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GOVERNMENTAL BANK

THE FAROE ISLANDS

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 Information Memorandum 2009 Appendix.
 Available together with this publication at www.landsbankin.fo

1. FACT SHEET

Location

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

Land Area

1,400 square kilometres; 545 square miles

Population (January 2009)

48,778.

Males 25,370 (52%) Females 23,408 (48%)

Main Population Centres (January 2009)

Torshavn (capital): 19,649

Klaksvík: 4,927

Language

The written and spoken language is Faroese. The Faroese language is a North Germanic language closely related to Icelandic and to the dialects of western Norway. Nordic languages and English are understood and spoken by most Faroese.

Religion

Approximately distributed as follows:

Evangelical Lutheran Church: 85%

Christian Brethren: 10%

Other: 5%

History

The Faroe Islands are believed to have been discovered and inhabited in the 8th century or earlier by Irish settlers. The Norwegian colonization began about hundred years later and developed throughout the Viking Age. The settlers established their own parliament on Tinganes in Tórshavn.

Norway and Denmark joined in a double monarchy in the late 14th century. When Norway in 1814 was ceded by cession to the King of Sweden, the Faroe Islands and Greenland remained under the sovereignty of the Danish Monarch. Due to the large geographical distance to Norway and Denmark, the Faroese always constituted a special jurisdiction and they were able to maintain their distinct language and culture over the centuries.

The Royal Trade Monopoly in the Faroe Islands was abolished in 1856 and the country has since then developed towards a modern fishing nation. The Faroese National Movement was established in 1888 as a struggle for more cultural autonomy, but after 1906 became more politically oriented with the foundation of the political parties of the Faroe Islands, Sambandsflokkurin (The Unionist Party) and Sjálvstýrisflokkurin (The Independence Party).



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

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

During the early 1990's the islands experienced considerable economic difficulties following the collapse of the fishery and fishing industry. The economy has since recovered with considerable growth and efforts have been made to diversify the economy. The recent financial crisis and global economical downturn have though had some effect in the Faroe Islands with a slowdown in economic growth and increase in unemployment rates.

The Political System

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

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

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

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

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

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

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

Head of the Faroese Government

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

Present Government

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

Currency

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

Rate of exchange: DKK/100 Foreign Currency. (16 Nov 2009)

EUR 744.08

USD 497.21

GBP 831.51

Main industries

Fishing, fish processing and fish farming.

GDP (Nominal GDP at market price)

Calculation Statistics Faroe Islands:

DKK 12,474 million (2008)

Estimation Governmental Bank:

DKK 12,078 million (2009). Expected growth 2009: -3.2%

Export (fob) of Goods (2008)

DKK 4,323 million

Export of Services (2006)

DKK 1,036 million

Main export product groups (2008)

Fish and fish products: 82% (Avr. 1999-2008 94%)

Ships: 14%

Other: 4%

Import (cif) of Goods (2008)

DKK 5,013 million

Import of Services (2006)

DKK 1,591 million

Labour force composition 2008-09

Estimated Labour Force (15 – 74 years) (2008 Labour Force Survey) 29,430.

Labour force in % of population (15 – 74 years) 84.9%

Males 87,3% and Females 82,1%

Full time unemployed: Average June-September 2009 1,100 (3,9%)

Employees divided by industries (December 2008)

Fishing, fish farming and fish processing (incl. agriculture and mining): 16%

Construction, engineering and energy: 15%

Sales, private services, transport and communication: 33%

Public administration and services: 35%

The Public Account 2008

Of the DKK 5,6 billion the authorities spent in expenses and investments in 2008, the proportional distribution was as follows: Social Security and Pensions 27.9%, Financial and Economic Affairs 24.5%, Education, Research and Culture 17.3%, Transport and Communication 13.9%, Health 13.7%, and Political Administration 2.8%.

Investments in 2008 were DKK 232 million.

In 2008 the total government income DKK 5.2 billion came from income tax DKK 1.34 billion (25,7%), other direct taxes DKK 0.4 billion (7,6%), VAT DKK 1.46 billion (28,0%), other indirect taxes DKK 0.5 billion (9,7%), other DKK 0.28 billion (5.3%), sales of products and services DKK 0.6 billion (11,5%), and Danish block grant DKK 0.63 billion (12,2%).

The Public Account deficit was about DKK 330 million in 2008.

Education

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

Health and Social Security

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

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

Transportation & Communication

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

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

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

More than 100 books (2008), several magazines, and daily newspapers are published in Faroese.

2. GEOGRAPHY AND POPULATION

The Faroe Islands are an isolated archipelago in the North Atlantic. The distance to the closest neighbour, The Shetland Islands, is just over 300 km. The distance to Iceland is about 450 km and to Norway roughly 675 km. The sailing distance to Copenhagen is about 1,500 km.

The Faroe Islands consists of 18 islands, mostly separated by narrow sounds. Of the 18 islands, 17 are inhabited. The total area is 1,400 km². The largest island is Streymoy (375 km²) and the capital, Tórshavn, is situated there. The islands, towns and villages are connected by a developed system of roads, tunnels and sea and helicopter routes.

The distance from the northernmost point of the archipelago to the southernmost is 113 km, and the distance from east to west is 75 km. The highest point, the mountain Slættaratindur, is 882 m and the average elevation above sea level is just over 300 m. The total coastline is approximately 1,000 km long, and at no time is one more than 5 km away from the ocean.

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

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

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

The climate is typically oceanic; the weather is moist, changeable and at times windy. Due to the influence of the Gulf Stream, there is little variation between winter and summer temperatures. For example, the average temperatures in Tórshavn during the coldest and warmest months are 3°C and 11°C, respectively. The shortest period of daylight is 5 hours and the longest 19 hours.

In January 2009 the population of the Faroe Islands totalled 48,778 (0,7% increase compared to January 2008); males 25,370 (52%) and females 23,408 (48%). Of this number, 19,649 (40%) lived in the capital Tórshavn and 4,927 (10%) in Klaksvík, which is the second largest town.

The last five years the population growth rate has been low, on average only 0.38% p.a.

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

The Faroe Islands have a modern infrastructure with good roads and tunnels. The roads are mainly asphalted, dual-track carriageways. A bridge connects the two largest islands (Streymoy and Eysturoy) and two sub-sea tunnels connect these two islands with two other major islands (Vágoy and Borðoy).

The Faroese Parliament has in 2009 passed a bill where the islands commit themselves to reduce the emission of CO₂ with 20% in the years 2010 to 2020 (Reference year: 2005).

3. THE POLITICAL SYSTEM

Until 1948, the Faroe Islands were formally a county of the Kingdom of Denmark, although the islands have always enjoyed some special privileges in a number of respects.

After the Second World War a vast majority of the Faroese people wanted a new political status within the Kingdom of Denmark. After negotiations between representatives of the Løgting and the Danish Government it was decided that a plebiscite was to take place on 14 September, 1946. The voters could choose between a very limited Home Rule or total independence from Denmark. The result of the plebiscite was a narrow majority for independence. This led to a dispute as to how to interpret the result. After the following election to the Løgting in November 1946 new talks resulted in the Home Rule Act of 1948.

Act No. 137¹ of the Kingdom of Denmark (the Home Rule Act) promulgated on 23 March 1948 accorded Home Rule to the Faroe Islands whereby they obtained the status of a self-governing community within the Kingdom of Denmark. In the Act, the Faroese language and the Faroese flag are acknowledged.

The fundamental principle of the Home Rule Act is that the administration of all local matters should be transferred to the Faroese authorities. On the other hand, matters of common interest for the realm are handled by the High Commissioner, who represents the Kingdom's authority in the Faroe Islands. Matters relating to the Faroe Islands have been divided into Special Matters and Joint Matters.

Special Matters

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

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

Joint Matters

These are administered by the Danish Government (Regeringen) according to the laws of the Kingdom of Denmark.

The provisions of the Home Rule Act from 1948 stipulate, however, that the administration of certain matters of common concern can be wholly or partly assigned to the Faroese Government or undertaken by the Danish and Faroese authorities jointly.

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

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

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

- The Danish Constitution
- Danish internal affairs
- The Danish Supreme Court
- Foreign affairs, security and defence policies
- Currency and monetary policy

To cover Joint Matters, the Faroe Islands receives State block grants from Denmark.

Areas that generally concern the Faroe Islands only, especially matters concerning Home Rule procedures, rest with the Office of the Danish Prime Minister. The Office of the High Commissioner in Tórshavn is under the Danish Prime Minister. The general rule, however, is that Faroese matters, managed by the Danish Government are handled by the relevant Danish ministry.

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

The Ministry of Interior and the Danish Government has agreed that the Faroese authorities will take over the responsibility for immigration and border control from 1 January 2011.

