

# DANMARKS NATIONALBANK

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## THE FAROESE ECONOMY

# Mounting pressures in the labour market



### Labour market under pressure due to high demand

Larger catches and high salmon prices have resulted in higher private and public investment and consumption since 2013. Pressures in the labour market have increased over the past year, which may lead to overheating of the economy.



### Fiscal policy should stabilise the economy

The 2019 Finance Act should dampen demand in order to mitigate the risk of overheating. The possibilities of pursuing stabilising fiscal policy will improve if the framework of local government finances is tightened.



### Fiscal policy must be prepared for the future

The ageing of the population over the next decades makes fiscal policy unsustainable. This should be addressed now by increasing the labour supply or tightening fiscal policy.

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### The boom appears to be continuing

The Faroese economy is booming, and labour market pressures are high. Strong increases in the price of farmed salmon and larger catches of particularly mackerel and herring have been the strongest drivers of growth since 2013. This has led to higher incomes, which in turn has resulted in increased private and public demand. Hence, employment has risen considerably. This trend continued into the 1st half of 2018, when the rise in waged employment continued unabated, cf. Chart 1.

Although employment has continued to rise, the outlook is for decreasing growth in the nominal gross domestic product, GDP. Búskaparráðið, the Economic Council for the Faroe Islands, ECFI, expects nominal GDP growth to be around 2 per cent in 2018, cf. ECFI (2018). This is a considerably lower growth rate than seen in the past five years when GDP increased by just under 7 per cent annually in nominal terms. But the number of unemployed people is low and continues to fall, so the risk of the economy overheating remains.

The slowdown in GDP growth is partly attributable to deterioration in the terms of trade due to lower salmon prices combined with higher oil prices. Still, lower salmon production and an expected decline in fish catches also have an effect. For that reason, the lower rate of GDP growth in current prices in 2018 is only a limited indication that the increase in real economic activity in the Faroe Islands has abated. In

the slightly longer term, lower increases in income may reduce growth in private and public demand. In such case, lower demand would ease labour market pressures.

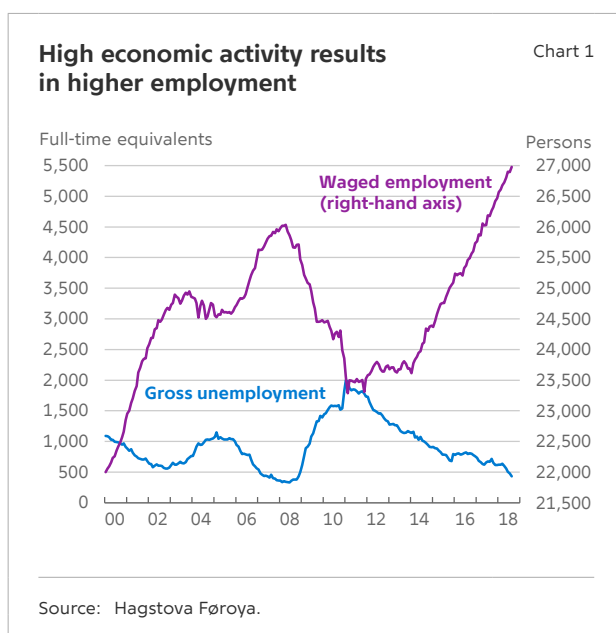
Rising employment and low interest rates have increased household disposable income considerably. At the same time, sizeable wage increases and the low rate of consumer price inflation have further supported household purchasing power, cf. Chart 2. The development in private consumption has been subdued relative to previous upswings, however.

But over the last year, demand for e.g. cars and other consumer durables has contributed to increasing imports, cf. Chart 3. This indicates growth in private consumption. Since August 2017, due to the upward trend in imports combined with lower fish exports, the trade surplus has been reduced by half to kr. 750 million (4 per cent of GDP).<sup>1</sup>

### Fiscal policy amplifies labour market pressures

The Faroese economic upswing has generated a considerable increase in central and local government tax revenue. But expenditure for e.g. more public employees has grown at the same time, so the surplus on the public sector current, investment and lending accounts has not increased sufficiently in view of the booming economy.

