

Information Memorandum

# The Faroe Islands



**N o v e m b e r 2 0 0 5**



**Landsbanki Føroya**

Governmental Bank



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

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## 1. FACT SHEET

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### THE FAROE ISLANDS

#### *Location*

The Faroe Islands is located in the North Atlantic (62°N 7°W), approximately 430 kilometers south-east of Iceland, 600 kilometers west of Norway and 300 kilometers northwest of Scotland. The Faroes is comprised of 18 islands, separated by narrow sounds or fjords.

#### *Land Area*

1400 square kilometers; 545 square miles

#### *Population (1 Jan 2005)*

48,371

#### *Main population centers (1 Jan 2005)*

Tórshavn (capital): 19,348

Klaksvík: 4,914

#### *Language*

The written and spoken language is Faroese. The Faroese language is a North Germanic language closely related to Icelandic and to the dialects of western Norway. Nordic languages and English are understood and spoken by most Faroese.

#### *Religion*

Approximately distributed as follows:

Evangelical Lutheran Church: 85%

Christian Brethren: 10 %

Other: 5%

#### *History*

The Faroe Islands is believed to have been discovered and inhabited in the 8<sup>th</sup> century or earlier by Irish settlers. The Norwegian colonization began about hundred years later and developed throughout the Viking Age. The settlers established their own parliament on Tinganes in Tórshavn. The Faroese Parliament is believed to be the oldest in Europe.

Norway and Denmark joined in a double monarchy in the late 14<sup>th</sup> century. When Norway in 1814 was cessioned to the King of Sweden, the Faroe Islands

and Greenland remained under the sovereignty of the Danish Monarch.

Due to the large geographical distance to Norway and Denmark, the Faroese always maintained a special jurisdiction along with their distinct language and culture.

#### *The Political System*

Together with Denmark and Greenland, the Faroe Islands constitutes the Kingdom of Denmark, which is a constitutional monarchy.

Since 1948, the Faroe Islands has had an extensive Home Rule – where so-called Joint Affairs are under Danish State authority, while Faroese affairs are under Faroese Home Rule administration and legislation.

The Faroe Islands has, for example, its own independent area regarding customs and excise, taxation and administration.

Judicial, defense and foreign affairs are among those affairs that cannot be taken over by the Faroese Government according to the Home Rule Act.

The Faroese Parliament (Løgting) is the legislative assembly for Faroese affairs, and also appoints the Prime Minister (Løgmaður), who - along with his cabinet ministers - constitutes the Faroese Government (Landsstýri).

The Løgting has at most 32 MPs elected from seven constituencies. In addition to the elections to the Løgting, the Faroese people elect two representatives to the Danish Parliament.

#### *Head of State*

The Prime Minister, Jóannes Eidesgaard (Social Democrat), since 3 February 2004.

## FACT SHEET

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**THE FAROE ISLANDS***Present Government*

The Faroese Government (Landsstýri) consists of at least two Cabinet ministers led by the Prime Minister. The present cabinet number is seven, including the Prime Minister.

The Faroese Government coalition is currently made up of representatives from the Social Democrats, the Unionist Party and the People's Party.

*Currency*

The Faroes is part of the Danish currency area. The Faroese currency unit, the króna, has the same value as the Danish krone.

1 Euro = 7.44 DKK

1 US\$ = 5.47 DKK<sup>1</sup>

*Main industries*

Fishing, fish processing and fish farming.

*GNP (Nominal GNP at market price)*

9,699 mill. DKK (2003).

The estimated GNP for 2004 is 9,987 mill. DKK and 10,176 mill. DKK for 2005.

*Export of Goods (2004)*

3,668 mill. DKK

*Main export product groups (2004)*

Fish and fish products: 94.2%

Ships: 5.2%

Other: 0.6%

*Import of Goods (2004)*

3,738 mill. DKK

*Labor force (2004)*

Approximately 27,000

*Labor force divided by industries (approximated)*

Fishing, fish processing and manufacturing: 1/3

Construction and private services: 1/3

Public services: 1/3

*Education*

Mandatory from 7 to 16 years of age. Primary school is compulsory up to the ninth class, after which education can be continued in a High School, Business, Technical, Industrial Fishing, or Mariners school.

There are also colleges for Marine Engineering, Nautical, Teacher, Business and Nurses training. There is one University in the Faroe Islands – *Fróðskaparsetur Føroya*.

*Transportation*

The transportation of people and goods to and from the Faroe Islands is by both air and sea. Regular flights and car and cargo ferries are available all year round to Denmark, Iceland, Norway and Great Britain. The flight time to Copenhagen (Denmark) is 2 hours and 15 min.

The Faroe Islands has a modern infrastructure with good roads and tunnels. The roads are mainly asphalted, dual-track carriageways. A bridge connects the two largest islands and a subsea tunnel connects two islands while another subsea tunnel is under way.

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<sup>1</sup> 31-12-2004

## 2. RECENT DEVELOPMENTS 2004 – 2005

Below are the recent developments since the latest publication of *Information Memorandum*.

### 2.1.1 Population

The population of the Faroe Islands totaled 48,371 in January 2005.

### 2.1.2 Political

The last election was held on 20 January 2004 and the outcome is discussed below.

In February 2004, the Social Democrats (Javnaðarflokkurin), the Conservatives (Fólkaflokkurin) and the Unionists (Sambandsflokkurin) formed a coalition government. The present Cabinet number was reduced to seven, including the Prime Minister.. The former Government planned to make the Faroe Islands an independent country, but the Government is pursuing a new course. The plan is to take over some special matters, and to pass a new and more flexible Home Rule Act.

### 2.1.3 International relations

A new and more flexible Home Rule Act was ratified by Parliament in 2005. The new act will make it easier for the Faroese Government to take over special matters.

The Parliament also ratified another important new treaty with Denmark regarding foreign relations. The new act will allow the Faroese Government on its own to negotiate and become signatory to certain bilateral and multilateral agreements, if these only concern special matters for which the Faroese Government has full responsibility.

### 2.1.4 Economy

In 2002, the growth was 4.0% in the nominal GNP (at market price), but the growth reversed in 2003 and became negative at -2.75%. In 2004, the growth is estimated to have been 3%, while the estimated growth for 2005 is 1.9%.

The outlook for 2006 is approximately 1% growth.

