

Fiscal planning can increase the resilience of the Faroese economy

The Faroese economy is in a boom period with low unemployment and high employment. High inflation and widespread labour market pressures in recent years have resulted in high agreed wage increases in a number of recent collective agreements. The economic boom has been going on for several years, but has not resulted in significant surpluses in public finances. For a relatively unified economy like the Faroe Islands, it is important to focus on a stability-orientated fiscal policy where good times are used to increase resilience and prepare for future challenges. In the financial sector, banks are better equipped to deal with a crisis than ever before.

Written by

Mikkel Bess
Senior Economist
mbes@nationalbanken.dk
+45 3363 6600

Sofie Heerup Friis
Senior Bank Analyst
sfr@nationalbanken.dk
+45 3363 6319

Tina Saaby Hvolbøl
Principal Bank Modeling Expert
tsh@nationalbanken.dk
+45 3363 6583

Time consumption

🕒 22 pages



The Faroe Islands is experiencing a boom with capacity pressures in several parts of the economy

The Faroese economy is healthy overall. The Faroe Islands are currently experiencing a boom with widespread pressure in several parts of the economy. The labour market is still characterised by low unemployment and high employment. During the last year, a number of collective agreements have resulted in high wage increases this year and next year in several areas of the labour market.



Banks are better prepared now than in the past

Faroese banks have been building up capital for a number of years, partly due to higher capital requirements, and their profits are currently high. This puts them in a good position to withstand a change in the economic climate. However, impairment charges have increased slightly over the past year.



Good times should be used to increase the resilience of the economy

Despite the economic boom of recent years, the Faroe Islands have not had a significant surplus in public finances. Their relatively unified economy increases the need to use good times to increase resilience. A fiscal framework that ensures comprehensive and appropriate management of the public economy can help prepare the Faroe Islands for known future challenges.

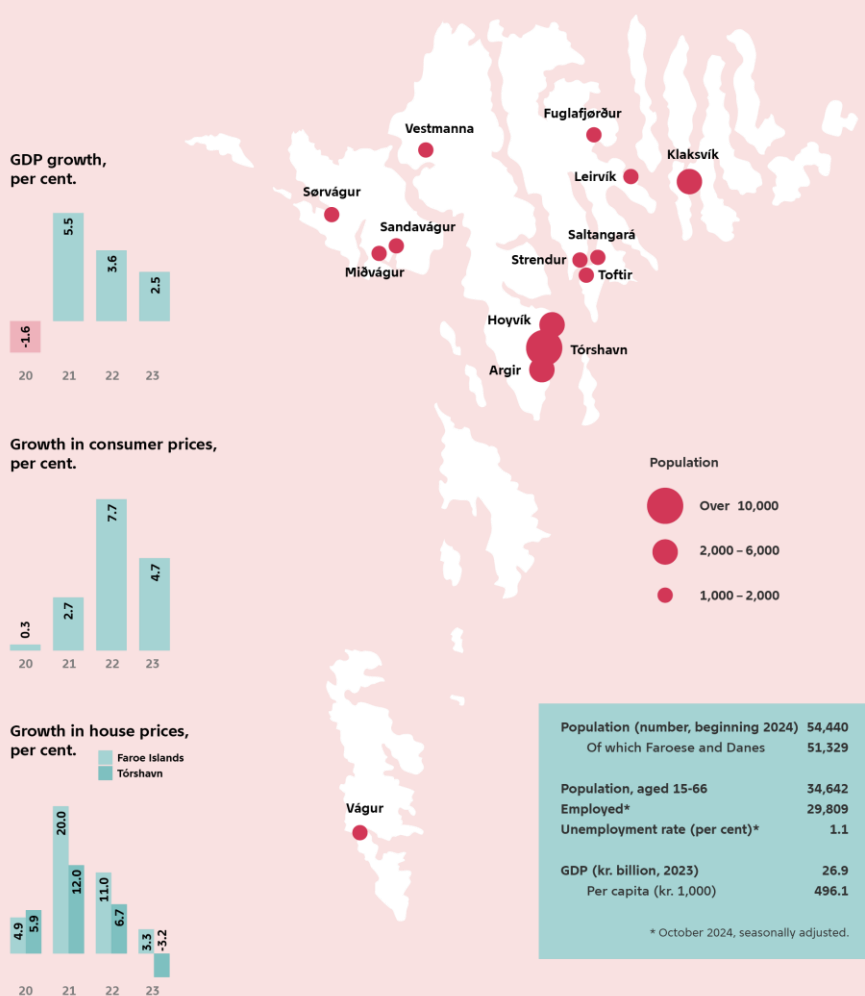
Why is it important?

Danmarks Nationalbank is the central bank for the entire Danish Realm. We therefore continuously analyse the development in the Greenlandic and Faroese economies to live up to our purpose of ensuring stable prices and ensuring the best basis for assessing the possible emergence of socio-economic imbalances.



Comprehensive management and long-term planning of the public economy is needed

Main chart Facts about the Faroe Islands



Note: GDP growth is calculated in real terms.
Source: Hagstova Føroya, Betri Banki and own calculations.



Topics

The Faroese Economy

01 Economic boom with pressure on production capacity

Many parts of the Faroese economy continue to grow and the Faroese gross domestic product, GDP, increased by 2.5 per cent in real terms last year. The increase in activity over the past year has been broad-based, but has in particular been driven by growth in the primary sector, where gross value added grew by more than 7.5 per cent last year. Growth in the Faroe Islands has been among the highest in Europe over the past decade, and the expansion has resulted in widespread pressure on production capacity in many parts of the economy.

The strong growth in recent years has also contributed to the overall health of the Faroese economy. The Faroese economy is currently characterised by high employment and low unemployment, well-consolidated households, low public debt and positive foreign assets. These factors make the economy well equipped to handle unforeseen shocks.

Moderate growth in exports

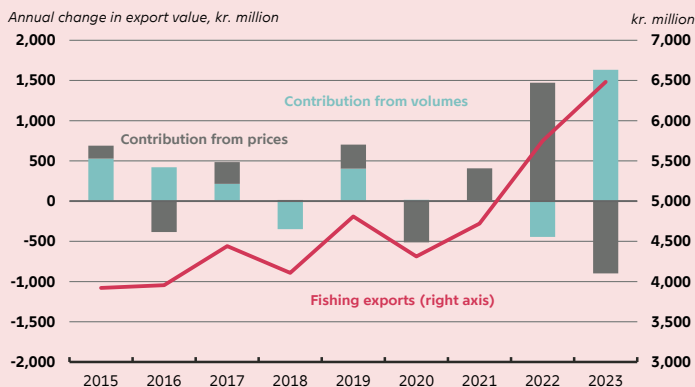
The Faroe Islands is a small, open economy that relies heavily on trade with the outside world. The export sector is centred around fishing and aquaculture, which accounts for almost 95 per cent of total goods exports. The fisheries industry comprises both aquaculture, focused on salmon farming, and fishing activities targeting pelagic and demersal fish, as well as their processing.



