

# DANMARKS NATIONALBANK

16 DECEMBER 2020 — NO. 29

## THE FAROESE ECONOMY

# The Faroese economic boom is losing momentum



### Labour market pressure despite lower growth

Employment in the Faroe Islands is high, unemployment is very low, and parts of the economy are hit by labour shortages. However, exports have slowed this year, and the economic boom seems to have peaked.



### Framework conditions are key to growth potential

Productivity has been improving for several years, underpinned by fisheries and trade policies, among other factors. Framework conditions must ensure continued productivity gains. An important element in this respect is labour market flexibility.



### Solution to long-term challenges should not be pushed ahead

The possibility of funding the higher level of service in recent years is challenged by an increasing elderly population and a decrease in working-aged people. Reforms that balance expenditure and revenue in the future are important, and should already be prioritized now.

## CONTENTS

- 2 INTRODUCTION AND SUMMARY
- 4 FAROESE ECONOMY RELIES ON FISH EXPORTS
- 6 CONSUMPTION SUPPORTED BY LABOUR MARKET DEVELOPMENTS
- 9 HOUSEHOLD AND CORPORATES HAVE BUILT UP BUFFERS
- 11 BOTH SHORT-TERM AND LONG-TERM CHALLENGES FOR PUBLIC FINANCES

## Introduction and summary

The Faroese economy has been booming for several years. Larger catches and increasing prices have led to high export revenue and boosted incomes to Danish levels, see Chart 1.

The favourable economic growth has been underpinned by considerable productivity gains. Activity has been concentrated on fewer farms and shipping companies, both in aquaculture and in the pelagic fisheries,<sup>1</sup> making these industries more profitable.<sup>2</sup>

Faroese corporations and households have taken advantage of growth to consolidate. In contrast to the years leading up to the financial crisis, they were braced for the economic shock that has hit both the Faroese and the global economy this year in form of the coronavirus pandemic.

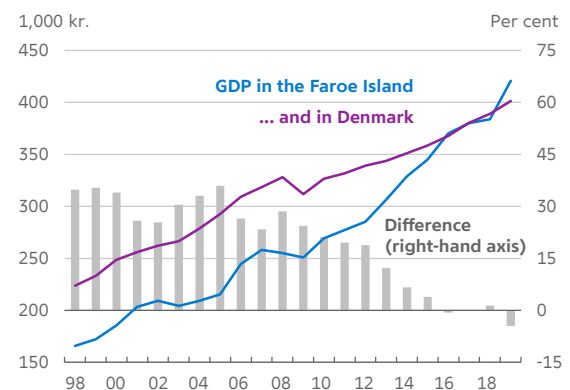
The coronavirus reached the Faroe Islands in March. The public health crisis quickly rippled through to the Faroese economy, where short-term measures taken to contain the infection, similar to the Danish ones, weighed on economic activity. The Faroe Islands implemented an effective containment strategy, reducing the need for long-term, austere measures to prevent the spread of infection, see Chart 2.

### Business structure has underpinned the boom

The coronavirus outbreak has taken a toll on the tourism industries across the world, and the Faroe Islands are no exception. But the tourism industries make up only a small part of the Faroese economy – the economy is concentrated on fish exporting industries. Demand for fish, and food in general, is less cyclical than for many other products. This makes Faroese exports less exposed to global economic fluctuations.

The global economic downturn and uncertainty surrounding the outlook have put a damper on fish prices. But the aquaculture sector and fisheries

**Big prosperity gains in the Faroe Islands during expansion** Chart 1

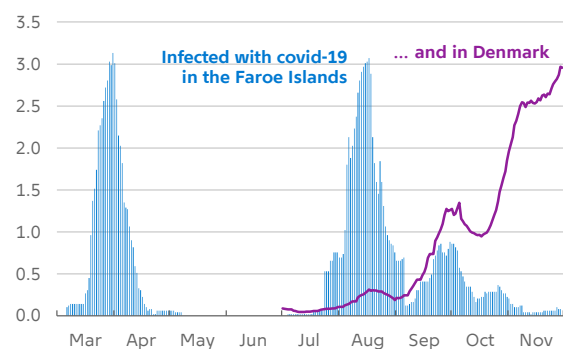


Note: Current prices. GDP for 2019 in the Faroe Islands is an estimate from Hagstova Føroya and Búskaparráðið.

Source: Statistics Denmark, Hagstova Føroya and own calculations.

**Rapid containment of coronavirus in the Faroe Islands** Chart 2

Number of new infected cases, 14-day sum, per thousand of the population



Note: The infection rates for Denmark are shown starting on 1 July due to test strategy differences in the 1st half.

Source: Landslæknin, Hagstova Føroya, Statens Serum Institut (SSI), Statistics Denmark and own calculations.

<sup>1</sup> Pelagic fish are species that live in the water column (non-demersal species) such as mackerel and herring.

<sup>2</sup> During the expansion, return on equity (ROE) for fisheries and aquaculture has risen, while the number of corporations has declined. See Hagstova Føroya accounts statistics.

have used existing supply chains to convert a large portion of their sales from restaurant customers to retail trade customers. At the same time, corporate investment appetite has remained intact as corporations were well consolidated before the coronavirus outbreak. This has kept the Faroese economy afloat.

The economy has also been underpinned by labour market compensation schemes this year. Some parts of the economy are enjoying strong demand, and the construction sector is recording wage growth of about 4 per cent and labour shortages. In September, the wage cost compensation scheme had been phased out, and levels of both employment and unemployment were more or less back at pre-pandemic levels, see Chart 3. So, the Faroese economy is still booming – despite this year’s fluctuations.

