

BÚSKAPARRÁÐIÐ

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Búskaparfrágreiðing

- I. Konjunkturmeting
- II. Fíggjarliga haldfórið hjá almenna geiranum

Mars 2015

Economic report from the *Economic Council of the Faroe Islands*, Spring 2015, with Executive Summary in English: (I) Economic outlook, and (II) a long-term projection with focus on the the sustainability of the Faroese public sector finances.

Redegørelse fra det *Økonomiske Råd på Færøerne*, forår 2015: (I) Udsigterne for konjunkturudviklingen, og (II) beregninger angående den langsigtede holdbarhed af den offentlige sektors finanser.

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English Summary – Short Term Economic Outlook

Statistics Faroe Islands and The Economic Council have jointly evaluated *economic growth* in 2014 and 2015 and 2016. To facilitate the evaluations, an economic model developed by the former Faroese Landsbankin and Statistics Faroe Islands was used. Statistics Faroe Islands has determined that nominal economic growth for 2013 was 7.5%, which is somewhat higher than estimated (5.1%).

For 2014, nominal economic growth was projected to be 4.1% in current prices, and for 2015 the estimate is 2.5%, and for 2016, growth is projected to be 2.2%. Wage payments according to the national accounts are expected to grow by 3.7% in 2014, 2.5% in 2015 and 2.3% in 2016.

Aside from 2010, the trend since the financial crisis through and including 2012 showed little economic growth, while at the same time the public sector accounts showed a large deficit, which in the main derived from a deficit in the National Treasury (landskassin).

A shift was observed in the trend in the last half of 2013, when most key economic indicators revealed a hint of growing economic activity and economic growth in current prices. Nevertheless, this did not prove sufficient to turn the result in the National Treasury (landskassin) from a deficit to a surplus, but there is a suggestion, however, of a declining deficit in the National Treasury.

What has sustained economic growth over the last few years especially is the price trend for exported farmed salmon, the trend in exports in general, the trend in investment activity and the trend in private consumption. It is believed that the growth in private consumption over a somewhat longer period of time will be limited by low pension savings by the Faroese and the obligatory pension system, and that this can contribute to limited economic growth. Given the current level of technology, there is also a limit to how much the aquaculture industry can grow, and, with the current pelagic fisheries quota, the catch is limited. A increasing part of the economic growth observed in the last few years stems from an increase in capital earnings rather than in wages.

The growth in export prices reflects the export of farmed salmon over the last several years. Around half of the growth in GDP in 2013 in current prices stems from the upward growth of the price of farmed salmon. The price for farmed salmon grew as well in 2014, but perhaps not as much as in 2013. The amount of farmed salmon was estimated to be exceptionally large in 2014, while it is believed that there will be a small decline in 2015.

Growth in the export value of the pelagic fisheries, especially of mackerel, stems from increasing catches because, among other things, the mackerel stocks have increased, and the Faroe Islands has unilaterally set its own quota. In 2014, a new agreement was entered into among some of the coastal states regarding mackerel. For the Faroe Islands, the agreement meant higher prices, but not a higher quota compared to the years without an agreement. For the other pelagic fisheries, namely herring and blue whiting, no agreement has been reached for 2015. It is anticipated that the quota for herring will remain constant, while the quota for blue whiting could rise. In the end, it is expected that the export value for 2015 will remain consistent with 2014.

Private consumption is a significant part of the economy; the level of private consumption in the Faroe Islands is greater than the export of goods and services. The trend of private consumption, therefore, has a major impact on economic growth. Private consumption is calculated at the same time as the national accounts, but the latest updated figures on consumption are from 2013. For the period of time after 2013, we have some indicators, including import figures, wage payments, VAT data and the data from the Economic Confidence Survey conducted by the Ministry of Finance.

Changes for all imports in 2014, compared to 2013, reveal a decline of some 6.6%. Excluding ships and airplanes, imports rose by 3.4%. For 2014, the import figures for immediate consumption show a growth of 5.4%, which gives some indication of a growth in private consumption. The latest data on wage payments shows an annual growth of 6%. The greatest growth is seen in the goods production

industry, which also includes the construction industry and shipyards, while there was lower growth in public sector wage payments. Data on VAT payments to the National Treasury also points to an increase in private consumption. The Consumer Confidence Survey of the Ministry of Finance for private households indicates greater confidence than has been seen since the financial crisis. The data from the confidence survey, together with import, wage and VAT figures, give an indication that there is growth in consumption. The growth in private consumption in 2014 is estimated to be 7.6% and for 2015 it is estimated to be 4%.

