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GOVERNMENTAL BANK

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TABLE OF CONTENTS

1. FACT SHEET	3
2. GEOGRAPHY AND POPULATION.....	7
3. THE POLITICAL SYSTEM.....	8
3.1 The Parliament and Government.....	10
3.2 The Government Organization.....	11
3.3 Foreign Relations	12
4. THE ECONOMY	14
4.1 The Economy in General.....	14
4.2 Recent Economic Development.....	15
4.3 Industries.....	17
4.4 The Financial and Securities Market.....	25
4.5 Labour Market	28
4.6 Foreign Trade.....	29
5. THE PUBLIC SECTOR	32
5.1 Foreign Currency Rating.....	33
5.2 Public Income.....	33
5.3 Public Expenditure.....	35
5.4 The Public Financial System	36
5.5 The Current Public Budget Status.....	36
5.6 Government Foreign Debt	37
5.7 The Municipalities.....	38
6. OUTLOOK	39
7. LINKS	40

For additional statistical information see also:
Information Memorandum 2008 Appendix.
Available together with this publication at www.landsbankin.fo

1. FACT SHEET

Location

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

Land Area

1,400 square kilometres; 545 square miles

Population (1 Jan 2008)

48,433. Males 25,174 (52%)

Females 23,259 (48%)

Main Population Centres

(1 Jan 2008)

Torshavn (capital): 19,425

Klaksvík: 4,888

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 8th 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 Torshavn.

Norway and Denmark joined in a double monarchy in the late 14th century. When Norway in 1814 was ceded by cession 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 constituted a special jurisdiction and they were able to maintain their distinct language and culture over the centuries.

The trade monopoly in the Faroe Islands was abolished in 1856 and the country has since then developed towards a modern fishing nation. The Faroese National Movement was established in 1888 as a struggle for more cultural autonomy, but after 1906 became more politically oriented with the foundation of the political parties of the Faroe Islands.



The Faroes were occupied by British troops during the World War 2. After the war Denmark and the Faroe Islands in 1948 made an agreement that assured the islands Home Rule and a high degree of local autonomy.

The Faroe Islands is not a member of the European Union.

During the early 1990's the islands experienced considerable economic difficulties following the collapse of the fishing industry. The economy has since recovered with considerable growth and efforts have been made to diversify the economy.

The Political System

The Faroe Islands is a self governing country within the Kingdom of Denmark which also comprises Greenland.

Since 1948, the Faroe Islands has had Home Rule – a political system by which so-called "Joint Matters" are under Danish State authority, while "Special Matters" are deemed matters of Faroese State competence and are under Faroese control.

For example, the Faroe Islands is an independent area with regard to customs and excise duties and taxation.

According to the Home Rule Act, the judiciary, defence and foreign affairs are among those Joint Matters that currently cannot unilaterally be taken over by the Faroese Government.

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

The Løgting has 33 members. The Faroese people also elect two representatives to the Danish Parliament.

The Faroese head of state is the Danish head of state, Queen Margrethe II.

Head of the Faroese Government

The Prime Minister, Kaj Leo Johannesen (The Unionist Party), since 26 September 2008.

Present Government

The Faroese Government (Landsstýri) consists of at least two Cabinet ministers led by the Prime Minister. The present cabinet is comprised of 9 ministers, including the Prime Minister. The Faroese Government coalition is currently made up of representatives from the Unionist Party, the People's Party and the Social Democrats.

Currency

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

Rate of exchange: DKK/100 Foreign Currency. (9 Sep 2008)

EUR 745.69

USD 527.21

GBP 928.63

Main industries

Fishing, fish processing and fish farming.

GDP (Nominal GDP at market price)

Calculation Statistics Faroe Islands:

DKK 11,878 million (2006)

Estimation Governmental Bank:

DKK 12,983 million (2007). Expected growth 2008: 4.7%

Export (fob) of Goods (2007)

DKK 4,023 million

Export of Services (2006)

DKK 1,036 million

Main export product groups (2007)

Fish and fish products: 94.3%

Ships: 2.3%

Other: 3.4%

Import (cif) of Goods (2007)

DKK 5,300 million

Import of Services (2006)

DKK 1,591 million

Labour force composition (Labour Force Survey nov. 2007)

Labour force 29,500

Unemployed 540

Employment rate 84.2%. (males 86.8% and females 81.2%)

Labour force divided by industries (2007)

Fishing and fish processing: 18%

Construction, engineering and energy: 15%

Sales, private services, transport and communication: 33%

Public administration and services: 34%

The Public Account 2007

Of the DKK 4 billion authorities used for expenses and investments in 2007, proportional distribution was as follows: Social Security and Pensions 34.3%, Education, Research, and Culture 20.5%, Health 16.8%, Political Administration 12.6%, Transport and Communication 9.5%, and Economic Affairs 6.3%. Investments in 2007 were DKK 292 million.

The total public income was about DKK 4.2 billion. Of this, DKK 3.6 billion was derived from income and corporate taxes (DKK 1.8 billion) as well as VAT and duties (DKK 1.7 billion). Other sources of income include DKK 632 million in the form of a block grant from Denmark, and income from share returns and interests equalling DKK 50 million.

Education

Child day-care is a municipality responsibility, and education is mandatory for children 7 to 16 years old. Primary school is compulsory through the ninth grade, after which education can be continued in a high school or a business, technical, industrial fishing, or mariner school. There are also marine engineering, nautical, teaching, business, and nursing colleges.

There is one university in the Faroe Islands – Fróðskaparsetur Føroya.

Health and Social Security

Health service is a public matter. The Faroe Islands have a well-established system of primary health care, which is partly user-financed. Specialised treatment is also offered in hospitals outside the country, mainly in Denmark.

Social protection lives up to the Nordic standard and is maintained by the public. Social Security offers unemployment and maternity/paternity leave benefits (insurance is compulsory), social assistance, and cash benefits in the event of illness. Social Security also offers disability pensions and retirement pensions when people reach the age of 67.

Transportation & Communication

The transportation infrastructure in the Faroe Islands is good. Road connections now link all villages on each island, and all islands are connected by bridge, tunnel, ferry, or helicopter. In December 2002, the first sub-sea tunnel in the Faroe Islands was opened between Vágur and Streymoy. A second sub-sea tunnel between Borðoy and Eysturoy opened in May 2006. Both tunnels are partly user-financed.

Transportation to and from the Faroe Islands is made easy with regular flights and a car and cargo ferry available year round to Denmark, Iceland, Norway, and Great Britain. The international airport is located in Vágoy, and flight time to Copenhagen is 2 hours.

The Faroese enjoy a highly developed telecommunications system, and telephone and Internet technology is widely used. People have ready access to both government subsidised and private Faroese radio and television stations. In addition, many have access to cable and satellite television from abroad.

Several books, magazines, and daily newspapers are published in Faroese.

2. GEOGRAPHY AND POPULATION

The Faroe Islands is an isolated archipelago in the North Atlantic. The distance to the closest neighbour, 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 1,500 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 km². The largest island is Streymoy (375 km²) and the capital, Torshavn, is situated there. The islands, towns and villages are connected by a developed system of roads, tunnels and sea and helicopter routes.

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, the mountain Slættaratindur, is 882 m and the average elevation above sea level is just over 300 m. The total coastline is approximately 1,000 km long, and at no time is one more than 5 km away from the ocean.

The Faroe Islands are built up of layers of volcanic basalt. The towns and villages lie on the coast or in fjords surrounded by cultivated pastureland. The outfield and the mountains are uncultivated land where some 70,000 sheep graze. Vegetation and wildlife on land is rather unvaried, although seabirds are plentiful around the islands.

Territorial sea extends 12 nautical miles from coastal baselines. The exclusive economic zone extends for 200 nautical miles (370 km) beyond the baselines of the territorial sea, or is delimited according to the median line principle in the United Nations Convention on the Law of the Sea. The exclusive economic zone is the main fishing ground for the coastal fishing fleet.

Since 2000 oil explorations have been carried out in the subsoil in Faroese waters.

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 Torshavn 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.

In January 2008 the population of the Faroe Islands totalled 48,433 (males 25,174 (52%) and females 23,259 (48%)). Of this number, 19,429 (40%) lived in the capital Torshavn and 4,888 (10%) in Klaksvík, which is the second largest town.

The last five years the population growth rate has been low, on average only 0.3% p.a.

Population growth is concentrated in the northern area, where the islands are connected by roads or tunnels, while the growth rate is negative in the southern area and in most of the small islands, which are more cut off from the main area.

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 (Streymoy and Eysturoy) and two sub-sea tunnels connect these two islands with two other major islands (Vágoy and Borðoy).

3. THE POLITICAL SYSTEM

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. 137¹ 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 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.

Special Matters

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

The areas that are assigned to the legislative and administrative bodies in the Faroe Islands are, for instance, financial, economic and cultural matters, industry, foreign trade and resources in the subsoil. The educational system was officially assigned to the Faroe Islands in 2002 and the State block grants from Denmark were reduced accordingly. On the national holiday Ólavsøka, 29 July, in 2007, the National Church became the responsibility of the Faroese Government.

Joint Matters

These are administered by the Danish Government (Regeringen) 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.

Today, the Faroese Government administers most of the social welfare system and the health services, etc. Legislative competence still resides in the Danish Government, but legislation has to be ratified by the Faroese Parliament for it to be applicable to the Faroe Islands.

However, the new Act No. 578/24 June 2005, The Assumption Act of Matters and Fields of Responsibility by the Faroese Authorities,² gives the Faroese Government the unilateral authority to take over all matters except matters that are directly connected with full independence:

- The Danish Constitution
- Danish internal affairs

¹ 'Act' in this context refers to laws adopted by the Danish Parliament, while the short form 'LI' ('Løgtingslóg') refers to laws adopted by the Faroese Parliament. The Home Rule Act is confirmed by the Faroese Government in the announcement Kunngerð nr. 11 from 31 March 1948.

² LI 79, 12 May 2005.

- The Danish Supreme Court
- Foreign affairs, security and defense policies
- Currency and monetary policy

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 Office of the Danish Prime Minister. The Office of the High Commissioner in Torshavn is under the Danish Prime Minister. The general rule, however, is that Faroese matters, managed by the Danish Government are handled by the relevant Danish ministry.

Among joint matters, which are still administered by the Danish Government is e.g. financial institutions and financial supervisory authorities, family and inheritance law, judicial administration, special care for the mentally impaired, immigration and border control, etc.³

Latest developments

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

When a new Faroese Government came into power in May 1998, the main objective was to work for Faroese independence or sovereignty. After publishing a White Book in 2000 on the matter, the Government made a basis for negotiation with the Danish Government. Four rounds of negotiations were about how to settle the transition period between the then current status and future independence. The negotiations ended without the parties reaching an agreement, and a planned referendum in 2001 in the Faroe Islands about the future relations to Denmark was abandoned.