According to international organisations, the global economy has now entered a recession and a long and uncertain recovery lies ahead.<sup>3</sup> This impacts the outlook for a small open economy like the Faroese. Although exports are less cyclical, fish prices are squeezed by weakened purchasing power in export markets and elevated uncertainty. This means that the export industries will be looking at slightly lower earnings in the coming years, and that the Faroese boom has probably peaked.

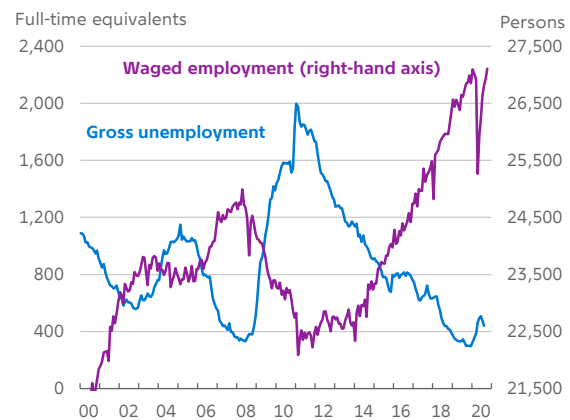
### Ageing population challenges public finances

Public finances have had room to absorb this year’s higher expenditure, and this has helped to stabilise the economy. By international standards, the Faroese government debt is modest, and financing of the wage compensation scheme through the unemployment fund has helped to limit the central government’s corona-related expenditure. Healthy public finances, with buffer-building when times are good, are key to being able to pursue a stability-oriented fiscal policy.

In the longer term, the ageing Faroese population will weaken the sustainability of public finances. To maintain the high level of service to citizens established over a number of years, the Faroese government must prioritise this issue in due course. Expanding the tax base is a way to improve sustainability.

Unemployment remains very low

Chart 3



Source: Hagstova Føroya.

<sup>3</sup> International Monetary Fund, A Long and Difficult Ascent, *World Economic Outlook*, October 2020 ([link](#)).

## Faroese economy relies on fish exports

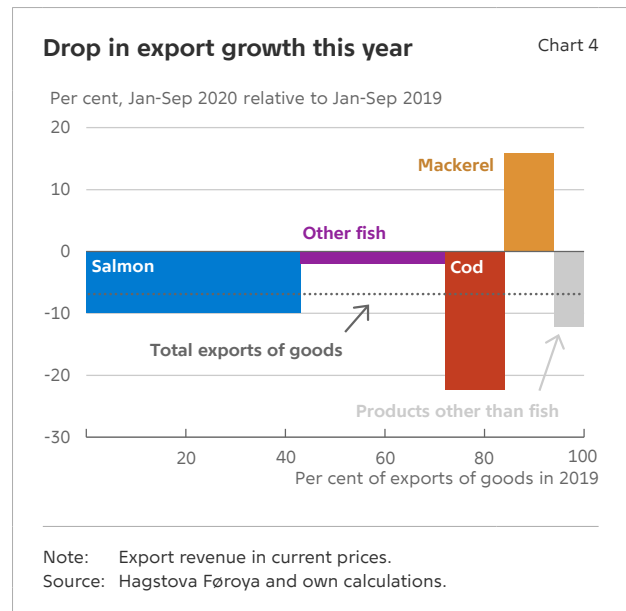
Fisheries and aquaculture are the driving forces of the Faroese economy, with fish exports accounting for more than 95 per cent of goods exports. The tourism industries have been booming in recent years, but still account for only about 2 per cent of GDP.<sup>4</sup> This means that the Faroese economy is one-pronged and exposed to supply shocks such as weather conditions and fish stock changes.<sup>5</sup> Still, the export industries have some resilience – mainly because fish exports are less sensitive to global cyclical fluctuations, which is a general characteristic of food.<sup>6</sup>

Moreover, aquaculture, pelagic and demersal fisheries can, to some extent, be seen as separate sectors. Therefore, activity growth is not necessarily uniform across fish species. In addition, these sectors have been expanding their sales channels over recent decades, making them more diversified in terms of both geography and product types. As a result, the Faroese economy is believed to be more resilient now than it was 10 or 15 years ago.

### Fish exports have peaked for now

During the first nine months of the year, the value of exports of goods decreased by 7 per cent compared to last year, dragged down by salmon and cod, see Chart 4. However, the decline in exports should be seen in the context of strong growth in 2019. Búskaparráðið, the Economic Council for the Faroe Islands, estimates that GDP in current prices expanded by 11 per cent in 2019,<sup>7</sup> driven particularly by fish exports.

This year's decline in exports especially reflects the steep increase in export market uncertainty caused



by the coronavirus outbreak in Western economies. Temporary factors led to stockpiling, subsequently putting downward pressure on prices.

However, the export industries quickly managed to convert sales from hard-hit industries to growing industries, shifting large sales volumes from restaurants and catering to processed retail products. This conversion prevented a large drop in volumes, but sales have occurred at lower prices.

So, the decrease in export revenue primarily reflects that fish has been selling at lower prices. However, overall world trade has declined by close to 11 per

<sup>4</sup> In 2017, tourism accounted for 2.1 per cent of gross value added (GVA). See Hagstova Føroya, Vitjandi ferðafólk, 2011 to 2018, Búskaparískoyti, May 2019 (only in Faroese, [link](#)).

<sup>5</sup> See Box 2 in Sune Malthé-Thagaard and Flora Nagy, Labour market squeezed by very low unemployment, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 22, November 2019 ([link](#)).