The increase in the number of public employees has coincided with a rise in private sector employment,



### Facts about the Faroe Islands

Population (September 2018)	51,060
Gross domestic product, GDP (2017, kr. billion) <sup>1</sup>	18.9
per capita <sup>2</sup> (kr. '000)	376.6
Currency	Danish kroner

Source: Hagstova Føroya, Statistics Denmark, Búskaparráðið and own calculations.

- GDP is an estimate from Hagstova Føroya and Búskaparráðið.
- By comparison, GDP per capita in Denmark was kr. 373,000 in 2017.

<sup>1</sup> The most recent current account figures for 2015 showed a surplus of almost kr. 1.5 billion.

**Wages are rising faster than consumer prices**

Chart 2

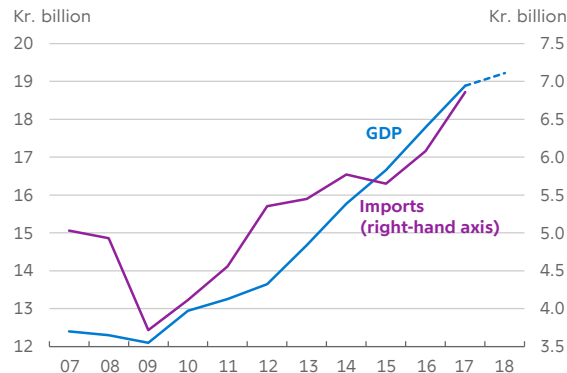


Note: The rise in wages is calculated by distributing the payroll costs on the number of wage earners. Accordingly, changes in working hours or the distribution on types of labour have not been taken into account. The growth contribution from interest expenses for housing is not included in consumer prices.

Source: Hagstova Føroya.

**Growth in imports has accelerated in recent years**

Chart 3



Note: Imports exclude ships and aircraft, which vary strongly, and are retrieved from foreign trade statistics. GDP is a forecast for 2016-17 and ECFI's projection in 2018.

Source: Hagstova Føroya, Búskaparráðið and own calculations.

cf. Chart 4. This has increased labour market pressures. At the same time, publicly initiated investments in e.g. infrastructure which is funded by debt via publicly owned companies, have increased by more than 20 per cent p.a. since 2016, cf. ECFI (2018).

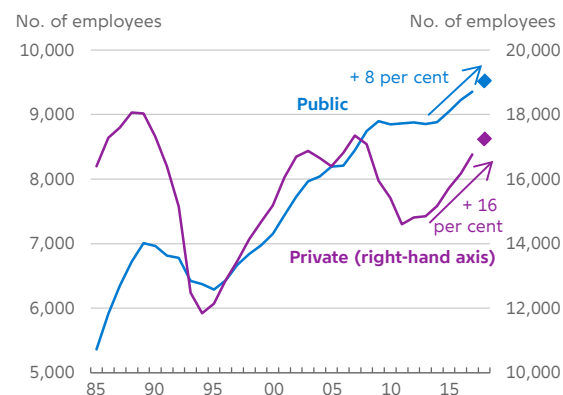
The Faroese government should ensure tighter fiscal policy to reduce pressures on the labour market. So it is positive that the Faroese government has proposed postponing a number of building and construction projects in connection with the tabling of its finance bill for 2019. In addition, central and local government should consider whether some of the large planned investment projects in publicly owned companies can be postponed. New initiatives increasing operating costs in central and local government should be financed by a permanent tax increase or savings in other areas.

The fact that public sector consumption and investments contribute to amplifying labour market pressures during a Faroese boom period is not a new phenomenon. ECFI calculations have shown that fiscal policy has historically amplified fluctuations in the Faroese economy, cf. ECFI (2015b).

In local government in particular, operating costs are rising in step with tax revenue. This is partly attributable to the institutional framework. Unlike in Denmark's

**The public sector has amplified the upswing**

Chart 4



Note: "Private" indicates employees who are not working in public administration, training and education or health-care. Observations for 2018 are averages for the first eight months of the year.

Source: Hagstova Føroya.

case, annual budget agreements are not concluded between central and local government to determine the budgetary limits for growth in local government expenditure. Limitations apply only to local government's access to raising debt. The cyclical position of the economy is not taken into account.

