
Current Trends in the Faroese Economy

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INTRODUCTION AND SUMMARY

The Faroese economy is slowly recovering from the downturn that hit the Faroe Islands in connection with the international financial crisis. Growth in the nominal gross domestic product, GDP, was slightly below the level of consumer price inflation in 2011¹.

Private consumption has been subdued in recent years, and even more so than warranted by the economic situation. Hence, households have reduced their debts, and uncertainty still seems to prevail. In this context it should be borne in mind that the Faroe Islands are a small, open economy with fisheries as the main business sector. As a result, incomes fluctuate and depend on the world market economy. Recently, the sovereign debt crisis in a number of euro area member states has added to the uncertainty.

2011 saw a notable increase in catch values for mackerel, which partly made up for the decline in more traditional fisheries. Combined with growth in aquaculture, this led to higher exports in 2011. Imports rose at a faster rate, but the balance of trade was still in surplus. This trend in foreign trade continued in the 1st half of 2012.

Public finances still show a deficit, although it has been reduced since 2008. The Løgting (parliament) aims for balanced government finances in 2016. The expected growth in economic activity will contribute, but further consolidation measures will be required. The sooner they are implemented, the more credible this target will be.

ECONOMIC ACTIVITY

According to the preliminary national accounts, the Faroese economy grew by 1.8 per cent nominally in 2011. By comparison, it grew by 7 per cent in 2010, when the development in fish prices was favourable. During the crisis, nominal GDP fell by 0.8 per cent in 2008 and 1.7 per

¹ A limited range of statistics makes it difficult to assess the cyclical position of the Faroese economy. For example, GDP is compiled on a nominal annual basis only and with a considerable lag. Instead, other indicators such as payroll and employment statistics are taken into account.

FACTS ABOUT THE FAROE ISLANDS

Population (beginning of 2012)	48,327
of which in Tórshavn	19,822
of which 18-66	29,351
Waged employment (annual average, 2011)	23,464
Unemployment (annual average, 2011)	1,846
Gross domestic product (kr. million, 2011)	13,173
Per capita (kr. '000) ¹	271

Source: Hagstova Føroya.

¹ By comparison, GDP per capita in Denmark was kr. 320,000 in 2011.

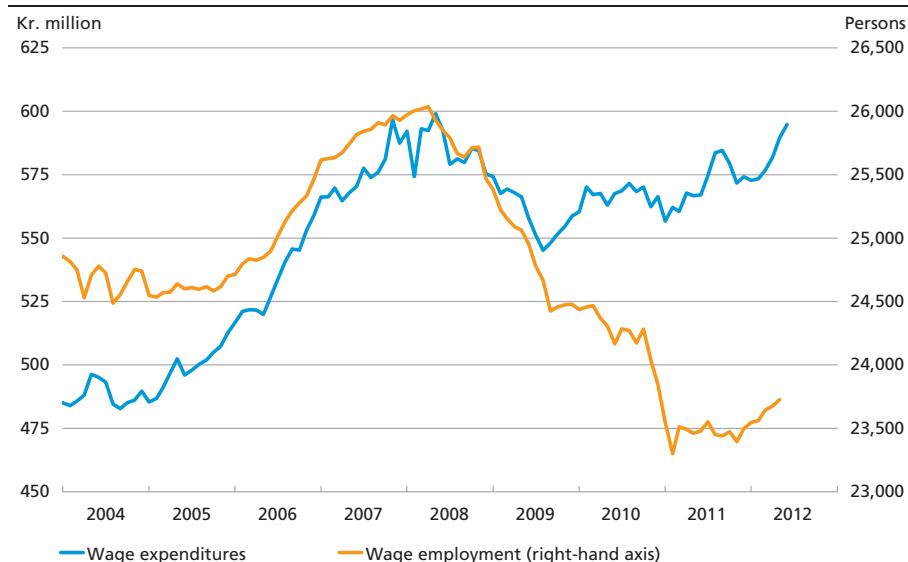
cent in 2009, implying that the Faroe Islands were less severely affected than most other western economies.

