

Information Memorandum

The Faroe Islands



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Landsbanki Føroya

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The following presentation of the Faroe Islands has been prepared by the Landsbanki Føroya on behalf of the Government of the Faroe Islands.

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1. GEOGRAPHY AND POPULATION

The Faroe Islands is an isolated archipelago in the North Atlantic. The distance to the closest neighbor, the Shetland Islands, is just over 300 km. The distance to Iceland is about 450 km and to Norway roughly 675 km. The sailing distance to Copenhagen is about 1500 km.

The Faroe Islands consists of 18 islands, mostly separated by narrow sounds. Of the 18 islands, 17 are inhabited. The total area is 1,399 km². The largest island is Streymoy (373.5 km²) and the capital, Tórshavn, is situated there.

The population of the Faroe Islands totaled 47,704 at the beginning of 2003. Of this number, 18,420 lived in the Tórshavn municipality and 4,794 in Klaksvík, which is the second largest town.

The distance from the northernmost point of the archipelago to the southernmost is 113 km, and the distance from east to west is 75 km. The highest point, Slættaratindur, is 882 m and the average elevation above sea level is just over 300 m; the total coastline is 1,117 km.

The climate is typically oceanic; the weather is moist, changeable and at times windy. Due to the influence of the Gulf Stream, there is little variation between winter and summer temperatures. For example, the average temperatures in Tórshavn during the coldest and warmest months are 3°C and 11°C, respectively. The shortest period of daylight is five hours and the longest 19 hours.

2. THE POLITICAL SYSTEM AND FOREIGN RELATIONS

2.1 The government and administration

Until 1948, the Faroe Islands was formally a county of the Kingdom of Denmark, although the islands have always enjoyed some special privileges in a number of respects.

Act No. 137 of the Kingdom of Denmark (the Home Rule Act) promulgated on 23 March 1948 accorded Home Rule to the Faroe Islands whereby it obtained the status of a self-governing community within the Kingdom of Denmark. In the Act, the Faroese language and the Faroese flag are acknowledged.

The Faroe Islands elects two representatives to the Folketing (Danish Parliament). On 20 November 2001, the Sambandsflokkurin (Unionists) and the Tjóðveldisflokkurin (Republicans) each won a seat in the Folketing, while the Javnaðarflokkurin (Social Democrats) and the Fólkaflokkurin (Conservatives) lost their seats.

The fundamental principle of the Home Rule Act is that the administration of all local matters should be transferred to Faroese authorities. On the other hand,

matters of common interest for the realm are handled by the High Commissioner who represents the Kingdom's authority in the Faroe Islands.

Matters relating to the Faroe Islands are divided into Special Matters and Joint Matters:

1) Special matters

In these areas, the Løgting (Faroese Parliament) has legislative authority and the Landsstýri (the Faroese Government) has executive power.

There are two types of special matters:

- a) Matters that can be assigned to the Faroese Government, if it or the Danish Government so wishes.
- b) Matters that, after prior negotiations between the parties, wholly or partly, can be assigned to the Faroese Government.

The areas that are assigned to the legislative and administrative bodies in the Faroe Islands are, for instance, financial and economic matters, industry,

foreign trade and resources in the subsoil. In early 2002, the educational system was officially assigned to the Faroe Islands and the State block grants from Denmark were reduced accordingly.

Certain matters of particular Faroese concern still fall within the jurisdiction of the Danish authorities in accordance with the agreement between the High Commissioner and the Faroese Government.

2) Joint matters

These are administered by the Danish Government according to the laws of the Kingdom of Denmark. Foreign policy, judicial matters and social legislation are primarily joint matters.

The provisions of the Act stipulate, however, that the administration of certain matters of common concern can be wholly or partly assigned to the Faroese Government or undertaken by the Danish and Faroese authorities jointly.

The Faroese Government now administers the social welfare system and the health services, etc. The legislative authority still lies with the Danish Government, but legislation has to be ratified by the Faroese Parliament for it to be applicable to the Faroe Islands.

To cover joint matters, the Faroe Islands receives State block grants from Denmark.

Areas that generally concern the Faroe Islands only, especially matters concerning Home Rule procedures, rest with the Department of the Danish Prime Minister. The Office of the High Commissioner is under this department. The main rule, however, is that Faroese matters managed by the Danish Government are handled by the relevant Danish ministry.

2.2 The Faroese Parliament and Government

The Faroe Islands is governed by the Løgting¹, which is the legislative body dealing with special matters and joint matters, etc. Laws passed by the Faroese Parliament pertaining to special matters are termed "Løgting Acts", and to enter into effect must receive the consent of the Løgmann, the Prime Minister of the Faroe Islands. Laws on joint matters passed by the Folketing must be ratified by the Løgting to be applicable to the Faroe Islands. These laws are termed "Danish Kingdom Law Recommendations".

The Faroese Parliament is elected every four years, however, a majority of the members of Parliament or the Prime Minister may call an unscheduled election. There is universal suffrage for those over the age of 18. The Parliament consists of up to 33 members of which 28 are directly elected from the various constituencies and up to 5 are distributed according to a special at-large system. There are 7 constituencies² comprised of geographical regions and at present there are six political parties represented in the Parliament. The last election was held on 27 April 2002 and the outcome is shown below.

In addition to being divided into the usual spectrum of political left and right, the electorate is also divided in accordance with the attitude towards the political relationship with Denmark, in particular to what extent the Faroe Islands should or should not be independent of Denmark.

The executive or administrative body is called the Landsstýri³. In June 2002, the Fólkaflokkurin, Tjóðveldisflokkurin, Sjálvstýrisflokkurin and the Miðflokkurin formed a coalition government. The principal goal of this government is to make the Faroe Islands more economically independent and self-supportive, so that the Faroese people, without economic or administrative restrictions, can decide their constitutional future.

In the election of 1998, independence was the major issue and the parties in favor of autonomy gained

¹ www.logting.fo

² Vágur, Northern and Southern Streymoy, Eysturoy, Norðoyggjar, Sandoy and Suðuroy.

³ www.fl.fo

the majority. These same parties, in addition to the Midflokkurin party, still comprise the government. However, the pursuit of independence has been

transformed into a process of overtaking more of the joint matters on a “step-by-step” basis.

Føroya Løgting (the Faroese Parliament) now has the following composition:

	1998		2002	
	Percentage of votes	Number of seats	Percentage of votes	Number of seats
Tjóðveldisflokkurin (Republicans, for independence):	23.8	8	23.7	8
Fólkaflokkurin (Conservatives, moderate autonomists):	21.3	8	20.8	7
Sjálvstýrisflokkurin (Conservatives, moderate autonomists):	7.7	2	4.4	1
Miðflokkurin (Christian Center Party):	4.1	1	4.2	1
Coalition forming the Government (as of 6 May 02)	56.9	19	53.1	17
Javnaðarflokkurin (Social Democrats, moderate unionists):	21.9	7	20.9	7
Sambandsflokkurin (Conservatives, unionists):	18.0	6	26.0	8
Others	3.3	0	0.0	0
Opposition:	43.2	13	46.9	15

The Faroese Parliament elected in 1994 was the first parliament to function under a new system of governing based upon ministerial directorates. The executive currently is divided into nine ministries:

- The Office of the Prime Minister
- The Ministry of Justice
- The Ministry of Finance
- The Ministry of Fisheries and Maritime Affairs
- The Ministry of Trade and Industry
- The Ministry of Family and Health
- The Ministry of Social Affairs
- The Ministry of Culture and Education
- The Ministry of Petroleum and the Environment

A director general, who reports to the minister in charge, heads each ministerial directorate. The directorates are again split up into different divisions with sub-directors.