Despite contractual wage increases of 4% in 2004, total wages and salaries paid in 2004 increased by only 0.9%. For the first three quarters in 2005, compared to the same quarters in 2004, wages increased by 2.2%.

### 2.1.5 Industries

#### *Fishery*

In 2004, there was a drop in the value of the catch by 13%, which can be attributed mainly to falling volumes. Especially the total catch of cod (*Gadus morhua*) and haddock (*Gadus aeglefinus*) was significantly lower in 2004. The declining trend for the value of the catch slowed significantly in the first half year of 2005; the value of the catch is down approximately 1% compared with the same period in 2004.

#### *Aquaculture*

The Faroese aquaculture industry experienced a record year in 2003, if one considers only the harvest (salmon and trout) and not the prices. In 2001, the harvest was 46,000 tons, in 2002, 45,000 tons and in 2003, 58,000 tons. In 2004, the harvest fell to around 37,000 tons. For 2005 and 2006, the estimates are down to 16,000 tons and 14,000 tons, respectively. In 2007, the harvest is expected to grow again, as the aquaculture industry is recovering and preparing for the coming years. The harvest in 2007 is expected to be around 19,000 tons and in 2008 around 24,000 tons. For the industry, future price developments are of the utmost importance. Prices have increased during the first half of 2005 and are approximately 25% higher than when they reached their lowest point in 2003.

### *Construction*

Although the level of activity is still high, the growth appears to have peaked in 2004, when the growth in wages and salaries was 10.5%, compared to 2003.

In the first three quarters of 2005, the wages and salaries paid have declined with -2%, if compared to the same quarters in 2004.

### *Transportation*

A second subsea tunnel, between Borðoy and Eysturoy, is on its way, connecting Tórshavn and Klaksvík. Started in December 2003, the project is expected to be finished in May 2006.

In October 2005, the old ferry Smyril, which sails from Tórshavn to Suðuroy, was replaced with a new ferry.

The Danish airline company, Maersk Air, stopped to service Vágur Airport as of 30 October 2004. Now there will be only one company flying to the Faroes – the Faroese company, Atlantic Airways.

The Faroese Government has announced, that the “air transport market” to and from the Faroe Islands will be liberalized, and become part of the European Common Aviation Area on 1 January 2007, and that the Faroese airline company, Atlantic Airways, will be partly privatized in 2006.

### *Oil*

During 2004, the Ministry of Petroleum was replaced by an oil administration and the responsibilities of the ministry have been divided between the Ministry of Trade and Industry and the Ministry of the Interior. Petroleum affairs will continue as an administration with the official name “Faroese Petroleum Administration”.

Also during 2004, a second oil licensing round was opened and a number of companies expressed interest in applying for these licenses. The licenses were awarded in January 2005 to 8 oil companies, organized into 5 consortia.

#### 2.1.6 Labour market

Wage negotiations were settled this year.

Unskilled workers had their wages settled in May. Wages increased by 0% in 2005 and 0% in 2006, while the pension payment increased by 1% in 2005 and 2% in 2006. The main public sector agreement was settled in October 2005, and resulted in a 1-year agreement, and an increase in wages of 0.9% in 2005. In addition to the increased wages, the agreement was improved in other ways.

In 2004, the total wage payments increased by 0.9%, but in the first three quarters of 2005 the growth has been 2.2%, compared to the same quarters in 2004.

Unemployment is still at a low level. But because economic growth has slowed since 2002, unemployment has increased. In 2002, unemployment was 2.3 % on average. In September 2005, it was 3.6 %.

In times of low growth, the Faroese labour force migrates to neighbouring countries in search of work, and migrates back to the islands in times of high growth. The migration statistics are therefore a major business cycle indicator.

In 2002, there was a net immigration of 391 to the Faroe Islands. The net immigration has steadily declined over the last years, and in 2005 there will be a net emigration of around 400 from the Faroe Islands.

#### 2.1.7 Foreign trade

For 2003, the BoP fell to approximately DKK -85 million, and the trade balance became negative. This downward movement did not continue through 2004, as the main contributing factors were non-recurring ship purchases. In 2004 and 2005 the BoP is estimated to become positive again.

#### 2.1.8 The financial system

The major banks, which experienced losses in 2004, are now profitable again. During the first half year of 2005 the results of the major banks have been positive and very satisfying.

The Faroese Securities Market (VMF) has had its first corporate listing - P/F Atlantic Petroleum - in

June 2005. New bond issues of the Faroese Government have all been listed on the market as well.

The 500 and 1000-króna notes were released during 2004 and 2005. The release of the 1000-króna note in September 2005 completed the issuing of new notes, which has been in progress from 2001.

#### 2.1.9 The public sector

The budgeted deficit for 2004 was set at DKK -204 mill. However, the actual deficit came in at DKK -152 mill. and was smaller than anticipated. The deficit for the 2005 budget has been revised downward to DKK -270 mill. from DKK -228 mill. For 2006, a deficit of DKK -219 mill. is expected. But due to public investment expenses that are held outside the state budget (at least DKK 50 million), the deficit is likely to become more than DKK 219 million.

The repayments of principal and interest on loans in 2004 were DKK 208 million (DKK 131.5 million in interests and DKK 76.5 million in repayments). Furthermore, 750 million of the bond debt was re-financed in 2004.

In November 2005 the remainder of the 5% 2018-loan to the Danish State (approx. DKK 1.5 bill.) will be repaid by issuing bond debt with varying duration on the Faroese Securities Market on Iceland Stock Exchange (ICEX).

#### *Municipalities*

The number of municipalities was reduced from 48 to 34 during 2004. The long-term goal to create larger municipal areas is to provide a basis for decentralizing public administration, social services and to strengthen local government.



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### 3. GEOGRAPHY AND POPULATION

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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 1,400 km<sup>2</sup>. The largest island is Streymoy (375 km<sup>2</sup>) and the capital, Tórshavn, is situated there.

The population of the Faroe Islands totaled 48,371 in January 2005. Of this number, 19,348 lived in the Tórshavn region and 4,914 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 approximately 1,000 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.

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### 4. THE POLITICAL SYSTEM

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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.

In May 2005, the Home Rule Act was supplemented with Act No. 91/2004. The new act will make it easier for the Faroese Government to take over all matters, except matters that are directly linked to full sovereignty. Acceptance from the Danish authority in each case is no longer necessary.

