

CURRENT TRENDS IN THE FAROESE ECONOMY

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INTRODUCTION AND SUMMARY

The strong upswing in the Faroese economy that began in 2013 continued in 2014. According to the most recent forecast, the nominal gross domestic product, GDP, rose by 5.8 per cent, while consumer prices fell by 1.0 per cent. Growth in nominal GDP was driven by fish exports, which increased in value mainly as a result of high prices and rising volumes of farmed fish. The fall in oil prices acted as a stimulus by improving the terms of trade considerably. There are indications that public and private consumption is increasing. Employment is rising in most sectors, while unemployment is low and declining.

The government budget deficit has decreased. This is mainly attributable to budget effects of the strong cyclical position and growth in fisheries. On the other hand, measures to improve the un-

derlying fiscal position are still required. Demographic challenges are considerable. The Economic Council for the Faroe Islands has performed fiscal sustainability calculations. It is estimated that a permanent fiscal improvement of 5 per cent of GDP will be required in order to stabilise government debt, which is currently at a low level.

Seen over a number of years, public consumption and public investment have amplified cyclical fluctuations. Planned investment projects in the public sector and elsewhere in the coming years are expected to be considerable in size and if the boom continues, this could entail a risk of bottlenecks, especially in the construction sector.

The high rate of growth in fisheries is attributable to unusually favourable conditions in two of the three main branches of the industry, namely aquaculture and pelagic fishing, i.e. fishing in open waters for e.g. herring and mackerel. Pre-

Facts about the Faroe Islands

Population (beginning June of 2015)	48,881
Waged employment (May 2015)	24,693
Unemployment (July 2015), per cent	2.9
Gross domestic product, GDP (kr. million, 2013)	14,678
GDP per capita (kr. 1,000, 2013) ¹	305.4
Gross national disposable income per capita, (kr. 1,000, 2012) ²	316.2

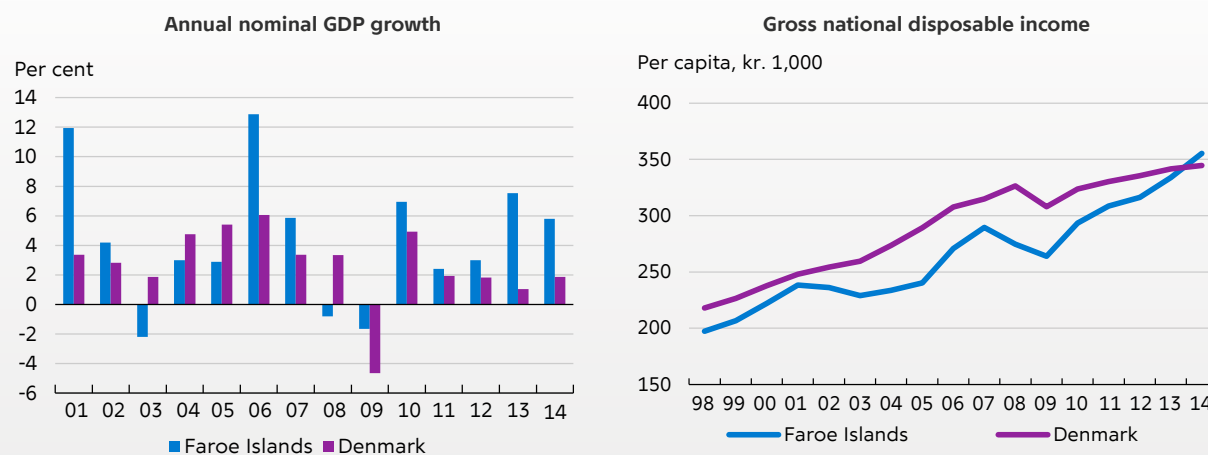
Source: Hagstova Føroya, Statistics Denmark.

1. By comparison, GDP per capita in Denmark was kr. 336,700 in 2013. Based on the population on 1 January 2013.

2. By comparison, gross national disposable income per capita in Denmark was kr. 335,400 in 2012. Based on the population on 1 January 2012.

GDP growth and development in gross national income in the Faroe Islands and Denmark

Chart 1



Note: For the Faroe Islands, GDP growth in 2014 and gross national disposable income for 2013-14 are based on forecasts prepared by Hagstova Føroya. Gross national disposable income per capita has been calculated based on the population on 1 January.
Source: Hagstova Føroya, Statistics Denmark and own calculations.

sumably, nature will limit potential future growth in these two areas. The last branch, fishing for demersal species such as cod, saithe and haddock, is financially squeezed due to low catches and excess capacity. According to the Faroe Marine Research Institute, stocks of demersal species are under pressure, so increased catches would not seem realistic in the short term.

NATIONAL ACCOUNTS AND BALANCE OF TRADE

According to the most recent forecast, nominal GDP grew by 5.8 per cent in 2014 after having increased by 7.5 per cent in the preceding year, cf. Table 1. The strong upswing in the Faroese economy in recent years has been driven by fish exports. Dependency on aquaculture and fishing – sectors in which activity fluctuates with stocks – means that the economy is highly volatile, cf. Chart 1 (left). Growth in nominal GDP has been higher in the Faroe Islands than in Denmark every year since 2009.

Growth in domestic demand has been more moderate. Private consumption increased only slightly in 2013, the latest year for which national accounts data is available¹, but data for, inter alia, retail sales and imports of vehicles indicate that private consumption has risen strongly in 2014 and 2015. Public consumption showed a larger increase in 2013 than in the preceding two years. Judging by public sector wage expenditures, the high rate of growth continued in 2014 and the 1st half of 2015. In 2013 investments fell, especially investments in ships and aircraft, which are to a large extent imported and therefore have no immediate impact on activity. Wage expenditures in the construction sector rose by more than 10 per cent in 2014 and in the 1st half of 2015. This indicates a rise in fixed investment.