Employment in terms of number of wage earners rose in the 1st half of 2012, having stabilised in 2011 at a level some 10 per cent below the peak in mid-2008, cf. Chart 1. Compared with 2010, employment fell by 3.3 per cent in 2011. One of the underlying reasons was that the largest Faroese company, Faroe Seafood, went into liquidation in December 2010 and around 800 people lost their jobs. Since then, production has been resumed only to a minor extent.

In the sector breakdown, this is reflected in the strong decline in employment in the fish-processing industry in 2011, cf. Chart 2 (right). Employment on fish farms increased in 2011 and in the first few months

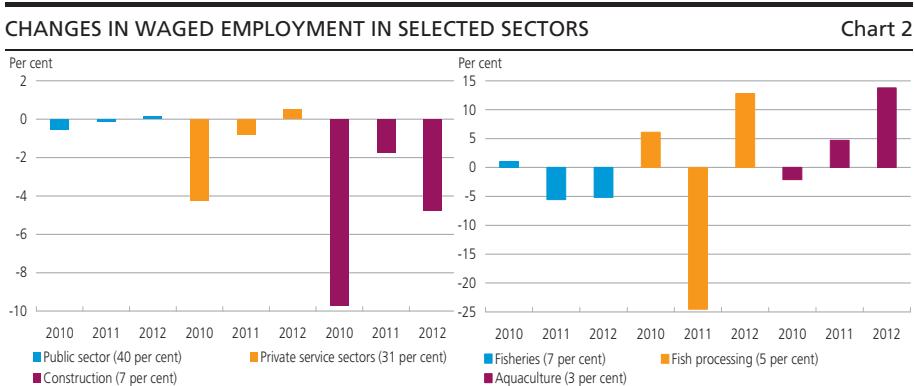
WAGE EXPENDITURES AND EMPLOYMENT

Chart 1



Note: Seasonally adjusted monthly data. 3-month moving averages for wage expenditures. The most recent observation is from May 2012 for waged employment and July 2012 for wage expenditures.

Source: Hagstova Føroya.



Note: Data for 2012 shows the change in the period January-May 2012 in relation to the same period of 2011. Figures in brackets in the legend indicate the sectors' shares of total waged employment in 2011.

Source: Hagstova Føroya.

of 2012, but since the number of wage earners on fish farms is small, this has only a limited effect on overall employment.

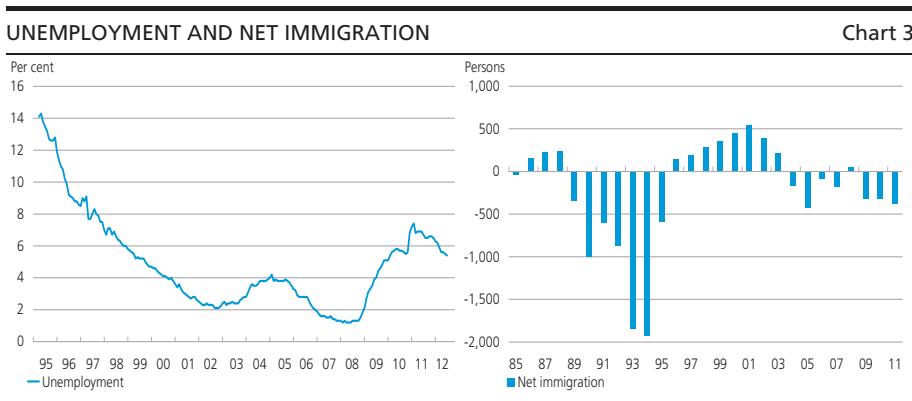
The number of public-sector employees has declined marginally over the last couple of years, but more slowly than total waged employment. Consequently, public-sector employment as a share of total waged employment has risen to more than 40 per cent in early 2012.

