

Faroese Economic Council
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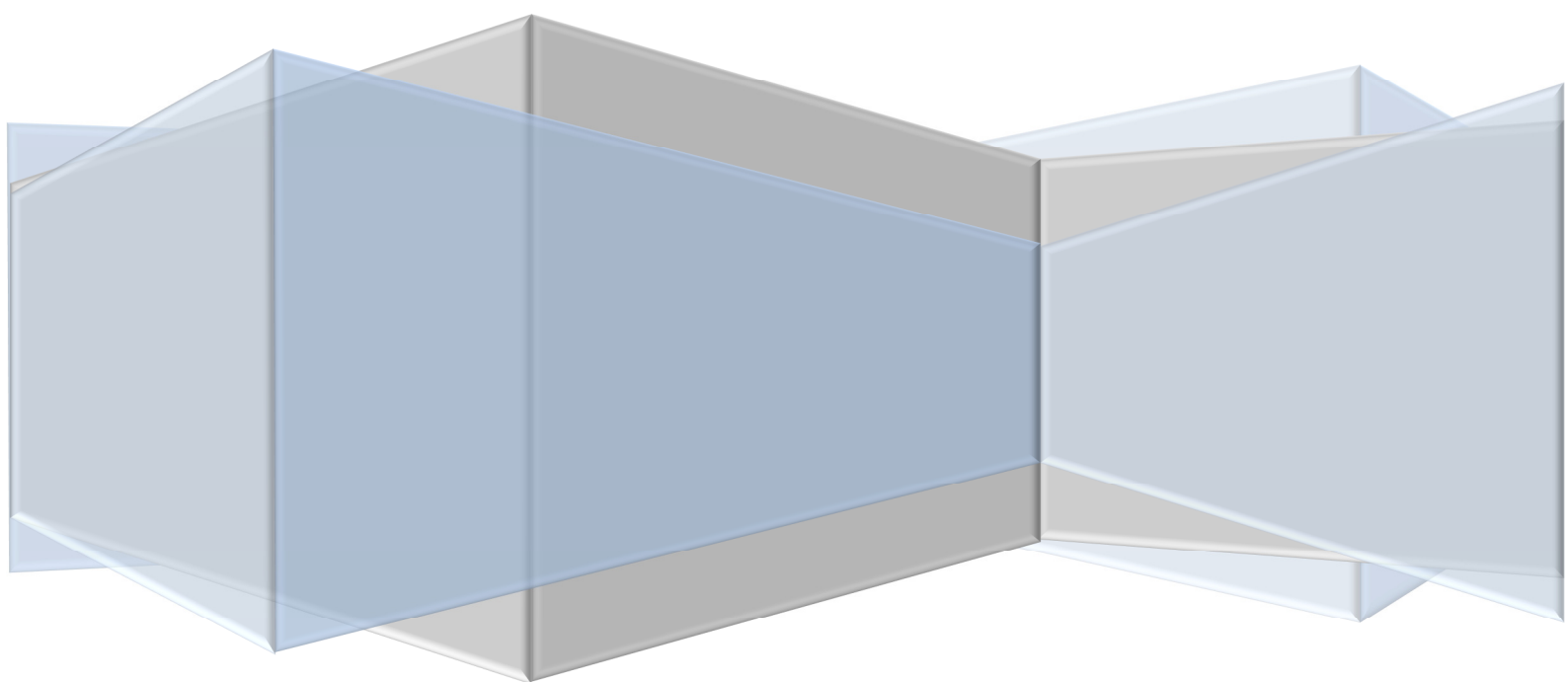
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Economic Report

Faroese Economic Council

Autumn 2012



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THE FAROESE ECONOMIC COUNCIL

The Faroese Economic Council hereby publishes its autumn 2012 economic report. Pursuant to Faroese Parliamentary Act No 50 of 11th May 2009 on the Economic Council, the Faroese Economic Council twice a year publishes economic reports.

The members of the Council of Economic Advisers are elected for a term of three years and six months starting from 1st July 2009. The Council is assigned to monitor the Faroese economy and to deliver independent economic advice and reports on economic development. As prescribed in the Act on the Economic Council, the Council will publish two economic reports per annum which are published March 1st and September 1st.

The secretariat to the Economic Council is placed at the Faroese Governmental Bank according to an agreement.

The members of the council are:

Thomas Dam, *cand.merc, chairman*

Durita Tausen, *cand.scient.oecon*

Gunn Danielsen, *cand.polit*

1. SUMMARY AND RECOMMENDATIONS

Initiate further measures to reduce youth and long-term unemployment In international comparison, unemployment in the Faroe Islands is not considered high. The phenomenon of long-term and youth unemployment can nonetheless prove to have damaging effects on economic growth in the long run. Faroese authorities should therefore – alongside the measures undertaken by the Faroese Unemployment Scheme (ALS) – initiate further measures aimed at decreasing unemployment further.

p. 11-12

Provide clear information on the true rate of youth unemployment According to official statements, the unemployment rate in the age groups between 16-24 and 25-34 is around 5-6%. The actual rate of youth unemployment can however prove to be higher than indicated by the statistics. It is therefore vital to coordinate the statistical data from ALS, The Department of Social Service, the Faroese Student Grant Fund etc., in order to get a complete overview of the youth unemployment.

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Investments in education prevents unemployment ALS statistics indicate that long-term unemployment is equally severe in the Faroe Islands, as in neighbouring countries. The best instrument to prevent unemployment is to ensure that the entire workforce is given the opportunity to obtain further education. During times of economic crisis, it is usually unskilled workers who are struck the hardest by unemployment. Furthermore, the technological development is expected to reduce demand for unskilled work in the future. It is therefore important that all people have the opportunity to educate themselves beyond primary and lower-secondary school.

p. 11-12

More admissions to upper secondary schools and technical schools as well as additional apprenticeships It is recommended that the upper secondary schools and technical colleges be granted more funds, with a view to admitting more students. According to numbers from the Ministry of Education, Research and Culture, the upper secondary schools were forced to turn down around 100 qualified applicants due to shortage of student places. Specific educational institutions in particular are experiencing that the numbers of applicants are outnumbering the places available.

p. 17-18

Other initiatives to prevent youth unemployment could be to establish more public sector apprenticeships and provide financial support to private businesses and masters who take on new apprentices. Given the financing is in order; this sort of financial support system can be established within a short period of time and should not require much preparation.

p. 17-18

Supply a wider range of higher educations It can have severe consequences that a great number of young Faroese people travel abroad to seek education and do not return to the Faroe Islands. The people moving abroad are between 20-29 years old, which is the age where people seek education. The choice to move abroad within this particular age group can therefore be connected to the lack of educational opportunities in the Faroe Islands. The prospect of keeping the Faroese youth in the country for a longer period of time would be increased if the possibilities for higher education were increased. The longer the young people live in the Faroe Islands, the deeper their connection to the Faroese society is expected to become and thereby the possibility of them returning enhances. Offering a wider range of educational options could thereby prevent some of the young

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people from moving, and enhance the prospect of people returning to the Faroe Islands after having finished their education abroad.

The need to revise the fishing industry is evident The Faroese government has set out to modernise the Fishery Legislation. The need to change and modernise the legislations concerning the fishing industry is clear. The past years poor profitability in the fleet fishing in Faroese waters combined with the uncertainty regarding the allocation of the fishing rights for mackerel are clear indicators of a need for a revised system.

p. 19-20

Important features when updating the fishing industry When planning to revise the fishing industry, there are several different areas and issues that must be taken into account. A continuing development of instruments, which can contribute to managing the fishery in a sustainable manner, is an important factor. When updating the regulations in the upcoming years, there are some main points, which need to be addressed:

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- The fishing industry has to be run in a biologically as well as economically sustainable manner
- That the fishing industry *and the Treasury* – and thereby society as a whole – benefits from a greater return from its natural resources
- Market access and environmental labels (*eco labels*)

Cod and haddock stocks on the Faroe Shelf are in a historically poor condition Since 2004, the annual catch of cod has been approximately 10,000 tonnes, which is well below the last 100-year average of around 25,000 tonnes. Marine biologists have estimated that if the cod stock in the Faroe Shelf was around 80-100,000 tonnes, it would be possible sustainably and sensibly, to catch 25-30,000 tonnes annually. Due to the cod stock's poor condition, the catch is annually short around 15,000 tonnes – landed values at well above DKK 200 million.

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The system of fishing days ought to be revised The Economic Council recommends that the current system of fishing days be revised. The possibility of implementing a system of quotas, as seen in the neighbouring countries, ought to be discussed. Marine biologists are questioning whether sustainability is obtainable within a system of fishing days, area preservations and technical regulations alone.

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The stipulation of fishing days ought to be moved from the parliament To the knowledge of the Economic Council, the Faroese parliament is the only parliament in the western world, which stipulates the allowed catch and other decisions regarding fishery. Decisions regarding a country's fishing industry are normally maintained by the Ministry of Fisheries and Maritime Affairs or an affiliated institution and are based on independent biological recommendations. It is therefore recommended that the stipulation of fishing days be removed from the parliament.

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The Faroese Treasury and society as a whole should retrieve a greater return from the marine resources One objective in changing the fishery regulations is that the treasury will retrieve a greater return from the natural resources in Faroese waters. If

p. 20-21

society yielded a greater return from the allocated fishing rights, it could for instance lead to a lowering in income taxes, which would benefit all.

It ought to be discussed - and concluded upon - how the public sector through fishing fees or by allocating fishing rights via an organised market system, can generate higher returns from natural resources in Faroese waters. In 2011, an experimental scheme regarding the allocation of fishing rights for mackerel proved a success. Apart from a few issues, which can be resolved with minor adjustments, the scheme was successful. Compared to the current system, transparency is one of the advantages of a system where rights are allocated according to regular market conditions.

Growing importance of eco labels The demand for sustainably produced fish products is increasing. On the area of pelagic fisheries and fisheries in the overseas areas, several Faroese businesses have received MSC-approval. The demersal fishery in Faroese waters is however yet to receive an official label marking the fishery sustainable. According to recent information, the factory trawlers Gadus and Vesturvón have received MSC-approval for their cod and haddock fishery in the Barents Sea.

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In order for Faroese businesses to receive eco labels for demersal fishery and thereby gaining access to important western markets, the future development of the administration and sustainability of Faroese fishery is crucial.

Fishing rights should be allocated according to clear procedures The distributional issues following the development in the mackerel fishery has shown that the administration is lacking necessary tools to allocate fishing rights - especially in situations where it is difficult to allocate the fishing rights according to historical catches. Regarding mackerel, the total quota was allocated based on a political administrative procedure, agreed upon without any prior guidelines on the area.

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A consequence of this procedure is that valuable natural resources are allocated to certain businesses and sectors in the industry almost free of charge - and on unclear grounds. The allocation of mackerel quotas can be expected to follow specific procedures in the coming years. The current questionable procedure of allocating quotas without clear general guidelines can be considered most unfortunate, especially since the procedure to some extent is going to set precedents for future allocation of quotas.

The mackerel fishing rights serve as a governmental subsidy system Part of the mackerel fishing rights for the 2012 season was allocated to a group of ships, which were not equipped for mackerel fisheries (given the short notice in 2012) and the rights were then forwarded (i.e. sold) to other groups of ships. The logic of this procedure can therefore be considered as a support system, where mackerel fishing rights to some extent were used as governmental subsidies to a specific group of ships, who for years have suffered from poor profitability. If it is a political desire to subsidise industries, it is better done through direct public operating subsidies.

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Total production in 2012 is on the same level as 2011 Projections indicate that GDP in current prices in 2012 and 2013 will grow 2.5% and 3.6% respectively, and if the average growth in consumer prices continues throughout 2012, it is likely that the total

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production in 2012 will be the same as last year. Faroese households are still cautious and household consumption is still relatively low.

The global economic growth outlook deteriorated in the first six months of 2012 and growth projections have decreased in most countries. However, recent developments indicate that the current slump in the European economy might start turning around.

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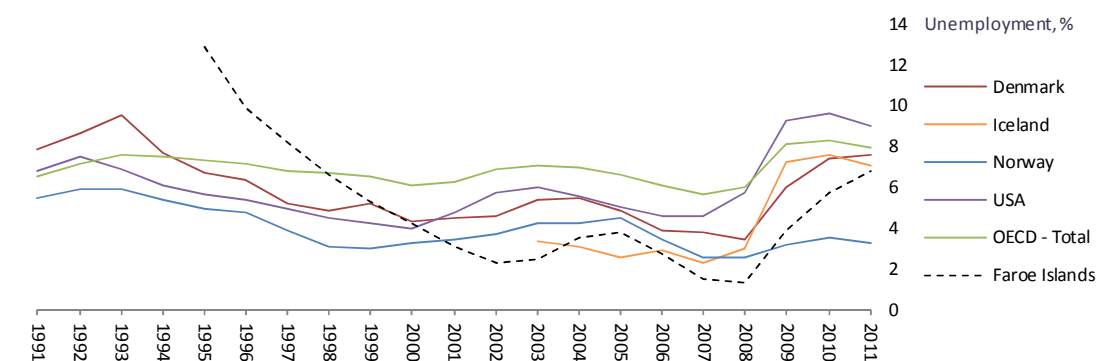
2. INCREASE SUPPLY OF EDUCATION OPPORTUNITIES TO PREVENT EMIGRATION AND UNEMPLOYMENT

2.1 INTRODUCTION

Since the financial crisis started to unfold in 2007, western countries have experienced rapidly growing unemployment and many countries are experiencing the highest rate of unemployment since the crisis in the 1930s. Unemployment has also gone up in the Faroe Islands (Figure 2.1). In July 2012, the unemployment rate was estimated at 5.2% (approx. 1,400 people), which is considered high in Faroese terms. Unemployment has gradually decreased since the beginning of 2011, where unemployment nearly reached 8%, being the highest since the crisis in the 1990s.

Unemployment, by country, 1991-2011

FIGURE 2.1



Source: Statistics Faroe Islands and OECD.

During times of unemployment, the Faroe Islands normally experience increased emigration. People move to neighbouring countries in search for work and education. During the past three years, the level of net emigration has increased significantly. Close to 400 people net emigrated during 2011, while the net emigration during the years 2005-2007 was around 200 people. Immigration and emigration by age in 2011 is shown in figure 2.2. Moreover, the fact that a larger part of the younger generation is seeking higher education abroad is a contributing factor to the rising level of emigration.