It is likely that investments will increase in the coming years, particularly since the planned volume of public investment is higher than in recent years. Central and local government as well as government-owned companies are planning investments in the coming years that are very large

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 measures must be applied, e.g. wage expenditures and waged employment, which are compiled with a relatively short lag and usually provide a good indication of the development in the Faroese economy.

National accounts, nominal growth rates

Table 1

Per cent	Share of GDP (2013)	2006	2007	2008	2009	2010	2011	2012	2013	2014
Private consumption	52.0	8.0	5.8	-0.2	-1.4	-1.6	9.6	1.2	1.3	n.a.
Public consumption	29.6	3.3	8.2	10.5	1.8	3.7	1.9	0.9	3.3	n.a.
Total gross investment	24.9	42.1	28.4	-34.6	-17.4	20.7	-3.3	61.1	-7.5	n.a.
Exports of goods and services	50.6	11.2	6.5	7.8	-11.0	15.2	12.9	2.2	11.7	n.a.
Final consumption equal to total addition	157.1	12.5	10.3	-3.0	-5.7	6.8	7.2	8.6	3.2	n.a.
Imports of goods and services	57.1	11.9	18.7	-6.8	-13.2	6.6	17.2	18.8	-3.6	n.a.
Gross domestic product	100.0	12.9	5.9	-0.8	-1.7	7.0	2.4	3.0	7.5	n.a.
Gross national income	n.a.	12.8	5.7	-2.9	-3.6	11.2	3.3	3.8	n.a.	n.a.
Gross national disposable income	n.a.	12.3	7.3	-5.1	-3.3	11.0	5.0	2.0	n.a.	n.a.
Memo: Consumer prices		1.5	3.6	6.3	-1.0	0.4	2.3	2.2	-0.6	-1.0

Note: The gross national disposable income is GDP plus wage and investment income, net, and transfers from abroad, net.
Source: Hagstova Føroya.

relative to the size of the Faroese economy. These include the construction of two underwater road tunnels, expansion of the energy infrastructure, enlargement of one of the three hospitals and of the port of Tórshavn and purchase of new equipment for e.g. the airline company and marine research. The import content of many of these investments is very large, but nevertheless the investment programme will contribute to economic growth and increase the risk of bottlenecks, especially within the construction sector.

Further growth in fish exports in 2014 meant that the value of exports of goods, excluding ships and aircraft, rose by almost 6 per cent in 2014, cf. Table 2. Imports of goods, excluding ships and aircraft, rose by 5.5 per cent. Preliminary data for the 1st half of 2015 show that the value of exports has increased strongly, once again driven by fish exports. Imports, excluding ships and aircraft, are lower than in the corresponding period of the previous year. Presumably this is mainly attributable to a 23 per cent drop in the value of imported fuel in the 1st half of 2015 compared with the same period of 2014, reflecting the fall in oil prices in the world market.

The surplus on the balance of trade in goods was kr. 391 million in 2014, corresponding to almost 3 per cent of GDP. The balance of services

is expected to show a deficit. In recent years it has been negative by around kr. 1 billion. There is an additional positive contribution in the range of kr. 7-800 million net in the last couple of years from wage income for people living in the Faroe Islands but working abroad (including in Denmark). Furthermore, transfers, primarily from the Danish government, amount to around kr. 800 million. Consequently, the balance of payments for 2014 is expected to show a considerable surplus.

Gross national disposable income was almost 12 per cent higher than GDP in 2012. This is attributable to the block grant from the Danish government and net wage income from abroad. Net investment income was marginally negative. Over the last five years, gross national disposable income has risen more strongly than in Denmark, and the most recent forecast shows that it will exceed the Danish level from 2014, cf. Chart 1 (right).

PRICE DEVELOPMENTS

Consumer prices have been falling since the spring of 2013, cf. Chart 2. In the 2nd quarter of 2015 they were 1.3 per cent lower than in the same quarter of 2014. Notably, the fall in oil prices

in the world market has caused the prices of energy and fuel to drop in 2015.

Homeowners' interest payments are included in the index of consumer prices. Falling interest costs on housing loans continue to exert downward pressure on the consumer price index, but the contribution was larger in late 2013 and 2014, as the fall in interest rates was more pronounced then. The low rate of consumer price inflation

boosts household real income and hence private consumption.

LABOUR MARKET CONDITIONS

Waged employment has risen a little in the last two years, after having been virtually flat in the preceding years, cf. Chart 3 (left). The 3.3 per cent