Latest developments

The economic crisis in the first half of the 1990s, led to many negotiations and agreements between the Danish and the Faroese Governments about how to manage the crisis. The latest agreement entered into force on 10 June 1998. It deals with Faroese debt repayments, rescission of previous agreements, etc. The Danish Government also observed in this agreement the Faroese Government's objective to make the Faroe Islands a sovereign state.

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

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

² LI 79, 12 May 2005

³ LI 41, 10 May 2006 and later amendments.

In May 2005, the Home Rule Act as mentioned above was supplemented with Act No. 578/2005⁴. This new act makes it easier for the Faroese Government to take over all matters, except matters that are directly linked to full sovereignty. Acceptance from the Danish authority in each case is no longer necessary.

As part of the same process a new Act No. 579/24 June 2005, The Empowerment of the Faroese Authorities in Matters of Foreign Policy, confirms the Faroese Government the right in accordance with preliminary stated procedures to enter into international agreements with foreign states and cross-national communities in all special Faroese matters.⁵ In this Act Denmark also promise to support Faroese applications on membership in cross-national communities, which admit other entities than specifically named states as members, as long as this does not contradict with the current constitutional position of the Faroe Islands.

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

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

3.1 The Parliament and Government

The Faroese Parliament (Løgtingið) is the legislative body dealing with Special Matters and Joint Matters. Laws passed by the Faroese Parliament pertaining to Special Matters are termed "Løgtingslógir", and must formally receive the consent of the Prime Minister of the Faroe Islands (Løgmaður).⁶

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

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

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

⁴ LI 79, 12 May 2005.

⁵ LI 80, 14 May 2005.

⁶ LI 103, 26 July 1994 um stýrisskipan Føroya. (The Constitutional Act)

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

At present there are six political parties represented in the Parliament. The last election was held on 19 January 2008. In addition to being divided into the usual spectrum of political left and right, the electorate is also divided between respective attitudes towards the political relationship with Denmark – in particular, to what extent the Faroe Islands should or should not be independent of Denmark.

The executive or administrative body in the Faroese political system is the Faroese Government (Landsstýrið), which is appointed by the Faroese Parliament. In February 2008, the Social Democrats (Javnaðarflokkurin), the Republicans (Tjóðveldi), and the Christian Centre Party (Miðflokkurin) formed a coalition government. In September 2008 this Government was replaced by a new, three-party government coalition made up of representatives from the Unionist Party, the People's Party, and the Social Democrats.

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

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

3.2 The Government Organization

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

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

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

Jóannes Eidesgaard (Social Democrats)
Minister for Finance

Aksel Vilhelmson Johannesen (Social Democrats)
Minister for Health Affairs

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

Jacob Vestergaard (People's Party)
Minister for Fisheries

Johan Dahl (Unionist Party)
Minister for Trade & Industry

Rósa Samuelson (Unionist Party)
Minister for Social Affairs

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

3.3 Foreign Relations

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

The particular status of the Faroe Islands, as well as the unique structure of trade and industry, makes it difficult to share common interests and views with Denmark, particularly regarding international co-operation and bilateral or multilateral agreements. Therefore, various treaties and international agreements, which are subject to the consent of the Danish Parliament and which are of special Faroese concern, are to be submitted to the Faroese Parliament for review. Because of this, Denmark's participation in international economic organizations does not automatically include the Faroe Islands. Negotiations are often conducted with the Faroe Islands at a later stage. This explains the time lag before the Faroe Islands joins various international organizations. For instance, Denmark subscribed to GATT in 1950 and the Faroe Islands in 1954.

Although Denmark has been a member of the European Union since 1973, the membership does not extend to the Faroe Islands. In 1974, the Faroese Parliament voted unanimously against applying for membership.

Instead of membership, the Faroe Islands has a trade agreement with the EU. In principle, the agreement with the EU has been a mutual free trade agreement similar to the type made by the EU and the EFTA countries in the 1970s. The agreement with the EU originates from 1992 and has been adjusted and amended over the years.

On 28 November 2003, the Faroe Islands and the EU entered into an agreement on Faroese membership in the Pan-European System of Cumulation of Origin. The "Cumulation Agreement" was fully implemented on 1 December 2005. The Faroe Islands also participate in EU's Seventh Research Framework Programme (FP7).

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

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

Since November 2007, the Faroe Islands has been associate member of FAO, and in October 2009 associate member of UNESCO.

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

The Faroe Islands take active part in the Regional Fisheries Management Organizations NAFO, NASCO and NEAFC in conjunction with Greenland.

Denmark is represented in the Regional Fisheries Management Organizations (RFMOs) by the EU.

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

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

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

4. THE ECONOMY

4.1 The Economy in General

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

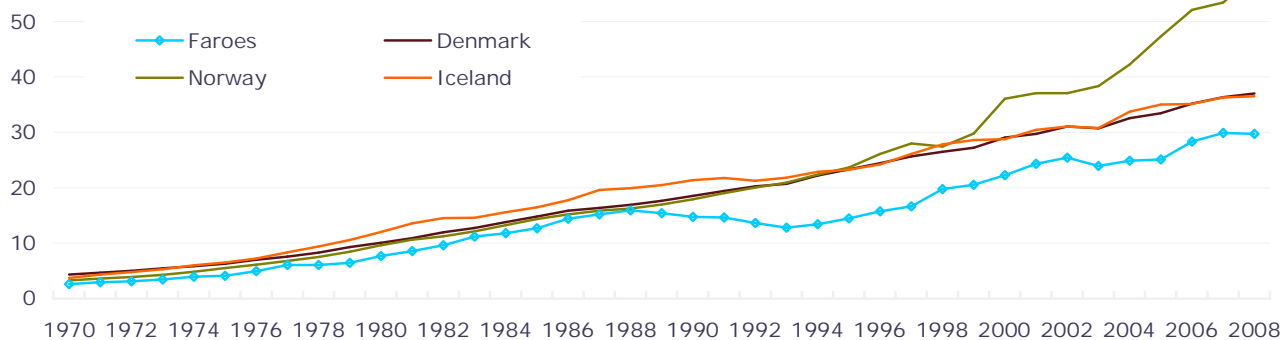
Fishery and related industries are of such importance that its influence determines the overall performance of the Faroese economy. This dependence on a resource-based industry is evident in the Export Account of Goods, of which fish products account for about 95% of the export value.

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

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

GDP pr cap in current prices and PPP in USD, 1970-2008

60 1,000 US\$ / cap



Source: Governmental Bank, Statistics Faroes and OECD

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

The national accounts up to 2008 indicate that a proportionally larger output value now comes from production related to construction, transportation, banking, and other financial services. The proportional output value from fishery and the manufacturing of fish products has declined correspondingly. Faroese companies are also actively seeking investment opportunities abroad at a much higher level than in the past. These developments, together with a shift since the mid-1990's towards a more market oriented economic policy, will most likely contribute to a more diverse and stable economy.

4.2 Recent Economic Development

The Faroe Islands had high GDP growth rates in 2000 and 2001 - about 10% or more in current prices. The growth rates slowed in 2002-2005 to a yearly increase averaging 2%. In

2006, the GDP increased more than 12% in current prices compared to the year before. With a moderate increase in consumer prices at about 2% in 2006, this indicated significant growth. The GDP in 2007 in current prices was 5.8% higher than the previous year. However, the growth in GDP came to a halt in 2008.

In the *Economic Assessment: Economic Outlook 2009 and 2010* 30 October 2009 the Governmental Bank states, that there are indicators that the GDP in current prices will decline with about 3% in 2009, only to increase again by about 3% in 2010. If the increase in prices will be 2% in 2010, then it means that the Faroese economy in real terms already will start growing again from this year.

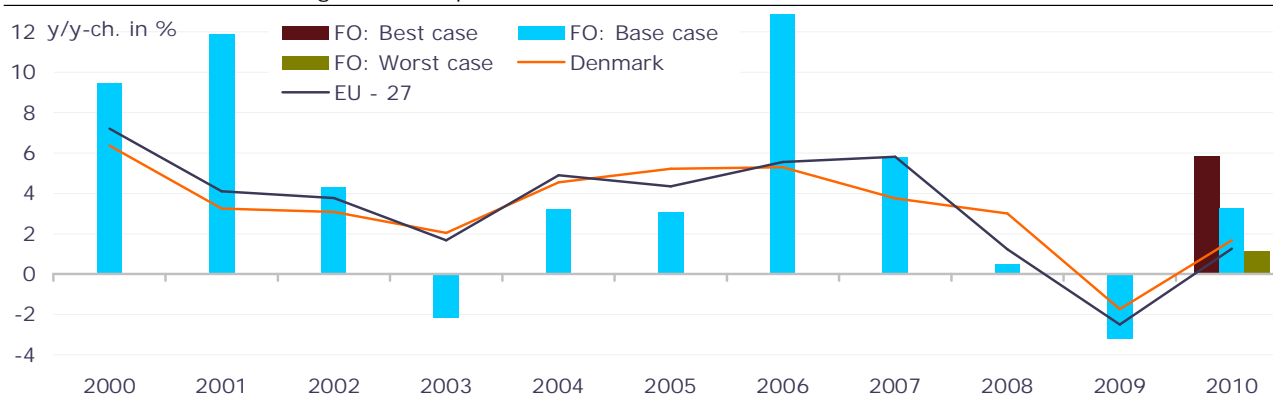
The high growth in 2006 and 2007 can be explained by an increase in credit-financed, private consumption, and investment growth.