It would be expedient to reform the fiscal policy framework to allow determination of Faroese central and local government budgets by binding agreements. This could contribute to stabilising economic developments in future.

### Labour shortage

Employment has risen by 14 per cent since mid-2013. One in four new jobs was created in the construction and public sectors, respectively. But the public sector actually makes up a larger share of the rise in economic activity. The reason is that part of the higher employment rate in e.g. the construction sector is attributable to very large public port and tunnel construction projects.

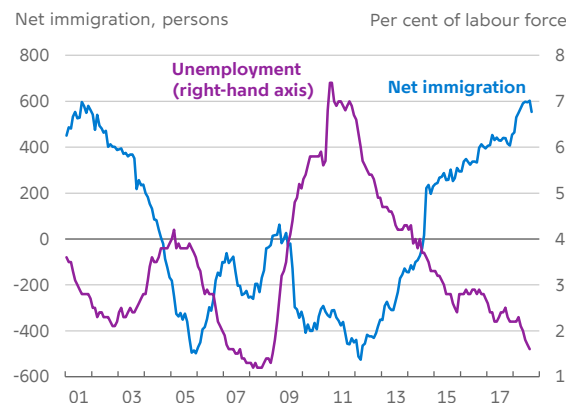
Among other factors, increasing numbers of tourists have contributed to approximately 35 per cent employment growth in the hotels and restaurants sector since the beginning of 2017. To this must be added derived effects on other sectors and rental of private homes. Although the tourist industry remains small, it contributes positively to the diversification of the Faroese economy.

Higher employment also forced unemployment down to 1.6 per cent in August. This is the lowest level in 10 years, indicating a tight labour market. However, the Faroese are more likely than other populations to respond to changes in the economic conditions by immigrating or emigrating, so the level of unemployment is not directly comparable with unemployment figures in Denmark, for example. So – as was the case during previous upturns – good employment opportunities in recent years have increased the labour force, especially due to immigration of Faroese people living abroad, cf. Chart 5.

The low level of unemployment is a challenge to firms, which are increasingly stating that shortage of labour is an impediment to production. Construction is a case in point, cf. Chart 6. For example, it can make it more difficult to attract labour to build housing, which is important in order to dampen the rise in house prices in Tórshavn caused by considerable net migration to the Faroe Islands.

**Low unemployment induces Faroese people to return home**

Chart 5

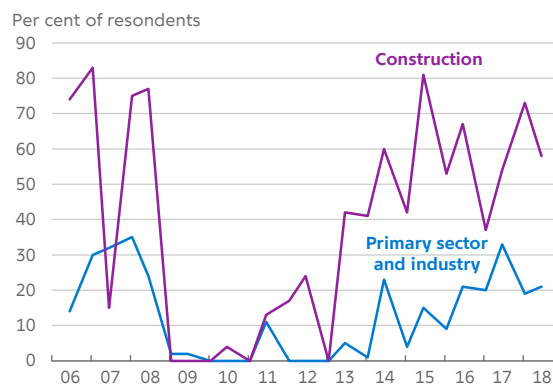


Note: Net immigration mainly consists of Danish nationals, which indicates that Faroese people living in Denmark are moving back home.

Source: Hagstova Føroya and own calculations.

**Firms experience labour shortage**

Chart 6



Note: Share of firms in the sector stating that shortage of labour is an impediment to production.

Source: Hagstova Føroya.

### Rising salmon prices in particular have increased exports

The strong increase in Faroese exports has been driven by a combination of favourable conditions in aquaculture and fisheries.

Record high farmed salmon output has been sold at high prices in the last five years, cf. Chart 7. The largest fish farm, Bakkafrost, expects a steady increase in output in the coming years. This will take place in step with its implementation of large investments in onshore facilities to expand production capacity by extending the onshore farming period, cf. Bakkafrost (2018).

Higher global output has recently reduced prices after a number of years with disease problems in Chile, among other countries, cf. the United Nations (2018). Global demand remains strong, and export prices for salmon during the summer were still 40 per cent higher than in 2013. In future, the expected production capacity expansion in the Faroe Islands may compensate for any further fall in salmon prices in the world market.

