
Current Trends in the Faroese Economy

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The Faroese economy has been stagnant for the last couple of years, with growth in the nominal gross domestic product, GDP, more or less matching consumer price inflation in 2011 and 2012.¹

The Faroese economy is heavily dependent on fisheries and aquaculture. Export values for mackerel and salmon continued to develop favourably in 2012. At the aggregate level, this more than made up for the further decline in the traditional demersal fishing sector, where many fishermen are financially squeezed.

Households have consolidated and seem to be influenced by great uncertainty. This has dampened private consumption and hence also certain derived investments. However, imports, excluding ships and aircraft, rose substantially in 2012, mainly driven by imports for the corporate sector. Exports also rose, but to a lesser extent. As a result, the trade surplus in 2011 turned into a deficit in 2012.

Unemployment has declined in recent years, without an equivalent increase in employment. This reflects net emigration as well as an increase in the number of people living in the Faroe Islands but working abroad.

Consumer prices were 0.3 per cent lower in the 2nd quarter of 2013 than one year earlier. The fall is mainly attributable to lower energy and transport prices and housing-related expenses.

National accounts

Nominal GDP rose by 1.9 per cent in 2012, following an increase of 2.4 per cent the year before. In both years, growth in nominal GDP was very close to the annual rate of consumer price inflation.

Thus, activity seems to have been stagnant over the last couple of years. However, this comes after a considerable increase in nominal GDP in 2010, cf. Table 1, primarily on account of favourable fish prices. Moreover, during the downturn in 2008-09, the Faroe Islands were less severely affected than most other western economies. Nominal GDP was

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. However, the Faroese statistical agency, Hagstova Føroya, is planning to publish real national accounts in a few years.

FACTS ABOUT THE FAROE ISLANDS

Population (beginning of 2013)	48,197
of which in Tórshavn	19,827
of which 18-66 years	29,161
Waged employment (full time, annual average, 2012)	23,684
Unemployment (full time, annual average, 2012)	1,490
Gross domestic product per capita, 2012 (kr. 1.000) ¹	280
Gross national disposable income per capita, 2011 (kr. 1.000) ¹	299

Source: Hagstova Føroya.

¹ By comparison, GDP per capita in Denmark was kr. 326,000 in 2012, and gross national disposable income per capita was kr. 323,000 in 2011.

just under 9 per cent higher in 2012 than in 2007. In the same period, consumer prices rose by just over 10 per cent.

Recent years' increase in nominal GDP has been driven by exports of fish. Domestic demand has been weak, with subdued growth in public consumption and gross investments, which remain below the level in 2006-07, albeit with large fluctuations from year to year. Private consumption fell in 2008-10, but picked up again in 2011.

Households

Households remain hesitant to spend, which dampens private demand. Consumption as a ratio of disposable income dropped from almost 98 per cent in 2007 to just under 85 per cent two years later. Since then the consumption ratio has risen only slightly, and in 2012 it was almost 5 percentage points below the average for the last 15 years. The easing of

NATIONAL ACCOUNTS, NOMINAL GROWTH RATES

Table 1

Per cent, year-on-year	(Share of GDP, 2011)	2007	2008	2009	2010	2011	2012
Private consumption	(55.4)	5.8	-0.2	-1.4	-1.6	8.2	n.a.
Public consumption	(31.5)	8.2	10.5	1.8	3.7	1.9	n.a.
Total gross investment	(18.4)	28.4	-34.6	-17.4	20.7	-4.1	n.a.
Exports of goods and services	(49.1)	6.5	7.8	-11.0	15.2	12.9	n.a.
Final consumption equal to total addition	(154.4)	10.3	-3.0	-5.7	6.8	6.6	n.a.
Imports of goods and services	(54.4)	18.7	-6.8	-13.2	6.6	15.4	n.a.
Gross domestic product	(100.0)	5.9	-0.8	-1.7	7.0	2.4	1.9
Gross national income	(104.9)	5.7	-2.9	-3.6	11.2	3.7	n.a.
Gross national disposable income	(113.2)	7.3	-5.1	-3.3	11.0	5.4	n.a.
Memo: Consumer prices		3.6	6.3	-1.0	0.4	2.3	2.2

Note: The gross national product is GDP plus wage and investment income, net. The gross national disposable income is the gross national income plus transfers from abroad, net.