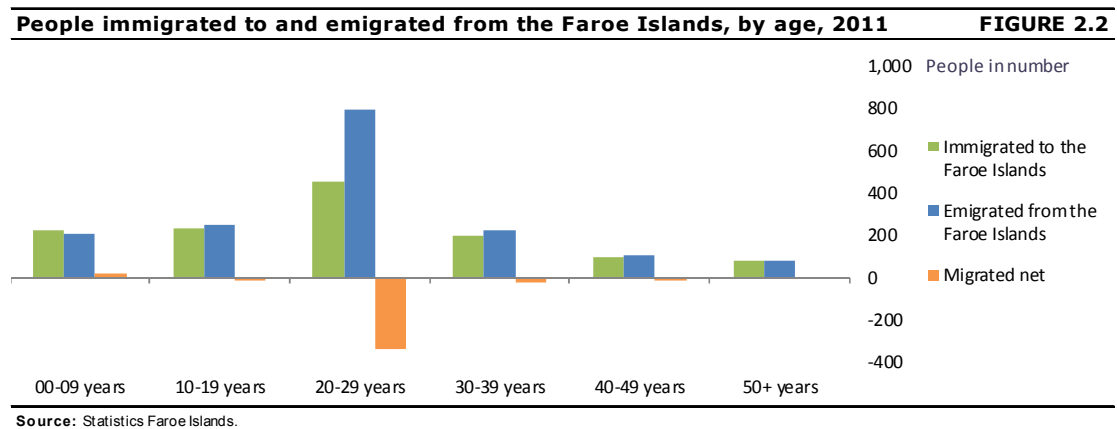
Apart from the crisis during the 1990s, the Faroe Islands do not generally experience high rates of unemployment. This can to a large extent be explained by a tendency for the workforce to seek employment in neighbouring countries during difficult times in the Faroe Islands. Official unemployment benefits were not introduced until the 1990s. A lacking support system is bound to have contributed to the emigration during times of crisis in the Faroe Islands prior to the 1990s.

It is extremely unfortunate for an economy to have parts of the labour force which are not fully active. When part of the labour force is unemployed, it represents a resource, which is currently not contributing to value adding. Similar to other western countries, unemployment and part of the workforce not being fully utilized are factors contributing to low economic growth in the Faroe Islands. High youth and long-term unemployment can

also be detrimental to economic growth in the long run. If people get detached from the labour market, it can cause unemployment to continue even after an economic upturn.¹

There are indications that structural unemployment, i.e. the expected unemployment rate under *normal* economic conditions, is low in the Faroe Islands. The Faroese labour market is highly flexible and transitional forces between industries are effective.

According to official statistics, the Faroe Islands are not troubled with high youth unemployment. In the age groups between 16-24 and 25-34, the unemployment rate is 5-6%,² which is not high in international comparisons. However, the *true* rate of youth unemployment can be higher than indicated by official numbers. Unemployment in the Faroe Islands is at the moment decreasing more rapidly than in neighbouring countries (Figure 2.7). Long-term and youth unemployment are nevertheless considered such serious issues that public authorities should initiate preventative measures.



It is recommended that the authorities invest more in medium long and long educations, which would enable the Faroese University (Fróðskaparsetur Føroya) to admit more students. Figure 2.2 shows that particularly young people aged 20-29 years are emigrating. If a better supply of medium length and long educations were available, young people would be more likely to take a complete education or part of an education in the Faroe Islands. This would make it possible to keep the young people in the Faroe Islands for a longer period of time and furthermore attract foreign students by offering them to partly take their education in the Faroe Islands.

2.2 INVESTING IN EDUCATION PREVENTS UNEMPLOYMENT

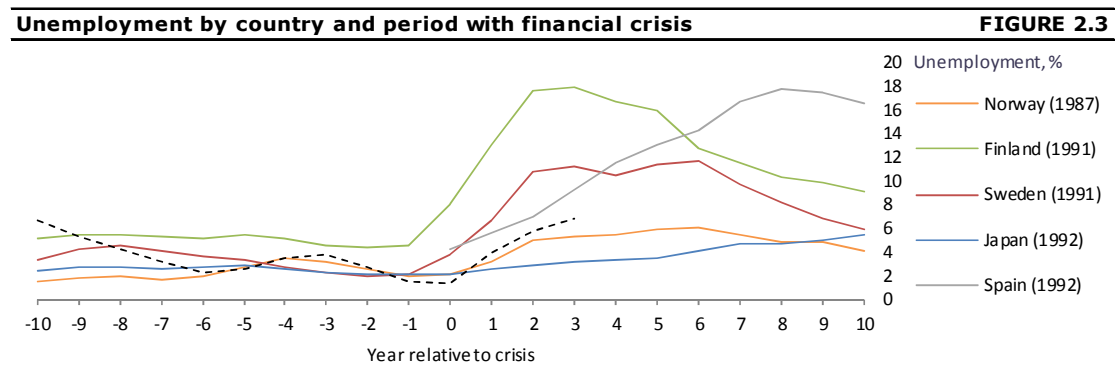
One major risk with high unemployment is the possibility of high unemployment continuing in spite of an economic upturn. Figure 2.3 shows examples of countries, which have experienced a high unemployment rate long time after the economy has turned. The Faroese authorities should – along with the initiatives organized by the Faroese Unemployment Scheme – initiate measures to reduce unemployment even further. A tool

¹ See e.g. [13], [23] and [24].

² Source: Statistics Faroe Islands (Hagstova Føroya), Unemployment statistics July 2012, dated august 31. 2012. See www.hagstova.fo.

to prevent high and prolonged unemployment is investing in the educational system as a whole.³

During the past 15-20 years, production in the Faroe Islands has become more versatile and not dependent on only few branches of industries. This has resulted in the economy becoming more resistant to shocks without unemployment growing immensely and remaining high during longer periods. The past couple of years with various export businesses developing very differently are a positive indicator that the Faroese economy is becoming more resistant to shocks of varying sorts. An increase in people living in the Faroe Islands while working in neighbouring countries has also contributed to keeping unemployment at bay.



Note: The figure shows unemployment in % of labour force by country and different periods with financial crisis. E.g., for the Faroe Islands, the unemployment rate in 2008 is depicted at year 0.

Source: Statistics Faroe Islands and OECD, from [24].

The Faroese Unemployment Scheme (ALS) focuses a large part of its resources on courses aimed at competence development, further education and other measures aimed at maintaining a connection between unemployed and the labour market. ALS has also in co-operation with the Ministry of Education, Research and Culture initiated preparations in order to assess and develop the qualifications of the part of the labour force with little to none formal education. This will improve the possibilities for unskilled workers to obtain further education and thereby find employment in other areas of the labour market.

This initiative will ensure that people beyond the age of primary school also have an opportunity to take preparatory courses with a view to prepare them for further education. To ensure that as many people as possible are given this opportunity, the Faroese Government could grant more funding to upper secondary schools and technical colleges, so these can admit more students. This would make the work force more capable of taking on more various and shifting tasks and assignments in future years, which undoubtedly will require more and varying qualifications compared to before.

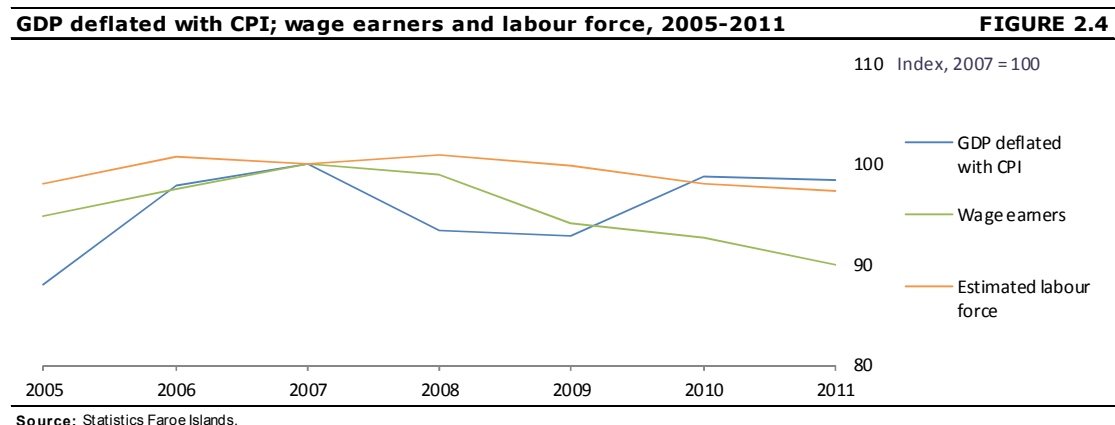
³ For further reading on the importance of education, see e.g. [1], [15], [24], [28] and <http://www.ilo.org/global/topics/skills-knowledge-and-employability/lang--en/index.htm>.

2.3 THE LABOUR MARKET AND THE COURSE OF THE ECONOMY IN RECENT YEARS

The Faroese labour market is characterised by *an agreement based system* between the parties on the labour market, where the parties organise the conditions among themselves. This is one of the reasons for the high flexibility on the Faroese labour market.⁴ Compared to southern European countries, it is relatively easy for employers to lay off workers in times of financial hardship. There is often a short term of notice, and as an employee your position is not very well guaranteed. Employers are on the other hand ready to hire people when the economy improves and the need for labour increases.

The system resembles the Danish labour market system, which compared to other countries, has ensured a flexible labour market. Obviously, the presence of a well-functioning social safety net is a prerequisite for a system of this sort to function properly, which incites people to take work although one's job is not fully guaranteed.

The development in unemployment, wage earners, labour force and nominal GDP are shown in figures 2.4 and 2.5. There was exceptional growth in GDP in the years 2004-2007, particularly during 2006. The growth during those years can to a large extent be attributed to the growth in credit financed private consumption and investment and stimulating fiscal policy.



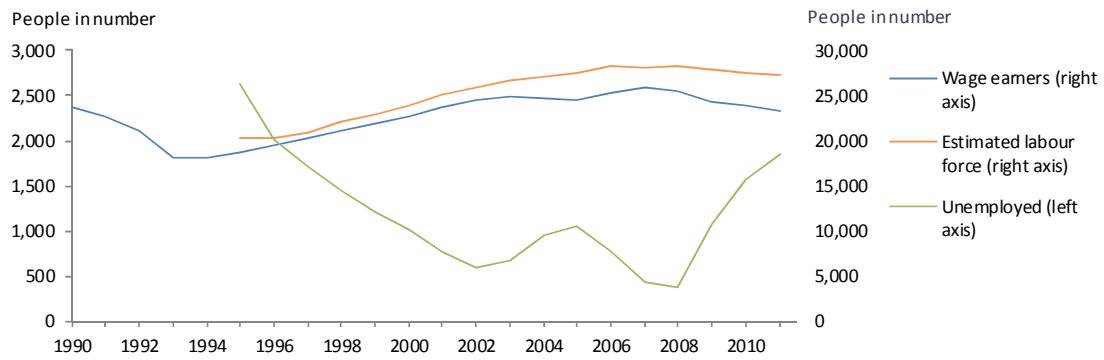
During these years, the economy was *overheated*, in the sense that the growth was unsustainable and to a large extent a result of stimulating economic policies and an increase in bank credits rather than increased production. The rate of unemployment was also exceptionally low. During the years 2007 and 2008, there were about 300-400 people unemployed equalling 1-2% of the labour force. In mid-2012, the number of registered unemployed had reached 1,400 people.

The rate of unemployment began to increase in the fourth quarter of 2008, when the activity in the economy started to decrease. The wage earners have become fewer in number and the labour force as a whole has decreased since the economic downturn set in. The reduced labour force has caused unemployment to increase relatively less than the decrease in the number of wage earners (i.e. employed).

⁴ This is also explained in [10].

Wage earners, unemployed and labour force, 1990-2011

FIGURE 2.5



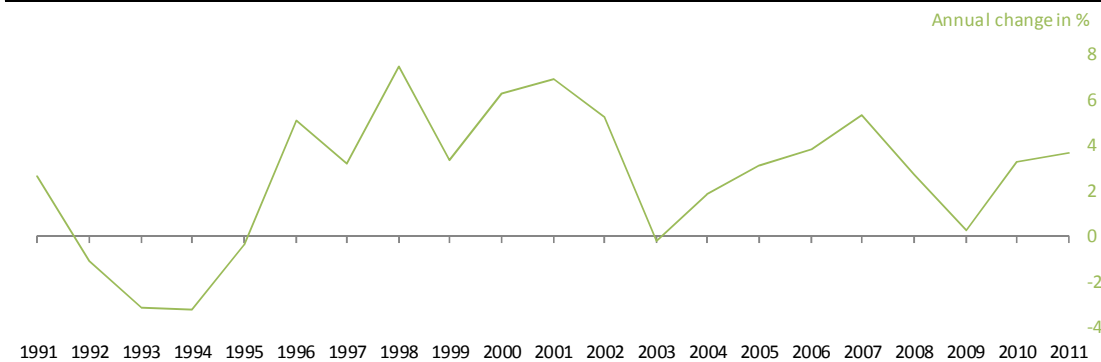
Source: Statistics Faroe Islands.

The growth in GDP during the years 2004-2008 - combined with the particularly overheated economy in 2006 - has obviously affected wage expenditures. The annual change in wage expenditures divided by wage earners is shown in figure 2.6. Changes in wage expenditures can be caused by a number of reasons and the graph is therefore to be read with some reservations.

For example, the rise in wage expenditures does not necessarily derive from increases in hourly wages. The work force can for example work more hours insofar as more working hours are available. Official statistics on average hourly wages are not available in the Faroe Islands. Therefore, unlike the standard statements in the neighbouring countries regarding wage expenditures, figure 2.6 is not to be compared to the annual growth in hourly pay as this often is stated for neighbouring countries.

