

DANMARKS NATIONALBANK

18 NOVEMBER 2021 — NO. 27

THE FAROESE ECONOMY

The boom has regained momentum



Widespread labour shortages

Due to very low unemployment and an already high labour market participation rate, virtually all industries in the Faroe Islands are experiencing labour shortages. At the same time, export prospects have improved with the global roll-out of vaccines, supporting the continued economic boom.



Households and companies have built up substantial buffers

The private sector has built up buffers during the economic upswing and is better positioned to withstand economic shocks. But risks could materialise quickly with surging house prices and labour market pressures.



Need of long-term public sector planning

Long-term fiscal planning will improve the resilience of the Faroese economy. Capital should be set aside in good times to draw upon in bad. With the ageing of the Faroese population, balance between expenditure and revenue in the future is important.

CONTENTS

- 2 SUMMARY
- 4 EXPORT MARKET GROWTH UNDERPINS THE FISH INDUSTRY
- 6 INCREASED CONSUMPTION HAS HELPED TO SUSTAIN ECONOMIC ACTIVITY
- 7 LABOUR MARKET PRESSURES HAVE RETURNED
- 9 EXPANSION SPILLOVER EFFECTS ON HOUSE PRICES AND LENDING
- 13 NEED OF LONG-TERM PLANNING OF ECONOMIC POLICY

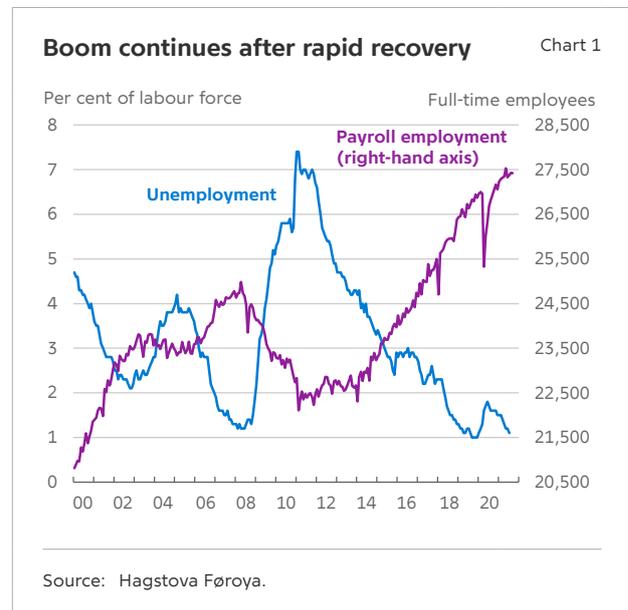
Summary

The covid-19 outbreak hit the global economy hard, and the pandemic also caused activity in the Faroe Islands to fall sharply. The gross domestic product, GDP, contracted by 2.4 per cent¹ in 2020 following several years of economic boom and substantial growth, driven by increasing fish prices.

But the Faroese export industries, which engage almost exclusively in fish sales, were quick to shift their sales from locked down restaurants to open grocery stores. This supported earnings, while export markets were affected by virus containment restrictions.² As a result, the economic downturn was limited, and, so far, has merely been a break from the boom.

Employment returned to pre-pandemic levels already at the end of 2020, and currently the Faroese unemployment rate is only just above 1 per cent of the labour force, see chart 1. As a result of the rapid recovery of activity and employment, the Faroe Islands are again experiencing labour shortages. It is essential that labour market structures support a flexible labour force, for instance by enabling foreign labour to come to the Faroe Islands in times of pressure.

However, in an economy like the Faroese, centred around marine resources, labour market pressures cannot be expected to have a similar spillover effect on the competitiveness of the export industries. The explanation is that – compared with more traditional industrial production – sales prices depend more on factors such as catch opportunities, biological conditions and world market prices than on payroll costs. So, companies' ability to compete on the world market is largely determined by factors other than wage competitiveness. Structural conditions such as fisheries and trade agreements and effective fisheries managements are also significant determinants of companies' competitiveness.



But periods of labour market pressures should not lead to overoptimism in those segments of the economy that are impacted by export industry developments. Instead, both the public and private sectors should set aside capital in good times to draw upon in bad. Faroese households and companies have generally built up substantial buffers, but risks could materialise quickly, in the light of surging house price increases in recent years and labour shortages.

Going forward, continued growth is supported by a brighter outlook for export markets, which have seen demand recover faster than expected. The faster-than-expected recovery should be viewed in the context of the global roll-out of vaccines over the year, among other factors. However, a fisheries agreement with the UK on mackerel fisheries has yet to be agreed, which weighs on the outlook for parts of Faroese fish exports. The lack of an agreement has, for instance, resulted in lower prices, illustrating

¹ Preliminary data. GDP in the Faroe Islands is stated in current prices only.

² See Adrian Michael Bay Schmith and Nagy, The Faroese economic boom is losing momentum, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 29, December 2020.

Facts about the Faroe Islands and the fish industry

THE PUBLIC SECTOR

36
per cent

of employment in 2019 was in the public sector

34
per cent

of GDP is the size of government debt

TOURISM

2
per cent

of GVA in 2017 came from tourism*

FISH INDUSTRY

81
per cent

of total exports are goods exports

95
per cent

of goods exports are fish

40
per cent

... of which are exports of salmon

17
per cent

of employment in 2019 was in fisheries, aquaculture, manufacturing and shipyards

28
per cent

of GVA in 2019 came from fisheries, aquaculture and manufacturing

other industries are impacted by export revenue from fish**

| | |
|----------------------------|---|
| Population: | 53.559 as of 1 August 2021 |
| Per capita GDP: | Kr. 384,000 in 2020 Kr. 400,000 in Denmark in comparison |
| Participation rate: | 84 per cent in 2020 78 per cent in Denmark in comparison |
| Currency: | Danish kroner |

* GVA represents gross value added.

** See e.g. Arnason et al., Økonomisk rente og ringvirkninger i de Vestnordiske fiskerier (Economic rent and knock-on effects in western Nordic fisheries – in Danish only), Nordic Atlantic Corporation (NORA), 2015.

that good framework conditions are key to the competitiveness of Faroese export industries.