Source: Hagstova Føroya.

central government tax on incomes, which took effect in January 2012, seems to have had little impact on consumption.

VAT payments indicate that private consumption grew somewhat in the 1st half of 2013.

While overall private consumption has shown a weak trend, sales of passenger cars, measured by import value, have risen notably since the spring of 2009, but from a very low level. The import value of passenger cars now exceeds the average since 2000.

Consumer confidence is measured biannually and was marginally positive in both January and June 2013, at the highest level since June 2007. The reasons for this improvement are that consumers assessed their situation to be better than it was 12 months earlier, and that they took a more optimistic view of the future. This applied to both their own finances and the Faroese economy.

House price statistics fluctuate from one quarter to the next, but generally prices have been constant in recent years, following a decline of some 20 per cent in the period 2007-09. Prices are now back at the level from 2006, when they had already started the strong increase that continued until mid-2007. House sales have risen substantially since mid-2009, and in 2012 they were more than one third above the average since 1985.

The labour market

Employment, measured by the seasonally adjusted number of wage earners, rose in the 1st half of 2012 and has been virtually unchanged since then, cf. Chart 1. Only a very small part of the strong fall in 2008-10 has been made up for, and employment remains well below the level from before the surge in 2006-08.

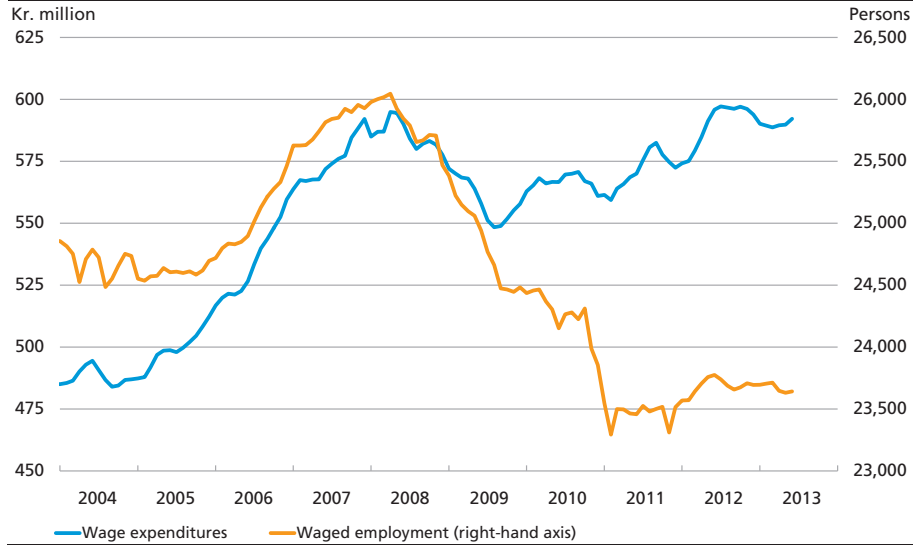
Broken down by sector, the number of employees within fish processing increased in 2012, cf. Chart 2. This is partly because catches of mackerel and herring have increased, but it should also be noted that the largest company in the Faroe Islands, Faroe Seafood, went into liquidation in December 2010. 800 employees at the company's fish-processing plants and on its ships lost their jobs in that connection. Since then, parts of the company have been sold, but production has been resumed only to a minor extent.

Aquaculture has developed very favourably in recent years. This has boosted employment, but since this sector is not very labour-intensive, it has had only a limited effect on overall employment.

The number of employees in the private service sectors stabilised in the latter part of 2012, having declined in the preceding years. In the first months of 2013, year-on-year employment rose. The decline in 2012

WAGE EXPENDITURES AND WAGED EMPLOYMENT

Chart 1



Note: Seasonally adjusted monthly data. 3-month moving averages for wage expenditures. The most recent observation is from June 2013 for waged employment and July 2013 for wage expenditures.