**The Faroese economy
is healthy overall**

CHART 1

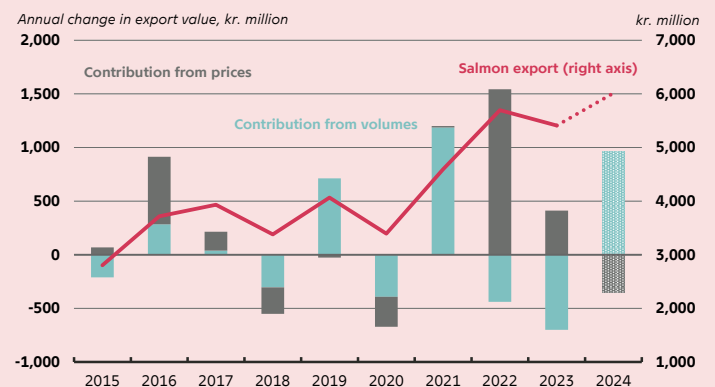
**Increase in exported volumes increased
export value in the fishing industry last year**



Note: The figures are total exports of fish and fish products excluding salmon.
Source: Hagstova Føroya and own calculations.

CHART 2

Salmon exports remain high



Note: The export value for 2024 is calculated as the annualised average value from January to September.
Source: Hagstova Føroya and own calculations.

In recent years, the Faroese fishing industry has benefited from high fish prices, which for most in the industry has offset the higher prices they have had to pay for feed and fuel.¹ For the entire industry, higher fish prices have contributed to a sharp increase in exports, and overall growth in the Faroese economy has been driven by the very favourable conditions for the export-oriented fishing and aquaculture industries in particular.

However, the growth in Faroese exports of fish and fish products has slowed, increasing by 2 per cent (in value terms) last year. This comes after a few years of annual growth in export value reaching over 20 per cent. The slowdown in growth last year was due to a decline in the export value of farmed salmon, while the export value in fisheries increased, see charts 1 and 2. The continued growth in fisheries exports last year should be seen in light of the fact that part of the mackerel quotas from previous years were fished in 2023 and the export value of fishmeal and fish oil was extraordinarily high.

This year, export volumes are expected to be lower as quotas for herring, mackerel, cod and especially capelin have been reduced. In the first nine months of the year, the value of exports of fish and fish products excluding salmon decreased by more than 25 per cent compared to the first nine months of 2023, due to fewer exported volumes of fish and a normalisation of exports of fishmeal and fish oil. The mackerel and herring season is at the end of the year and is therefore not yet included in the export figures for 2024. Both the total amount of quotas and the Faroe Islands' share of these have been reduced this year for mackerel and herring.²

The Faroe Islands signed a new mackerel fishing agreement with Norway and the UK in June. The agreement gives the Faroe Islands 12 per cent of the total allowable catch (TAC), a reduction of 0.6 percentage points compared to the mackerel agreement from 2014. In return, the Faroe Islands will have the right to fish 35 per cent of its share in UK waters and 40 per cent of its share in Norwegian waters, up from 30 and 35 per cent respectively.³ Although the agreement gives Faroese fishermen a smaller share of the total permitted amount of mackerel fished, the agreement ensures that Faroese vessels now have a greater opportunity to fish a large part of the mackerel when it is best suited for sale and the price is therefore also best. Faroese fisheries generally benefit greatly from being able to fish in different waters. A number of international agreements have historically ensured that the Faroe Islands and neighbouring countries have been able to fish in each other's waters, thus spreading the risk.

For the aquaculture industry, the export value of salmon in the first nine months of the year was at a historically high level. This is largely due to an increase in the amount of salmon exported, despite a minor outbreak of infectious salmon anaemia, ISA virus, in two aquaculture farms in May. The virus resulted in 550 tonnes of salmon being slaughtered.⁴ Salmon prices, on the other hand, have started to fall after a number of years of very high prices and were approximately 10 per cent lower in the first nine months of the year than in the same period last year.

The overall favourable development in total exports in recent years has occurred despite the fact that growth in a large number of Faroese export markets has been subdued in recent years. Fish exports are generally less sensitive to global



Salmon prices in the first nine months of the year were 10 per cent lower than the previous year

¹ See Lasse Holm and Thomas Rasmussen Damsgaard Tørsløv, Faroese economy - Economic upturn and growing reform needs, *Danmarks Nationalbank Analysis*, no. 1, January 2023.

² The Faroe Islands have 19 and 12 per cent of the total TAC for herring and mackerel in 2024, down from 22 and 12.6 per cent respectively. TACs for the two species are correspondingly reduced by 24 and 5 per cent from 2023 to 2024 respectively.

³ See the Ombudsman of the Faroe Islands, *Orientering*, no. 11/2024.

⁴ See the Ombudsman of the Faroe Islands, *Orientering*, no. 10/2024.

economic fluctuations, and the Faroese export sector can therefore be expected to have a certain degree of resilience to cyclical changes.⁵ Going forward, a number of international organisations expect growth in the global economy to pick up again,⁶ which is also expected to support the export opportunities for Faroese companies.

Labour market remains tight

The continued high level of activity in the Faroese economy is also reflected in the labour market, where employment is historically high, see chart 3. Employment growth has slowed slightly over the course of this year, with employment increasing by around 470 people (1.5 per cent) compared to a year ago⁷. The majority of job growth has occurred in the public sector. In October, employment reached 29,800, which corresponds to more than 85 per cent of the population aged 15 to 66. At the same time, the unemployment rate has remained stable at around 1 per cent of the labour force since the beginning of 2022 and there is effectively full employment in the Faroe Islands.

The increase in employment in recent years is a result of a significant expansion of the labour force. This is partly a result of many foreigners entering the Faroese labour market, and since 2019, around half of the increase in employment has been driven by foreigners⁸. This indicates a labour market dominated by a high degree of flexibility, able to attract foreign labour in times of prosperity. Conversely, the proportion of foreign labour has historically decreased in times of economic downturn. It is important that the structures of the Faroese labour market continue to support flexibility so that labour can be accessed when needed.



