

BÚSKAPARRÁÐIÐ

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## Búskaparfrágreiðing

- I. Konjunkturmeting
- II. Greiningar viðvíkjandi almennum ílögum og viðvíkjandi eldraðkinum

September 2015

Economic report from the *Economic Council of the Faroe Islands*, Autumn 2015, with Executive Summary in English: (I) Economic outlook, and (II) Special analyses (government investments and elderly care)

Redegørelse fra det *Økonomiske Råd på Færøerne*, efterår 2015: (I) Udsigterne for konjunkturudviklingen, og (II) Særlige analyser (offentlige investeringer og ældreplejen)

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## English Summary

### SHORT TERM ECONOMIC OUTLOOK AND ANALYSIS OF SPECIAL TOPICS

Statistics Faroe Islands and The Economic Council have jointly estimated the economic growth in current prices in 2014, 2015 and 2016. To facilitate the estimates, an economic model was been used, which was developed by the former Faroese National Bank (Landsbankin) and Statistics Faroe Islands and is maintained jointly by The Economic Council and Statistics Faroe Islands.

The trends in the Faroese economy over the last few years have been unusual. As a consequence, it has been difficult to generate short-term projections. This current re-evaluation of the economic growth indicates that for 2014 and 2015 the growth is somewhat higher than projected in the last report.

The report on the economic outlook this time is organized around elements of the demand side of the economy, i.e., Gross Domestic Product expenditures. Overall aggregate demand for goods and services is based on: domestic demand for consumption and investment, and foreign demand for exports.

For the year 2014, economic growth was calculated to be upwards of 5.9% in current year prices. This growth is in the main based on foreign demand rather than domestic demand.

For the year 2015, economic growth is estimated to be upwards of 6.4% in current year prices. This growth is in the main based on domestic demand rather than foreign demand.

For the year 2016, economic growth is estimated to be upwards of 2.8% in current year prices. This growth is in the main based on, it is anticipated, only domestic demand. Foreign demand is expected to pull Gross Domestic Product downward because import will grow more than export.

While public sector consumption has been the most stable aspect of domestic demand, private and public investments have been the most fluctuating elements of domestic demand. Public investment, as a part of domestic demand, has been correlated positively with the business cycles, and The Economic Council considers this to be problematic.

Private consumption as a part of the overall Gross Domestic Product (GDP) has held steady since the economic crisis of the 1980s and the beginning of the 1990s, but declined significantly in the years 2007-2009. This level of private consumption as part of overall GDP resulted in a drastic decline in the economy. We have calculated that the private consumption ratio (private consumption as a percentage of available household income) grew only a bit during 2014 and thereafter.

Net export has been a highly fluctuating part of overall consumer demand and thus from time to time has resulted in major up and down swings in the Faroese economy. Over the last few years, net export has been growing and this has dragged the Faroese economy upward.

It is one thing to highlight short-term trends in the economy, it is quite another to explore long-term trends, which in the Faroes, to a marked degree, can be impacted by demographic changes. While today we have **4.5** people in the age group 16-66 for every person in the age group 67 and older, by 2050 there will be **2.1** persons in the age group 16-66 for each person in the age group 67 and older, according to projections from the Faroe Islands Statistics. The changes occurring between now and 2050 will occur slowly from year to year. Therefore, there is a great danger that we will not observe the changes and not realize the gravity of these changes until it is too late.

Housing prices have been more or less steady since the financial crisis, but recently there are indications of growth in the housing market. It is advisable that the political leadership, for example, be prepared to postpone public investment if there emerge clear signs of the economy overheating, e.g., housing prices growing quickly and sharply above a level that is deemed sustainable in the long term.

Major structural changes have occurred in the Faroese economy over the last few years, including changes in the age composition of the population, business sector transformations, and changes in export patterns and export markets. The trends relative to the primary, secondary and tertiary business sectors have been somewhat different in the Faroes compared to the countries in the European mainland where tertiary businesses are growing and where natural resource-based industry is declining, as well as the production sector. In the Faroes since 2009, especially the natural resource-based industries (primary industry), i.e., especially the pelagic fisheries and aquaculture operations grew relatively quite a bit, while the services sector (tertiary businesses) have stagnated and have, in proportion, declined and the same is true for the production industries (secondary businesses).

The wage earner element of the Gross National Product has declined proportionally over the last few years, while capital profits have grown. Since 2008, the share of wages of the value-added by industry has only grown 2.3%, while the capital profit share of the value-added has grown by 112%. The degree to which the tax load is greater on wage earnings than on profit earnings will have public revenue consequences, and, of course, will also lead to inequality problems within Faroese society.

Acknowledging the existence of some exceptions from one year to the next, the normal pattern of migration to and from the Faroes has been that with high unemployment there is a net out-migration and vice versa. This pattern has been especially clear the last six years.

Over the course of the last year there has been a major decline in the price of oil, while at the same time the exchange rate of the dollar has increased such that the decline in oil prices had but little impact on us. Oil comprises a large part of the Faroese import, but, at the same time, many Faroese work in the oil industry and the work prospects of these individuals are therefore somewhat poor. The price of farmed salmon has grown considerably since 2012. Prices have fallen somewhat during the first half of the year, but the average price of farmed salmon is expected to be the same this year as last. Faroese companies no doubt can command a totally different price for farmed salmon than the world market price because of our access to the Russian market.

Recently, the balance of trade has yielded a larger surplus than previously experienced. One reason is improved terms of trade due to an increase in salmon prices and declining oil prices. Also a greater pelagic fish catch will influence the result.

The Economic Council has looked closely at the investment plans set forth by the central and local government. The Council has concluded that there is a danger that the planned public investment will be positively correlated with the business cycles (and thus over-stimulate the economy) and recommends that the investment plans as a consequence are re-evaluated.

Such a policy is detrimental. When the market trends are on an upswing, such policies contribute to a GDP-growth that rises above the output capacity of the economy, beyond the level that otherwise would have been achieved. This strategy yields additional pressure on demand within the labour market, and to "wage drift", and to increases in the prices of corporate shares and real estate, including a greater increase in private sector debt.

Correspondingly, such policies have also had unfortunate consequences in situations of a declining economy that follows after a soaring economic cycle. During a subsequent downturn, GDP growth declines well below the output capacity of the economy than would have otherwise occurred. This in turn places additional stress on unemployment payments and the lowering of prices for corporate shares and real estate and technical insolvency of companies and private households.

The Economic Council has also closely reviewed the municipal financing of services to the elderly care. The Council projected the revenue and expenditure via the sustainability calculation model<sup>23</sup> of the Economic Council that incorporated the population projections of Statistics Faroe Islands as the basis of the calculations. The projections indicate that the current fiscal model is unsustainable, i.e., revenue will be much less than expenses unless the elderly citizens of the future enjoy much better health than the elderly of today.

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<sup>23</sup> See the previous report of The Economic Council, Chapter II