The Faroese boom has generally been underpinned by productivity growth in both fisheries and aquaculture.³ Companies have consolidated, and credit has grown less than the Faroese economy as a whole. This means that the Faroese economy is able to withstand external shocks better than it was both in the 1990s and in the run-up to the financial crisis, as it has also shown during the pandemic. This is essential for a one-pronged economy, whose exter-

nal earnings rely on a few large industries that are highly exposed to fluctuations in catch volumes and fish prices.

Long-term fiscal planning can improve resilience

The public sector can help to strengthen economic resilience by setting aside capital in good times to draw upon in bad. This also applies if the private sector has built up buffers. As much activity and employment are indirectly linked to the export industries, stability-oriented fiscal policy is needed to bolster

³ During the expansion, return on equity (ROE) for fisheries and aquaculture has risen, while the number of companies has declined. See Hagstova Føroya accounts statistics.

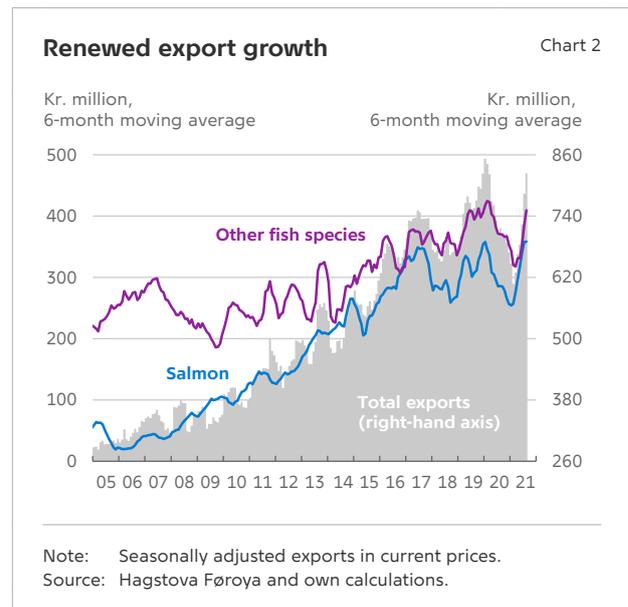
the economy for changes to the business cycle and declining fisheries earnings.⁴ Low government debt contributes to this, for instance by ensuring that the government of the Faroe Islands has room to manoeuvre.

The government of the Faroe Islands should also prioritise long-term planning to ensure the sustainability of government finances. Prioritising long-term budget projections that provide an overview of the expenditure for, for instance, future public service would be appropriate – particularly in view of the ageing of the Faroese population. Generally, an expansion of the tax base, for instance by introducing a housing tax, may help to balance expenditure and revenue in the future.

Export market growth underpins the fish industry

The Faroese economy is small and open. It largely relies on trade with other countries, and exports account for just over 50 per cent of GDP, the same as in Denmark. However, the fish industry, accounting for more than 90 per cent of the Faroe Islands' goods exports, is the largest source of export revenue. Generally, demand for fish, and food in general, is less cyclical than for other products. But fish supply and prices are more sensitive and largely determined by external factors, for instance energy prices and catch conditions, rendering the economy vulnerable to sudden changes in fish prices and biological factors.

From 2019 to 2020, the export value of fish from the Faroe Islands declined by 13.5 per cent as a result of the covid-19 outbreak. However, a number of factors helped mitigate the downturn. For instance, the export industries were quick to shift their sales to grocery stores when restaurants were locked down in many countries. This sustained the volume of fish exports, although at the expense of slightly lower prices.



Recently, fish exports have gradually regained strength and are back to pre-pandemic levels, see chart 2. From January to August 2021, the export value was in line with the corresponding period in 2019.

The gradual export recovery is attributable to growth in salmon exports, among other factors. Salmon exports account for about 40 per cent of total goods exports. Salmon exports, unlike other fish exports, are made up predominantly of aquaculture salmon. The aquaculture industry is more comparable to traditional industry.

The primary driver of the recovery of salmon exports is the lifting of restrictions on restaurants in most countries, making it possible to a greater degree to sell fresh fish at higher sales prices. In recent years, Faroese salmon has been selling at higher prices than those of competitors, see chart 3. One reason for the higher prices is the favourable aquaculture conditions in Faroese fjords, benefiting from good temperatures. The pandemic does not seem to have impacted the price difference, and the IMF expects the general level of salmon prices to go up slightly. Higher salmon prices have been a

⁴ See, for instance, Hermann Oskarsson, Economic policy in a resource-rich micro-state, *Landsbanki Føroya (the Faroe Islands Governmental Bank)*, 18 March 2021 ([link](#), in Faroese only).

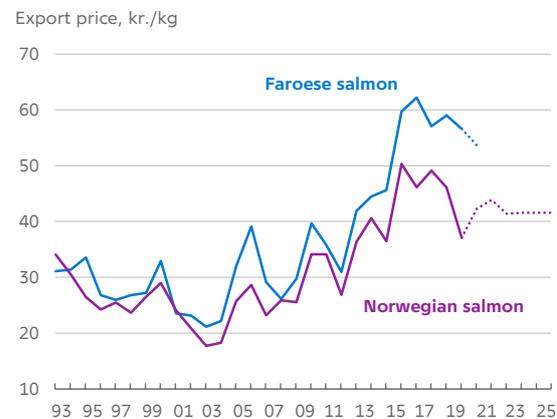
key driver of economic growth in the Faroe Islands during the expansion since 2013, increasing the risk that if the price premium for Faroese salmon was no longer achieved, this would take a heavy toll on the economy. In the short term, outbreak of disease⁵ is the primary risk that the price difference will vanish, and in the longer term risks are associated with technological advances in onshore salmon farming.