A new Faroese Government came into power in February 2004. Now, the Government was pursuing a more moderate course to create a new and more flexible Home Rule-system. In a joint declaration from 4 April 2005 the Faroese and the Danish prime ministers agreed to make changes in the Home Rule-system in accordance with the rules in international law regarding the right of self-determination of the Faroese people.

In May 2005, the Home Rule Act as mentioned above was supplemented with Act No. 578/2005⁴. This new act makes 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.

As part of the same process a new Act No. 579/24 June 2005, The Empowerment of the Faroese Authorities in Matters of Foreign Policy, confirms the Faroese Government the right in accordance with preliminary stated procedures to enter into international agreements with foreign states and cross-national communities in all special Faroese matters.⁵ In this Act

³ LI 41, 10 May 2006 and later amendments.

⁴ LI 79, 12 May 2005.

⁵ LI 80, 14 May 2005.

Denmark also promise to support Faroese applications on membership in cross-national communities, which admit other entities than specifically named states as members, as long as this does not contradict with the current constitutional position of the Faroe Islands.

The Faroe Islands have in recent years expanded their activities in the foreign policy area and appointed ambassadors and established embassies in EU (Brussels), Copenhagen, London and Reykjavík.

The Faroe Islands elects two representatives to the Danish Parliament (Folketinget). On 13. November 2007, the Unionists (Sambandsflokkurin) and the Republicans (Tjóðveldi) each won a seat in the Folketinget, while the Conservatives (Fólkaflokkurin) lost their seat.

3.1 The Parliament and Government

The Faroe Islands is governed by the Faroese Parliament (Løgtingið), which is the legislative body dealing with Special Matters and Joint Matters. Laws passed by the Faroese Parliament pertaining to Special Matters are termed "Løgtingslógir", and must formally receive the consent of the Prime Minister of the Faroe Islands (Løgmaður).

Legislation passed by the Danish Parliament regarding Joint Matters must be ratified by the Faroese Parliament to be applicable to the Faroe Islands. These laws are termed "Danish Kingdom Law Recommendations".

COMPOSITION OF THE FAROESE PARLIAMENT (FØROYA LØGTING)				
	2004		2008	
	% of votes	Number of seats	% of votes	Number of seats
Fólkaflokkurin (Conservatives, moderate autonomists)	20.6	7	20.1	7
Sambandsflokkurin (Conservatives, unionists)	23.7	7	21.0	7
Javnaðarflokkurin (Social Democrats, mod. Unionists)	21.8	7	19.3	6
Sjálvstýrisflokkurin (Conservatives, mod. autonomists)	4.6	1	7.2	2
Tjóðveldi (Republicans, for independence)	21.7	8	23.3	8
Miðflokkurin (Christian Centre Party, for independence)	5.2	2	8.4	3
Other parties	2.4	0	0.7	0
Total	100.0	32	100.0	33

Note: Due to the nature of the special at-large distribution system, votes and seats do not necessarily coincide in the 2004-election. A 2007 change in the rules of election means that seats in the Løgtingið are now distributed with direct proportionality to the number of votes.

The Faroese Parliament is elected every four years. However, a majority of Parliament or the Prime Minister may call an unscheduled election. There is universal suffrage for those over the age of 18. A November 2007 change in the rules of election states that the Faroe Islands is one constituency, and the number of members of the Parliament is now fixed at 33. Before this change, the Parliament consisted of up to 32 members of which 27 were directly elected from seven constituencies, and up to five were distributed according to a special at-large system.

At present there are six political parties represented in the Parliament. The last election was held on 19 January 2008. In addition to being divided into the usual spectrum of political left and right, the electorate is also divided between respective attitudes 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 in the Faroese political system is the Faroese Government (Landsstýrið), which is appointed by the Faroese Parliament. In February 2008, the Social Democrats (Javnaðarflokkurin), the Republicans (Tjóðveldi), and the Christian Centre Party (Miðflokkurin) formed a coalition government. In September 2008 this Government was replaced by a new, three-party government coalition made up of representatives from the Unionist Party, the People's Party, and the Social Democrats.

According to a co-operation-document created by this coalition, the new, three-party government will focus more on foreign relationships and foreign trade policy. This includes consideration of membership in EFTA and closer relations to EU. The coalition will also introduce a long-term public budgeting scheme. A public subsidy paid to private homeowners to reduce their interest on loans will be reduced or phased out, and a new pension scheme based on individual savings will be introduced.

A commission examining the need to revise the fishery management structure was also introduced. Extensive changes will be made in the municipal structure, which will lead to fewer and bigger municipalities.

The new government has plans to assume responsibility for civil aviation and the inspection of airspace, foreign immigration, and criminal and family law. Plans for a new Parliamentary Constitution have also been announced, as well as the establishment of a National Savings Fund.

3.2 The Government Organization

The Faroese Parliament elected in 1994 was the first Faroese parliament to utilize a new governing system based on ministerial directorates.

A director general, who reports to the minister in charge, heads each ministerial directorate. The directorates are again split into different divisions with sub-directors. The number of ministers is intended to match the number of directorates, however, for political considerations, the number of ministers may vary. At present, there are 9 ministers comprising the Faroese Government:

Kaj Leo Johannesen (Unionist Party)
Prime Minister
Minister for Constitutional Affairs & Central Administration

Jørgen Niclasen (People's Party)
Deputy Prime Minister
Minister for Foreign Affairs

Johan Dahl (Unionist Party)
Minister for Trade & Industrial Affairs & Natural Resources

Jóannes Eidesgaard (Social Democrats)
Minister for Finance & Economic Affairs

Jacob Vestergaard (People's Party)
Minister for Fisheries

Hans Pauli Strøm (Social Democrats)
Minister for Health

Rósa Samuelsen (Unionist Party)
Minister for Social Affairs

Helena Dam á Neystabø (Social Democrats)
Minister for Educational & Cultural Affairs

Annika Olsen (People's Party)
Minister for Internal Affairs

3.3 Foreign Relations

In general, the Danish Government assumes responsibility for foreign affairs throughout the Danish Kingdom, including the Faroe Islands. However, it has become common practice for the Faroese Government to conduct negotiations involving fishing and trade with other countries. This practice has been extended with the above mentioned Act No. 579/2005, The Empowerment of the Faroese Authorities in Matters of Foreign Policy.

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, particularly 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. 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.

Although Denmark has been a member of the European Union since 1973, the membership does not extend to 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. The "Cumulation Agreement" was fully implemented on 1 December 2005.

The Faroe Islands also participate in EU's Seventh Research Framework Programme (FP7).

As a self governing area, the Faroe Islands is a member of the Nordic Council.

On 1 November 2006, the Faroes entered into a special economic treaty with Iceland. The Hoyvík Agreement established a single economic area encompassing both countries where any discrimination regarding goods, services, capital, and persons is prohibited.

The Faroe Islands is a full member of the North Atlantic Marine Mammal Commission (NAMMCO), and an associated member of the International Maritime Organization (IMO).

The Faroe Islands take active part in the Regional Fisheries Management Organizations NAFO, NASCO and NEAFC in conjunction with Greenland. Denmark is represented in the Regional Fisheries Management Organizations (RFMOs) by the EU.

Since November 2007, the Faroe Islands has been a associated member of FAO.

The Faroe Islands also participate in the work of ICES, which coordinates and promotes marine research in the North Atlantic.

The Faroe Islands have also entered into fisheries agreements with EU, Greenland, Iceland, Norway, and Russia.

The new Government has decided to investigate current conditions of membership or developing closer relations to the European Union. The majority of the Faroese Parliament wishes to apply for Faroese membership in EFTA (European Free Trade Association), and the present Faroese Government is currently pursuing EFTA membership. No final decision has been made, and it is not clear what the positions of the current EFTA members might be.

4. THE ECONOMY

4.1 The Economy in General

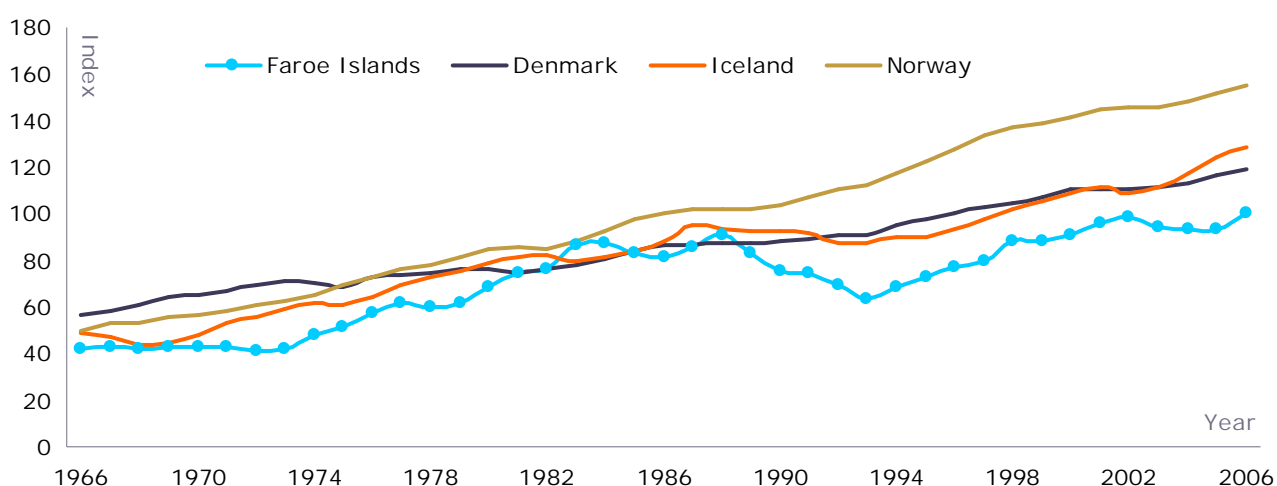
The Faroe Islands is a modern, developed society with a standard of living comparable to other Nordic countries. However, the economy is not yet as diversified as in other highly developed countries.

Fishery and related industries are of such importance that its influence determines the overall performance of the Faroese economy. This dependence on a resource-based industry is evident in the Export Account of Goods, of which fish products account for about 95% of the export value (Appendix C, Table 3).

An economy with high dependence on fish products and exportation is bound to be vulnerable to the changes in catches, fish prices, and exchange rates. These often cyclical and unforeseen changes are volatile, and have left their mark on the economic history of the islands.