<sup>6</sup> For the cyclical nature of food in Denmark, see Adrian Michael Bay Schmith and Helle Eis Christensen, Large drop in Danish exports, but the composition might ease the fall, *Danmarks Nationalbank Economic Memo*, No. 8, June 2020 (only in Danish, [link](#)).

<sup>7</sup> From 2013 to 2018, GDP in current prices, on average, expanded by just under 6 per cent per year.

cent in value, so the 7 per cent drop is more limited. The global recession is likely to weaken the purchasing power of export markets going forward, putting a damper on prices. But Faroese corporations benefit from having consolidated in recent years. Both return on equity (ROE) and equity financing increased sharply during the expansion, see Chart 5, and, at the same time, lending grew at a slower pace than the economy as a whole.<sup>8</sup> This means that corporations are braced for slightly lower prices.

### Framework conditions are key to the growth potential

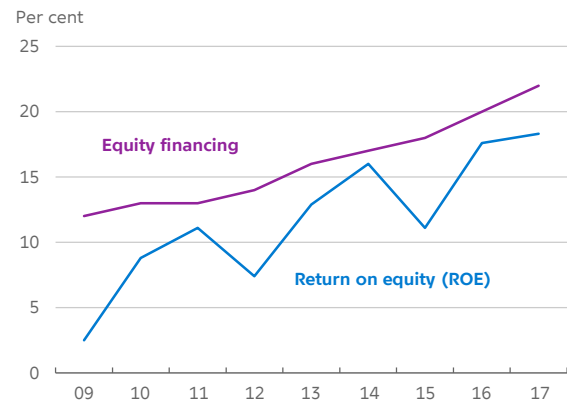
Framework conditions that facilitate export industries' ability to deliver productivity to match that of global competitors are essential to the economy – for instance by ensuring good and stable market access and sustainable and concentrated fisheries.

Trade and fisheries agreements are a precondition for enabling export industries to achieve high earnings. At a time of ever-growing globalisation pressures, the Faroese government's trade agreement work is becoming increasingly important. Following the UK's exit from the EU, yet another coastal country will take a seat at the multilateral negotiating table. This adds to the uncertainty about future agreements, although the Faroese government has negotiated and, for now, achieved an extension of the current conditions with the UK. If new trade agreements with large countries can be achieved, this will help make the Faroese economy more resilient by further diversifying export sales opportunities.

In January, the Løgting (parliament) adopted a new fisheries reform, see Box 1. Fisheries policy should sustain high productivity of fishing by furthering the transferability of fishing quotas and fishing rights, helping, for instance, to concentrate the fishing fleet.<sup>9</sup> It is essential for the profitability of a resource industry such as fisheries to support long-term, productivity-improving investments, thereby ensuring optimal use of the natural resource. Excess capacity in fisheries erodes the profitability of the industry, and should be prevented by regulation.

### Corporations consolidated during the expansion

Chart 5



Note: Equity financing is non-financial corporations' ratio of equity to total liabilities. Return on equity (ROE) is the ratio of return to this equity.

Source: Hagstova Føroya and the Systemic Risk Council, Requirements for Faroese Banks, Analysis, March 2020.

### New fisheries reform in the Faroe Islands

Box 1

On 21 December 2019, the Løgting adopted a new fisheries act, implemented at the turn of the year. The fisheries act includes the following:

- Abolition of auctions of quotas lasting up to eight years and introduction of fishing licences lasting up to 12 years.
- Expansion of foreign ownership possibilities from 0 to 25 per cent of fisheries.
- Wish for full transferability in fisheries, i.e. free trade in quotas and licences.

Through conversion of quota auction revenue to higher tax on catches, the new fisheries act is expected to generate roughly the same tax revenue as obtained in the previous two years.

Fisheries policy involves a number of allocation policy considerations. From a socio-economic perspective, it is important that fisheries are biologically sustainable, offering flexibility and transferability of fishing quotas and fishing rights.

<sup>8</sup> See Sune Malthe-Thagaard and Flora Nagy, Labour market squeezed by very low unemployment, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 22, November 2019 ([link](#)).

<sup>9</sup> See, for instance, Thor Bjørndal and Gordon R. Munro, *The Economics and Management of World Fisheries*, Oxford University Press, 2012.

### Tourism hit hard – prospects uncertain

While the manufacturing industries have largely escaped the economic shock, the tourism industries are hit hard by measures to contain the spread of infection as these measures restrict international travel.

The number of overnight stays in hotels and the like has dropped sharply, causing associated employment to plunge, see Chart 6. Indications are that, over the summer, employment increased at a higher rate than overnight stays, which could point towards a positive outlook for the future of this sector.

The decline in the number of bednights coincides with a capacity expansion by two new hotels, among other things, increasing the loss exposure of the tourism industries. The outlook for the tourism industries is uncertain and highly dependent on the course of the pandemic.

Tourism, although accounting only for a small part of the Faroese economy, has important spillover effects. For instance, tourism increases the diversity of the Faroese economy, making the islands less reliant on fish exports, and in the longer term, the industry may support income and employment in peripheral areas.

### Consumption supported by labour market developments

This year, domestic demand has helped to keep the economy afloat. Household consumption has been higher than normal, which should be seen in the context of travel restrictions and staycations, among other factors. Sales of both food and housing-related products were just under 13 per cent higher in the 2nd quarter than in the prior-year period, see Chart 7.