Mackerel exports, accounting for about 10 per cent of the Faroe Islands' goods exports, are still languishing after last year's downturn although the Faroe Islands have increased their catch quotas. This increase should be seen in the context that a fisheries agreement with the UK on mackerel catches has yet to be agreed. This means that the Faroe Islands cannot fish for mackerel in UK waters as in previous years. As a result, mackerel is in some cases caught earlier in its life cycle, before entering UK waters, which has led to lower prices. The lack of a fisheries agreement with the UK also generates considerable uncertainty about mackerel fisheries in the future.

Generally, the outlook for Faroese export markets has improved considerably since last winter, see chart 4. Higher demand will strengthen the economic boom in the coming years. But future developments are still subject to risks. First, the pandemic is not over, and new restaurant lockdowns in Faroese export markets could again detract from fisheries earnings. Second, fish prices are largely determined by global factors, and so risks are generally associated with changes in prices. If the current pressures on global supply chains are long-lasting, sales to remote markets, for instance in the USA and China, could be affected by long delivery times and high freight rates in the time to come. However, so far, the export industries have not been severely affected in this regard.

Although the Faroese economy is largely a one-pronged economy, its resilience has improved in recent years. Exports are sold to a broader range of

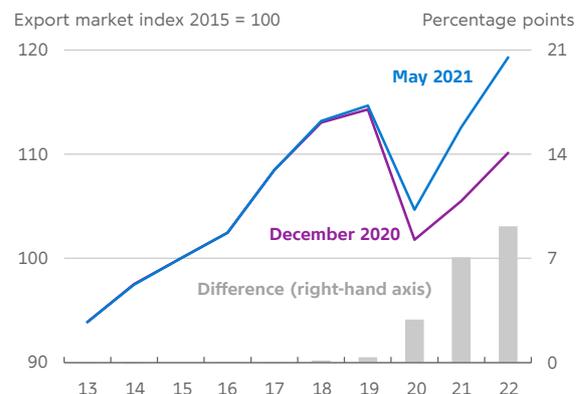
The price premium for Faroese salmon has persisted during the pandemic Chart 3



Note: The price of Faroese salmon is calculated implicitly based on the total export volume and value. The dotted blue line indicates the implied price of Faroese salmon for the first eight months of the year. The dotted purple line indicates the IMF forecast. Prices of Norwegian salmon have been converted into Danish kroner at the year-end exchange rate.

Source: Hagstova Føroya, the International Monetary Fund, IMF, *World Economic Outlook October 2021*, Macrobond and own calculations.

Growth in Faroese export markets Chart 4



Note: The export market index is based on the OECD Economic Outlook from December 2020 and May 2021, respectively. The export market index is calculated based on trade-weighted imports of goods and services of the Faroe Islands' 12 largest trading partners.

Source: Hagstova Føroya, Organisation for Economic Co-operation and Development, OECD, and own calculations.

⁵ However, Faroese aquaculture is subject to some of the world's strictest veterinary requirements, contributing to favourable trends in biological indicators. See, for instance, the High Commissioner of the Faroe Islands, *Report 2021*, the High Commission of Denmark in the Faroe Islands, 2021.

trading partners, both within and outside of the EU, and growth in salmon aquaculture has helped to diversify fish exports. Low current mackerel earnings, the result of the lack of a fisheries agreement with the UK, illustrate the significance of good and stable framework conditions for export industries. The quality and stability of fisheries and trade agreements are fundamentally key to the resilience of the Faroese economy.

Strong recovery of the tourism industry, but it will take time to utilise increased capacity

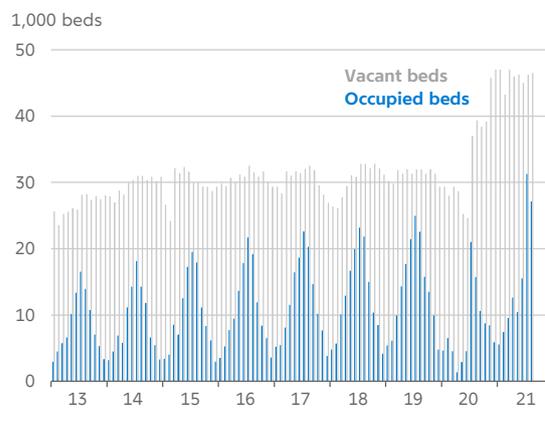
Faroese tourism has been booming in recent years, and the economic significance of the tourism industry has generally increased. But its contribution to overall growth and prosperity is still modest,⁶ and the global travel standstill has had a fairly limited impact on the Faroese economy.

The number of tourists coming to the Faroe Islands plunged at the onset of the pandemic. But effective containment of infection made the Faroe Islands an attractive travel destination compared with other countries, and tourism returned to the Faroe Islands more quickly than in many other countries. During the low season, increased Faroese staycations also buoyed up activity, as large outbreaks of infection and lockdowns abroad prevented much overseas travel. In July, the highest-ever number of visitors to the Faroe Islands was recorded, so the peak season also had higher-than-normal activity.

In line with the global roll-out of vaccines, the outlook for tourism has improved significantly. However, the pandemic has coincided with the completion of two new hotels in Tórshavn. Hotel capacity has increased with the new hotels, causing occupancy rates to be low despite higher activity, see chart 5. This also means that the tourism industry is probably some way away from full capacity utilisation – despite the brighter outlook for global travel.

Tourism industry underpinned by effective virus containment and increase in staycations

Chart 5



Note: Beds in hotels, hostels etc. From spring 2020, two new hotels in Tórshavn have increased the accommodation capacity.

Source: Hagstova Føroya.

Increased consumption has helped to sustain economic activity

Household domestic consumption has increased substantially since the onset of the pandemic. The increase in consumption has offset some of the downturn in exports and has helped keep economic activity afloat. There are indications that Faroese consumption during the pandemic has more than offset what the Faroese typically spend on overseas travel.⁷

The increased Faroese consumption has largely been focused on goods, with food, clothing and housing-related consumption rising substantially during the pandemic, see chart 6. This trend has shown in many economies during the pandemic, including the Danish economy.

⁶ In 2017, tourism's share of gross value added, GVA, was an estimated 2 per cent. See Hagstova Føroya, Vitjandi ferðafólk, 2011 to 2018, Búskaparískoyti, May 2019 (in Faroese only) ([link](#)).