Source: Hagstova Føroya.

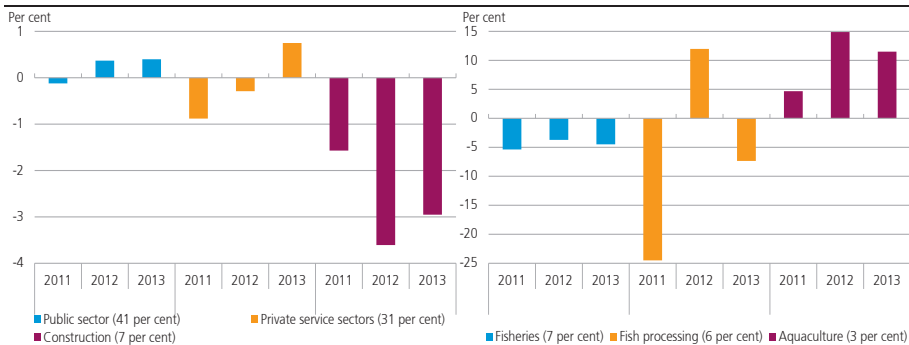
was mainly seen in the communications and finance sectors, while hotels and other transport than sea freight showed a positive trend.

Public-sector employment has been more or less constant since early 2009, accounting for over 40 per cent of total waged employment in the Faroe Islands in 2012.

Waged employment in the building and construction sector continued to decrease in 2012. However, after a strong fall from mid-2008 until early 2010, the decline has been moderate. Data for the first months of 2013 do not indicate that the curve has bottomed out yet. Employment

CHANGES IN WAGED EMPLOYMENT IN SELECTED SECTORS

Chart 2



Note: Data for 2013 shows the change in the period January-June 2013 in relation to the same period of 2012. Figures in brackets in the legend indicate the sectors' shares of total waged employment in 2012.

Source: Hagstova Føroya.

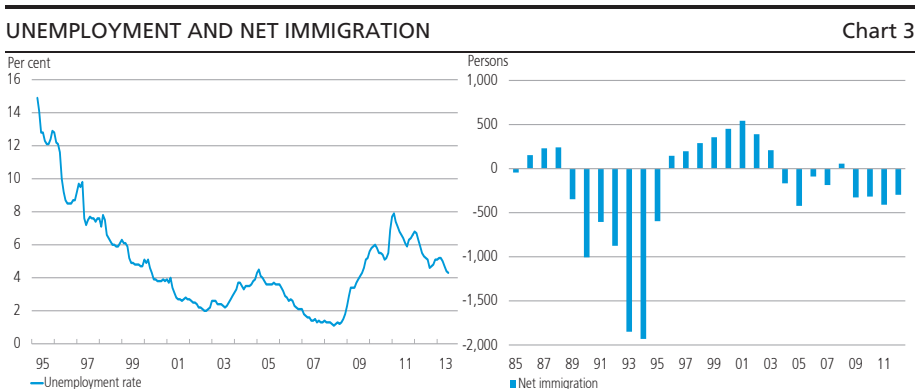
is now at the same level as in 2002, i.e. before the boom with soaring house prices began in the Faroe Islands.

In step with the slowdown in construction activity in the Faroe Islands, a considerable number of Faroese craftsmen have found employment abroad, especially in Norway. As such, it is positive that the qualifications of Faroese craftsmen are in demand abroad and that labour is highly mobile. But the large number of Faroese people working abroad should also be seen in the light of the very favourable Faroese tax allowances for this group.

However, in the Faroe Islands there is a shortage of certain types of labour, e.g. electricians, and there are indications of bottlenecks. This entails a risk that neither small nor large construction and maintenance projects can be commenced as the necessary labour for parts of the project is not available or would be very expensive. This may result in the cancellation of otherwise profitable construction investments or in excessive wage increases. With a continued shortage of labour within certain areas, large projects – including in the public sector – could put the economy under unnecessary pressure. If the shortage of labour continues for some years, this could also eventually lead to a structural problem as there will be very few skilled craftsmen left in the Faroe Islands to train new generations.