Higher domestic consumption is partly a consequence of the Faroe Islands' effective coronavirus containment strategy. Since 1 July alone, more than 165,000 tests have been performed, equivalent to three times the population size. Extensive testing capacity, used especially at Faroese borders, has enabled rapid detection of carriers of coronavirus infection. As a result, no restrictions, other than

**Sharp tourism drop squeezes the hotel and restaurant industry**

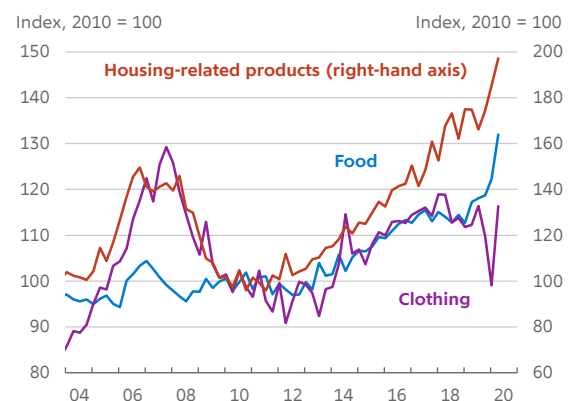
Chart 6



Note: Both series are three-month moving averages.  
Source: Hagstova Føroya and own calculations.

**Strong retail sales in the 1st half of 2020**

Chart 7



Note: The chart shows retail turnover figures in real prices.  
Source: Hagstova Føroya.

general hygiene recommendations, are currently imposed on the corporate sector.

Consumption has been supported by labour market compensation schemes related to the coronavirus pandemic, see Box 2. Wage subsidies for reduced working hours have helped to cushion income losses, keeping households afloat. And their consumption appetite has remained intact.

High consumption is boosting imports, given that just over 20 per cent of household consumption is imported from abroad. However, car imports dropped sharply in the spring and have not recovered the loss. The reason is that Faroese car imports are linked to the tourism industries, where the cars are used for rental services.

### Rapid labour market transition

The wage subsidy scheme for reduced working hours was used extensively. At its peak, more than 4,000 people were included in the scheme, equivalent to about 15 per cent of the labour force. The scheme helped to reduce job losses in service industries experiencing short-term drops in revenue.

Despite labour market compensation schemes, employment still decreased by 1,650 persons in April. The hotel and restaurant industry and transport businesses bore the brunt of the decline in employment in relative terms. However, in July, employment had already recovered to 2019 levels, but with a different composition. While the hotel and restaurant industry still has lower employment than in March, retail trade employment is up, see Chart 8. This pattern illustrates the flexibility of the Faroese labour market, where labour in industries set for a protracted decline has now shifted to growing industries.

### Faroese labour market has a built-in buffer

The short-term drop in employment in the spring did not translate into higher unemployment rates, but rather into lower employment rates. The reason is that a relatively high proportion of job losses was among young, elderly or non-ethnic Faroese, who are generally more likely to leave the labour force.

A general characteristic of the Faroese labour market is the cyclical sensitivity of its labour force. Faroese people with skills in construction and shipping are in demand abroad, which has contributed

## Relief packages for financially distressed households and corporations

Box 2

In the spring, the Faroese government adopted a number of relief packages targeted at households and corporations to address the coronavirus-induced economic uncertainty.

### Relief package 1

comprised corporate reimbursement for sick leave and a three-month deferral of VAT payments. Moreover, subsidies for reduced working hours were introduced, totalling up to kr. 20,000 per month, in the form of unemployment benefits and subsidies for self-employed people.

### Relief package 2

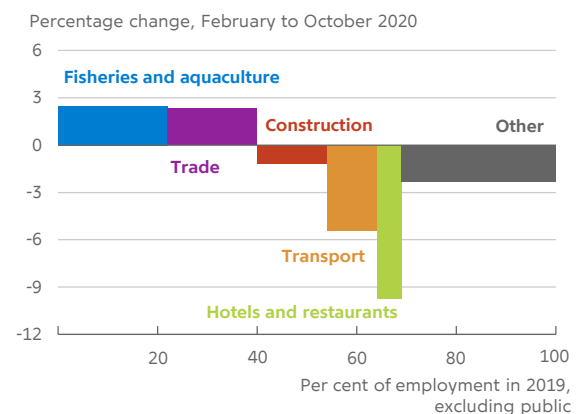
comprised subsidies to financially distressed corporations suffering coronavirus-related reductions in revenue. The wage subsidy scheme for reduced working hours (relief package 1) was extended to include working pensioners.

### Relief package 3

comprised targeted support to the tourism industry (hotels, travel agencies, transport, restaurants, experiences, etc.) and culture in the form of partial reimbursement of overheads. Moreover, Framtaksgrunnur Føroya, the Faroese Business Development Fund, offers kr. 30 million as venture capital for the tourism industry in 2020 and 2021.

## Rapid employment transition

Chart 8



Note: Fisheries and aquaculture include fish processing.

Source: Hagstova Føroya and own calculations.

to the flexibility of the labour force.<sup>10</sup> Employment changes in the Faroe Islands also reflect, to a greater degree than in many other countries, that young and elderly people join or leave the labour force.

Foreign labour also contributes to expanding the labour force in good times and reducing it when the economy reverses. This especially applies to unskilled labour, which helps to build a buffer in the labour market.

Internal labour market mobility in the Faroe Islands has generally been high. Over the last 20 years, employment intensity in fisheries has been trending down, meaning that many fisheries employees have had to convert to other sectors such as public or private service. This trend is expected to continue in fisheries and spread to aquaculture as productivity continues to grow in export industries. It is important to support the necessary and continued labour market conversion, for instance by offering continuing education and training programmes.