The estimated almost zero growth in GDP in 2008 and negative growth in 2009 may have several reasons. Some related to the international financial and economic crisis. Since the summer 2009, the private consumption in the Faroe Islands has dropped significantly and rapidly. Private investments decreased both in 2008 and 2009, but an increase is expected in 2010. Fish product exports is 2.7% lower January to September 2009 compared to the same period the previous year. There has been a significant fall in both volume and value of fresh fish catches the first nine months of 2009, and the economic situation in the fish processing industry is deteriorating. The fish farming industry on the other hand has made significant progress since 2007.

The yearly growth rate in total wage expenditure in the Faroe Islands has on average been 4.7% for the years 2005 to 2008. The growth in total wage expenditure was above average in 2006 and 2007, while growth in 2008 was only 2.5%. From January to October 2009 the total wage expenditure was 4.5% lower than total wage expenditure for the same period the previous year.

In 2008, wages paid in agriculture, fishery, and the fishing industry were proportionally 17.7% of total wage expenditure, which is 4.6 %-points less than in 2004. Wages paid in engineering, construction, and energy were 14.4% or 1 %-points more than in 2004. Wages paid in the private service sector were 32.1% or 3 %-points more than in 2004. In public administration and service delivery, wages were 33.4% or 0.6 %-points more than in 2004.

The Faroese nominal GDP-growth compared to other economies, 2000-2010



Source: Governmental Bank, Statistics Faroes and OECD

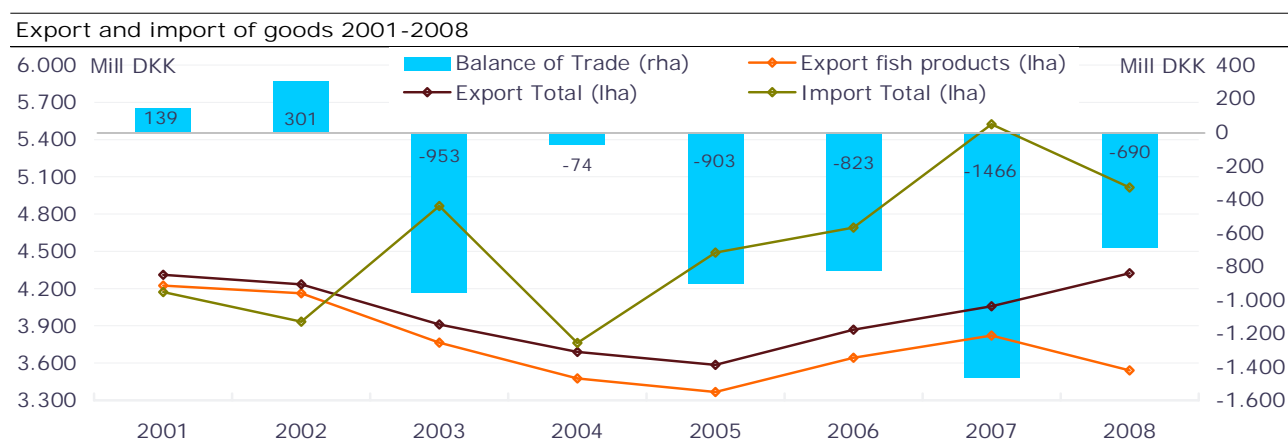
Prices seem to have gone up especially in the first half-year of 2008 after having been relatively stable for some years. From 2001 (CPI-figures second-quarter) until 2007 (CPI-figures second-quarter) prices rose about 8%, while they rose 6.7% in only one year from 2007 to 2008 (CPI-figures second-quarter). In 2009 prices have gone down with on average slightly 1%.

The fall in the CPI in 2009 is mainly due to lower oil prices and lower interest rates on private housing loans.

The export and import figures show the economic conditions eloquently. Excluding ships and aeroplanes, Faroese export was DKK 3.5 billion in 2008, a 7.4% lower than 2007. Usually about 95% of the export value of commodities comes from fish and fish products. Exports value, excluding ships and aeroplanes, in January to September 2009 was 2.7% lower compared to the corresponding period in 2008. The decline in export value includes most fish species but excludes farmed fish.

Import value was DKK 4.9 billion DKK in 2008, excluding ships and aeroplanes or 2.2% lower than 2007, when imports increased with almost 10% compared to 2006. In the period January to September 2009 import value excluding ships and aeroplanes was DKK 2.7 billion, which is almost 30% less than for the corresponding period of the previous year. Import value changes in 2009 stem from e.g. lower fuel prices, significant less import of materials for building and construction and an almost stop in the imports of new cars.

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



Source: Statistics Faroes

The Balance of Payments figures for 2005 and 2006 stood at a small surplus. The balance is negative with regards to goods and services, which are counterbalanced by a significant surplus from incomes from wages and dividend, including the annual grant from Denmark.

Judging by the balance of trade, the deficit on the balance of payments in 2007 is expected to be about DKK 600 million. In 2007, the deficit on the balance of trade reached DKK 1.5 billion. The deficit on the balance of trade was about DKK 700 million in 2008. The surplus on the balance of payments was most likely at the same level in 2008 as it was in 2006. From the development in imports and exports so far this year it seem resonable to conclude that the surplus in 2009 will be higher.

The unemployment rate has been remarkably low and midyear figures in 2008 showed levels lower than 1.5%. The average unemployment figure for 2003 was 2.5%, 2004 3.5%, 2005 3.8%, 2006 2.7%, and 2007 1.5%. Female workers generally have higher unemployment rates than males. Unemployment has risen since and in September 2009 the unemployment was 4.4% (Males 4.6% and Females 4.1%).

4.3 Industries

Fishery and the Fishing Industry

Before the mid-1970s, the Faroese fishery was mainly based on fishing in overseas fishing areas. The extension of national fishing boundaries, however, necessitated, to a significant degree, a reorganization of the Faroese fishing industry towards exploiting the resources in the Faroese exclusive 200 mile economic zone.

Today, a significant part of the fish export value still comes from fishing in foreign waters and on the high seas, although most of the fishing in foreign waters is reimbursed by reciprocal rights in the Faroese exclusive economic zone. This is done in agreements on fisheries with some countries among them Iceland, Russia, Norway, Greenland, and EU.

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

Beginning in the early 1970s, the fishing fleet became increasingly subsidised and this affected the market in unfortunate ways. In the late 1980s, a condemnation plan was initiated whereby ship owners were paid to give up their fishing vessels. This resulted in a capacity reduction of around 30%. In 1992, the subsidies were replaced by a capital subsidy, and in 1998, removed altogether. Now the fishing fleet relies very little on subsidies. The only direct government subsidies to the fishing industry are minimum payment guaranties and health insurance payments for fishermen (DKK 27.5 mill. in 2008), and subsidies to reduce cost for local transport of fish from landing place to factories (DKK 3.9 mill. in 2008). In addition, fishermen have a 14% tax-free reduction in their yearly income up to DDK 470,000.

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

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

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

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

The export value of fish products peaked in 2001 with DKK 4.2 billion. In 2003-2004, the prices were lower again, but the total catch was one of the best ever. Prices were rising in 2005 and 2006, but were lower again in 2007. Good catches in 2007 compensated for the fall in price and export value increased with 4% compared to the year before. The general increase in prices and the overall growth in the catch within the Faroese exclusive economic zone have resulted in an elevation of the export value. From 2000 to 2008 the export value of fish products has been comparatively high and stable.

The value of the fish export from January to September 2009 fell about 3% compared to same period in 2008. This is caused by a significant fall in the prices on products from some of the demersal species, while there has been a more than 65% cut in the value of products from pelagic species due to large reduction in quotas. However, the value of products from farmed fish has increased by DKK 289 mill or 42% from January to September 2009 compared to same period the year before.

