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THE FAROESE ECONOMY

Economic upturn and growing reform needs



Economy can cope with current crisis

Like in many other countries, inflation has accelerated in the Faroe Islands in the past year. Fish export prices have also risen sharply, which has benefited the fishing industry and further boosted the economy. Together with low debt and a strong labour market, this gives the Faroese economy a sound foundation for coping with the current crisis.



Rising interest rates and widespread use of variable rate home loans

The widespread use of variable rate home loans, which often have a short period until the next interest rate adjustment, means that interest rate increases are quickly passed through to homeowners on the Faroe Islands. Higher interest rates on home loans during 2022, combined with inflationary pressures, will presumably weaken Faroese homeowners' ability to service their debt.



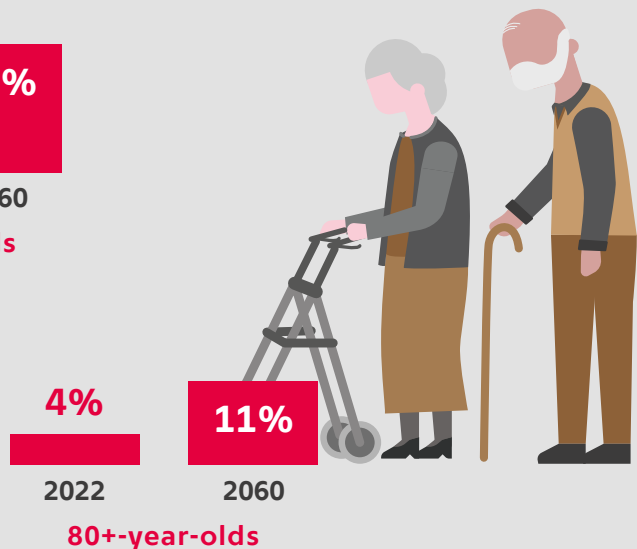
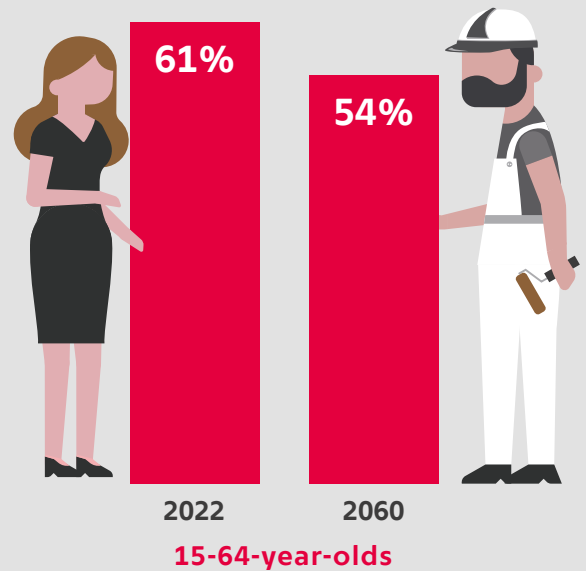
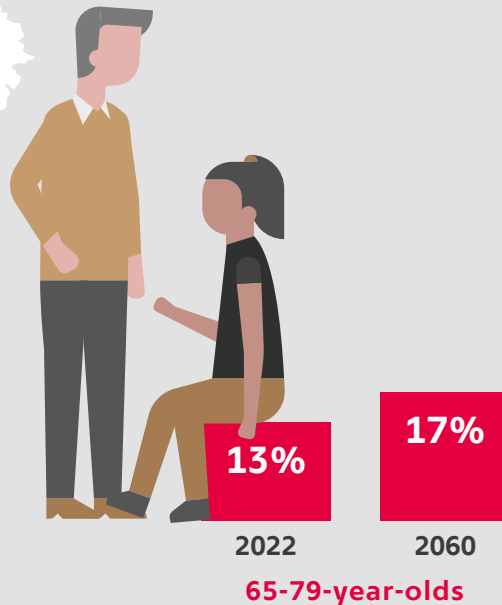
Demographic changes pose challenges

In future, a declining proportion of the Faroese population will be of working age, and the proportion requiring care will increase. This will put pressure on public finances. In the current economic upturn, the Faroe Islands have been running government budget deficits, underlining the need for reforms.