#### Labour market pressures despite lower growth

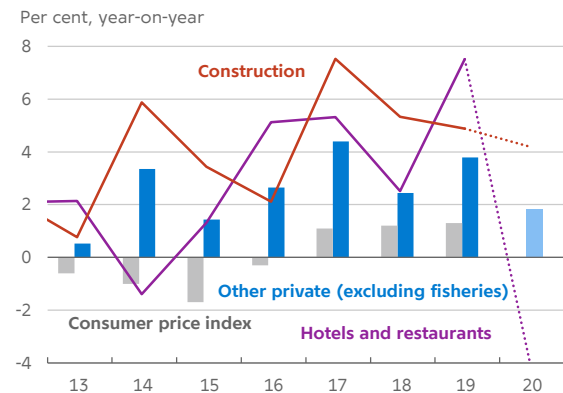
The low level of unemployment, which has largely remained unaffected in the last six months, leaves the impression of a labour market under pressure. Labour shortages may occur, increasing the risk of overheating the economy. Wages were not significantly impacted by the economic slowdown in the spring, except for wages in highly exposed industries such as hotels and restaurants, see Chart 9.

Construction, in particular, which has seen high wage growth and labour shortages in recent years, is displaying signs of labour market tightness. Unemployment is low, wages are high and, in a longer-term perspective, labour shortages are high.

Foreign labour plays a key role in the Faroese labour market and, by extension, in the Faroese economy. This means that the ability of Faroese corporations to attract foreign labour, also from non-EU member states, is important to the economy, especially when parts of the economy are at risk of overheating, as is still the case in construction.

Wage growth remains strong

Chart 9



Note: Wage growth is calculated as an implied wage index based on wage disbursements and the number of wage earners. The fisheries industry has not been included as wages in fisheries are closely linked to earnings on vessels. Hence, remuneration in fisheries includes a kind of profit-sharing, which does not provide a true view of general wage pressures in the Faroe Islands as a result of, for example, labour shortages. 2020 figures are based on developments from January to October.

Source: Hagstova Føroya and own calculations.

<sup>10</sup> Under current legislation, tax benefits are available to people working abroad, which has a distorting impact. Reducing these tax benefits would increase both the structural labour supply and tax revenue in the Faroe Islands.



## Household and corporates have built up buffers

The economic expansion since 2013 has boosted household incomes, giving the Faroese more leeway in their budgets. The proportion stating that they are able to save up has increased by 20 percentage points during the expansion to 75 per cent.<sup>11</sup> This is also reflected in banks, where households have increased their deposits more than their borrowings during the expansion, see Chart 10.

Most Faroese household assets are tied up in housing, making the housing market the key risk factor for households. Faroese households account for just over half of Faroese banks' total lending, primarily for home financing.

Household borrowing has grown by more than 20 per cent since early 2014, and is still driven by loans for housing purposes. In addition, borrowing through Danish mortgage credit institutions, accounting for approximately 30 per cent of total Faroese home financing, has risen by more than 17 per cent over the same period. Still, relative to income gains and house price growth, credit growth has been limited.

### Housing market continues upward trend

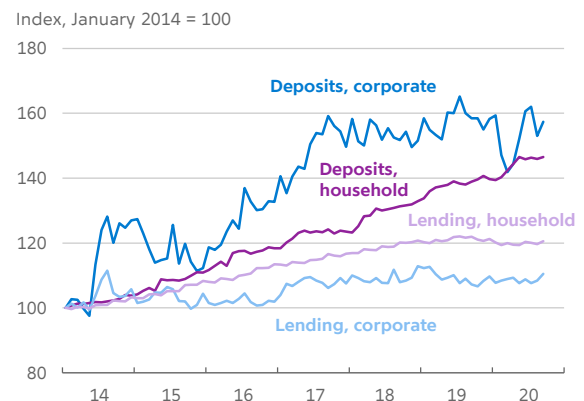
Faroese house prices have increased sharply in recent years, underpinned by low interest rates, higher incomes and migration due to the expansion. Prices have continued to grow this year, albeit at a slightly slower pace, see Chart 11.<sup>12</sup>

Price increases, especially for houses in the Tórshavn area, are more subdued. One reason could be that high prices have prompted some households to move to Faroese settlements. Moreover, construction in Tórshavn in recent years probably means that supply has, to some extent, caught up with demand, which will also dampen price growth.

Also, the opening of the Eysturoyartunnilin tunnel in 2021 is expected to significantly shorten the travel time between Tórshavn and the southern part of

**Increase in deposits from Faroese customers**

Chart 10

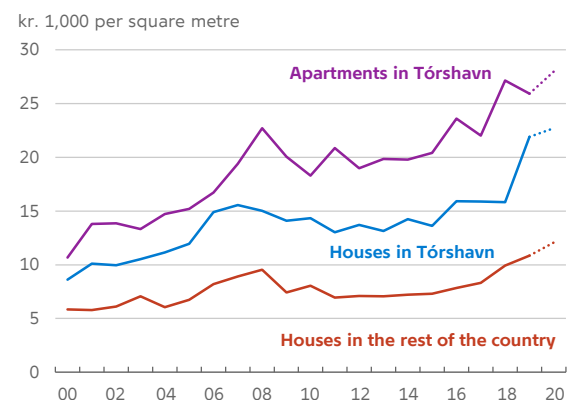


Note: Faroese banks' deposits from and loans to Faroese customers.

Source: Data cooperation with the Danish Financial Supervisory Authority (MFI statistics).

