

---

# The Economic Situation in the Faroe Islands

---

*Winnie Jakobsen and Pernille Thinggård, Secretariat*

## INTRODUCTION

---

The significant progress in the Faroese economy observed since 1995 has been replaced by a downturn from 2003. The last ten years have seen extensive consolidation of the public finances, as well as the finances of most households and business enterprises, and there is thus no sign that the slowdown will develop into a crisis on the scale witnessed in the early 1990s.

This article outlines the current economic situation in the Faroe Islands and follows up on the article on the Faroese economy in Danmarks Nationalbank's *Monetary Review*, 3rd quarter 2003.<sup>1</sup>

The Faroe Islands are part of the Danish currency area, and the Danish monetary and foreign-exchange policy thus also applies to the Faroe Islands, cf. Box 1.

## RECENT ECONOMIC TRENDS

---

The development in the Faroese economy has taken a downward course from 2003 following a period of unusually high growth, cf. Chart 1. The Faroese Ministry of Finance estimates GDP growth in current prices for 2003 to be in the area of zero per cent or slightly decreasing, corresponding to a decline in real terms of 3-4 per cent. The fall is attributable to a general economic downturn and a decline in fish farming and fish processing. In addition, fisheries have seen a decrease although most of the fleet still makes a good profit.

Unemployment has been rising since August 2003, but was still at a low level of 4-5 per cent in May 2004. Unemployment varies across regions, and in some of the peripheral regions of the Faroe Islands it has

---

<sup>1</sup> This article is, *inter alia*, based on a visit to the Faroe Islands in May 2004, during which we met with the High Commissioner's Office, the Faroese Ministry of Finance, the Faroese Economic Council, Landsbanki Føroya (the Governmental Bank of the Faroe Islands), trade organisations, Føroya Sparikassi and Føroya Banki.

## INSTITUTIONAL FACTS ABOUT THE FAROE ISLANDS

Box 1

The currency of the Faroe Islands is Danish kroner. Danmarks Nationalbank's decisions relating to monetary and foreign-exchange policy – including interest-rate decisions – apply fully and directly to the Faroe Islands. The Faroese banks may hold accounts at Danmarks Nationalbank and may make deposits or raise collateralised loans. Danmarks Nationalbank may provide liquidity support to a bank that is solvent, but nevertheless incurs liquidity problems. The Faroe Islands have their own banknotes, which are legal tender in the Islands. The banknotes are printed and issued by Danmarks Nationalbank. The Faroese banknotes can be exchanged for Danish banknotes free of charge on a 1:1 basis in Danmarks Nationalbank. Danmarks Nationalbank has cash depots in the Faroe Islands supplying banknotes to the local banks in the same way as in Denmark.

The fundamentals are described in Governor Bodil Nyboe Andersen's speech "A common currency or separate currencies?", which can be found on page 81 and at Danmarks Nationalbank's website, [www.nationalbanken.dk](http://www.nationalbanken.dk).

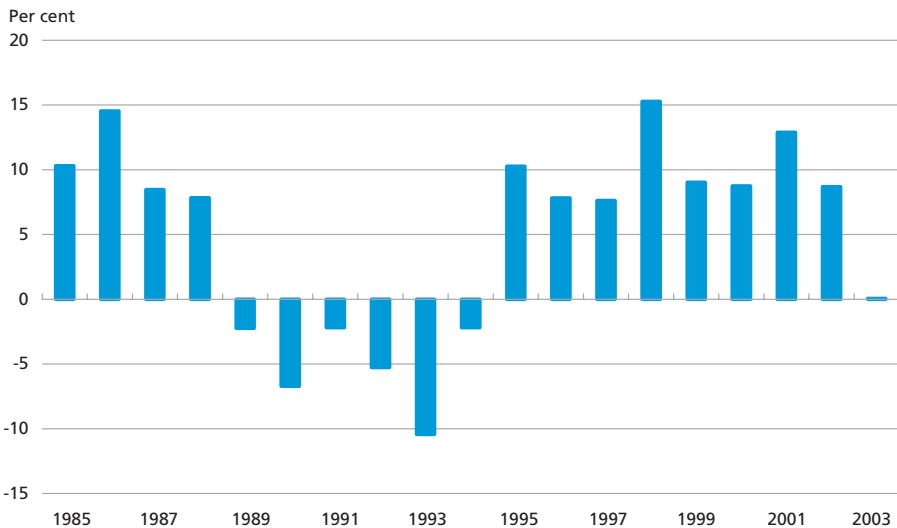
almost doubled due to the adverse situation in fish farming and fish processing.