CONTENTS

- 2 ECONOMIC UPTURN AND INFLATIONARY PRESSURES
- 5 FAROESE BANKS ARE BETTER GEARED TO HANDLE LOSSES
- 7 DEMOGRAPHIC DEVELOPMENTS INCREASE NEED FOR REFORMS

The Faroese population today and in the future



Population	54,081 as at 31 August 2022
GDP per capita	Kr. 431,000 in 2021
	Kr. 425,000 in Denmark for comparison
Participation rate	84 per cent in 2021
	77 per cent in Denmark for comparison

Economic upturn and inflationary pressures

The Faroe Islands are experiencing an economic upturn with very low unemployment and high fish export prices. As there are already very few people outside the workforce, it is difficult for businesses to fill vacancies.

Unemployment has been falling steadily for over a decade and was down to 151 full-time unemployed persons, equal to 0.5 per cent of the labour force, in September, see chart 1. Over the same period, the workforce has increased significantly, partially as a result of immigration.

High inflation

Like in the rest of Europe, consumer prices have risen sharply in the Faroe Islands. Since the beginning of 2021, the development in the consumer price index has accelerated and was almost 10 per cent higher in the 3rd quarter 2022 relative to the same quarter in 2021. The development follows that of Denmark closely, see chart 2.

Excluding energy prices, which have been relatively volatile, the inflation rate in the Faroe Islands is just over 6 per cent, which is slightly above the Danish level.

A comparison of the Faroe Islands' price development with other countries is complicated by the weights in the consumption curve not being updated regularly in the Faroe Islands. The weights are based on a consumption survey from 2007, and the calculated inflation is thus based on the assumption that the consumption pattern of the Faroese population has not changed since then. As people usually shift their consumption towards goods that become relatively less expensive, fixed weights mean that the inflation rate is likely to be overestimated. If the same applied in Denmark, inflation in the 3rd quarter of 2022 would be just over 1 percentage point higher.

Unlike what is the case in Europe, the Faroe Islands' energy supply is not based on natural gas from Russia, but on oil. Oil prices have been less volatile than natural gas prices, but they have also seen significant increases – around 33 per cent between the 3rd quarter of 2021 and the 3rd quarter of 2022. Energy price increases may explain approximately 2.5 percentage points of Faroese inflation. In comparison, energy price increases accounted for 3.4 percentage points of Danish inflation in the same period.¹

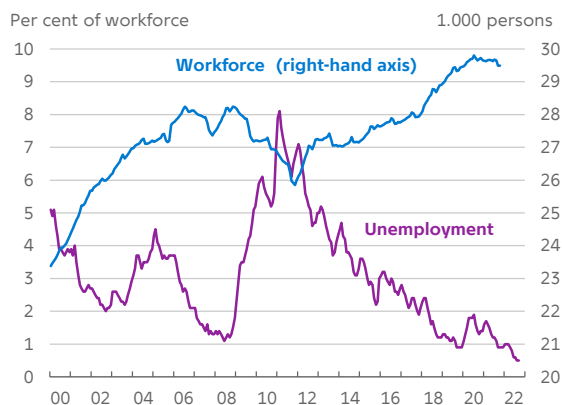
Inflation affects the economy asymmetrically

In the past few years, the Faroese fishing industries have benefitted from unusually high fish prices. For most businesses in the industry, the selling prices have been high enough to offset the higher prices they pay for, for example, feed and fuel. For example, the salmon price rose 48 per cent from 2021 to 2022, while the oil price increased by 43 per cent in the same period. The higher fish prices are reflected in the value of Faroese exports, which, so far, are 39 per cent higher in 2022 than in the same months in 2021, see chart 3.