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

Disposable income pr. capita, PPP-adjusted, index (Faroe Islands 2006 = 100)



Source: OECD, Statistics Faroes and Governmental Bank

As can be seen from the chart above, Faroese Disposable Income per capita has varied considerably. Since 1966, the growth has been 2.4%, with a standard deviation of 6.0. Similar to other countries in the chart, growth has been steady, but not nearly as stable.

The national accounts to 2007 indicate that a proportionally larger output value now comes from production related to construction, transportation, banking, and other financial services. The proportional output value from fishery and the manufacturing of fish products has declined correspondingly. Faroese companies are also actively seeking investment opportunities abroad at a much higher level than in the past. These developments, together with a shift since the mid-1990's towards a more market oriented economic policy, will most likely contribute to a more diverse and stable economy.

4.2 Recent Economic Development

The Faroe Islands had high GDP growth rates in 2000 and 2001 - over 10% in current prices. The growth rates slowed in 2002-2005 to a yearly increase averaging 2%. In 2006, the GDP increased more than 14% in current prices compared to the year before. With a moderate increase in consumer prices at about 2% in 2006, this indicated significant growth. Landsbanki Føroya has estimated a 9.3% increase in the GDP in 2007, and a 4.7% increase in 2008, based on the assumption that the total wage expenditure increase in 2008 not exceeds 3.8%.

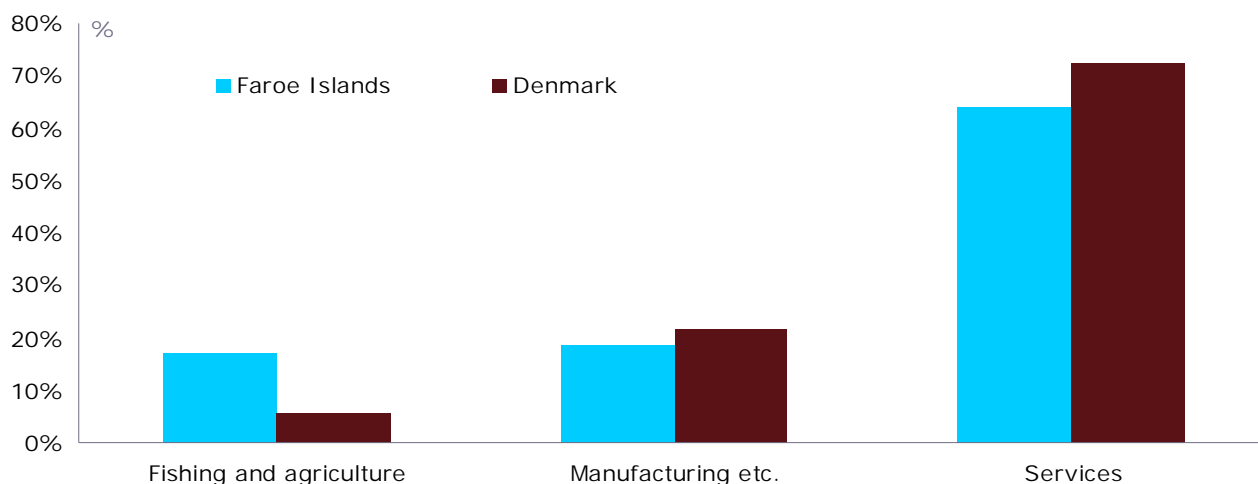
The high growth in 2006 and 2007 can be explained by an increase in credit-financed, private consumption, and investment growth.

The estimated moderate growth in 2008 may have several reasons. One is a significant fall in value of fresh fish catches for the first half-year of 2008. Others include a more stagnant private house market, an increase in nominal interest rates, credit constraints, and inflation stemming from higher consumer good prices and significantly higher oil prices. Higher oil prices also mean the Faroese fishing fleet incur higher operating costs.

The growth rate in total wage expenditure in the Faroe Islands has on average been 5.9% for the years 2001 to 2007. The growth in total wage expenditure was above average in 2006 and 2007, while growth in 2008 will apparently be below average.

In 2007, wages paid in agriculture, fishery, and the fishing industry were proportionally 21.4% of total wage expenditure, which is 7.2 percentage points less than in 2001. Wages paid in engineering, construction, and energy were 13.8% or 1.1 percentage points more than in 2001. Wages paid in the private service sector were 30.0% or 3.5 percentage points more than in 2001. In public administration and service delivery, wages were 32.8% or 2.6 percentage points more than in 2001.

GDP distribution on industries in 2006, %



Source: Statistics Denmark and Governmental Bank

Prices seem to have gone up especially in the first half-year of 2008 after having been relatively stable for some years. From 2001 (CPI-figures second-quarter) until 2007 (CPI-figures second-quarter) prices rose about 8%, while they rose 6.7% in only one year from 2007 to 2008 (CPI-figures second-quarter). Housing (incl. electric and heating), food,

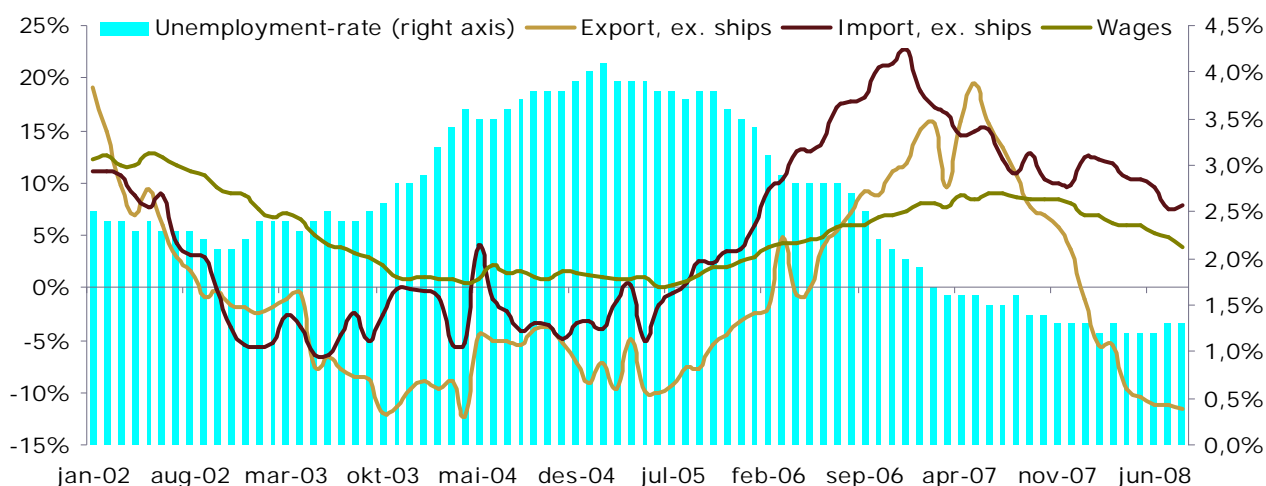
transportation, recreation, and cultural events have become more expensive, while furnishings, household equipment, and communications have become cheaper. (The CPI is shown in Appendix E, Tables 4 and 5).

The export and import figures show the economic conditions eloquently. Excluding ships and aeroplanes, Faroese export was 4 billion DKK in 2007, a 3.6% increase from 2006. 96% of the export value of commodities comes from fish and fish products. Exports value, excluding ships and aeroplanes, in January-August 2008 was significantly lower, almost 15% compared to the corresponding period in 2007. The decline in export value includes most fish species but excludes farmed fish.

Import value was 5 billion DKK in 2007, excluding ships and aeroplanes. This is an almost 10% increase compared with 2006. In the period January-August 2008 import value was 3.4 billion DKK, which is 4.1% more than import value for the corresponding period of the previous year. Import value changes, excluding ships and aeroplanes, in 2008 stem from higher fuel prices. Import value has been decreasing for almost all other commodity groups, while imports of consumer goods have shown a slight decrease.

The fluctuations in export and import value for the year 2001-2008 are shown in the below figure.

Economic indicators, y/y %-change



Source: Statistics Faroes

The Balance of Payments figures for 2005 and 2006 stood at a surplus DKK 19 million and 142 million respectively. In 2006 the surplus was about 1% of GDP. The balance is negative with regards to goods and services, which are counterbalanced by a significant surplus from incomes from wages and dividend, including the annual grant from Denmark (see Appendix C, Table 1). It is likely that the outcome in 2007 will be about the same as 2006, while the outlook for 2008 indicates there may be a deficit.

The unemployment rate is remarkably low and recent figures (January-June 2008) show levels lower than 1.5%. The average unemployment figure for 2003 was 2.5%, 2004 3.5%, 2005 3.8%, 2006 2.7%, and 2007 1.5%. Female workers generally have higher unemployment rates than males.

4.3 Industries

Fishery and the Fishing Industry

Before the mid-1970s, the Faroese fishery was mainly based on fishing in overseas fishing areas. 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 200 mile economic 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. This is done in agreements on fisheries with some countries among them Iceland, Russia, Norway, EU and Greenland.

After a period of transition in the second half of the 1970s, the problem of surplus capacity became clear and grew worse in the 1980s. In addition, the fleet was becoming increasingly more effective due to more efficient fishing methods. This increasing pressure, mixed with a deterioration of the fish stocks from natural causes, resulted in a slump in catches. This slump was most prevalent for Cod, Haddock and Saithe – species that make up most of the Faroese catch destined for human consumption. The downtrend, which hit bottom in 1991-94, ruined the fishing fleet and most land-based fishing industries, and led to a severe socio-economic crisis.

Beginning in the early 1970s, the fishing fleet became increasingly subsidised and this affected the market in unfortunate ways. In the late 1980s, a condemnation plan was initiated whereby ship owners were paid to give up their fishing vessels. This resulted in a capacity reduction of around 30%. In 1992, the subsidies were replaced by a capital subsidy, and in 1998, removed altogether. Now the fishing fleet relies very little on subsidies. The only direct government subsidies to the fishing industry are minimum payment guaranties, health insurance payments for fishermen (DKK 22 mill. in 2007), and subsidies to reduce cost for local transport of fish from landing place to factories (DKK 3.3 mill. in 2007). In addition, fishermen have a 14% tax-free reduction in their yearly income up to DDK 470,000.

During the 1980's, the problem of surplus capacity was also evident in the fish processing sector. Large catches combined with government subsidies gave the Faroese people incentive to build fish filleting plants in large numbers.

When fish resources became scarce in 1992, most of the plants closed and the sector went through reorganisation. The number of plants was reduced, the size of the remaining plants grew, and more specialised plants were opened.

In 1992 and 1993, legislation was enacted requiring fish (demersal species) caught in Faroese waters be registered, landed, and then offered for sale on public auction in the Faroe Islands. An exception was made for 25% of catches, which ship owners could register and then sell directly on foreign fish markets.