The number of ministers was intended to match the number of directorates, however, for political considerations the number of ministers may vary. At present, there are nine ministers comprising the Faroese Government:

Anfinn Kallsberg, Prime Minister (Fólkaf.), minister for constitutional affairs, central administration and foreign policy.

Høgni Hoydal, Deputy Prime Minister (Tjóðveldisfl.), minister for home rule relations, municipal affairs, justice and Nordic affairs.

Karsten Hansen (Tjóðveldisfl.), minister for finance and economic affairs.

Jacob Vestergaard (Fólkaf.), minister for fisheries, the fish processing industry and sea transport.

Bill Justinusen (Miðflokkurin), minister for family and health affairs.

Páll á Reynatúgvu (Tjóðveldisfl.), minister for social affairs.

Høgni Hoydal (Tjóðveldisfl.), acting minister for education and cultural affairs.

Bjarni Djurholm (Fólkaf.), minister for trade and industry.

Eyðun Elttør (Sjálvstýrisfl.), minister for petroleum and environmental affairs.

Anfinn Kallsberg, Høgni Hoydal, Bjarni Djurholm and Páll á Reynatúgvu were elected to the Parlia-

ment and yielded their seats to their alternates upon entering the government.

2.3 Currency

The currency of the Faroe Islands is the Faroese króna, issued by the National Bank of Denmark. Unique Faroese notes are in circulation in the Faroe Islands and are constituted by a currency board as defined by Danish law as equal in value to the Danish krone. The base of the Faroese króna is the amount of Danish krone deposited in an account in the Danish Central Bank at a ratio of 1 to 1. Though the notes used in the Faroe Islands are Faroese, the coins are the same as those in circulation in the remainder of the Danish Kingdom. Faroese and Danish notes are fungible in the Faroe Islands.

A new series of Faroese notes is being issued. A new 50-króna note was issued in the summer of 2001 and was followed by a 100-króna note in early 2003. The rest of the series, a 200, 500 and 1000-króna note is due out before the end of 2004.

Concerning the future of Faroese currency, the Danish people rejected the Euro in 2001. This essentially preserved the status quo for the short term. It is likely that a new referendum on the Euro will be held in Denmark within a few years.

2.4 Foreign relations

In general, the Danish Government has the responsibility for the foreign affairs of the whole Kingdom, including the Faroe Islands. However, it has become common practice for the Faroese Government itself to conduct negotiations involving fishing and trade agreements with other countries, although assisted by the Danish Foreign Office.

The particular status of the Faroe Islands, as well as the unique structure of trade and industry, makes it difficult to share common interests and views with Denmark on a number of areas regarding international co-operation and bilateral or multilateral agreements. Therefore, various treaties and international agreements, which are subject to the consent of the Danish Parliament and which are of special Faroese concern, are to be submitted to the Faroese Parliament for review.

Because of this, Denmark's participation in international economic organizations does not automatically include the Faroe Islands. Negotiations are often conducted with the Faroe Islands at a later stage and this explains the time lag before the Faroe Islands joins various international organizations. For instance, Denmark subscribed to GATT in 1950 and the Faroe Islands in 1954.

Unlike Denmark, the Faroe Islands is not a member of the European Union. In 1974, the Faroese Parliament voted unanimously against applying for membership. Recently, some parties have sought to re-open the question to investigate the current conditions of membership, but discussions have not gained any momentum.

2.5 Agreements with Denmark

Because of the economic crisis in the first half of the 1990s, many agreements have been entered into between the Danish and the Faroese Governments.

The aim of the first agreements was to ensure the continuation of the two biggest banks at that time, Sjóvinnubankin and Føroya Banki, and to ease the Faroese exchequer's lack of liquidity. These agreements included restrictions on the economic policy of the Faroe Islands, e.g., the ability to borrow and / or guarantee loans.

The latest agreement entered into force on 10 June 1998. It deals with Faroese debt repayments, rescission of previous agreements, etc. The Danish Government also observed in this agreement the Faroese Government's objective to make the Faroe Islands a sovereign state.

Three rounds of negotiations were held without reaching an agreement on how to settle the transition period between the present status and future independence.

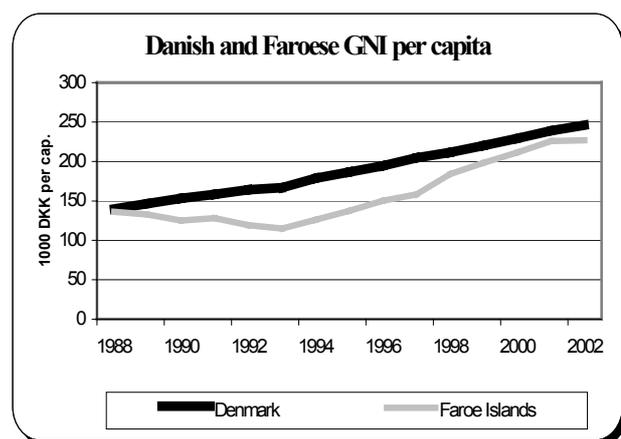
Now, the Faroese Government is pursuing a new course. The plan is to take over as many special matters as possible within the Home Rule Act. In the current coalition agreement, the planned take-overs include the State Church, immigration and family-related judicial matters. The Danish authorities seem to be willing to follow through with this endeavor.

3. ECONOMY

3.1 The Faroese economy in general

The Faroe Islands is an industrialized country with a standard of living comparable with the other Nordic countries. The economy is mainly founded on the fishing industry, sea farming and subsidies from Denmark.

Any economy based on only two industries is bound to be vulnerable to the cyclical change in those industries, especially when both are related to the fishing industry. Prices and catches are volatile and these have left their mark on the economic history of the islands.



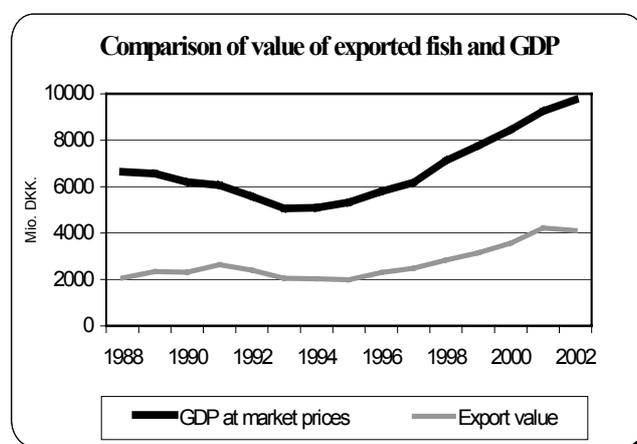
The subsidy from Denmark steadily grew over the years up to 2002. During the depression years of 1991 - 1994, the state transfer in percentage terms increased to almost a quarter of GDP, but by 2002 it had decreased to about 8% of GDP (Appendix D, Table 4).

Prior to the economic depression, the Faroese Gross National Income (GNI) per capita was above the Danish GNI per capita, due to the Danish Government subsidy. Now the GNI per capita is lower (Appendix C, Table 1).