As wages in the fishing industries are typically linked to the catch value, the high export prices have allowed the industries to pay higher wages in the competition for labour. Payroll costs per person in fisheries and fish farming increased by 37 per cent between 2012 and 2022, while they rose 25 per cent in the rest of the economy. This is equal to 3.2 per cent and 2.2 per cent, respectively, per annum.

Low unemployment and growing workforce

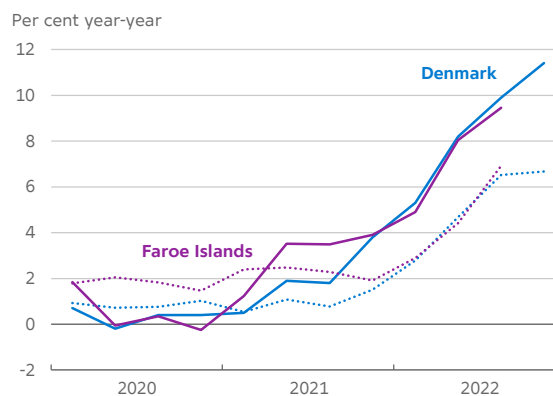
Chart 1



Source: Hagstova Føroya.

Faroese inflation is close to Danish level

Chart 2



Note: The chart shows the annual rate of increase in the consumer price index excluding rental value of own home and interest payments on mortgage loans. This makes the Danish and Faroese consumer price indices more comparable. Fully drawn lines indicate inflation, dotted lines indicate inflation excl. energy.

Source: Hagstova Føroya.

¹ Measured as The Harmonised index of consumer prices (HICP).

It is generally positive that higher productivity in the fishing industries results in higher pay increases and thus attracts labour from other industries. This increases productivity for the Faroe Islands as a whole. However, it can also lead to a further concentration of the Faroese economy around the fishing industries and thus make the economy more vulnerable to fluctuations in these industries.

Having an export sector with high pay levels can also hamper the development of the other industries in the Faroe Islands. If, for example, the aim is to expand elderly care in step with demographic developments, it may be difficult to attract sufficient labour.

Moderate pay increases

The tight labour market combined with high inflation and increased export prices does not yet seem to have put any significant pressure on salaries in the Faroe Islands, see chart 4. The average wage growth in the past decade has been around 2.2 per cent (measured as compensation per employee). In 2022, payroll costs have so far been around 3.5 per cent higher than in the same months in 2021. This reflects an increase in payroll costs per employee of 13.2 per cent in the fishing industries and of 1.6 per cent in the rest of the economy.

As fishing industry wages rise and fall with earnings in the industry due to the composition of the employment contracts, the increase is unlikely to give rise to concerns about a wage-price spiral.

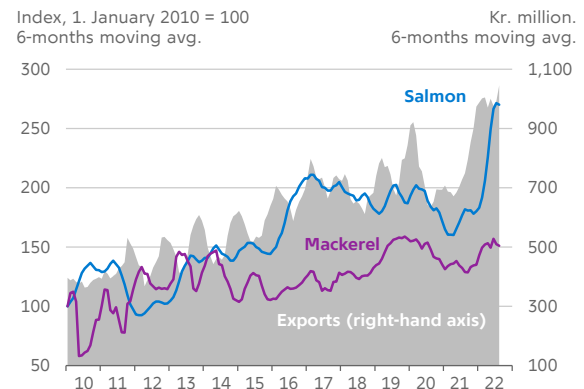
Faroese fisheries benefit from trade and fisheries agreements with Russia

Faroese fisheries benefit greatly from being able to fish in different waters, so that they are not dependent on the fish swimming into Faroese waters. A number of international agreements have historically ensured that neighbouring countries can fish in each other's waters, which has acted as a diversification of risk. Most recently, in November 2022, the Faroe Islands extended its agreement with Russia, as did Norway earlier in 2022. It gives Faroese fishermen access to the Russian part of the Barents Sea, in exchange for Russian fishermen having access to Faroese waters.