Approaching the mid-1990s, the cod stock was in better shape than previously estimated, and Cod and Haddock catches increased gradually from 1993 to 1997. The export value, however, did not increase in an equivalent manner because a large portion of the export was unprocessed fish. Over a five-year period, this changed partly because of more local processing, but more specifically because of a general increase in world market prices of fish products.

The export value of fish products peaked in 2001 with DKK 4.2 billion. In 2003-2004, the prices were lower again, but the total catch was one of the best ever. Prices were rising in 2005 and 2006, but were lower again in 2007. Good catches in 2007 compensated for the fall in price and export value increased with 4% compared to the year before. The general increase in prices and the overall growth in the catch within the Faroese exclusive economic zone have resulted in an elevation of the export value. From 2000 to 2007 the export value of fish products has been comparatively high and stable.

Statistically, total catches by Faroese ships increased from 1993 to 2002, but there were differences among various species, as can be noted in Appendix I, Tables 1 and 2.

Since the 1950s, the total yearly Faroese wet fish catch has been about 100,000 tonnes, and since the mid-1970s, most years have been more than 100,000 tonnes. (Mean value 112.000 tonnes, standard deviation 20.000 tonnes) The most important wet fish species in recent years have been Saithe, Cod, Haddock, and Greater Silver Smelt. The catch of these species is done mainly by smaller fishing boats, long-line vessels, and pair trawlers.

The pelagic fishery arose in the mid-1960s and has increased since. From 1995 the most important pelagic species have been Blue Whiting, Herring, Capelin, and Mackerel. These species are caught mainly by high capacity, pelagic trawlers, and purse seiners.

Other species fished by Faroese ships are prawns and shellfish.

In 2007, the total Faroese catch was 582,000 tonnes. 231,000 tonnes or 40% were fished in Faroese fishing areas. Of the total catches, wet fish accounted for about 131,000 tonnes, which were mainly fished in Faroese waters. Of the total Cod catches in 2007, however, more than 60% were fished in foreign fishing areas like the Barents Sea and East Greenland. This is mainly caused by a significant fall in the catches of Cod in Faroese water over the last 3 years.

Most of the Cod fished in foreign waters is caught by big filleting trawlers.

From January to September 2008, the wet fish catch landings from Faroese waters dropped by 5% compared to same period in 2007.

On-land fish industry

After the economic crisis in 1992, the on-land fish industry went through a reconstruction, and the number of plants was reduced to fewer, bigger, or more specialised plants. The filleting factories are producing a range of fresh, iced, and frozen products to the retail and food service markets. About 25% of the total fish export value in 2007 was fresh, frozen, or salted fillets: DKK 402 million Cod fillets (7,785 tonnes), DKK 147 million Haddock fillets (4,838 tonnes), and DKK 373 million Saithe fillets (18,656 tonnes). The fish fillet plants are dependent on a stable supply of raw material. This has led to vertical integration of some plants and ships. Other smaller factories produce more specialised fish products.

The export of fried fishmeal and fish feed produced from pelagic species was about 57.000 tonnes in 2007. The export value was DKK 422 million, which is 11% of the total export value of fish products.

In the last three years the on-land fish industry has had difficulties recruiting labour, and the decrease in catches has had an effect on the industry's profit.

Fishery Management

The Ministry of Fisheries is responsible for the management of all fisheries in Faroese waters and fisheries by Faroese vessels in other waters.

Quotas (TAC) were introduced in the Commercial Fisheries Act of 1994⁶, but by June 1996 the quotas were replaced by a new system of "Fishing Days". The amended legislation from 1994 covers vessel and fishing licences, area closures, gear and data requirements, and other technical regulations for commercial fisheries. Fishing vessels under the Faroese flag must be at least 2/3 owned by persons or companies domiciled in the Faroe Islands.

The Fishing Days system focuses on viability, and takes into account the differences in fishing gear and vessel size. The number of fishing days in a fishing year (commencing on 1 September) is set by legislation passed in the parliament. The Proposal for Parliamentary Resolution is prepared by The Minister of Fisheries on the recommendation of an advisory board comprised of representatives familiar with the industry. The Minister also takes into account the recommendation, which comes from the Faroese Fisheries Laboratory, based on estimates of the fish stocks and the level of fishing effort.

Each ship within each group gets a certain number of active fishing days and those fishing days are partly tradable. Therefore, the TAC Quota is used as a guideline instead of enforcing an exact amount.

The advantages of a Fishing Days system to a strict quota system are that vessels can take their entire catch ashore rather than throwing fish overboard to stay under a quota amount. The system also curtails the fraudulent practice of landing fish under a false name. Some disadvantages are that the system is not efficient in protecting specific species, and that it does not compensate for technological improvements. For these reasons, it is necessary to adapt the number of fishing days as the Faroese fleets' catching capability increases.

Although there has been significant restructuring within the fishing industry, there are still too many Faroese fishing vessels. Other ways to indirectly reduce the fishing capacity and diversify the fishing industry are limiting the number of fishing days and encouraging the fishing of other species.

The Faroese fishing fleet catches many species of fish (Appendix I, Tables 1 and 2.). Restrictions are enforced by limiting or banning fishing in specific areas or during specific times. This is especially useful during spawning and to protect juvenile fish stocks.

In 2008, the number of fishing days was reduced 10% through recommendations from the Faroese Fisheries Laboratory and ICES. These recommendations were made to significantly reduce catch capacity.

Faroese fisheries in foreign and international waters are regulated through bi-lateral and multilateral agreements.

⁶ LI 28, 10 March 1994 with later amendments.

Aquaculture

The fish farming industry⁷ is relatively new in the Faroe Islands. It started in the early 1980s and has since emerged into the second largest export industry in the Faroese economy. Production has been volatile over the years, and the industry is currently in a redevelopment phase.

In the early 1990s, the industry was in distress, and through a series of mergers and acquisitions, the number of licenses went from 60 to about 15. Vertical integration took place and now companies own most aspects of production, from the handling of smolt to processing the final product. This comprehensive approach has allowed for larger permits and better planning for production, environment impact, and profit increase. The boom in the industry has also attracted direct foreign investment.

The industry experienced a record harvest in 2003. Production was around 62,000 tonnes with the export value at DKK 964 million. This amount corresponds to 25.8% of total export.

After a period of high growth and volatile prices, the industry ran into major problems with infectious salmon anaemia (ISA), and expectations were greatly reduced. Thus, the record harvest was a result of selling out the stock.

The harvest in 2004 was much less than previous years – around 37,000 tonnes. The harvest took a new plunge in 2005 with 19,000 tonnes. The fish farming industry has since rebounded and is experiencing a more positive development stage. The industry seems to have successfully fought the fish disease plague and production is growing.

Future price development is of great importance. Price has improved slightly since it reached rock bottom in the summer of 2003. Government authorities now demand ISA vaccination of the fish, which likely will help the situation greatly.

The fish farming industry conducts research to improve quality and production efficiency. There is also ongoing research in the farming of other species of fish, mainly Cod and Halibut, but to date, these endeavours have not proven commercially viable.

In 2007, the industry exported 21,000 tonnes of salmon and trout products. Although 2007 export prices were low compared to 2006, the export value was higher, DKK 589 million or 16% of the total export value of fish products.

Export quantity is expected to increase in 2008 to around 24,000 tonnes.

Compensation of employees in the aquaculture industry was DKK 350 million in 2007, which is more than 28% higher than the previous year. The growth continues and in January-October 2008 compensation of employees in the aquaculture industry is 30% higher compared to the same period in 2007.

Whaling

The pilot whale still contributes to the meat supply in the Faroe Islands. In 2007 the total catch was just under 400 tonnes or about 9 kg per person. In recent years, catches have varied from zero to 900 tonnes.

⁷ Farming of salmon and trout.

Although these catches are culturally and economically significant to the Faroese, the annual catch is only about 0.1% of the total North Atlantic stock. This figure maintains a sustainable growth/catch balance. Therefore, the Faroese catch poses no threat to the pilot whale stocks.

Agriculture

Farming in the Faroe Islands is not a major sector of trade. Only about 1% of GDP in factor prices is derived from farming. The over 7 million litres of milk produced in 2007 meets the domestic demand. The production has been relatively stable during the last four years. 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 yearly production of mutton is approximately 1,000 tonnes, which corresponds to about 75% of the total demand. The production of beef and beef products amounted to only around 70 tonnes in 2007. This is just a small percentage of the total consumption. Meat imports remain at a comparatively high level. In 2007, import of meat was 2,545 tonnes.

Construction

The construction industry in the Faroe Islands has had a significant impact on the economy. Most Faroese homes are spacious and the people of the Faroe Islands have generally high private housing standards.

During the 1980s, all over the country, many houses, roads, tunnels, and harbours were built or upgraded. However, when the depression hit, there was a dramatic decrease in the number of homes built every year. Worker compensation fell from DKK 348 million per year to DKK 98 million in 1995.

Recently, both private and public construction has been booming and compensation of employees has risen to DKK 495 million in 2007 (Appendix E, Table 1). This figure is 13% higher than in 2006. Overall rise in total compensation of employees was 8%. From January to October 2008 compensation of employees in the construction industry was 9.2% higher compared to the same period in 2007.

Construction activity is still high, but it is likely there is only a small possibility for further growth given the current low unemployment.

Transport & Communication

Internal

The transportation infrastructure in the Faroe Islands is good. Road connections now link all villages on each island and also between some of the islands.

In December 2002, the first sub-sea tunnel in the Faroe Islands was opened between Vágur and Streymoy. This is the first partially user-financed investment of its kind in the Faroe Islands. A second sub-sea tunnel between Borðoy and Eysturoy opened in May 2006. Both passenger and cargo transport is provided daily 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 all other areas. The public transport company, Strandfaraskip Landsins, maintains most of these routes, while numerous private companies offer passenger and cargo services by request.

As of the 1st of January 2008, there were 20,225 registered private cars, which reflects 417 per 1,000 inhabitants.

External

The national airline carrier of the Faroe Islands, Atlantic Airways, is currently the only operator offering routes to and from the Faroe Islands. Depending on the season, there are four to seven daily flights to Denmark (Copenhagen and Billund). Atlantic Airways also flies to Iceland, Norway, Sweden, Aberdeen and London. There are several flights each week to these destinations. The number varies according to season. In 2007, 217,096 passengers travelled through Vággar Airport, which is 5.4% more than in 2006. On 1 May 2007, the Vagar Airport was taken over from the Danish Authorities by a Faroese public limited company. A building project budgeted at DKK 365 million will offer better transit facilities, and the runway will be extended to 1.6 km. The project is financed by the de-capitalisation of the Investment Fund (Íleggingargrunninum) with a corresponding amount.