Balance of trade and balance of payments

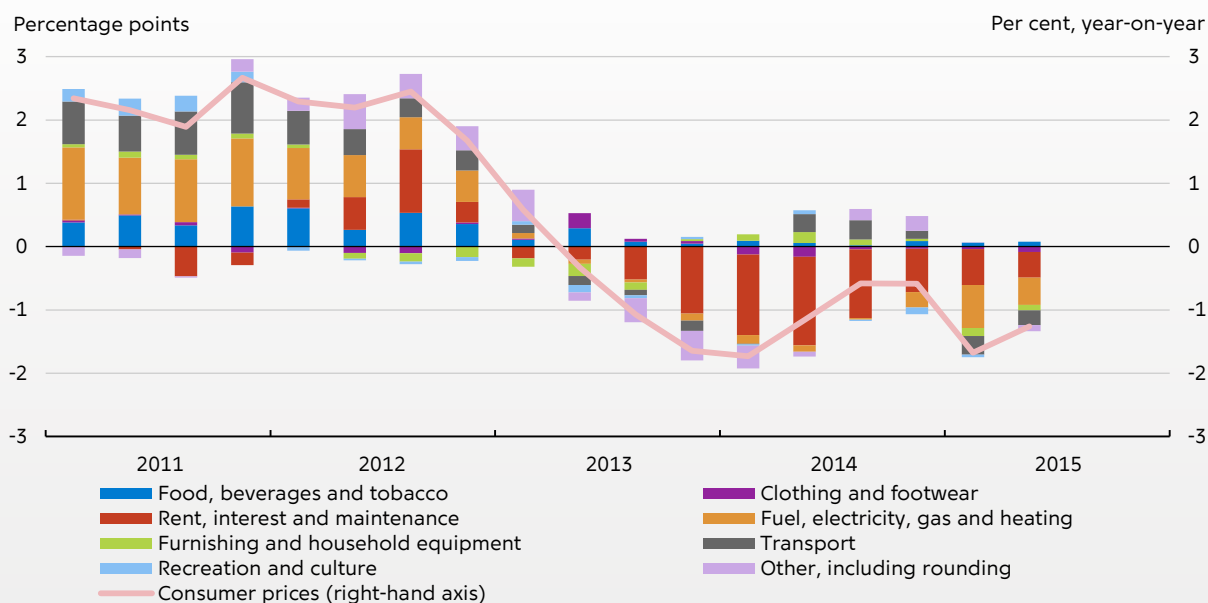
Table 2

Kr. million	2011	2012	2013	2014
Exports, goods	5,407	5,515	6,104	6,362
Exports, goods excluding ships and aircraft	4,778	5,209	6,000	6,350
Imports, goods	5,279	6,683	6,273	5,971
Imports, goods excluding ships and aircraft	4,556	5,355	5,448	5,747
Balance of trade, goods	128	-1,167	-169	391
Balance of trade, goods excluding ships and aircraft	222	-145	552	602
Balance of payments, current account	884	-447	n.a.	n.a.

Source: Hagstova Føroya.

Increases in consumer prices and contributions from subcomponents

Chart 2

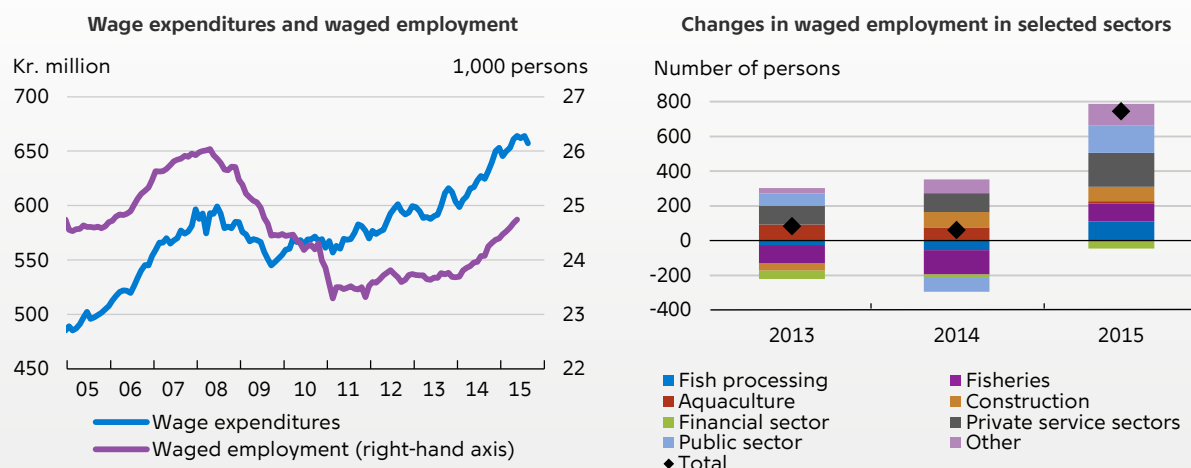


Note: Transport includes fuel. The weight of components on which oil and energy prices have a direct impact is more or less the same for Denmark and the Faroe Islands. However, the volatility of price indices for the energy components in connection with changes in oil prices is substantially higher in the Faroe Islands, partly reflecting a different taxation system.

Source: Hagstova Føroya and own calculations.

Wage expenditures, waged employment and change by sector

Chart 3



Note: Left-hand chart: Seasonally adjusted monthly data. 3-month moving averages for wage expenditures. The most recent observation is from May 2015 for waged employment and August 2015 for wage expenditures. Right-hand chart: Change in average employment in the 1st quarter of the period in question.

Source: Hagstova Føroya.

rise in waged employment on an annual basis in April 2015 was also reflected in total wage expenditures, which grew by 7.4 per cent year-on-year in the same period.

The rise in employment from 2014 to 2015 has been broad-based across sectors, cf. Chart 3 (right).

Following a period of stagnation in the wake of considerable adjustment in 2009-10, waged employment in the private service sectors has increased in 2013-15. In contrast, the financial sector has continued to reduce its staffing.

Employment in fishing-related industries has increased after some years with falling employment despite growth in the sector. Employment in aquaculture, which has been very successful in recent years, was virtually unchanged in 2015 after having risen for some years. Production requires relatively little labour and this sector employs less than 5 per cent of wage earners even though it accounts for more than 40 per cent of exports.

Employment in the construction sector is rising. One of the reasons is the commencement of a number of large public sector projects. Employment in the sector is now at the same level as around 2004, i.e. before the boom with soaring house prices began in the Faroe Islands, but well below the level in the peak years around 2007.