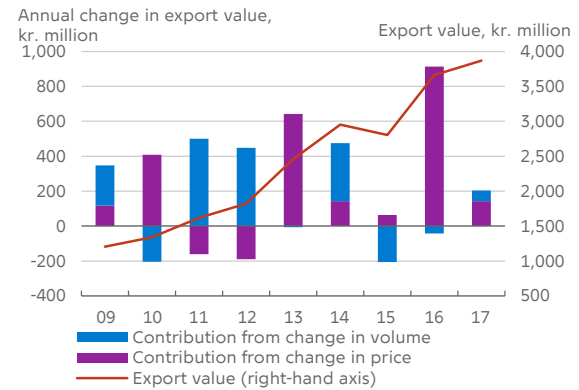
The fisheries sector has benefited from large catches, for which sales prices have also been higher in the last couple of years, cf. Chart 8. This positive trend has mainly been driven by fishing for e.g. mackerel and herring, known as pelagic fish. On the other hand, traditional fishing for demersal fish such as cod, haddock and saithe has been financially squeezed in recent years due to smaller catches and low prices, cf. High Commissioner of the Faroe Islands (2018).

However, pelagic fish catches were generally slightly lower in 2018 relative to previous years. This is attributable to smaller quotas because stocks of especially mackerel and herring are smaller according to advice from international marine biologists from the International Council for the Exploration of the Sea, ICES, cf. ICES (2018a, 2018b, 2018c). The advice suggests that mackerel quotas should be further reduced in 2019, while catches of herring can be increased.

Overall, quotas for demersal fishing in Faroese waters were unchanged in 2018. Quotas for 2019 have not yet been fixed, but stocks of cod and haddock, in particular, are developing positively, cf. ICES (2018d, 2018e, 2018f).

### Salmon prices have risen considerably since 2013

Chart 7

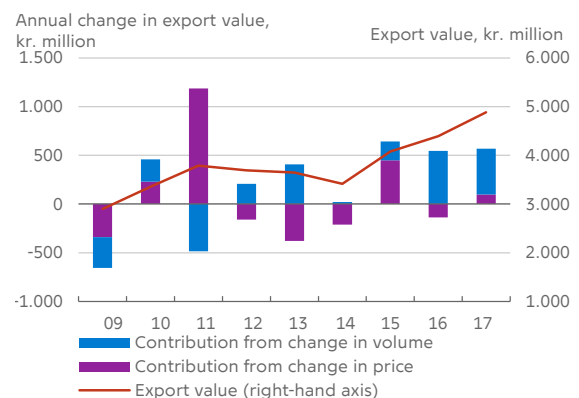


Note: Annual changes in exports are broken down by changes in price and volume and are approximative.

Source: Hagstova Føroya and own calculations.

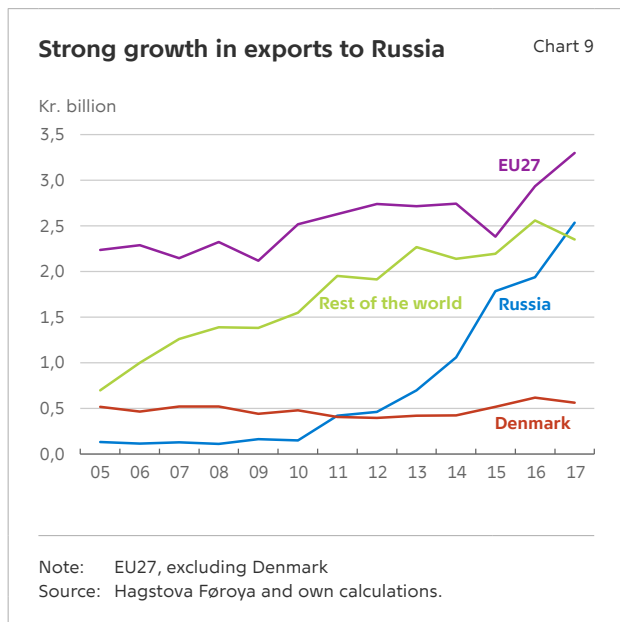
### The fisheries sector has benefited from better catches during the upswing

Chart 8



Note: Annual changes in exports are broken down by changes in price and volume and are approximative. Fish exports, excluding salmon.

Source: Hagstova Føroya and own calculations.