Unemployment in the Faroe Islands has decreased since early 2011, standing at 4.3 per cent of the labour force in July 2013, cf. Chart 3 (left). The fall in unemployment exceeds the rise in the number of wage earners. This should be viewed in the context of recent years' rise in the number of people living in the Faroe Islands but working abroad.

There is a clear tendency for rising unemployment in the Faroe Islands to lead to higher net emigration. This has also been the case in recent years, although the trend is far less pronounced than in the first half of



Note: Seasonally adjusted monthly data for the unemployment rate; the most recent observation is from July 2013.
 Source: Hagstova Føroya.

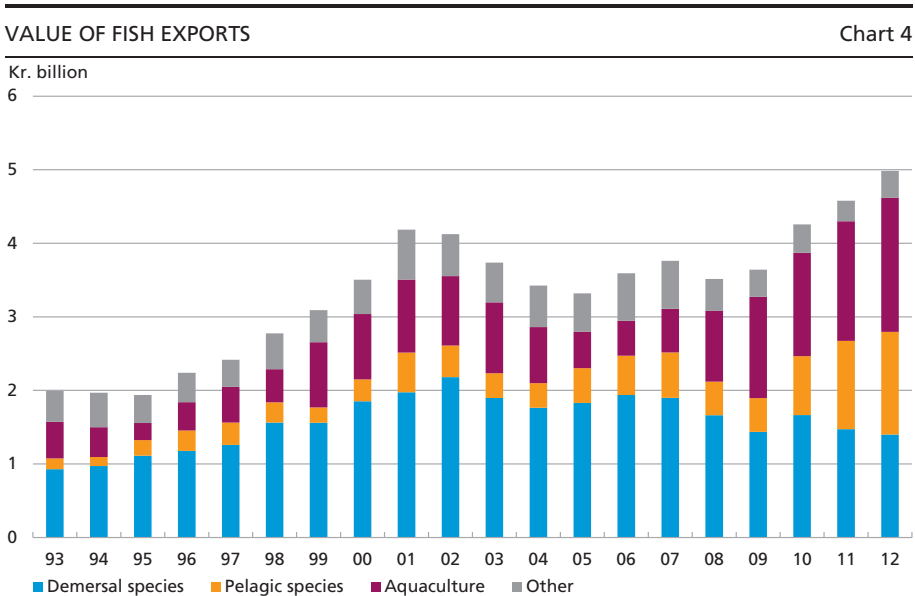
the 1990s, cf. Chart 3 (right). Recent years' net emigration has been of a sufficient magnitude to mask a demographic change whereby the number of people of working age has increased a little. Over the last decade, the number of people aged 18-66 has been more or less constant at around 29,000.

The Faroese labour force could potentially increase if those who have emigrated return, or if Faroese people working abroad seek employment at home. This could ease pressures on the labour market if the economy starts booming.

Fisheries and aquaculture

In 2012, fish accounted for around one seventh of total gross value added in the Faroe Islands and just below 95 per cent of exports of goods. This means that the Faroese economy is highly dependent on developments in the fisheries and aquaculture sectors.

Both fish prices and catch volumes may fluctuate considerably over time, which makes the overall economy vulnerable. However, the risk has been reduced by increasingly spreading earnings on different species, cf. Chart 4. Furthermore, the Faroe Islands have swapped fishing rights with a number of countries, thereby making the economy more resilient to temporary declines in stocks in Faroese waters.



Note: Pelagic species live in open waters, not near the seabed or in coastal waters. These species are mackerel, herring, whiting, capelin and sprat, among others. Demersal species include cod, saithe and haddock. Aquaculture comprises salmon and trout. Other is shellfish, etc.

Source: Hagstova Føroya.

Traditional local demersal fishing is financially weak. Catches of cod and haddock in Faroese waters are very low, and according to the Faroe Marine Research Institute the outlook for the coming years is not good. The low catches are presumably attributable to overfishing. Moreover, prices in the European market have fallen as catches in the Barents Sea have risen. At the same time, oil prices have been high, which has pushed up costs in a sector that was already financially squeezed.