Unemployment has decreased steadily since early 2011, standing at 3.0 per cent of the labour force (seasonally adjusted) in July 2015, cf. Chart 4 (left). However, unemployment has previously been much lower, e.g. in 2007-08. Comparison with other countries is difficult, in that the Faroese population is relatively mobile and responds to high unemployment. The labour force increased in 2014, partly due to net immigration, cf. Chart 4 (right). So the fall in unemployment is actually attributable to higher employment and not to emigration of unemployed people from the Faroe Islands, as has previously been the case.

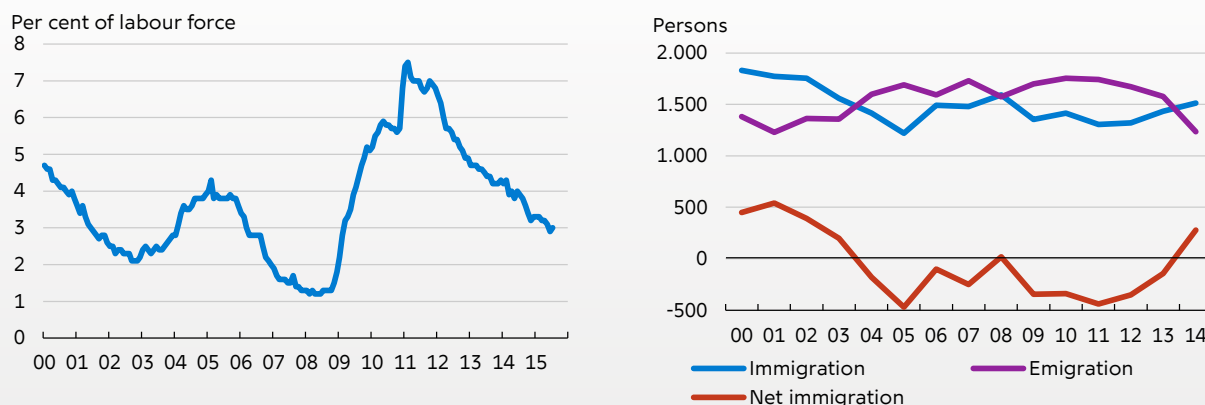
As the Faroese economy gathers steam, a shortage of labour could emerge. A large number of Faroese people, especially skilled tradesmen, live in the Faroe Islands but work abroad, attracted by higher wages and tax benefits. The Faroese government may to some extent make up for the shortage of labour by reducing the tax incentives for working abroad. Besides dampening the risk of overheating, this would increase tax revenue.

FISHERIES AND AQUACULTURE

The fisheries sectors account for around one sixth of total gross value added in the Faroe

Unemployment (left) and immigration and emigration (right)

Chart 4



Note: Left-hand chart: Seasonally adjusted data. The most recent observation is July 2015.
Source: Hagstova Føroya.

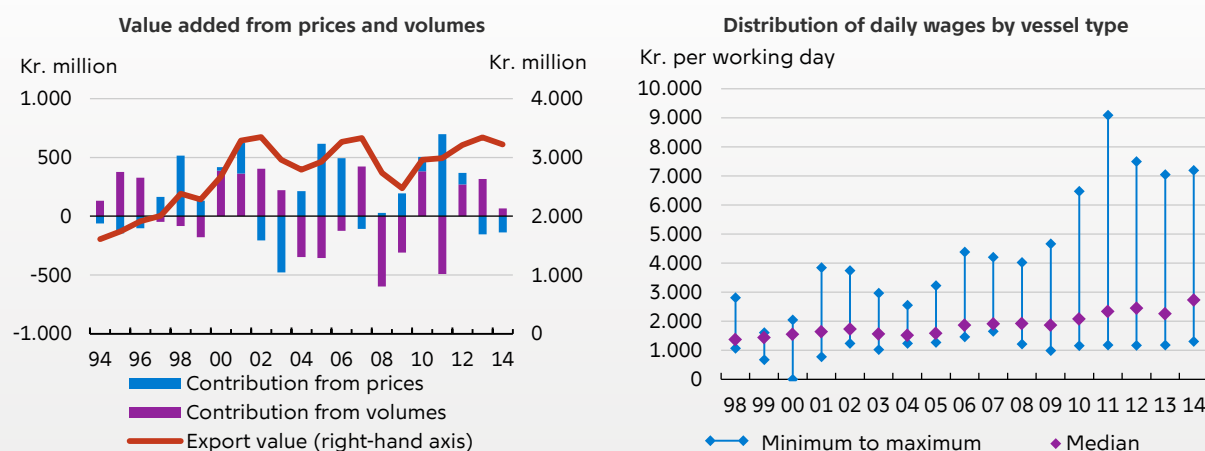
Islands and approximately 95 per cent of exports of goods, excluding ships and aircraft. This means that the Faroese economy is highly dependent on developments in catch volumes and fish prices. Both fluctuate considerably over time, but not necessarily in the same direction for the various branches of fisheries and species. The fact that earnings have increasingly been diversified across different branches of fisheries helps to reduce the vulnerability of the economy overall.

In recent years, earnings from fish have risen substantially, driven primarily by aquaculture. Other fisheries than aquaculture declined a little in 2014, cf. Chart 5. This was attributable to a slightly unfavourable development in prices. Pelagic fishing for, inter alia, herring and mackerel, is most profitable. Conversely, traditional local demersal fishing, mainly comprising cod, saithe and had-dock, remains financially weak.