The ferry *Norröna* is a combined cruise/cargo ship that can carry roughly 1,500 passengers and 800 cars. The ship offers weekly service to Bergen in Norway, Seydisfjørður in Iceland, Scrabster in Scotland, and regular service to Denmark. Nearly 70,000 passengers travelled to the Faroe Islands by sea in 2007.

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.

Telecommunication

In 2007 there were about 21,000 fixed network telephone subscriptions. The number has been falling for some years now. Two telephone companies Faroese Telecom and Vodaphone have 80% and 20% market share respectively.

Mobile telephone subscriptions were 52,169 (half of these were pre-paid cards subscriptions). In the Faroese telecommunications market, Faroese Telecom has 68% and Vodaphone 32% of the market share. The use of mobile technology has increased significantly in recent years. The Faroese mobile phone users also sent about 22 million text messages (SMS) in 2007.

Broadband coverage is high (well over the OECD average) with 13,255 subscribers in 2007 or about 29 subscribers per 100 inhabitants. Also the use of internet generated long distance calling programs, VOIP, has increased.⁸

In 2007 there were about 15,280 cable television subscribers. 50% of the subscriptions were from the Faroese cable television company *Televarpið*, owned by Faroese Telecom Ltd. The rest were from cable television companies outside the Faroe Islands.

Viewers and listeners of television and radio by the Faroese Broadcast Company (*Kringvarp Føroya*) are required to pay a license fee if they have got a receiving set.

Tourism

For many years, efforts have been made to develop the tourism industry as a diversification for the Faroese economy. Information offices are located around the islands and a national development council, *SamVit*, has recently been established to support and co-ordinate the progress of the industry and develop tourism policy.

⁸ Source: Postal and Telecom Surveillance Authority <http://www.fse.fo/>

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

SamVit has just started work preparing a new strategic tourism plan. The aim is to improve international collaboration and support further tourism development. The goal is to generate more income and employment opportunities.

About 116,000 tourist accommodations or stays were registered in the Faroe Islands in 2006. About 75% of the total accommodations were foreign visitors, mostly from Scandinavian countries. From 2005 to 2006, the number of overnight visitors from foreign countries increased by about 19%. Also a growing number of cruise ships visit the Faroese Islands during the summer months.

Due to the lack of current statistical accounts, it is difficult to determine the economic gains from tourism. The direct income effect of the tourism industry is estimated to be between DKK 150-200 million. This figure excludes transport to and from the Faroe Islands.

Tourism is not a major industry in the Faroe Islands. However, given the progress in the Faroese tourism industry to date, it is anticipated that tourism will slowly become a more reliable source of income in the Faroe Islands.

Oil

On 22 December 1992, the Danish Government agreed to transfer the rights to mineral resources in the subsoil 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.

The Act on Hydrocarbon Activities⁹ was passed by Parliament in March 1998. This Act regulates all phases of hydrocarbon activities in Faroese territory. Some aspects of the Act include regulations for a proportion of the licence expenditure being used in the Faroe Islands. This includes the use of Faroese manpower and the supply of goods and services by Faroese undertakings and supply bases, and payments to training and educational measures etc. It is also stated that transport of equipment and passengers to and from offshore installations on Faroese territory shall be conducted via Faroese quay or Faroese airport.

The Hydrocarbon Taxation Act was passed by the Parliament in April 1999, and amended by an Act about special tax from March 2000¹⁰. Income tax from oil production is 27%, besides a 2% production royalty and a field based special tax of "rate-of-return"-type.

The Hydrocarbon Tax Administration Act¹¹ was passed by the Parliament in February 2000.

These regulations laid the final conditions for exploration and production of oil on Faroese territory.

In February 2000, the first licensing round was opened. The area offered for licensing lies offshore to the southeast of the Faroe Islands and covers approximately 14,000 km². In August 2000, seven licenses were awarded to 12 oil companies, organised into five consortia.

⁹ LI 31, 16 March 1998.

¹⁰ LI 26, 21 April 1999 and LI no. 26, 7. March 2000.

¹¹ LI 16, 14 February 2000.

To date, six exploration wells from the first round have been drilled. None encountered hydrocarbons in commercial quantities.

The third exploration well, the Marjun drilling site Licence 001, which was terminated in November 2001, did encounter oil and gas 4,246 m below the surface, but further investigations will be needed to determine if this field is commercial.

In July 2006, Statoil started the first exploration drilling in the thick layers of Basalt rock. Their drilling range (Licence no. 006 from First Round) covers large areas with possible oil and gas pockets. Drilling in the hard Basalt was not as difficult as expected. Traces of gas were found in the well. Later BP, Shell, and Anadarko started drilling through the basaltic layers in 2007-08 (Licence no. 007 from First Round). Although, the well did not encounter hydrocarbons, the findings are expected to give valuable seismic data and expand knowledge about Faroese, Basalt-covered subsurface.

So far the explorations have discovered no commercial findings, but they have showed the presence of an active hydrocarbon system in Faroese subsurface.

The Second Licensing Round was opened 17 August 2004. Seven licenses were awarded to 8 oil companies, organised into five consortia. The Faroese oil companies, Faroe Petroleum Ltd. and Atlantic Petroleum Ltd. participated in 3 of these licences. The areas offered lie southeast and southwest of the Faroe Islands and cover approximately 19,000 km².

The objective of launching the Second Licensing Round was to continue the exploration activities that began under the First Licensing Round and establish the existence of commercially exploitable hydrocarbon reserves in the Faroese subsoil. Until now no exploration drilling plans have been set going, but it is expected that two new exploration wells will be drilled in 2009.

Pursuant to Act no. 45 from 28 May 2008¹² concerning the Third Faroese Licensing Round, the

Minister of Fishery and Natural Resources in July 2008 invited interested companies to apply for hydrocarbon exploration licenses. The acreage offered lies to the east, to the south and to the southwest of the Faroe Islands. It covers 38,405 km². The Minister intends to award licenses by the end of 2008.

From 2008 oil exploration and exploitation is the responsibility of the Ministry of Trade & Industrial Affairs & Natural Resources. The Faroese Earth and Energy Directorate (Jarðfeingi) is responsible for all the administrative tasks related to petroleum exploration and exploitation on the Faroe Shelf.

The influence from the oil industry has not yet had the economic effect that was expected when the explorations first took place. Expectations have become more moderate, the exuberant talk has moderated and circumstances have normalised.

The oil companies as license holders have e.g. through the Sindri programme¹³ contributed to knowledge stock relevant to the future investigation of the Faroese continental shelf.

¹² LI 45, 28 May 2008

¹³ The Sindri Group was officially established by the license holders on 17 August 2001 as part of the stipulated work programmes for licensees within the Faroese area

It is also evident that oil exploration activities have made Faroese firms more aware of expectations while operating in an international business environment.

The offshore base placed in Runavík has proven reliable and effective during the exploration activities. So far, the harbour facilities in Runavík have been expanded, and various companies servicing the oil industry have established a presence there. The same applies to air transport for the oil industry, and helicopter transport between land and the offshore installations is performed via Vágur Airport.

It is difficult to estimate the outlook for future activity. Oil and gas explorations in the Faroese subsoil will continue in new areas in the coming years, and expectations are still kept alive.

4.4 The Financial and Securities Market

Financial affairs (except insurance companies and mortgage-credit institutions) are a "Joint Matter" under Danish State authority and under the supervision of the Danish Financial Supervisory Authority (Finanstilsynet)¹⁴.

Four banks – Eik Banki, Føroya Banki, Norðoya Sparikassi, and Suðuroyar Sparikassi – service the financial market in the Faroe Islands. Kaupthing Bank, a Faroese branch of the parent Icelandic bank, which was mainly involved in industrial financing, stopped in 2007 and most of its' activities in the Faroe Islands were taken over by Eik Banki.

Because of a revision in the banking law, banks and savings banks now compete on equal terms. The law 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.

Savings traditionally were deposited in banks, but lately asset management and investment banking has grown in importance.

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 1992¹⁵, 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 merge¹⁶. The merger entered into force on 1 January 1994 and the merged bank continued under the name Føroya Banki. Today, the situation has turned around and the financial institutions are well consolidated. The economic upturn has largely limited losses and yielded good results on the balance sheets.

Most of the banks activities are in housing funding, but enterprise financing is also an important activity.

¹⁴ Act (Danish Kingdom Law Recommendation) no. 1531, 14 December 2007 for the Faroe Islands about Financial Business & Act no. 87, 10 February 2006 for the Faroe Islands about Securities Trading, etc.

¹⁵ The Financing Fund's board of directors consists of five members appointed by the Faroese Minister of Finance.

¹⁶ 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 assumptions. In an agreement dated 10 June 1998, the Faroese Government received compensation of about DKK 1 billion.

The high level of activity in the Faroese economy has given rise to greater profits within the financial sector. Eik Banki (until December 2006 Føroya Sparikassi) has shown the best results and had its best profit ever in 2007, DKK 437 million from operations. One third of this was from business abroad. Eiks foreign investments include Eik Bank Danmark A/S and Skandiabanken. Eik Banki also runs the real estate company Inni Ltd.

The formerly public-owned Føroya Banki has also shown positive results, DKK 180 million in 2007. In an attempt to move activity abroad, Føroya Banki has established Føroya Banki Ltd. in Denmark. Føroya Banki also runs the insurance company Trygd Ltd. and the real estate company Skyn Ltd. In 2007 the Government sold 2/3 of its' shares in Føroya Banki.

Moody's Investors Service has 16 May 2008 assigned a C- bank financial strength rating ("BFSR") to Faroese bank P/F Føroya Banki as well as A3 long-term and Prime-2 short-term local and foreign currency deposit ratings. The outlooks on all ratings are stable.

Both Eik and Føroya Banki were listed on NASDAQ OMX Iceland hf. in 2007 and double listed on NASDAQ OMX Copenhagen A/S at the same time.

Two small banks, Norðoya Sparikassi and Suðuroyar Sparikassi, have also shown positive results, with DKK 30 million and DKK 4 million in 2007 respectively.

In 2007 total profit in the bank sector was DKK 652 million which is the best result ever.

Various financing institutions than banks both private and public 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, apart from the Financing Fund of 1992, are the insurance companies, Føroya Realkreditstovnur (a mortgage credit institution financing ships), Húsálansgrunnurin (a mortgage credit institution financing residential houses), and Framtak (Faroese Business Development Fund) which provides venture capital as equity and loan to Faroese companies).¹⁷

Several privately owned investment and holding companies now operate in the Faroese business environment and have made investments, bought shares, and placed venture capital in both well-established and new companies. Among these are TF Holding owned by the insurance company Tryggingarfelagið Føroyar, SET and Notio partly owned by Eik Banki and Løkir partly owned by Føroya Banki, and Royndin owned by The Life Insurance Company (Føroya Lívstrygging).