Wage expenditures divided by wage earners, annual change in %, 1991-2011

FIGURE 2.6

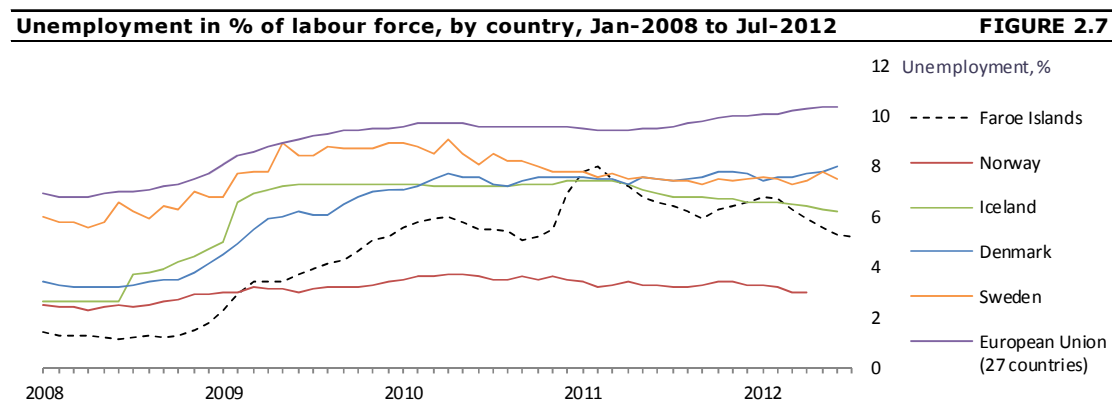


Source: Statistics Faroe Islands.

Wage expenditures rose particularly during 2006 and 2007. As expected, there had been a large increase in wage expenditures the years following the crisis in the 1990s, especially from 1998 to 2001. In the years leading up to the economic upswing in 2008, there was a large decrease in the rate of unemployment - at one point unemployment was less than 2%. Although there was great pressure on the labour market during this time, it did not cause an exceedingly high rise in wage expenditures.

2.3.1 Unemployment compared to neighbouring countries

During the last two years, unemployment has decreased faster in the Faroe Islands compared to neighbouring countries (Figure 2.7). This can be explained by a number of reasons. One likely factor is the increased emigration during the last two years.



It is also possible that the Faroese unemployment system is more effective compared to neighbouring countries. The advantages of the unemployment system can be attributed to the fact that the system administers the *unemployment pay-out system* as well as *the employment agency* and furthermore administers the competence development courses. In neighbouring countries a range of different institutions normally administers these areas. The advantages of having these activities centralised in one institution are clear. There are substantial benefits from economies of scale by combining the payment system and employment agency in one single institution.

The rate of youth unemployment is according to official Faroese statistics around 6% in the age groups, 16-24 and 25-34,⁵ which is not high, compared to international numbers (Table 2.1). As previously mentioned, the *true* rate of youth unemployment can be higher than official statistics indicate.

Unemployment in the ages 15-24 years, % of labour force in ages 15-24 year **TABLE 2.1**

Country	2007	2008	2009	2010	2011
Denmark	7.5	8.0	11.8	14.0	14.2
Norway	7.3	7.5	9.2	9.3	8.6
Iceland	7.2	8.2	16.0	16.2	14.6
Sweden	18.8	19.2	24.8	25.2	22.9
Finland	15.7	15.7	21.6	20.3	18.9
Germany	11.7	10.4	11.0	9.7	8.5
United Kingdom	14.2	14.1	19.0	19.3	20.0
USA	10.5	12.8	17.6	18.4	17.3
Europe	15.8	15.8	20.2	20.3	20.0
OECD - Total	12.0	12.7	16.7	16.7	16.2

Source: OECD.

⁵ Source: Statistics Faroe Islands (Hagstova Føroya). See footnote no 2 on p. 11.

For instance, there are several young people taking an education, although they personally would rather be working. Secondly, there is the possibility that young people have fallen out of the system, after having been in the system for the maximum length of time and therefore no longer appear in the statistics. Thirdly, it is possible that unemployed young people have not been working the required amount of time prior to the state of unemployment and therefore do not live up to the requirements to be registered in the system.

It is important that the statistics of the Faroese Unemployment Scheme, The Department of Social Security, The Ministry of Education and Culture, the tax authorities (TAKS), the National Register and the 2011 Census are coordinated in order to get the full scope of youth unemployment in the Faroe Islands. This is crucial in order to fully grasp the problem of youth unemployment and subsequently create the right measures to solve the problem.

Unemployment by duration, % of total, 2011					TABLE 2.2
	< 1 month	1 to 3 months	3 to 6 months	6 to 12 months	> 12 months
Denmark	16.5	21.9	19.4	17.8	24.4
Iceland	18.6	21.2	19.0	13.4	27.8
Norway	26.0	24.6	16.9	21.0	11.6
Sweden	25.7	24.9	16.9	15.4	17.2
Finland	13.6	31.0	19.7	13.1	22.6
United Kingdom	10.5	19.9	17.8	18.3	33.4
USA	19.5	21.8	15.0	12.4	31.3
Faroe Islands	6.7	13.3	16.0	28.9	35.1

Note: Faroese numbers are from mid 2012 and only include people in the ALS system. People who have left the ALS system and receive public assistance are not included. Numbers for other countries are averages for 2011. Caution is warranted when comparing numbers directly.

Source: OECD and the ALS system.

Table 2.2 shows unemployment by duration of unemployment. The table indicates that people are unemployed just as long or even longer in the Faroe Islands compared to neighbouring countries. The table indicates for example that 35% of the unemployed in mid-2011 had been out of work for more than one year. This indicates that the problem of *long-term unemployment* is just as severe in the Faroe Islands as in the neighbouring countries. When reading the numbers it must be taken into account that the Faroese numbers are from mid-2012, while the comparing numbers are 2011 average numbers.

The danger of long-term unemployment is the risk of the work force losing attachment to the labour market, resulting in continuing unemployment even after the economy starts to turn. Studies show that the most effective tool to prevent long-term unemployment is to further educate the workforce and provide courses aimed at upgrading skills and qualifications as well as offering different sorts of educations. The Economic Council therefore highly stresses the importance of providing the workforce with continuous possibilities of obtaining further education.

It is important that people above the age of primary school also have the opportunity to take preparatory courses for upper secondary school and other educations such as a primary school final examination. Studies of long-term unemployment indicate that changes in the business structure, i.e. sudden decreases in certain industries, are major

causes of long-term unemployment. It is therefore vital that the workforce continuously is offered different sorts of further educations so that the workforce can develop competences and work in different areas of the labour market.

2.4 INITIATIVES TO REDUCE UNEMPLOYMENT

Much effort is being put into preventing unemployment as well as preventing a permanent state of high unemployment. ALS is investing a great deal of resources into further education and competence development of different sorts. ALS also finances a trainee work-system, where unemployed can participate in a practical training program for up to five months. Many of those who participate in the trainee work-program are offered permanent employment when the program is finished. The Ministry Education, Research and Culture is also working towards securing that as many students as possible are admitted to the upper secondary- and technical schools within the funding available.

Private businesses and public limited companies are taking in new trainees on a regular basis, whereas the public institutions and ministries are taking in exceptionally few new trainees. According to statistics from the Faroese Department of Accounting and Financial Administration there are about ten traineeships in the public sector (this excludes public limited companies, The Public Transport Company, SSL, and nursing homes). One way to reduce unemployment – especially amongst young people - is therefore to establish more traineeships in the public sector. It should also be considered to incite the private sector to establish more apprenticeships.

It could for example be considered to offer financial subsidies to those private businesses and masters who establish new apprenticeships. The public funding could be given as either direct financial support or as part of the trainee's salary. These measures can be put into system in a relatively short time and do not require much preparatory work. However, the initiative obviously relies upon the financing funds being made available.

As previously mentioned the current net emigration causes great difficulties for the Faroese economy and can potentially have great consequences in the long run. The authorities should therefore address this situation very seriously. Further investments in education, especially the medium and long educations, are initiatives, which could amend this particular problem. The Economic Council strongly recommends investing in education to prevent emigration from the Faroe Islands.

2.4.1 Competence development, adult trainee programs and other initiatives

Numbers from ALS show that around 50% of the unemployed do not have any registered formal education apart from primary school and close to 60% of them are in the age group of 40 years and older.

There are clear indications that unemployment among unskilled workers to a large extent can be explained by *structural causes*, i.e. that there are less unskilled jobs available in the economy due to certain industries becoming smaller during recent years. Part of the structural changes can to a large extent be attributed to the overall technological development. This stresses the importance of establishing systemised competence development for people with little to none formal education. ALS and the Ministry of

Education, Research and Culture have undergone preparations for such a system and it is vital that these preparations continue.

A system aiming at organising preparatory courses in order for people to undergo for instance an upper secondary education will make it easier for the workforce to further educate itself. Due to well-established upper secondary schools and evening schools, the country already has the qualifications needed to provide preparatory courses and further education. The pre-existing resources also mean that it would not be excessively costly to establish such a system.

2.4.2 Additional admissions to secondary and technical schools and higher educations

The Economic Council recommends that more funding be granted to the upper secondary and technical schools in order for them to admit more students. The upper secondary and technical schools have been granted larger appropriations in 2012. It is recommended that this course must continue so that more students can be enrolled in the school year 2013-2014.

The schools receive many applications and in many cases the applications outnumber the places available. Statistics from the Ministry of Education, Research and Culture show that around 100 qualified people out of a total of 1400 applicants were turned down due to lack of places. There are specific educations that experience this problem in particular.

One way to prevent increased youth unemployment is for the upper secondary and technical schools to admit more students. For young people, who are unable to find work, it is vital that they have the opportunity to undergo upper secondary or other education. It is therefore also recommended that more funding be granted to educational institutions with a view to admitting more students.

A school for people with reduced working capacity (Dugni-skúlin) is an educational institution, which is not discussed in this report. However, it is worth mentioning that the institution has significantly larger numbers of applicants than places available. It is therefore considered natural to strengthen this educational institution so it can admit more students.

3. A CLEAR NEED TO REVISE THE FISHING INDUSTRY

3.1 INTRODUCTION

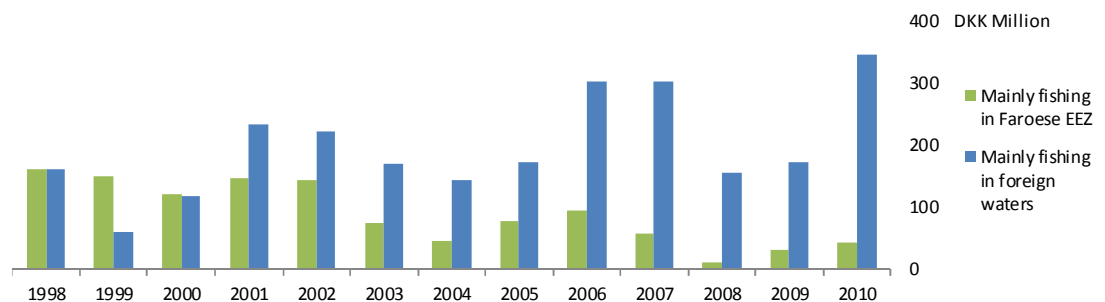
The Faroese Government has in the government platform set out to update the legislation regarding fishery.⁶ A proposal for a new system is scheduled to be presented to the political decision makers in 2012. The need to modernise the regulations regarding the fishing industry area is evident. The main legislation, the Law on Commercial Fishery, has been in force for 20 years and has over the years been subject to adjustments. The profitability of the different parts of the fleet has been very different. There are also great differences in the level of success in harvesting the fish stocks sustainably.

Fishing mortality in cod fishing in Faroese waters has exceeded the recommendations of marine biologists for years. The questionable sustainability of the fishing effort, combined with the poor profitability in the fresh fish industry the past many years, indicate that the Faroese authorities do not have necessary tools to administer the fisheries sustainably. Sustainable fishing is a precondition for a profitable industry. These past years of fishing effort continuously exceeding scientific recommendations are clear signs that the fishing days system (days-at-sea system) is not as *self-regulating*, as often is claimed.

The fundamental sets of regulations vary across the different areas of the fleet. The distant water fishing fleet (pelagic, factory and prawn fishing) is arranged with individual transferable quotas, while fisheries in Faroese waters is arranged with convertible days-at-sea (there are exceptions to this, e.g. regarding netting vessels and the great silver smelt fishery).

In addition to the fishing days system, the Faroe Islands have implemented area closures and technical regulations, as seen in neighbouring countries. In section 3.3.1, it is pointed out that international fisheries researchers doubt whether it is realistic to sustainably manage fisheries solely through area closures, technical regulations of equipment and a maximum days-at-sea system.

Financial results, before financial expenditures and taxes, 1998-2010 **FIGURE 3.1**



Note: Fleet fishing mainly in foreign waters includes pelagic og large factory trawlers. Industrial and prawn trawlers are not included. The figure is only indicative and should be read with caution.

Source: Financial accounts from accounting firm NOTA and Hans Ellefsen.

⁶ This is stated in the 2011 Government Platform.

Figure 3.1 shows results before interest, taxes and write-downs in the fleets fishing in domestic and distant waters. The figure therefore shows the financial surplus which is left to generate a return on the capital investment and to writing down of the capital investment. The picture also shows that the fleet administered with individual transferable quotas has experienced progress, while the course in the domestic fleet has been negative. The illustrations in 3.1 are clear indicators that the fishing intensity in distant waters has adjusted to the natural resources available. The same adjustments have not been made in the fisheries in Faroese waters. One explanation could be the days-at-sea system's lack of ability to adjust the fishing intensity to the actual natural resources available.

The profitability in the domestic fleet has for many years been poor due to fisheries being affected by the historically poor state of many important fish stocks – caused by high fishing intensity and effort. When updating and revising the fishing industry in the near future, the importance of equipping the authorities with the tools required to manage the fish stocks sustainably should be emphasised.

The poor results of the fisheries in Faroese waters are costly for the Faroese economy. The total catches of cod on the Faroe Shelf has since 2004 been around 10,000 tonnes annually. This is well below the 100-year average of 25,000 tonnes annually. Marine biologists have estimated that it would be possible to fish in average around 25-30 thousand tonnes annually if the cod stock (biomass) on the Faroe Shelf was 80-100 thousand tonnes, under the preconditions that the fishery is sustainable and the stocks are managed sensibly. Changes in the natural conditions will under any circumstances cause fluctuations in the fisheries; it need, however, not be as severe gyrations as seen during the past years.