⁷ Payment card statistics from BankNordik show that Faroese payment card consumption from May to December 2020 was just under 3 per cent lower than the prior-year period. These data, along with increased home improvement consumption, typically paid by bank transfer, indicate that household consumption was higher than normal during the 2020 pandemic.

Food and clothing consumption remained high in the 2nd quarter, while housing-related consumption declined quite substantially. The decline in housing-related products is likely due to product scarcity and higher prices caused by bottlenecks in global supply chains. But better opportunities for overseas travel could also have replaced some of the demand for home improvements.

Generally, imports are closely linked to household consumption because a large proportion of consumer goods are imported to the Faroe Islands. However, during the financial crisis household goods consumption declined faster than the rest of the economy, and consumers have subsequently been cautious about spending. So, despite considerable income growth in the Faroe Islands, imports for consumption have been low. But during the pandemic, the domestic increase in consumption has resulted in higher imports for consumption. Going forward, increased overseas travel will probably put downward pressure on goods imports as Faroese consumption patterns return to the pre-pandemic composition.

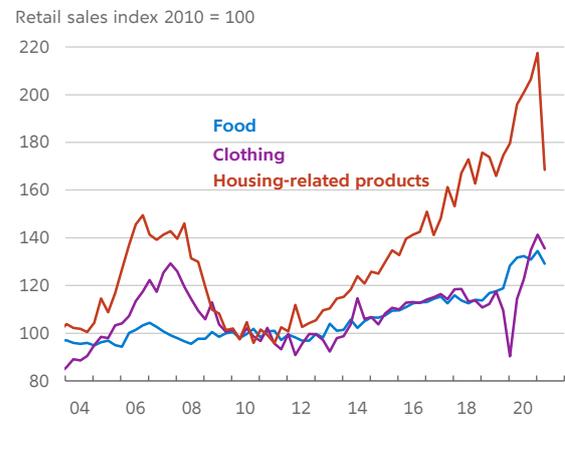
Labour market pressures have returned

The increase in household consumption has been underpinned by labour market developments. In spring 2020, employment suffered a severe but short-lived decline, and since then it has not only returned to its pre-pandemic level, but to its trend level from before the coronavirus outbreak. In other words, incomes in the Faroe Islands have been sustained during the pandemic.⁸

However, the current composition of employment is different from that of spring 2020. Employment in fisheries, aquaculture and trade has risen, see chart 7. This should be seen in the context that aquaculture's shift of sales from restaurants to grocery stores

Substantial increase in consumption of goods

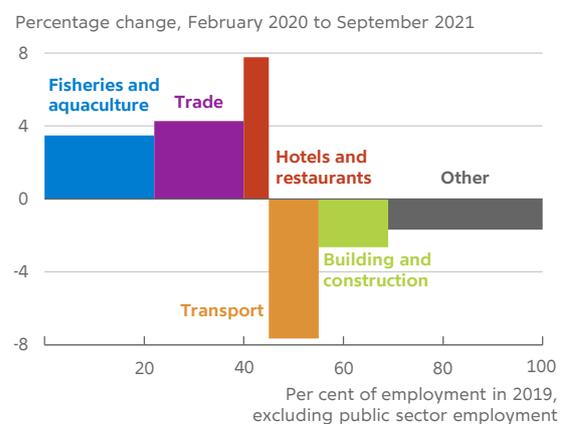
Chart 6



Note: Retail sales in volumes, seasonally adjusted.
Source: Hagstova Føroya and own calculations.

Major employment composition changes after the pandemic

Chart 7



Note: Seasonally adjusted employment.
Source: Hagstova Føroya and own calculations.

⁸ During the 2020 summer months, comprehensive wage compensation schemes also helped to keep the labour market afloat. See Adrian Michael Bay Schmith and Flora Nagy, The Faroese economic boom is losing momentum, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 29, December 2020.

during the pandemic has required more labour for packing, etc. and that retail trade has prospered due to increased household consumption. Public sector employment has also increased, particularly in local government and in the health care sector. But recently health care employment has declined slightly because fewer resources are spent on testing and vaccinations. Also, employment is currently lower in industries suffering a slowdown in activity during the pandemic, for instance in construction. The pattern in the various industries reflects the flexibility of the Faroese labour market, where labour can quickly adapt to growing industries.

Increasing labour shortages

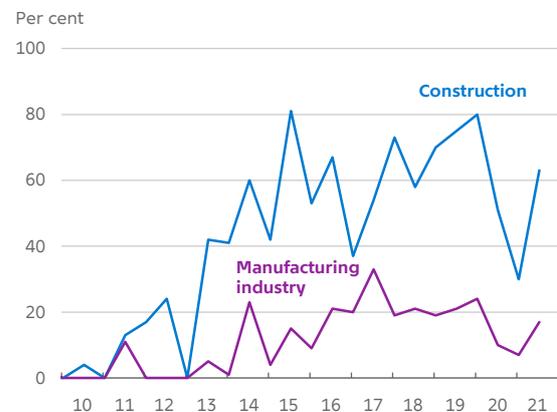
Faroese unemployment is again very low. In July, the Faroe Islands had only 332 full-time unemployed people, accounting for seasonal fluctuations, and the rate of unemployment was 1.1 per cent, indicating that the labour market is under pressure. And in the last couple of months, employment has stagnated, and companies increasingly assess that labour shortages are an impediment to production, see chart 8. Unlike the situation in Denmark, for instance, there still seems to be some way to go before the Faroe Islands reach the shortage levels from before the pandemic, although Faroese unemployment is back to pre-pandemic levels, when the economy was also booming and the labour market was under pressure.⁹

Labour shortages are especially pronounced in the construction and tourism industries¹⁰ – industries that are heavily reliant on foreign labour. Before the pandemic in 2019, one in three employees in the hotel and restaurant industry was of foreign origin, while this figure for construction was one in five.