Recent years' growth in fish exports has taken place mainly in the Russian market, cf. Chart 9. This reflects improved market access after Russia introduced a trade embargo on food from the EU and a number of other countries in response to those countries' sanctions against Russia. The Faroe Islands are not in the EU and consequently not subject to the embargo. It has also led to rising sales prices for Faroese fish. As a result, Faroese exports are potentially vulnerable to normalisation of trade between Russia and the EU. Overall, Faroese exports are more geographically diversified today than 15-20 years ago.

In June, the Minister for Industry, Business and Financial Affairs increased the capital requirements for banks with financial exposures in the Faroe Islands, i.e. the systemic risk buffer rate, cf. Ministry of Industry, Business and Financial Affairs (2018). The purpose of the buffer is to make the banks more resilient to large fluctuations in the Faroese economy. Potentially, the fluctuations may be large, since the business structure makes the economy highly dependent on fish exports, cf. Box 1.

### The housing market is still growing

The low interest rates and the rise in household disposable income have buoyed up the housing market in recent years, cf. Chart 10. Price increases have been strongest in Tórshavn, because considerable migration to the Faroe Islands has increased demand for housing especially in the Islands' main town.

### High degree of dependence on fish makes the economy vulnerable

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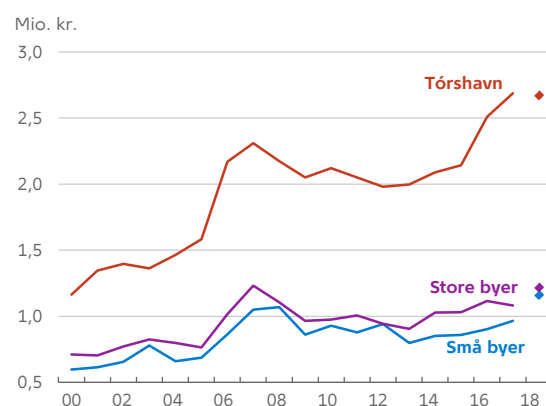
The Faroese economy is small, open and based on commodity exports concentrated on fish products. Thus, fisheries and aquaculture account for one sixth of total gross value added in the Faroe Islands and practically all exports of goods. This means that activities in the Faroe Islands are sensitive to changes in fish stocks and prices. Both fluctuate considerably over time, but not necessarily in the same direction for the various branches of fisheries and species.

Earnings are increasingly diversifying across different branches of fisheries, which to some extent helps to reduce the vulnerability of the economy overall. Moreover, the Faroe Islands have a number of bilateral agreements allowing them to fish in other countries' waters, cf. Malthe-Thagaard (2017). This may, for example, reduce dependence on the size of fish stocks in Faroese waters and makes the economy less vulnerable to fluctuations of such stocks. Furthermore, growth in aquaculture and tourism is likely to result in a more stable economy.

Nevertheless, the overall picture is that the economy will fluctuate strongly from time to time. The decline in fisheries may also, via direct and indirect effects, entail losses in the banking sector and further amplify real economic fluctuations. This underscores the importance of pursuing a stability-oriented economic policy.

### House prices have risen the most in Tórshavn during the boom

Chart 10



Note: Average price of houses traded, partly adjusted for property characteristics to ensure that it reflects price developments for a normal house. 2018 comprises the 1st half of the year only, so the number of transactions is limited.

Source: Hagstova Føroya and Betri Heim.

But according to the most recent figures, which are subject to substantial uncertainty, the housing market growth may have spread to the rest of the Faroe Islands. At the same time, housing prices in Tórshavn have slowed down a little.

Rising house prices may result in higher growth in lending to households. House prices are leading indicators of credit growth in a number of other countries, including Denmark, cf. Grinderslev et al. (2017). Until now, growth in lending by Faroese and Danish banks to both households and the corporate sector in the Faroe Islands has been subdued.

This means that this upswing is more robust than previous upswings. However, some private and public sector firms finance their investments by foreign borrowing, which is not stated in the balance sheets of Faroese and Danish banks.