Fish prices have generally been low in 2009. Prices on cod and haddock landed fresh in the Faroe Islands on average did fell about 40% and 30% respectively the first nine months of 2009, compared to the same period of 2008. Although, there have been a rise in the prices the latest few months. Saithe prices have been more stable, but slightly higher in 2009 than in 2008.

Statistically, total catches by Faroese ships increased from 1993 to 2002, but there were differences among various species.

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

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

Other species fished by Faroese ships are prawns and shellfish.

In 2008, the total Faroese catch was 521,306 tonnes (2007: 582,000 tonnes). 181,788 tonnes (2007: 231,000 tonnes) or 35% (2007: 40%) were fished in Faroese fishing areas. Of the total catches, wet fish accounted for about 112,000 tonnes (2007: 131,000 tonnes), which were mainly fished in Faroese waters. Of the total Cod catches in 2008, however, nearly 65% were fished in foreign fishing areas like the Barents Sea and East Greenland. This is mainly caused by a significant fall in the catches of Cod in Faroese water over the last 3 years. Most of the Cod fished in foreign waters is caught by big filleting trawlers.

A recent report on the business results in the fishery sector clearly shows, that there have been changes in the period between 2004 and 2008. From 2004 to 2006 fishery was a prosperous business, while the business was in decline in 2007 and 2008. The whole of the fishing fleet had negative results of operations in 2008, and it is expected, that the situation will remain about the same in 2009. Prices were low in 2008 and there was a significant fall in both catch volume and value.

Catch volume fell with 10,4% in 2008 compared with 2007. Significant decrease was in the Blue Whiting, Capelin, Haddock, and Saith catch, although the Horse Mackerel and Herring catch did increase. The 26% fall in catches of Blue whiting in 2008 compared to 2007 stems from large reductions in fishing quotas.

In most of the companies in the fishery business owner equity remains almost unchanged, but liabilities have increased with more than 50% in the last 5 years and mortgage debt even more.⁷

From January to October 2009, the wet fish catch landings from Faroese waters dropped by 2% compared to same period in 2008. The difference in catch value was 18% or DKK 137 million lower in 2009 compared to the same period the previous year.

On-land fish industry

After the economic crisis in 1992, the on-land fish industry went through a reconstruction, and the number of plants was reduced to fewer, bigger, or more specialised plants. The filleting factories are producing a range of fresh, iced, and frozen products to the retail and food service markets. About 30% of the total fish export value in 2008 was fresh, frozen, or salted fillets: DKK 420 million Cod fillets (8,289 tonnes), DKK 77 million Haddock fillets (2,511 tonnes), and DKK 427 million Saithe fillets (21,000 tonnes) and other species DKK 157 million (5,695 tonnes). The fish fillet plants are dependent on a stable supply of raw material. This has led to vertical integration of some plants and ships. Other smaller factories produce more specialised fish products.

In the last four years the on-land fish industry has had difficulties to make profit. The supply of raw materials has gone down by about 19% since 2005, production costs have risen and so has debt. Most of the factories also have liquidity problems.⁸

The export of fried fishmeal and fish feed produced from pelagic species was about 30,000 tonnes (2007: 57,000 tonnes) in 2008. The export value was DKK 165 million (2007: DKK 422 million), which is 4.5% (2007: 10%) of the total export value of fish products. From January to September 2009 the export of fried fishmeal and fish feed produced from pelagic species was about 6,000 tonnes (2008: 28,000 tonnes).

Fishery Management

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

Quotas (TAC) were introduced in the Commercial Fisheries Act of 1994⁹, but by June 1996 the quotas were replaced by a new system of "Fishing Days". The amended legislation from 1994

⁷ NOTA: Roknskapargreining av fiskiflotanum 2004 til 2008. Tórshavn, 2009

⁸ NOTA: Roknskapargreining av flakavirkjum 2004 til 2008. Tórshavn, 2009.

⁹ LI 28, 10 March 1994 with later amendments.

covers vessel and fishing licences, area closures, gear and data requirements, and other technical regulations for commercial fisheries. Fishing vessels under the Faroese flag must be at least 2/3 owned by persons or companies domiciled in the Faroe Islands.

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

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

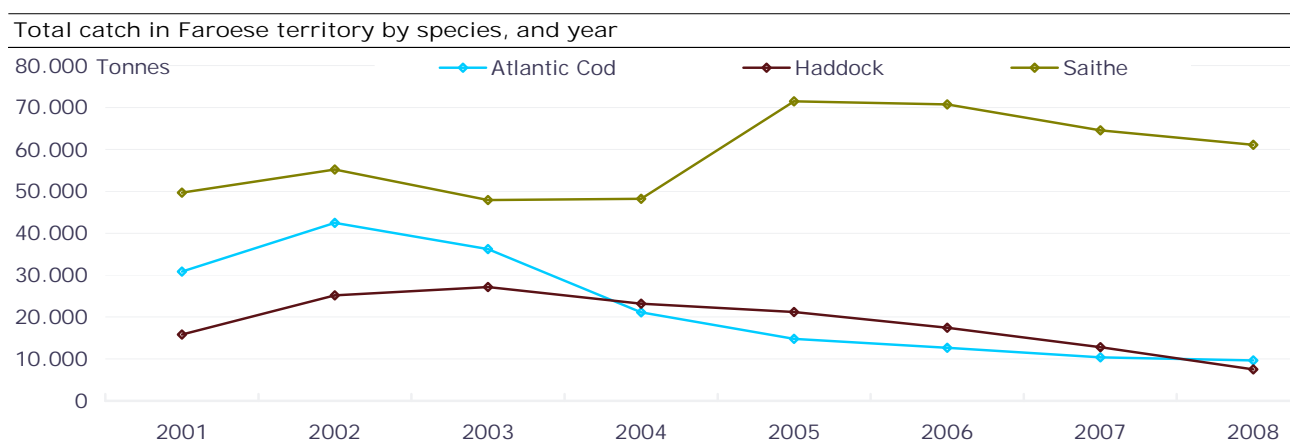
The advantages of a Fishing Days system to a strict quota system are that vessels can take their entire catch ashore. Some disadvantages are that the system is not efficient in protecting specific species, and that it does not compensate for technological improvements. For these reasons, it is necessary to adapt the number of fishing days as the Faroese fleets' catching capability increases.

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

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

Since 2007-08 the number of fishing days has been reduced 10% through recommendations from the Faroese Fisheries Laboratory and ICES. These recommendations were made to significantly reduce catch capacity.

However, the total catch in Faroese territory for the most important species has varied through the years as shown in the diagram below. This variation is mainly related to changes in stock size, which may come from both natural causes and overfishing.



Source: Statistics Faroes

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

Aquaculture

The fish farming industry¹⁰ is relatively new in the Faroe Islands. It started in the early 1980s and has since emerged into the second largest export industry in the Faroese economy.

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

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

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

The harvest in 2004 was much less than previous years – around 37,000 tonnes. The harvest took a new plunge in 2005 and 2006 with 19,000 and 16,000 tonnes respectively. The fish farming industry has since rebounded and is experiencing a more positive development stage. The industry seems to have successfully fought the fish disease plague and production is growing. The harvest in 2007 was 25,000 tonnes and in 2008 around 38,000 tonnes.

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

In 2008, the industry exported 37,000 tonnes (2007: 21,000 tonnes) of salmon and trout products. Export prices were low in 2007 and 2008 compared to 2006, but the export value was higher, DKK 955 million (2007: DKK 589 million) or 25% of the total export value of fish products. Export quantity is expected to increase even more in 2009.

Compensation of employees in the aquaculture industry was DKK 153 million in 2008, which is more than 30% higher than the previous year. The growth continues and in January to October 2009 compensation of employees in the aquaculture industry is 13% higher compared to the same period in 2008.

Whaling

The pilot whale still contributes to the meat supply in the Faroe Islands. In 2007 the total catch was just under 400 tonnes or about 9 kg per person. In recent years, catches have varied from zero (e.g. 2008) to 900 tonnes.

¹⁰ Farming of salmon and trout.

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

Agriculture

Farming in the Faroe Islands is not a major sector of trade. Only about 1% of GDP in factor prices is derived from farming. The over 7 million litres of milk produced in 2008 meets the domestic demand. The production has been relatively stable during the last four years. The domestic production of other dairy products is open to competition from abroad, yet about 75% of the home market is supplied by domestically produced products. The yearly production of mutton is approximately 1,000 tonnes, which corresponds to about 75% of the total demand. The production of beef and beef products amounted to only around 65 tonnes in 2008. This is just a small percentage of the total consumption. Meat imports remain at a comparatively high level. In 2007, import of meat was 2,545 tonnes.

Construction

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

Both private and public construction has been booming lately and compensation of employees was high in 2007 and 2008. However, construction activity has slowed down in the wake of the recent financial and economic crisis, and it has been difficult to finance construction projects and the building of new private houses.