The Faroe Islands elects two representatives to the Danish Parliament (Folketinget). On 8 February 2005, the Conservatives (Fólkaflokkurin) and the Republicans (Tjóðveldisflokkurin) each won a seat in the Folketinget, while the Unionists (Sambandsflokkurin) lost their seat.

#### 4.1 The government and administration

The fundamental principle of the Home Rule Act is that the administration of all local matters should be transferred to the 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 have been divided into Special Matters and Joint Matters:

##### 1) Special matters

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

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 as-

signed to the Faroe Islands and the State block grants from Denmark were reduced accordingly.

The new Act No. 91/2004 gives the Faroese Government the authority to take over all matters except:

- 1) The Danish Constitution
- 2) Danish internal affairs
- 3) The Danish Supreme Court
- 4) Foreign affairs, security and defense policies
- 5) Currency and monetary policy

## 2) Joint matters

These are administered by the Danish Government according to the laws of the Kingdom of Denmark.

The provisions of the Home Rule Act from 1948 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.

However, the new Act No. 91/2004 gives the Faroese Government the authority to take over all matters except matters that are directly connected with full independence, as shown above.

Today, the Faroese Government 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.

If the new Act No. 91/2004 from 2005 is fully implemented, and the Faroese Government takes over all matters possible, the only joint matters will be: the Danish Constitution; Danish internal affairs; the Danish Supreme Court; foreign affairs, security and defense policies, and currency and monetary policy.

## 4.2 The Parliament and Government

The Faroe Islands is governed by the Faroese Parliament (Løgting)<sup>2</sup>, 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 must formally receive the consent of the Prime Minister of the Faroe Islands (Løgmaður). Laws on joint matters passed by the Danish Parliament (Folketinget) must be ratified by the Faroese Parliament 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 32 members of which 28 are directly elected from the various constituencies and up to five are distributed according to a special at-large system. There are seven constituencies<sup>3</sup> comprised of geographical regions and at present there are six political parties represented in the Parliament. The last election was held on 20 January 2004 and the outcome is discussed 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 the Faroese Government (Landsstýri)<sup>4</sup>, which is appointed by the Faroese Parliament. In February 2004, the Social Democrats (Javnaðarflokkurin), the Conservatives (Fólkaflokkurin) and the Unionists (Sambandsflokkurin) formed a coalition government. Autonomy is still being pursued by gradually increasing more of the joint matters on a step-by-step basis.

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<sup>2</sup> [www.logting.fo](http://www.logting.fo)

<sup>3</sup> They are: Vágar, Northern and Southern Streymoy, Eysturoy, Norðoyggjar, Sandoy and Suðuroy.

<sup>4</sup> [www.tinganes.fo](http://www.tinganes.fo)

**Føroya Løgting (Faroese Parliament) now has the following composition<sup>5</sup>:**

	2002		2004	
	Percentage of votes	Number of seats	Percentage of votes	Number of seats
Fólkaflokkurin ( <i>Conservatives, moderate autonomists</i> ):	20.8	7	20.6	7
Sambandsflokkurin ( <i>Conservatives, unionists</i> ):	26.0	8	23.7	7
Javnaðarflokkurin ( <i>Social Democrats, moderate unionists</i> ):	20.9	7	21.8	7
Sjálvstýrisflokkurin ( <i>Conservatives, moderate autonomists</i> ):	4.4	1	4.6	1
Tjóðveldisflokkurin ( <i>Republicans, for independence</i> ):	23.7	8	21.7	8
Miðflokkurin ( <i>Christian Center Party</i> ):	4.2	1	5.2	2

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 seven ministries:

- The Office of the Prime Minister
- The Ministry of Finance
- The Ministry of Fisheries & Maritime
- The Ministry of Trade and Industry
- The Ministry of Social Affairs & Health
- The Ministry of Education and Culture
- The Ministry of Interior

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 seven ministers comprising the Faroese Government:

**Jóanes Eidesgaard (Javnaðarf.):**

Prime Minister.

Minister for Constitutional Affairs, Central Administration and Foreign Policy.

**Bjarni Djurholm (Fólkaf.):**

Deputy Prime Minister

Minister for Trade and Industrial Affairs

**Bárður Nielsen (Sambandsfl.):**

Minister for Finance and Economic Affairs

**Bjørn Kalsø (Sambandsfl.):**

Minister for Fisheries and Maritime Affairs

**Hans Pauli Strøm (Javnaðarf.):**

Minister for Social Affairs & Health

**Jógvan á Lakjuni (Fólkaf.):**

Minister for Educational and Cultural Affairs

**Jógvan við Keldu (Fólkaf.):**

Minister for Interior Affairs

Jóannes Eidesgaard, Bjarni Djurholm, Bárður Nielsen, Jógvan á Lakjuni and Jógvan við Keldu were elected to the Parliament and yielded their seats to their alternates upon entering the government.

<sup>5</sup> Note that due to the nature of the special at-large distribution system, votes and seats do not necessarily coincide.

### 4.3 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.

#### 4.3.1 Agreements with Denmark

The economic crisis in the first half of the 1990s, led to many agreements between the Danish and the Faroese Governments during the 1990s.

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.

Four 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 Government has passed a new and more flexible Home Rule Act, and the plan is to take over some special matters.

#### 4.3.2 International Organizations

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.

The Faroese Government has also applied for full and independent Faroese membership in the Nordic Council. The application is currently being discussed in the Nordic Council.

#### 4.3.3 Relations to the European Union

Although Denmark has been a member of the European Community since 1973, the membership does not include the Faroe Islands. In 1974, the Faroese Parliament voted unanimously against applying for membership.

Instead of membership, the Faroe Islands has a trade agreement with the EU.

In principle, the agreement with the EU has been a mutual free trade agreement similar to the type made by the EU and the EFTA countries in the 1970s. The agreement with the EU originates from 1992 and has been adjusted and amended over the years.

On 28 November 2003, the Faroe Islands and the EU entered into an agreement on Faroese membership in the Pan-European System of Cumulation of Origin. This was a positive development in the negotiations with the EU for Faroese industry and the society as a whole. The "Cumulation Agreement" will be fully implemented on 1 December 2005.

Recently, some political parties have sought to reopen the question to investigate the current conditions of membership in the European Union, but discussions have not gained any momentum. Instead it seems like the majority of the Faroese Parliament wishes to apply for Faroese membership in EFTA (European Free Trade Association).