There is effectively full employment in the Faroe Islands

CHART 3

Full employment in the Faroe Islands



Note: Employment is calculated by a person's primary job and is therefore only counted once.
Source: Hagstova Føroya.

⁵For cyclical sensitivities of food products 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.

⁶ See for example *OECD World Economic Outlook*, September 2024.

⁷ October 2024.

⁸ People with non-Danish citizenship.

Despite the influx of foreign labour, there is still some pressure on the labour market and several companies consider labour shortages to be a limiting factor in production. This is especially true in the construction industry, where the need for skilled labour is high. The situation looks a little easier in the manufacturing sector, where the labour shortage indicator has declined slightly over the past few years and is at a level similar to the mid-2010s.

In the current situation with many companies looking for skilled labour, native Faroese should not have a separate incentive to work abroad, but rather an incentive to contribute their skills to their domestic labour market. However, the current tax deductions for Faroese working abroad make it relatively less attractive to take a job in the Faroe Islands than abroad, which can make it harder to attract the skilled labour needed. Such schemes can be inappropriate, especially in times like the present when the economy is short of labour, but also in light of the expected need for more workers in the public sector and elsewhere in the future. From next year, the Faroese Parliament has decided to lower a number of deductions, including the deduction for income earned abroad, which provides a tax deduction on income earned abroad.

High agreed wage increases this year and next

Wage increases in the Faroese labour market have remained relatively stable at just over 4 per cent over the past year, see chart 4. This is slightly higher than in the period before the corona pandemic, when wage increases were around 3 per cent per year. The slightly higher wage increases are partly a result of the tight labour market and widespread demand from employees for compensation for real wage losses in the wake of high inflation in recent years. This has also led to higher agreed wage increases in the Faroese labour market in recent collective bargaining agreements compared to those seen in the 2010s. Collective bargaining in the Faroe Islands takes place separately for each professional group.

In the private labour market, this summer's collective agreement for a number of worker groups such as port and warehouse workers resulted in a general wage increase of 8.2 per cent in 2024 and 2025.⁹ The agreement was reached after an extended strike in May and June, affecting up to 5,000 people. The agreement also includes a so-called wage boost for workers, which together with the general wage increase will result in wage increases of up to 13 per cent over the two-year collective agreement period.¹⁰

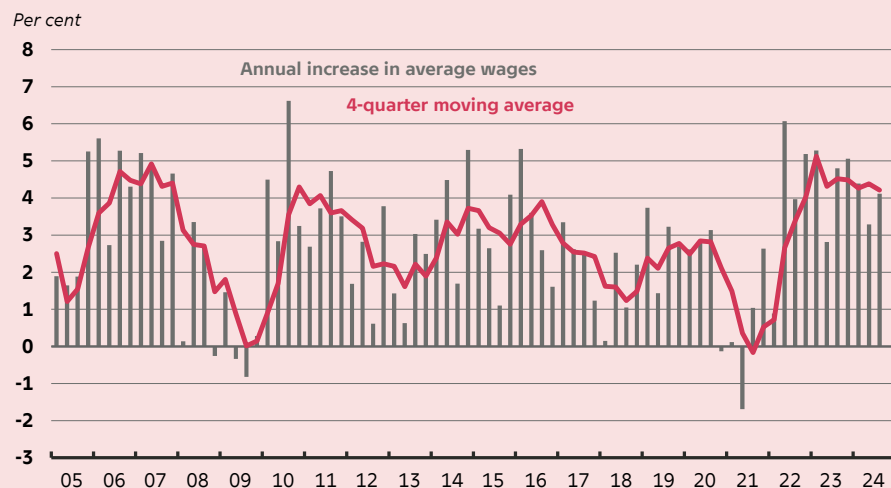
⁹ See the Ombudsman of the Faroe Islands, *Orientering*, no. 10/2024.

¹⁰ The wage boost will result in a wage increase of kr. 3.75 in 2024 and kr. 3.5 per hour in 2025, which for a worker with the lowest seniority will result in a total wage increase of approximately 13 per cent. These labour groups make up almost a fifth of employment in the Faroe Islands.

CHART 4

Wages in the Faroese labour market have increased by approximately 4 per cent in the past year

Wages per employee



Note: Calculated as the actual wage per employee in the entire economy. The bars show quarterly annual growth. The line shows the 4-quarter moving average. Employees are not counted twice if employed in more than one jobs.

Source: Hagstova Føroya and own calculations.

A number of public sector labour groups are also set for higher salary increases this year and next year. The outcome of a number of public sector collective agreements has resulted in wage increases of around 4 per cent per year on average over 2024, 2025 and 2026. The coalition agreement from December 2022 also states that the lowest paid professional groups in the care sector will receive a pay rise. Last year, the government announced that teachers and teacher assistants, social and healthcare workers and social and healthcare assistants will be included in the salary increase.¹¹ The wage boost will ensure that these groups receive a salary increase in the same range as workers in the private labour market during 2024 and 2025.

Inflation has fallen further in the past year

Consumer price growth on the Faroe Islands has slowed further in the past year, see chart 5. The rise in Faroese consumer prices is similar to that in Denmark and the rest of Europe and in the third quarter of this year was again below 2 per cent. Unlike in Denmark, for example, it is mainly increases in consumer food prices that continue to keep inflation high in the Faroe Islands. Food prices increased by 4.2 per cent in Q3 compared to the previous year.

However, an assessment of actual inflation and the contribution of individual consumption groups to price rises is complicated by the fact that the weightings used to measure consumption on the Faroe Islands are not regularly updated. They are based on a consumption survey from 2007, so the calculated inflation assumes that Faroese consumption patterns have not changed since then. As people tend to shift consumption towards goods that become relatively



Food prices increased in Q3 by 4.2 per cent year-on-year

¹¹ See the Ombudsman of the Faroe Islands, *Orientering*, no. 6/2023.