From January to October 2009 compensation of employees in the construction industry was 17% lower compared to the same period in 2008.

Construction activity is low at the moment, but expected increase in public investments and some major private infrastructure project plans will likely be followed by higher activity in near future.

Transport & Communication

Internal

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

In December 2002, the first sub-sea tunnel in the Faroe Islands was opened between Vágur and Streymoy. This is the first partially user-financed investment of its kind in the Faroe Islands. A second sub-sea tunnel between Borðoy and Eysturoy opened in May 2006. Both passenger and cargo transport is provided daily to all but two of the inhabited islands and most villages. Ferries and helicopter services are available to the islands that are not directly linked to the road system, and bus service is the most common form of transport for all other areas. The public transport company, Strandfaraskip Landsins, maintains most of these routes, while numerous private companies offer passenger and cargo services by request.

In the beginning of January 2009, there were 20,293 registered private cars, which reflects 416 per 1,000 inhabitants.

External

The national airline carrier of the Faroe Islands, Atlantic Airways, is currently the only operator offering routes to and from the Faroe Islands. Depending on the season, there are several daily flights to Denmark (Copenhagen and Billund). Atlantic Airways also flies twice a week to Reykjavík and in the summer season twice a week to London.

In 2008, 222,000 passengers travelled through Vágur Airport, which is 2.2% more than in 2007. From January to November 2009 the number of air travellers through Vagar Airport was 8,4% less than the same period the previous year.

On 1 May 2007, the Vagar Airport was taken over from the Danish Authorities by a Faroese public limited company. A building project budgeted at DKK 365 million will offer better transit facilities, and the runway will be extended to 1.6 or 1.8 km. The project is financed by the de-capitalisation of the Investment Fund (Ílleggingargrunninum) with a corresponding amount.

The ferry Norröna is a combined cruise/cargo ship that can carry roughly 1,500 passengers and 800 cars. The ship offers weekly service to Seydisfjørður in Iceland and Esbjerg and Hanstholm in Denmark. Nearly 65,000 passengers travelled to and from the Faroe Islands by sea in 2008.

Icelandic and Faroese freight companies provide cargo carriage to and from the Faroe Islands. The most important routes are to Denmark, Iceland, Scotland, Norway, and Sweden.

Telecommunication

In 2007 there were about 20,100 fixed network telephone subscriptions. The number has been falling for some years now. Two telephone companies Faroese Telecom and Vodaphone have 80% and 20% market share respectively.

Mobile telephone subscriptions were 54,860 (half of these were pre-paid cards subscriptions). In the mobile telephone market Faroese Telecom has 65% and Vodaphone 35% of the market share. The use of mobile technology has increased significantly in recent years. The Faroese mobile phone users also sent about 20 million text messages (SMS) in 2008.

Broadband coverage is high with 14,878 subscribers in 2008 or about 30 subscribers per 100 inhabitants. Also the use of internet generated long distance calling programs, VOIP, has increased.¹¹

In 2008 there were about 16,000 cable television subscribers. 56% of the subscriptions were from the Faroese cable television company Televarpið, owned by Faroese Telecom Ltd. The rest were from cable television companies outside the Faroe Islands.

Viewers and listeners of television and radio by the Faroese Broadcast Company (Kringvarp Føroya) are required to pay a license fee if they have got a receiving set. Apart from the public radio there are two private radio stations operating in the Faroe Islands.

¹¹ Source: Postal and Telecom Surveillance Authority <http://www.fse.fo/>

Tourism

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

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

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

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

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

Oil

On 22 December 1992, the Danish Government agreed to transfer the rights to mineral resources in the subsoil of the Faroe Islands to the Faroese Government. The initial oil exploration phase started in 1994 and since then, many firms have been exploring the subsoil.

The Act on Hydrocarbon Activities¹² was passed by Parliament in March 1998. This Act regulates all phases of hydrocarbon activities in Faroese territory. Some aspects of the Act include regulations for a proportion of the licence expenditure being used in the Faroe Islands. This includes recommendation on the use of Faroese manpower and the supply of goods and services by Faroese undertakings and supply bases, and stipulations on funding of training and educational measures etc. It is also stated that transport of equipment and passengers to and from offshore installations on Faroese territory shall be conducted via Faroese quay or Faroese airport.

The Hydrocarbon Taxation Act was passed by the Parliament in April 1999, and amended by an Act on special tax from March 2000¹³. Income tax from oil production is 27%, besides a 2% production royalty and a field based special tax of "rate-of-return"-type.

The Hydrocarbon Tax Administration Act¹⁴ was passed by the Parliament in February 2000. These regulations laid the final conditions for exploration and production of oil on Faroese territory.

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

¹² LI 31, 16 March 1998.

¹³ LI 26, 21 April 1999 and LI no. 26, 7. March 2000.

¹⁴ LI 16, 14 February 2000.

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

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

In July 2006, Statoil started the first exploration drilling in the thick layers of Basalt rock (Licence no. 006 from First Round). Drilling in the hard Basalt was not as difficult as expected. Traces of gas were found in the well. Later BP started drilling through the basaltic layers in 2007-08 (Licence no. 007 from First Round). Although, the well did not encounter hydrocarbons, the findings expanded the knowledge base about the Faroese, Basalt-covered subsurface.

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

The third Licensing Round was launched in July 2008. The area offered lies to the east, to the south and to the southwest of the Faroe Islands. It covers 38,405 km². Three exploration licenses were awarded.

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

The oil companies as license holders have e.g. through the Sindri programme¹⁵ contributed to knowledge stock relevant to the future investigation of the Faroese continental shelf.

It is also evident that oil exploration activities have made Faroese firms more aware of expectations while operating in an international business environment. An offshore base is placed in Runavík, and helicopter transport between land and the offshore installations is performed via Vágar Airport.

So far the explorations have discovered no commercial findings, but they have proven the presence of an active hydrocarbon system in the Faroese subsurface. The exploration related activity has not fully met the expectations as to the economic effect. Expectations have become more moderate, the exuberant talk has moderated and circumstances have normalised.

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

One exploration well, operated by ENI, is planned for 2010.

¹⁵ The Sindri Group was officially established by the license holders on 17 August 2001 as part of the stipulated work programmes for licensees within the Faroese area

4.4 The Financial and Securities Market

Financial affairs (except insurance companies and mortgage-credit institutions) are a "Joint Matter" under Danish State authority and under the supervision of the Danish Financial Supervisory Authority (Finanstilsynet)¹⁶.

Four banks – Eik Banki, Føroya Banki, Norðoya Sparikassi, and Suðuroyar Sparikassi – service the financial market in the Faroe Islands.

Because of a revision in the banking law, banks and savings banks now compete on equal terms. The law affords the same conditions for Faroese financial institutions as for Danish financial institutions relative to the Danish Central Bank. This legislation thus enables the Faroese banks to participate in the international capital markets.

Savings traditionally were deposited in banks, but lately asset management and investment banking has grown in importance. Most of the banks activities are in housing funding, but enterprise financing is also an important activity.

The Faroese financial market experienced much turbulence at the beginning of 1990-ies. In 1992 and 1993, huge write-offs were demanded in bank assets. Through the Financing Fund of 1992¹⁷, the Faroese Government injected new capital into Sjóvinnubankin and Føroya Banki with loans provided by the Danish Government. Altogether, the injection amounted to about DKK 3 billion, resulting in the banks becoming publicly owned. In August 1993, it was decided that Føroya Banki and Sjóvinnubankin should merge¹⁸. The merger entered into force on 1 January 1994 and the merged bank continued under the name Føroya Banki. Today, the situation has turned around and the financial institutions are well consolidated. The economic upturn up to 2008 has largely limited losses and yielded good results on the balance sheets.

Since 2008 the international financial crisis, however, have affected the banks directly with higher financing and liquidity costs and extra costs from the Danish public bank packages. At the same time lending and deposits have not increased the latest 12 months, and the interest rate margin between loans and deposits has also increased in 2008.

Eik Banki (The Eiks Banki Group also include Eik Bank Danmark A/S) had its best profit ever in 2007, DKK 437 million from operations. One third of this was from business abroad. Eik Banki also runs the real estate company Inni Ltd.

In 2008 the business has deteriorated and the bank had DKK 353 million loss in 2008. Loss is also expected in 2009.

The formerly public-owned Føroya Banki has shown positive results, DKK 180 million in 2007 and DKK 200 million in 2008. Good results are also expected in 2009. In an attempt to move activity abroad, Føroya Banki has established Føroya Bank Ltd. in Denmark. Føroya Banki also runs the insurance company Trygd Ltd. and the real estate company Skyn Ltd.