The housing market remains stable. House prices, especially in Tórshavn, have levelled off since 2001, but are still at a high level compared with previous periods.

Table 1 shows key figures for the Faroese and Danish economies.

## GDP GROWTH IN CURRENT PRICES

Chart 1



Note: Hagstova Føroya has not provided a figure for 2003. The 2003 figure is therefore based on estimates from the Faroese Ministry of Finance and Landsbanki Føroya.

Source: Hagstova Føroya (Statistics Faroe Islands).

KEY FIGURES FOR THE FAROE ISLANDS AND DENMARK, 2003 Table 1

	Faroe Islands	Denmark
Number of inhabitants .....	48,214	5,397,640
Inhabitants per km <sup>2</sup> .....	34	125
Agriculture and fisheries, per cent of GDP, 2001	22.1	3.7
GDP in current prices, kr. billion .....	10	1,398
GDP in current prices, per capita .....	212,843	259,454
Disposable GNI per capita, 2002 .....	237,557	243,947
Gross government debt, per cent of GDP <sup>1)</sup> .....	58	46
Exports of goods, per cent of GDP <sup>2)</sup> .....	37	31
Imports of goods, per cent of GDP <sup>2)</sup> .....	36	27
Balance of payments, per cent of GDP .....	2	3
Net external debt, per cent of GDP .....	-40	16
Unemployed, per cent of labour force .....	3.6	6.2

Source: Hagstova Føroya, Landsbanki Føroya and Statistics Denmark.

<sup>1)</sup> For the Faroe Islands the figure is for 2002.

<sup>2)</sup> For the Faroe Islands the figure is excluding ships and aircraft.

### Total payroll expenditures

The statistical basis for assessing the Faroese economy is limited, and some of the statistics are subject to considerable uncertainty. Total payroll statistics are taken as an essential indicator of economic development. Growth in payroll expenditures in 2003 and the first seven months of 2004 was notably lower than in previous years, cf. Table 2.

The various sectors show different patterns. In the period January-July 2004 payroll expenditures in the fishing industry decreased by approximately 5 per cent compared with the same period in 2003. Conversely, payroll expenditures in services increased by 5 per cent. In the building and construction sector payroll expenditures rose by 12 per cent, but levels were low in the first half of 2003 due to, *inter alia*, a strike. The labour shortage in recent years has diminished.

TOTAL PAYROLL EXPENDITURES Table 2

Kr. million	2001	2002	2003	2003 Jan. - July	2004 Jan. - July
Primary sector .....	1,581	1,646	1,476	820	777
Manufacturing including building .....	1,177	1,306	1,337	755	791
Services .....	2,792	3,048	3,222	1,860	1,951
Total .....	5,550	6,001	6,035	3,435	3,519
Change in per cent against the preceding year .....	13.8	8.1	0.6	1.1	2.4

Note: Payroll expenditures comprise paid-out income taxed at source, as well as the tax deducted at source. Unemployment insurance and public disbursements such as social pensions, unemployment benefits and various subsidies have been deducted.

Source: Hagstova Føroya.

In May/June 2003 there was an extensive 4-week strike in connection with collective bargaining agreements, resulting in a 9-per-cent wage increase over two years. The strike brought filleting activities to a standstill and prevented fishermen from unloading their catches in Faroese ports.

## THE FISHING INDUSTRIES

Fisheries, fish processing and fish farming are the dominant industries in the Faroe Islands.