Aquaculture has been a success in recent years. Earnings have been extraordinarily high since 2009, and in 2012 salmon accounted for 37 per cent of the total export value of fish. Prices have been favourable and are somewhat higher than production costs. Moreover, the volume of slaughtered fish has increased substantially, to almost 63,000 tonnes in 2012, which was about 25 per cent higher than in 2011. This year's volume is expected to be more or less in line with last year's. This is assessed to be close to the capacity limit if disease epidemics and resultant high costs are to be avoided. However, pilot projects are being conducted to move aquaculture further out into the fjords and also into the open sea. If this proves to be profitable, production could be increased substantially in the long run.

Pelagic fishing around the Faroe Islands, i.e. mainly for herring and mackerel, has risen strongly since 2010. This is mainly attributable to mackerel, for which the Faroe Islands have fixed their own quota since 2010 following fruitless negotiations with Norway, Iceland and the EU on a new distribution of the aggregate quota. In 2012, the Faroese government autonomously fixed the Faroese quota at just under 150,000 tonnes. Part of it was swapped with Russia and Iceland in return for fishing rights in their waters. 134,000 tonnes were allocated to Faroese vessels, which only caught just over 100,000 tonnes, however. In 2013, Faroese vessels have been allowed to catch 144,000 tonnes, compared with approximately 30,000 tonnes under the old international agreements.

In 2013, the Faroe Islands have also fixed their own quota for Atlanto-Scandian herring at 105,000 tonnes. This is more than three times the volume allocated under the previous years' agreements with Norway, Iceland, the EU and Russia.

In the assessment of the International Council for the Exploration of the Sea, ICES, the mackerel quotas fixed individually by the Faroe Islands, Norway, Iceland and the EU will result in overfishing, as will the individually fixed Faroese herring quota.

The Faroese argument for autonomously fixing considerably higher mackerel and herring quotas than those previously agreed is that

migration patterns have changed so that herring and mackerel stocks in Faroese waters are now substantially larger than when the old quotas were fixed. If the quotas are fully exploited, the contribution to the Faroese economy will be considerable, although the price level is also a key factor.

However, the disagreement on the herring and mackerel quotas means that no new agreements for other species have been concluded with Norway and the EU. Consequently, Faroese vessels are banned from fishing in the Norwegian part of the Barents Sea and from catching herring in Norwegian and EU waters. This has a negative impact on earnings in the Faroese fisheries sector.

In late August, the EU introduced trade sanctions against the Faroe Islands in response to the unilaterally fixed Faroese herring quota. The sanctions imply an EU-wide ban on imports and transit of herring and mackerel from the Faroe Islands. Furthermore, Faroese vessels catching herring and mackerel, as well as vessels catching Faroese herring and mackerel under Faroese fishing licences, may not call at EU ports.

These sanctions may have negative consequences as the European market is important. In 2012, exports of herring and mackerel to the EU accounted for some 10 per cent of total Faroese exports. However, the industry believes that markets outside the EU are sizeable too. In that case, the economic implications will depend on whether the Faroe Islands succeed in exploiting the quotas, accessing non-EU markets and obtaining reasonable prices.

The financial sector

Lending by Faroese banks to households in the Faroe Islands has been more or less constant over the last couple of years, while corporate lending has declined. At end-July 2013, lending to households and the corporate sector accounted for approximately 50 and almost 40 per cent of GDP, respectively.

The development in bank lending should be viewed in the context of the far too easy credit conditions in the period leading up to the crisis, one result of which was the winding-up of Eik Bank. According to the banks, demand for credit is also low among both households and firms, reflecting how demand for loans typically fluctuates with the business cycle.

At end-2012, the balance sheet of Faroese banks totalled approximately 210 per cent of GDP, some of which relates to lending activity in Denmark and Greenland. In the event of problems in the banking sector, the losses could be so large that the Faroese government would be unable to handle them.