In addition to the fisheries agreement, Russia has also been the largest buyer of Faroese fish for several years. That has changed in 2022, with virtually no fish being sold to Russia so far this year. As the

Export growth is boosted by rising fish prices on world market

Chart 3

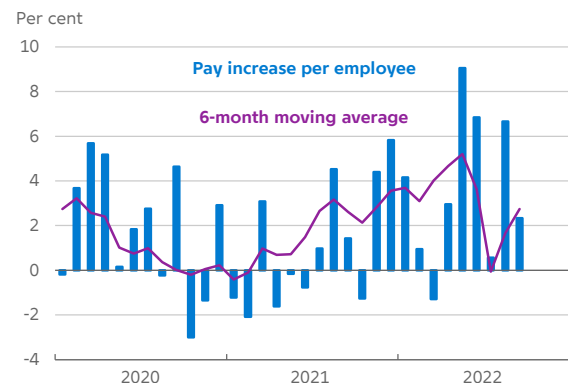


Note: The chart shows price developments for Faroese salmon and mackerel exports. In 2021, salmon and mackerel exports accounted for 45 and 23 per cent of total Faroese exports respectively. Overall, fish accounts for approximately 95 per cent of all Faroese exports of goods.

Source: Hagstova Føroya.

Wage growth remains moderate

Chart 4



Note: The chart shows the growth in compensation per employee in the Faroe Islands. The columns show monthly data for annual growth. The line shows the 6-month moving average. Employees are not counted twice if employed in more than one job. The latest data point is from September 2022.

Source: Hagstova Føroya.

sanctions against Russia do not cover foods, this is largely due to companies themselves having refrained from selling to Russia.

At the time of writing this analysis, it is still too early to calculate the trade with Russia for 2022, as the herring season is not yet included in the data. While most fish species are sold in many countries, it is difficult to find export markets other than Russia when it comes to herring. Russia may therefore end up accounting for a larger share of exports in the rest of 2022 than it has done so far.

Faroese banks are better geared to handle losses

Credit provision on the Faroe Islands is mainly provided by the four Faroese banks. They are also responsible for the provision of mortgage loans, as cooperations have been established with Danish mortgage credit institutions regarding intermediation of mortgage loans on the Faroe Islands.

In October 2022, lending to Faroese households and corporates was approximately 6 per cent and 2 per cent, respectively, higher than in the previous year.² Lending growth to corporates has decreased significantly since mid-2021, which may reflect a more subdued demand for loans from Faroese companies.

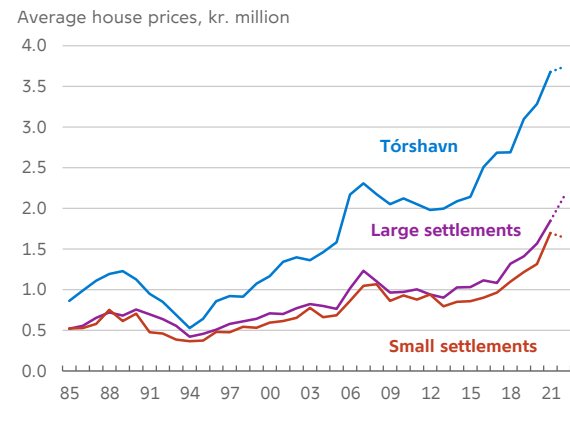
Growth in housing lending should be viewed in connection with rising house prices

Housing lending by Faroese banks and Danish mortgage credit institutions accounts for just over half of the institutions' total lending on the Faroe Islands. In October 2022, housing lending was almost 7 per cent higher than in the previous year. Housing lending has been growing in recent years, which should be viewed in connection with rising house prices, especially in Tórshavn, see chart 5.