Part of the explanation for the recruitment difficulties could be that labour in the construction and tourism industries is in short supply in many European economies, including Denmark. Also, many resources are still tied up in pandemic-related work in the Faroe Islands and in segments of the fish industries

Companies are again reporting growing labour shortages

Chart 8



Note: The chart shows the proportion of companies citing labour shortages as the primary impediment to production. Manufacturing also includes the primary industries (such as agriculture, aquaculture and fisheries).

Source: Hagstova Føroya.

that have required increased labour for packing, etc. during lockdowns. So, part of the pressure may be temporary in nature, which is also expected to be the case in Denmark.¹¹

Labour market pressures are not reflected in wage growth

Despite the expansion from 2013 to 2019, private sector wage growth has been subdued, at 2.8 per cent on average, see chart 9. This should be seen in the context of low consumer price rises, but also strong population growth.

The Faroese population is currently at a record high. Since 2013, the population has increased by just under 11 per cent, and by almost 3 per cent during the pandemic alone. The rise is due to a higher rate of natural increase (excess births over deaths) and to a decline in the number of people leaving the country. From 2014 to 2020, 11,600 people moved

9 See Flora Nagy and Sune Malthé-Thagaard, Labour market squeezed by very low unemployment, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 22, November 2019.

10 See, for instance, Búskaparráðið, Konjunkturmeting á heysti 2021 (Economic report from the Economic Council of the Faroe Islands, autumn 2021), *Búskaparráðsfrágreiðing*, September 2021 ([link](#)).

11 See Danmarks Nationalbank, Outlook for the Danish economy – The economy heading back towards a moderate boom, *Danmarks Nationalbank Analysis (Outlook for the Danish economy)*, No. 24, September 2021.

to the Faroe Islands, while only 8,700 left the country. During the boom, the non-Danish proportion of foreign labour has more than doubled and currently accounts for just over 5 per cent of employment.

However, in periods of economic downturns, the opposite trend has applied, and the population and the proportion of foreign labour have decreased. This adjustment reflects the mobility and flexibility of the Faroese labour market.

It is essential that Faroese labour market structures support this agility, where easy and flexible access to foreign labour is a key element. Also, Faroese working abroad should have the incentive to return to the Faroe Islands when the labour market is under pressure. The current tax deductions for Faroese working abroad help to support labour flexibility in periods of economic downturns, but limit the flexibility in periods of economic expansion.¹² Schemes of this nature should be designed to benefit the economy both when it is expanding and when it is contracting.

Moreover, in the longer term further expansion of the Faroese public welfare system may help to retain and attract labour. To this end, labour market structures that facilitate continuing education and training programmes etc. are expedient. Such structures may enable the labour force to meet the continued structural transition from fisheries and aquaculture, requiring still fewer employees, to private and public sector service, where demand is growing. These structures may also help to improve the overall education and skills levels of the labour force.

Expansion spillover effects on house prices and lending

Economic growth is also reflected in the Faroese housing market. Momentum in the housing market is high, as it has been throughout the economic expansion, and so far house prices have increased by 18 per

Subdued wage inflation in recent years

Chart 9



Note: The rates of wage growth are calculated as an implied wage index based on wage disbursements and 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. 2021 figures are based on developments from January to September.

Source: Hagstova Føroya and own calculations.

cent in 2021. Overall, house prices have increased by just over 9 per cent¹³ annually since end-2013.

Recently, prices in small settlements have seen the highest rises, growing 31 per cent since 2020, see chart 10. The increases should be seen in the context of factors such as the new tunnel between the islands of Streymoy¹⁴ and Eysturoy, Eysturoyartunnilin, which has made it easier for people to settle in areas outside the capital. Prices in Tórshavn and large Faroese settlements have also increased by more than 8 per cent since start of the year, so there is a momentum in the entire Faroese housing market.

One driver of house price growth has been an increase in demand for housing, underpinned by falling interest rates, higher incomes from strong employment growth and a general population

¹² Among other things, *daily deductions* of kr. 300 per day are granted as compensation for additional expenses for foreign labour, for instance food, rent and transport.

¹³ Calculated as a weighted average of house price growth in Tórshavn and large and small Faroese settlements during the period, weighted with the number of transactions during the period. Including preliminary transactions in 2021, i.e. the 1st to the 3rd quarter.

¹⁴ The Faroese capital Tórshavn is located on the island of Streymoy.

growth. As in many other countries, there are also indications that the pandemic has boosted interest in second home purchases and home improvements. This also supports house price growth, although the pandemic-induced acceleration in house price growth is not as prominent as that seen, for instance, in Denmark.¹⁵

More homes can ease housing market pressures

Despite growing demand, the Faroese housing supply has not followed suit during the expansion. This has contributed to pushing prices further up, particularly in Tórshavn, where house prices have outpaced incomes, see chart 11. An estimated 1,000 new homes¹⁶ were built from 2014 to 2020, while the population grew by just under 5,000.

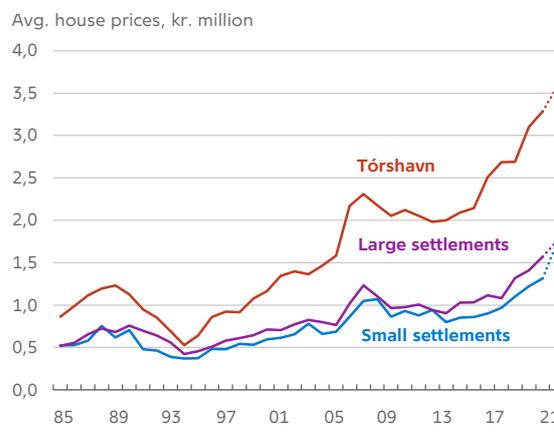
To ease housing market pressures, it is essential to increase the Faroese housing supply. Measures targeted at addressing bottlenecks in housing construction, including labour shortages, may help to relieve the Faroese housing shortages.