Efforts to diversify the economy have been made, but so far without any notable success.

3.2 The fishing industry

The Faroese economy can be characterized as a mono-economy that is very dependent on the fishing industry. This statement is supported in the export account, of which fish products on average account for more than 95 percent of the export value (Appendix E, Table 3).



Since nearly all the fish products are exported, the Faroese economy is very sensitive to the market. Consequently, the export income can fluctuate significantly from one year to the next because of changes in catch and price, and these fluctuations spread quickly throughout the economy. This is clear from the figure above, where the trend of the value of exported fish is very similar to the trend of GDP.

More than a quarter of GDP comes from the fishing and fish processing industries (Appendix C, Table 2). The fishing industry is also the basis for other sectors, such as shipyards and industries equipping the fishing industry.

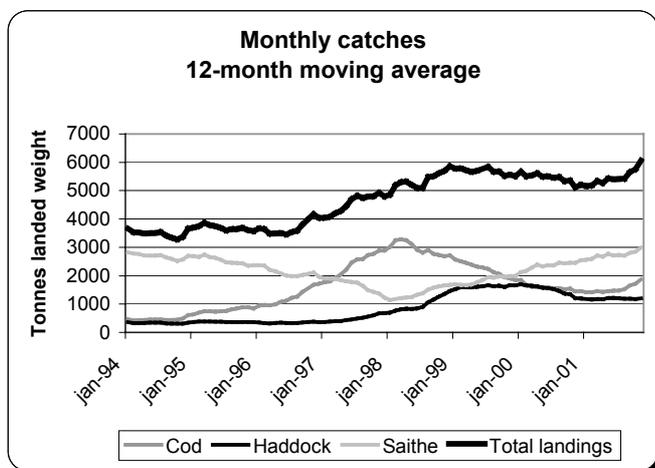
3.2.1 Development

Before the mid-1970s, the Faroese fishery was mainly based on fishing in foreign waters. The extension of national fishing boundaries, however, necessitated to a significant degree a re-organization of the Faroese fishing industry towards exploiting the

resources in Faroese territorial waters. Today, about 40% of the fish export value still comes from fishing in foreign and international waters, although most of the fishing in foreign waters is reimbursed by reciprocal rights in Faroese territorial waters.

After the transition period, a problem concerning surplus capacity became clear and this grew worse during the expansion of the fleet in the 1980's. In addition, the fleet was becoming increasingly more effective due to more efficient fishing methods partly because more modern fishing equipment was increasingly used. This increasing pressure, mixed with a deterioration of the fishing stocks from natural causes, resulted in a slump in catches, especially for cod, haddock and saithe, which make up most of the catch destined for human consumption.

Beginning in the early 1970s, the fishing industry also became increasingly subsidized and this twisted the market forces in unfortunate ways. Finally in 1992, the subsidies were replaced by a capital subsidy and later in 1998, removed altogether. Now the fishing industry relies very little on subsidies, although some indirect measures have been introduced instead.



Around this time, a condemnation plan was initiated whereby the ship owners were paid to give up their fishing vessels⁴. This resulted in a capacity reduction of around 30%. The intent of this plan was to increase the catch for each remaining vessel and in the end, increase the competitiveness and the total catch.

Approaching the mid-1990s, the cod stock turned out to be in better shape than previously estimated and the catch of cod increased gradually from 1993 to 1997. The export value, however, did not increase as much because a large portion of the export was unprocessed fish. Over a five-year period, this has changed partly because of more local processing, but more specifically because of a general increase in world market prices, especially for cod. In 2002, the prices were lower again, but the total catch was one of the best ever.

Statistically, total catches by Faroese ships in general increased from 1993 to 2002, but there were differences among the various species, as can be noted in Appendix G, Table 1. Year 2002 was even better than 2001 and this is visible in the export weight statistics as well, but the total value is about the same.

The general increase in prices and the overall growth in catches within Faroese territorial waters has resulted in an elevation of the export value. From 1998 to 2002, the total export value increased by 47%, while the landed weight increased somewhat less. This even understates the actual value increase, because the catch of the cheaper blue whiting has grown by a multiple of 13 since 1996.

3.2.2 Fisheries management

Quotas (TAC) were introduced by law in 1994, but by June 1996 the quotas were replaced by a new system of "Fishing Days". The new system focuses on viability and takes into account the differences in fishing gear and relative size of the vessels. The number of Fishing Days in a fishing year (commencing on 1 September) is set by law on the recommendation of an advisory board, comprised of representatives from in and around the industry. The recommendation is based on estimates of the fish stocks and the level of fishing effort. Each ship within each group thus gets a certain number of fishing days in which it may fish. Therefore, the TAC quota is a guiding factor rather than an exact amount. Fishing days are partly tradable.

The advantages of a fishing-days system compared to a quota system are mainly that vessels can take all their catch ashore rather than throwing fish overboard and furthermore curtails the fraudulent practice of landing fish under a false name. The disadvantages are mainly that the system is not efficient in protecting specific species and it does not take

⁴ Development of fleet. See Appendix G, Table 2 and 3.

into account technological improvement over the years. For these reasons, it is necessary to adapt the number of fishing days to the catching capability, which increases over the years.

Although there has been significant restructuring within the fishing industry, there still is a slight over capacity of vessels. Other means, such as limiting the number of fishing days and encouraging fishing of other species are being used to diversify and, hence, reduce the capacity indirectly. Restrictions are also enforced by limiting and banning fishing in specific areas for longer or shorter periods. This is especially useful for the protection of spawn and young fish.

The Faroese fishing fleet catches various species of fish. See Appendix G, Table 1. The catches of cod, haddock, saithe and redfish in Faroese waters are mostly chilled and processed to fillets. Blue whiting and Norwegian pout are processed into animal feed, fishmeal and fish oil.

3.3 Other industries

3.3.1 Aquaculture

The fish farming industry⁵ is a relatively new industry in the Faroe Islands. It started in the early 1980s and has since emerged into the second most important contributor to the Faroese economy. Production has been volatile over the years. In 2002, the production was around 45,000 tonnes and the export value DKK 943 million, which corresponds to 23% of total export. The production was just below the record year of 2001, but prices have remained low and hence the value was about the same.

In the early 1990s, the industry was in distress and the number of licenses went from 60 to about 15 through a series of mergers and acquisitions. Vertical integration took place such that companies now, wholly or partly, own the production from smolt to processing factory. This also allowed for larger permits and a foundation for better planning in production, less strain on the environment and a better financial result. The boom in the industry has also attracted foreign investments, but foreign ownership is by law restricted to 33% of equity.

The outlook for the industry is gloomy at the moment. After a period of high growth, yet volatile prices, the industry has run into major problems with infectious salmon anemia (ISA) and expectations are greatly reduced. Prices have been below production costs in the first quarter of 2003 and all together this has drained many companies financially, reducing the number of fish being set out.

The harvest in 2003 is expected to be a little lower than 2002, but for 2004 and 2005 estimates are down to 38,000 and 30,000 tonnes, respectively. For the industry though, future price development is of greater importance. One thing that could change this scenario is if an ISA vaccine would prove to be successful. It is not clear if the EU will allow this or if it will be as effective as hoped.