An annual loss of 15,000 tonnes of cod has an obvious effect on the national economy. If the landing price for cod is at DKK 15 per kilo, then 15,000 tonnes is sold for DKK 225 million. annually.⁷ It would furthermore lead to an increase in value for the fish factories on land. Lowering the fishing intensity and effort and the size of the fleet would also reduce operating costs of running the fishing industry.

The poor condition and vulnerability of the cod stock can to some extent be explained by the past year's unfortunate natural conditions. However, the fishing mortality continuously exceeding the biological recommendations is also a logical explanation for the poor state of the cod stock.

3.2 MAIN CONSIDERATIONS WHEN REVISING THE FISHING INDUSTRY

Regarding the plan to revise the fishing industry system and legislation, a continuous development of the instruments needed to sustainably harvest fish stocks is recommended. This includes among other things that fisheries and effort are managed on the basis of clear *harvest control rules* and the total allowable catch is assigned according to biological preconditions.

⁷ An average landing price of DKK 15 per kilo is not far from average numbers for the last 3-4 years. During the years 2005-08, average cod landing prices were higher, about DKK 20 per kilo. Source: Statistics Faroe Islands.

Below are stated some main considerations, which need to be addressed in relation to the update of fishing industry regulations:

- That the fishing industry is managed in a biologically as well as economically sustainable manner
- That the fishing industry *and the Faroese Treasury* – and thereby society as a whole - retrieve greater return from its natural resources
- Market access and eco labels (international environmental approvals)

The natural resources in the sea surrounding the Faroe Islands are the property of the Faroese nation. The property is being administered by the public sector on behalf of the original owners, which is the Faroese society including future generations.⁸ The aim should therefore be to distribute the return from the natural resources fairly amongst the members of the society.

The past years, return on equity in many businesses in the fishing industry has been exceptionally high (especially in the pelagic industry). The return on equity has been considerably higher than regular returns on equity in other branches of industry. This is a result of allowing some particular companies a mostly free of charge access to harvest the return from a common natural resource.

One of the main objectives in changing the fishery regulations, is to ensure that the Faroese Treasury and the Faroese society as a whole yield a greater return from the natural resources in Faroese waters and outside the territorial waters, which according to international law, is a property of the Faroese State. Insofar as the allocated fishing rights generated a higher return to the Treasury, it could for instance facilitate a substantial lowering of income taxes and thus be of benefit to all.

When planning to revise the fishery regulations, it ought to be considered how to fully utilize the resource, either by charging fees or allocating fishing rights on an organised market place. In order to reduce the public sector deficit, it will be necessary to increase the Government revenues through taxes and other income over coming years (public spending is not expected to rise considerably). Increasing the revenue from the publicly allocated fishing rights would serve as a source of revenue in this respect.

The higher revenue can be achieved through fees on fishing rights (quotas and days-at-sea) or by allocating fishing right on an organised market place. In 2011, an experimental scheme where mackerel fishing rights were allocated (auctioned) on an organised market place proved largely successful.

Compared to the current system, a clear advantage of a market-based system is the enhanced transparency. A market-based system can furthermore contribute to adjusting the fishing fleet to market terms and thereby ensure that the most productive fishing vessels are given access to harvest the natural resources.

⁸ The Faroese Economic Council explains in [2] how it understands the property rights with respect to natural resources in the Faroese waters.

3.2.1 Insufficient guidelines and procedures regarding allocation of fishing rights

The development in recent years in the mackerel fishery has revealed an administrative inadequacy in allocating fishing rights – especially allocating based on historical catches is a difficulty.

The total quota was allocated according to political administrative procedures based on political agreements made without clear general guidelines. The fishing rights are valuable public assets, which have been given to some businesses and groups without prior official guidelines.

This makes it difficult to anticipate which procedures are being used from year to year and can therefore give rise to a sense of insecurity regarding future allocation of fishing rights. Since the allocation of mackerel fishing rights can be expected to follow certain procedures during the coming years, it is unfortunate that the allocation is conducted without specific guidelines. It poses a risk that this procedure to some extent sets precedent for allocating rights in the following years.

It can also be questioned whether this procedure of administering significant societal values is in accordance with fundamental rules of law. The equality principle and no discrimination principle mentioned in article 26 in the *International Covenant on Civil and Political Rights*, ratified by Denmark (along with most western countries) is considered relevant in this context.⁹

Parts of the fishing rights for mackerel were allocated to groups of vessels technically unable to catch mackerel (considering this year's short preparation time for the season). The mackerel rights have since been transferred to other groups of ships (i.e. sold). This process can therefore to a large extent be considered as a public subsidy scheme to particular groups of ships which have struggled financially for years.

3.3 NECESSARY TO REVISE THE SYSTEM OF DAYS-AT-SEA

The Council of Economic Advisers recommends that the issue of whether the Faroese fisheries is to be administered through a system of fishing days or quotas be incorporated in the upcoming presentations of proposals to revise the fishery system and regulation.

The possibility of returning to a system of quotas, as practised in the neighbouring countries, should be discussed. It should also be discussed which authority is given the right to stipulate the maximum of total allowable catches, effort etc. with respect to the different fish stocks.

⁹ See e.g. Bekendtgørelse af international konvention af 16. december 1966 om borgerlige og politiske rettigheder med tilhørende valgfri protokol, <https://www.retsinformation.dk/Forms/R0710.aspx?id=60860>. Article 26 in the *International Covenant on Civil and Political Rights* states that "All persons are equal before the law and are entitled without any discrimination to the equal protection of the law. In this respect, the law shall prohibit any discrimination and guarantee to all persons equal and effective protection against discrimination on any ground such as race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status."

3.3.1 Doubtful whether fisheries can be managed via a system of days-at-sea

Under the current system, the Faroese political system, the Faroese Parliament, is responsible of stipulating the maximum allowed days-at-sea in the Faroe Islands – for demersal fishing it is administered with fishing days (days-at-sea). The procedure of the parliament stipulating an annual maximum of allowed days-at-sea across the varying groups of fishing boats has proven to be nearly impossible to manage sustainably.

Case in point, although the number of days-at-sea in the system has gone down by more than 50 per cent since 1996-97, the effort on the cod stock on the Faroe Shelf is still above the recommendations of marine biologists. Since the law on commercial fishing was passed in 1994, the fishing mortality has been estimated at an average of 39 per cent of the amount of cod (in number). In the years of 2008-2010, fishing mortality was lower, about 31 per cent (in number). The scientific recommendations however state that fishing mortality should not exceed 25 per cent of the total stock in number with respect to the cod stock.¹⁰ These issues indicate that the days-at-sea system is not as self-regulating as is often claimed.

Regarding the number of days-at-sea, it is important to bear in mind that the number of days are not necessarily comparable from year to year. For fishing groups 2, 3 and 4 the days-at-sea in the outer waters count for 1/3 compared to the inner waters. This means that vessels can fish for three days in outer waters before it is considered as one used day in the system. Same rule applies for boat groups 4A and 4B, where boats can change fishing tools and switch between long line and jigging reels. Days-at-sea thereby count 1:2, which means that fishing boats in group 4A fishing with jigging reels can fish for two days before it counts as one day used in the days-at-sea system. Furthermore, the system allows days, within specific boundaries, to transfer between main groups in the system during the last three months of the fishing year.

When an important fish stock – e.g. the cod stock on the Faroe Shelf - is threatened due to overfishing or difficult natural circumstances, it is necessary to lower the total number of days-at-sea. Furthermore, the fishing fleet will become more efficient through improved technology and equipment, in spite of the fishing fleet remaining the same size (or even decreasing). This should also give rise to a gradual decrease in days-at-sea. These unfortunate characteristics make it almost impossible to sustainably manage the fishery.¹¹

A precondition for managing the system of days-at-sea sustainably is a clear connection between the number of days and the fishing intensity, *effort*. Researchers in the fishing industry question whether it is possible to administer the fishery sustainably within a system of days-at-sea (an effort system).¹² Because of the technological development, there is a vital need to continually decreasing the number of fishing vessels in order to create and maintain good profitability in the industry. The days-at-sea system poses

¹⁰ Source: Faroese Marine Research Institute.

¹¹ These characteristics of *effort*-systems are mentioned in [16], [17], [27] and [29].

¹² Different experiences of effort regulation systems are discussed in [27], [29] and [17].

similar difficulties as unregulated fisheries where the system instigates excessive investments as well as too large fishing intensity and effort (*the race-to-fish*).¹³

Alongside the days-at-sea system, area closures and technical regulations of fishing equipment are also used to manage the Faroese fishery. Researchers however question whether it is possible to manage the fishery sustainably with measures such as area closures and technical regulations alone. Experiences have shown that such measures generally do not generate impressive results when used in isolation.¹⁴

The Economic Council recommends that the question of whether the current system of days-at-sea is a suitable instrument to manage the demersal fisheries in Faroese waters onwards should be addressed. Instead, as seen in neighbouring countries, a system of quotas and maximum allowable catches ought to be considered and decisions made based on professional studies and recommendations.

A system of quotas will obviously require more inspection and supervision compared to a system with days-at-sea. For a system of quotas to function as intended, the Faroe Islands Fisheries Inspection will need to employ more supervisors and observers, whose tasks will be to monitor the fishery by being on board the vessels for periods of time and observe landings of the catches. Such systems are used in Iceland and Norway and have to some extent also been used in the Faroe Islands. There are several examples of Faroese vessels fishing in international waters having had observers on board.

In neighbouring countries, the costs of managing the fishing industry is around 6-7% of the selling value (i.e. landing values). The cost of managing the fishing industry in the Faroes, Norway and Great Britain is estimated at around six per cent of the total landed values, while the cost in Iceland is around two per cent (public subsidy schemes are included in these numbers).¹⁵ There is therefore nothing indicating that the current system of days-at-sea leads to lower management costs.

Due to the obvious difficulty of inspecting the activities of smaller fishing boats, it could be an option to let the smaller boats (e.g. group 5A and 5B) continue under the current days-at-sea system, while other groups convert to quotas.

Lastly, fishery in groups 3 and 4 is already partly being managed quotas, so a quota-based system is not an unfamiliar phenomenon to Faroese ships and boats. The demersal fishing quotas in Icelandic waters are examples of fishery being managed through quotas - including Faroese fishing boats and long liners in Icelandic waters. As in Faroese waters, it includes mixed fisheries with bycatches of different demersal species of fish (as is the case regarding demersal fishing in the Barents Sea).

3.3.2 Mixed fisheries not a specific phenomenon in Faroese waters

The introduction of the days-at-sea system in 1996 was based on two main arguments. First, the fact that because the demersal fishery in Faroese waters was *mixed*, setting

¹³ This is explained in [27], [29] and on p. 331 in [17].

¹⁴ Experiences of this sort are discussed in [29]. See also [17] and [27].

¹⁵ See e.g. pp. 46-47 in [22].

quotas would result in bycatches being discarded back in the sea. Second, that supervising a system of quotas would be too costly. However, the neighbouring countries, Iceland and Norway, are good examples of how mixed fishery can be managed profitably with quotas.

As in Faroese waters, cod, haddock, saith and other codfish (ling, blue ling and tusk), flatfish and other demersal fish are harvested in mixed fisheries in Norwegian and Icelandic waters. There are no indications of excessive mixed fisheries in Faroese waters compared to demersal fishing elsewhere. Compared to Faroese waters, catching a range of species is considered normal in demersal fishery in EU-waters and is *to a larger extent* mixed compared to demersal fisheries in Faroese waters.¹⁶

In regards to mixed fisheries, it is impossible to avoid bycatches, which can be difficult to manage in a quota system. It is therefore necessary to establish systems to manage bycatches in order to avoid parts of the catches being discarded. For example, it is possible to have *combined quotas* including various species or to have *separate quotas* for bycatches (see table 3.1.).

There are tools available in order to prevent discards, which are used in the Faroe Islands and neighbouring countries, see table 3.1.¹⁷ For instance, landings of bycatches, which have been caught without the necessary quotas, can be permitted under certain conditions. The profit from the landed catches can then be transferred to a fund with the purpose of financing research and development in the fishing industry, marine research ships, etc., from which the fishing industry can benefit. This line of procedure is for example practiced in Iceland.

Furthermore, it is also an option to put in place a ban on discards, which is also practised in the Faroe Islands.¹⁸ In table 3.1, there are shown examples of arrangements used in some northern countries in order to prevent discards. When striving to prevent discards, it is important that boats and ships are encouraged to land and sell bycatches, which to a large extent are inevitable. The main reasons for discarding in EU waters are probably firstly, that the fishing vessels are not allowed to land and sell bycatches and secondly, the absence of an official ban on discards.¹⁹

Not being allowed to land and sell bycatches and not banning discards are issues related to the EU principle of relative stability in the common fisheries policy, meaning that total TACs of the different fish stocks are allocated among countries in a stable manner based on their historical fisheries and catches.

¹⁶ Source: [18].

¹⁷ This is explained in [18].

¹⁸ An official ban on discards is stated in articles 9 and 10 in the Faroese Law on Commercial Fisheries.

¹⁹ Source: [18].

Measures with regard to discards, by country				TABLE 3.1
	Faro e Islands	Denmark	Iceland	Norway
Ban on discard	Yes	Nei	Yes	Yes
Closed areas	Yes	Yes	Yes	Yes
Real-time closures	Yes	Yes	Yes	Yes
Sorting devices	Yes	Yes	Yes	Yes
Gear selectivity	Yes	Yes	Yes	Yes
Economic incentives	Bycatch value	Additional quota can be bought	Additional quota	Bycatch value
Effort regulation	Fishing days/licence	Fishing days/licence	Licence	Licence
Bycatch rates	Yes	Yes	Yes	Yes

Source: From [18].

Therefore, it can be concluded that there should be good possibilities of establishing quotas for demersal fishery in Faroese waters. This of course requires that the necessary funding and resources be granted for establishing and maintaining the required inspection and supervision of a system of quotas. In this context, it should be mentioned that the costs of managing the Icelandic fishing industry are not higher than the Faroese, although the fishery in Iceland is managed through quotas.