House prices on the Faroe Islands have been driven by rising disposable incomes, among other factors. High population growth since 2013 and falling inter-

Large house price increases in recent years

Chart 5



Note: Figures for 2022 cover only current transactions for the 1st to the 3rd quarters of the year and are subject to uncertainty.

Source: Hagstova Føroya, BankNordik and own calculations.

est rate levels up until the end of 2021 may also have buoyed housing demand. At the same time, housing supply has not kept up with the boom.³

A characteristic feature of the Faroese housing market is that most of the lending for home purchases consists of home loans with amortisation. This contributes to increasing Faroese homeowners' resilience to shocks to the economy.

Faroese homeowners are interest rate sensitive

Variable rate home loans are very popular among Faroese homeowners, see chart 6, left. For approximately 85 per cent of the total variable-rate housing lending, there is less than one year until the next interest rate adjustment. Rising interest rates are therefore quickly passed through to Faroese homeowners' interest expenses.

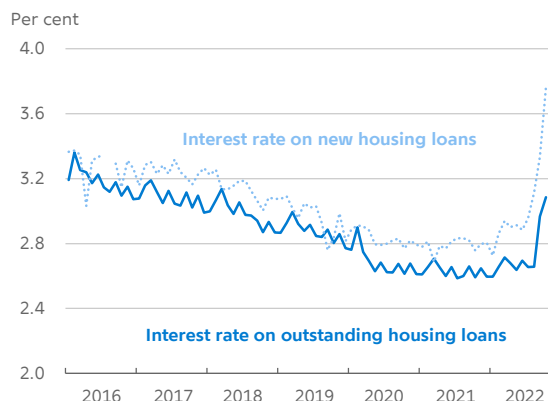
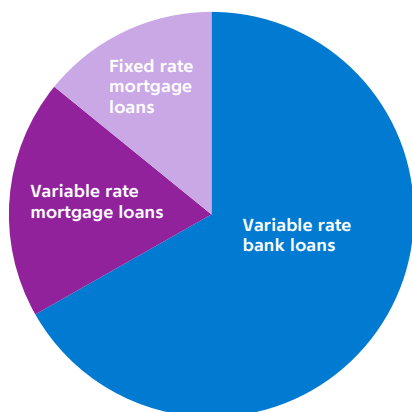
Interest rates on Faroese home loans have started to rise during 2022, but from a low level, see chart 6, right. The interest rate increases come on top of current high inflationary pressures in the Faroese economy. Overall, the increased interest expenses

² Lending from Faroese banks and Danish mortgage credit institutions.

³ See Adrian Michael Bay Schmith and Flora Nagy, The boom has regained momentum, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 27, November 2021 ([link](#)).

Many Faroese homeowners have variable rate home loans and are now facing higher interest rates

Chart 6



Note: Left-hand chart: Lending for housing purposes to Faroese households (excluding sole proprietorships) from Faroese banks and Danish mortgage credit institutions. For most of the total fixed rate mortgage lending, there is more than ten years until the next interest rate adjustment. Data for October 2022. Right-hand chart: Faroese banks' and Danish mortgage credit institutions' interest rates (incl. administrative fee) on lending for housing purposes to Faroese households (excluding sole proprietorships). A single observation has been omitted due to confidentiality. The most recent observations are from October 2022.

Source: Danmarks Nationalbank.

on home loans and general price increases will presumably weaken Faroese homeowners' ability to service their debt.

However, a home loan interest subsidy mitigates the effect of interest rate increases on Faroese homeowners' finances. The interest subsidy reduces homeowners' interest expenses on home loans by the equivalent of 35 per cent of the interest expenses up to a ceiling of DKK 100,000.