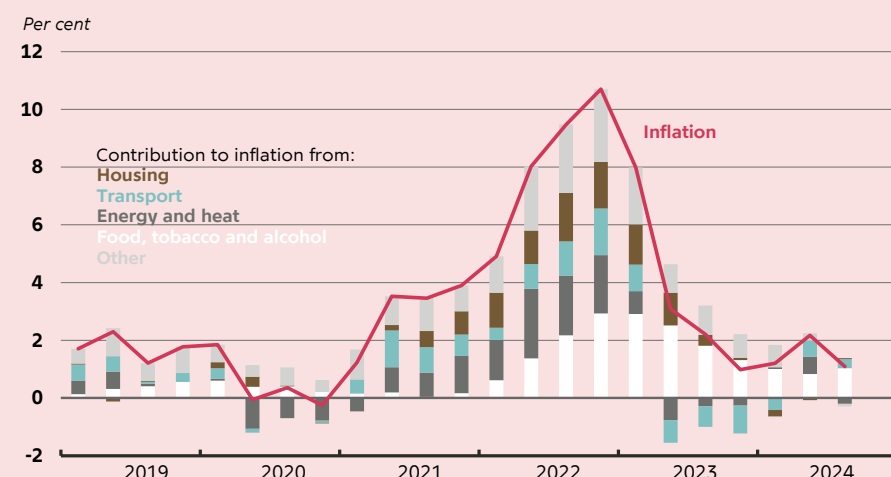
cheaper, fixed weightings mean that overall inflation is likely to be overestimated.¹²

The Faroe Islands' energy supply is based on oil, whereas Europe's supply is based on natural gas, among other things. Oil prices have generally been less volatile than natural gas prices in recent years, and therefore the direct contribution of energy prices has been smaller in the Faroe Islands compared to Denmark, where decreases in energy prices have contributed strongly to lower inflation. This has not been the case in the Faroe Islands, where falling energy prices have only had a limited impact on consumer prices in the past year.

Although falling energy prices have not contributed directly to lower consumer price increases in the same way, lower energy prices abroad have probably helped bring inflation back down in the Faroe Islands. This is because much of what is consumed by Faroese households is imported. This means that some of the falling energy prices abroad are still passed on to the Faroese economy through lower price increases on imported goods produced in countries where it has become cheaper to produce.

CHART 5

Consumer price increases have come down



Note: Annual changes in the consumer price index. The consumer price index excludes the rental value of homes and interest payments on mortgage loans. This makes Danish and Faroese consumer prices more comparable. Bars indicate growth contribution. Others are calculated residually.

Source: Hagstova Føroya and own calculations.

High wage increases in Denmark and the rest of Europe in recent years have resulted in inflationary pressures coming more from service industries, which make relatively high use of labour. It is still too early to assess to what extent the wage increases agreed in the Faroese labour market in recent years will result in costs for companies in higher wages being passed on to consumer prices. This will depend on companies' competitive conditions and sales opportunities, as well as their ability to absorb the higher labour costs through lower earnings.

¹² See Lasse Holm and Thomas Rasmussen Damsgaard Tørsløv, Faroese economy - Economic upturn and growing reform needs, *Danmarks Nationalbank Analysis*, no. 1, January 2023.

Households have a brighter outlook on the future

Optimism among Faroese households has started to rise again. This is a result of wage increases in recent years outpacing consumer price developments and the average Faroese household once again experiencing increasing purchasing power.¹³ The prospect of high wage increases in the coming year, a continued strong labour market and gradually lower interest rates also generate greater optimism among Faroese households. The consumer confidence indicator has increased over the past two years, but remains at a lower level than in the pre-pandemic period. This trend reflects both a general improvement in consumer views on their own current financial situation and their expected financial situation in a year's time. The results were collected in the period around the strike in May and June and may therefore have been affected by it.

However, the growth in household consumption is still limited and the total retail sales index shows that retail sales have remained unchanged since the beginning of 2023 (in volume terms). The flat development comes after a significant drop in 2022 as a result of high inflation, which reduced household purchasing power, and higher interest rates.

¹³ See Mikkel Bess and Lasse Holm, Demographic headwinds increase the need for fiscal adjustment in the Faroe Islands, *Danmarks Nationalbank Analysis*, no. 1, January 2024, for an account of real wage developments up to and including Q2 2023.

02

Bank resilience strengthened by increased capital and earnings

The recovery of the Faroese economy is also reflected in its financial sector, which is generally performing well. Faroese banks have built up capital over a number of years and earnings are currently high, which increases their resilience. Through 2024, credit growth has slowed and become more moderate. However, impairment charges have increased slightly.

Moderate lending growth during 2024

Overall lending growth in the Faroe Islands has been moderate in recent months at around 4 per cent year-on-year and has slowed since the beginning of 2024. Part of the growth in lending can be attributed to the public sector and households.

Credit in the Faroe Islands is mainly provided by the four Faroese banks, which are also responsible for the provision of mortgage loans.¹⁴ Around half of their total lending is to households, with the vast majority related to home financing via bank loans. Faroese household borrowing has generally increased in recent years. Since the end of 2023 and up to September, there has been moderate credit growth of around 2 per cent for Faroese households, including mortgage lending.

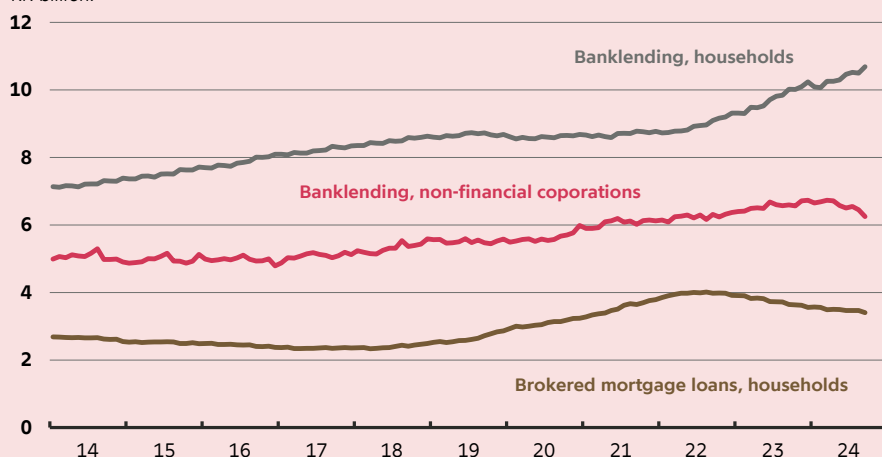
For businesses, however, borrowing from Faroese banks has been more limited and lending has slowed, see chart 6. It should be noted, however, that the largest Faroese companies in particular also take out loans in other countries

¹⁴ The Faroese banks are also responsible for issuing mortgage loans, as co-operation agreements have been established with Danish mortgage credit institutions. In addition, large companies in particular take out loans directly from foreign institutions.

CHART 6

Slightly lower credit growth in 2024

Kr. billion.