**House prices continue to rise**

Chart 11

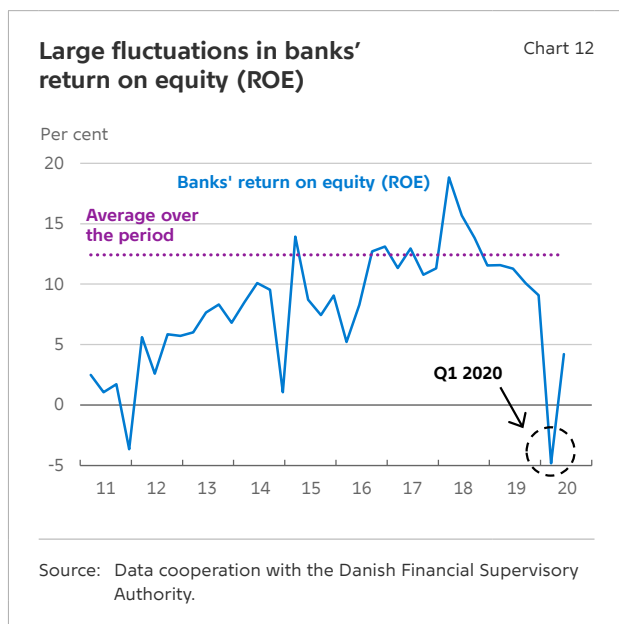


Note: 2020 covers only current transactions of the year. Prices in the 3rd and 4th quarters are subject to particular uncertainty. For houses in the rest of the country, an average of the index for large and small towns, excluding Sandoy and Suðuroy, is shown.

Source: Hagstova Føroya and BankNordik.

<sup>11</sup> See Hagstova Føroya's business tendency survey for households.

<sup>12</sup> Estimates subject to great uncertainty.



Eysturoy,<sup>13</sup> making it more attractive to move to larger settlements northwest of Tórshavn, which supports price growth in that area.

### Limited impact of the coronavirus pandemic on Faroese banks

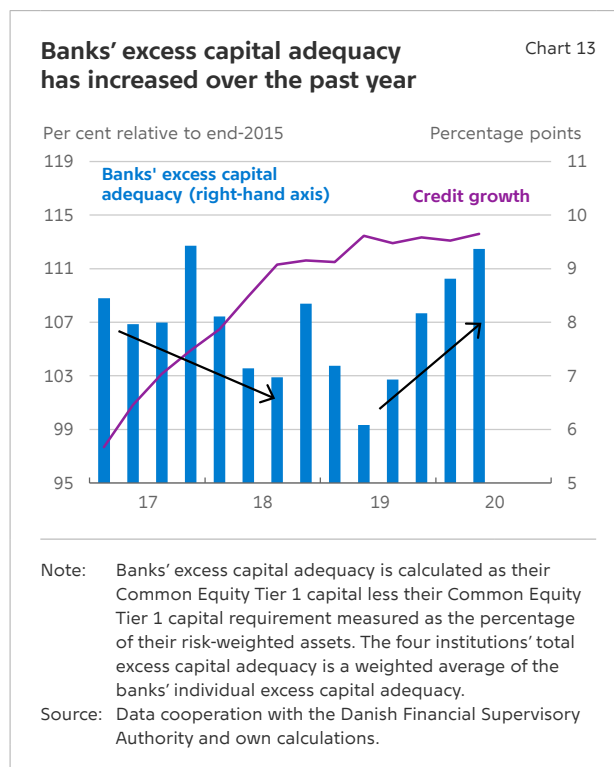
In the 1st quarter of 2020, return on equity (ROE) of the four Faroese banks dropped sharply, see Chart 12. Much uncertainty surrounded the impact of the pandemic, causing financial markets to tumble. Therefore, banks were affected by negative developments in value adjustments and also posted higher impairment charges based on management estimates.

The hotel and restaurant industry was hit particularly hard. As a result, the industry accounted for a large portion of banks' total impairment charges in the 1st quarter, totalling kr. 32 million, or 0.1 per cent, of Faroe banks' total lending.<sup>14</sup>

In the 2nd quarter, coronavirus-related losses materialised for banks to a small extent only, one reason being that bank customers had strong buffers after a number of years of economic expansion. This means that additional provisions have only been required to

<sup>13</sup> Landsbanki Føroya, Figgjarligt Støðufesti 2018 (only in Faroese, [link](#)), 2018.

<sup>14</sup> Includes both lending and guarantees as well as impairment charges on bank exposures outside the Faroe Islands.



a limited extent. In addition, financial markets have recovered from the significant price declines in March and April. So, although banks forecast lower profits than last year, the annual outlook is better than assessed by the banks going into the 2nd quarter.

### Banks' buffers increased up to the slowdown

Historically, the Faroese economy has seen significant fluctuations, resulting in higher levels of impairment charges and losses in Faroese banks than in Danish banks, especially for corporate customers.<sup>15</sup> Solid excess capital adequacy for banks, i.e. a sufficient gap between the institutions' capital requirements and their capital ratios, can help to prevent losses in the banking sector from amplifying possible fluctuations in the real economy.

From end-2016 until mid-2019, Faroese banks' excess capital adequacy decreased by 2.7 percentage points on average, see Chart 13. At the same time, lending rose, and capital requirements for banks

<sup>15</sup> The Systemic Risk Council, Requirements for Faroese Banks, Analysis, March 2020 ([link](#)).

