English Summary

Short Term Economic Outlook

Statistics Faroe Islands and The Economic Council have jointly evaluated *economic growth* in 2014 and 2015. To facilitate the evaluations, an economic model developed by the former Faroese National Bank and Statistics Faroe Islands was used. For 2014, nominal economic growth was estimated to be 4.6% in current prices, and for 2015 the nominal economic growth was estimated to be 4.3% in current prices. *Wage payments* were anticipated to grow by 5.5% in 2014, and 4.0% in 2015.

Over the last few years, economic growth in the Faroe Islands has been low, while at the same time a considerable deficit in the public sector accounts was present, which in the main was a result of a deficit in the National Treasury. However, over the last half-year there have been some significant changes in the trends expressed in most all the key economic indicators. Most indicators now suggest increasing economic activity and growth in the economy in current prices, and there is also a hint that the deficit of the National Treasury is declining.

Faroese *fish products export* is much changed compared to the last few years during which there has been little economic growth. Trends over the last few years have offered a new pattern in exports. Exports are now composed of three groups of essentially equal value. These three groups are *aquaculture (farmed fish), pelagic fisheries,* and the *demersal and other fisheries.* There has been considerable growth in the export of *farmed fish* since 2005 or so. There has also been considerable growth in the export of *pelagic fish* since 2010. On the other hand, there has been a decline in the export of *demersal and other fish* from around 2003.

At the same time as the Faroese *fish products export* has greatly changed over the last few years, there have been major changes in our export markets. Exports to the EU market have declined, while other markets have grown in its stead, such as China, Russia, the USA and Nigeria.

Price increases are characteristic of *farmed salmon* export in recent years. More than half of the growth in GDP in current-prices in 2013 resulted from the price increases for *farmed salmon*. It is anticipated that the price of *farmed salmon* will also increase in 2014 and 2015, but perhaps not so much as in 2013. There is little, if any, growth in farmed salmon production, while demand continues to accelerate.

The growth experienced in the export value of the *pelagic fisheries*, especially mackerel, is the result of increases in the size of the fish stocks, i.e. the size of the mackerel stocks has increased and therefore the Faroe Islands has unilaterally stipulated its quota accordingly. In 2014, a new agreement on mackerel was negotiated between some of the coastal states. For the Faroe Islands, the agreement represented higher prices, but not an increase in the quota, compared to the years without an agreement. The anticipated increase in prices is a result of the access to mackerel fishing in EU and Norwegian waters. Moreover, the rescinding of the EU boycott might support increasing prices.

The third group is *demersal and other fisheries* caught in Faroese waters and subject to the Fishing Days System, as well as other fisheries in other ocean sectors, e.g. the Barents Sea, under a quota system. The demersal fisheries in Faroese waters subject to the Fishing Days System remains in crisis. This export has remained constant or declined over a period of many years. On the other hand, the export of fish from other fishing grounds has increased, but the price trends have not been so advantageous. The Faroese fishing vessels that are under the quota system would appear to be doing quite well based on their financial statements, while the opposite would appear to be the case for the vessels under the Fishing Days System. This might indicate that the quota system encourages the minimizing of costs, while the Fish Days System encourages the maximizing of turnover (i.e. catch in tonnes). This maximizing of turnover could encourage overfishing and diminished regard to costs and profitability.

Current year-on-year changes to June 2014 in all *imports* showed a decline of some 8%. Exempting vessels and airplanes, imports held constant. Some of the import numbers indicate a small increase in private consumption, and at the same time growth in domestic investment.

The trend in *wage payments* is generally indicative of economic growth. The latest wage figures show an annual increase in wage payments upwards of 4%. The largest increase was seen in the goods production industry sector, but this trend was also visible in the construction industry and in the shipbuilding sector, while there was less wage-payment growth in the public sector.

Deflated by the consumer price index, *wage payments* have remained constant or decreased between 2007 and 2013. In 2014, we see growth in deflated wage payments. The growth seen in 2014 in deflated wage payments could, however, also stem from the declining trend in the consumer price index.

The *number of wage earners* has grown little between April 2011 and today (some 380 people). On the other hand, the number of *full-time unemployed* fell from around 1900 in January 2011 to some 1000 in April 2014. One explanation is that people in the Faroe Islands can more easily find work abroad, while at the same time maintaining their residency in the Faroe Islands.

Within the *fishing industry sector*, the number of wage earners has declined considerably within *fishing operations* and *fish processing*, while the number of wage earners within the *fish farming industry* has grown significantly. Within *fishing operations*, the number of wage earners declined from 2731 in January 2004 to 1440 in April 2014. Within *fish processing*, the number of wage earners declined from 2178 in March 2006 to 1171 in April 2014. On the other hand, the number of wage earners in *fish farming* grew from 295 in March 2006 to 867 in April 2014.