Note: Faroese banks' lending to Faroese customers. *Mortgage lending* consists of mortgage loans from Danish mortgage credit institutions to Faroese households brokered by Faroese banks. Direct loans from foreign institutions are not included in the chart. Latest observations September 2024.

Source: Danmarks Nationalbank.

Faroese banks generally have a high proportion of term deposits

Faroese banks primarily finance their lending activities with deposits from customers, and deposits have been stable in recent years. At the end of the first half of 2024, loans accounted for almost 90 per cent of deposits, although with some variation among banks.

Faroese banks generally have a high proportion of term deposits in relation to their total deposit base, and the proportion of term deposits has increased in recent years. Compared to Danish systemic banks and non-systemic banks, term deposits make up a larger share of Faroese banks' total deposit base¹⁵. When customers choose to place their deposits as term deposits instead of holding deposits as demand deposits, it is often from an investment perspective. Term deposits are therefore considered more volatile than demand deposits, both in regulation and in Danmarks Nationalbank's liquidity stress test. If a deposit is made to obtain a higher interest rate, there is a risk associated with the expiration of the term deposit, where banks need to ensure they have liquid assets to match, as the customer will typically be willing to move the term deposit to where the gain is greatest.

Some of the banks also issue market financing, which can be used to fulfil capital requirements or to finance lending. These banks thus run the risk of having to access the financial markets.

House prices continue to rise

House prices in the Faroe Islands have risen sharply during the recent expansion, which began in 2013. This development should be seen in light of the fact that the supply of housing in the Faroe Islands has for a number of years been unable

¹⁵ See Danmarks Nationalbank, Geopolitical uncertainty impacts the risk outlook for the financial sector, *Danmarks Nationalbank Analysis (Financial stability - biannual review and recommendations)*, no. 18, November 2024 ([link](#)).

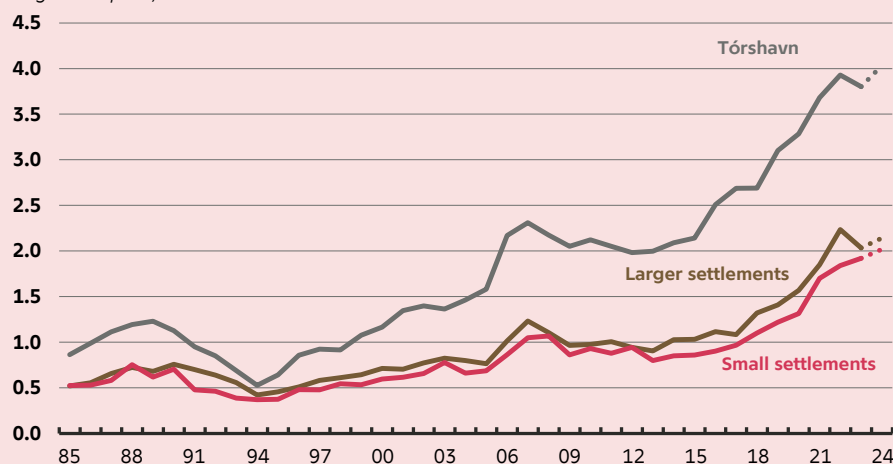
to keep up with the higher demand, which has been driven by both population growth and an increase in disposable income. Real incomes have thus increased more than the supply of housing, which has helped drive the increase in house prices, see box 1. The underlying economic fundamentals can thus generally explain the increase in house prices over a longer period of time.

By 2023, however, there were signs of a slowdown in house prices after a period of rising interest rates and erosion of real household wages.¹⁶ This seems to have reversed this year, with preliminary figures indicating that house prices are rising again, see chart 7. Rising prices may be supported by the increase in household purchasing power, while interest rates have fallen during the second half of 2024, see also chapter 1.

CHART 7

Sharply rising house prices

Avg. House price, kr. million



Note: Figures for 2024 are house prices for 2023 projected with the growth in preliminary house prices for 2024 calculated by Føroya Banki.

Source: Hagstova Føroya, Føroya Banki and own calculations.

There is no taxation of real estate in the Faroe Islands, and homeowners can obtain an interest deduction in connection with interest expenses on housing loans. Both factors reduce the user costs on housing and increase fluctuations in house prices. The introduction of housing taxation in the Faroe Islands, where the tax payment follows the prices on the housing market, could thus dampen price fluctuations to the benefit of macroeconomic and financial stability.

A large proportion of the disposable income of Faroese homeowners goes towards servicing their housing debt. The interest rate increases since 2022 have increased the housing burden, i.e. the proportion of homeowners' disposable income that goes towards paying their housing loan.¹⁷ However, this is expected to decrease if interest rates fall. The interest rate sensitivity of Faroese homeowners is high, as the most common home financing for households are variable-rate bank loans with the option to adjust the interest rate within one month. This means that interest rate changes are quickly passed on to Faroese

¹⁶ See Mikkel Bess and Lasse Holm, Demographic headwinds increase the need for fiscal adjustment in the Faroe Islands, *Danmarks Nationalbank Analysis*, no. 1, January 2024 ([link](#)).

¹⁷ See the Economic Council of the Faroe Islands autumn report 2024, *Føroyski búskapurin* ([link](#)).

homeowners. On the other hand, the vast majority of Faroese homeowners are paying off their debt, which helps to increase their resilience. In addition, more than half of the homeowners in the Faroe Islands have a relatively low debt-to-income ratio of 3 or less. Faroese homeowners borrow less than Danish homeowners in relation to their incomes.

BOX 1

House price relationship for the Faroe Islands

Faroese house prices have fluctuated widely over the past four decades and have risen sharply during the recent expansion. A house price relationship for Faroe Islands is estimated to explain the development from 1986 to 2023. In traditional macroeconomic models, housing demand is assumed to be determined by households' real disposable income and the user cost.¹ In the short term, housing supply is given, so a change in housing demand is initially reflected in the price. In the long term, the housing stock adapts to the changing demand in the form of new construction. We do not analyse the supply side. The relationship is set up in error correction form. Based on the estimated relation, the inverted demand curve for the real house price can be derived:

$$\log p^H = -11,7 * uc + 1,3 * (\log Y - \log K^H) + 1,4$$

where p^H is the real house price, uc is the user cost rate, Y is real disposable income, and K^H is the housing stock. According to the estimated relation, a decrease in interest rates after tax of 1 percentage point in the long term will increase the real house price by almost 12 per cent for an unchanged housing stock. If real disposable income increases by 1 per cent, the real house price will increase by 1.3 per cent for a given housing stock. Elasticities for income and interest rates are on par with the corresponding elasticities in Danmarks Nationalbank's macroeconomic model, MONA.