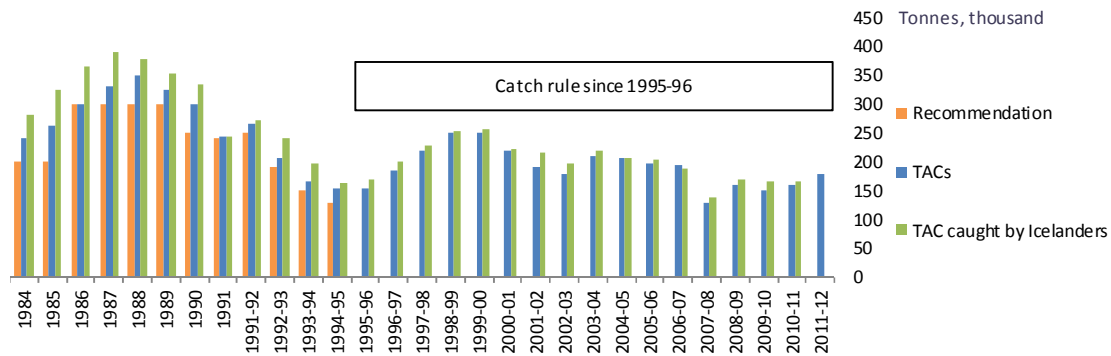
3.3.3 Which authority is to stipulate the total allowable catch?

The Economic Council recommends that the stipulation of maximum days-at-sea be removed from the Faroese Parliament. Instead, it is recommended that the Ministry of Fisheries (or an independent institution organised under the Ministry) is given the authority to stipulate the total allowed catches of significant fish stocks in Faroese waters. Similar procedures are also practised in the neighbouring countries.

To the knowledge of the Economic Council, The Faroese Parliament is the only political system in the western world that stipulates the total allowed catches of fish. Normally, the Ministry of Fisheries, or an institution managed by the ministry, stipulates the total allowed catches of the different fish stocks, based on scientific recommendations from an independent institution.²⁰

Figure 3.2 illustrates how the total allowable catches (TAC) for cod in Iceland has been determined. Here, the Icelandic Ministry of Fisheries states the TAC according to specific objectives estimated by ICES to be in correspondence with the precautionary approach. Figure 3.2 shows that up to 1995, the catch of cod in Icelandic waters exceeded the scientific recommendations. The figure also shows how the deviations between the stipulated total quota and landings have decreased since the implementation of total allowable catches stated in accordance with ICES guidelines. It ought to be considered implementing similar procedures, where the TAC for demersal fishery in the Faroe Islands is stated in accordance with clear objectives and biological preconditions.

²⁰ Examples of this are given in [25].

Recommendation, TACs and actual catches of cod in Icelandic EEZ**FIGURE 3.2**

Note: A harvest control rule has been in place since 1995-96. It specifies the percentage of the biomass that may be caught. The Ministry of Fisheries is responsible for determining the TACs for the different fish stocks.

Source: ICES and OECD, from [24].

3.3.4 Market access, eco labels, etc.

The market for processed goods is demanding – to a continuously higher degree – sustainable fish products. International business chains have announced that they will only sell seafood, which is sustainably produced and harvested and marked with an eco-label – a stamp of approval. This development is expected to continue over the years to come.²¹

Several Faroese companies have received MCS-approval in the areas of pelagic fish, other fisheries in the overseas fishing areas and ships fishing for great silver smelt. Demersal fishery in Faroese waters is, however, yet to be MSC-approved. Recently, it became known that the cod and haddock fishery in the Barents Sea of the two factory trawlers, Gadus and Vesturvón, has received the MCS-approval. Several businesses in the neighbouring countries of Norway, Iceland and Denmark have received eco labels in relation to demersal fishery. This development will make it more difficult for Faroese companies to compete on the market for processed products.

For demersal fisheries in Faroese waters to be approved as sustainable, it will require that the authorities are supplied with better instruments to manage the fisheries in Faroese waters more sustainably.²²

Such issues ought to be discussed when planning to change the regulations concerning the fishing industry, so that Faroese companies are able to compete with companies in the neighbouring countries and enter crucial markets (especially in Northern and Central Europe).

In connection to this, it will be necessary to discuss whether the management system of demersal fisheries in Faroese waters is to be based on a system of days-at-sea or a quota system. A serious issue with the days-at-sea system is that harvest control rules and management plans are difficult to formulate and administer.

²¹ <http://www.msc.org/track-a-fishery/certified> presents an overview of MSC-approved fisheries.

²² <http://www.msc.org/about-us/standards/msc-environmental-standard> presents the general rules and requirements for fisheries to receive labels of approval from the *Marine Stewardship Council*. See also [20].

4. ECONOMIC ASSESSMENT

4.1 ECONOMIC OUTLOOK

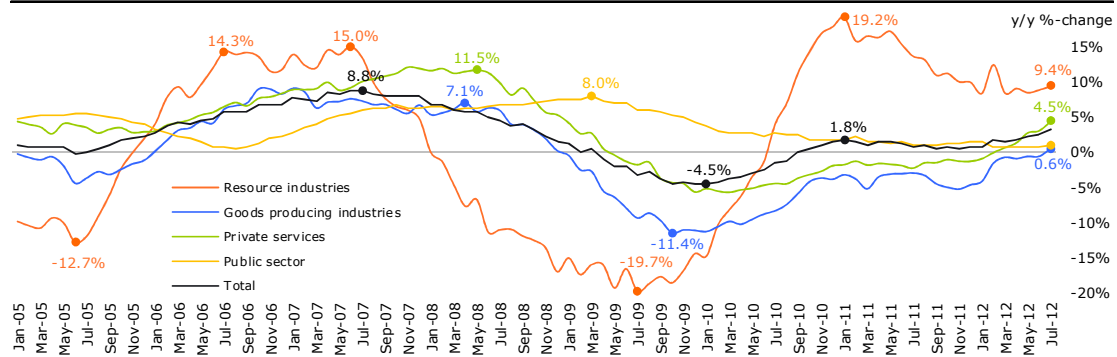
4.1.1 Recent economic developments

Wage payments – measured in moving annual sums – have increased since October 2010. The latest wage statistics from July this year show an annual growth of 3.3 per cent, which is the highest growth since October 2008.

Wage payments in the resource industries²³ fluctuate significantly and since the significant decrease from early 2008 to the summer of 2010 most of the increases in wage payments is attributable to the resource industries. Annual wage payments in the production industries,²⁴ which have been declining since the first half of 2009, are on the rise again. The service industries²⁵ have experienced a downturn in the same period, but in the latest statistics from July, annual growth was 4.5 per cent.

Public sector wages have increased since May 1995 and have in the last 12 months grown by less than 2 per cent. In the latest statistics, public wages grew by 1.1 per cent. On the individual industry level, a noteworthy observation is that following growth in the construction industry from April 2011 to March 2012 the construction industry has experienced a downturn in the recent months. Yet, overall the statistics show growth in total wage payments.

Annual %-change in wage expenditures, moving 12 months sum, Jan-05 to Jul-1 **FIGURE 4.1**



Source: Statistics Faroe Islands.

It is likely that unemployment will continue to decrease during the course of the year. After the bankruptcy of Faroe Seafood in late 2010, unemployment rose to 7.4 per cent, which is relatively high in Faroese terms. But unemployment has since then steadily decreased and is currently at 6.2 per cent. Several new workplaces are expected to form shortly, e.g. nursing homes as well as a large pelagic fish processing plant in Tvøroyri. Furthermore, the number of wage-earners in the retail, service, and construction

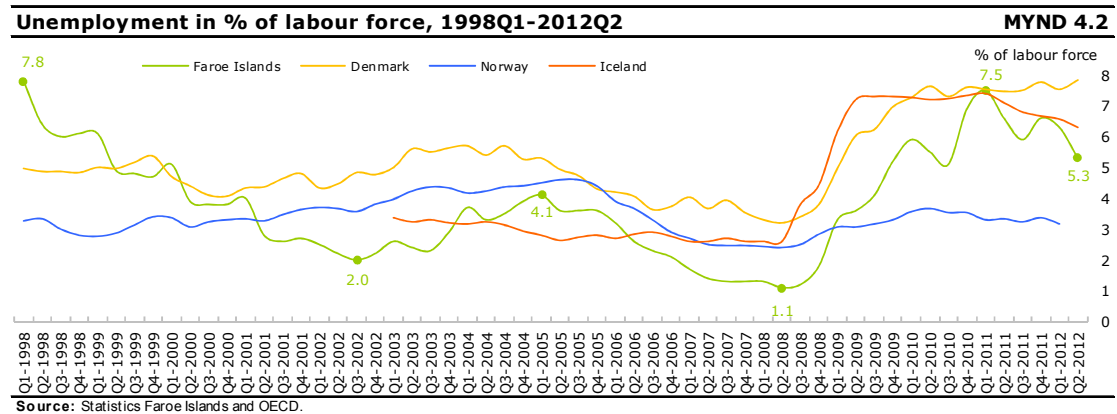
²³ I.e. agriculture, fisheries, fish farming and gutting, and natural resource industry.

²⁴ I.e. fish processing, shipbuilding, other industry, construction, and energy industry.

²⁵ I.e. trade and commerce, restoration, hotel and restaurant, transportation, postal services and telecommunication, financial services and insurance, and private and household service industry.

industries seems to have stopped declining. According to the latest consumer sentiment report, increases in demand for workers in the service and resource industries are likely to occur. Faroese unemployment is comparable to unemployment in neighbouring countries, apart from in Norway where it is significantly lower.

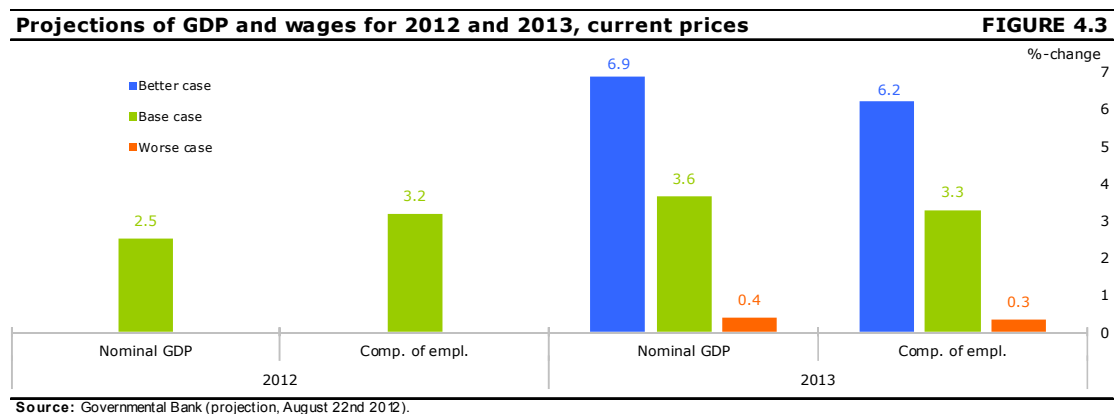
Research shows that as the period of unemployment increases, the likelihood of resuming to employment decreases. The Faroese Unemployment Scheme (ALS) is putting a focussed effort into trying to help unemployed in maintaining attachment to the labour market and thus increasing the likelihood of getting a job (see also chapter 2).



4.1.2 Projections of economic growth in 2012 and 2013

The latest Economic Assessment from the Faroese Governmental Bank was issued in February 2012. The projections were then made on the basis of the finalized statement of national accounts for 2009, and a provisional statement on economic sector production in 2010. In May this year Statistics Faroe Islands issued a revised statement on economic sector production for 2010 and issued a new one for 2011.

In the revised 2010 statement, GDP is considerably higher than in the provisional statement. Nominal GDP growth was calculated at 7.0 per cent as opposed to the 3.3 per cent in the provisional statement. The provisional statement on GDP in 2011 by Statistics Faroe Islands shows a nominal growth of 1.8 per cent. The basis for the Governmental Bank's current projection has therefore been adjusted.



The statement of GDP for 2008 and 2009 shows a nominal growth of 0.8 and 1.6 per cent, respectively (Table 4.1).²⁶ As the average annual price increase for the same years has been 6.3 and -1 per cent, respectively, it means that there has been a GDP decrease in real terms. GDP increased 7.0 per cent in 2010 according to the latest revised statement on value added by Statistics Faroe Islands. The average consumer price index grew only 0.4 per cent in 2010, which means that the Faroese economy in real terms grew substantially in 2010. The provisional statement on GDP in 2011 by Statistics Faroe Islands shows a nominal growth of 1.8 per cent and as CPI increased 2.3 per cent in 2011, this should in real terms indicate a stagnant economy in 2011.

Annual change in nominal GDP								TABLE 4.1		
<i>Annual %change</i>	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP	3.0	2.9	12.9	5.9	-0.8	-1.6	7.0	1.8	2.5	3.6

Source: Statistics Faroe Islands (2004-2011) and Governmental Bank (projection for 2012 and 2013, August 22nd 2012).

If one examines economic production (Table 4.2), it becomes clear that especially fisheries lowered the economic value added in 2008,²⁷ and fisheries and the construction industries made the largest negative contributions in 2009. Developments in fisheries improved significantly in 2010 and growth in the industry contributed 3.7 percentage points, and recent years have also been good for the fish farming industry, which on its own contributed 2.6 percentage points to the total growth of 7.2 per cent in value added in 2010.

Activity in the construction industry continued to decline in 2010 and the construction industry contributed negatively to growth. Maritime transport has increased production quite substantially in 2009 and 2010 and the public sector has made positive contributions to growth since 2008. Fisheries contributed 1.3 percentage points to total growth in economic production of 2.2 per cent in 2011. Most of the service industries declined in 2011 and growth in the public sector was less than in the previous years.

On a whole, higher growth is expected in 2012 than in 2011. Combined value added in the resource, fish farming, and fish processing industries is expected to be roughly the same as in 2011, while the service industries will make a larger contribution to growth than previous years. In the construction industry value added is expected to be less in 2012 than it was in 2011.

The projected growth in value added of 3.5 per cent in 2013 is particularly dependant on improved outlook for the trade and service industries, while the resource and production industries as well as the public sector are expected to grow, albeit less than before.

²⁶ The table illustrates how different parts of final consumption have affected GDP in recent years and how the different parameters affect the economic projections for the years 2012 and 2013.

²⁷ The term value added is comprised of compensation of employees, operating surplus, and other production taxes and subsidies. GDP contains value added as well as product taxes and subsidies.