TRADE BALANCE AND BALANCE OF PAYMENTS		Table 2		
Kr. million	2010	2011	2012	
Exports	4,697	5,407	5,493	
Exports, excluding ships and aircraft	4,480	4,778	5,187	
Imports	4,370	5,279	6,660	
Imports, excluding ships and aircraft	4,116	4,556	5,332	
Trade balance	327	128	-1,167	
Trade balance, excluding ships and aircraft	364	222	-145	
Balance of payments	811	1,043	n.a.	

Source: Hagstova Føroya.

Foreign trade

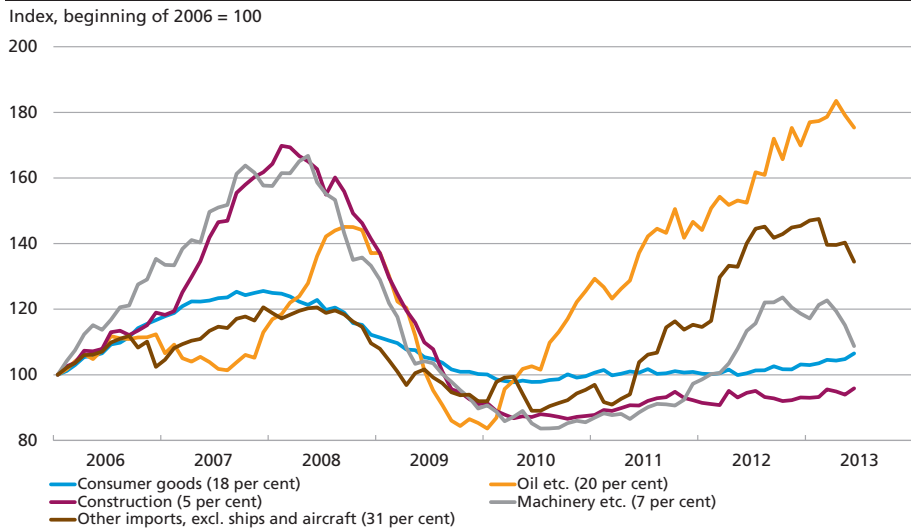
The balance of trade, excluding ships and aircraft, showed a deficit of kr. 145 million in 2012, corresponding to 1.1 per cent of GDP. If ships and aircraft are included, extraordinarily large purchases increased the trade deficit to kr. 1,167 million, cf. Table 2, corresponding to 8.6 per cent of GDP.

In value terms, exports, excluding ships and aircraft, grew by 9 per cent from 2011 to 2012, primarily as a result of further increases in exports of salmon and mackerel.

The value of imports, excluding ships and aircraft, rose by 17 per cent from 2011 to 2012. The increase was mainly driven by higher imports for the corporate sector, cf. Chart 5, but rising oil prices also played a role.

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

Chart 5



Note: Sum of last 12 months converted into indices. The most recent observations are July 2012-June 2013. Figures in brackets indicate percentages of total imports in 2012. In 2012, aircraft and ships accounted for 20 per cent of the total import value, which is extraordinarily high.

Source: Hagstova Føroya.

Fuel constitutes a considerable share of Faroese imports as the fishing fleet is very energy-intensive and oil is a major source of heating for homes. Imports of household consumer goods rose only slightly. Preliminary data shows that both exports and imports, excluding aircraft and ships, were higher in the 1st half of 2013 than in the same period of 2012.

The current account for 2012 has not been compiled yet, but will reflect the large trade deficit. On the other hand, wage income from people living in the Faroe Islands but working abroad is expected to have increased from 2011 to 2012.

Public finances

The public finances have shown a deficit since 2008. However, the deficit has been decreasing and was kr. 300 million in 2012, corresponding to 2.2 per cent of GDP. Local government and the public-sector pension funds that are being built up posted surpluses, while the central government and the unemployment fund posted deficits, cf. Table 3.