In the private service sectors, waged employment fell further in 2011, but not as strongly as in the preceding year. However, the first few months of 2012 saw a modest increase on the same period of 2011. The decline in 2011 was mainly attributable to the financial sector, trade and repairs as well as business services, whereas shipping grew and continued to do so in early 2012.

Waged employment in the building and construction sector continued to shrink in 2011. The downward trend was somewhat less steep than in previous years, but data for the first five months of 2012 do not suggest that a turning point has been reached yet. The number of wage earners is now at the same level as in 2003, i.e. before the boom with soaring housing prices began in the Faroe Islands.

The declining number of wage earners has only to a limited extent been reflected in the unemployment rate, which was 5.4 per cent in July 2012, cf. Chart 3 (left). This is attributable to net emigration in recent years, although the trend has been far more subdued than in the first half of the 1990s, cf. Chart 3 (right). Moreover, the number of people living in the Faroe Islands, but working elsewhere, has also risen.

Inflation, measured by the consumer price index, was 2.2 per cent in the 2nd quarter of 2012. This means that it has stabilised at a level of just over 2 per cent, after having risen since the trough in the 3rd quarter of 2009. Price inflation is mainly attributable to higher oil prices. This



Note: Seasonally adjusted monthly data for the unemployment rate.
 Source: Hagstova Føroya.

was reflected in the index for energy and heating, which rose by 10.1 per cent year-on-year in the 2nd quarter.

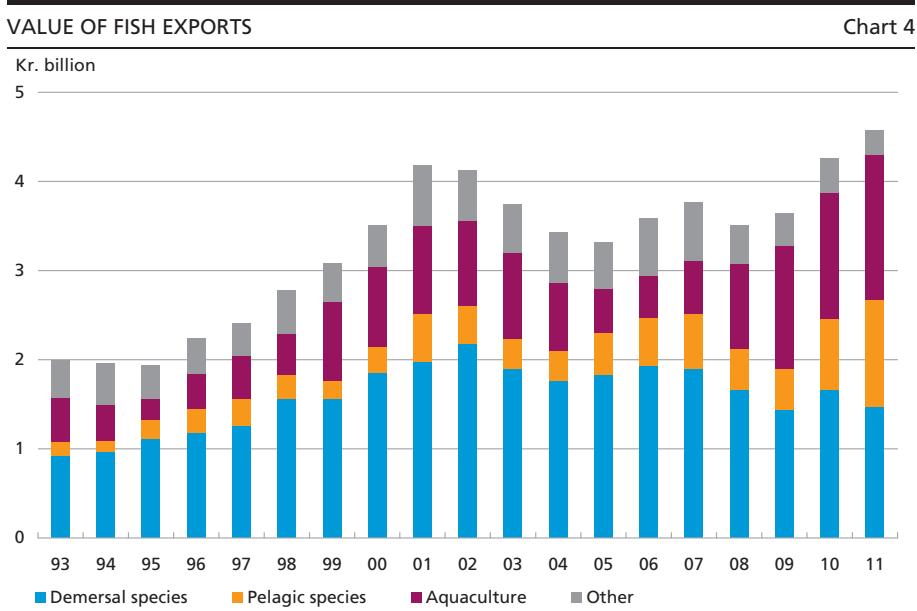
Fisheries and aquaculture

In 2011, fish accounted for around one sixth of total gross value added in the Faroe Islands and just over 95 per cent of exports of goods. This means that the Faroese economy is highly dependent on developments in the fisheries sectors and aquaculture.

Catch volumes and prices may fluctuate strongly over time. However, vulnerability has been reduced as earnings are now spread on a larger number of species. In recent years, traditional local demersal fishing for cod, haddock and saithe has declined, but growth in farming and local pelagic fishing¹, especially for mackerel, has more than made up for this, cf. Chart 4. Within the individual branches of the sector there is also a tendency for catch values to decline for one species while increasing for another. Moreover, the Faroe Islands have concluded agreements with a number of other countries to swap fishing rights. For example, Faroese vessels also operate in Greenlandic, Russian and Chilean waters, thereby making the economy less vulnerable to any decrease in stocks in Faroese waters.