Demersal fishing is characterised by local stocks which do not migrate the way pelagic

Value added in fisheries and wages earned by employees

Chart 5



Source: Hagstova Føroya and own calculations.
Note: Right-hand chart: Distribution of daily wages by vessel type ranks the average wages of employees on eight different types of fishing vessel.

species do. Therefore regulation is a local issue. Stocks of demersal fish are critically low for several species, and despite a decrease, catches have been higher than recommended by biologists, cf. Hegland and Hopkins (2014).

Earnings from pelagic fishing have risen substantially in recent years. This is primarily because catches have increased as a result of larger mackerel stocks around the Faroe Islands. In 2010-13, the Faroe Islands set their own quota for mackerel following fruitless negotiations with the EU, Norway and Iceland on a new distribution of the aggregate quota. In March 2014, the Faroe Islands, Norway and the EU concluded a 5-year agreement on mackerel quotas, allowing mackerel catches to remain at more or less the same level. Iceland is not a party to this agreement.

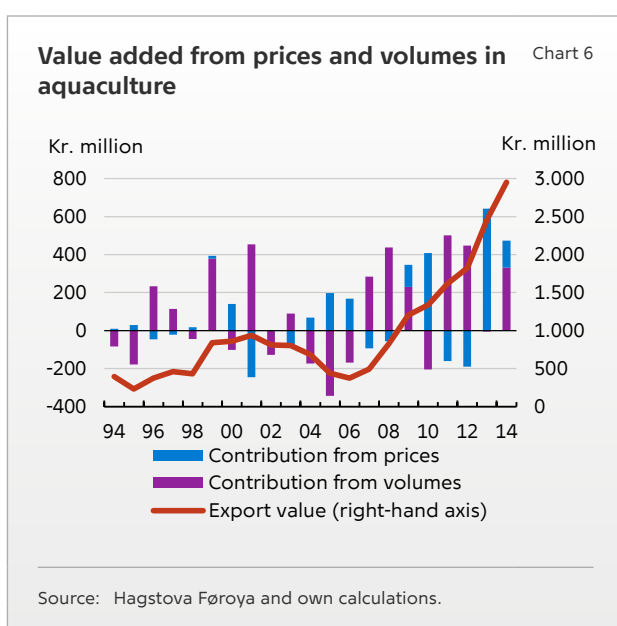
Attempts to reach agreement on herring quotas for 2015 and 2016 have been given up. For 2015, the Faroe Islands have set their own quota at the same level as the 2014 quota. However, this quota represents a substantially larger share of the overall North East Atlantic herring quota, which has been reduced by 32 per cent relative to 2014. In 2014, the Faroe Islands and the EU reached mutual agreement on that year's fishing, and hence the EU suspended its trade sanctions. No agreement was reached on the distribution of the blue whiting quota for 2015 and the Faroe Islands have set their own quota.

The very different financial conditions for the various branches of fisheries are reflected in

a large spread in wages for employees on the various vessel types, cf. Chart 5 (right). Wages on traditional demersal fishing vessels are low and have been so for many years. However, fishermen enjoy certain tax advantages over ordinary wage earners. Conversely, wages on some pelagic fishing vessel types are far higher than for equivalent jobs elsewhere. For example, the average income of employees on seiners has been kr. 1.5 million per year over the last five years. They enjoy the same tax benefits as fishermen in the financially squeezed demersal sector. The return on capital investments in these segments is also very high. In 2014, the Economic Council for the Faroe Islands assessed that the operating profit for pelagic fishing in 2010-12 was around 40 per cent, which is far higher than in the other branches of fisheries. The primary reason is that until now quota rights have been distributed free of charge.

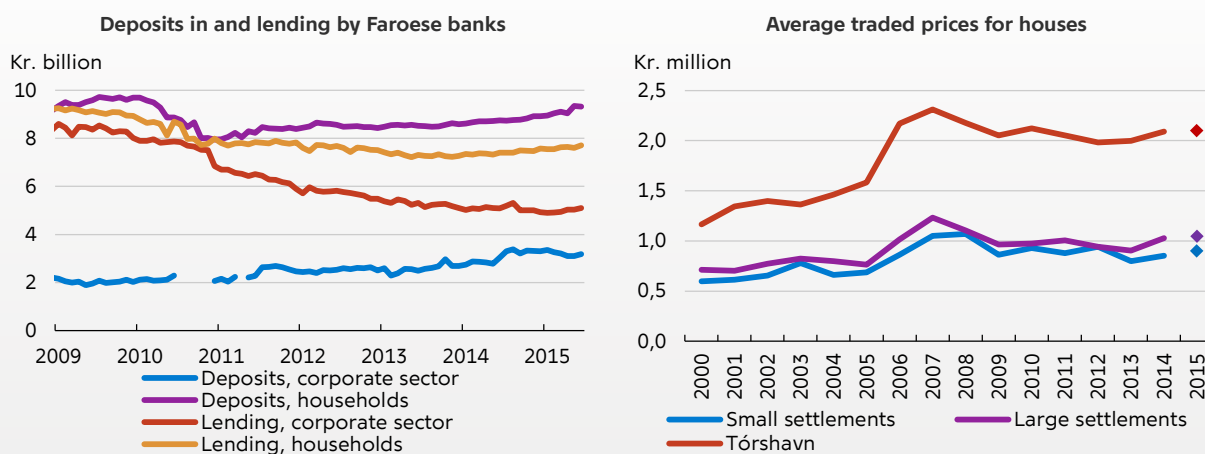
Aquaculture continued to increase its profits in 2014, accounting for around 50 per cent of total exports of fish. In addition, the sector uses e.g. fish meal produced by other fish industries in its production, thereby supporting the other fish industries. The only species farmed is salmon, which has seen high prices in recent years, cf. Chart 6. One of the reasons is that the Faroe Islands still have access to the Russian market after the Russian trade embargo on food from the EU. In 2014, exports to Russia accounted for 17 per cent of total exports. The market share has almost tripled compared with the average for the preceding five years and Russia is now the Faroe Islands' largest single export market.