The European Free Trade Association (EFTA) is an intergovernmental organisation promoting free trade and the strengthening of economic relations. EFTA's Member States are Iceland, Liechtenstein, Norway and Switzerland. Three of the four EFTA Member States are part of the European Economic Area (EEA). EFTA also has free trade agreements with many countries outside the EU, and is constantly making more free trade agreements around the world.

5. THE ECONOMY

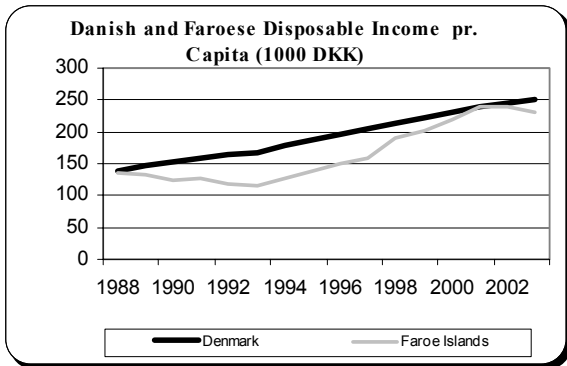
5.1 The economy in general

The Faroe Islands is an industrialized country with a standard of living comparable to other Nordic countries. The economy has, however, a high dependence on the fishing industry, compared to other Nordic countries.

Any economy with high dependence on the fishing industry is bound to be vulnerable to the cyclical changes in prices and catches. These are volatile and have left their mark on the economic history of the islands as well as the present.

This dependence is evident in the export account of goods, of which fish products on average account for more than 95 percent of the export value (Appendix E, Table 3).

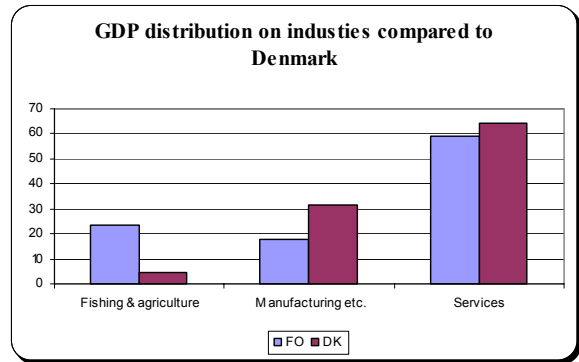
The Faroese economy is thus very sensitive to the international market for fish. Consequently, the export income can fluctuate significantly from one year to the next because of changes in catch and price, and these fluctuations spread quickly throughout the economy.



As can be seen from the chart above, the Faroese Gross National Income (GNI) per capita has varied considerably, from the economic crisis in the beginning of the 1990s and through the growth period from 1994 to 2002 (Appendix C, Table 1). The chart also shows that the spread between the Danish GNI and the Faroese almost disappeared in 2002, only to widen again in 2003 and 2004.

More than a quarter of GDP is derived 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. The chart below shows Faroese and Danish GDP distribution in 2002.



The chart shows that the economy is more dependent on primary industries than other economies, i.e. the Danish. Efforts to diversify the economy have been made, but so far without any notable success.

5.1.1 Recent developments in the economy

The Faroese economy experienced an extraordinary growth period after the depression years 1990-1994. In the years 1999-2001, the growth of nominal GNP (at market price) was over 8% p.a. The growth was 4.0% in 2002. Growth stopped in 2003 and became negative with -2.75%. In 2004 the growth is estimated to have been 3%, and for 2005 the growth is estimated to be 1.9%. The outlook for 2006 is a growth of approximately 1%.

Growth has stagnated and became negative, especially due to the negative contribution of the exporting industries. First, the prices of consumption fish have stagnated or decreased and the volumes have been reduced for some of the important species. Second, the prices for shrimp and salmon have decreased, and third infectious salmon anemia (ISA) has limited the output of the aquaculture industry.

The consumer price index has been revised as of the beginning of 2001. The medium year-on-year inflation in 2004 was 0.4%, which remains a relatively modest inflation rate. The price level is shown in

Appendix H, Table 6. The third quarter of 2005 showed that the medium year-on-year inflation has grown 2.0% the last four quarters, compared to the four quarters before.

Another influential factor for the Faroese economy is the annual grant from Denmark, which steadily grew over the years up to 2002 when the Faroese Government lowered the grant, and made the grant a fixed amount of DKK 615.5 million for the following and coming years.

The recent developments in wages illustrates a similar pattern. From 1997 to 2002, total wages and salaries paid have increased by approximately 10% p.a. The business cycle flattened off in 2003 as total wages and salaries paid in 2003 were only 0.4% higher than in 2002. Despite contractual wage rises of 4% in 2004, total wage payments increased by 0.9% in 2004, and by 2.2% in the first three quarters of 2005, compared with the same quarters of 2004. In 2005, the contractual wages negotiated so far show an increase between 0-2% a year, and are expected overall to be at the low end of the spread. This, in effect, means that wages in real terms are falling.

## 5.2 Industries

### 5.2.1 The fishing industry

#### *Developments in the fishing industry*

Before the mid-1970s, the Faroese fishery was mainly based on fishing on the high seas. The extension of national fishing boundaries, however, necessitated, to a significant degree, a reorganization of the Faroese fishing industry towards exploiting the resources in the Faroese exclusive economic zone ("200 mile zone"). Today, a significant part of the fish export value still comes from fishing in foreign waters and on the high seas, although most of the fishing in foreign waters is reimbursed by reciprocal rights in the Faroese exclusive economic zone.

After the transition period, a problem concerning surplus capacity became clear and this grew worse during the expansion of the fleet in the 1980s. 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 natu-

ral 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 (e.g. tax breaks for fishermen) have been introduced instead.

In the late 1980s, a condemnation plan was initiated whereby the ship owners were paid to give up their fishing vessels<sup>6</sup>. 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.

The general increase in prices and the overall growth in catches within the Faroese exclusive economic zone 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.

However, in 2003 there was a drop in the value of the catch by 11% that can be attributed to both fal-

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<sup>6</sup> Development of fleet. See Appendix G, Table 2

ling prices and volume. Especially the price for haddock and saithe was significantly lower in 2003. The declining trend for the value of the catch continued in 2004 the value of the catch is down approximately 13%, compared with 2003. However the declining trend seems to have stagnated in the first half of 2005 with only a 1% decline in the value compared with the first half year of 2004.

### *Fishery 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 during 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 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 the fishing of other species are being used to diversify and, hence, reduce the capacity indirectly. The Faroese fishing fleet catches various species of fish (see Appendix G, Table 1). 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.