There has been a tendency towards more processing of sea-farmed fish. Traditionally, farmed fish has been exported iced or frozen, but a growing share has been processed to smoked or dinner-ready portions. The portion of processed fish did not increase in 2002, but growth is expected to pick up again in 2003, as prices and projected harvest are both down.

The fish farming industry conducts research to improve the quality and efficiency of production. There is also ongoing research in the farming of other species of fish, mainly cod and halibut, but so far this has not proven to be commercially viable.

3.3.2 Whaling

The pilot whale still contributes considerably to the meat supply in the Faroe Islands. Total catch was 162 tonnes or 4 kilos per person in 2002. The blubber, which is also eaten, amounted to 145 tonnes.

Catches have varied between zero and 900 tonnes in recent years. Although these catches are significant to the Faroese, the annual catch is only about 0.1% of the total stock of pilot whales in the North Atlantic. Therefore, the catch poses no threat to the pilot whale stocks.

3.3.3 Agriculture

Farming in the Faroe Islands is quite insignificant. Only about one percent of GDP in factor prices is derived from farming. The seven and a half million litres of milk produced in 2002 meets the domestic demand. The domestic production of other dairy products is open to competition from abroad, yet

⁵ Farming of salmon and trout.

about 75% of the home market is supplied by domestically produced products.

The annual production of mutton is on average 500 tonnes, which corresponds to 40% of the total demand. The production of beef and beef products amounts to around 110 tonnes. This is just a small percentage of the total consumption; meat imports, therefore, remain at a comparatively high level.

3.3.4 Construction

The construction industry in the Faroe Islands has had a very significant impact on the economy, compared to other countries. Most Faroese homes are spacious and the Faroe Islands has generally high private housing standards.

During the 1980s, many houses, roads, tunnels, harbors, etc. were built or upgraded all over the country. However, when the depression hit, only about 20 houses were built per year, compared to a couple of hundred previously. Worker compensation fell from DKK 348 million per year to DKK 98 million in 1995.

Now both private and public construction is booming again and compensation of employees has risen to DKK 344 million in 2002, up by 13% compared to 2001 (Appendix H, Table 3). Although the level of activity is still high, the growth in 2003 appears to have peaked and is expected to remain around the 2002 level. The previously referenced workforce shortage in the industry is not critical at present, even though unemployment figures remain very low.

3.3.5 Transport

Internal

The transportation facilities in the Faroe Islands are good. With the new tunnel to Gásadalur, which was finished in February, road connections now link all villages on each island and also between some of the islands.

In January this year, the first subsea tunnel in the Faroes was opened between Vágur and Streymoy. This is the first user-financed investment of its kind in the Faroe Islands. A second subsea tunnel is planned for between Borðoy and Eysturoy and the project is expected to start later this year.

Both passenger and cargo transport are provided on a daily basis to all but two of the inhabited islands and most villages. Ferries and helicopter services are available to the islands that are not directly linked to the road system, and bus service is the most common form of transport for the other areas. The public transport company, Strandfaraskip Landsins⁶, maintains most of these routes, while numerous private companies offer passenger and cargo services on request.

External

Three airline companies⁷ from the Faroe Islands, Denmark and Iceland, handle the air services to and from the Faroe Islands. Depending on the season, there are two to four daily flights to Denmark (Copenhagen and Billund), two to five flights a week to Iceland and two to four flights per week to Aberdeen. In the summer, there are two flights to Norway (Oslo/Stavanger) as well as to London. Just below 157,000 passengers traveled through Vágur Airport in 2002, which is 0.7% fewer passengers than in 2001. So far this year the number of passengers has increased by 7.8%, due to general increased demand and increased oil activity on the Faroe Shelf.

During the summer, the Faroese ferry Norröna⁸ offers weekly services to Denmark, Iceland, Shetland and Norway. In March of this year, the old Norröna was replaced by a brand new DKK 700 million combined cruise and cargo ship that can carry roughly 1,500 passengers and 800 cars. This project is the biggest single investment of its kind ever to take place in Faroese history. The winter schedule has been revised to offer new service to Bergen and Shetland in addition to the normal service to Denmark. Almost 41,000 passengers traveled to the Faroe Islands by sea in 2002; 4,000 were in transit to another country.

⁶ A timetable of the routes for the ferries and buses is available at www.ssl.fo and for helicopter services at www.atlantic.fo/default.asp?sida=102.

⁷ The three companies are: Atlantic Airways (www.atlantic.fo), Maersk Air (www.maersk-air.com/en) and Air Iceland (www.airiceland.is).

⁸ www.smyril-line.com

One Icelandic and two Faroese freight companies provide cargo carriage to and from the Faroe Islands. The most important routes are to Denmark, Scotland, Norway and Sweden.

The continued availability of transportation links in the future seems good for passengers and cargo alike. Airfare prices have dropped and the route net is under development. The new ferry and expanded travel programs will probably attract more passengers, both Faroese and foreign. Given that oil exploration / exploitation in the Faroe Islands has started, it is likely that the total number of passengers will increase in the coming years.

3.3.6 Tourism

For many years, efforts have been made to develop the tourist industry in order to diversify the Faroese economy. Information offices have been set up around the islands and a national tourist council, Ferðaráð Føroya,⁹ was established.

The first task for the industry was to market the Faroe Islands as a tourist destination. At the same time, the industry has had to build up a domestic network, designed to service organized tourism. There was and still remains a need to develop products and services.

A few years ago, a goal of 50,000 tourists per year was set. Last year about 44,000 tourists visited the Faroe Islands and it is expected to be about the same this year. About 17,000 of these come to visit family and friends. The direct income effect of the tourism industry was estimated to be about DKK 150 million.

It is unlikely that tourism ever will become a major industry in the Faroe Islands. However, given the progress that has taken place to date and anticipated in the future, tourism will slowly become a more reliable source of income for people throughout the islands.

3.3.7 Insurance

On 1 January 1997, the Faroese Parliament passed a new insurance industry law. The monopoly was abolished and a Faroese insurance supervisory body

was appointed. Now, any Faroese company that complies with the statutory requirements may enter the insurance business on the condition that they obtain permission from the Faroese Government.

In 1998, the company, Trygd, re-started its business in housing and car insurance and subsequently expanded into ship insurance. Trygd and the old monopoly incumbent, Tryggingarfelagið Føroyar, are at present the only insurance companies active in the Faroese market.

3.3.8 Oil

On 22 December 1992, the Danish Government agreed to transfer the rights to the subsoil mineral resources of the Faroe Islands to the Faroese Government.

On 18 May 1999, the dispute regarding the boundary between the United Kingdom and the Faroe Islands was settled and an agreement, based on the mid-line principle, was reached.

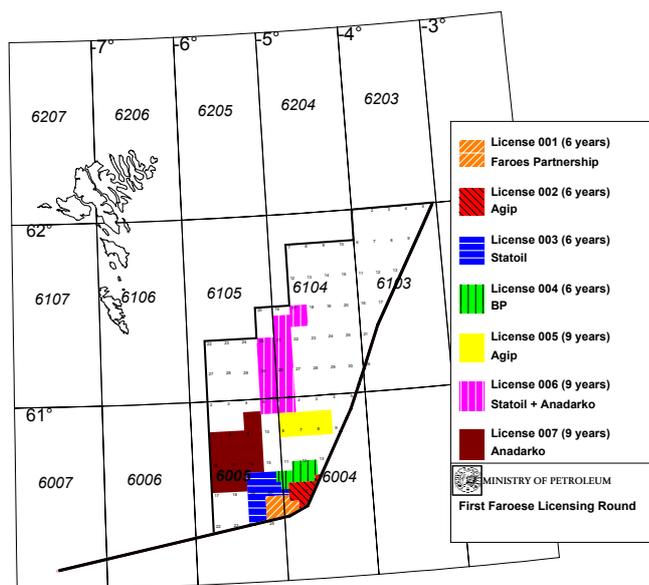
The initial oil exploration phase started in 1994 and since then many firms have been exploring the subsoil. Oil reserves (Foinaven and Schiehallion) have been located in UK territory near the Faroese border.