Insurance

In June 2008 a new insurance industry law¹⁸ passed by the Faroese Parliament came into force. In conformity with the insurance industry law from 1997, the monopoly was abolished and a Faroese Insurance Supervisory Body was appointed. This allowed any Faroese company complying with statutory requirements to enter the insurance business on the condition that they obtain permission from the Faroese Government and the Faroese Insurance Supervisory Body.

¹⁷ Act (Danish Kingdom Law Recommendation) no. 87, 1113 20 September 2007 for the Faroe Islands about Commercial Foundations as amended by LI 18 8. May 2008.

¹⁸ LI 55, 9 June 2008.

In 1998, the company, Trygd Ltd., re-started its business as a subsidiary company of Føroya Banki in housing and car insurance and subsequently expanded into ship insurance. Trygd, and the old monopoly incumbent, Tryggingarfelagið Føroyar Ltd. (established in 1940) are currently the only non-life insurance companies active in the Faroese market.

In the last years, competition has increased in the life insurance market. The public owned company Føroya Lívstrygging (also a pension and life insurance company established in 1967) became a limited company in 2000. The Tryggingarfelagið Føroyar company TF Holding established in February 2007 a new pension and life insurance company Betri Pensjón Ltd. (in english: "Better Pension").

The Faroese Securities Market

The Faroese Securities Market, the limited company VMF (P/F Virðisbrævamarknaður Føroya), which was founded in 2000 in cooperation with the Iceland Stock Exchange¹⁹, had its first three bond-listings in 2003. The Faroese Government bonds expiring in 2008, 2010 and 2018 were listed on the market with varying durations, when the Government decided to refinance the DKK 3,074 million debt with the Danish State.

In June 2005, the first company (Atlantic Petroleum) was listed on the VMF market on ICEX (later NASDAQ OMX Iceland hf).

The newly established Faroese Securities Market, organised so Faroese companies are 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 for Faroese companies desiring to expand within the Faroe Islands or abroad. Capital intensive, innovative, and avant-garde industries and businesses benefit from having access to a localised securities market. Such a market will enable investors to safely invest in Faroese companies. With pension savings expected to increase considerably in the coming years, the lack of a securities market would mean this capital would be exported abroad, and would not be available to help Faroese industry.

The securities market is also a tool to not only assist in the privatisation of the publicly owned companies, but also give ordinary people a better understanding of how business works. Thus, a securities market is anticipated to generate greater potential for growth than if no exchange were available.

Four companies are now listed on VMF: Eik Banki, Føroya Banki, Atlantic Petroleum, and Atlantic Airways. These companies are all listed on NASDAQ OMX Iceland hf. and double listed on NASDAQ OMX Copenhagen A/S.

Currency

The currency of the Faroe Islands is the Faroese króna, and is issued by the Danish National Bank. The Danish National Bank considers the Faroese króna to be a "special version" of the Danish krone and unique, Faroese bank notes are in circulation in the Faroe Islands. The Faroese currency is pegged to the Danish krone by the *de jure* Faroese currency board. Thus, the basis of the Faroese króna is an equal amount of Danish kroner deposited in an account in the Danish National Bank. Although the bank notes used in the Faroe Islands are Faroese, the

¹⁹ On 30 March 2004, the Iceland Stock Exchange, now a part of OMX Nordic Exchange, and the Faroese Securities Market (Virðisbrævamarknaður Føroya P/F) entered into an agreement relating to the listing of Faroese securities on ICEX and the facilitation of trading of Faroese securities.

coins are the same as those in circulation in the remainder of the Danish Kingdom. Faroese and Danish bank notes are fungible in the Faroe Islands. The Danish National Bank is the lender of last resort and all local Faroese accounts are denominated in Danish kroner.

A new series of Faroese bank notes have been issued. A new 50-króna note was issued in the summer of 2001, followed by a 100-króna note in early 2003 and a 200-króna note in early 2004. The rest of the series, 500 and 1,000-króna notes, were issued in 2004 and 2005.

With regard to the future of Faroese currency, the Danish people rejected the Euro in a referendum in 2001. The Faroese did not participate in this referendum. This essentially preserved the status quo for the time being.

4.5 Labour Market

In general, the Faroese labour market is characterised 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 receives 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.

In December 2007 there were about 26,000 employees in private and public businesses, 53% males and 47% females. According to a labour survey from November 2007, 81% of the male employee and 51% of the female employee are full time employed.

The Faroese workforce is paid according to different wage systems. Fishermen are paid with a share of the catch value. Others have wage systems stated in the collective agreements between employees and the employers' organisations.

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. Lately, there is growing interest in negotiating longer wage agreements. Several recent agreements have been for more than two years.

In general workers, office workers, and public employee wages only increased moderately in 2005 and 2006, between 1 and 2%. Unskilled workers agreed upon their wages in 2007 with an agreement for the period 1 May 2007 to 1 May 2009. According to this agreement wages in this period will increase 9% including the payments to the workers pension fund.

The main public sector agreement period is from October 2006 to October 2010. According to this agreement wages in the period will increase 10% including payment to the employees' pension fund.

Unemployment insurance has been in effect since 1992. Employers and workers each pay 1% 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. 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 0.62% 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 the Faroe Islands, total wage payments are one of the best and most up to date economic performance indicators.

Total wage payments increased by 12.5% in 2001, 8.7% in 2002, 0.8% in 2003, 1.3% in 2004, 2.4% in 2005, 7.3% in 2006 and 8.0% in 2007 from DKK 6,442 million in 2006 to DKK 6,957 million. Total wage payments increased by 2.7% from January to October 2008 compared to the same period the previous year.

During the economic crisis of the early 1990s, the Faroe Islands experienced an unemployment rate of around 20%. That number 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.

Unemployment is still at a low level. Recent numbers showing less than 2% unemployment.

Usually in times of low growth, the Faroese labour force migrates to neighbouring countries in search of work, as well as immigrating back to the islands in times of high growth. Emigration statistics are therefore a major business cycle indicator. Recently labour shortage has been a growing problem in both manufacturing and construction sector, and it has been difficult to recruit young Faroese people with high education and persuade them to move back to the Faroe Islands. However, changes in the Aliens Act²⁰ in 2008 will make it easier for EU-citizens to get residence and work permits in the Faroe Islands.

4.6 Foreign Trade

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

The trade balance was slightly negative in 2004. The trade balance deficit increased in 2005. The deficit is still present in 2006, but is slightly decreased. In 2007 trade deficit was more than DKK 1.2 billion.

Around 95% 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 2007, 65% of the export and 64% of the import was with EU countries. Outside the EU, Norway, Nigeria, China, Russia and Iceland are the main business partners (see Appendix C, 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

²⁰ Act of the Danish Parliament no. 462 17 June 2008 on foreigners' residence and work permits in the Faroe Islands.

agreement and 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. Excise duties replaced the fiscal import duties. The value-added tax now stands at 25%.

The present trade agreement with EU is from 1996 and became effective 1 January 1997. After negotiations between the parties, many of the restrictions in the original agreement from 1996 were removed, enabling the Faroes to export most of its fish products to the EU market. There remain nevertheless, quantitative restrictions on some areas of vital importance for the Faroese industry.

In 2001, the Faroes and the European Union finished negotiations on a Veterinary Protocol, that is part of the Trade Agreement. In 2005 the Faroes also joined the System of Pan-Euro-Mediterranean Cumulation.

The Faroe Islands also has signed free trade agreements with Norway, Iceland, Switzerland, and a most-favoured-nation clause with Russia. (See also part 3.3 Foreign Relations)

Trade with the rest of the world is based on WTO regulations. The Government has plans to apply for full Faroese membership of the WTO.

The Balance of Payments (BoP)

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 in the early 1990s. During the ten years from 1999 through 2002, the surplus in the BoP was more than DKK 1,000 million or 12% of GDP on average per year (Appendix C, Table 1). Because of the big surpluses since 1993, the net debt has turned into net assets of about DKK 3,738 million in 2006. (See Appendix F, Table 1)

The main reasons were a surplus in trade, the Danish block grant, lower interest payments, and wage transfers from Faroese citizens working in foreign countries.

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 thus 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 implemented. Accounting procedure legislation governing the various types of limited liability companies, as well as legislation regulating the accounting industry, was renewed in 2007 to comply with international accounting and business standards.²¹ Companies can be registered as either public limited liability companies with a share capital minimum of DKK 500,000 indicated by the acronym P/F, or as private limited liability companies with a minimum share capital of DKK 125,000 indicated by the acronym Sp/f.

²¹ Act (Danish Kingdom Law Recommendation) no. 1355 9. December 2007 for the Faroe Islands about annual accounts as amended by LI 18 8. May 2008. Act no. 1356 9 December 2007, Act no. 1111 20. September 2007 and Act 1114 no. 20 September for the Faroe Islands about private, private limited and limited companies as amended by LI 18 8. May 2008.

The act regarding accounting procedures contains provisions 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 engaged in the same type of business.

It has been Government policy to continuously attract foreign investment to the Faroe Islands. Investment and foreign ownership have been common in the trade and construction business. In recent years, foreign investment has also developed in the fish farming sector and telecommunications.

Foreign investment in the fishing fleet is, however, restricted. Fishing vessels under the Faroese flag must be at least 2/3 owned by persons or companies domiciled in the Faroe Islands.

Since 1992, the Faroe Islands have had an International Ship Registry (FAS). Cargo vessels 100 GT or more may be registered in the FAS. Vessels that are registered in the FAS must comply with all relevant international conventions such as the Convention on Safety of Life at Sea (SOLAS), the International Convention on Tonnage Measurement of Ships 1969 (ITC 69), and The International Standards of Training, Certification and Watch keeping for Seafarers 78 as amended in 1995 (STCW), etc.

5. THE PUBLIC SECTOR

The Faroe Islands public sector plays an important role in the development and maintenance of the country's welfare system, which is based on The Scandinavian Welfare Model.

Of the DKK 4 billion the authorities used for expenses and investments in 2007, the proportional distribution was as follows: Social Security and Pensions 34.3%, Education, Research and Culture 20.5%, Health 16.8%, Political Administration 12.6%, Transport and Communication 9.5%, and Economic Affairs 6.3%.

Investments in 2007 were DKK 292 million. Most of the investments went to transport and communication (DKK 125 million), health and social security (DKK 74 million), and education and culture (DKK 70 million).