### Fisheries

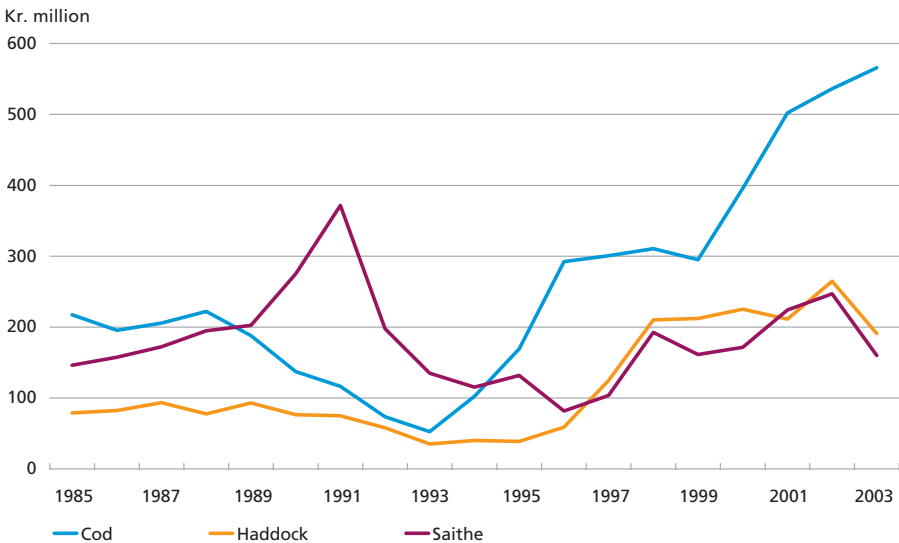
Catches in Faroese waters mainly comprise cod, haddock and saithe. Cod fishing still yields an extremely high profit. By contrast, world-market prices for haddock and particularly saithe dropped in 2003 and the beginning of 2004, which is reflected in declining catch values, cf. Chart 2.

Fishing in Faroese waters is regulated by a scheme under which each vessel is assigned a total number of fishing days per year. For one year as from 1 September 2004 the number of annual fishing days has been reduced by 1.5 per cent.

Fishing in external waters is regulated by international agreements and quotas, imposing a ceiling on catch volumes. Primarily as a result of falling prices the profit on herring, mackarel, capelin and blue whiting declined in 2003, but is still good.

CATCH VALUES FOR COD, HADDOCK AND SAITHE

Chart 2



Note: Catch values are pure market values.

Source: Hagstova Føroya.

The situation is critical for the shrimp fleet owing to e.g. the low shrimp prices. Of seven shrimp trawlers, only four are in operation, and the future of the shrimp fleet is uncertain.

### Fish processing

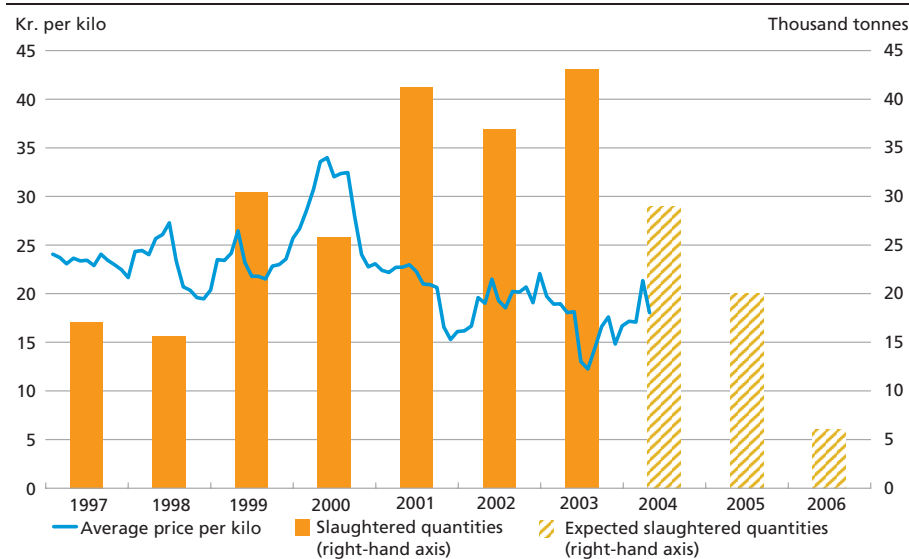
In general, the situation is difficult for the fish-processing industry, which is facing keen competition from particularly Scotland and Iceland, but also from China. An increasing share of the total catch of cod, haddock and saithe is exported unprocessed as frozen or iced fish instead of being processed in the Faroe Islands. In 2003, 33 per cent of this catch was exported for processing abroad against 28 per cent in 2002, and domestic output fell from 81,000 tonnes in 2002 to 71,000 tonnes in 2003. However, fish-processing factories producing salted fish still enjoy favourable development.