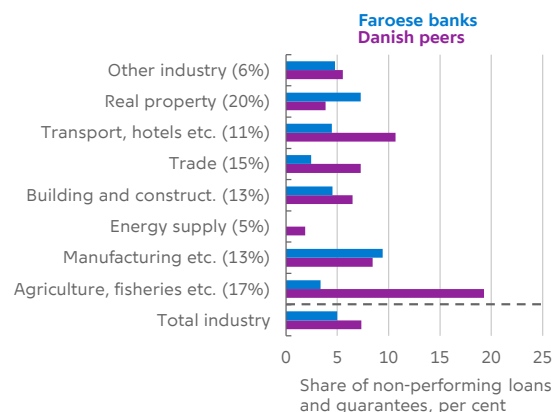
Faroese banks have a slightly lower share of non-performing corporate loans than Danish banks

Overall, the Faroese banks' corporate customers appear to be doing well. This is reflected in Faroese banks having a slightly lower proportion of non-performing loans and guarantees to corporate customers than Danish banks, so-called peers, see chart 7. Low impairment charges and several major reversals on corporate exposures since 2016 also point towards a positive development in the credit quality of corporate customers.

In 2020 and 2021, the Faroese business sector's return on equity was around the historical average for the 1998-2021 period. However, this follows several years of high earnings, and the business sector's solvency ratio are close to being historically high.

Slightly smaller share of non-performing corporate loans etc. in Faroese institutions relative to Danish peers

Chart 7



Note: Data for end of first half of 2022. The banks' non-performing loans and guarantees to individual industries as a percentage of loans and guarantees to the individual industries. The percentages in brackets show the Faroese banks' loans and guarantees to the industry as a percentage of their total corporate loans and guarantees. Loans and guarantees to industries that constitute less than 5 per cent of the Faroese banks' total corporate loans and guarantees are excluded. Danish peers consists of banks in the Danish Financial Supervisory Authority's groups 2 and 3.

Source: The Danish Financial Supervisory Authority and own calculations.

Overall, Faroese companies have thus become better geared to bear losses if business conditions deteriorate as a result of, for example, rising input prices or an economic downturn.

Faroese banks have become better capitalised in recent years

The Faroese banks have also become better capitalised in recent years, see chart 8. This makes them better able to absorb future losses that cannot be covered by current earnings. The increase in the Faroese banks' Common Equity Tier 1 capital ratio has also had a positive effect on their excess capital adequacy, resulting in more excess capital relative to the regulatory requirements.

The Faroese banks' earnings have been impacted by fluctuations in the financial markets in 2022, and the return on equity has been reduced to a level somewhat below the average rate of return seen since 2017. Conversely, earnings in the 1st to 3rd quarters 2022 were supported by reversals of impairment charges.

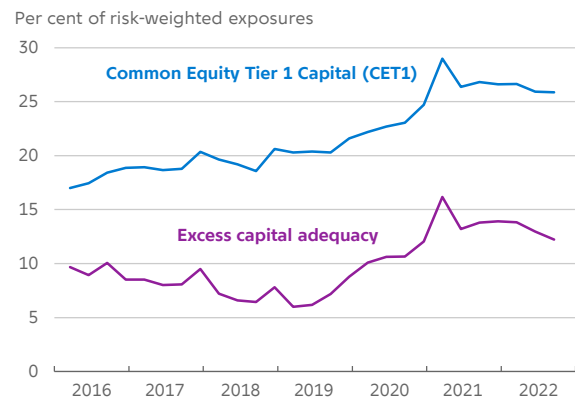
It is important for the Faroese economy that the Faroese banks are sufficiently resilient to shocks and losses on customers to enable them to act as efficient providers of capital and services, also during bad times in the economy. This applies not least to the two largest Faroese banks, BankNordik and Betri Banki. With a balance sheet total of approximately half the Faroe Islands' GDP in 2021 each, they are designated as systemically important financial institutions on the Faroe Islands.⁴

Demographic developments increase need for reforms

The Faroese economy is very much a one-sector economy and highly dependent on the fishing industries, which are characterised by relatively unpredictable earnings. This basic condition makes it particularly important that good times are also used to prepare for bad times, where, for example, there

Faroese banks have become better capitalised in recent years

Chart 8



Note: Excess capital adequacy for the four Faroese banks is calculated as Common Equity Tier 1 capital less the total Common Equity Tier 1 capital requirement (including capital buffers). The most recent observations are from the 3rd quarter of 2022.