The largest, single-item expenditure on the public account was Social Security and Pensions DKK 1.4 billion. Of this, DKK 260 million went to social protection, DKK 480 million to home-based care, care of elderly and handicapped, DKK 400 million to the National Pension Scheme and DKK 210 million to National Supplementary Disability Pensions.

The public income in 2007 was about DKK 4.2 billion. Of this DKK 3.6 billion comes from income and corporate taxes (DKK 1.8 billion) and VAT and duties (DKK 1.7 billion), DKK 632 million was block grant from Denmark and income from share returns and interests was about DKK 50 million.

The Public Account surplus was DKK 145 million in 2007. This was about DKK 140 million more than provided for in the budget. This positive result is mainly due to DKK 100 million more income from taxes and duties than estimated in the budget.

The public sector also runs some publicly owned companies and also completely or jointly owns some limited companies.

Among the public funds are e.g. the Mortgage Credit Institution (Realurin), which finances the acquisition of new fishing ships, the House Financing Fund (Húsálánsgrunnurin), the Investment Fund (Framtak), the Unemployment Insurance Fund (ALS), the Pension Supplementary Fund (AMG), and the Industry Promotion Fund (Vinnuframagrunnurin).

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 has been in the form of a general block grant.

The Danish block grant for 1995 to 1998 was fixed in real terms, and since 1999 the block grant has been fixed in nominal terms. The grant for 2002 was reduced by DKK 366 million to DKK 630 million in part because the official transfers of public education to the Faroese authorities. The Faroese and the Danish Governments agreed that the grant be fixed in nominal terms at DKK 615.5 million per year from 2003 until 2006. The grant has been on the same level in 2007 and 2008.

New negotiations between the Faroese and Danish governments on the block grant are expected to take place in 2008.

In 2006 the Danish State expenditure and investment in Danish institutions in the Faroe Islands was about DKK 250 million. In 2007 the Danish State also paid about DKK 95 million to War Disablement Pensions and other pensions.

Faroese students who study in another Nordic country receive educational aid in the same way as Danish students.

5.1 Foreign Currency Rating

In October 2008 the Moody's Investors Service affirmed its Aa2 foreign currency rating with a stable outlook to the Faroe Islands. This rating reflects a Baseline Credit Assessment (BCA) of 5 (on a scale of 1 to 21, where 1 represents the lowest credit risk) and a high likelihood that the Kingdom of Denmark (Aaa, stable) would act to prevent a default by the islands.

In the Credit Opinion report from 13 October 2008, the Moody's Investors Service explains that The Faroe Islands' BCA of 5 reflects a number of factors, including their economic strength and increasing diversification. The BCA also reflects the government's powers to raise revenues through taxation and fees and to control spending as well as the strong financial results achieved since 1995. The Faroese government maintains ample reserves, while the debt level is moderate and decreasing and the interest burden falling. The BCA takes into account the islands' relationship within the Kingdom of Denmark and the subsidies it receives for joint matters, which it administers in conjunction with the Kingdom of Denmark. The support also take into account the establishment of the settled relationship the Faroese have with Denmark in the consideration of further autonomy and potential independence.

Among the credit challenges the Moody's Investors Service mentions were the volatility of the fishing industry as well as substantial challenges in the management of commercial exploitation of its fishing grounds. It is also mentioned that the trade balance has moved sharply negative and would be further weakened by any decline in fishing, which makes up all of export. The Moody's Investors Service see it as a challenge that the Governmental accounting standards, including the monitoring and control of municipal governments within the Faroe Islands, are not as comprehensive as those of other Nordic countries.

5.2 Public Income

Apart from the grant from Denmark, the total public income originates mainly from income and corporate taxes and VAT and duties.

The Faroese Government fixes and collects duties, taxes, income and corporate taxes, customs duties, production and vehicle taxes. Municipality income derives mainly from income taxes. The Government collects all taxes and transfers the municipalities their share.

A & B-income

Two classes of personal income taxes are defined: taxes from wage income, which is, for the most part, defined as A-income, and taxes from business income, mainly defined as B-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 centralised tax system. Each tax payment is calculated based on the income up to the date of the latest wage payment, which is then converted into annual income.

The calculation of the tax from B-income is based on the expected yearly income a person has from a business or self-employment, rent, or additional income. The amount is divided into 12 monthly payments. B-income does also include some benefits such as deductions for expenses.

Adjustments are made after the close of each year, and then excess tax is refunded, and extra tax owed is collected.

The highest tax rate (government and municipality combined) in 2008 is between 49% and 56.5%, depending on municipality. The tax ceiling is 50%, which means that no one has to pay more than 50% of their yearly income as tax. This excludes payments of about 3.4% to different funds.

Members of National Church also pay church tax, on average 0.66%. Every person from 18 years old shall also pay a yearly fee to a local Sick-benefit association (In Torshavn DKK 2,640). The yearly radio and television licence fee for the Faroese Broadcast Association (Kringvarp Føroya) is DKK 3,625 incl. VAT.

Income tax levied by the Customs and Tax Administration is calculated on a sliding scale, with various allowances having the highest marginal rate of 33% in 2009. However, municipal taxes are calculated on a fixed rate.

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.

Basic personal allowance is DKK 30,000, which can be transferred between husband and wife. For each child under 18 years the annual income is deduced by DKK 5,500.

Municipal taxes are assessed using the same calculation of income as that of the Customs and Tax Administration, except that a flat tax rate is used. The economic situations of the municipalities differ greatly. In 2008, municipal taxes ranged from 16% to 23.5%.

On average, the tax is 20.65%. For each child under 18 years the annual income is deduced with between DKK 3,000 and DKK 6,500 depending upon in which municipality one resides.

Corporate Taxes

All corporations in business must render an account and are allowed to deduct for expenses.

Corporate taxes before 1999 were 27%, but have since been lowered to 18%. Of the tax amounts, 62% is paid to the national Treasury, and the remaining 38% to the local municipal authorities.

The tax rate for companies in the oil industry still remains at 27%, which is all paid to the national Treasury.

The corporations that do not pay VAT, like banks and insurance companies, must pay a 5% tax on total paid wages.

Shipping firms with ships registered in the Faroese International Ship register (FAS), will get back 30% of wages and other payment paid to persons liable to pay taxes in the Faroe Islands.

Capital Gains Tax

Interest on deposits in Faroese 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%. However, this does not include corporations and some foundations, which pay a corporate tax of 18%. There is no property or wealth tax.

Customs and VAT

The Faroese Customs Act is based on the international World Custom Organisation's (WCO) Harmonised Commodity Description and Coding System (HS Code). Customs duties are based on the GATT rates. Because of the trade agreement from 1992 with the EU, renewed by agreement in January 1997, the fiscal duties levied on imports are replaced by a value-added tax (VAT – normally 25% of invoice value) and excise duties on some consumption items.

The Faroe Islands also has signed free trade agreements with Norway, Iceland, Switzerland, and a most-favoured-nation clause with Russia. With a few exceptions VAT is imposed on all internal trade and delivery of services.

5.3 Public Expenditure

The distribution of government expenditure for different items follows the new budgeting procedures and shows actual financial outlays (Appendix F, Tables 1 and 2). Investments in large assets are financed largely by current provisions and are booked immediately as expenses in the appropriate fiscal year.

There are exceptions to this rule. Lately, a new procedure has emerged wherein public limited companies are created to operate and manage public services and large, public construction projects. This has been the case for Faroese Telecom, the Postal Service, the sub-sea tunnel between Vágur and Streymoy, and the sub-sea tunnel between Eysturoy and Borðoy.

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. The policy is to stress the need for the industry to be cost efficient and independent of public funds.

Historically, outlays for effective guarantees have been massive. In 1991, private guarantees amounted to DKK 642 million. They were zero in 2003. New outlays from 1999 and onward have been at a minimum and the public guaranteed debt is decreasing. In 2007, all guaranteed debt was only DKK 3 million for loans raised by the municipalities. In addition the Government also guarantees for private insurance policies made before 1999 in the Faroese Life Insurance Company (Føroya Lívstrygging) and is by law committed in the future to pay pensions to politicians and some public servants.

The interest line item in the budget increased as the public sector took over a greater part of the private debt during the depression. In 1995, interest expenses were 16% of the total budget, but after the debt agreement with Denmark in 1998, interest payments were halved. In the Public Budget for 2008 interest expenses appropriation is DKK 122 million, 2.6% of total expenses DKK 4.7 billion.

5.4 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 changed 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.

5.5 The Current Public Budget Status

The Government account has shown both surplus and deficits from 2001 to 2007 (see Table below). The budgeted deficit for 2006 was set at the same level as in 2005, but the result showed a DKK 142 million surplus due to an increase in tax revenue. The Public Account surplus was DKK 146 million in 2007 (see also Appendix F, Table 2).

In 2008 the expected budget surplus will be about DKK 5 million.

The repayments of principal and interests on loans in 2005 were DKK 2,100 million (DKK 138 million in interests and DKK 1,952 million in repayments). This is due to a prepayment of the DKK 1,494 million debts with the Danish State. This payment was financed by issuing new bonds of DKK 1.9 billion. The repayments of principal in 2006 were DKK 900 million and interest payments were DKK 50 million. The debt was partly repaid with the proceeds of DKK 600 million in extraordinary dividends from the Financing fund of 1992 and by a reduction in liquidity. In 2007 repayments of principal and interest on loans were about DKK 80 million in interests and about DKK 75 million in repayments. As part of privatisation plans, the Government in 2007 sold 2/3 of its shares in Føroya Banki and 1/3 of its shares in Atlantic Airways. This increased the Government financial liquidity by about DKK 1.3 billion.

The total appropriation for interest expenses in 2008 budget is DKK 122 million.

Income

Economic growth increased the level of public income dramatically both in 2000 and 2001, growth was around 10%. Tax and VAT revenues stagnated in 2003 to 2005 but have shown big growth in 2006 and 2007 as the economy grew. The growth in the public income will probably plateau in 2008 due to expected lower economic growth. Public income will depend on the level of economic activity, and be influenced by the export prices and activity.

Expenditures and Investments

From 1998 to 2007, public expenses increased steadily by approximately 5% annually. The increase was high from 1999 to 2002, but in 2003 the Government stopped the accelerating growth in expenses and has managed to maintain this low growth policy ever since.

Investments have grown from DKK 100 million in 1998 to DKK 292 million in 2007. Expected investments in the 2008 budget are DKK 234 million. Interest payments were high in 1997, 18% of net-expenses. Interest payments were significantly lower in 1998, 14% of net-expenses and have, since 2005, fallen subsequently well below 4% of net-expenses.