After several good years in two of the three branches of fisheries, it is doubtful whether the high growth rates can continue. Aquaculture production is approaching the capacity limit for the existing technology if disease epidemics and resultant high costs are to be avoided. But technologies to increase production from existing aquaculture facilities are being tested. In the pelagic sector, future growth will depend on the quotas agreed between countries and the overall sustainability of fishing in the North East Atlantic Ocean. According to figures from the Faroe Marine Research Institute, the inflow of new demersal fish is very low, and there are no indications that there will be a basis for increasing fishing activities for some time to come.



House prices and deposits in and lending by Faroese banks

Chart 7



Note: Left-hand chart: In September 2013, a new set of statistics were introduced, which is linked to the old set. Data for households and non-profit institutions serving households (NPISH) have been merged. Right-hand chart: Data for 2015 covers the 1st half only. An index of prices for the Faroe Islands overall does exist, but it is calculated as the weighted average of all trades. For example, it shows that prices fell in 2014, although prices rose in each of the three categories. Therefore it is not used here.

Source: Danmarks Nationalbank, Hagstova Føroya, Eik Bank and own calculations.

FINANCIAL CONDITIONS

Lending by Faroese banks to firms was virtually unchanged in the 1st half of the year, while deposits increased. According to the banks, the flat development in loans was primarily attributable to very low demand. The fisheries sector, which previously raised many loans and was a source of major credit losses for banks in crisis periods, borrows only little from banks now. Large investments are made mainly in pelagic fisheries and aquaculture. Both these sectors are currently operating with large surpluses so that most investments can be funded by the firms themselves or repaid over a short period of time. Loans for the largest investments in e.g. aquaculture are typically granted by foreign banks, chiefly from Norway.

Lending by banks for housing purposes is rising slightly, but outstanding lending to households is still considerably lower than in 2008, cf. Chart 7 (left).

The Faroese banks have increased their capitalisation and now have a loan to deposit ratio below one. Profitability has increased over the last few years as loan impairment charges have

decreased. Three of the four banks are expected to be subject to the SIFI requirements.² The last one is far smaller and has been posting large loan impairment charges for some years.

The housing market is supported by rising disposable income and falling interest rates. Turnover is on the increase and in 2014 it reached the highest level since 1985 when the statistics began. Both in Tórshavn and in the smaller settlements, prices for traded houses have risen over the last couple of years, cf. Chart 7 (right), but they remain a little below the level in 2007-08. In the same period, disposable income has risen by around 20 per cent, however. The Faroese housing market is generally characterised by shorter loan amortisation periods than in e.g. Denmark. This makes homeowners more resilient to shocks and dampens price developments. On the other hand, no land taxes or property value taxes are paid, and, all else equal, this reduces the user cost, thereby pushing up prices. Subsidies for interest costs also help to reduce the user cost. The ceiling on and percentage rate of support from central and local government for homeowners' interest costs have both been reduced gradually since 2009 so that

² The rules regulating SIFIs in Denmark also apply in the Faroe Islands, subject to the necessary adjustments. SIFIs in the Faroe Islands will be designated by the Danish Financial Supervisory Authority on the basis of the same indicators as the Danish SIFIs.

in 2015, 35 per cent of interest costs are refunded up to a ceiling of kr. 120,000. The ceiling will be lowered further, to kr. 100,000 p.a. by 2018.

PUBLIC FINANCES

In recent years, the Faroe Islands have posted government deficits, but they have declined, primarily as a result of the positive economic

development. The deficit is mainly attributable to the central government, while local governments posted a small surplus. In 2014, the central government posted an operating surplus for the first time since 2007 as tax revenue increased. The current, investment and lending (CIL) balance remained negative. Government debt has been rising due to the deficits, cf. Box 1.

The Finance Act 2015 operates with a CIL deficit in 2015 of kr. 140 million for the central govern-

Main items of the government accounts

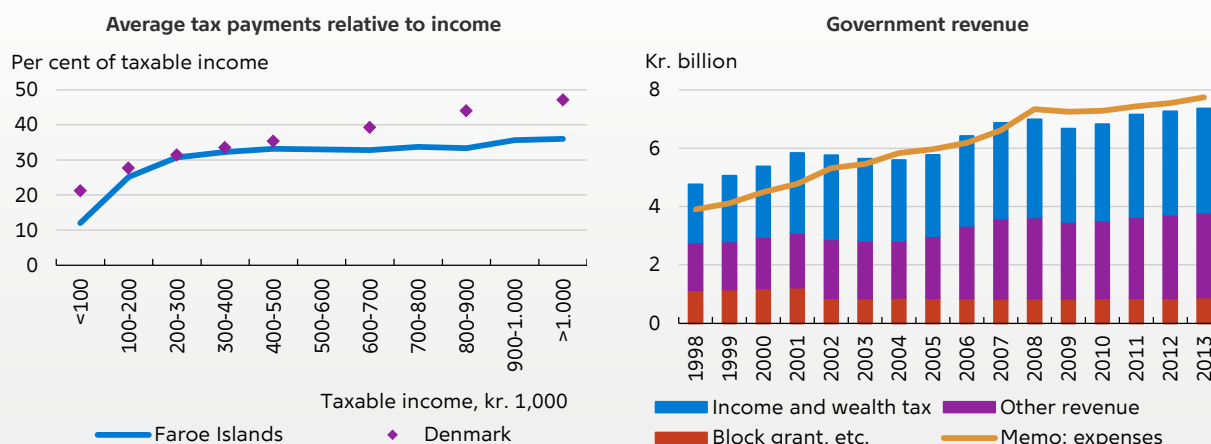
Table 3

Kr. million	2011	2012	2013	2014	2015 ¹
Taxes and duties, etc.	3,705	3,610	3,686	4,014	3,836
Other revenue	113	33	63	62	74
Block grant	616	624	632	635	642
Total income	4,433	4,268	4,381	4,712	4,552
Operating costs	4,541	4,375	4,463	4,588	4,333
Fixed investments	150	182	237	360	274
Net interest expenses	65	45	94	18	85
Total expenses	4,756	4,602	4,794	4,966	4,692
Balance (CIL)	-322	-335	-413	-254	-140