On 18 November 1997, the Oljufyrisiting¹⁰ (Ministry of Petroleum and the Environment) presented a report to the Faroese Parliament concerning hydrocarbon legislation, exploration, exploitation and related fiscal matters. The bill subsequently passed is considered framework legislation and entered into force on 18 March 1998. The report also dealt with such topics as the environment and security.

On 21 April 1999, the Hydrocarbon Tax Act was passed by the Faroese Parliament and on 13 March 2000 an amendment (Special Tax) to the Act was ratified.

⁹ www.tourist.fo

¹⁰ www.oms.fo



On 17 February 2000, the first licensing round was opened. The area offered for licensing lies to the southeast of the Faroe Islands and covers approximately 14,000 km². It is divided into 56 whole blocks and 26 partial blocks. The licensing round closed on 17 May and 17 oil companies submitted 23 applications. On 17 August, seven licenses were awarded to 12 oil companies, organized into five consortia.

Three consortia, represented by Statoil, BP and Amerada Hess, drilled their first wells in the summer of 2001. Statoil concluded their operations on the first of September 2001 with essentially a dry well, as only traces of oil were found. BP finished drilling shortly thereafter. Although some oil was found, it was not of commercial quantities.

The Amerada Hess group then started drilling the *Marjun* well in license area 001. On 19 November 2001, the Ministry of Petroleum and the Environment announced that oil and gas had been found in significant volume, but it was not possible to say if it was enough to start production. Later studies have brought no significant clarification. In the summer of 2003, ENI Agip drilled one well in area 002, but it came up dry. Four wells remain to be drilled before 2006.

The influence of the oil industry is beginning to emerge. Oil companies have established offices in Tórshavn where housing prices jumped in anticipation of potential oil prospects. With time, expectations have become more realistic, the exuberant talk has moderated and circumstances have normalized.

There are also other visible activities apart from oil company initiatives. The offshore base was placed in Runavík and proved reliable and effective during the exploration activities. This has led to and will undoubtedly continue to lead to further activity, both directly and indirectly. So far, the harbor facilities in Runavík have been expanded, and the various companies servicing the oil industry have established a presence there.

The same goes for air transport for the oil industry, which is performed via Vágur Airport. A temporary offshore terminal was built and hosts the helicopter transportation (mostly personnel) that will take place between land and the offshore installations in Faroese waters.

It is hard to estimate the outlook for future activity. The *Marjun* drilling site did not strike oil in the expected sediment and, therefore, the oil companies have had to review their plans. It is still unclear when Amerada Hess will follow up on the promising find they had in 2001.

The seismic and other data obtained from the drilled wells is still being interpreted and it is impossible to predict what will be on the agenda for 2004.

3.3.9 The financial market

Four banks and one investment bank service the financial market in the Faroe Islands. Savings traditionally were deposited in banks, but lately asset management and investment banking have grown in importance. Because there is no securities market yet in the Faroe Islands these investments are made abroad. The industry's domestic assets are loans to businesses, households and the public sector.

The Faroese financial market has experienced much turbulence in the last decade. In 1992 and 1993, huge write-offs were demanded in bank assets. Through the Financing Fund of 1992,¹¹ the Faroese government injected new capital into Sjóvinnubankin and Føroya Banki with loans provided by the Danish Government. Altogether, the injection amounted to about DKK 3 billion, resulting in the banks becoming publicly owned.

¹¹ The Financing Fund's board of directors consists of five members appointed by the Faroese Minister of Finance.

In August 1993, it was decided that Føroya Banki and Sjóvinnubankin should merge¹². The merger entered into force on 1 January 1994 and the merged bank continued under the name Føroya Banki¹³.

Today, the situation has turned around and the financial institutions are well consolidated. The economic upturn has largely limited losses and the reality lecture on healthy business practices offered by the depression has so far yielded good results on the balance sheets. Given the gloomy outlook for the aquaculture industry, the banks in their first-half 2003 financial reports have had to set aside considerable reserves against possible losses for the first time since the early 1990s.

Because of a revision in the banking law, banks and savings banks now compete on equal terms. The law also affords the same conditions for Faroese financial institutions as for Danish financial institutions relative to the Danish Central Bank. This legislation thus enables the Faroese banks to participate in the international capital markets.

Various public financing institutions hold about a 10% share of the total financial assets and play an important role in selected areas of the financial market. The most important are the Føroya Realkreditstovnur (mortgage credit institution financing ships), Húsalánsgrunnurin (mortgage credit institution financing residential houses) and Framtaksgrunnur Føroya (Faroese Business Development Fund, which provides equity capital to Faroese companies).

Plans to establish a Faroese stock market have been under way for some time now. In November 2000, the major players – investors, brokers, issuers and the government authorities – founded a company to establish a stock exchange. The establishment has taken longer than expected, but the outlook now is that an agreement will be made with the Icelandic

Stock Exchange in late 2003 to establish a local market for Faroese securities in the beginning of 2004.

3.4 Labour market

In general, the Faroese labour market¹⁴ is characterized by a relatively large workforce in the fishing sector and the public sector. Unskilled and skilled workers work 40 hours per week, according to agreement. Public employees and office staff work 37-38 hours per week. The holiday law grants five weeks of paid annual leave. Salaried staff receive a holiday allowance of 1.5% of their annual wages in addition to their base salary, while hourly paid workers receive a 12% holiday allowance for every hour worked.

Usually wage negotiations are held every other year and almost all unskilled workers, public employees and shop assistants have their wages adjusted according to negotiated settlements. For skilled labourers and people working in the service trades, the settlements are regarded as guidelines.

Wage negotiations are to be settled this year. Unskilled workers had their wages settled in June after a five-week strike. Wages increased by 4.7% or DKK 4.30 this year. The same increase is scheduled for 2004. The public sector agreements are due to be re-negotiated before 1 October of this year.

Unemployment insurance¹⁵ has been in effect since 1992. Employers and workers each pay 0.75%¹⁶ of wage payments to the unemployment compensation program. The unemployment benefit from the insurance program is at maximum 70% of the income earned during the last 12 months before the unemployment occurred. The unemployed worker can stay in the system for 598 days over a period of five years.

A Family Leave Fund was established in June 2001. Employers and workers pay 0.25% of wages to the

¹²On 22 March 1993, Den Danske Bank exchanged the major part of its stock in Føroya Banki to the Financing Fund of 1992, in return for 30 percent of the stock in Sjóvinnubankin. A commission investigated the exchange and concluded that the Faroese Government did not have the necessary information and, therefore, had negotiated under false pretences. In an agreement dated 10 June 1998, the Faroese Government received compensation of about DKK 1 billion.

¹³ www.foroyabanki.fo

¹⁴ Tables 3 through 5 in Appendix H show a variety of figures concerning the labour market.