The mandatory unemployment fund has been operating at a loss in recent years. This reflects the economic situation, with large disbursements due to relatively high unemployment and dwindling contributions as a result of low wage earnings. Tightening measures in 2012 reduced disbursements, and based on average levels of unemployment and wages in recent years, these measures seem to be sufficient to ensure that the finances of the fund will balance over time.

The central government deficit of kr. 335 million in 2012 was in line with the previous year's deficit, cf. Table 4. However, both income and expenses had fallen by more than kr. 150 million.

The block grant has been frozen in nominal terms since 2002, but from 2012 it is regulated in accordance with the general price and wage index over the Danish Finance Act. In 2012, this meant an increase of kr. 8.6 million, bringing the block grant to 4.6 per cent of GDP. The block grant for 2013 is kr. 632.2 million.

BALANCES OF PUBLIC SUBSECTORS				Table 3
Kr. million	2009	2010	2011	2012
Central government	-688	-581	-322	-335
Local government	-74	-93	28	34
Unemployment fund	22	-112	-189	-77
Public-sector pension funds	120	94	65	78
Government budget balance	-620	-692	-418	-300

Note: CIL balance for central and local government.

Source: Landsbanki Føroya, Arbeiðsloysisskipanin (the Faroese unemployment fund) and High Commissioner of the Faroe Islands.

CENTRAL GOVERNMENT FINANCES					Table 4
Kr. million	2009	2010	2011	2012	Finance Act 2013
Taxes and duties, etc.	3,234	3,489	3,705	3,610	3,850
Other income	43	40	113	33	57
Block grant	616	616	616	624	632
Total income	3,893	4,145	4,433	4,268	4,538
Operating costs	4,366	4,500	4,541	4,375	4,477
Capital investments	184	169	150	182	258
Net interest expenses	31	57	65	45	46
Total expenses	4,581	4,726	4,756	4,602	4,782
Budget balance	-688	-581	-322	-335	-243
Gross government debt, year-end....	3,903	4,954	5,604	5,443	5,434

Note: Gross debts for 2012 and 2013 are estimates from March 2013 by Landsbanki Føroya. Repayment of kr. 300 million in loans from Iceland reduces the gross debt in 2012. Settlement in connection with the discontinuation of Landsbanki Føroya is expected to reduce the gross debt by kr. 160 million in 2013.

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

The Faroese government has decided that the government budget must show a surplus from 2016. Recent years' economic recovery has contributed to this, and certain savings and new taxes on mackerel fishing have also reduced the deficit. Furthermore, since 2012 pension savings have been taxed when contributions are made, not on disbursement. This will boost revenue these years, but reduce future tax revenue. Since this revenue has to a large extent been used for tax cuts, it has increased pressure on the sustainability of public finances.

Further measures are required if the target of a surplus in 2016 is to be achieved. In this context it is positive that the Faroese government has prepared a consolidation plan with specific proposals. However, only a small number of these initiatives have been adopted and implemented. This increases uncertainty in the population and may dampen consumption and investment. Bringing forward the decisions would boost confidence in the government's ability to reach its target of surplus in 2016.

Part of the improvement in central government revenue is to come from resource taxes on fisheries and aquaculture. The government is calculating with revenue of kr. 120 million in 2013. In 2012, taxes on mackerel fishing generated kr. 69 million. The resource tax is highly dependent on the situation in the fisheries sector and hence revenue may fluctuate substantially over time. In years with extraordinarily high revenue it is therefore important not to increase public spending correspondingly, as this will lead to a funding gap in years with normal or low revenue from resource tax.