In 2007 the Government sold 2/3 of its' shares in Føroya Banki.

¹⁶ Act (Danish Kingdom Law Recommendation) no. 1531, 14 December 2007 for the Faroe Islands about Financial Business & Act no. 87, 10 February 2006 for the Faroe Islands about Securities Trading, etc.

¹⁷ The Financing Fund's board of directors consists of five members appointed by the Faroese Minister of Finance.

¹⁸ On 22 March 1993, Den Danske Bank exchanged the major part of its stock in Føroya Banki to the Financing Fund of 1992, in return for 30 percent of the stock in Sjóvinnubankin. A commission investigated the exchange and concluded that the Faroese Government did not have the necessary information and, therefore, had negotiated under false assumptions. In an agreement dated 10 June 1998, the Faroese Government received compensation of about DKK 1 billion.

In April 2009 Moody's Investors Service updated a C- bank financial strength rating ("BFSR") to Føroya Banki as well as A3 long-term and Prime-2 short-term local and foreign currency deposit ratings. The outlooks on all ratings are stable.

In August 2009 Føroya Banki entered into a cooperation with DLR Kredit A/S regarding intermediation of mortgage loans on the Faroe Islands. At the same time the Bank became a shareholder of DLR Kredit A/S. In October 2009 Føroya Banki acquired a 51% stake in the Icelandic insurance company Vörður Tryggingar hf.

Both Eik Banki and Føroya Banki are dual listed on Nasdaq OMX Nordic Exchange in Copenhagen and Iceland in 2007.

Two small banks, Norðoya Sparikassi and Suðuroyar Sparikassi, have also shown positive results, with DKK 30 million and DKK 4 million in 2007 respectively. Mainly due to problems in the local fishing industry Norðoya Sparikassi had a DKK 64 million loss in 2008, while Suðuroyðar Sparikassi had a small surplus.

In 2007 total profit in the bank sector was DKK 652 million which is the best result ever. In 2008 the total loss in the bank sector was DKK 217 million.

Various financing institutions than banks both private and public hold about a 10% share of the total financial assets and play an important role in selected areas of the financial market. The most important, apart from the Financing Fund of 1992, are the insurance companies, Føroya Realkreditstovnur (a mortgage credit institution financing ships), Húsálansgrunnurin (a mortgage credit institution financing residential houses), and Framtak (Faroese Business Development Fund) which provides venture capital as equity and loan to Faroese companies).¹⁹

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

Insurance

In June 2008 a new insurance industry law²⁰ passed by the Faroese Parliament came into force. In conformity with the insurance industry law from 1997, the monopoly was abolished and a Faroese Insurance Supervisory Body was appointed. This allowed any Faroese company complying with statutory requirements to enter the insurance business on the condition that they obtain permission from the Faroese Government and the Faroese Insurance Supervisory Body.

In 1998, the company, Trygd Ltd., restarted its business as a subsidiary company of Føroya Banki in housing and car insurance and subsequently expanded into ship insurance. Trygd, and

¹⁹ Act (Danish Kingdom Law Recommendation) no. 87, 1113 20 September 2007 for the Faroe Islands about Commercial Foundations as amended by LI 18 8. May 2008.

²⁰ LI 55, 9 June 2008.

the old monopoly incumbent, Tryggingarfelagið Føroyar Ltd. (established in 1940) are currently the only non-life insurance companies active in the Faroese market.

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

Like other financial institutions the insurance companies have suffered from the impact of the recent financial crisis.

The Faroese Securities Market

The Faroese Securities Market, the limited company VMF (P/F Virðisbrævamarknaður Føroya), which was founded in 2000 in cooperation with the Iceland Stock Exchange²¹, had its first three bond-listings in 2003. The Faroese Government bonds expiring in 2008, 2010 and 2018 were listed on the market, when the Government decided to refinance the DKK 3,074 million debt with the Danish State.

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

The newly established Faroese Securities Market, organised so Faroese companies are listed on the Icelandic stock exchange, will afford domestic issuers easier access to capital for both existing and future initiatives. This is of great importance for Faroese companies desiring to expand within the Faroe Islands or abroad. Capital intensive, innovative, and avant-garde industries and businesses benefit from having access to a localised securities market. Such a market will enable investors to safely invest in Faroese companies. With pension savings expected to increase considerably in the coming years, the lack of a securities market would mean this capital would be exported abroad, and would not be available to support Faroese industry.

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

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

Currency

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

²¹ On 30 March 2004, the Iceland Stock Exchange, now a part of OMX Nordic Exchange, and the Faroese Securities Market (Virðisbrævamarknaður Føroya P/F) entered into an agreement relating to the listing of Faroese securities on ICEX and the facilitation of trading of Faroese securities.

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

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

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

4.5 Labour Market

In general, the Faroese labour market is characterised by a relatively large workforce in the fishing sector and the public sector. Unskilled and skilled workers work 40 hours per week, according to agreement. Public employees and office staff work 37-38 hours per week. The Holiday Law grants five weeks of paid annual leave. Salaried staff receives a holiday allowance of 1.5% of their annual wages in addition to their base salary, while hourly paid workers receive a 12% holiday allowance for every hour worked.

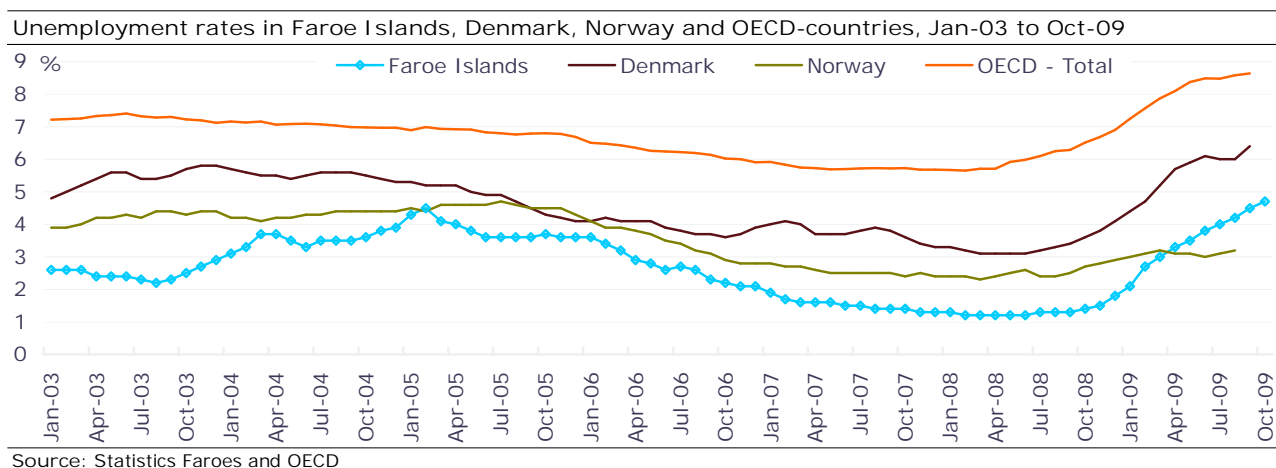
In August 2009 there were about 25,000 employees (2008: 25,992) in private and public businesses, 51% males and 49% females. According to a labour survey covering the age group 15-74 years from November 2008, 84% of the male employed and 52% of the female employed are full time employed (35 or more hours weekly).

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

Usually wage negotiations are held every other year and almost all unskilled workers, public employees, and shop assistants have their wages adjusted according to negotiated settlements. For skilled labourers and people working in the service trades, the settlements are regarded as guidelines. Lately, there is growing interest in negotiating longer wage agreements. Several recent agreements have been for more than two years.

In general workers, office workers, and public employee wages only increased moderately in 2005 and 2006, between 1 and 2%. Unskilled workers agreed upon their wages in 2007 with an agreement for the period 1 May 2007 to 1 May 2010. According to this agreement wages in this period will increase 9.7% including the payments to the workers pension fund.

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



Unemployment insurance has been in effect since 1992. Employers and workers each pay 1% of each wage payment to the unemployment compensation program. The unemployment benefit from the insurance program is set at a maximum of 80% of the income of an unskilled worker for the first 253 days and then 75%. Unemployed can stay in the system for a total of 723 days over a period of three years.

A Family Leave Fund was established in June 2001. Employers and workers pay 0.62% of total wages to the fund, which provides for up to 24 weeks of paid leave after childbirth with a maximum of DKK 25,000 per month.

In the Faroe Islands, total wage payments are one of the best and most up to date economic performance indicators.

Total wage payments increased by 12.5% in 2001, 8.7% in 2002, 0.8% in 2003, 1.3% in 2004, 2.4% in 2005, 7.3% in 2006, 8.0% in 2007 and 1.5% in 2008 from DKK 6,914 million in 2007 to DKK 7,017 million. Total wage payments decreased by 4.5% from January to October 2009 compared to the same period the previous year.