There has been little growth in *public sector consumption* since the financial crisis. The growth is estimated to be 2.3% in 2014 and 1.9% in 2015. Data from 1999 indicate that changes in public sector consumption is pro-cyclical – when there is much in the treasury, much is spent and vice-versa – and this has exacerbated rather than mitigated the fluctuations 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, if economic activity otherwise increases in the years ahead.

We see a significant growth in total *public sector investment* in 2014, compared to 2013. We anticipate that the investment in 2015 and 2016 will lie at the same level as in 2014. The growth in public sector investment from 2013 to 2014 especially stems from investment by the national government and not from investment by the municipalities. The investment activities of the national government are considerably impacted by the construction occurring at Marknagilsdepl [the new secondary education building]. Municipal investment has remained steady since 2008, but had been growing exponentially up to that time. Investment in the main stemmed from loans in the 1990s. Improvements in the fiscal status of the municipalities also impacts investment interest.

Just as with public sector consumption, public sector investments are deemed to be pro-cyclical, both for the national government and the municipalities. It is therefore advisable for the public sector here again not to repeat the actions taken during 2007 and 2008, if economic activity otherwise grows in the coming years. The debt ceiling of the municipalities – meaning that debt shall not exceed the yearly taxes assessed – does not necessarily encourage systematic planning of fiscal policy that encompasses all public investment.

The deficits in all the *public sector accounts* have been large over the last several years and in the main stems only from a deficit in the National Treasury. It is estimated that the net operational deficit of the National Treasury for 2014 will be around DKK 230 million. Net assets of the public sector accounts were around DKK 2.5 billion in 2007, but will be close to zero in 2014.

English Summary – Fiscal Sustainability

For the first time ever, The Economic Council undertook a fiscal sustainability analysis of the Faroese economy. For this purpose, the Council created an economic model to calculate the fiscal consequences of demographic changes and economic policy changes. This model enables a projection of public sector expenses and revenue as well as GDP. The calculations are based on a projection of population size and composition. Further, a financial formula is used to calculate present value as well as the fiscal sustainability indicator, which indicates, in a single number, the fiscal sustainability of the public sector economy.

The basis year for the calculations is 2012. This means that the projections of public sector revenue and expenses is based on the public sector expenses and revenue in 2012, as compiled in the statistical accounting data maintained by Statistics Faroe Islands of the public sector accounts. Projections were made through 2051.

Positive fiscal sustainability means that the anticipated future public sector revenue at the very least should cover future public sector expenses. If not, the level of fiscal sustainability is insufficient and such situations customarily require intervention through politically-driven economic policy initiatives.

Most all countries in Western Europe and the Western World conduct regular calculations of their respective annual fiscal sustainability as a required element of forging public economic policy. It is anticipated that in the future this will be done in the Faroe Islands as well. The main reason for this interest is the demographic changes that lie ahead, and also the financial crisis.

Of course, there is always a certain amount of uncertainty associated with such calculations. In essence, the goal of the calculations is simply an attempt to ascertain and pull together all the relevant trends. For the Faroe Islands, some conditions are more explicit than others, e.g., the age distribution of the elderly part of the population, and that GDP and public sector revenue and expenses are conditioned on age distribution.

There is a presumption that the demographic situation in the Faroe Islands is more distorted relative to age distribution than found in those countries with which we normally compare ourselves. The Table below shows the historical trend and projections from 2013 for the older age groups in the Faroe Islands.

Population of older age groups 1990 - 2050

Year	1990	1995	2000	2010	2013	2020	2025	2035	2045	2050
Over 70	3728	4159	4397	4864	5475	6669	7488	9257	10173	10158
Over 80	1074	1267	1510	1939	2091	2267	2778	3860	4819	5150

Source: Statistics Faroe Islands

GDP projections were based on 2013 data (provisional figures from the last audited public sector accounts). Projections to 2051 are based on an assumed average annual price index increase of 1.75%, and an average annual growth in productivity of 1.5%. Otherwise, the calculations (present value calculations) are based on an assumed average nominal interest rate of 4.75% for the period.

The fiscal sustainability calculations are based upon, among other things, how much each person on average in each annual age band costs in 2012 for certain public expenses (individual public consumption and individual public financial transfers). For each year forward to 2051, projections are made for these expense groupings [age bands], based on assumptions about the yearly average price index increase, as well as real growth, which corresponds to assumed growth in productivity (grounded in the bases referenced above). The projections are made by multiplying the projected number of people in each age band every year forward by how much each person on average in each annual age band costs, where the costs are adjusted for assumed price index increases and assumed real growth, corresponding to growth in productivity.

For non-age-specific (collective) public services and public sector consumption, the projections are made based on projected growth in the population; also in this regard here again the cost is adjusted for price index increases and a real growth that corresponds to growth in productivity.

For investment, the projections are formulated as a percentage of projected GDP (historical average figures for the year 1998 – 2012 are used).