### Recent developments in financial regulation in the Faroe Islands

Box 3

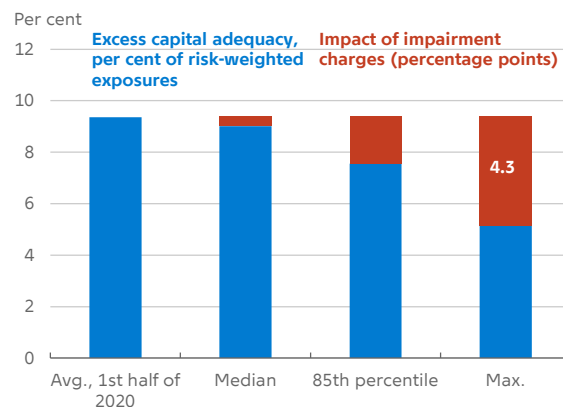
- Change in criteria for SIFI designation in the Faroe Islands expected to take effect in the beginning of 2021.**  
A minimum requirement for when a credit institution can be designated as systemically important is expected to be introduced. As a result, the third-largest bank, Norðoya Sparikassi, will no longer be designated as a SIFI, effective from the next SIFI designation in the Faroe Islands in June 2021. The proposal to change the criteria is currently being considered by the Lagting.
- The general systemic risk buffer in the Faroe Islands was temporarily reduced from 3 per cent to 2 per cent on 19 March 2020.**  
The Systemic Risk Council has announced that it will not recommend an increase of the buffer rate to 3 per cent until June 2021, at the earliest. Moreover, the Council has decided to provide 12 months' notification from the time it is recommended that the buffer rate be changed until the change should take effect.
- The Danish Financial Supervisory Authority extended the phasing-in of the minimum requirement for own funds and eligible liabilities (MREL).**  
The MREL for Faroese institutions were extended by six months due to the negative impact of the coronavirus pandemic on their earnings. Before the extension, the requirements should formally be met on 1 January 2025. Now the date is 1 July 2025.

increased.<sup>16</sup> This trend reversed in the 2nd half of 2019, when banks' excess capital adequacy began to increase again, which should be seen in the context of banks preparing for stricter capital requirements. However, in the spring, the general systemic risk buffer was temporarily relaxed from 3 per cent to 2 per cent, see Box 3, and at the same time, credit growth slowed. Overall, this contributed further to increasing banks' excess capital adequacy. As a result, Faroese banks had, on average, solid buffers when the coronavirus pandemic struck.

Nevertheless, high impairment charges could potentially reduce banks' excess capital adequacy, see Chart 14. If, for instance, impairment charges coincide with a sharp decline in bank earnings, some institutions could even lose their excess capital adequacy altogether.

### Higher impairment charges reduce banks' excess capital adequacy

Chart 14



Note: The chart shows the impact of various impairment charge scenarios on banks' excess capital adequacy (as measured by their Common Equity Tier 1). The scenarios are calculated based on each institution's impairment charge ratios for the years 2000 to 2019. For instance, the 'Max' scenario shows the impact on banks' total average excess capital adequacy today if each institution were to be affected simultaneously by their highest impairment charge ratio over the period 2000 to 2019.

Source: Data cooperation with the Danish Financial Supervisory Authority and own calculations.

## Both short-term and long-term challenges for public finances

Government debt is currently low, meaning that the central government was able to keep the economy afloat during the economic downturn in the spring. Less revenue from registration fees and the plunge in oil prices in the spring were only partly offset by higher VAT revenue resulting from the Faroese consumption appetite and staycations. As a result, central government revenue is lower than expected this year.

At the same time, expenditure has increased, although less so than in many other countries around the world. Viewed in isolation, the coronavirus pandemic has increased expenditure by just under 1

<sup>16</sup> The systemic risk buffer was increased, and the capital conservation buffer was phased in.

per cent of GDP. One reason is that the wage subsidy scheme for reduced working hours was equity financed by *Arbejdsloysisskipanin*, the Faroese unemployment fund, until and including June, equivalent to 0.5 per cent of GDP.

Fíggjarmálaráðið, the Faroese Ministry of Finance, expects the central government deficit to amount to kr. 500 million this year.<sup>17</sup> This year's large deficit is due, among other things, to extraordinary capital subsidies for Atlantic Airways and Vágar Airport, totalling kr. 115 million. The deficit follows in the wake of a few years of modest government budget surpluses, see Chart 15.

To ensure the central government's liquidity, *Landsbanki Føroya*, the Faroe Islands Governmental Bank, raised debt totalling kr. 1.6 billion in June. As a result, government debt has increased from 41 per cent of GDP at the beginning of the year to 48 per cent of GDP.<sup>18</sup> By international standards, the debt level remains modest, and the interest rate on the new debt is low.

### Important that fiscal policy stabilises cyclical fluctuations

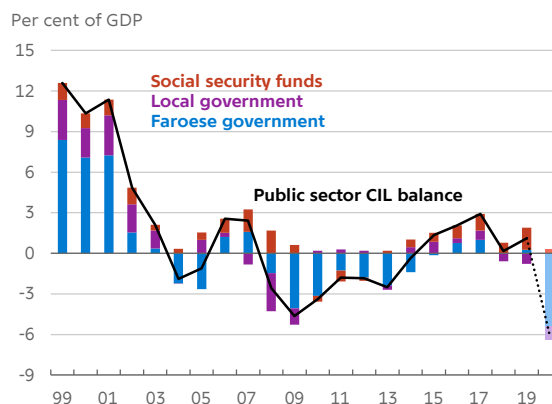
Historically, the Faroese economy has seen significant fluctuations, placing demands on fiscal policy to save when times are good in order to keep the economy and incomes afloat when times are bad.

However, during the expansion, fiscal policy was largely procyclical,<sup>19</sup> and the economy is still booming. So, the Faroese government should not increase expenditure further at this point, but should instead focus on consolidating when the temporary expenditure stops.

### Solution to long-term challenges should not be delayed

Faroese demographics will be changing over the coming years. Firstly, more elderly people will need

Government budget deficit this year Chart 15



Note: The chart shows the current, investment and lending (CIL) balance. 'Faroese government' includes both the central government's current, investment and lending (CIL) balance according to the finance act and expenditure related to public companies responsible for expansion and operations of parts of the infrastructure. For 2020, the deficit amounts to kr. 1,100 million, of which kr. 600 million is accounted for by public companies.