Source: The Danish Financial Supervisory Authority.

may be a need to borrow money abroad. This may, for example, be achieved by increasing the international investment position and by creating expedient economic structures. If it becomes necessary to borrow money abroad, it is important that the Faroese economy is still attractive and that investors find it likely that the Faroe Islands will be able to reverse the trend – even if the main industry is hit hard and a large part of the workforce may leave the country.

Overall, the Faroe Islands have a healthy economy with high employment rates, low public debt and positive net foreign assets. Basically, the Faroese economy is relatively well geared to coping with economic downturns.

Demographic changes increase need for reforms

Like many other countries, the Faroe Islands are facing a significant demographic shift over the next decades. The ratio of children and seniors to working-age adults has been relatively stable at around 60 per cent since 1985. This means that for every ten persons of working age, there are six children

⁴ See the Danish Financial Supervisory Authority's press release on the annual designation of SIFI institutions (in Danish only), 24 June 2022 ([link](#)).

and seniors who typically receive more public funds than they pay in tax. By 2030, the ratio is expected to increase to just under 70 per cent, and by 2060 to just under 90 per cent, see chart 9.

In addition to the increase in the proportion of people of non-working age, pensioners will also be older. As health expenditure increases with age, this will put additional pressure on public finances. For example, the DREAM group has calculated that government expenditure per person in Denmark was twice as high for 80-year-olds as for 65-year-olds in 2014.⁵

In the Faroe Islands, the proportion of persons aged 65+ is expected to increase from 18 per cent today to 27 per cent in 2060. For 80+-year-olds, the increase is relatively higher. The group is expected to increase from 4.5 per cent of the population to approximately 11 per cent, see chart 9. This must be expected to result in a drastic deterioration in public finances.

For most countries, demographic forecasts are usually relatively accurate in the short and medium terms. The reason is that most of the population growth is based on the number of births less deaths, which can be predicted with reasonable precision. The situation is different in the Faroe Islands, where a relatively large proportion of the population growth is due to immigration, see chart 10. Firstly, it is difficult to predict the number of immigrants and emigrants in the coming years. Secondly, it is difficult to predict their age and gender.

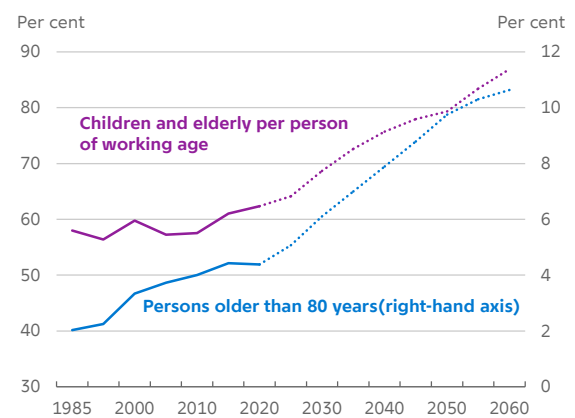
Large fluctuations in immigration and emigration may affect fiscal sustainability in different ways. If people of working age who become unemployed move abroad, this will benefit public finances in the short term, as no unemployment benefits have to be paid to them. Conversely, the demographic challenges may worsen if they are not liable to return when the situation changes.