A dynamic simulation shows that the relationship over the period captures the development in house prices well, see the chart. In general, there have been large fluctuations in disposable income in the Faroe Islands since the mid-1980s. Income trends affect housing demand and, according to the macroeconomic analysis, help explain the large fluctuations in house prices over the period. The Faroese economy was hit by a severe recession in 1989, leading to significant net emigration from the Faroe Islands and a large decline in disposable income. The relationship also captures developments during the economic upswing of the mid-1990s. However, the sharp price increases that occurred in 2006-07 cannot be explained by the economic fundamentals. The sharp rise in prices in 2021 during the coronavirus pandemic cannot be explained by fundamentals either. The same development occurred in the Danish housing market during the corona pandemic.² Overall, however, the house price development between 2013 and 2023 can broadly be explained. Judging from the house price relationship, there is no indication that house prices in the Faroe Islands are overvalued.

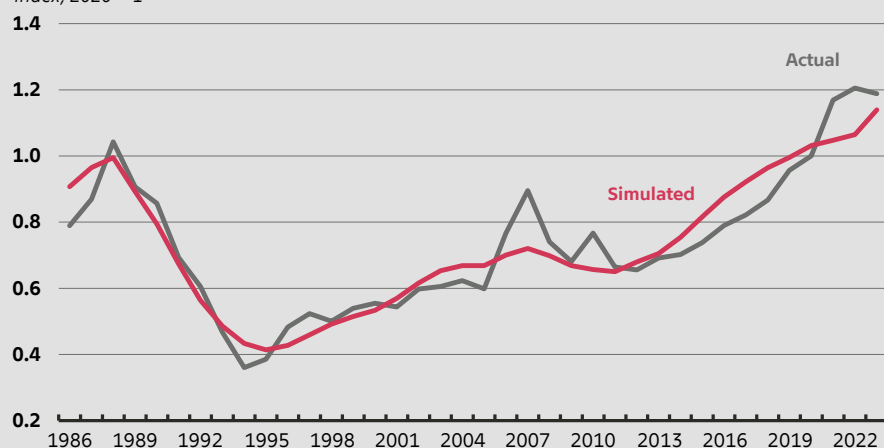
Continues ...

... continued

Chart

Real house price, actual and simulated

Index, 2020 = 1



Note: The simulated values are based on a dynamic simulation of the demand relationship from 1986 onwards.

Source: Hagstova Føroya, Statistics Denmark, the Ombudsman's report (various years), MONA's databank, Føroya Banki and own calculations.

Data

There is no published data on housing investment and housing stock for the Faroe Islands, which is why we partially compile the data ourselves. There is some uncertainty associated with this. Housing investments are estimated based on the number of new homes built since 1985. The housing volume can be calculated based on the accumulated net investments plus a baseline level. An annual depreciation rate of 2 per cent is assumed. Disposable incomes for the Faroe Islands are available back to 1990 and have been calculated using disposable gross national income. Income and house prices are deflated with the consumer price index. The user price consists of the nominal interest rate after tax minus inflation expectations. The majority of homes in the Faroe Islands are financed with bank loans. Household inflation expectations are not observable. We therefore use the modelled inflation expectations from MONA. In general, inflation in the Faroe Islands and Denmark follow each other relatively closely. Housing is not taxed in the Faroe Islands.

¹ See Niels Arne Dam, Tina Saaby Hvolbøl, Erik Haller Pedersen, Peter Birch Sørensen and Susanne Hougaard Thamsborg, Developments in the Market for Owner-Occupied Housing in Recent Years - Can House Prices be Explained?

Danmarks Nationalbank Monetary Review, 1st Quarter, Part 2, 2011 ([link](#)).

² See Abildgren, Hviid, Klein, Krause, Kuchler, von Rüden and Zhuang, Large shocks to the economy have driven house prices, *Danmarks Nationalbank Analysis*, no. 14, September ([link](#)).

Bank earnings increase their resilience

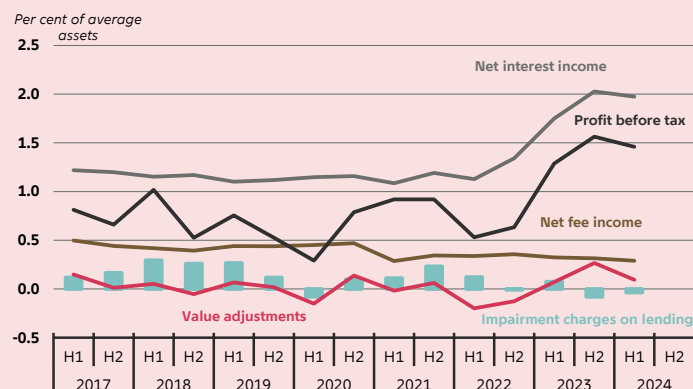
2024 promises to be another good year for Faroese banks, despite earnings for the first half of 2024 being slightly lower than at the end of 2023. The decrease in bank earnings was mainly driven by lower earnings from value adjustments, see chart 8A. The recent higher earnings for Faroese banks improve their first line of defence against losses.

Since the end of 2022, net interest income has supported bank earnings and net interest income has stabilised at a high level. The higher net interest income

should be seen in light of a widening interest margin as banks have increased lending rates more than deposit rates. However, the interest margin seems to have peaked in the beginning of the first half of 2024 and has since levelled out, partly due to lower lending rates, see chart 8B.

CHART 8A

Net interest income supports bank earnings

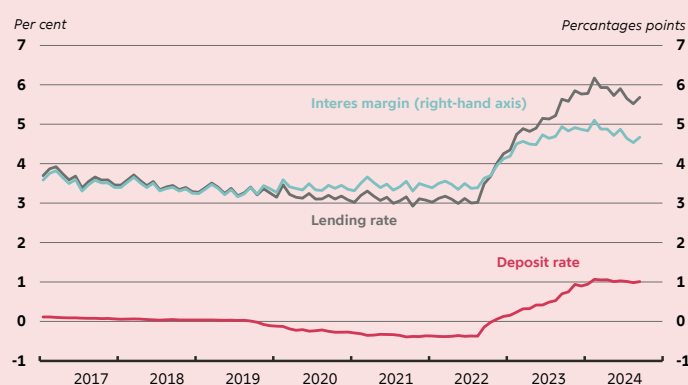


Note: Half-year data for Faroese banks. Average assets are calculated as the average of total assets at the beginning and end of the period.