Lately, it has once again been debated whether or not the Fishing Day quotas should be sold at auction rather than be distributed for free.

### 5.2.2 Aquaculture

The fish farming industry<sup>7</sup> 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 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 was by law restricted to 33% of equity. However, in 2004, this restriction was removed for the Faroese fish farming industry.

The industry experienced a record harvest in 2003. The production was around 62,000 tons and the export value DKK 964 million, which corresponds to 25.8% of total export. 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.

The harvest in 2004 was much less than in previous years – around 37,000 tons. For 2005 and 2006, the estimates are down to 16,000 tons and 14,000 tons, respectively. In 2007, the harvest is expected to grow again, as the aquaculture industry is recovering and preparing for the coming years. The harvest in 2007 is expected to be around 19,000 tons and in 2008 around 24,000 tons. For the industry, future price development is of great importance and the price has improved slightly since it reached bottom in the summer of 2003<sup>8</sup>. 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

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<sup>7</sup> Farming of salmon and trout.

<sup>8</sup> Source: "Statistics Norway" - <http://www.ssb.no/laks/>

has been processed to smoked or dinner-ready portions.

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.

### 5.2.3 Whaling

The pilot whale still contributes to the meat supply in the Faroe Islands and the catch more than doubled from the 2003 level. Total catch was 314 tons or 6.5 kilos per person in 2004. The blubber, which is also eaten, amounted to 281 tons.

Catches have varied between zero and 900 tons 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.

### 5.2.4 Agriculture

Farming in the Faroe Islands is not a major sector of trade. Only about one percent of GDP in factor prices is derived from farming. The seven and a half million liters of milk produced in 2002 meets the domestic demand. The production has been relatively stable during the last three years – 2002 to 2004. The domestic production of other dairy products is open to competition from abroad, yet about 75% of the home market is supplied by domestically produced products.

The 2003 production of mutton was approximately 800 tons, which corresponds to 60% of the total demand. The production of beef and beef products amounted to around 100 tons in 2004. This is just a small percentage of the total consumption; meat imports, therefore, remain at a comparatively high level.

### 5.2.5 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.

Recently, both private and public construction has been booming again and compensation of employees has risen back to DKK 385 million in 2004 (Appendix H, Table 3). The level of activity is still high; growth appears to have flattened out in 2003, up only 1% from 2002. However, growth from 2003 to 2004 picked up again and resulted in a 10% increase.

### 5.2.6 Transport

#### *Internal*

The transportation facilities in the Faroe Islands are good. With the new tunnel to Gásadalur, which was finished in February 2003, road connections now link all villages on each island and also between some of the islands.

In December 2002, the first subsea tunnel in the Faroe Islands was opened between Vágur and Streymoy. This is the first partly user-financed investment of its kind in the Faroe Islands. A second subsea tunnel is on its way between Borðoy and Eysturoy. The project started in December 2003 and is expected to be finished in May 2006.

Both passenger and cargo transport is 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 Landsins<sup>9</sup>, maintains most of these routes, while numerous private companies offer passenger and cargo services on request.

#### *External*

Only one airline company,<sup>10</sup> the national carrier of

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<sup>9</sup> A timetable of the routes for the ferries and buses is available at [www.ssl.fo](http://www.ssl.fo) and for helicopter services at [www.atlantic.fo](http://www.atlantic.fo)

<sup>10</sup> Atlantic Airways ([www.atlantic.fo](http://www.atlantic.fo)).



the Faroe Islands, services the country. Until 30 October 2004, the Danish airline company Maersk Air also served Vágur Airport, but its service has now stopped. Atlantic Airways has increased the number of its flights to fill in the gap.

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. Approximately 163,000 passengers traveled through Vágur Airport in 2003, which is 3.8% more passengers than in 2002.

In March 2003, the old *Norröna*<sup>11</sup> was replaced with a 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 54,000 passengers traveled to the Faroe Islands by sea in 2003; 6,000 were in transit to another country.

Icelandic and 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 appears 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, but the big hopes for an oil adventure looming on the near horizon have been dampened, and there is no further clarification on when or if oil production will become a part of the Faroese society in the future. The recent surge in oil prices in 2004 will most likely stimulate further exploration.

### 5.2.7 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*,<sup>12</sup> 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.

Last year (2004), about 100,000 tourist accommodations or stays were registered in the Faroe Islands. Tourism remained fairly constant at around 90,000 between 2000 and 2003, but last year there was an increase of 11%, of which the main part of the increase can be attributed to domestic (Faroese) visitors. About 2/3 of the total accommodations were foreign visitors – mostly from the Scandinavian countries. The direct income effect of the tourism industry is estimated to be about DKK 150 million.

Tourism is not a major industry in the Faroe Islands. Given the progress in the Faroese tourism industry that has taken place to date and that is anticipated in the future, however, it can be expected that tourism slowly will become a more reliable source of income throughout the Faroe Islands.

### 5.2.8 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.

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<sup>11</sup> [www.smyril-line.com](http://www.smyril-line.com)

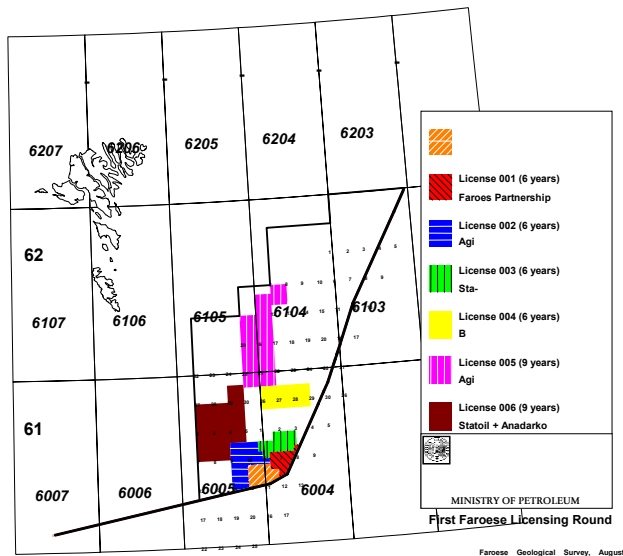
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<sup>12</sup> [www.tourist.fo](http://www.tourist.fo)

### 5.2.9 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.

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.