Contribution to changes in gross value added in %, by sector								TABLE 4.2	
<i>Árlig %-broyting, ársins prísir</i>	2005	2006	2007	2008	2009	2010	2011	2012	2013
Gross value added	3.0	12.2	4.9	0.0	0.0	7.2	2.2	2.9	3.5
Resource industries	0.9	4.9	-1.1	-3.6	-0.3	6.4	0.8	14	0.7
Production industries	-0.2	11	0.1	-0.4	0.5	-0.4	0.0	-0.1	0.4
Private services	10	5.2	4.3	2.3	-16	0.7	0.9	14	2.0
Public sector	13	10	16	17	14	0.6	0.4	0.1	0.4

Source: Statistics Faroe Islands (2005-2011) and Governmental Bank (projection for 2012 and 2013, August 22nd 2012).

The development in demand (final consumption) for production shows that the decrease in 2008 came predominantly from private investments. In 2009 and 2010, public investments decreased compared with the previous years, while public consumption and net exports contributed positively to growth in 2009.

Government and municipal expenditures combined grew 3.7 per cent in 2010, and then decreased 1.5 per cent in 2011, and according to budgeted public expenditure growth, will be approximately 1.5 per cent annually in 2012 and in 2013. Public investment were significantly reduced in 2009 and 2010 compared with previous years, but grew again in 2011 compared with 2010. Public investments are budgeted to grow by approximately 12 per cent in 2012 and 2 per cent in 2013.

Access to finance, interest rates and economic outlook are crucial for the willingness of businesses to make investments. Following a downturn from 2008 to 2010 compared with 2006 and 2007, private investments are expected to have increased slightly in 2011. In 2012 and 2013 private investments are projected to grow in the same proportion as total production.

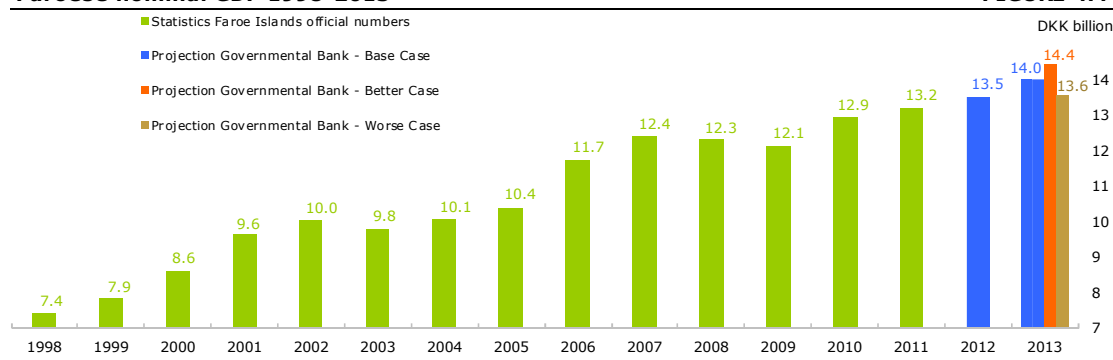
Private consumption normally comprised around 92 per cent of disposable household income. The statement of national account indicates that in 2005, 2006 and 2007 private consumption nearly equalled disposable income. Private consumption relative to disposable income had gone down significantly in 2008 and 2009 to 89 and 85 per cent, respectively. Indications are that consumption has remained at this relatively low level since. In the projection for 2012 and 2013, the consumption level is assumed to grow gradually but is assumed to remain at a level below the long-term average.

Substantial reductions in inventories were made in 2008 and 2009. This is probably due to the fact that a large share of the private sector firms experienced losses in that period. Firms have therefore adjusted their operations during this difficult period and a reduction in inventory formed part of the adjustment. The difficulties in operations and some of the adjustments made have reduced economic growth.

It is assumed that businesses have made the necessary operating adjustments, which has since resulted in improvements in operations. Following this line of reasoning, inventories do not change much in the projection model, but are assumed to grow in 2012 and 2013. These two assumptions on improvements in business operations and increased investments in inventories exert a positive influence on the growth estimates for 2012 and 2013.

Faroese nominal GDP 1998-2013

FIGURE 4.4



Source: Statistics Faroe Islands (1998-2011) and Governmental Bank (projection for 2012 and 2013, August 22nd 2012).

Statistics show that total exports (excluding ships) fell by 4.5 per cent in 2009, but grew approximately 15 per cent in 2010 and 6 per cent in 2011. The Governmental Bank estimates that total export in goods and services (excluding ships) will grow by approximately 4 per cent in 2012 compared with 2011. The projections of the Governmental Bank are based on the assumption that total exports will grow by 2 per cent in 2013 compared with 2012.

4.1.3 Global economic outlook

The global economy had been severely affected by developments in Europe these last six months. The situation is particularly dire in Spain where several banks are struggling. These difficulties have become so severe that it is not likely that Spain will be able to deal with them without assistance. Therefore, the Spanish government will receive support from the newly formed European Financial Stabilisation Mechanism and the European Financial Stability Facility.

One consequence is that interest rates have gone up significantly. The interest rates on Spanish and Italian 10-year bonds has been around 6-7 per cent, and faced with low economic growth it will become increasingly difficult for these countries to service their debt.

Annual change in GDP in fixed prices in %, 2010-2013 **TABLE 4.3**

	2010	2011	2012	2013
World Output	5.2	3.9	3.5	3.9
Advanced Economies	3.2	1.6	1.4	1.9
Emerging and Developing Economies	7.5	6.2	5.6	5.9

Source: IMF World Economic Outlook Update, July 16th 2012.

Another consequence of the situation in the Mediterranean countries is that interest rates in the Northern European countries are at record low levels. In recent months, 2-year Danish government bonds have had a negative interest rate. Investors are currently so cautious that they are willing to accept a negative interest for a period of time insofar as this means that the capital is safely placed.

Global economic outlooks deteriorated in the first six months of 2012 and economic growth estimates went down in most countries. It is particularly the instability in Southern

Europe that has affected growth negatively. However, recent indications point to the possibility of a resumption of economic growth in Europe.

4.2 THE DIFFERENT SECTORS OF THE ECONOMY

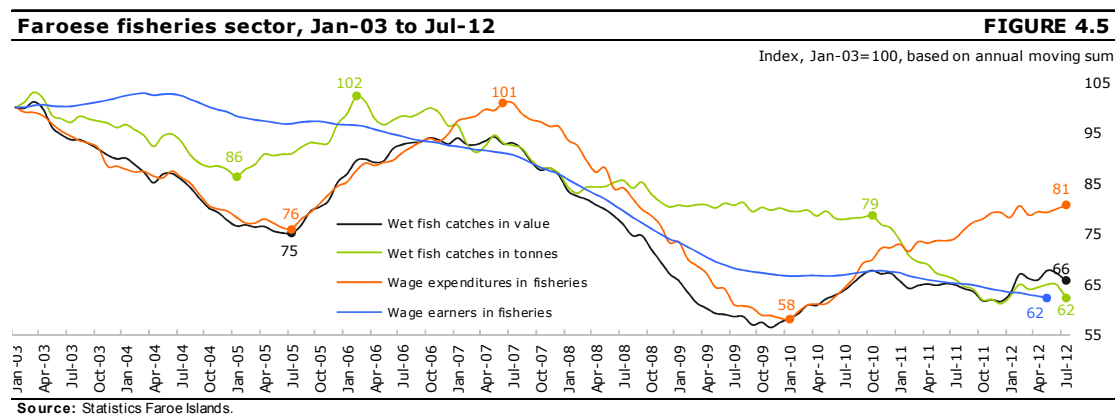
This section of the report deals with different sectors of the economy, which are important to overall developments and future prospects.

4.2.1 The resource industries

The resource industries can be categorized into four subgroups, all of which operate under different conditions at different times. The subgroups are: demersal fishing in Faroese waters, demersal fishing on distant fishing grounds, pelagic fishing and fish farming.

Demersal fisheries in Faroese waters

Conditions are in general quite poor in most subgroups of the industry and landed catches are historically low for most species. Total demersal catches in Faroese waters are significantly lower than they have been historically. However, individual vessels have been able remain profitable, and saithe fisheries have improved somewhat compared with 2011.

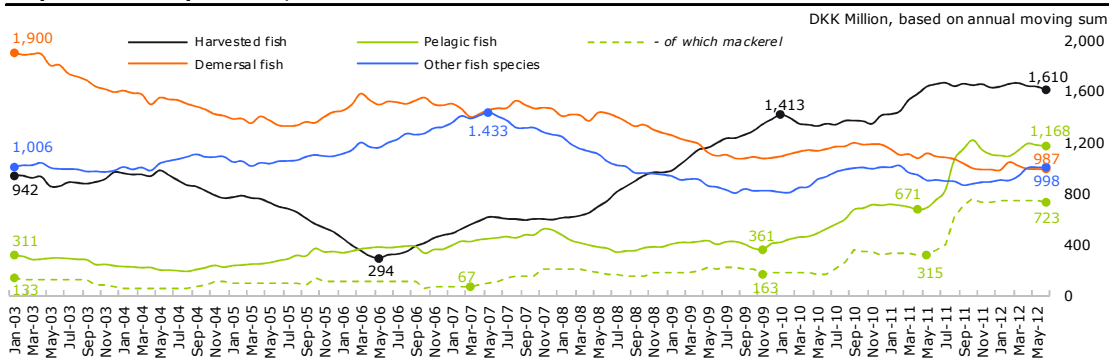


The cod and haddock stocks on the Faroe Shelf are in poor conditions (particularly the haddock stock). Survey trawling by the Faroese Marine Research Institute indicates that the cod stock on the Faroe Bank is also in a poor condition. Indications are that the saithe stock, which also migrates outside Faroese waters, is in quite good shape. The intensity of fishing has been somewhat elevated in recent years, but has now probably gone down again.

The landed catches of demersal fish from January to May 2012 are 8 per cent higher compared with the same period last year. Cod and haddock catches (weight) have gone down 19 per cent and 21 per cent, respectively. Prices have on the whole been quite stable in 2012. The high price of oil put a strain on the performance of the whole fishing industry. A major uncertainty is whether the price of oil will continue to rise in 2012 and 2013, which would severely affect industry profitability.

Exports of fish products, Jan-03 to Jun-12

FIGURE 4.6



Source: Statistics Faroe Islands.

Demersal fisheries in distant waters

There are no significant changes to the prospects of this part of the industry compared with the most recent Economic Assessment. Prospects are that production in this part of the industry will increase slightly in 2012 and 2013 compared with 2011.

Total Faroese cod and haddock quotas in Russian territory have increased 27 per cent in 2012 relative to 2011. According to ICES, cod and haddock fisheries in the Barents Sea seem to be at a sustainable level and outlook is stable for the future. Prices will likely also remain stable for these products. Oil prices, which greatly affect performance, on the other hand, are uncertain. Current estimates are that the price of oil may continue to increase in 2012.

The Faroese cod quota on Flemish Cap will be approximately 2,000 tonne, which is roughly the same as in 2011. On a whole, the production of this part of the Faroese fishing fleet will most likely increase slightly in the coming two years. The primary uncertainty is the price of oil, which may increase more than expected.

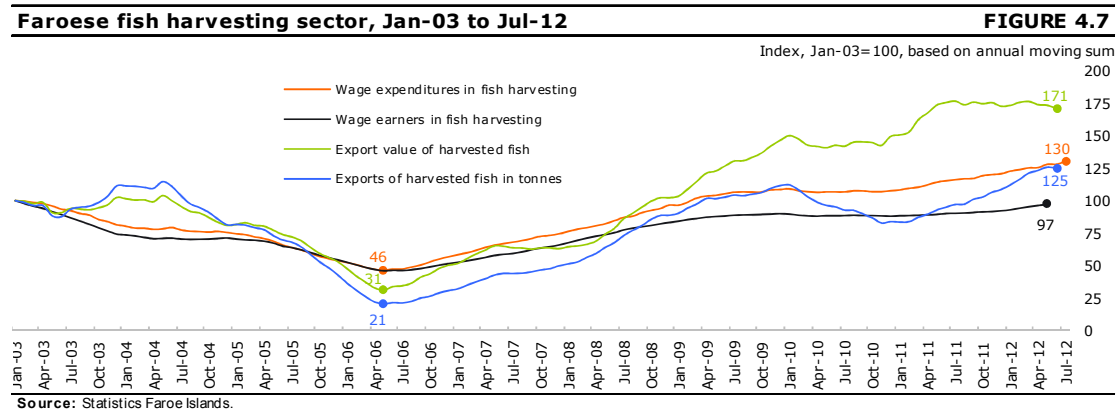
Pelagic fisheries

Production in 2012 is likely to remain at roughly the same level as in 2011, which was a good year for this part of the fleet. The pelagic fleet is affected by the conflict on mackerel fisheries. Once again the coastal states were not able to reach an agreement on the distribution of the mackerel quota for 2012, and instead unilaterally assigned their own quotas. Quotas are roughly the same as in 2011.

The Faroese quota for Atlanto-Scandinavian herring will be approximately 43,000 tonne in 2012, which is 16 per cent less than in 2011. The total allowable catch for blue whiting will increase in 2012 as it is estimated that the condition of the stock has improved. The Faroese quota for blue whiting will be 94,000 tonne in 2012, which is a substantial increase from approximately 10,000 tonne compared with 2011. 50,000 tonne of blue whiting will be traded for demersal quotas in the Russian part of the Barents Sea. The Faroese pelagic fleet will therefore not benefit from this proportion of the blue whiting quota. The Faroese capelin quota for the 2011/2012 season is 30,000 tonne.

Fish harvesting

Prospects are that profit levels and the export values in fish farming will decrease slightly in 2012 compared with 2011, which was a good year for the industry. Harvested quantities will most likely remain stable at approximately 60,000 tonne in the next 2 to 3 years. Approximately 60,000 tonne were harvested in 2011 and the same amount is expected in 2012. The price of farmed fish decreased in mid-2011. Developments in prices are uncertain, but prices will most likely remain at the same level throughout 2012. The export value of farmed fish was DKK 1.6 billion in 2011 and will likely be roughly the same in 2012 and 2013. Export quantities will increase slightly while average prices are expected to decrease somewhat.