Following fruitless negotiations between the Faroe Islands, the EU, Iceland and Norway on the distribution of quotas for the shared mackerel stocks, the Faroe Islands have fixed their own mackerel quota for 2012 at just under 150,000 tonnes. The Faroe Islands and Iceland have been dissatisfied with the existing distribution since changing migration patterns have boosted mackerel stocks in their catch areas. The other countries have also fixed their own quotas, and the total mackerel quota

¹ As opposed to demersal species, pelagic species live in open waters, not on or close to the sea bed.



Note: Pelagic species are mackerel, herring, whiting and capelin, among others. Demersal species include cod, saithe and haddock. Aquaculture comprises salmon and trout. Other is shellfish, etc.

Source: Hagstova Føroya.

now exceeds the level assessed by the International Council for the Exploration of the Sea, ICES, to be sustainable.

The quota fixed by the Faroe Islands for 2012 is more or less in line with the level in 2011, when agreement was not reached either. In 2011, the Faroe Islands exported mackerel worth kr. 733 million, equivalent to 5.6 per cent of GDP. This was slightly more than kr. 410 million higher than in 2010.

The disagreement on the mackerel quota means that no new fishing agreements for other species have been concluded with Norway and the EU. The resultant negative impact on other branches of the Faroese fisheries sector has, however, been outweighed by increased earnings from the larger mackerel quota.

Due to the disagreement about mackerel quotas, Faroese vessels are not allowed to land mackerel in Norwegian ports. In response, Faroese fishermen have invested in increased freezing capacity for mackerel, among other species.

The period 2009-11 was exceptionally good for aquaculture. Prices were very favourable following a fall in the global supply of salmon. As global production has picked up, prices have fallen, but nonetheless remain well above the production costs.

Just under 50,000 tonnes of farmed fish were slaughtered in 2011. This is assessed to be close to the capacity limit that is compatible with the

prevention of epidemic diseases such as those that hit Faroese salmon production in the first half of the 2000s. However, experimental fish farming is currently taking place in open Faroese waters to supplement farming in the fiords. If this proves to be profitable, production capacity could be enhanced substantially.

Parts of the Faroese fisheries sector is suffering from a structural problem, i.e. excess capacity, resulting in low earnings for owners. This impedes investments which would otherwise be optimal in the longer term. Thus, parts of the fleet are old and inefficient and require more employees than would otherwise be necessary. On the other hand, subsidies have been phased out in recent years, so that jobs within the sector are not being sustained purely by government subsidies.

In 2018, all fishing licences in the Faroe Islands will in principle be revoked and may subsequently be reallocated by political decision. According to representatives for the fishermen, this creates uncertainty and makes it less attractive to invest, as the yields after 2018 are less certain. Likewise, it is more difficult to attract external funding. Hence, uncertainty delays an otherwise necessary adaptation process within the sector.

A financially squeezed fisheries sector may also add to the pressure for higher quotas. This will increase earnings, in the short term at any rate. But it may also reduce sustainability, thereby squeezing earnings further in the longer term.

Foreign trade

The trade surplus, excluding ships and aircraft, was kr. 222 million in 2011, corresponding to 1.7 per cent of GDP.

In value terms, exports, excluding ships and aircraft, grew by almost 7 per cent from 2010 to 2011, cf. Table 1. Significant growth in the export value of mackerel and salmon more than offsets the decline in traditional species such as haddock, cod and saithe.

TRADE BALANCE AND BALANCE OF PAYMENTS			Table 1
Kr. million	2009	2010	2011
Exports	4,105	4,697	5,401
Exports, excluding ships and aircraft	3,879	4,480	4,772
Imports	4,211	4,370	5,273
Imports, excluding ships and aircraft	3,717	4,116	4,550
Trade balance	-106	327	128
Trade balance, excluding ships and aircraft	162	364	222
Balance of payments	-128	761	n.a.