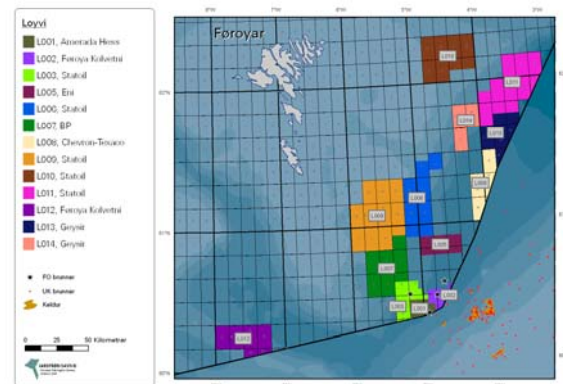
On 17 February 2000, the first licensing round was opened. The area offered for licensing lies to the southeast of the Faroe Islands and covers approximately 14,000 km<sup>2</sup>. It is divided into 56 whole blocks and 26 partial blocks. The licensing round closed on 17 May and 17 oil companies submitted 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.

During 2004, the Ministry of Petroleum was replaced by an administration, and the responsibilities of the ministry were divided between the Ministry of Trade and Industry and the Ministry of the Interior. Petroleum affairs will continue as an administration with the official name "Faroese Petroleum Administration". This administration will be responsible for all the administrative tasks related to petroleum exploration on the Faroe Shelf.

Also during 2004, a second licensing round opened and a number of companies expressed interest in applying for these licenses. The licenses were awarded in January 2005 to eight oil companies, organized into five consortia.



The influence of the oil industry has emerged. 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 Vágar Airport. A temporary offshore terminal was built to host the helicopter transport (mostly personnel) between land and the offshore installations.

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 much valuable information about the Faroese subsoil has been obtained in the process.

The oil companies BP, Shell and Anadarko will drill a well through the basalt in the Faroese subsoil at the latest in 2007. The findings from this well are expected to give valuable information on how to interpret the seismic results from the subsoil that is covered with basalt.

Furthermore, the recent surge in oil prices will most likely stimulate further exploration.

### 5.3 Labour market

In general, the Faroese labour market<sup>13</sup> 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 were settled in 2005. Unskilled workers had their wages settled in May. Wages were increased by 0% in 2005 and 0% in 2006, while pension payments were increased by 1% of the payed wage in 2005 and 2% in 2006. The main public sector agreement was settled in October 2005, and resulted in an 1-year agreement, and an increase in wages by 0.9% in 2005. In addition to the increased wages, the agreement was improved in other ways.

Unemployment insurance<sup>14</sup> has been in effect since 1992. Employers and workers each pay 1%<sup>15</sup> of each wage payment to the unemployment compensation program. The unemployment benefit from the insurance program is set at a maximum of 70% of the income of an unskilled worker (Appendix H, Table 4). The unemployed worker can stay in the system for a total of 798 days over a period of five years.

A Family Leave Fund was established in June 2001. Employers and workers pay 0.25% of total wages to the fund, which provides for up to 24 weeks of paid leave after childbirth with a maximum of DKK 25,000 per month.

In 2001, 2002 and 2003, total wage payments increased by 13.7%, 8.3% and 0.4%, respectively. In 2004, total wage payments increased by 0.9% from 5.907 mill. DKK in 2003 to 5.967 mill. DKK in 2004.

In the first three-quarters of 2005, total wage payments increased by 2.2%.

#### *Developments*

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%. 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.

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<sup>13</sup> Tables 3 through 5 in Appendix H show a variety of figures concerning the labour market.

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<sup>14</sup> [www.als.fo](http://www.als.fo)

<sup>15</sup> As of 1 September 2003.

Population in the Faroe Islands (end of year)						
Age	1989	1995	1999	2001	2003	2004
0-14	11.660	10.324	10.821	11.146	11.243	11.174
15-64	30.595	27.056	28.439	29.574	30.558	30.772
over 64	5.585	6.013	6.149	6.276	6.385	6.425
Total	47.840	43.393	45.409	46.996	48.186	48.371

Source: *Hagstova Føroya*, [www.hagstova.fo](http://www.hagstova.fo)

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.

Unemployment is still at a low level. As economic growth has slowed since 2002, unemployment has steadily increased. In 2002, unemployment was 2.3 % on average. In September 2005, it was 3.6 %.

In times of low growth, the Faroese labour force migrates to neighbouring countries in search of work, as well as it migrates back to the islands in times of high growth. The migration statistics are therefore a major business cycle indicator.

In 2002, there was a net immigration of 391 to the Faroe Islands. The net immigration has steadily declined over the last years, and in 2005 it is anticipated that there will be a net emigration of around 400 from the Faroe Islands.

## 5.4 Foreign trade

The Faroe Islands is an independent custom 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 few years, the trade balance was negative in 1999 and 2000, positive in 2001 and 2002, and in 2003 the trade balance again went negative, especially because of the situation in the aquaculture industry, lower prices for fish in general and large imports of vessels<sup>16</sup>. The trade balance was also slightly negative in 2004.

<sup>16</sup> The new *Norröna* alone will contribute with DKK 700 million in the negative direction.

Around 99% of the registered export of goods is fish and fish products. The import is widely spread between ordinary consumer goods, goods for production and investment goods. In 2004, 78% of the export and 66% 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.

On 28 November 2003, the Faroe Islands and the EU entered into an agreement on Faroese membership in the Pan-European System of Cumulation of Origin. This was a positive development in the negotiations with the EU for Faroese industry and the society as a whole. The agreement will be fully implemented on 1 December 2005.

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

### 5.4.1 The balance of payments (BoP)

The Faroe Islands has had a National Account / BoP compilation since 1964. 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

1,000 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 2,967 million in 2004. (See Appendix F, Table 1.) 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 2003, the BoP entered negative territory and fell to approximately DKK -85 million, mostly because of the purchase of the new ferry, *Norröna*, and the reduction in the transfer subsidy from Denmark in 2002. For 2004 and 2005 the BoP is estimated to become positive again, as the main contributing negative factors are non-recurring.

#### 5.4.2 Adapting to the international economic environment

The Faroese economy is open, as the export and import of goods and services are about 45-50% of GDP. 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 changes from the outside world.

In order to encourage Faroese businesses to respond effectively to international competition and to attract foreign direct 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 services<sup>17</sup>. Apart from oil exploration-related industries, the impact has been limited.