Source: Landsbanki Føroya and own calculations.

to be supported by the working population, see Chart 16. This represents a challenge for virtually all Western economies.

During the economic downturns of the 1990s and early 2010s, the Faroe Islands experienced massive emigration, which was only partly offset by immigration during subsequent booms. If net emigration continues in the long term, the sustainability of public finances will deteriorate because the proportion of working-aged people declines, leading to less tax revenue.

However, the current expansion has seen high immigration. The standard of living in the Faroe Islands has improved since the 1990s, so when the econo-

17 The central government deficit does not include expenditure related to public companies responsible for expansion and operations of parts of the infrastructure.

18 Part of the liquidity of the kr. 1.6 billion debt has not yet been used, and Landsbanki Føroya expects to repay part of the debt raised in June 2021.

19 See Sune Malthe-Thagaard and Flora Nagy, Labour market squeezed by very low unemployment, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 22, November 2019 ([link](#)).

my reverses, the Faroe Islands may not experience large-scale emigration. This illustrates considerable uncertainty as to the prerequisites for long-term sustainability of public finances.

However, uncertainty as to calculations of the sustainability of public finances does not mean that the challenge should not be addressed. Timely reforms of, for instance, the tax system may ensure long-term sustainability and help make the Faroese economy more resilient.

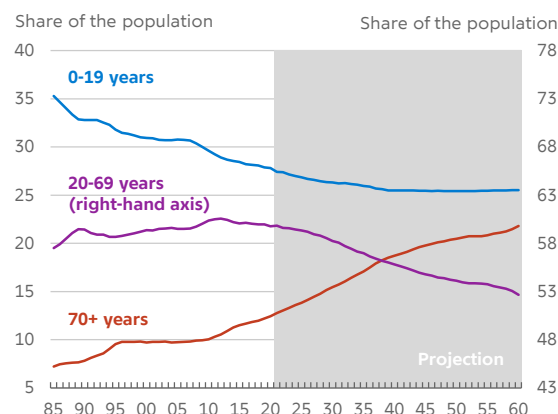
An expansion of the tax base may address some of the sustainability challenges. For instance, property tax on non-primary residences would increase revenue. Property taxes based on house price growth also act as automatic stabilisers for both the real economy and the financial sector and are generally less distorting than many other taxes.

Moreover, a considerable amount of revenue in the Faroe Islands is generated by corporations exploiting the natural sea and fish resources around the Faroe Islands. The fisheries profits remaining when catch costs<sup>20</sup> and a normal return on investment and equity have been settled is referred to as economic rent. Although economic rent calculations are subject to considerable uncertainty, the Faroese government should continuously assess the tax potential to ensure that returns from Faroese natural resources accrue to the population at large.<sup>21</sup> At present, fish resources are probably not taxed sufficiently.<sup>22</sup>

Moreover, the Faroese government can improve the general government structural balance by reducing expenditure unrelated to services offered to citizens. For instance, phasing out the central government's 35 per cent subsidy to household interest costs will help to achieve this purpose.<sup>23</sup>

More elderly people and fewer working-aged people in the future

Chart 16



Source: Hagstova Føroya and own calculations.

20 Catch costs include wages to the crew.

21 See, for instance, Gregor Schwerhoff, Ottmar Edenhofer and Marc Fleurbaey, Taxation of Economic Rents, *Journal of Economic Surveys*, 2019 ([link](#)).

22 See, for instance, Búskaparráðið, Búskaparfrágreiðing várið, 2020 (only in Faroese but with English summary, [link](#)).

23 See Box 3 in Sune Malthe-Thagaard and Flora Nagy, Labour market squeezed by very low unemployment, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 22, November 2019 ([link](#)).

## PUBLICATIONS



### NEWS

News offers a quick and accessible insight into an Analysis, an Economic Memo, a Working Paper or a Report from Danmarks Nationalbank. News is published continuously.



### ANALYSIS

Analysis from Danmarks Nationalbank focuses on economic and financial matter. Some of the analyses are published with a regular frequency e.g. *Outlook for the Danish economy and Financial stability*. Other analyses are published continuously.



### REPORT

Report comprises recurring reports and reviews of the functioning of Danmarks Nationalbank. For instance Report includes the *Annual report* and the annual publication *Danish government borrowing and debt*.



### ECONOMIC MEMO

Economic Memo is a cross between Analysis and Working Paper and it often shows the ongoing study of the authors. The publication series is primarily targeted at professionals. Economic Memo is published continuously.



### WORKING PAPER

Working Paper presents research projects by economists in Danmarks Nationalbank and their associates. The series is primarily targeted at professionals and people with an interest for academia. Working Paper is published continuously.

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

DANMARKS NATIONALBANK  
LANGELINIE ALLÉ 47  
DK-2100 COPENHAGEN Ø  
WWW.NATIONALBANKEN.DK

This edition closed for contributions  
on 1 December 2020.



**DANMARKS  
NATIONALBANK**

**Flora Nagy**  
Senior Bank Analyst  
[fna@nationalbanken.dk](mailto:fna@nationalbanken.dk)  
FINANCIAL STABILITY

**Adrian Michael Bay Schmith**  
Economist  
[ams@nationalbanken.dk](mailto:ams@nationalbanken.dk)  
ECONOMICS  
AND MONETARY POLICY

## CONTACT

**Ole Mikkelsen**  
Communications  
and Press Officer

[omi@nationalbanken.dk](mailto:omi@nationalbanken.dk)  
+45 3363 6027

SECRETARIAT  
AND COMMUNICATIONS