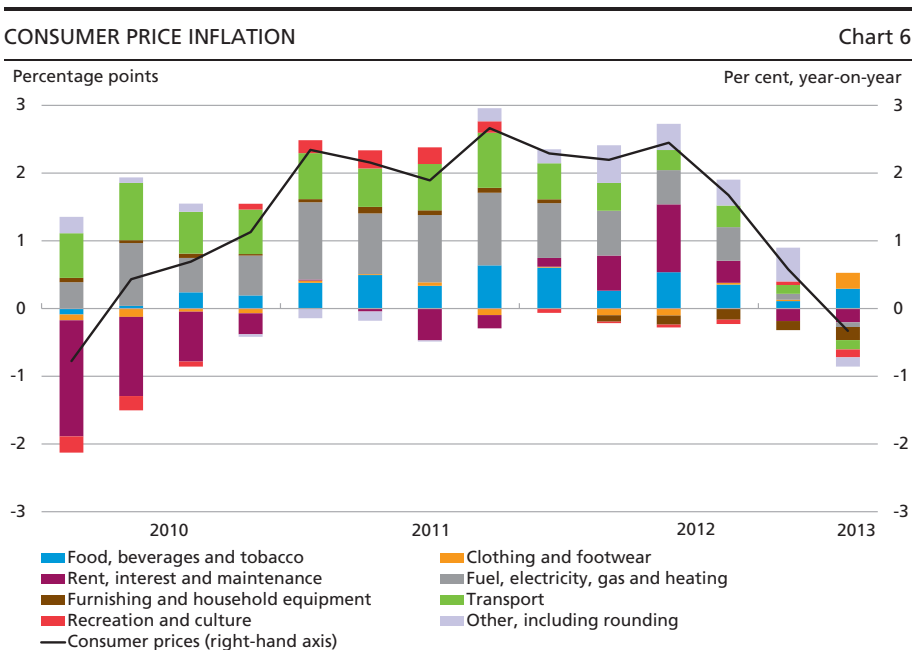
Consumer prices

Annual consumer price inflation has declined in recent quarters, and in the 2nd quarter of 2013 consumer prices were 0.3 per cent lower than in the same quarter of 2012, cf. Chart 6. This is well below the average since 2000 of just under 2 per cent. The lower rate of price increase is primarily attributable to the prices of energy and transport and housing-related expenses such as rent, interest and maintenance being a little lower now than one year ago. Throughout 2012, these items made a positive contribution to consumer price inflation.

Economic outlook

The outlook for the Faroese economy is closely linked to developments in fisheries and aquaculture, where both prices and volumes may fluctuate considerably over time. This is a fundamental condition in an economy which relies so strongly on fish.

At present aquaculture is doing extremely well, and in recent years the Faroe Islands have also increased mackerel catches substantially. If the autonomously fixed herring quotas are also exploited, they will contribute to activity in the form of increased catch volumes. But to ensure sound earnings in the longer term, it is important also to take sustainability into account when fixing the quotas for the various species.



The EU's sanctions in response to the autonomously fixed herring quotas for 2013 prevent the Faroe Islands from landing and selling herring and mackerel in the EU. This means that the Faroe Islands lose access to the important European market and cannot expect to obtain the same prices as they would otherwise get.

Private-sector confidence is low, which may dampen domestic demand. The uncertainty partly reflects the status of the Faroe Islands as a small open economy which is highly dependent on the international economy. This applies to import prices, but also to fish prices and sales opportunities for fish. If the global economy picks up, this can be expected to have a positive knock-on effect on the Faroe Islands. On the other hand, the EU's sanctions in relation to mackerel and herring may increase uncertainty about future earnings, which in turn may dampen domestic demand.

It is positive that the Faroese government aims for a surplus from 2016. An unsustainable fiscal policy may quickly lead to a lower credit rating and higher interest rates. However, there is considerable uncertainty as to how the government plans to reduce the deficit. The faster it consolidates, the sooner households and firms will know what to expect so that they can plan accordingly.

Speedy implementation will also increase fiscal credibility, thereby boosting the credit rating of the Faroese government. In September 2013, the credit rating agency Moody's confirmed its Aa3 rating of the Faroe Islands. But there is a risk of a later downgrading due to uncertainty about the Faroese economy as a result of the EU's trade sanctions.

Many people living in the Faroe Islands work abroad. With the prospect of continued high demand for Faroese labour abroad, there are no immediate indications that this will change. In recent years, this has helped to dampen the negative effects of the weak economic activity in the Faroe Islands. But rising domestic demand, especially for housing investments, may be impeded by an existing or imminent shortage of labour within certain sectors.