### Fish farming

Fish farming, primarily salmon, is the second-largest export industry in the Faroe Islands, but it is in a deep crisis because of the low prices and the disease ISA (infectious salmon anaemia). With average production costs of kr. 18-20 per kilo, production was not profitable in 2003. Because of ISA, salmon in infected areas have been slaughtered before they have attained a suitable age and size, and the total volume of slaughtered salmon was thus extraordinarily high in 2003, cf. Chart 3.

SALMON PRICES AND SLAUGHTERED QUANTITIES

Chart 3



Note: The figures for 2004-06 are estimates of the expected slaughtered quantities.

Source: Vinnuhúsið.

In the coming years the volumes of exported salmon will drop markedly due to "advance" slaughtering because of ISA and a considerable reduction of smolt volumes from 2003. Farming exports have amounted to approximately kr. 900 million annually in the last five years, equivalent to approximately 20 per cent of the Faroese exports of goods.

Because of the long production time of 2-3 years, production is capital-intensive. Low prices and ISA have caused liquidations and closures, and the equity, which was kr. 0.5 billion in 2001, is gone. The future of the industry is uncertain even though foreign capital has been admitted from 2004. The critical situation is also reflected in the accounts of the Faroese banks, which showed considerable losses and provisions for the fish farming industry in 2003.

## THE FINANCIAL SECTOR

The total financial result of the banks deteriorated considerably from a profit of kr. 293 million in 2002 to a loss of kr. 100 million in 2003, cf. Table 3. The reversal was due to the marked losses and provisions of kr. 425 million, most of which can be attributed to fish farming. In the first half of 2004 no further provisions were needed, and the banks became profitable again. The solvency ratio of the banks remains high.

## PUBLIC FINANCES

The surplus on public finances decreased in 2003 by kr. 168 million to kr. 23 million, cf. Table 4. The budget for 2004 operates with a deficit of kr. 204 million. The deficit, as well as a repayment of kr. 77 million on the debt to the Danish government will be financed via the liquidity of the Exchequer.

THE BANKS' TOTAL FINANCIAL RESULTS

Table 3

Kr. million	2000	2001	2002	2003	1st half 2004
<i>Income</i>					
Net interest, fee and commission income, etc .....	531.5	556.2	568.4	599.8	283.1
Value adjustments .....	-5.1	19.9	50.2	18.2	81.6
<i>Costs</i>					
Operating expenses, etc. ....	266.6	272.2	301.9	293.5	156.6
Losses and provisions on debtors .....	-154.0	-5.7	23.3	424.5	95.4
<i>Ordinary operating result</i> .....	413.8	309.6	293.4	-100.0	112.7

Source: Føroya Banki, Føroya Sparikassi, Norðoya Sparikassi and Suðuroyar Sparikassi.