¹⁵ www.als.fo

¹⁶ As of 1 September 2003.

fund, which provides for up to six months of paid leave after childbirth.

During the economic crisis of the early 1990s, the Faroe Islands experienced an unemployment rate of around 20%, which is now dramatically lower. The rate gradually fell and is hovering around 3%.

In 2001 and 2002, total wage payments increased by 13.8% and 4.4%, respectively. The wage situation in 2003 was greatly influenced by the 5-week-long strike amongst unskilled workers, but the amount paid over the first six months this year is only 0.5% above the 2002 level.

From 1989 to 1995, the population in the Faroe Islands decreased by 9% from 47,838 to 43,393. The workforce was reduced by 12%. Most moved to Denmark. The net emigration eased the pressure on the unemployment insurance fund and lowered the actual unemployment figures.

Population in the Faroe Islands (end of year)						
Age	1989	1991	1995	1997	1999	2001
0-14	11,660	11,578	10,324	10,502	10,821	11,146
15-64	30,595	29,982	27,056	27,560	28,439	29,574
over 64	5,585	5,734	6,013	6,228	6,149	6,276
Total	47,840	47,294	43,393	44,290	45,409	46,996

The table above shows that people of working age moved abroad during the crisis, while those of pension age remained. In 1996, the net emigration stopped and the movement pattern reversed to that prior to 1990 – although at a slightly higher rate of immigration.

Because of the emigration in the early 1990s, a relatively large part of the potential Faroese workforce is situated outside the Faroe Islands. This has benefited the Faroese economy as shortages of labour have appeared and still might do so for the future. It is hard to say, however, exactly how many of those located outside will return if their skills become needed.

3.5 Prices

The consumer price index has been revised as of the beginning of 2001. The weights are based on a survey of household consumption from 1998. The old

index used weights from 1972. The year-on-year inflation in 2001 was 0.3% and in 2002 it was 2.4%, which is a relatively modest inflation rate in a boom period. The price level is shown in Appendix H, Table 6.

3.6 Foreign trade

The Faroe Islands is an independent customs area. Import duties and the rules pertaining to import and export are determined by the Faroese Government. In this respect, the other parts of the Danish Kingdom are considered "foreign".

Over the last ten years, the trade balance has been positive with the exception of year 2000. During the depression, imports plunged while exports remained stable. During the upturn, import and export gradually rose, but the surplus became smaller. Considering the situation in the aquaculture industry, lower prices for fish in general and large imports of vessels¹⁷, the outlook is that 2003 will end in the red.

Around 97% of the registered export is in fish products. The import is widely spread between ordinary consumer goods, goods for production and investment goods. In 2002, 80% of the export and 63% of the import was with EU countries. Outside the EU, Norway is the main business partner. (See Appendix E, Table 2.)

When the Faroe Islands declined membership in the Common Market in 1974, a trade agreement was concluded instead. The trade agreement was fundamentally a free trade agreement and as such reported to GATT by the EU. As a condition of the 1991 trade agreement, the Faroe Islands in 1993 implemented a value-added tax regime and excise duties replaced the fiscal import duties. The value-added tax now stands at 25%.

At the end of 1998, a new agreement was concluded between the Faroese Government and the EU, invalidating the following sections of the trade agreement: price arrangements, reference ceilings for export, restrictions on salmon, statistics control and other product specific agreements. Thus, some 95-97% of all Faroese exports are listed as free trade.

¹⁷ The new *Norröna* alone will pull around DKK 700 million in the negative direction.

The Faroe Islands also has free trade agreements with Norway, Iceland, Switzerland, Estonia and Poland. The trade with the rest of the world is based on WTO regulations.

3.7 The balance of payments (BoP)

The Faroe Islands has had a National Account / BoP compilation since 1964. The quality of the compilation has been questioned over the years and currently there is a new “flow” compilation system being developed.

From the early 1970s to the beginning of the 1990s, there was a deficit and in the latter years a very large deficit in the BoP. In 1990, the foreign net debt had accumulated to DKK 8,533 million, corresponding to DKK 176,000 per inhabitant.

This picture changed significantly beginning in the early 1990s. During the ten years from 1992 through 2001, the surplus in the BoP was more than DKK 800 million or 13% of GDP on average per year (Appendix E, Table 1). Because of the big surpluses since 1993, the net debt has turned into net assets of about DKK 2,000 million in 2001. (See Appendix F, Table 2.)

For 2002, it is estimated that the BoP has fallen below DKK 800 million, mostly because of the reduction in the transfer subsidy from Denmark. This downward spiral is likely to continue through 2003, as it is anticipated that the trade balance will go into deficit.

3.8 Adapting to the international economic environment

The Faroese economy is very open, as the export and import of goods and services are about 49% of GDP. It is painfully obvious that changes in the international economy have a larger impact on the Faroese economy than most other countries. It is, therefore, essential for the Faroe Islands to be able to adapt to the exigencies thrust upon the country from outside.

Imports and exports of goods and services in percent of GDP						
	1995	1997	1999	2000	2001	2002
Export	45.1	48.7	50.4	52.1	44.9	39.7
Import	44.8	48.9	54.4	61.1	43.6	37.6

In order to encourage Faroese businesses to respond effectively to international competition and to attract direct foreign investment, some important trade and industry legislation has been put into force. Accounting procedure legislation governing the various types of limited liability companies, as well as legislation regulating the accounting industry, entered into force in 1994.

One important change in the Companies Act is the requirement for companies to hold more equity capital, placing greater risk upon the owners. Companies now can be listed as either public limited liability companies with a share capital of minimum DKK 500,000 or as private limited liability companies with a share capital of minimum DKK 80,000.

The act regarding accounting procedures contains regulations governing the accounting principles to be employed, and requires that the accounts of all limited liability companies be available to the public. This regulation ensures that those who invest money and give loans can have better insight into the activities of a business and make it easier to compare a specific business with others of the same kind.

Government authorities, in co-operation with employer associations, are continuously trying to attract foreign investment to the Faroe Islands by sending out material and providing information services¹⁸. Apart from oil exploration-related industries, the impact has been limited.

¹⁸ www.trade.fo

4. PUBLIC FINANCE

4.1 Financial system

The annual budget is presented to the Faroese Parliament before October and must be approved before 1 January of the following year. In practice, approval occurs before Christmas.

Beginning with the 1991 fiscal year, the Budget Act was considerably changed compared to preceding years in order to obtain a better governing instrument. Blanket approvals for government investments and certain other expenditures are not permitted. Instead, government investments and other expenditures have to be approved in the budget for the year in question.

The accounts and bookkeeping of the government exchequer are audited by an audit department, as well as by an external chartered accountant. Once audited, the books are passed on to a committee, consisting of members selected by the Faroese Parliament, which is responsible for the finances of the government.

The government Treasury introduced a new accounting system in 1997. Supporting documentation is required to a much higher degree than previously. This makes it easier to track and monitor the government's income and expenses.

4.2 Public income

The Faroese Government fixes and collects duties, taxes, income taxes, customs duties, production and vehicle taxes, whereas municipal government income derives mainly from income taxes.

Two classes of income are defined: wage income, etc. is defined as A-income while business income, etc. is defined as B-income.