For almost all of the public revenue, the projections are formulated as a percentage of projected GDP (historical average figures from the years 1998 – 2012 are used). For the Block Grant and other Danish revenue support to the Faroe Islands, the projections are based on available Danish P/W figures. (i.e., price and wage index used by the Danish government)

Special attention has been focused on the calculations of public revenue under the old pension scheme (with deferred tax) and the new pension scheme (with advanced tax). Changing from a deferred tax scheme to an advanced tax scheme does not in and of itself affect fiscal sustainability (i.e., the calculated fiscal sustainability indicator), but the consequences of this change could, on the other hand,

easily worsen liquidity, if there occurs an adverse impact on the result of the public sector accounts over time.

By basing our projected expense calculations on the assumption that real growth is equal to growth in productivity, we also submit to the assumption that productivity growth has a neutral impact on fiscal sustainability. Growth in productivity results in growth in GDP and public revenue. However, public expenses have historically been seen to grow concomitant with growth in public revenue. The real growth in public sector wages and services has in the long-term corresponded to growth in productivity. Thus, historical experience demonstrates that growth in productivity and the economy does not in and of themselves shelter fiscal sustainability – weak fiscal sustainability reflects disturbances or disruptions in the economic structure. On the other hand, growth in productivity does occasionally protect jobs by strengthening commercial competitiveness, and thereby indirectly strengthening the fiscal sustainability of the public sector. But this type of impact, however, cannot be inserted into the computer model being used. As with productivity growth, price index increases are also assumed in the calculations to have a neutral impact on fiscal sustainability.

The following assumptions regarding “quality aging” were used in the projections for the three expense line items listed below under the Ministry of Health (HMR) and the Ministry of Social Services (AMR):

- Consumption under “10.2 old age services”, which encompasses home help, nursing homes and retirement homes (under AMR);
- Consumption under “7 health services” (under HMR)
- Financial transfers provided under “7 health services” (under HMR).

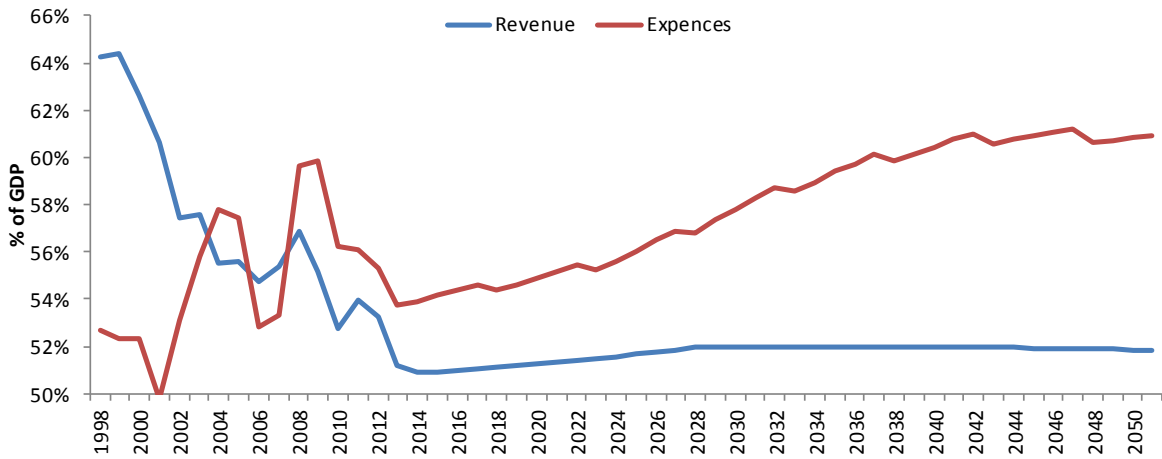
These assumptions are incorporated into the economic model in the following manner: Beginning with the 35-year-old age group, the 2012 expenses for each person are moved one year forward for each 5-year age band. This means, for example, that a 99-year-old in 2018 would cost the equivalent of what was provided to a 98-year-old in 2012. The assumption regarding “quality aging” is based on experience from our neighbouring countries. Impact consequence analyses have shown that this assumption or element in economic calculations has a major impact on the calculated fiscal sustainability.

The graph below shows the result of a consequence calculation using the fiscal sustainability model wherein the assumptions used by the Council are considered realistic, and also are deemed to be essentially consistent with the policies articulated by the broad political majority. The assumptions on quality aging are incorporated. Also incorporated into the model’s calculations is the assumption that the price index and/or real growth adjustments would not be integrated into the national pension scheme in the future. The base pension rate has not been adjusted since 1999, although the supplemental rate has been adjusted. For 2015, no adjustment was made to the early retirement pension scheme, etc., but in our projections we have, however, indexed these for price increases and real growth.