From January to October 2009 the unemployment rose from 2.3% (Males 2.1% and Females 2.5%) to 4.4% (Males 4.6% and Females 4.1%).

Usually in times of low growth, the Faroese labour force migrates to neighbouring countries in search of work, as well as immigrating back to the islands in times of high growth. Emigration statistics are therefore a major business cycle indicator. Recently labour shortage was a growing problem in both manufacturing and construction sector, but this has apparently changed by now.

However, it is still a major issue to find ways to recruit young Faroese people with high education and persuade them to move back to the Faroe Islands.

4.6 Foreign Trade

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

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

Around 95% of the registered export of goods is fish and fish products.

The import is widely spread between ordinary consumer goods, goods for production, and investment goods. In 2008, more than 62% of the export and 61% of the import was with EU countries. Outside the EU, Norway, Nigeria, China, Russia and Iceland are the main business partners.

When the Faroe Islands declined membership in the Common Market in 1974, a trade agreement was concluded instead. The trade agreement was fundamentally a free trade agreement and reported to GATT by the EU. As a condition of the 1991 trade agreement, the Faroe Islands, in 1993, implemented a value-added tax regime. Excise duties replaced the fiscal import duties. The value-added tax now stands at 25%.

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

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

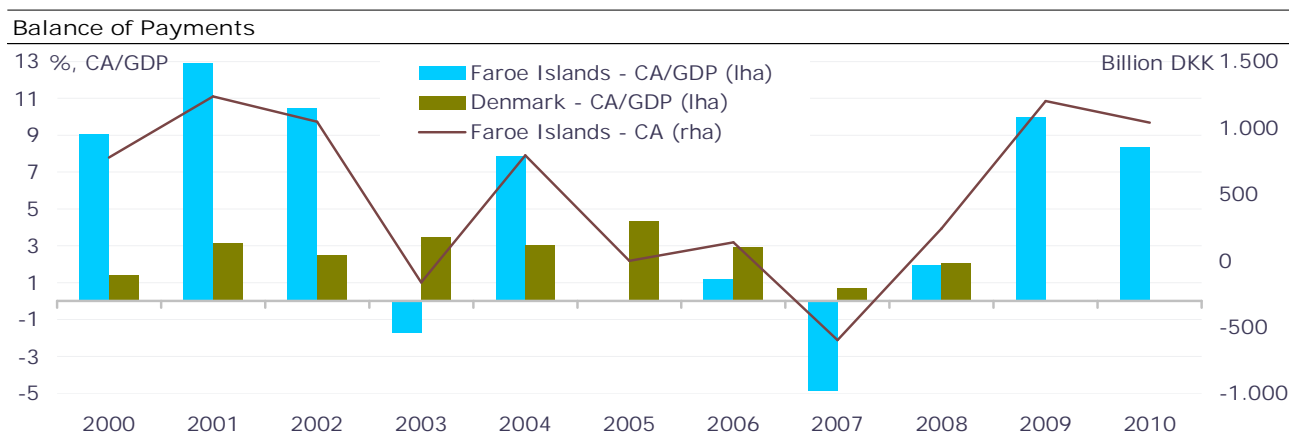
The Faroe Islands also have signed free trade agreements with Norway, Iceland, Switzerland, and a most-favoured-nation clause with Russia. (See also part 3.3 Foreign Relations)

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

The Balance of Payments (BoP)

From the early 1970s to the beginning of the 1990s, there was a deficit in the current account, this picture changed significantly in the early 1990s. During the years from 1999 through 2002, the annual surplus was more than DKK 1,000 million or 12% of GDP on average. Because of the surpluses since 1993, the net debt has turned into net assets of about DKK 3,738 million in 2006.

The newest statement from Statistics Faroes is from 2006. The surplus on the current account was on average substantial in the years 1998 to 2006. The figures for 2003 and 2005 are greatly affected by the fact that two large ships were imported, while 2006 is influenced by the fact that spending funded by credit really accelerated that year. In 2007 there was a big increase in imported goods, both durable and semi-durable consumer goods, and in materials for the construction, which resulted in a large deficit on the current account.



Judging by the balance of trade, the deficit on the current account in 2007 was most likely at the same level or higher than the deficit in 2003. In 2007, the deficit on the balance of trade reached DKK 1.5 billion. The deficit on the balance of trade was app. DKK 700 million in 2008. The surplus on the current account was most likely at the same level in 2008 as it was in 2006. The surplus in 2009 will probably be higher.

Adapting to the International Economic Environment

The Faroese economy is open, as the export and import of goods and services are about 45-50% of GDP. Changes in the international economy thus have a larger impact on the Faroese economy than most other countries. It is, therefore, essential for the Faroe Islands to be able to adapt to changes from the outside world.

In order to encourage Faroese businesses to respond effectively to international competition and to attract foreign direct investment, some important trade and industry legislation has been implemented. Accounting procedure legislation governing the various types of limited liability companies, as well as legislation regulating the accounting industry, was renewed in 2007 to comply with international accounting and business standards.²² Companies can be registered as either public limited liability companies with a share capital minimum of DKK 500,000 indicated by the acronym P/F, or as private limited liability companies with a minimum share capital of DKK 125,000 indicated by the acronym Sp/f.

The act regarding accounting procedures contains provisions governing the accounting principles to be employed, and requires that the accounts of all limited liability companies be available to the public. This regulation ensures that those who invest money and give loans can have better insight into the activities of a business and make it easier to compare a specific business with others engaged in the same type of business.

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

²² Act (Danish Kingdom Law Recommendation) no. 1355 9. December 2007 for the Faroe Islands about annual accounts as amended by LI 18 8. May 2008. Act no. 1356 9 December 2007, Act no. 1111 20. September 2007 and Act 1114 no. 20 September for the Faroe Islands about private, private limited and limited companies as amended by LI 18 8. May 2008.

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

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

5. THE PUBLIC SECTOR

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

Of the DKK 5.55 billion the authorities spent in expenses and investments in 2008, the proportional distribution was as follows: Social Security and Pensions 27.9%, Financial and Economic Affairs 24.5%, Education, Research and Culture 17.3%, Transport and Communication 13.9%, Health 13.7%, and Political Administration 2.8%.

Investments in 2008 were DKK 232 million. Most of the investments this year went to education and culture (DKK 110 million), health and social security (DKK 62 million), and transport and communication (DKK 45 million).

The largest, single-item expenditure on the public account was Social Security and Pensions DKK 1.5 billion. Of this, approximately DKK 520 million to home-based care, care of elderly and handicapped, DKK 418 million to the National Pension Scheme, DKK 265 million went to social protection, and DKK 238 million to National Supplementary Disability Pensions.

In 2008 the total government income DKK 5.22 billion came from income tax DKK 1.34 billion (25,7%), other direct taxes DKK 0.39 billion (7,6%), VAT DKK 1.46 billion (28,0%), other indirect taxes DKK 0.50 billion (9,7%), other DKK 0.28 billion (5.3%), sales of products and services DKK 0.60 billion (11,5%), and Danish block grant DKK 0.63 billion (12,2%).

The Public Account deficit was about DKK 330 million in 2008. This was about DKK 260 million more than provided for in the budget. This negative result is mainly due to DKK 200 million less income from taxes and duties than estimated in the budget.

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

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

In addition to tax revenues, public expenditure in the Faroe Islands is also financed by the Danish Government. Beginning with fiscal year 1988, most of the grant subsidy from the Danish Government has been in the form of a general block grant.

The Danish block grant for 1995 to 1998 was fixed in real terms, and since 1999 the block grant has been fixed in nominal terms. The grant for 2002 was reduced by DKK 366 million to DKK 630 million in part because the official transfers of public education to the Faroese authorities. The Faroese and the Danish Governments agreed that the grant should be fixed in nominal terms at DKK 615.5 million per year from 2003 until 2008. The grant is expected to be on the same level in 2009 and 2010.

In 2008 the Danish State expenditure and investment in Danish institutions in the Faroe Islands was about DKK 280 million. The Danish State also paid about DKK 98 million to War Disablement Pensions and other pensions.

Faroese students who study abroad receive educational aid in the same way as Danish students.

5.1 Foreign Currency Rating

In a Credit Analysis from May 2009 the Moody's Investors Service affirmed its Aa2 foreign currency rating with a stable outlook to the Faroe Islands. This rating reflects a Baseline Credit Assessment (BCA) of 5 (on a scale of 1 to 21, where 1 represents the lowest credit risk) and a high likelihood that the Kingdom of Denmark (Aaa, stable) would act to prevent a default by the islands.