4.2.1 A-income

A-income has to be transferred to an account in a financial institution, post giro or the exchequer. Upon receipt of an individual's wages from an employer, the receiving bank automatically deducts and transfers the appropriate withholding tax to the exchequer via the Customs and Tax Administration

centralized tax system. Each tax payment is calculated based on the income up to the date of the latest wage payment, converted into annual income. Adjustments are made after the close of each year; excess tax is refunded, extra tax owed is collected.

The highest tax rate (government and municipality combined) is between 53 and 60%¹⁹, although the tax ceiling is 50%, excluding payments of about two percent to different funds.

Income tax levied by the Tax Administration is calculated on a sliding scale, thus with various allowances the highest marginal rate at present is 37%.

A gross tax system was introduced in 1997. This means that instead of providing for tax deductions, specific subsidies are allowed to compensate for certain expenses.

Municipal taxes are assessed using the same calculation of income as that of the Tax Administration, except that a flat tax rate is used. The economic situations of the municipalities differ greatly and for the year 2002 municipal taxes ranged from 13 to 23%. On average, the tax is 19%.

4.2.2 B-income

B-income is based on a business' annual accounts and is, therefore, collected by the Treasury the year after the accounting year.

Corporate taxes before 1999 were 27%, but were lowered to 20%, except for companies in the oil industry. The tax rate for these companies remains at 27%. Of the tax amounts, 62% is paid to the national treasury, and the remaining 38% to the local municipal authorities.

¹⁹ Depending upon which municipality one resides.

4.2.3 Other taxes

Interest on deposits in Faroese banks and savings banks is not included in the income subject to income tax. Instead, a yearly tax of 35% of the interest is deducted from the interest payment by the financial institutions and transferred to the Treasury. Interest derived from Faroese bonds is also taxed at 35%. From 2001 onwards, all income from securities (interest, dividends and capital gains) are taxed at 35%. There is no property or wealth tax.

Because of the trade agreement (1 January 1992) with the EU, the Faroese Customs Act is based on the international Customs Cooperation Council's (CCC) Harmonized Commodity Description and Coding System and customs duties are based on the EU GATT rates. The agreement was replaced by a new agreement in January 1997. In addition, the fiscal duties levied on imports were replaced by a value-added tax (VAT) and excise duties on some consumption items.

From 1994, the corporations that do not pay VAT, for example banks and insurance companies, have to pay a five percent tax on total paid wages.

4.3 Public expenditure

The distribution of government expenditure for different items follows the new budgeting procedures and shows the actual financial outlays (Appendix H, Table 1). Investments in large assets are financed largely by current provisions and are booked immediately as expensed in the appropriate fiscal year.

There are exceptions to this rule, however. Lately, a new procedure has emerged wherein public limited companies are created to operate and manage public services and large, public construction projects, etc. This has been the case for Faroese Telecom, the newly-opened subsea tunnel between Vágur and Streymoy, etc.

The composition of expenditures has changed since the early 1990s. Expenditure to the fishing industry has fallen considerably since 1991 due to the change in subsidies to the industry (confer Section 3.2). The policy is to emphasize the need for the industry to be cost efficient and independent of public funds.

As can be seen under, "Other industrial purposes", outlays for effective guarantees have been massive historically. In 1991, private guarantees amounted to

DKK 557 million. Outlays from 1999 and onward have been at a minimum and the public guaranteed debt is decreasing. In 2002, it was only DKK 167 million, DKK 834 million less than in 1995. (See Appendix B, Table 2.)

Outlays were mainly in high-risk areas such as fishing vessels and fish processing, but also transport and municipal institutions. In 2000, all effective guarantees of DKK 15 million were for fishing vessels.

The interest line item in the budget increased as the public sector took over a greater part of the private debt during the depression. (See Appendix F, Table 2; Appendix H, Table 1.) In 1995, interest was 16% of the total budget, but after the debt agreement with Denmark in 1998, interest payments were halved.

The most significant expenditures in the budget are social welfare services, which account for over one-third of the total.

4.4 Payments from Denmark

In addition to tax revenues, public expenditure in the Faroe Islands is also financed by the Danish Government. Beginning with fiscal year 1988, most of the grant subsidy from the Danish Government is in the form of a general block grant (Appendix H, Table 1). In addition to the general grant, the Danish Government spends some DKK 280 million directly in the Faroe Islands to cover joint matters, mainly for public order and judicial administration.

The Danish block grant for 1999, 2000 and 2001 was fixed in real terms and has been so since 1995. The grant for 2002 was reduced by DKK 356 million to DKK 642 million partly in relation to the official transfer of public education to the Faroese authorities. The Faroese and the Danish Governments have agreed that the grant will be fixed in real terms at DKK 630 million per year from 2003 till 2006. Any further takeover of executive areas pursuant to the Home Rule Act, will precipitate further cuts in the block grant.

4.5 Foreign debt

On 31 December 2002, the total debt of the Faroese Treasury amounted to DKK 4,412 million, of which DKK 111 million was internal debt and DKK 4,301 million was external.

From 1992 to 1997, the debt to the Kingdom of Denmark increased from DKK 500 million to DKK 5,594 million. According to the agreements with the Danish Government, the Faroese Government injected DKK 2,500 million into the Financing Fund of 1992²⁰ and rearranged foreign debt elsewhere with loans from the Danish Government (Appendix A, Table 1; Appendix F, Tables 1 and 3).

According to the agreements with the Danish Government, Faroese budget deficits would not be financed by the Danish Government, but by the Faroese Government. In December 1994, the Faroese Government for the first time issued bonds for public sale. In addition to meeting the liquidity demands of the Treasury, the aim was also to create a bond market in the Faroe Islands. This would give the Faroese population an additional opportunity to place extra liquidity and work as a credit rating for the Faroese Government. The bonds are so far registered with the Danish Securities Centre and quoted on the Copenhagen Stock Exchange.

On 10 June 1998, the Faroese and the Danish Governments entered into an agreement on government debt. The repayment regime agreed upon was based on the settlement reached in connection with the banking crisis, the anticipated development of the Faroese economy in the future and the possibility of hydrocarbon exploitation in Faroese waters.

A long-term settlement was reached, containing these premises: 1) the total debt of the Treasury to the Kingdom of Denmark was devalued by DKK 900 million; 2) DKK 500 million was converted to an interest free loan without any repayment requirements (if hydrocarbon exploitation is not initiated within twenty years, the debt will be forgiven); 3) the remaining debt, with a nominal value of DKK 4,023 million, shall be repaid via a twenty-year annuity with yearly payments of DKK 323 million.

4.6 The municipalities

The Faroe Islands at present have 47 municipal councils, which vary in size and population from 20 to 18,000 inhabitants. Some of them have a debt of DKK 90,000 per inhabitant while others have modest or no debt at all. For those who have large debts,

interest and installments are a large part of the municipal budget.

The temporary debt solidarity agreement of 1995 expired in 2001 and was replaced by individual solutions. Some of the municipalities needed assistance from the "Municipalities Loan and Guarantee Fund"²¹. Twelve municipalities co-operated in a refinancing plan in 2000 with a five-year loan from FKI, a special loan association with a guarantee from the above-mentioned fund.

In 1995, the Faroese Government set up a committee to make a proposal for a new municipal system and the report was published in 1998. It recommended a system of 7 to 9 municipalities with clearer distinctions between the national government and the local municipalities.