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<sup>17</sup> [www.trade.fo](http://www.trade.fo)

## 6. THE FINANCIAL SYSTEM

### 6.1 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.

In November 2003, the first bonds were issued on the new Faroese Securities Market (VMF) at Iceland Stock Exchange (ICEX), and in June 2005 the first company (Atlantic Petroleum) was listed on the VMF market.

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,<sup>18</sup> 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.

In August 1993, it was decided that Føroya Banki and Sjóvinnubankin should merge<sup>19</sup>. The merger entered into force on 1 January 1994 and the merged bank continued under the name Føroya Banki<sup>20</sup>.

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

<sup>18</sup> The Financing Fund's board of directors consists of five members appointed by the Faroese Minister of Finance.

<sup>19</sup> On 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.

<sup>20</sup> [www.foroyabanki.fo](http://www.foroyabanki.fo)

the depression has so far yielded good results on the balance sheets.

Key figures	Føroya Banki		Føroya Sparikassi		Norðøya Sparikassi		Suðuroyar Sparikassi	
	2003	2004	2003	2004	2003	2004	2003	2004
Solvency Surplus coverage*	47%	47%	19%	19%	29%	30%	22%	21%
Loss**	3%	0%	7%	2%	1%	0%	0%	1%
Growth in borrowing	3%	4%	-2%	1%	12%	9%	9%	4%

Note: \*Surplus coverage above the legal requirement for liquidity

\*\*and provision for loss

Source: *Finanstilsynet* ([www.finanstilsynet.dk](http://www.finanstilsynet.dk))

Given the gloomy outlook for the aquaculture industry, the two major banks had to set aside in their first-half financial reports for 2003 considerable reserves against possible losses for the first time since the early 1990s. The other two banks Norðøya Sparikassi<sup>21</sup> and Suðuroyar Sparikassi<sup>22</sup> are not involved with financing this industry and both showed positive results halfway through 2003. In 2004, the losses of the major banks seemed to be restrained, and no further losses are expected for 2005 or 2006. The outlook for the aquaculture industry is now looking brighter.

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), Húsálansgrunnurin (mortgage credit institution, financing residential houses) and Framtaksgrunnur Føroya (Faroese Business Development Fund, which provides equity capital to Faroese companies).

<sup>21</sup> [www.ns.fo](http://www.ns.fo)

<sup>22</sup> [www.sparsu.fo](http://www.sparsu.fo)

*The Faroese Securities Market*

The Faroese Securities Market (VMF)<sup>23</sup> on the Iceland Stock Exchange<sup>24</sup> had its first three listings in 2003. The Faroese Government bonds expiring in 2004, 2006 and 2008 have all been listed on the market.

On the first of June 430 million DKK of Faroese Government bonds were listed, and on the 15<sup>th</sup> of June 2005, the first company (Atlantic Petroleum) was listed on the VMF market on ICEX.

Due to the refinancing of the debt with the Danish State to the Faroese Government on the 24<sup>th</sup> of November 2005, 750 million DKK of Faroese Government bonds will be listed on the VMF markets at ICEX. The rest of the 1,494 million debt with the Danish State will be re-financed by issuing bond debt with varying duration on the Faroese Securities Market on the Iceland Stock Exchange (ICEX).

The newly established Faroese Securities Market, that is organized in such a way that Faroese companies will be listed on the Icelandic stock exchange, will afford domestic issuers easier access to capital for both existing and future initiatives. This is of great importance, especially when a Faroese company desires to expand within the Faroe Islands or abroad. Industries that are capital intensive, like fish farming, and companies that are innovative and avant-garde also benefit from having access to a localized securities market.

Such a market will enable investors to safely invest in Faroese companies. Because pension savings are expected to increase considerably in the coming years, the lack of a securities market would mean that this capital would not be available to help Faroese industry, but would be exported abroad.

The securities market is also a tool to assist in the privatization of the publicly owned companies, and can give ordinary people a better understanding of

how business works, and what influences the success or failure of an investment.

Thus, a securities market is anticipated to generate greater potential for growth than if no exchange were available.

## 6.2 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 basis of the Faroese króna is an equal amount of Danish krone deposited in an account in the Danish central bank. 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, and a 200-króna note in early 2004. The rest of the series, 500 and 1000-króna notes, were issued in 2004 and 2005.

Concerning the future of Faroese currency, the Danish people rejected the Euro in 2001. This essentially preserved the status quo for the time being.

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<sup>23</sup> www.vmf.fo – The company P/F Virðisbrævamarknaður Føroya was founded in 2000.

<sup>24</sup> On 30 March 2004 the Iceland Stock Exchange and the Faroese Securities Market (Virðisbrævamarknaður Føroya Pf) entered into an agreement relating to the listing of Faroese securities on ICEX and facilitation of trading of Faroese securities.

## 7. THE PUBLIC SECTOR

### 7.1 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, which is for the most part defined as A-income, and business income, mainly defined as B-income.

#### 7.1.1 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) in 2005 is between 50 and 57.5%<sup>25</sup>, 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 35% in 2005.

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 2005 municipal taxes ranged from 15 to 22.5%. On average, the tax is 19.6%.

#### 7.1.2 B-income

B-income is based on the annual accounts of a business 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. The Government has announced that corporate taxes will be lowered to 18% in 2006.

#### 7.1.3 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. All income from securities (interest, dividends and capital gains) is 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.

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

### 7.2 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

<sup>25</sup> Depending upon which municipality one resides.



largely by current provisions and are booked immediately as expenses 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 subsea tunnel between Vágur and Streymoy, and the subsea tunnel between Eysturoy and Norðoy, 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.

Outlays for effective guarantees have been massive historically. In 1991, private guarantees amounted to DKK 642 million; this was zero in 2003. New outlays from 1999 and onward have been at a minimum and the public guaranteed debt is decreasing. In 2004, all guaranteed debt was only DKK 94 million, DKK 762 million less than in 1996. (See Appendix B, Table 2.) It is expected that this rate of decline will continue, and municipalities will be the only group with guaranteed debt from 2005 onward.

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 1; 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.

In December 2003, the Faroese Government decided to pay DKK 500 million toward the debt with the Danish State. This resulted in yet another cut in interest payments. In November 2005, the Faroese Government is expected to re-finance the debt with the Danish State, to lower the interest payments even more.

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

### 7.3 The public 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 the National Audit Office. 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.

### 7.4 The current public budget status

The Government account showed a surplus of DKK 697 million in 2001, 191 million in 2002 and 22 million in 2003.