The result of this consequence calculation is a fiscal sustainability indicator of minus five. This means that a long-term tightening of fiscal policy, which in DKK equates to -5% of GDP, is necessary in order to ensure that the net debt/asset of the public sector accounts as a percentage of GDP will remain the same at the end of the projection period as at the beginning, i.e., unchanged. In 2015, 5% of GDP equals around DKK 750 million (5% of DKK 15 billion).

The graph below shows how this result is derived. As depicted, expenses grow from revenue. One trend that is evident from the graph below is prevented in and of itself because of extreme growth in debt. Apart from this, we believe that the trend identified is correct, i.e., if no other economic policy measures are enacted, or if nothing totally unexpected occurs.

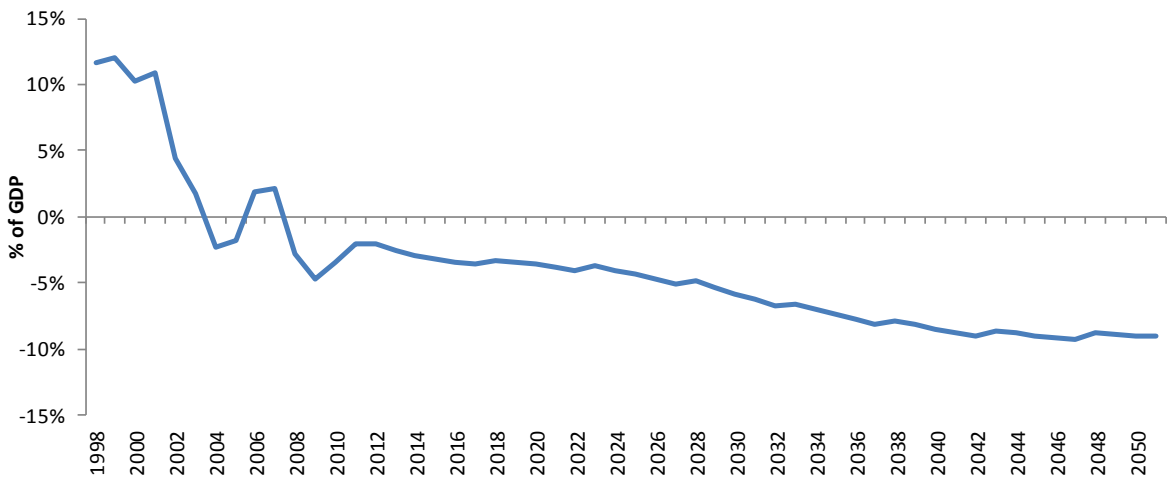
Revenue and Expenses in percent of GDP 1998 - 2051



Source: Calculation of sustainability. For 1998 -2011, data are actual balances, while for 2012-2051(projected) data are primary balances (less interest)

The result also shows a growing deficit as a percentage of GDP.

Results of annual accounts in percent of GDP 1998-2015



Source: Calculation of sustainability. For 1998 -2011, data are actual balances, while for 2012-2051(projected) data are primary balances (less interest)

This graphic representation shows quite clearly that there is considerable pressure on expenses; demographic changes push expenses upward as a percentage of GDP, and revenue as a percentage of GDP cannot withstand this pressure.

It is possible that rationalization efforts within the public sector could lead to reduced expenses; in the first instance, this will cost jobs. To “offload” expenses from the public sector was the principal goal of the new pension scheme. Given the lack of data, The Economic Council cannot determine if and when this might become an actuality. Otherwise, major and/or drastic reductions in expenses could easily result in the level of public services, public financial transfers, and also the basis for investments falling well under the level found in our neighbouring countries. Such radical cuts could also set into motion a vicious cycle of a declining economy and growing emigration.

To increase tax revenue and other related fee/surcharge revenue through the pressure of tightening tax measures can have the same impact on the economy as the cutting of expenses. It is possible, however, to impact both the revenue side and the expense side of the public sector accounts by making the pension age more upwardly flexible, consistent with the trend in “quality aging”. At the same time,

the government could broaden its tax and revenue basis. In this regard, we refer the reader, for example, to the analysis of resource rent in The Economic Council's report from the autumn of 2014.

Given the desire to assure a level of welfare that does not decline much below that provided in our neighbouring countries, the problems with fiscal sustainability referenced above can be explained by the fact that we will in future have too few working-age employees and too few competitive jobs for them – we will lack both people and jobs. Therefore, the revenue trend will be what it is shown to be.

In conclusion, The Economic Council believes, however, that it is possible to safeguard public sector fiscal sustainability in the Faroe Islands. In large measure, the question is dependent on political will and political choice.