There has been much discussion following the report and the view on merging municipalities is controversial, but sentiments seem to be moderating. Two municipalities, for example, merged in 2000 and others have decided to follow.

The long-term goals for creating larger municipal areas are to provide a basis for decentralizing public administration and to strengthen local government.

²⁰ Founded with the purpose to restructure the banks.

²¹ A fund was set up into which one percent of the municipal councils' tax income from 1994 to 1996 was paid. In 1996, the fund had on deposit from the municipalities DKK 98 million and loans outstanding of DKK 14 million.

5. CURRENT ECONOMIC DEVELOPMENT

The Faroese economy is still on a relative high-growth track, but growth rates close to and beyond two digits are history – at least temporarily. The overall activity in the economy is still high, but as growth stagnates the signs of overheating become less visible.

After the depression, growth picked up in 1995, with a real GDP increase of about 5%. This continued in 2001 where the growth was estimated to be around 7%, but growth in 2002 was estimated to be a little lower around 5%.

The compensation of employees increased around 10% each of the last years prior to 2003 and the trade balance is now approaching a deficit, mainly due to the import of ships and the expected downturn in the export of farmed fish.

5.1 The development in the credit system

After the capital injection into Føroya Banki in 1993, the credit system stabilized. The banks have had solid profits over the years. Føroya Sparikassi²² had an after tax profit of DKK 57 million in 2001 and DKK 61 million in 2002. Net capital is now 877 million for a solvency ratio of 22%. Føroya Banki had a profit²³ of DKK 168 million in 2001 and DKK 146 million in 2002. Net capital is now DKK 1,492 million, which corresponds to a solvency ratio of 47%.

Such profit taking has come to a halt in 2003 and for the first half of 2003 the picture is reversed. To offset the slump in the sea farming industry, both banks set aside provisions for anticipated bad debts and thus are reporting deficits; Føroya Sparikassi with DKK 67 million and Føroya Banki with DKK 23 million. The other two banks Norðoya Sparikassi²⁴

and Suðuroyar Sparikassi²⁵ are not involved with financing this industry and both showed positive results halfway through 2003.

5.2 The Government cash flow budget

The Government account showed a surplus of DKK 197 million in 2002, compared to DKK 697 million in 2001. Although this is only less than a third of the previous year's surplus, this is slightly better than budgeted. The better than expected result was mainly caused by lower interest rates on debt and higher income from assets. Income tax revenue was lower, but higher income from VAT compensated for this.

Since 1997, the budget has also contained profit transfers from Føroya Banki, but it is not likely there will be any contribution this year.

The budgeted surplus for 2003 was set at DKK 240 million, but this figure is not expected to be consistent with the final result, mainly due to lower tax revenue. The repayments and interest on loans in 2002 are DKK 338 million, and these are to be financed by budget surplus and liquidity (Appendix A, Table 2).

5.2.1 Revenue

Economic growth increased the level of public income dramatically both in 2000 and 2001, where the growth was around 10 percent. Beginning in 2002, tax revenue income began to stagnate and this tendency has continued through 2003 partly due to lower taxation. Growth in income from VAT is also falling because of lower economic growth.

Income in the near future will be very much dependant on the level of activity, which again is influenced by the size of export and prices. The Danish grant is frozen, but if the Faroese Government is going to take over additional areas of administrative control this will cause further reductions.

²² www.sparikassin.fo

²³ Includes carry-back of DKK 171 and DKK 25 million of former depreciation, respectively.

²⁴ www.ns.fo

²⁵ www.sparsu.fo

5.2.2 Expenditures

From 1989 to 1997²⁶ total expenses decreased every year even with growing interest expense. In 1998, expenses also dropped due to lower interest payments²⁷ and the abolition of the capital subsidies. In 1999, expenses started to increase and the general increase per year was about 5%. In 2001 and 2002, expenses jumped to about 9% and the level seems to be holding in 2003 (Appendix H, Table 1).

Almost half of the expenses in the budget are wages. According to agreement, wage raises in 2002 increased expenses by more than DKK 60 million and judging from the private agreements already concluded, it is expected to be at least as much in 2003.

5.3 Policy

The current economic policy is expansive. The Government has been reluctant to restrict public spending and supported expansion through tax cuts, investments and expenditures. The expenditures are mainly in infrastructure, social welfare, health care and administration. For 2003, however, the Government has set a goal to cut expenses by 1%.

The Government has been working on privatizing some of the publicly owned companies to finance the reduction of debt and to help launch the expected Faroese stock exchange. Atlantic Airways, Faroese Telecom and some companies owned by the Business Development Fund are amongst the candidates.

5.4 The balance of payments

Since 1993, the BoP has been positive with a consequent decrease in the net foreign debt. The main reasons have been a surplus in trade, the Danish grant, lower interest payments and wage transfers from Faroese working in foreign countries.

In the year 2000, however, the trade balance was in deficit. The current account still shows a big surplus, yet at a lower level. The trade balance is going to be negative in 2003 as well, but the BoP will more than likely remain positive.

5.5 Summary

The Faroe Islands has a history of cyclical booms and busts. In the 1980s the economy became overheated because of subsidies, over-investment, poor political management, etc. This led to general overconsumption, of which much was financed by foreign loans.

When a down turn in the fishing industry emerged in the late 1980s, much of the industry went bankrupt and the repercussions affected the entire economy. A banking crisis was precipitated by liquidity shortages and as income fell, the Faroese Government had to tighten fiscal policy. This resulted in falling demand and, consequently, considerable economic decline.

The turning point came in the mid-1990s when catches and, later, prices increased. Improved general competitiveness and a pick up in private consumption and investment, became the drivers of an amazing economic recovery.

Since 1998 the economy has boomed again, thanks to developments in the fishing sector and the aquaculture industry, private and public consumption and a growth in investments. Unemployment has fallen from 20% to below 3% in 2003, despite net immigration of the workforce, which before had left the Islands.

5.6 Outlook

The outlook for the Faroe Islands is mixed. As the economy shifts into lower gear, the consequences are two-fold. The signs of economic overheating and the subsequent risks are disappearing. This should keep the BoP positive because consumption and investment will decrease. On the other hand, the public budget surplus and the BoP will be threatened and worsened by the current crisis in aquaculture, the cut in the Danish grant and possible further cuts in public expenditures.

The Government needs to establish control over public expenditures and take steps to maintain the

²⁶ Assuming exception of the capital injections into the banks in 1992 and 1993.

²⁷ The lower interest payments were a result of the agreement of 10 June 1998 with the Danish Government. The agreement lowered the interest rate and the repayments.

surplus; at least as long as activity in the economy remains relatively high.

So far there is no eminent danger of a recession and the country is in a much better state to tackle a downturn than previously. Although the public sector still owes DKK 4.5 billion, the country as a whole holds net assets of about DKK 4 billion and industry in general is healthy and well consolidated.

The pursuit for a more self-supporting economy and the efforts to take over areas previously under Danish administrative mandate are still part of the Government's main agenda. Understanding the economic responsibilities associated with such initiatives, the Government now has to develop old, as well as new, revenue sources.

The big hopes for an oil adventure looming on the near horizon have been dampened since another exploration well came up dry this summer. Thus, there is no further clarification on when or if oil production will become a part of the Faroese society in the future.

There are many other issues of interest facing the Faroe Islands in the coming years ahead, but for the first time in many years the big question is not how to control growth, but rather how to sustain it.