Source: The Danish Financial Supervisory Authority and own calculations.

CHART 8B

Interest margin appears to have peaked in H1 2024



Note: The average weighted interest rate of Faroese banks on deposits from Faroese households and non-financial corporations and the Faroese banks' average weighted interest rate on loans to Faroese households and non-financial corporations. The interest margin is calculated as the difference between the two interest rates. The most recent observations are from September 2024.

Source: Danmarks Nationalbank

Over the past year, there has been an increase in operational impairment charges, but despite the increase, Faroese banks' impairment charge ratios for corporate and household customers remain low. The continued recovery of the Faroese economy and the tight labour market are therefore also reflected in bank customers, who seem robust. So far, there are no significant signs that bank customers are struggling to fulfil their debt obligations.

Faroese banks have increased their capitalisation in the past year

Since 2017, Faroese banks have been building up capital, and over the past year, capitalisation has increased further. The build-up of capital should be seen in light of the phasing-in of the Faroese banks' eligible liabilities¹⁸, see chart 9. The increased capital build-up has contributed to higher excess capital adequacy, which has been fairly stable in recent years.

The Faroese banks have sufficient capital to meet the upcoming increase in the systemic risk buffer and the phasing-in of MREL requirements, including an increase in the requirement for eligible liabilities due to the increase in the systemic risk buffer.¹⁹

The purpose of a systemic risk buffer in the Faroe Islands is to make banks more resilient to structural vulnerabilities in the Faroese economy, which is relatively single-tiered with a high dependence on fishing and aquaculture. Currently, the

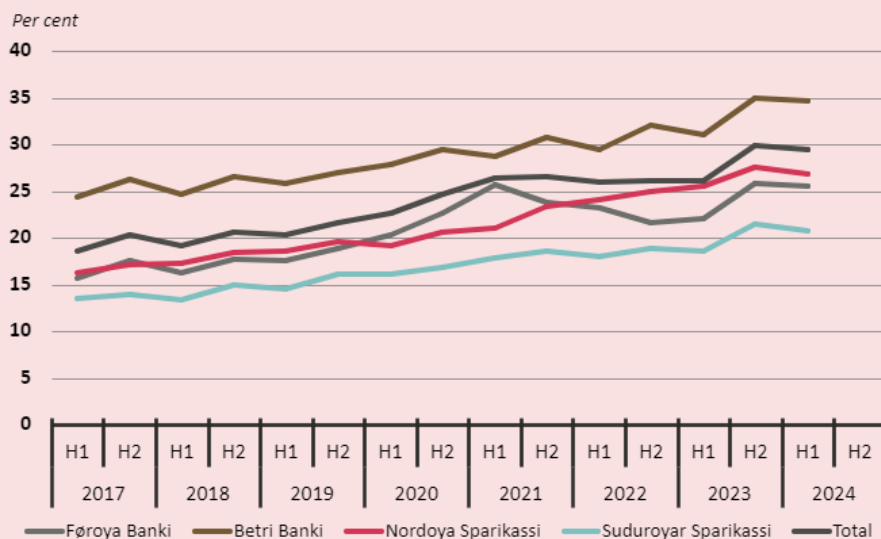
¹⁸ See e.g. the Systemic Risk Council's analysis, Requirements for Faroese banks, 4 March 2020 ([link](#))

¹⁹ See Systemic Risk Council, Increase in the systemic risk buffer rate in the Faroe Islands, 27 June 2024 ([link](#))

systemic buffer is set at 2 per cent, but from 1 July 2025 this will be increased to 3 per cent due to structural systemic risks in the Faroese economy.

CHART 9

Increased capitalisation of Faroese banks



Note: Half-year data for Faroese banks. Common Equity Tier 1 capital (CET1) as a percentage of risk-weighted exposures.

Source: Banks' financial statements and own calculations.

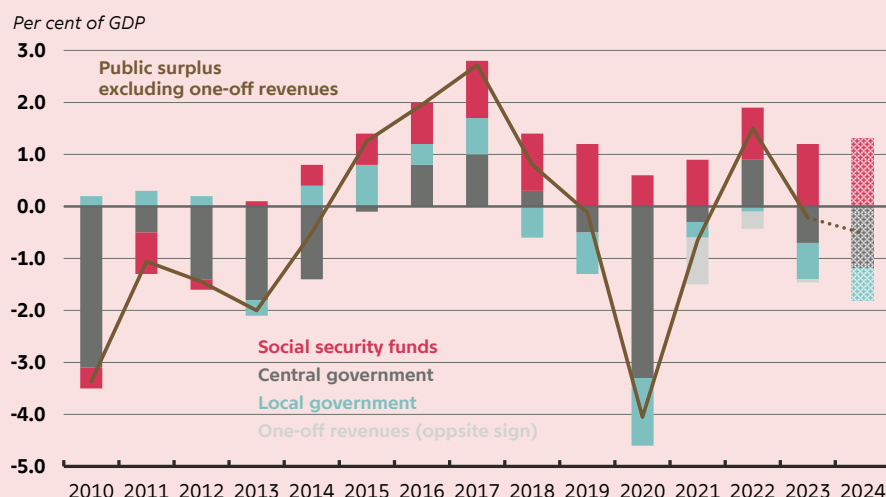
03 Need to address fiscal sustainability in the Faroe Islands

Although there has been significant growth in the Faroese economy in recent years, there has been no significant surplus in public finances, see chart 10. This year, the Economic Council expects a deficit in the public balance of 0.5 per cent of GDP,²⁰ and next year's budget also includes a deficit.²¹ This suggests that the public sector is fuelling activity at a time when there is already pressure on capacity in many parts of the economy.

The fact that public finances have not improved sufficiently during the boom also means that the public sector postpones necessary adjustments and risks having to tighten fiscal policy during a recession.

CHART 10

**Economic boom in the Faroe Islands
has not resulted in a surplus on public finances**



Note: The chart shows the sum of state and municipal current surpluses and social funds. 2024 is a forecast from the Faroe Islands Economic Council. One-off revenues in 2021, 2022 and 2023 of kr. 20, 83 and 16 million respectively have been deducted. The income in 2021 is due to the cancellation of the 1992 Financing Fund. Extraordinary dividends from the sale of Bank Nordik's Danish branch increased income in both 2021 and 2022. In 2023, there was extraordinary income from the divestment of the government's ownership shares in P/F Tjaldur.