Source: Hagstova Føroya.

 VALUE OF IMPORTS, EXCLUDING SHIPS AND AIRCRAFT, BROKEN DOWN BY
 SUBCOMPONENTS

Chart 5

Index, beginning of 2006 = 100

175

150

125

100

75

2006

2007

2008

2009

2010

2011

2012

— Consumer goods (24 per cent)

— Machinery etc. (7 per cent)

— Oil etc. (21 per cent)

— Other imports (28 per cent)

— Construction (7 pct.)

Note: Sum of last 12 months converted into indices. The most recent observations are June 2011-June 2012. "Other imports" are total imports excluding consumer goods, oil etc., construction materials, machinery etc., aircraft and ships. Figures in brackets indicate percentages of total imports in 2011.

Source: Hagstova Føroya.

The value of imports, excluding ships and aircraft, rose by just under 11 per cent from 2010 to 2011, mainly on account of higher oil prices, cf. Chart 5. Fuel constitutes a large share of Faroese imports as the fishing fleet is very energy-intensive and oil is a major source of heating. Imports of machinery have also increased since mid-2010, while imports of household consumer goods have been more or less flat since end-2009. The residual group, other imports, has also risen, reflecting higher imports for aquaculture and other industries, except building and construction.

Preliminary data shows that the rising trend in both exports and imports, excluding aircraft and ships, continued in the 1st half of 2012.

The financial sector

The stock of lending by Faroese banks to both retail and corporate customers continued to decline throughout 2011 and into 2012. At end-June 2012, seasonally adjusted retail and corporate lending was 19 and 35 per cent, respectively, lower than at the peak in 2008.

The development in bank lending should be seen in the context of easy credit conditions in the period leading up the crisis. Furthermore, demand for loans typically fluctuates with the business cycles. Another underlying factor is that retail loans have to some extent been converted into Danish mortgage loans arranged and guaranteed by Faroese banks.

Public finances

For the fourth year running, the public finances showed a deficit in 2011, cf. Table 2. The deficit was kr. 401 million, corresponding to just over 3 per cent of GDP. The central government and the unemployment fund posted deficits, while local government and the public-sector pension funds that are being built up posted surpluses.

The central government deficit of kr. 312 million in 2011 was an improvement of almost kr. 270 million on the previous year. This is mainly attributable to increased income, *inter alia* because some of the mackerel quota was sold at auctions, and because a resource tax was levied on part of the mackerel catch. This generated revenue of almost kr. 90 million. A majority in the Løgting has agreed to impose levies on mackerel catches in future.

From this year, the block grant, which has been frozen at kr. 615.5 million since 2002, will be adjusted to match price and wage inflation. Consequently, it will be increased by kr. 8.6 million this year, cf. Table 3.

In 2010 the Løgting decided that the government budget must be in balance from 2016. The expected economic recovery will contribute, but will not be sufficient, so further tightening will be required. This should be viewed in the context of a relatively poor point of departure for the public finances, as fiscal policy was lax in the years before the economic downturn. Taxes were cut and public consumption and investment increased. A number of consolidation plans have been announced, including tight management of public spending. However, so far only few of these plans have been adopted and implemented, which could weaken confidence in the government's ability to balance the budget by 2016.

With effect from 2012, central government taxes have been eased by a total of kr. 265 million, corresponding to approximately 2 per cent of GDP, according to calculations by the Faroese Ministry of Finance. This reform takes place against the background of a central government deficit of 2.4 per cent of GDP in 2011.

PUBLIC SECTOR FINANCIAL SURPLUS

Table 2

Kr. million	2008	2009	2010	2011	Estimate for 2012
Central government	-330 ¹	-688	-581	-312	-365
Local government	-347	-141	30	35	-73
Unemployment fund	56	22	-112	-189	-75
Public-sector pension funds	98	120	94	65	71
Government budget balance	-523	-688	-569	-401	-442

Source: Landsbanki Føroya and ALS (the Faroese unemployment fund).

