixed their herring quota at 40,000 tonnes this year, and in August 2014 the EU lifted its trade sanctions against the Faroe Islands. The sanctions were introduced in August 2013 in response to Faroese herring quotas for 2013 that were not assessed to be biologically sustainable. Among other things, the sanctions involved an EU-wide import and transit ban on herring and mackerel from the Faroe Islands, but they were introduced at a time when most of the catches and sales of mackerel and herring had already taken place.

Agreement on the mackerel quotas has also had an impact on other parts of the fisheries sector, as it once again became possible to conclude bilateral agreements with Norway and the EU on other species. Faroese vessels may now fish in the Barents Sea again, which is of significance to demersal fishing for cod and haddock in particular. This is especially important since catches of these two species in Faroese waters are very low and according to the Faroe Marine Research Institute the outlook for the coming years is not good.

PUBLIC FINANCES

Public finances have shown deficits since 2008, but they are falling. One reason is that disbursements from the mandatory unemployment fund have decreased due to falling unemployment and the tightening measures introduced in 2012. Taken as one, local government finances have been balanced in recent years, while the pension funds, which are still being built up, have posted surpluses. Most of the government deficit is therefore attributable to the central government, which in 2013 posted a deficit of kr. 413 million, equivalent

Main items of the government accounts Table 3

Kr. million	2010	2011	2012	2013	2014[1]
Taxes and duties, etc.	3,489	3,705	3,610	3,686	3,965
Other income	40	113	33	63	92
Block grant	616	616	624	632	635
Total income	4,145	4,433	4,268	4,381	4,692
Operating costs	4,500	4,541	4,375	4,463	4,558
Fixed investments	169	150	182	237	277
Net interest expenses	57	65	45	94	80
Total expenses	4,726	4,756	4,602	4,794	4,915
Budget balance	-581	-322	-335	-413	-223
Gross government debt, year-end	4,954	5,604	5,417	6,102	n.a.

Source: High Commissioner of the Faroe Islands.
1. Data from the Finance Act 2014, realised data (accounts) for other years.

to 2.9 per cent of GDP, cf. Table 3. Assessed on the basis of central government revenue in the 1st half of 2014, the deficit is set to be smaller than budgeted for in the 2014 Finance Act.

The Faroese government has decided that the central government budget must show a surplus from 2016. With the economy picking up and the potential for considerable revenue from resource taxes, it is not impossible that this target can be met. However, revenue from resource taxes is linked to developments in the fisheries sector and hence it may fluctuate considerably over time. At present, both pelagic fishing and aquaculture are doing extremely well, so government revenue is higher than usual. This means that any surplus posted in 2016 will not reflect the underlying position of the public finances. Consequently, further measures should be taken to structurally strengthen central government finances, especially since the government changed the rules for taxation of pensions with effect from 2012, so that they are now taxed at the time of contribution, not at the time of disbursement. This will boost revenue these years, but reduce revenue in later years. Thus, the deficit is reduced now without the sustainability of public finances having been improved. This highlights the need to take the structural balance into account when planning fiscal policy.

ECONOMIC OUTLOOK

The outlook for the Faroese economy is closely linked to fisheries and aquaculture, for which both volumes and prices may fluctuate considerably over time. This is a fundamental condition in an economy that is so heavily dependent on fish, but diversification of fish exports on more species increases robustness.

Agreement with other parties on mackerel and herring quotas means that Faroese fishermen are no longer restricted to catching these species in periods when they are found in Faroese waters. Instead, they can catch them when the quality is optimum and the best price can be achieved. The fishing capacity can also be utilised better. This provides a considerable potential for increased earnings from pelagic fishing, and the lifting of the EU trade sanctions will also provide renewed access to the lucrative European market.

Uncertainty in the fisheries sector has been reduced after agreement was reached regarding the mackerel and herring quotas. But according to the sector it is still a source of major uncertainty that all Faroese fishing licences will, in principle, be revoked in 2018 and may then be politically reallocated. This makes it less attractive to invest since quota access after 2018 is uncertain. Likewise, it is more difficult to attract external funding.

Domestic demand will presumably pick up. Households have consolidated in recent years, and combined with low interest rates this provides a good point of departure for increased private consumption. The most recent data points to an increase after some stagnant years. The construction sector is also recovering after a number of weak years, supported by e.g. large planned construction projects in the coming years.

The improved economy is reflected in public finances. This increases the risk that the central government will not introduce the measures required to ensure sustainable public finances. Such measures are particularly important since the Faroe Islands – like other western economies – are faced with an ageing population, which increases spending pressures. Unsustainable fiscal policy could lead to a lower credit rating and higher interest rates.

A considerable number of Faroese people live in the Faroe Islands, but work abroad. As the Faroese economy gathers steam, a shortage of labour could rapidly emerge, especially if the number of people working abroad rises. It can be difficult to turn this development, one reason being that wages are higher abroad. However, the government can limit the tax advantages of working abroad. Besides reducing the risk of overheating, this will also increase tax revenue, which could help to improve the underlying position of the public finances.