Source: Hagstova Forøya, Faroese Economic Council and own calculations.

²⁰ See the Faroe Islands Economic Council's autumn report *Føroyski búskapurin*.

²¹ The budget proposal for 2024 contains a deficit in the national treasury of kr. 83 million.

However, public debt in the Faroe Islands is relatively low, which in the short term contributes to the robustness of public finances and the Faroese economy. Political priorities, such as the current consideration of building a new tunnel to Suðuroy at an estimated value of up to around 20 per cent of GDP,²² should be weighed against the need to maintain a sufficient buffer in public finances to deal with future challenges.

A significant part of the income in the Faroe Islands is generated by companies utilising the Faroese marine and fishing resources. A monolithic economy like the Faroese is relatively vulnerable to external factors, and it is therefore important to focus on pursuing a stability-orientated fiscal policy that puts money aside in times of prosperity. This can help mitigate the consequences of, for example, changing external conditions that affect parts of the Faroe Islands' primary source of income.

One of the objectives of the Faroe Islands Economic Fund²³ is to even out revenues from the fishing and aquaculture industry, thereby ensuring economic stability and levelling out the business cycle. This is currently done by disbursing revenues from the fund to the Finance Act totalling up to kr. 400 million, while additional revenues are disbursed over a seven-year period.²⁴ From next year, the level of annual disbursed revenue will be raised to kr. 600 million,²⁵ which should be seen in light of recent years' increases in catch and aquaculture taxes, which are estimated to increase revenue. However, revenue assumptions can change from year to year and the increase could potentially make the treasury's revenue even more sensitive to fluctuations in the fishing and aquaculture industry than before.

Growing need to address fiscal sustainability

The demographic composition will change in the coming years. The ratio of people of working age to those over state pension age has steadily decreased in recent years and is expected to continue to fall, putting pressure on the long-term sustainability of public finances, even though public debt is currently low. The Economic Council's latest sustainability calculation estimates that a permanent fiscal tightening of 9 per cent of GDP will be required to bring public finances into balance in the long term.²⁶

The state pension age will be raised by half a year in 2025 and 2030, but will only counteract the increased proportion of people above retirement age compared to the number of people below retirement age to a limited extent.²⁷ Further increases in the state pension age can help improve long-term fiscal sustainability by ensuring a more even development in the relationship between working hours and lifespan across generations.

Fiscal framework can ensure proper management of the public economy

The demographic challenges of the coming years, combined with the fact that the Faroe Islands as a small and relatively unified economy is vulnerable to external factors, emphasises the need for comprehensive management and long-term planning of the public economy. This will ensure that known challenges are addressed in a timely manner, while saving during prosperous periods so that there is financial room for manoeuvre to support the economy in times of recession.



**It is important
to focus on a
stability-oriented
fiscal policy**

²² See the Ombudsman of the Faroe Islands, *Orientering*, no. 18, 2024.

²³ The Faroe Islands Economic Fund was established in 2011 and aims to support a self-sustaining economy and contribute to economic equalisation.

²⁴ Currently, up to kr. 250 million is paid out from the fishing industry and kr. 150 million from the aquaculture industry.

²⁵ Kr. 350 million from the fishing industry and kr. 250 million from the aquaculture industry.

²⁶ See the report *Figgjarpolitiskt haldføri*, Landsbanki Føroya, 2024.

²⁷ See for example Mikkel Bess and Lasse Holm, Demographic headwinds increase the need for fiscal adjustment in the Faroe Islands, *Danmarks Nationalbank Analysis*, no. 1, January 2024, for an account of real wage developments up to and including Q2 2023.

One of the ways in which the government can ensure room for manoeuvre in the future is to introduce a fiscal framework that will form the basis for appropriate management of the government's and municipalities' finances. This should be centralised to ensure a unified management of the public economy.

The framework should also aim to ensure appropriate expenditure management over the business cycle so that good times are also used to prepare for bad times and thereby contribute to a more stable economic cycle. The current local government financial management system, which focuses on ongoing debt management, inappropriately contributes to fiscal cyclicity, where times of high revenue and economic pressure incentivise spending increases at the same time.

Finally, the framework should ensure that known challenges that put pressure on longer-term fiscal sustainability, such as shifts in demographic composition, are taken into account when planning short-term fiscal policy.

A comprehensive framework for the coordination of public finances across central and local government can provide the foundation for ensuring that the public sector is prepared for changes in the ongoing need for public services while contributing to a more stable Faroese economy.



**A fiscal framework
can form the basis
for appropriate
management of
both central and
local government
finances**

Like to receive *updates* from Danmarks Nationalbank?

Get the latest news on our publications
sent straight to your inbox.

To learn more about our news service,
and to sign up, visit nationalbanken.dk/en/news-service,
or scan the QR code.



You can also receive our news as RSS feeds.
For details, visit nationalbanken.dk/en/rss-feeds.

Publications



NEWS

News is an appetiser offering quick insight into one of Danmarks Nationalbank's more extensive publications. News is targeted at people who need an easy overview and like a clear angle.



STATISTICAL NEWS

Statistical news focuses on the latest figures and trends in Danmarks Nationalbank's statistics. Statistical news is targeted at people who want quick insight into current financial data.



REPORT

Reports consist of recurring reports on Danmarks Nationalbank's areas of work and activities. Here you will find Danmarks Nationalbank's annual report, among other documents. Reports are targeted at people who need a status and update on the past period.



ANALYSIS

Analyses focus on current issues of particular relevance to Danmarks Nationalbank's objectives. Analyses may also contain Danmarks Nationalbank's recommendations. They include our projections for the Danish economy and our assessment of financial stability. Analyses are targeted at people with a broad interest in economic and financial matters.



ECONOMIC MEMO

Economic Memo provides insight into the analysis work being performed by Danmarks Nationalbank's employees. For example, Economic Memo contains background analyses and method descriptions. Economic Memos are primarily targeted at people who already have a knowledge of economic and financial analyses.



WORKING PAPER

Working Paper presents research work by both Danmarks Nationalbank's employees and our partners. Working Papers are primarily targeted at professionals and people with an interest in central banking research as well as economics and finance in a broader sense.

The analysis is available in a Danish, Faroese and English version. In case of doubt as to the correctness of the translation, the Danish version will prevail.

Danmarks Nationalbank
Langelinie Allé 47
DK-2100 Copenhagen Ø
+45 3363 6363

Editing complete 2 December 2024



**DANMARKS
NATIONALBANK**