¹ Plus kr. 300 million in loans to Iceland.

CENTRAL GOVERNMENT FINANCES					Table 3
Kr. million	2008	2009	2010	2011	Budget 2012
Taxes and duties, etc.	3,458	3,234	3,489	3,705	3,770
Other income	63	42	40	112	31
Block grant	616	616	616	616	624
Total income	4,137	3,892	4,145	4,433	4,425
Operating costs	4,251	4,366	4,500	4,541	4,436
Capital investments	232	184	169	150	266
Net interest expenses	-16	31	57	65	88
Total expenses	4,467	4,581	4,726	4,756	4,790
Budget balance	-330	-688	-581	-312	-365
Gross government debt, year-end ...	3,590	3,905	5,034	5,624	5,829

Source: Fíggjarmálaráðið (Faroese Ministry of Finance), Landsbanki Føroya and High Commissioner of the Faroe Islands.

The principal elements of the tax reform are as follows: the basic allowance for central government tax is more than doubled to kr. 65,000 and the marginal tax rate is reduced for the vast majority of tax payers. This is achieved by raising the thresholds for progressive taxation. A central government tax of 20 per cent is payable on incomes ranging from kr. 65,000 to kr. 500,000, rising to 25 per cent for incomes in the interval kr. 500,000 to kr. 800,000, and to 30 per cent for higher incomes. In addition local taxes are payable; this system has not changed. Hence the basic allowance for local tax remains kr. 30,000 and the average tax rate just over 21 per cent. The tax ceiling is still 50 per cent.

Only a small proportion of the tax cuts are expected to return through rising income from higher consumption and activity. All the same, the immediate impact of the tax reform on the government budget balance is limited since the taxation of pension savings is brought forward. This means that pension savings are taxed when contributions are paid, not when disbursed. This will reduce future tax revenue while also increasing pressure on the sustainability of public finances.

The mandatory Faroese unemployment fund has posted large deficits in recent years. As a result, equity had been reduced to kr. 412 million by end-2011. Since the fund should ultimately break even, the Board decided to strengthen the capital base by raising contributions and reducing disbursements with effect from 2012. The degree of compensation has been lowered from 80 to 75 per cent of the preceding year's wage income, and the maximum benefit per month has been reduced by kr. 2,500 to kr. 17,500. In addition, 10 waiting days have been introduced. The entitlement period for unemployment benefits remains three years.

Economic outlook

The Faroese economy is expected to grow at a moderate pace in the coming years. The fisheries sector is strongly dependent on the global economy, which to a large extent determines fish prices. Consequently, the international economic turmoil also affects the outlook for the Faroese economy. Furthermore, it remains to be seen which consolidation measures will be taken to address the central government deficit. This all adds to the uncertainty.

The uncertainty has a knock-on effect on the consumers, who have tightened their purse strings. But if confidence picks up, there is a potential for higher consumption and hence growth driven by domestic demand. The tax reform has increased household disposable income, some of which is expected to be channelled into higher consumption. Indeed, the most recent data for consumption taxes does indicate a boost in private consumption.

Catch volumes and fish prices, both of which may fluctuate substantially over time, have a major impact on incomes. This is a fundamental condition in an economy which relies so strongly on fisheries. At present the Faroese economy is benefiting from successful aquaculture and larger catches of mackerel. This more than compensates for the loss of earnings due to higher oil prices. To ensure sound earnings in the longer term, it is important also to take sustainability into account.

If the fisheries sector is to contribute higher value added over time, productivity must be stepped up. So in connection with a potential reallocation of fishing licences in 2018 it is important that the most productive fishermen hold the licences. The sector believes that the issue should be clarified as soon as possible so that those affected have time to adapt to the new rules.