Also, a more diversified housing supply in the Faroe Islands may contribute to support a more flexible labour force. An increased supply of smaller and rental housing may help to attract temporary labour that has neither the need nor the possibility of purchasing a home in the Faroe Islands. Structural reforms may also help to reduce house price fluctuations. This could for instance be in the form of a housing tax, where tax payments follow price developments in the housing market.¹⁷

Households increase borrowing for housing purposes

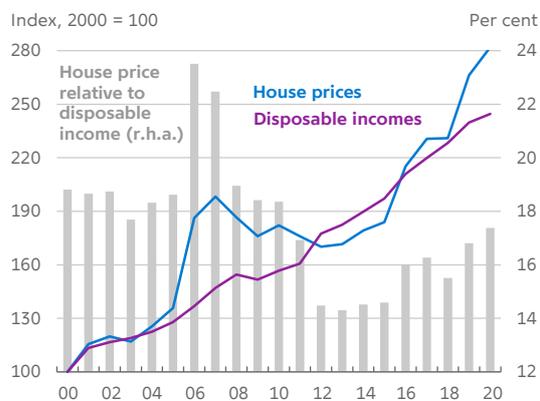
Lending to households primarily consisting of loans for housing purposes, has risen by 24 per cent since the onset of the current economic expansion. Household borrowing currently exceeds kr. 12 billion, see chart 12, which is equivalent to 56 per cent

Faroese housing market is booming Chart 10



Note: Data for 2021 cover only current transactions of the year (the 1st to the 3rd quarter) and are subject to uncertainty.
Source: Hagstova Føroya and BankNordik.

House prices are rising faster than incomes Chart 11



Note: Income comprises income, profit from own business (including self-employed people), public sector transfers (for instance, pension, unemployment and sickness benefits, interest deductions, SU student grants etc.) and capital income net of tax (and other statutory taxes). 2020 incomes are estimated. House prices calculated in Tórshavn.
Source: Hagstova Føroya, BankNordik, Landsbanki Føroya and own calculations.

15 See Adrian Michael Bay Schmith, Jesper Pedersen, Simon Juul Hviid and Simon Thinggaard Hetland, Housing market robustness should be strengthened, *Danmarks Nationalbank Analysis*, No. 16, June 2021.

16 See Búskaparráðið (the Economic Council of the Faroe Islands), *Konjunkturmeting á heysti 2021* (Economic report from the Economic Council of the Faroe Islands, autumn 2021), *Búskaparráðsfrágreiðing*, September 2021 ([link](#)).

17 See, for instance, Simon Juul Hviid and Paul Lassenius Kramp, Housing taxation agreement stabilises house prices, *Danmarks Nationalbank Analysis*, No. 14, September 2017.

of the Faroe Islands' GDP.¹⁸ Seen in the context of the strong growth in house prices, this increase has been moderate. Since the beginning of 2018, especially borrowing through Danish mortgage credit institutions has increased, by 80 per cent to just under kr. 4 billion, and currently accounts for one third of Faroese home financing.

Faroese households are particularly vulnerable to interest rate increases and falls in house prices. This is because just under 85 per cent of their loans are loans with variable interest rates and most of their assets are tied up in their homes. Also, there are indications that more Faroese private customers leverage themselves more than they did at the start of the expansion.¹⁹

However, household resilience has also improved during the expansion, and households have more leeway in their budgets. The improved resilience is the result of several factors. During the pandemic, households have built up further buffers and also increased their pension wealth through the new compulsory pension scheme, introduced on 1 January 2014²⁰. Furthermore, 92 per cent of the housing debt is debt with amortisation, which reduces the accumulation of debt. The improved resilience is among others reflected in better credit quality of their loans with Faroese banks, see chart 13.

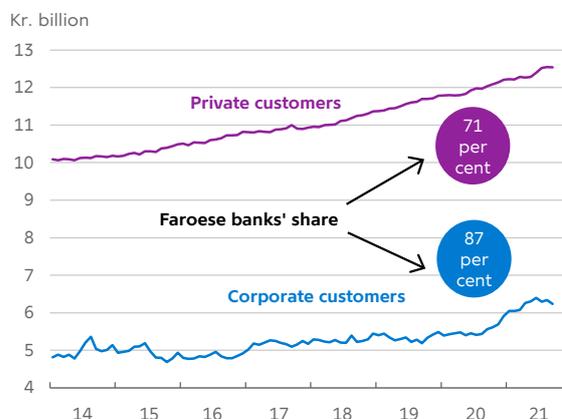
Rapid recovery also reflected in corporate lending

There are indications of increased credit demand from Faroese companies, with corporate lending from both Danish and Faroese credit institutions increasing over the past year.

Corporate lending by Faroese banks rose by a total of 14 per cent from July 2020 to end-September 2021, and is currently at one of its highest levels in

Lending to Faroese customers is on the rise

Chart 12

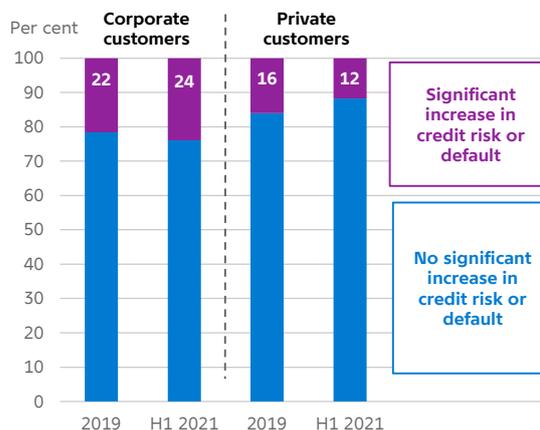


Note: Gross lending to Faroese customers by Faroese banks and credit institutions in Denmark. Corporate lending excluding the government-owned share of non-financial corporations. Bubbles indicate Faroese credit institutions' share of private and corporate lending. Latest observation is at the end of September 2021.

Source: Danmarks Nationalbank.

Credit risk on private lending declines, while credit risk on corporate lending increases slightly

Chart 13



Note: Proportion of credit exposures calculated according to IFRS9 stages, end of period. "Significant increase in credit risk" corresponds to stage 2 and 3 loans, while "No significant increase in credit risk or default" corresponds to stage 1 loans. These proportions are high compared with Danish SIFIs, for which the proportions for private and corporate customers, respectively, were 9 and 10 per cent in mid-2021.

Source: Danmarks Nationalbank and own calculations.