Summing up the resource industries

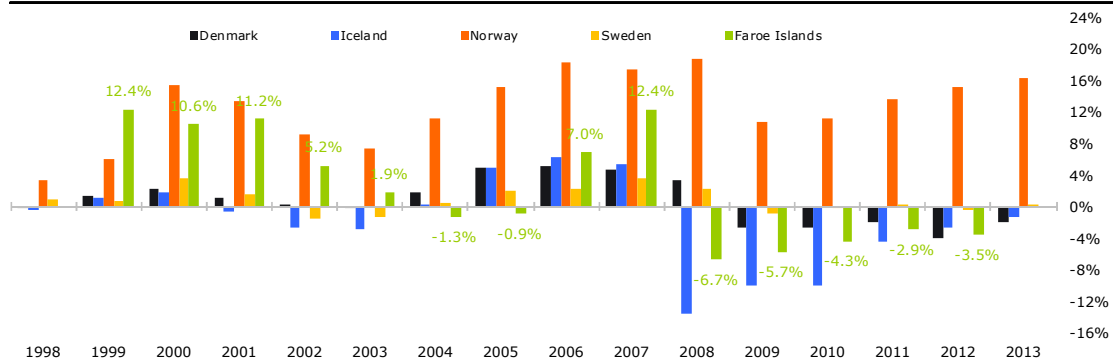
On the whole, indications are that production in the resource industries in 2012 and 2013 will be slightly less than in 2011. The primary uncertainty is related to the price of oil, which is currently high and this affect performance in the whole industry. Should the price of oil increase, it will affect industry performance. The price of oil was very high in the first quarter of 2012, but has since gone down somewhat. According to forward prices it is most likely that oil prices will increase in the future.

Another uncertainty is the price of farmed fish, which in the worst case scenario may decrease significantly in the third and fourth quarter of 2012 and thus affect the performance and export value of the fish farming industry. Given these reservations, it is estimated that the resource industries will contribute slightly less to GDP growth in 2012 and 2013 compared with previous years.

4.2.2 The public sector

The economic downturn has in recent years given rise to relatively large public deficits (i.e. central government, state government, municipalities and social funds).

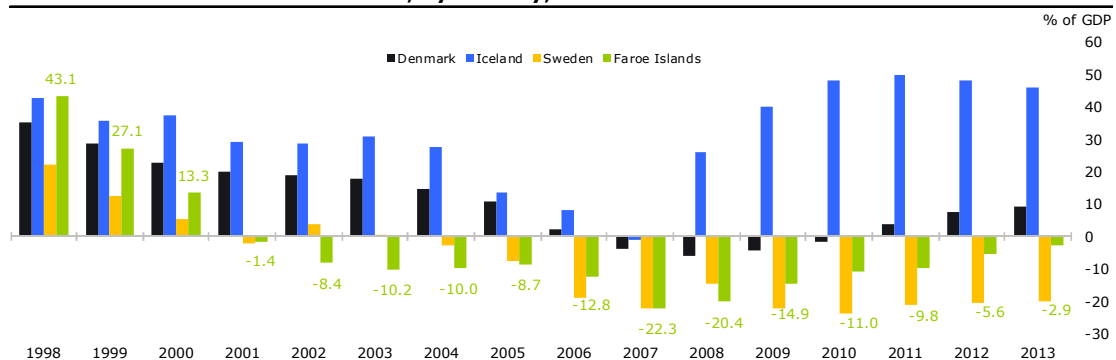
General government financial surplus in % of GDP, by country, 1998-2013 **FIGURE 4.8**



Source: Føroya Gjaldstova, Statistics Faroe Islands, Ministry of finance, Governmental Bank and OECD.

The total public deficit in 2008 was approximately 7 per cent of GDP and will in 2012 be around 3-4 per cent of GDP. The deficit is primarily due to the central government, but municipalities had a combined deficit from 2007 to 2009, and the Governmental Unemployment Scheme (ALS) has since 2010 also had a deficit as rising unemployment means that payments exceed receipts.

Public sector net debt in % of GDP, by country, 1998-2013 **FIGURE 4.9**



Source: Statistics Faroe Islands, Governmental Bank and OECD.

The public deficit has increased public debt, which given current economic projection will mean that by the end of 2013 public debt will exceed total public assets. Yet, compared with neighbouring countries, the Faroese public sector is quite well off. The Faroese public sector has e.g. less net debt than the Danish public sector and in 2011 only 5 of the 31 OECD countries had a public sector with net assets (Norway, Finland, South Korea, Estonia and Sweden).

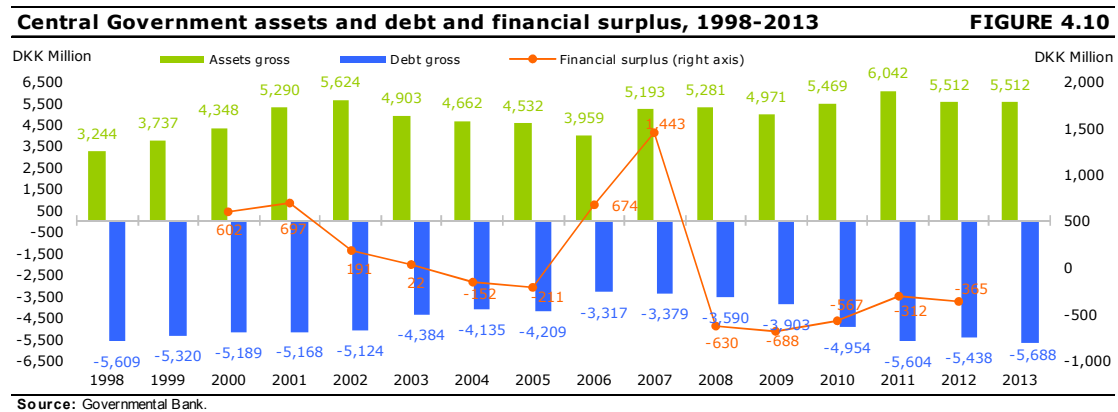
The central government

The central government has been running relatively large deficits over the last four years. The central government has thus kept economic activity and demand at a higher level than would have been experienced under a balanced budget. Government budget deficits are also expected several years ahead. The Faroese Government and Parliament have a stated goal of achieving a surplus on the budget in 2016.

Several years of deficits in a row have increased central government debt considerably and estimates are that the central government's gross debt will reach approximately DKK

5.4 billion by the end of 2012. Total assets are estimated at approximately DKK 5.5 billion by the end of 2012.

In the 2012 and 2013 projections of annual growth in consumption is set at 1.5 per cent. Investments are assumed to grow in 2012 by approximately DKK 50 million compared with 2011 and then grow a further 1.5 per cent in 2013 relative to 2012.



The municipalities

Historically, the municipalities have had an enhancing effect on a given economic development and this fact has been reaffirmed in the latest crisis. Since the economic downturn started in 2008, most municipalities have reduced investments and several of them have also reduced expenditures. In 2008, the municipalities had a combined deficit of DKK 346 million. They have now adjusted investments to such an extent that the municipalities ran a combined surplus of DKK 24 million in 2010 and DKK 29 million in 2011.

According to municipal budgets for 2012, municipalities as a whole increased expenditures as well as investment by 3.2 per cent and 11.8 per cent, respectively, compared with 2011.

According to budget estimates the total deficit will be DKK 74 million in 2012, however, tax revenues have been above estimate and budgets are therefore expected to roughly balance in 2012.

The fiscal situation and the amount of fiscal restrictions that the different municipalities are faced with varies significantly, which also will have an effect on their budgetary decision in the coming years. Fiscally sound municipalities are able to undertake investments, while municipalities facing fiscal restrictions have limited opportunities to do so and must prioritise repayment of debt.

The municipalities combined have had a stimulating effect on activity in 2011 and budgets indicate that this will also be the case in 2012. In the 2013 projections, expenditure and investment growth is assumed to equal inflation. In the projections for 2013, a 1.5 per cent growth in municipal expenditure and investment compared with 2012 is assumed.

The social funds

The Unemployment Scheme (ALS) counterbalances economic developments and given the current levels of economic activity it has a stimulating effect. Unemployment benefits strengthen the spending power of the unemployed and reduce the fear of becoming unemployed as well as influencing households to increase their savings to a lesser degree than they otherwise would have done.

ALS has (year-end 2011) equity of approximately DKK 440 million and at the current level of unemployment ALS pays out approximately DKK 25 million a month in unemployment benefits. Given the fact that the rate of unemployment is expected to fall during the year, the total pay-outs are likely to reach roughly DKK 275 million in 2012. Payments into the scheme were approximately DKK 140 million in 2011, and following the increase in incoming payments, receipts will most likely be around DKK 163 million in 2012.

The scheme is financially sound and able to withstand many years of relatively high unemployment.

The Labour Market Pension Fund is increasing equity in order to deal with a future increase in old-age pensioners, while the Parental Leave Scheme and the Health Insurance Scheme are institutions that pay out roughly the same amounts as they receive and therefore do not affect the economy as much as ALS.

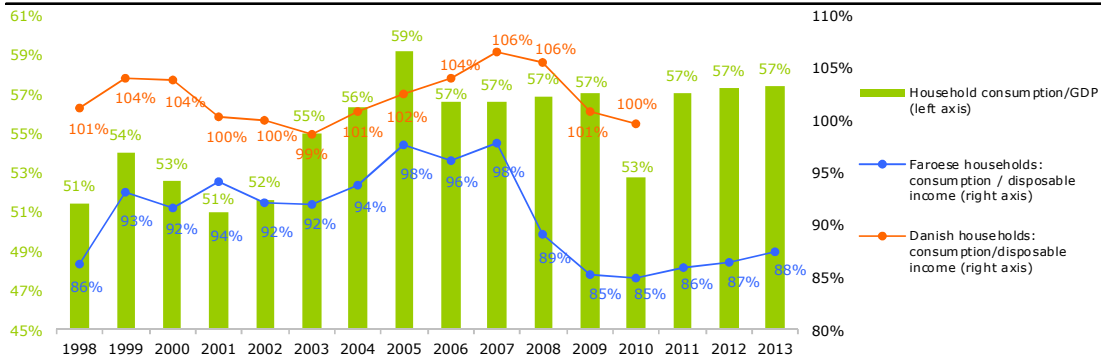
4.2.3 Households

More than half of all consumption is made by households. Therefore changes in the pattern of household consumption can substantially affect the economy in general. This fact has been quite apparent in recent years. When the economy is hit by a recession with subsequent increases in unemployment, reduction in business profits and growing government deficits, households become more anxious. They respond by decreasing consumption and increasing savings.

It is very clear that Faroese households have reduced their debt, rather than used disposable income for consumption of goods and services. It is uncertain when this tendency will change and it is largely dependent on Faroese household's assessment of perceived future outlooks.

Several blows have hit the Faroese economy in recent years: a) The global financial crisis with a resultant debt crisis in many European countries, b) Declining fish stocks, c) Increasing price of oil, d) The bankruptcy of Eik Bank and Faroe Seafood. It is quite likely that these blows have affected household consumption and have resulted in reduced consumption. According to the VAT-to-wage ratio (Figure 4.12), the Faroese households lowered their spending from the autumn of 2007 to the spring of 2010. The latest figures indicate that relative consumption has stabilized at its current low level. Thus it is possible that households will increase consumption when perceived future outlooks improve.

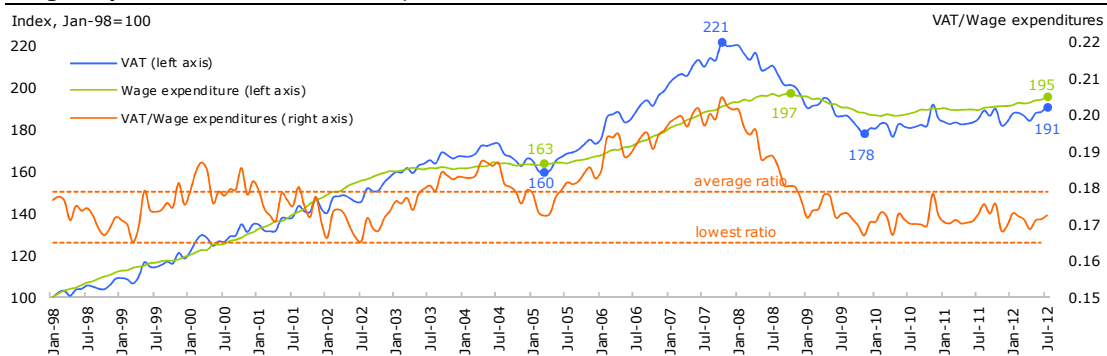
Household consumption in % of GDP and consumption ratio, 1998 to 2013 **FIGURE 4.11**



Source: Statistics Faroe Islands (1998 to 2009), Governmental Bank (projection 2010 to 2013, August 22nd 2012) and Statistics Denmark.

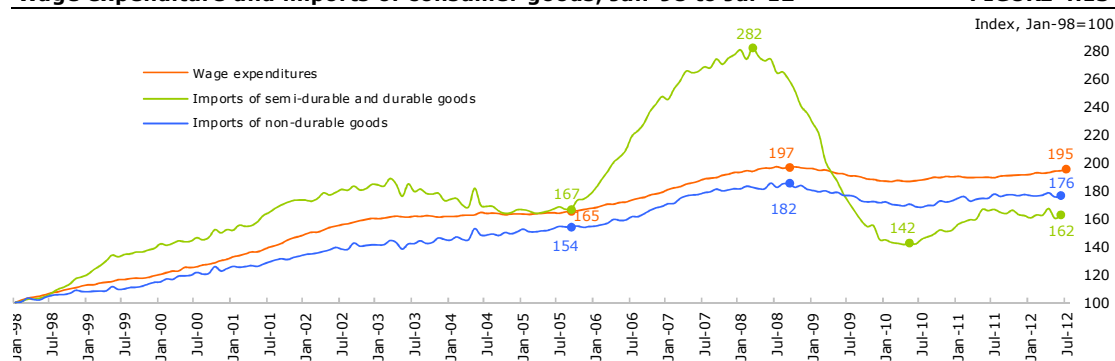
Government pay-roll taxes were reduced as of January 1st 2012, which means that a large share of Faroese wage earners received a tax cut. Disposable household income has therefore increased by app. DKK 260 million. Particularly high-income households will experience increases in post-tax income. This group will gain quite a substantial growth in disposable income. Private consumption will rise somewhat if the pattern of consumption remains the same as before the tax cuts. So far there is no observable change in the proportion of income used for consumption.