Source: High Commissioner of the Faroe Islands.
Data from the Finance Act 2015 for 2015, realised data (accounts) for other years.

Government revenue and expenses and tax payments relative to income

Chart 8



Note: Left-hand chart: Data for 2013 for the Faroe Islands; data for 2014 for Denmark. For Denmark, the income group 500,001-750,000 is included in the category 600-700 and the income group 750,001-1,000,000 is included in the category 800-900. Data for Denmark includes property value tax and labour market contributions.

Source: Hagstova Føroya, Statistics Denmark, High Commissioner of the Faroe Islands and own calculations.

Faroese government debt has increased

Box 1

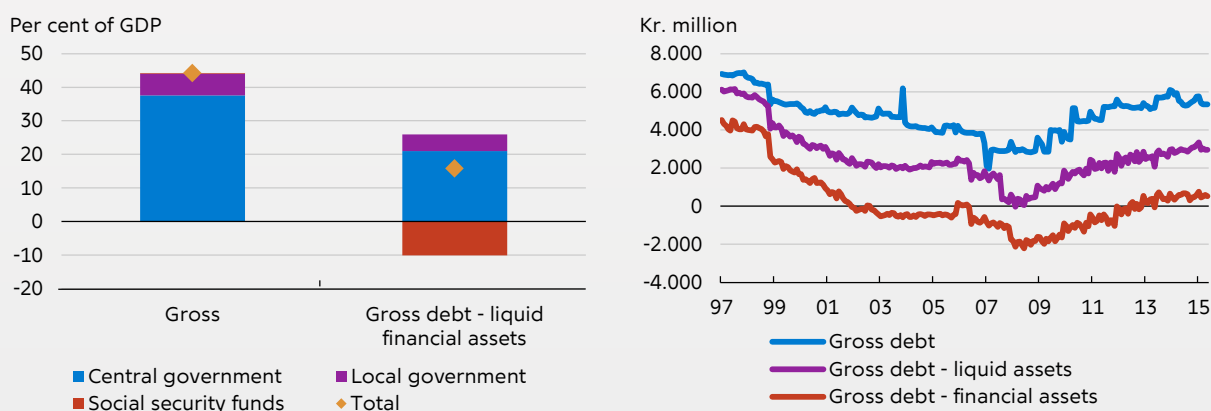
Government debt has been rising since 2008 due to government deficits. However, Faroese debt was low around 2008, i.e. before the financial crisis, after several years of fiscal consolidation. The gross debt was approximately 45 per cent of GDP at the end of 2014, which is low by international standards. Adjusted for liquid financial assets, the gross debt is just under 20 per cent of GDP.

The gross Faroese government debt comprises mainly the central government debt (just over 80 per cent of total gross government debt) and local government debt, which was approximately kr. 1,000 million gross at end-2014. If financial assets are included, the central government had considerable assets in 2008 and this did not make way for debt until around 2013. A small part of the debt is a kr. 500 million loan from the Danish government, on which no interest or amortisation is payable, and which will be cancelled in 2018 if extraction of raw materials has not commenced by then; at present there are no indications that this will happen. In addition, the central government has issued a 5-year bond in Danish kroner every year in the last couple of years. Moody's gives the Faroese bonds the credit rating Aa3, and

in July 2015 the outlook was changed from negative to stable. The credit rating includes an upgrade by two notches, reflecting Moody's assessment that extraordinary support from the Danish government has a strong likelihood even though no explicit commitment has been made by Denmark. Without the uplift, the assessment would have been A2.

Besides its debt, the central government has a number of indirect commitments, including the interest rate guarantee on pension schemes taken out before 1999 and early retirement benefits for government employees. According to calculations by the central government's department for debt and asset management, the equity of the company administering the schemes was negative by just over kr. 1 billion at end-2014. With unhedged guarantees of 4.5 per cent annually on a large share of the pensions, the unfunded commitment may increase, depending on how the financial markets, including the equity markets, develop. According to the assessment, this will not have any liquidity effect for the next 30 years or more as the company's assets will be depleted before the central government steps in.