#### **An ageing population puts pressure on public finances**

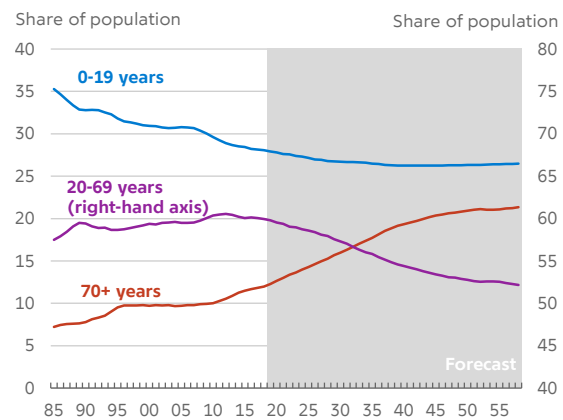
Like many other countries, the Faroe Islands are facing large challenges in terms of balancing government expenditure and revenue in the future. One reason is the ageing of the population, which will increase expenditure for pensions and healthcare, cf. Chart 11. At the same time, tax revenue will fall due to fewer people of working age.

The Faroe Islands are likely to face slightly larger public finance challenges than many other countries, however. For instance, the number of people of working age is approximately 5 percentage points lower than in Denmark, cf. Ellermann-Aarslev et al. (2018). According to population projections, this difference will increase towards the mid-century. Although the high fertility rate of Faroese women will eventually increase the number of people of working age, in the projections the average net annual emigration since 1985 is assumed to continue, cf. ECFI (2015a).

Projections of population figures are obviously subject to uncertainty, especially when it comes to the fertility rate and net immigration. However, this does not change the overall picture of strong demographic headwinds for the Faroese economy. Accordingly, the government deficits are expected to increase steadily over the next 40 years, unless the central government introduces reforms.

#### **Stronger demographic headwinds**

Chart 11



Source: Hagstova Føroya and own calculations.

In 2015, ECFI estimated that a permanent fiscal improvement of 5 per cent of GDP will be required in order to stabilise the net government debt.

#### **A higher retirement age is not enough to solve the problem**

There is considerable potential for increasing employment among persons over the current retirement age of 67 years. They have significantly less attachment to the labour market than the rest of the adult population, cf. Chart 12. In 2018, the Løgting (parliament) therefore decided to raise the retirement age by a year towards 2030. After that year, the retirement age will be linked to life expectancy. As a cap applies, the retirement age can rise no more than six months every five years, however. The rise in life expectancy has risen by 12 months every five years over the past 20 years. If this trend continues, the cap of the indexation rule means that the number of years in retirement will continue to grow.

Under the current rules, the retirement age will be 70 years in 2050, if life expectancy continues to increase at the same pace as it has so far. By comparison, the retirement age in Denmark is expected to be 72 years, cf. Ministry of Finance (2018). The partial indexation to life expectancy is an important step in the right direction towards ensuring sustainable fiscal policy. However, in 2015 ECFI estimated



that an increase in the retirement age of the planned magnitude would solve only just under one quarter of the sustainability problem.<sup>2</sup>

The booming economy and large profits in the fish-related industries make this a good time to address the challenges of fiscal sustainability.

Apart from raising the retirement age, there is no large potential for increasing the participation rate. Labour market participation for both men and women is already higher than in many other countries, cf. Chart 13. Although the participation rate of women is high, more than half worked part time in 2013. Accordingly, there may be a limited potential for increasing the supply of labour by increasing women's working hours.

### Higher taxation may contribute to sustainability

Tax system changes may also contribute substantially to ensuring fiscal sustainability. The tax burden is lower in the Faroe Islands than in Denmark.

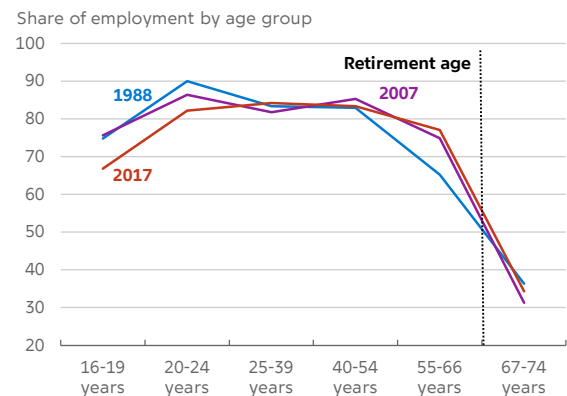
First of all, the Faroese government should ensure that it gets a larger share of the "economic rent" from the Faroe Islands' fisheries resources. Due to its cheap access to fishing rights, the fisheries sector may generate higher profits than firms in an open and free market subject to similar risk. It may also result in higher wages for employees on the fishing vessels concerned than for employees in other sectors when any risks and inconveniences associated with working on a ship are taken into account.