Wage expenditures and VAT taxes, Jan-98 to Jul-12 **FIGURE 4.12**



Source: Statistics Faroe Islands and TAKS.

The Faroese households are on a whole quite well off compared with households in most other countries. The total collateralized debt of Faroese households is around 75 per cent of GDP, which is close to average in international comparison. Households in Denmark, Switzerland, the UK, and in the US have levels of debt ranging from 90 to 120 per cent of GDP. The levels of household debt in Italy, France, Germany, and in Japan are on the other hand somewhat lower – between 40 and 60 per cent of GDP.

Wage expenditure and imports of consumer goods, Jan-98 to Jul-12**FIGURE 4.13**

Source: Statistics Faroe Islands.

The latest consumer sentiment report for Faroese households shows that in June this year, households were still rather pessimistic about their personal finances as well as overall economic outlook for the next 12 months.

4.2.4 The financial sector

Conditions in the Faroese financial sector have not changed much in the last year. Demand for finance is still relatively low and total lending has gone down as households and companies have chosen to repay debt instead of investing. The reduction in total lending has adversely affected the results of the Faroese banks and one consequence has been a widening of the gap between lending and borrowing interest rates. This trend can also be observed in neighbouring countries.

Liquidity is on the whole good in the Faroese banking sector and a lack of supply of credit is not a factor that is curbing growth in lending operations. In the years leading to the financial crisis households and business were given increasingly easy access to credit. This was the case in the Faroe Islands as well as in the rest of the Western world. Faroese banks also borrowed money abroad and lent them locally. Such possibilities are now significantly reduced.

As is usual following a large financial crisis, the total system of financial regulations is being scrutinised and re-examined and a tightening of regulation is currently unfolding. In the near future plans are to put in place more stringent demands on solvency and liquidity.

A well-functioning financial sector is ready to provide finance to project that can generate positive return over time. Insofar as access to credit is not given to such projects, there is a case of a *credit crunch*. It is not likely that the financial sector at the moment can be characterized as affected by a credit squeeze. On the other hand, demand for finance is low at the moment and this to some extent affects lending operations of the banks.

4.2.5 Other industries

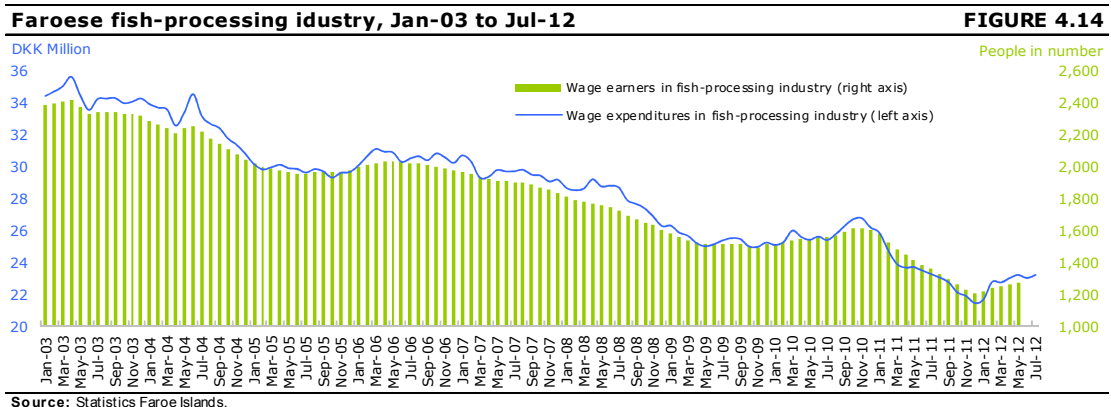
These are the manufacturing and service industries, which are not mentioned above, but combined they account for a large part of the total value added in the Faroese economy.

The fish processing industry

The fish processing industry has of lately undergone significant changes, and following the bankruptcy proceedings of Faroe Seafood the fish processing industry has been restructured. Only a small number of the company's processing plants have reopened after the bankruptcy. The number of wage earners in the industry has for many years gone down steadily. Since 2003 the total work force in fish processing has gone down by more than 50% (Figure 4.14).

The resource base for production has decreased in recent years and total demersal catches in Faroese waters have not been this low since the early 1990s. Current demersal production capacity seems to be better suited than the capacity in place prior to the industry restructuring; however, some investors have expressed intentions to open new processing plants. A large pelagic fish processing plant has just opened in Tvøroyri and minor attempts to process and freeze mackerel are being made at other processing plants.

The production in 2012 is likely to be at the same level as in 2011, possibly slightly higher, and the number of wage earners is expected to be slightly higher in 2012. According to the latest business sentiment report, the demand for labour will increase somewhat and the latest statistics indicate that the number of wage-earners as well as the actual wage payments in the fish processing industry have increased in the last six months.

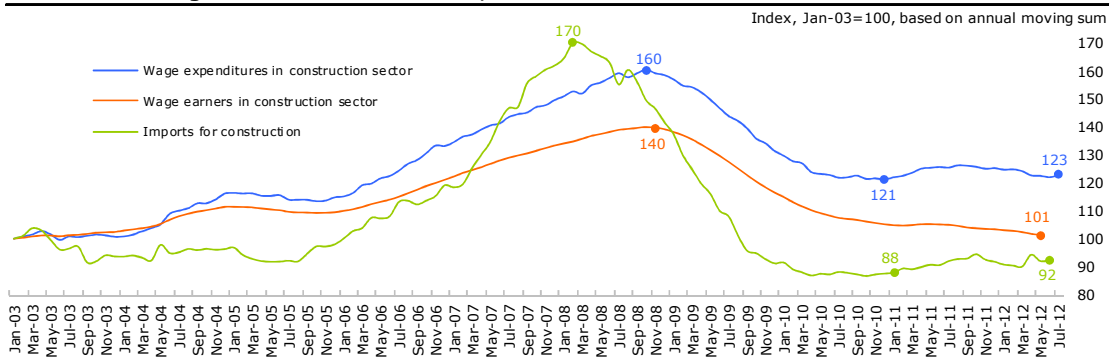


The construction industry

Construction activity has gone down significantly in the last three years. Consequently, the number of wage earners in the industry has also gone down quite substantially (Figure 4.15). A substantial number of Faroese construction workers have sought employment abroad as activity has slowed down on the Faroe Islands.

Faroese building and construction sector, Jan-03 to Jul-12

FIGURE 4.15



Source: Statistics Faroe Islands.

Small construction firms have had an adequate number of projects to work on, while the large construction companies that usually are involved in large public projects have had less to do than previously. There are, however, some large public projects under way, e.g. the terminal at Vágur Airport, the secondary school project at Marknagil, etc. In addition, Tórshavn municipality plans to initiate several small-scale projects and many are already underway and Landsverk (institute of public engineering) also plans to initiate some small-scale road construction projects.

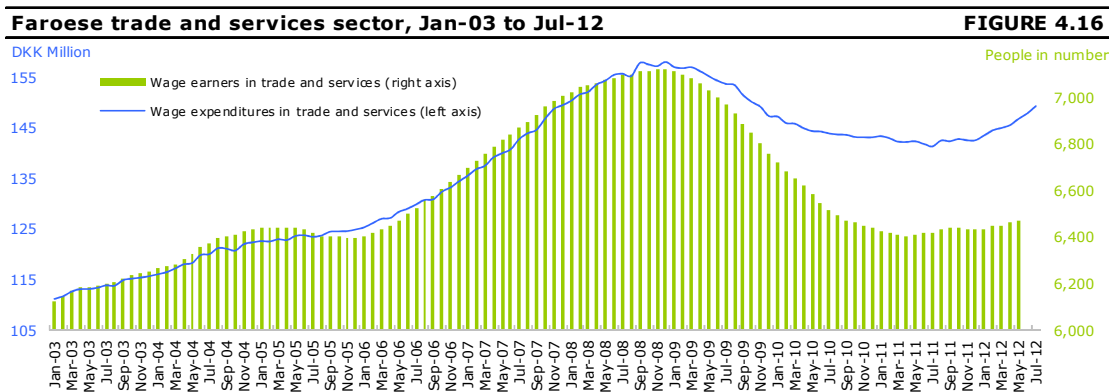
Despite relatively low activity in the construction industry companies are at times experiencing difficulties finding skilled labour. Many have sought employment abroad and this has already become an issue in the Faroese construction industry. This problem will naturally increase when the Faroese construction industry picks up pace.

Trade and service industries

The demand for goods and services is still low compared with historical figures. Particularly the sales of durable goods and certain services have gone down significantly while the sales of non-durable have not gone down as much. Imports of durable goods have slightly grow since mid-2010, however, this growth seems to have faded.

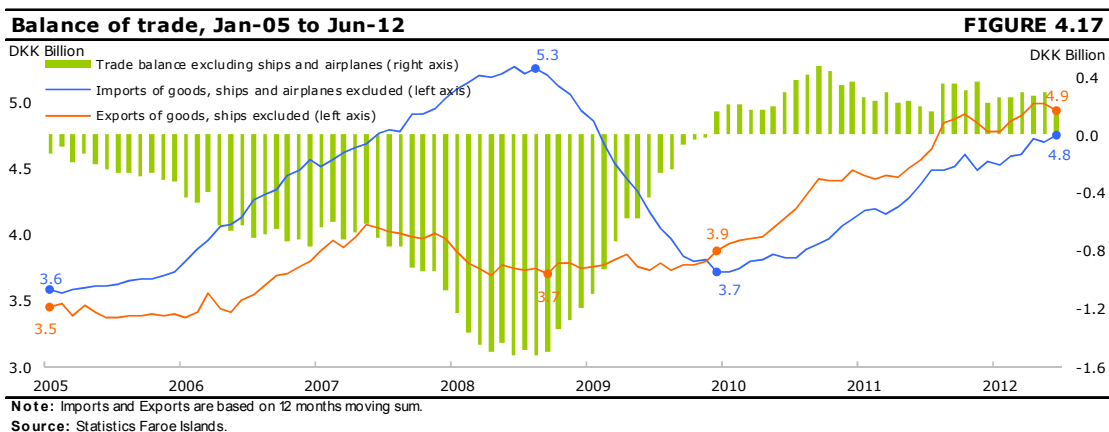
Structural changes have occurred in the consumer goods industry. Food shops and supermarkets are to an increasing degree being bought up by the large supermarket chains and the number of independent grocery shops is declining. Many companies in the service industries have gone through significant operational adjustments and have consequently been forced to lay people off.

Some companies in the service industry offer services that demand skilled labour, and they therefore on average pay higher wages than other companies. Such companies may export their services or provide service on the local market in competition with foreign firms, e.g. IT companies or offshore service providers. These companies may experience increased competitiveness in securing Faroese labour compared with foreign rivals as the tax rates have been reduced. This means that production may increase in these industries, but it, off course, will take some time before any effect is seen, as preparations are likely to be necessary in order to increase production.



4.2.6 The balance of payments

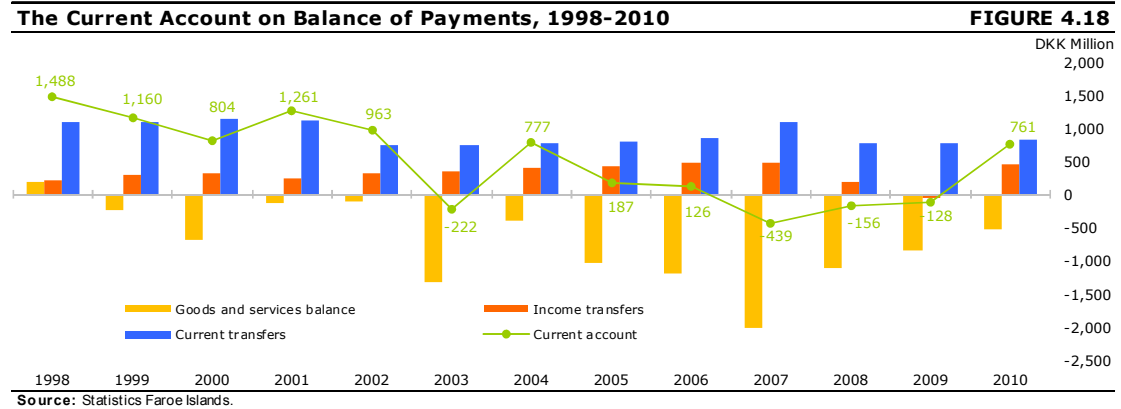
There is now a surplus on the Faroese balance of payments. After deficits in 2007, 2008, and 2009, the surplus was DKK 761 million in 2010. Estimates are that the surplus will be approximately half a billion in 2011. The balance of payments summarises all transfers between the Faroe Islands and the rest of the world and can be subdivided into trade in goods and services, income transfers and other current transfers (Figure 4.18).



The surplus on the trade balance is primarily due to increased exports of pelagic and farmed fish. At the same time, the import of goods has gone down significantly since 2008. Particularly imports of durable and semi-durable goods have decreased a great deal. There were large deficits on the trade balance from 2005 to 2007. During this period, private consumption grew substantially fuelled by increased lending by Faroese banks. The numbers so far this year indicate a deficit on the trade balance which mostly stems from large imports of aeroplanes and ships. There will most likely be a surplus if one excludes the unusually large imports of ships and aeroplanes this year (Figure 4.17).

Other current transfers mainly consist of the Danish Government subsidies. These transfers have been quite stable these past three years. The income transfers in Figure 4.18 consist of wage transfers to and from the Faroes as well as gains and losses from financial assets. In 2010 the loss from financial assets was DKK 182 million while gains from wage transfers were DKK 648 million.

It seems that the Faroe Islands currently have a large surplus on the balance of payments while at the same time running a large central government deficit. This indicates that Faroese private investments are currently at a rather low level, i.e. that a large proportion of Faroese savings are diverted to other countries. Investments are a prerequisite for future growth. Therefore, the current patterns of savings and investments may inhibit future Faroese economic growth.



The growth in wage transfers to the Faroe Islands has increased in recent years. In 2004, wage transfers to the Faroe Islands were DKK 295 million and in 2010 this figure had increased to DKK 823 million and has since likely increased to around DKK 1 billion.

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