Policy

Due to an expected fall in the economic growth rate in 2008, the current economic policy could be called less expansionary than the economic policies from the last 4 years. The Government has cancelled planned tax cuts in 2009, but investments and expenditures will apparently be on the same level, even though public income may go down.

The newly formed Government wants to pursue a cautious fiscal and economic policy and seek new sources of revenue. A more stable and durable economic growth will make it easier to withstand internal and external business fluctuations.

At present no actual plans are for further privatisation of publicly owned companies. If viewed beneficial for the society and the business environment, privatisation will continue. The companies still public are: Faroese Telecom, the Postal service, and the Life Insurance Company. The Government still owns 1/3 of the shares in Føroya Banki, and 2/3 of the shares in the airline Atlantic Airways.

5.6 Government Foreign Debt

From 1992 to 1997, the Faroese 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, which was established with the purpose of restructuring the banks,²² and rearranging foreign debt elsewhere with loans from the Danish Government.

In an agreement on 10 June 1998 between the Danish Government and the Faroese Government, the debt was reduced with DKK 900 million. DKK 500 million of the remaining debt was placed as a loan interest-free and free of amortisation and written off in 20 years if the Faroe Islands had not, in the meantime, started extraction of raw materials from the subsoil. The remaining debt, a DKK 4,023 million annuity loan, should be paid back in 20 years. Interest was 5% per annum.

In December 1994, the Faroese Government issued bonds for public sale for the first time. In addition to meeting the liquidity demands of the Treasury, the aim was 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.

It is common practice that the Government refinances maturing bond loans by issuing new bond loans. In November 2003 and November 2005, the Government also issued bonds in order to make extraordinary repayments on loans from the Danish State. Debt to the Danish State has also been repaid by reducing liquid reserves.

The total Government debt at the end of 2007 was DKK 3.4 billion. Total assets were DKK 4.8 billion and net assets DKK 1.4 billion (see Appendix G, Table 1).

The Government's long-term liabilities are about DKK 2.2 billion in Government Bonds running for 1 to 10 years. In 2008 about DKK 1 billion will be refinanced by issuing new bonds. Government bonds are registered with the Danish Securities Centre and listed on the Faroese securities market and on NASDAQ OMX Iceland hf. and NASDAQ OMX Copenhagen A/S.

²² As a consequence of the bank-crisis the government deposit in the Financing Fund (Figgingargrunnurin frá 1992) was written down with DKK 2,685 million in 1993.

5.7 The Municipalities

The Faroe Islands has 34 municipal councils that vary in population from 43 to 19,429 inhabitants.

In 1995, the Faroese Government appointed a committee to make a proposal for a new municipal system. 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 idea of merging municipalities is controversial, but sentiments seem to be moderating. Some municipalities have merged over the last few years, and other municipalities have decided to follow suit.

In 2004, the number of municipalities was reduced from 48 to 34. By the end of 2008, the number of municipalities will be 30.

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

In 2007, it was decided that the number of municipalities should be 7.

The Government has decided to reach this goal in this election period ending in 2011.

The municipalities' income was about total DKK 1.4 billion in 2007. Net expenditure on operations was DKK 990 million. The net expenditure is divided in the following items: social security and health care 37%, construction work and goods and services 27%, education and culture 21%, and administration 15%. The municipalities' total investments were DKK 486 million in 2007. Interest expenses were DKK 17 million. In the 2008 budget, expenses are expected to increase 10% and investments by about 25%. This increase in activities will lead to new borrowing requirements at about DKK 200 million.

By the end of 2007, the municipalities' debt was about DKK 17,000 per inhabitant. Some municipalities have modest debt or no debt at all, while 12 of the municipalities have debt ranging from DKK 20,000 to 50,000 per inhabitant. For those municipalities that have large debt, interest and instalments comprise a large part of the municipal budget. The total municipal gross debt in 2007 was about DKK 800 million.

The municipalities jointly run a refuse disposal plant (IRF) and an electric power station (SEV).

The municipalities are organised in two organisations. The Faroese Municipal Organisation (Kommunusamskipan Føroya) is the organisation of the greater municipalities of the Faroe Islands, while the smaller municipalities are organised in The Faroese Municipal Society (Føroya Kommunufelag).

6. OUTLOOK

In the past 2-3 years, economic progress in the Faroe Islands has been attributed first and foremost to domestic demand. Improved financing opportunities on financial markets and lower taxes for households have boosted consumption and investment. The central government and municipalities have increased spending significantly. This has particularly affected activity in the service industries, as well as the building and construction industries. Structural changes in parts of the business sector have contributed to dynamism.

Supply of raw material has been uneven in the natural resources industry, where the quantities of fish have in particular pulled down the value of exports, while production has increased in fish farming. There has been tremendous pressure on the labour market, particularly in the fishing industry and on skilled labour, making it difficult to optimise production; in the fishing industry, production has been below potential and in the building and construction industry, the situation is analogous, making it difficult to plan, and thereby, optimize resources and production.

The fish based industries are demersal fishing with the Faroes, demersal fishing in foreign waters, pelagic fishing and fish farming. These four industries are all important and have different business cycles. Demersal fishing in Faroese waters has experienced a sharp reduction in production and export value. Demersal fishing in foreign waters and pelagic fishing are in good shape with relatively positive outlook and the fish farming industry is contributing positively to the production and export value. All together a flattening out in incomes from these industries is expected in the near future.

The global financial crisis and the uncertainty regarding the global economy make it more difficult than usual to evaluate the outlook for the Faroese economy. The financial crises should not have severe direct effects in the Faroes other than investors' losses on securities. The banks are mainly traditional deposit financed banks (about 70% of the funding is from deposits). They have increased their funding on the money market the recent years and can expect increased funding costs in the near future and can therefore be expected to stop the growth in lending compared to the latest years as mentioned above.

The public sector has had an expansionary effect on economic growth in 2008 by increases in spending and tax cuts. It is doubtful whether the public sector can achieve balance or surplus with the existing tax levels to meet the current known demands on future spending. It is therefore doubtful, whether the public sector can afford to be the prime engine in the economy given it has played this role of increasing operational spending and tax cuts since 2003. The government can maybe increase investments but municipalities will probably reduce them.

Company mergers and acquisitions have been continuing but will probably slow down. To the extent this leads to increased productivity, this has a positive effect on the economy.

The households can be expected to be more cautious and reduce consumption as a part of income because of the more pessimistic outlooks in the world economy in the near future.

The economic activity will therefore probably be affected negatively in 2009 relative to 2008.

7. LINKS²³

THE PARLIAMENT

Løgtingið - The Parliament <http://www.logting.fo/>

THE GOVERNMENT

Løgmannsskrivstovan - Prime Minister's Office <http://www.tinganes.fo/>

Fíggjarmálaráðið - Ministry of Finance <http://www.fmr.fo/>

Vinnumálaráðið - Ministry of Trade and Industry <http://www.vmr.fo/>

Fiski- og tilfeingismálaráðið

Ministry of Fisheries and Natural Resources <http://www.fisk.fo/>

Mentamálaráðið –

Ministry of Education and Culture <http://www.mmr.fo/>

Almanna- og heilsumálaráðið –

Ministry of social security and health <http://www.ahr.fo/>

Løgmálaráðið - Ministry of Justice <http://www.imr.fo/>

Uttanríkisráðið - Ministry of Foreign Affairs <http://www.mfa.fo/>

GOVERNMENT INSTITUTIONS

Landsbanki Føroya - Governmental Bank <http://www.landsbankin.fo/>

Hagstova Føroya - Statistics Faroe Islands <http://www.hagstova.fo/>

TAKS – Custom and Tax Authorities <http://www.taks.fo/>

Landsgrannskoðanin –

The National Audit Office <http://www.lg.fo/>

Fiskirannsóknarstovan –

The Faroese Fisheries Laboratory <http://www.frs.fo/>

ALS – The Unemployment Fund <http://www.als.fo/>

THE HIGH COMMISSIONER

Ríkisumboðsmaðurin -

The High Commissioner of The Faroe Islands <http://www.rigsombudsmanden.fo/>

MUNICIPAL COMPANIES

SEV - The Municipal Electrical Power Plant <http://www.sev.fo/>

IRF – The Municipal Refuse Disposal Plant <http://www.irf.fo/>

BANKS

Føroya Banki <http://www.foroyabanki.fo/>

Eik <http://www.eik.fo/>

Norðoya Sparikassi <http://www.ns.fo/>

Suðuroyar Sparikassi <http://www.sparsu.fo/>

INDUSTRY

²³ Information on some of these homepages is in Faroese.

Samvit –

The Faroese Business Development Office
Vinnuhúsið - House of Industry

<http://www.samvit.fo/>
<http://www.industry.fo/>

Virðisbrævamarknaður Føroya (VMF) –

The Faroese Securities Market

<http://vmf.fo/>

Jarðfeingi –

Faroese Earth and Energy Directorate

<http://www.jarðfeingi.fo/>

TRANSPORT AND COMMUNICATION

Strandfaraskip Landsins –

The Public Transport Company

<http://www.ssl.fo/>

Atlantic Airways

<http://www.atlantic.fo/>

Smyril Line

<http://www.smyril-line.com/>

Fjarskiftiseftirlitið –

Postal and Telecom Surveillance Authority

<http://www.fse.fo/>

Føroya Tele Faroese Telecom

<http://www.ft.fo/>

Vodafone

<https://www.vodafone.fo/>

Postverk Føroya – The Postal Service

<http://www.postverk.fo/>

INSURANCE COMPANIES

Tryggingarfelagið Føroyar –

The Faroe Insurance Company

<https://www.trygging.fo/>

Trygd

<http://www.trygd.fo/>

Lív - The Faroese Life Assurance Company

<http://www.liv.fo/>

Betri Pensjón – Better Pension

<https://www.betri.fo/>

BUSINESS INFORMATION

Faroe Business Report

<http://www.faroebusinessreport.com/>

fishin.fo

<http://www.fishin.fo/>

Faroeislands.com Tourist Guide

<http://www.faroeislands.com/>

Føroya Vinnuskra –

Faroe Islands Business Directory

<http://www.vinnuskra.fo/>

Nummar.fo - Faroese Telephone Directory

<http://www.nummar.fo/>

finn.fo - Faroese Telephone Directory

<http://www.finn.fo/>

Faroe Islands Fisheries & Aquaculture: Responsible management for a Sustainable Future. 2008. (The report can be downloaded under 'Kunningartilfar' on Fiski- og tilfeingismálaráðið - Ministry of Fisheries and Natural Resources: <http://www.fisk.fo/>)

Statistical information provided by Hagstova Føroya/Statistics Faroe Islands and Landsbanki Føroya/Governmental Bank unless otherwise stated.



Landsbanki Føroya

GOVERNMENTAL BANK

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