INCOME AND EXPENSES OF THE EXCHEQUER						Table 4
Kr. million	1999	2000	2001	2002	2003	2004
Tax revenues .....	1,234	1,310	1,567	1,676	1,581	1,496
Customs and duties .....	1,043	1,117	1,148	1,239	1,274	1,254
Other income .....	117	88	90	58	81	31
Block grants including govern- ment pensions .....	945	973	995	629	632	630
<i>Total income</i> .....	3,339	3,489	3,800	3,602	3,568	3,411
Operating costs .....	2,400	2,586	2,846	3,147	3,192	3,334
Capital investments .....	135	174	180	240	262	242
Net interest costs .....	156	126	76	24	91	39
<i>Total expenses</i> .....	2,691	2,886	3,102	3,411	3,545	3,615
<i>Surplus</i> .....	648	603	698	191	23	-204

Note: Exchequer accounts 1999-2003 and budget for 2004. The increase in net interest costs in 2003 are due to reduced interest income on the Exchequer's deposits.

Source: The Faroese Ministry of Finance.

Tax revenues were reduced by kr. 95 million in 2003, and growth is lower in the first half of 2004 than in previous years. The decline in tax revenues is due to tax cuts and the weakening of the economy. The most recent tax cut, adopted in 2003, has reduced revenues by kr. 52 million in 2003 and kr. 71 million in 2004.

Operating costs increased by 39 per cent in the period 1998-2003, corresponding to average annual growth of approximately 7 per cent. Payroll expenditures in the public sector have risen by 4-5 per cent annually.

### Government debt

At the end of 2003 the Exchequer's debt to the Danish government was extraordinarily reduced by kr. 1.7 billion to kr. 2.2 billion.<sup>1</sup> The reduction was financed by drawing kr. 0.5 billion on the Exchequer's deposit with Landsbanki Føroya (the Governmental Bank of the Faroe Islands) and by issuing bonds worth kr. 1.2 billion. The Exchequer's gross debt at end-2003 was kr. 4.4 billion.

In July 2004, the Exchequer's liquidity was approximately kr. 1.5 billion. The Exchequer is under a statutory obligation to hold a deposit with Landsbanki Føroya of at least 15 per cent of GDP in the previous year, equivalent to approximately kr. 1.5 billion, and the deposit is only kr. 11 million from the statutory minimum requirement. Despite

<sup>1</sup> Of the kr. 2.2 billion kr. 500 million is an interest- and instalment-free loan, which will be amortised in 2018 if extraction of raw materials has not commenced by then. The remaining amount is settled as a 20-year annuity loan with a fixed annual interest rate of 5 per cent, maturing in 2018.

the considerable amount of liquidity, public borrowing may thus be necessary.

In addition to liquid deposits, the public sector has other considerable assets. These include the public sector's share of the Financing Fund of 1992 (particularly Føroya Banki) and other public enterprises and foundations. The possible privatisation of parts of these enterprises has been an issue in the Faroese debate for some time.

## FOREIGN TRADE AND EXTERNAL DEBT

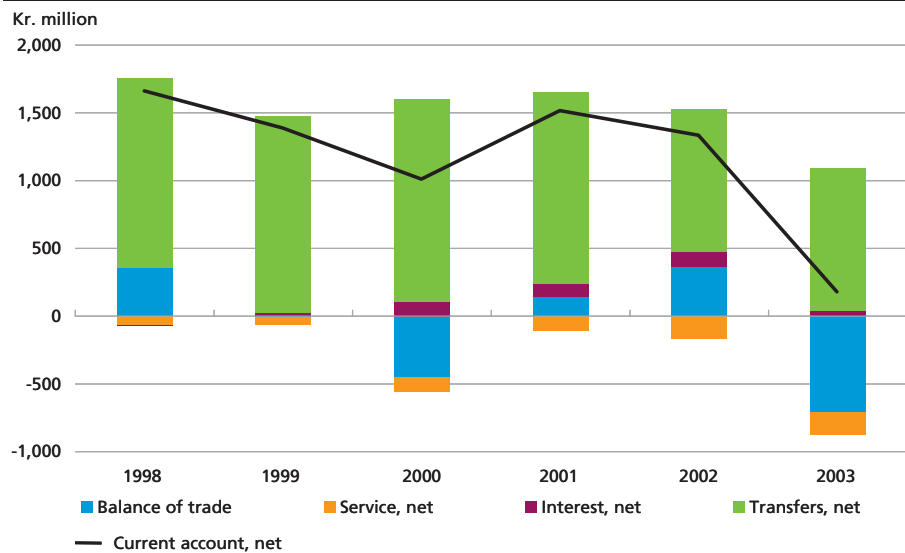
The balance of trade including ships deteriorated in 2003 by kr. 1,072 million to a deficit of kr. 711 million, cf. Chart 4. The fall is mainly attributable to the purchase of a ferry sailing between e.g. the Faroe Islands, Iceland and Denmark. Excluding ships, the balance of trade showed a surplus of approximately kr. 100 million. Both exports and imports declined, and the decrease in imports has continued in 2004. In the first four months of 2004 imports (excluding ships) fell by 10 per cent compared with the same period in 2003, while exports (excluding ships) only declined by 2 per cent.