Government deficit erodes future political room for manoeuvre

In 2015, the Faroese Economic Councils estimated that balancing the Faroese economy in the long term

Fewer persons of working age

Chart 9

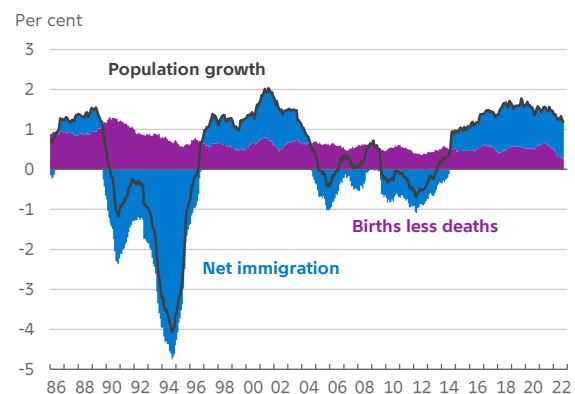


Note: Children and seniors are defined as persons aged over 65 and under 15. Working age is defined as persons aged 15-65.

Source: Hagstova Føroya.

Immigration and emigration are highly important to Faroese population growth

Chart 10



Anm.: The chart breaks down population growth (line) into birth rate less deaths (purple) and net immigration (blue).

Source: Hagstova Føroya.

⁵ See DREAM, Socio-economic consequences of healthy ageing, 2021 (only in Danish), ([link](#)).

would require lasting fiscal policy tightening of 5 per cent of GDP.⁶ This could be achieved by means of increased tax revenues, lower government spending or labour supply reforms.

Since then, the economic upturn has gathered momentum, and the Faroe Islands are now in a particularly favourable situation as regards levels of economic activity as well as world market prices. As both factors have a positive effect on public finances, higher surpluses would be expected today than in 2015, even without reforms to ensure fiscal sustainability.

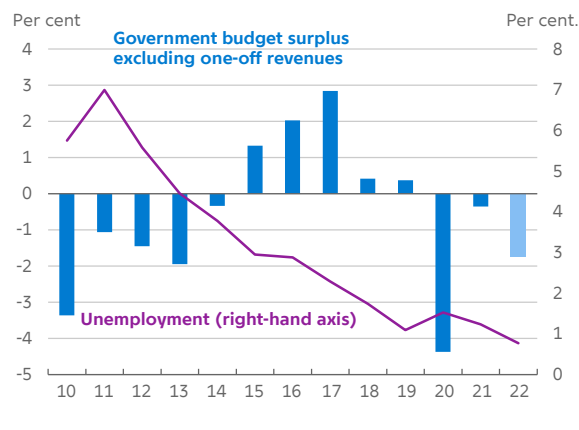
However, disregarding exceptional one-off revenues, there have been significant government budget deficits in recent years, see chart 11.⁷

Despite the current deficits in recent years, the Faroe Islands have not yet built up significant debt. In 2021, EMU debt totalled 33 per cent of GDP. This is due to several factors, including high nominal GDP growth and the divestment of central government assets. This means that it will still be possible to raise debt to finance public consumption in a possible future recession or to make public investments in, for example, infrastructure. However, with future deficits being driven by demographic trends, the debt is likely to increase over time, which will erode this possibility in the future.

There are signs that the Faroese economy will soon feel the consequences of the demographic challenges. It would make sense to address the challenges before they materialise.

Government deficit despite historic tailwinds

Chart 11



Note: The chart shows the sum total of central and local government current surpluses. 2022 is a forecast from the Faroese Economic Councils. One-off revenues of DKK 176 million have been deducted in 2022, equal to 0.7 per cent of GDP, and of DKK 212 million in 2021, equal to 0.9 per cent of GDP. The revenues are due to de facto sales of central government assets as well as extraordinary proceeds from the sale of BankNordik's Danish branch.

Source: Hagstova Forøya and the Faroese Economic Councils.

6 See Report F15, the Faroese Economic Councils, 2015 ([link](#)).

7 Extraordinary revenues include: Extraordinary dividend in 2021 and 2022 from BankNordik due to divestment of its Danish branch, sales of the public equities in P/FTjaldur in 2022, liquidation of the fund that managed the State's equities in P/F BankNordik and liquidation of Landsbanki Føroya's base capital.

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