Government debt end-2014 (left) and development in central government debt (right)



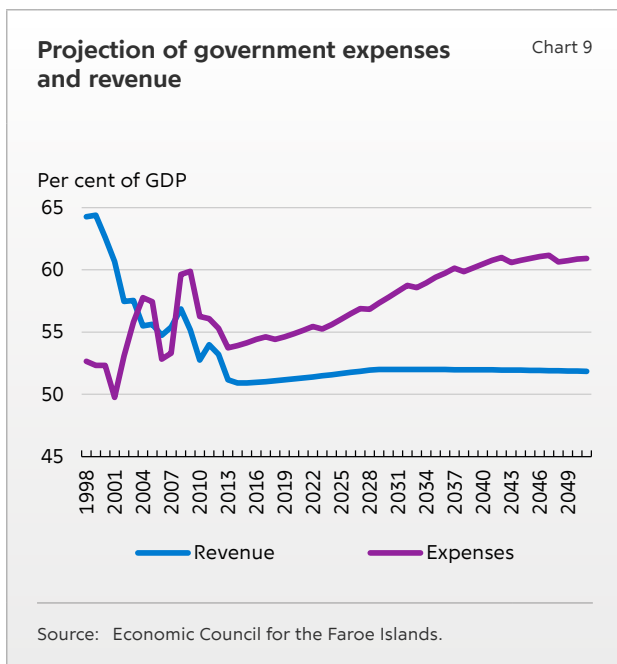
Note: Includes the S13 sector only. Left-hand chart: Social security funds include AMG, ALS, Vinnusjúkugrunnurin, Trygdargrunnur fiskivinnunar and Trygdargrunnurin. Right-hand chart: The liquid assets of the central government are used mainly to manage its refinancing risk on the debt.

Source: Hagstova Føroya.

ment, corresponding to almost 1 per cent of GDP. In addition, local government budgets show a deficit of kr. 78 million. The central government's proposal for allocations in 2016 entails a small surplus. The planned balancing of the budget takes place at a time when the economic situation is favourable. For example, tax receipts increased strongly in 2014 and have continued to rise in 2015. A deficit in a boom is problematic. Calculations by the Economic Council for the Faroe Islands show that for a number of years, overall

public consumption has risen when government revenue has increased due to an improved cyclical position. Hence, public consumption has been procyclical. The same applies to public investment.

The proposed allocations for 2016 include revenue from new resource taxes, primarily in connection with pelagic fishing. This is to ensure a budget more or less in balance, but it is still uncertain whether the taxes will be introduced soon enough, as agreement on this issue may be subject to the implementation of a fisheries reform.



Council for the Faroe Islands has made calculations regarding the sustainability of public finances. The conclusion is that without reforms the government deficit will increase steadily because public spending will rise, cf. Chart 9. There will be a need to permanently tighten fiscal policy by around 5 per cent of GDP (approximately kr. 750 million) in order to stabilise net government debt in the long term. The outcome is based on a number of assumptions. For instance, the Council has assumed that net emigration reaches more or less the same level as the observed average over the last 10 years. The immigration pattern is cyclical, and the shift to net immigration that took place in 2014-15 may therefore be only temporary, reflecting the current economic upswing.

In connection with the 2012 tax reform, income taxes were reduced considerably, and since then the degree of tax progression has been low for medium- and high-income groups, i.e. the tax rate has been virtually independent of income level, cf. Chart 8 (left). Other things being equal, the tax reform increased the structural government deficit. In the same connection, central government revenue was increased via taxation of pension contributions, in return for which future disbursements will not be taxed.

Taxes collected and other revenue covered around 83 per cent of the central government's expenses in 2013, down from around 95 per cent in the early 2000s, cf. Chart 8 (right). Just over 15 per cent of the public sector expense budget is met by the Danish government in the form of the block grant, other subsidies and operating costs and fixed investments for central government institutions.

The Faroe Islands are facing considerable demographic challenges. Many people of working age will be retiring in the coming years, and over the last decade there has been a fairly strong emigration trend, especially among young people of working age. Annual net emigration has been at a level of just over 0.4 per cent of the population.

The ageing of the population and the risk of a declining work force pose major challenges in relation to public finances if reforms are not introduced. Consequently, in 2015 the Economic

ECONOMIC OUTLOOK

The biannual confidence indicators show that firms and consumers are optimistic about the economy. Both indicators were in positive territory, albeit a little lower than in 2014. Especially the construction sector has very high expectations, which underscores the risk of bottlenecks in connection with large public sector investment projects.

The outlook for the Faroese economy is closely linked to developments in fisheries and aquaculture. Uncertainty about future volumes and prices in the fisheries sector is a fundamental condition in the economy. However, the fact that fish exports are now spread across several fish industries increases robustness.

Uncertainty in the fisheries sector has been reduced after an international agreement was reached regarding mackerel catches. But according to the sector it is still a source of uncertainty that all Faroese fishing licences will be re-distributed in 2018 and may potentially be reallocated on market terms. Such a reform could improve the government budget. The pelagic sector has been posting higher-than-normal profits, known as "economic rent", for some years, and Ellefsen et al. (2015) have estimated this economic rent at just over kr. 500 million in 2013, distributed on fewer than 10 quotas. They note that the economic rent may very well have increased since then due to the mackerel fishing agreement. The rest

of the fishing fleet taken as one earns only a small amount in economic rent. If fishing could reach a level that was optimum for society, it would, according to the same report, yield an even higher total economic rent. The calculations are subject to considerable uncertainty. In addition, it can be difficult to design a mechanism to ensure that the revenue of the central government will be of that size. For example, aquaculture already provides substantial revenue in the form of corporate tax payments. The volatility of income from fisheries means that the budget of the Faroe Islands should ensure budget surpluses and debt reduction in periods when the conditions for the sector are favourable, as they are at present.

Domestic demand is set to increase in the near term, reflecting factors such as rising employment and wages and falling oil prices. Household indebtedness is relatively low after some years of consolidation, and combined with low interest rates this may boost private consumption. The construction sector is also recovering after a series of weak years, supported by e.g. many planned construction projects in the coming years. Against that background, there is a risk of capacity problems, particularly in the construction sector.

The economic upswing improves government finances, but it may increase the risk that the central government will not introduce the measures required to ensure sustainability. Such measures are particularly important since the Faroe Islands – like other western economies – are faced with an ageing population, which increases spending pressures in the coming years.

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