The *fishing industry sector* has clearly been through a transformation. Catch capacity and the landing capacity for the processing of the pelagic fisheries has grown significantly over the last few years, and the new fishing vessels and processing facilities require a much smaller labour force than older ships and fish processing plants. The loss in the number of wage earners can only be regained by growth in other sectors within the industry or within other business sectors. The danger is always that this growth will not occur in the Faroe Islands, but abroad, resulting in emigration.

The Business Confidence Survey conducted by the Ministry of Finance indicates that the construction industry has shown the greatest activity since the financial crisis, but at the same time the construction industry expressed concern regarding recruitment and financing. Other business sectors reveal a certain optimism.

The Consumer Confidence Survey of the Finance Ministry revealed that c*onsumer confidence* was the highest since the financial crisis. Moreover, import, wage and VAT data suggest a small or beginning growth in private consumption.

There has been very little growth in *public sector spending* since the financial crisis. Growth is estimated to be 1.4% in 2013 and 1.5% in 2014. Data from 1998 indicate that changes in *public sector spending* is pro-cyclical – when there was much in the treasury, much was used and vice-versa – and this exacerbated rather than mitigated the swings in the economy. It is advisable that the government not repeat the excessive spending policies adopted at the beginning of the 21st century and in 2007 and 2008, in the event that activity otherwise increases in the years ahead.

We see clear evidence of growth in total *public investment* during 2014 compared to 2013. We anticipate that investment in 2015 will be at the same level as in 2014. The growth in *public* *investment* from 2013 to 2014 stems, in the main, from central government investment, rather than municipal investments. Central government investment is significantly impacted by the school building construction at Marknagil. Municipal investment has remained constant since 2008, but grew considerably up to 2008. In the main, this investment stemmed from diminished municipal investments during the 1990s. Healthier municipal finances up to 2008 also spurred interest in investment projects.

Just as with *public sector spending*, public investment appears to be cyclical as well, both with regard to the central government and the municipalities. As well, it is advisable for the public sector not to repeat the policies regarding public sector investment that were implemented in 2007 and 2008, if activity otherwise increases in the years ahead. Reliance on a municipal debt ceiling – i.e. that debt levels cannot exceed the annual tax revenue – clearly does not encourage systematic fiscal policy planning that should encompass all public investment.

The deficit for all *public sectors* was around 488 million DKK in 2013. It is estimated that the deficit for 2014 will be around 200 million DKK. For the most part, the deficits from both of these years reflect central government deficits. It is estimated that the central government current, investment and lending account (CIL) will be around 180 million DKK for 2014. Net assets of the public sector were around 2.5 billion DKK in 2007, but in 2014 are near zero.

Demographic Changes

Over the next 35 years, there will be major demographic changes in the Faroes. Without much doubt, the anticipated changes include, for example, that 1) both men and women will live longer; 2) the number of people over 80 years of age will more than double; 3) the number of people over 70 years of age will nearly double, and 4) quite probably, there will be a considerable reduction in the number of people working and paying taxes.

These changes will weigh heavily on the expense side of the public treasury, especially the expenses relative to health and human services. At the same time, lower tax revenue will have unfortunate consequences for the revenue side of the public treasury. These demographic changes, of course, will occur gradually and their individual consequences will be felt gradually, but altogether they will have considerable economic and financial consequences. In the Faroe Islands, these changes in the demographics of the country will be much more fiscally troubling than in our neighbouring countries. Mass emigration from the Faroes in the 1990s radically distorted the age and gender demographics. If it proves difficult in times of economic prosperity to gain control of mounting government debt because of a continuing, structural deficit in the National Treasury, then the anticipated demographic changes will increase the burden.

These demographic changes will thus create major challenges for public fiscal management to ensure long-term financial stability. It is thus imperative that the fiscal policy in the years ahead, and economic policy in general, address, to an even greater degree than before, the demographic changes that await the country in the near future.

Above and beyond all these other challenges comes the relatively low pension savings by the Faroese as one more drag on the long-term economic sustainability of the Faroe Islands. The same can be said for the pre-taxing of pension savings instituted in 2012 in order to finance the tax cut, which, given current demographic realities, makes achieving fiscal sustainability even more difficult in the long term.