For 2004, the Government account showed a deficit of 152 million, while the budgeted deficit for 2005 is estimated to be about DKK 270 million.

For 2006, the deficit is estimated to be about 219 million DKK, however, due to public investment expenses that are held outside the state budget (at least DKK 50 million), the deficit is likely to become more than DKK 219 million.

The repayments of principal and interest on loans in 2005 are estimated to be DKK 2,049 million (DKK 125 million in interests and DKK 1,924 million in repayments). This is due to a re-financing of 1,494 million debt with the Danish State.

#### 7.4.1 Income

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 and 2004, partly due to lower taxation. Growth in income from VAT is also falling because of lower economic growth.

The Danish grant will remain at the current level, until the Government decides to take over additional areas of administrative control. This will cause further reductions. 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.

#### 7.4.2 Expenditures

From 1989 to 1997,<sup>26</sup> expenses decreased every year even with growing interest expense. In 1998, expenses also dropped due to lower interest payments<sup>27</sup>.

In 1999, the expenses started to increase. In 1999, with 7%, 2000 with 6%, 2001 with 7.5% and in 2002 with 10%.

In 2003, the Government stopped the accelerating growth in expenses, and this resulted in an increase in expenses of 3.9% in 2003, 2.2% in 2004 and in 2005 the estimated increase in expenses is 3.3%.

If the budget proposal for 2006 holds, the expenses will decrease by 2.8% compared to 2005, but this may differ from the final result, because the current budget proposal does not include at least DKK 50 million of investment expenditures that are held outside the state budget, and does not include an extra DKK 45 million cut in taxes.

#### 7.4.3 Policy

The current economic policy could be called neutral. 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 2006, the Government has set a goal to decrease the expenses, and at the same time the Government wants to increase indirect taxes, but lower income taxes.

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<sup>26</sup> Assuming exception of the capital injections into the banks in 1992 and 1993.

<sup>27</sup> 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.

The Government has been working on privatizing some of the publicly owned companies to make a more clear distinction between public and private services, finance the reduction of debt and to help launch the Faroese Securities Market. Føroya Banki, Atlantic Airways, Faroese Telecom and some companies owned by the Business Development Fund are amongst the candidates for privatization.

#### 7.5 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 2). 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 366 million to DKK 630 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.

#### 7.6 Foreign government debt

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 1992<sup>28</sup> and rearranged foreign debt elsewhere with loans from the Danish Government.

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

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<sup>28</sup> Founded with the purpose to restructure the banks.

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 registered with the Danish Securities Centre and since 2003 are quoted on the Faroese Securities Market in cooperation with the Icelandic 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 on the Faroese shelf.

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.

In November 2003, the Government used bonds to refinance debt to the Danish State. The DKK 1,200 million of the proceeds from the bond issue were used as an extraordinary repayment of debt owed to the Danish State. DKK 300 million were used to refinance an existing bond loan that was due in December 2003. In addition to that, the Faroese Government extraordinarily repaid the Danish Government DKK 500 million from its liquid assets. The total debt owed to the Danish state, therefore, was reduced from DKK 3,351 million to DKK 1,651 million, whereas the total bond debt increased from DKK 300 million to DKK 1,500 million.

In June 2005, DKK 430 million were used to refinance an existing bond loan that is due in November 2005.

In November 2005, the Government will use bonds to refinance debt to the Danish State. The DKK 1,496 million of the proceeds from the bond issue in November 2005 will be used as an extraordinary repayment of the whole debt owed to the Danish State.

The total debt owed to the Danish State, therefore, will be reduced from DKK 1,496 million to zero, whereas the total bond debt will increase.

## 7.7 The municipalities' debt

The Faroe Islands at present have 34 municipal councils, which vary in size and population from 20 to 18,000 inhabitants. Some of them have a net debt of DKK 60,000 per inhabitant while others have modest or no debt at all. For those that have large debt, interest and installments comprise 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"<sup>29</sup>. 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 seven to nine 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. Some municipalities have merged over the last few years, and several municipalities have decided to follow suit. The number of municipalities was reduced from 48 to 34 in 2004.

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

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<sup>29</sup> 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.

## 8. SUMMARY & OUTLOOK

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### 8.1 Summary

The Faroese economy is at present on a low-to-negative growth track. The overall activity in the economy is still high, but has fallen in selected sectors, i.e. the prawn, fish farming and fish processing industry.

The Faroese economy experienced an extraordinary growth period after the depression years 1990-1994. In the years 1999-2001, the growth of nominal GNP (at market price) was over 8% p.a. Growth was 4% in 2002, but growth stagnated in 2003 and became negative at -2.75%.

In 2004, growth is estimated to have been 3%, and estimated growth in 2005 is 1.9%. The outlook for 2006 is a growth of approximately 1%.

Growth has stagnated and turned negative, due especially to the negative contribution of the exporting industries. First, the prices of consumption fish have stagnated or decreased. Second, the prices for shrimp and salmon have decreased, and third, infectious salmon anemia (ISA) has limited the output of the aquaculture industry.

From 1997 to 2002, total wages and salaries paid have increased by approximately 10% p.a. The business cycle flattened out in 2003, as total wages and salaries paid in 2003 were only 0.4% higher than in 2002. Despite contractual wage rises of 4% in 2004, the rise in the total wages and salaries paid was only 0.9%.

The total wages and salaries paid in the first three quarters of 2005 have increased by 2.2%, compared to the same quarters of 2004.

### 8.2 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 and the BoP will be worsened by the current decline in fishing and aquaculture.

The country is currently in a much better state to tackle a downturn than previously. Although the public sector still owes DKK 3.6 billion (2004), the country as a whole holds net assets of about DKK 3 billion (2004) (appendix F, table 2) 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 current Government's agenda.

It is hard to estimate the outlook for future activity in the oil industry. The big hopes for an oil adventure looming on the near horizon have been dampened.

The seismic and other data obtained from the drilled wells is still being interpreted and much valuable information about the Faroese subsoil has been obtained in the process. Furthermore, the recent surge in oil prices and the planned drilling in 2006 and 2007 will most likely stimulate further exploration.

There are many other issues of interest facing the Faroe Islands in the coming years, e.g. privatization of public companies, entering more and better free-trade-agreements, and changing the framework for the Faroese fishing industry.

The main challenge for the years ahead will be how to encourage and sustain growth.