18 Based on estimates of Faroese GDP for 2021 provided by Hagstova Føroya and Búskaparráðið.

19 According to Landsbanki Føroya, the number of households with a debt-to-income ratio above 3 increased by 8 per cent during the period 2014-19. During this period, in particular, there was an increase in the number of households with a debt-to-income ratio between 4 and 5, of 10 per cent. At the end of 2019, households with a debt-to-income ratio above 5 held debt of just under kr. 1 billion.

20 On 1 January 2014, a compulsory pension scheme was introduced under which all fully taxable individuals under the official retirement age (67 years) must contribute to their own pension scheme. Contributions increase gradually by 1 per cent per year, to 12 per cent in 2026.

the current economic expansion. The rise is especially due to increased lending to trade, transport, hotels etc., real estate and building and construction, see chart 14. The increase partly reflects a rise in investments by the Faroese companies, but should probably also be seen in the context that the Faroese companies to a greater extent than Danish companies have covered their liquidity needs with banks during the pandemic. Moreover, credit growth tends to fluctuate with the size of the economy, and individual loans may have great significance.

Although there are no clear signs of a significant deterioration in the quality of banks' corporate lending for present, and loan impairment charges are being reversed, it is essential that banks stick to their credit policies. Currently, financial conditions are generally loose,²¹ and the economy is booming, which increases the risk of credit standards being relaxed. The credit quality of loans granted during good times may quickly deteriorate if the economic expansion loses momentum or is replaced by an economic downturn.

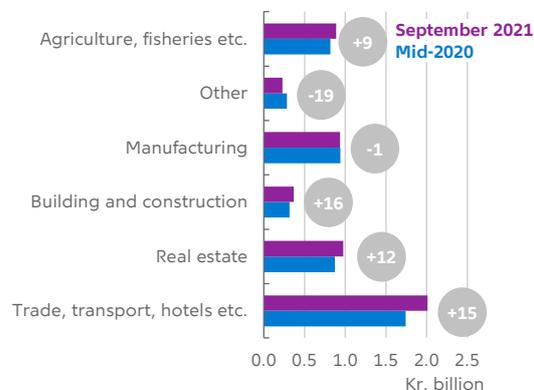
Banks should maintain their buffers

Faroese banks' return on equity (ROE) is about back to pre-pandemic levels, see chart 15. This reflects among others the rapid recovery of economic activity in the Faroe Islands, which has resulted in higher value adjustments and a reversal of loan impairment charges. This means that earnings have improved, which strengthens banks' first line of defence against losses. Banks' capital ratios have also increased, creating more distance to the regulatory requirements, thereby increasing their excess capital adequacy.²² At the end of the 1st half of 2021, Faroese banks' excess capital adequacy was about 12 per cent.²³

However, it is essential that banks maintain their buffers. Excess capital adequacy relative to the regulatory requirements means that banks are able to absorb losses, even when the economy reverses.

Across-the-board increase in corporate lending by Faroese banks

Chart 14

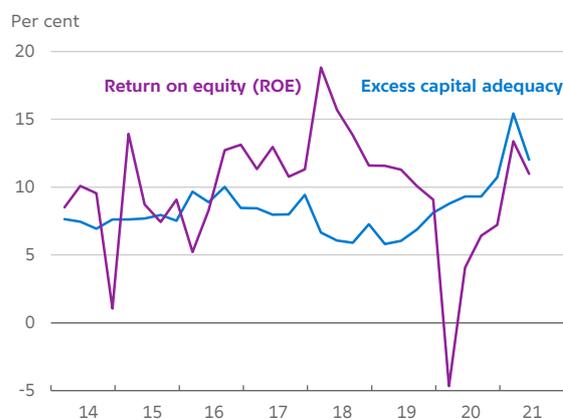


Note: Calculated as gross lending, end of period. Bank lending by Faroese institutions to Faroese customers. Figures in the grey circles reflect the percentage change from mid-2020 until end-September 2021.

Source: Danmarks Nationalbank and own calculations.

Banks' line of defence against losses is improving

Chart 15



Note: Return on equity (ROE) for the quarter. Excess capital adequacy calculated at the end of the quarter. Both calculated as a weighted average of the four Faroese banks. The most recent observations are for mid-2021.

Source: The Systemic Risk Council.

21 See, for instance, Danmarks Nationalbank, Accommodative financial conditions strengthen the upswing, *Danmarks Nationalbank Analysis (Monetary and financial trends)*, No. 23, September 2021.

22 Here, the excess capital adequacy relative to banks' Common Equity Tier 1 capital (CET1) is considered.

23 Weighted average of the four Faroese banks.

Global uncertainty resulting from covid-19 is still high, and Faroese banks are vulnerable to external shocks because the Faroese economy is a small, one-pronged economy. Moreover, the Faroese banking sector is highly concentrated, with just four banks, two of which, BankNordik and Betri Bank, are designated as systemically important institutions, SIFIs.²⁴

Faroese banks' direct exposures to the largest export industry (agriculture, forestry and fisheries) account for about 14 per cent of their loan portfolios, but the indirect dependency is actually much higher.²⁵ Consequently, external shocks may cause losses in the banking sector, which could further amplify fluctuations in the real economy.

Need of long-term planning of economic policy

It is key that a small economy, which is very vulnerable to external shocks, has a sufficient buffer to cushion the economy when the business cycle turns and through prolonged periods of lower export earnings. Although employment in the export industries is fairly low, these industries have large spillover effects on the rest of the Faroese economy, which increases the need for stability-oriented fiscal policy, where capital is set aside in good times.

However, in the pre-pandemic years, government budget surpluses were small, and limited surpluses are also expected in the coming years.²⁶ This is although some Faroese pension contributions are taxed at the time of contribution, which means that budgets are supported by revenue now whose expenditure matures many years from now when citizens retire and draw on government finances.