Economic Rent and Resource Rent in Fisheries

This report attempts to critically analyse and explain the idea of *Economic Rent* and related market concepts, especially the economic conceptualization called *Resource Rent.*

Economic Rent is defined as the additional monetary value, which, given the demand, emerges as a consequence of a limited availability of a production factor (e.g. natural resources, labour force, capital or special skills and competency). Other concepts related to *Economic Rent* are *Resource Rent, Intra-marginal Rent (Quasi-rent) and Monopoly Rent.* *Resource Rent* is an Economic Rent that is derived from the limited supply of natural resources. *Intra-marginal Rent* is Economic Rent that stems from the limited supply of human resources. *Monopoly Rent* is Economic Rent that is derived from the exploitation of a monopoly position creating functional scarcity.

With regard to the actions or measures instituted by the government, the creation of a competition board or commission addresses issues of *Monopoly Rent.* With regard to *Intra-marginal Rent* that is derived from human resources, the government, on the other hand, cannot limit or control this rent by applying fees or taxes. However, *Resource Rent* is a different matter altogether. *Resource Rent* stems from the limited supply of natural resources. The government could demand to have this "rent" paid, without, in principle, hindering the overall efficiency of an industry. The goal of governmental management of *Resource Rent* should be to establish the *Resource Rent* at the highest level possible, while at the same time addressing the issue of economic equality or the distribution of economic wealth.

There are three categories of natural resources that could spin off *Resource Rent*:

1) non-renewable resources, such as, e.g., oil and minerals;
2) renewable resources, such as, e.g. fish stocks;
3) permanent resources, but not unlimited, such as, e.g. water, wind, ocean energy and aquaculture areas (conditioned as well on environmental factors).

Revenues from *Resource Rent* payments from, respectively, non-renewable and renewable resources should be managed separately and individually. For non-renewable resources (e.g. oil), economists have recommended that only the profit from financial investments funded by the resource rent payments themselves should be designated for revenue/expenses within the public sector, if the actual resource assets shall be preserved for coming generations. For renewable resources (e.g. fish stocks), there is no such limitation.

It is clear that "*Resource Rent*" is not an empty, theoretical idea that can be dismissed as a mere chimera. We have repeatedly affirmed that in the Faroes the resource rent in the fishing industry is a tangible, economically empirical reality. At the same time, neither is it so simple and straightforward to calculate the resource rent without taking into consideration intra-marginal rent. The point is that the notion of "resource rent" is in reality collectively a concrete and empirical concept; at the same time, however, it is less tangible than an explicitly calculated amount of money.

The generally accepted practices or procedures relative to the calculation of resource rent (as a specific amount) within the fisheries industry are the following:

Turnover
    less all costs except wages and capital.
= Value added
    less "normal" wages and less "normal" return on capital
= Resource Rent.

Such a calculation, however, is subject to considerable uncertainty. First, using the calculation basis above, it is difficult to determine the size of any intra-marginal rent that will be incorporated into such a calculation of resource rent. Second, it is difficult to determine what are "normal" wages or what are "normal" return on capital. Strictly objective calculation methods simply do not exist to differentiate intra-marginal rent from resource rent, using the procedures / methods outlined above. If certain pre-conditions are in effect (e.g. the number of tendered offers), one can then ascertain the resource rent (without the intra-marginal rent) in the fisheries industry by selling the fishing permits via an auction. The resource rent is thus the value that the owner of the fishing vessel in open competition is willing to pay for access to the input for the production process (i.e., the fish).

Using procedures explained above, we calculated the resource rent for the Faroese fishing industry, both the current and the optimal resource rent. The current resource rent is the resource rent derived from calculations based on actual financial statements of the Faroese fishing fleet. Optimal resource rent, on the other hand, is the resource rent that would be generated, if the fishing effort were limited to the maximum economic yield. These calculations are described in Section 5 and Sections 7-9 of this report.

The conclusion is, among others, that the resource rent has been large for the pelagic fisheries fleet and the factory trawlers over the last few years. On the other hand, the demersal fisheries have had an insignificant resource rent over the last many years. Another estimate, among others, is that the optimal resource rent for 2012 would have been between 850 and 1050 million DKK, while the actual current resource rent for 2012 has been calculated to be 472 million DKK.

Section 8 and 9 of the report outlines the effort to estimate the optimal size of the Faroese fishing fleet and the crew requirements of the demersal fisheries in Faroese waters. The result suggests a considerable reduction in the number of vessels and crew. We also confirm that the Faroese administration of the fisheries resources has not been consistent with the biologic advice for many years. A comparative study was carried out to ascertain the actual catch landings compared to the biologic advisories. The findings indicate that the actual landings have been much greater than the recommended catch limits.

Section 6 of the report contains some estimates of the public costs and revenue relative to the natural resources industry. The costs are conditional catch-related costs set out in the national budget and revenue relates to tax and payments of the resource rent.