The reversal of the balance of trade has reduced the current-account surplus. However, preliminary figures indicate a small surplus in 2003.

The Faroe Islands still have high net assets totalling kr. 4.1 billion vis-à-vis other countries including Denmark, cf. Chart 5.

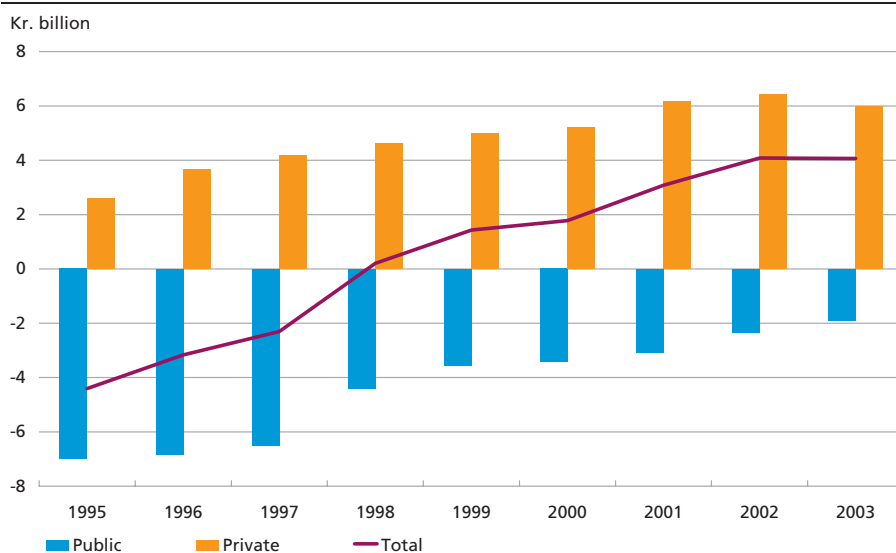
BALANCE OF PAYMENTS

Chart 4



THE FAROE ISLANDS' NET EXTERNAL ASSETS

Chart 5



Source: Landsbanki Føroya.

## CONCLUSION

The Faroese economy has experienced a downturn since 2003. The Faroese Ministry of Finance estimates real GDP to have fallen by 3-4 per cent in real terms in 2003. Total payroll expenditures have increased less in 2003 and the beginning of 2004 than in previous years, and payroll expenditures in the fishing industry have declined. Since August 2003 unemployment has gone up, and the pressure on the labour market has diminished. In addition, imports have declined.

Fisheries have deteriorated, but most of the fishing fleet still makes a good profit. The future of shrimp fishing and fish farming is uncertain. Fish farming is affected by low salmon prices and the salmon disease ISA, and the crisis is reflected in the banks' accounts for 2003, which show large losses and provisions for this sector. Generally, the fish processing industry is under pressure. In the first half of 2004 the contraction in the fishing industry had not fed through to the other sectors of the economy.

The government surplus has been declining in recent years, and the budget for 2004 operates with a deficit.

The last ten years have seen extensive consolidation of the public finances, as well as the finances of most households and business enterprises. Thus, there is no sign that the slowdown will develop into a crisis on the scale witnessed in the early 1990s.