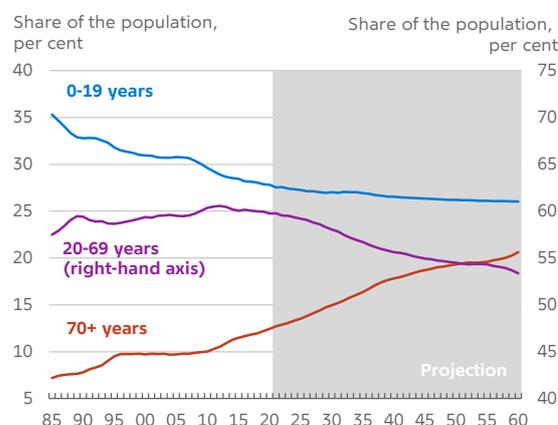
²⁴ Until recently, Nordoya Sparikassi, the third largest Faroese bank, was also designated as a SIFI, but the bank was not redesignated as a SIFI from 1 June 2021.

²⁵ Arnason et al., Økonomisk rente og ringvirkninger i de Vestnordiske fiskerier (Economic rent and knock-on effects in western Nordic fisheries – in Danish only), Nordic Atlantic Corporation (NORA), 2015 ([link](#)).

²⁶ The Finance Bill of 30 September 2021 includes a central government deficit of kr. 6 million in 2021, equivalent to 0 per cent of GDP. For 2022, a surplus of kr. 65 million is expected.

More elderly people in the Faroe Islands in the coming years

Chart 16



Source: Hagstova Føroya and own calculations.

The government of the Faroe Islands is faced not only with the need to build up a buffer to bolster for sudden changes in catches and fish prices, but also to address upcoming demographic challenges. In the coming years, the number of elderly people is expected to rise substantially, see chart 16. It should be mapped and assessed how increasing health care and nursing costs challenge fiscal sustainability with the current structure of the public sector.

Welfare and infrastructure investment should factor in the need for a buffer

Faroese government debt is relatively low, enabling the central government to support the economy despite large fluctuations in government revenue and expenditure during the pandemic. At the end of August, gross debt was 34 per cent of GDP, down from 44 per cent of GDP at the start of the year.²⁷ This should be seen in light of the fact that Landsbanki Føroya has used liquidity from a loan taken in June

²⁷ Landsbanki Føroya statement of EMU debt.

2020, in order to secure government liquidity during the pandemic, to repay a loan maturing in June 2021. Also, the average interest rate on the debt is low.

The low level of debt contributes to the resilience of government finances and of the Faroese economy. The past 20 years have seen a considerable expansion of the Faroese welfare state. It is essential that future investment is weighed against the need to preserve an adequate buffer for government finances. For instance, current considerations of constructing a new tunnel to Suðuroy, with an estimated draw on government debt of approximately 27 per cent of GDP,²⁸ should be seen in this context.

Reforms to generate more public sector revenue may strengthen sustainability

The government of the Faroe Islands has a number of options when it comes to increasing central government revenue in order to strengthen fiscal sustainability. First and foremost, taxation of housing in the Faroe Islands may strengthen economic resilience. Tax on primary or secondary homes may help to expand the central government's tax base and to mitigate the spillover effects of house price fluctuations to the rest of the economy. If housing taxation is designed to follow house price changes, it provides an automatic stabiliser – both for the real economy and the financial sector.²⁹ In other words, it is a good tool for a stability-oriented public sector.

In the Faroe Islands, a subsidy to household interest costs on housing loans of 35 per cent, up to kr. 100,000, is in place. This may not be desirable in terms of incentivising increased leveraging, and with the current low interest rates, it is a good time to reduce the subsidy.

Export industry earnings are key to economic growth, but are based on the natural sea and fish resources in and around the Faroe Islands. So, it is reasonable that part of the returns from Faroese natural resources should accrue to the population at large through taxation of the supernormal return from fisheries, the economic rent.³⁰ This may help to ensure that capital is set aside in good times to draw upon in bad.

The government of the Faroe Islands should regularly assess the extent of economic rent. The calculation may be subject to uncertainty, including the return on capital and wages, so it would be appropriate to implement general accounting principles in the public sector to strengthen the assessment of economic rent.³¹ There are indications that currently economic rent is not taxed sufficiently.³²

28 Based on a feasibility study in October 2021, Landsverk (an institution under the Faroese Ministry of Finance, responsible for public roads, among other things) estimated the cost of the tunnel link to be kr. 5.4 billion (*link, in Faroese only*).

29 See, for instance, Simon Juul Hviid and Paul Lassenius Kramp, Housing taxation agreement stabilises house prices, *Danmarks Nationalbank Analysis*, No. 14, September 2017.

30 See, for instance, Jens Warming, Om grundrente af fiskegrunde (On economic rent from fishing grounds – in Danish only), *Nationaløkonomisk Tidsskrift*, No. 49, pp. 499-505, 1911, and Jens Warming, Aalegaardsretten (The right to place eel weir – in Danish only), *Nationaløkonomisk Tidsskrift*, No. 69, pp. 151-162, 1931.

31 See, for instance, Nordic Council of Ministers, Samfundøkonomisk afkast af pelagiske fiskerier i nordøstatlantten (Socio-economic return of pelagic fisheries in the Northeast Atlantic Ocean (in Danish only), *Nordic Council of Ministers*, 2010 (*link*), for a common calculation framework across Nordic countries. Hagstova Føroya is currently working to improve Faroese wage statistics. This may help in the calculation of normal wage costs for the computation of economic rent.

32 See, for instance, Búskaparráðið, Konjunkturmeting á vari 2020 (Economic report from the Economic Council of the Faroe Islands, spring 2020), *Búskaparráðsfrágreiðing*, March 2020 (*link, in Faroese only*).

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 November 2021.



**DANMARKS
NATIONALBANK**

Flora Nagy Lomholt
Senior Bank Analyst
fna@nationalbanken.dk
FINANCIAL STABILITY

Adrian Michael Bay Schmith
Senior Economist
ams@nationalbanken.dk
ECONOMICS
AND MONETARY POLICY

CONTACT

Ole Mikkelsen
Communications
and Press Officer

omi@nationalbanken.dk
+45 3363 6027

SECRETARIAT
AND COMMUNICATIONS