In December 2017, the Løgting adopted a quota allocation reform allowing a limited share of fish quotas to be sold by auction, cf. Box 2. This is a good step towards a more market-based system providing the central government with a larger share of the economic rent. The resource tax levied on the remaining quotas is still not linked to the market price determined by the auctions. The auctions could be made more flexible and efficient by increasing the share of quotas offered and by giving non-residents bidding access.

Overall, there is potential for increasing central government revenue from fisheries. This may be an important contribution to fiscal sustainability over the coming decades.

### Higher retirement age may increase the labour force

Chart 12

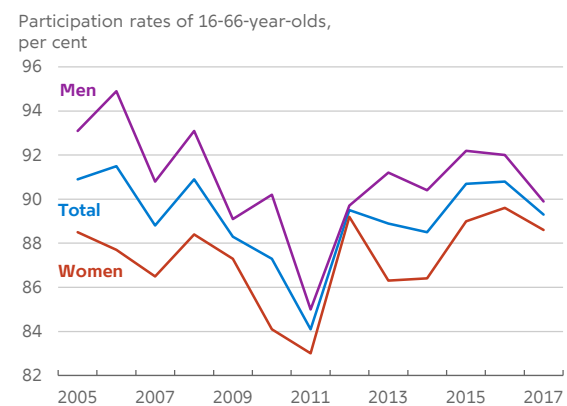


Note: Share of employees within each age group. Hence, the figures do not allow for people working abroad who are not taxable or who are self-employed.

Source: Hagstova Føroya and own calculations.

### Many people of working age in the labour force in the Faroe Islands

Chart 13



Source: Hagstova Føroya and own calculations.

<sup>2</sup> ECFI (2015a) estimated that an increase in the retirement age from 67 to 72 towards 2048 can improve sustainability by 1.9 per cent of GDP.



### Fisheries reform

Box 2

The principles of the reform closely resemble the Faroese government's proposal reviewed in last year's analysis, cf. Malthe-Thagaard (2017).

For a number of fish species, however, the share of quotas sold by auction has been reduced from 25 to 15 per cent. If the quotas are larger than in 2018, all additional quotas will be sold by auction. Under the new rules, non-residents are not allowed to own quotas. The transition period for phasing out foreign ownership of Faroese fish quotas has been extended from four to six years relative to the original proposal.

The Faroese tax system can also be adjusted in a number of other areas to ensure sufficient tax revenue if future cuts in public sector services are to be avoided.

Faroese homeowners pay neither land nor property taxes. Moreover, the central government pays 35 per cent of interest costs on housing loans by subsidies up to a ceiling of kr. 100,000. As a result of the low interest rates, the ceiling is binding only for fully leveraged homes at approximately kr. 10 million. Very few homes cost that much in the Faroe Islands. The favourable tax conditions for homeowners keep house prices up.

The high house prices make this a good time to implement a reform to reduce subsidies for interest costs and introduce housing taxation. Overall, this could contribute to improving public finances. At the same time, housing taxation could increase housing market stability if structured in such a way as to ensure that tax payments are linked to housing market prices, cf. Hviid and Kramp (2017).

A large number of Faroese people live in the Faroe Islands but work abroad, attracted by higher wages and considerable tax deductibility. The Faroese government may reduce the deduction, thereby increasing tax revenue and countering the shortage of labour. This could ensure better consistency with the separation allowance costs actually associated with working abroad and maintaining their primary residence in the Faroe Islands.

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## ABOUT ANALYSIS



As a consequence of Danmarks Nationalbank's role in society we conduct analyses of economic and financial conditions.

Analyses are published continuously and include e.g. assessments of the current cyclical position and the financial stability.

The analysis consists of a Danish and an English version. In case of doubt regarding the correctness of the translation the Danish version is considered to be binding.

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