In the Credit Opinion report from May 2009, the Moody's Investors Service explains that:

The Faroe Islands' BCA of 5 reflects a number of factors, including the strength and increasing diversification of the economy. The BCA also reflects the government's powers to raise revenues through taxation and fees and ability to control spending as shown by the strong financial results achieved since 1995. The Faroe Islands maintains ample reserves while the debt level interest burden are moderate.

The final rating takes into account the Islands' relationship with the Kingdom of Denmark and the funding it receives for "Joint Matters", which it administers in conjunction with the Kingdom of Denmark. The support also takes into account the settled relationship the Faroese have established with Denmark regarding further autonomy and potential independence.

Among the credit challenges the Moody's Investors Service mentions in the Credit Opinion from 13 October 2008 were the volatility of the fishing industry as well as substantial challenges in the management of commercial exploitation of its fishing grounds. It is also mentioned that the trade balance has moved sharply negative and would be further weakened by any decline in fishing, which makes up all of export. The Moody's Investors Service see it as a challenge that the Governmental accounting standards, including the monitoring and control of municipal governments within the Faroe Islands, are not as comprehensive as those of other Nordic countries.

5.2 Public Income

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

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

A & B-income

Two classes of personal income taxes are defined: taxes from wage income, which is, for the most part, defined as A-income, and taxes from business income, mainly defined as B-income.

A-income has to be transferred to an account in a financial institution, post giro or the exchequer. Upon receipt of an individual's wages from an employer, the receiving bank automatically deducts and transfers the appropriate withholding tax to the exchequer via the Customs and Tax Administration centralised tax system. Each tax payment is calculated based on the income up to the date of the latest wage payment, which is then converted into annual income.

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

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

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

Members of National Church also pay church tax, on average 0.66%. Every person from 18 years old shall also pay a yearly fee to a local Sick-benefit association (In Torshavn DKK 2,640). In 2009 The Ministry of Health Affairs will present a proposal to the parliament for a new compulsory public Sick-benefit system, which will take effect as from 1. January 2010. The yearly fee for persons older than 18 years will then be DKK 2.940. The yearly radio and television licence fee for the Faroese Broadcast Association (Kringvarp Føroya) is DKK 3,625 incl. VAT.

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

A gross tax system was introduced in 1997. This means that instead of providing for tax deductions, specific subsidies are allowed to compensate for certain expenses.

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

Municipal taxes are assessed using the same calculation of income as that of the Customs and Tax Administration, except that a flat tax rate is used. In 2008, municipal taxes ranged from 16% to 23.5%. On average, the tax is 20.65%. For each child under 18 years the annual income is deduced with between DKK 3,000 and DKK 6,500 depending upon in which municipality one resides.

Corporate Taxes

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

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

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

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

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

Capital Gains Tax

Interest on deposits in Faroese banks is not included in the income subject to income tax.

Instead, a yearly tax of 35% of the interest is deducted from the interest payment by the financial institutions and transferred to the Treasury. All income from securities (interest, dividends and capital gains) is taxed at 35%. However, this does not include corporations and some foundations, which pay a corporate tax of 18%. There is no property or wealth tax.

Customs and VAT

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

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

5.3 Public Expenditure

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

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

The composition of expenditures has changed since the early 1990s. Expenditure to the fishing industry has fallen considerably since 1991 due to the change in subsidies to the industry. The policy is to stress the need for the industry to be cost efficient and independent of public funds.

Historically, outlays for effective guarantees have been massive. In 1991, private guarantees amounted to DKK 642 million. They were zero in 2003. New outlays from 1999 and onward have been at a minimum and the public guaranteed debt is decreasing.

In 2008, all guaranteed debt was only DKK 59 million for loans raised by the municipalities. In addition the Government also guarantees for private insurance policies made before 1999 in the Faroese Life Insurance Company (Føroya Lívstrygging) and is by law committed in the future to pay pensions to politicians and some public servants.

The interest line item in the budget increased as the public sector took over a greater part of the private debt during the depression. In 1995, interest expenses were 16% of the total budget, but after the debt agreement with Denmark in 1998, interest payments were halved. In the Public Budget for 2009 interest expenses appropriation is DKK 138 million, 2.8% of total expenses DKK 4.9 billion.

5.4 The Public Financial System

Before 1. April the Finance Minister present to the Parliament an outline of expected appropriations for the next fiscal year.

The annual budget is presented to the Faroese Parliament before October and must be approved before 1 January of the following year. In practice, approval occurs before Christmas.

Beginning with the 1991 fiscal year, the Budget Act was changed to obtain a better governing instrument. Blanket approvals for government investments and certain other expenditures are not permitted. Instead, government investments and other expenditures have to be approved in the budget for the year in question.

The accounts and bookkeeping of the government exchequer are audited by the National Audit Office. Once audited, the books are passed on to a audit committee consisting of members selected by the Faroese Parliament.

5.5 The Current Public Budget Status

The Government account has shown both surplus and deficits from 2001 to 2007. The budgeted deficit for 2006 was set at the same level as in 2005, but the result showed a DKK 142 million surplus due to an increase in tax revenue. The Public Account surplus was DKK 146 million in 2007. In 2008 the Public Account showed a DKK 330 million deficit.

In 2009 the budget deficit will be about DKK 502 million. However, the latest figures on expenses and income in the public account indicate that the deficit will be about DKK 800 million.

Income

Economic growth increased the level of public income dramatically both in 2000 and 2001, growth was around 10%. Tax and VAT revenues stagnated in 2003 to 2005 but have shown big growth in 2006 and 2007 as the economy grew. The increase in tax and VAT revenues started to fall in the second half of 2008 and continued to fall in 2009. VAT revenues were 25% lower in the first half of 2009 compared with the same period in 2008.

Public income will depend on the level of economic activity and private consumption and will also be influenced by fluctuations in the fishery sector and the exports.

Expenditures and Investments

From 1998 to 2008, public expenses increased steadily by approximately 5% annually. In the latest five years expenses has increased with about 30%

Investments have grown from DKK 100 million in 1998 to DKK 232 million in 2008. The investments are about the same in 2009. In an effort to speed up the economic activity the Government has proposed a DKK 90 million increase in the investment level in the 2010 budget.

Policy

Over the past few years, the Faroese Government has been working towards stimulating the economy by the means of tax reductions and of a significant rise in public spending, even during the economic growth. The financial and economic crisis have also affected the Faroese economy with an expected fall in the economic growth rate in 2008, which is followed by less expansionary economic policies.

The Government did cancel a planned tax cut in 2009, but investments and expenditures will be on the same level, even though public income have gone down. For the fiscal year 2010 the Government has announced a plan for the public budget, that will contribute to the stimulation in the economic activity by increasing the public investments. At the same time the Government will try to reduce the increase rate in public expenses and furthermore initiate structural reforms in the public economy. This should also be seen as an effort to adapt to an economic development that have resulted in relatively large deficits in the public sector from 2008 to 2010.

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

5.6 Government Debt

From 1992 to 1997, the Faroese debt to the Kingdom of Denmark increased from DKK 500 million to DKK 5,594 million. According to the agreements with the Danish Government, the Faroese Government injected DKK 2,500 million into the Financing Fund of 1992, which was established with the purpose of restructuring the banks,²³ and rearranging foreign debt elsewhere with loans from the Danish Government.

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

In December 1994, the Faroese Government issued bonds for public sale for the first time. In addition to meeting the liquidity demands of the Treasury, the aim was to create a bond market in the Faroe Islands. This would give the Faroese population an additional opportunity to place extra liquidity and work as a credit rating for the Faroese Government.

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

In 2007 repayments of principal and interest on loans were about DKK 80 million in interests and about DKK 75 million in repayments. As part of privatisation plans, the Government in 2007 sold 2/3 of its shares in Føroya Banki and 1/3 of its shares in Atlantic Airways. This increased the Government financial liquidity by about DKK 1.3 billion.

The total Government debt at the end of 2008 was DKK 3.6 billion. Total assets were DKK 5.3 billion and net assets DKK 1.7 billion. The composition of government assets are as follows: DKK 2,158 million available funds in the Governmental Bank, DKK 2,283 in financial assets and DKK 841 other assets. In 2008 the Faroese Government made a DKK 300 million loan to Iceland, in the light of that country's banking woes.

²³ As a consequence of the bank-crisis the Government deposit in the Financing Fund (Fíggingargrunnurin frá 1992) was written down with DKK 2,685 million in 1993.

The repayments of principal and interests on loans in 2009 are about DKK 1,018 million. These payments including the financing of the expected DKK 500 million budget deficit in the public finances were financed by issuing new Government Bonds of DKK 1.9 billion in June 2009. Of this amount DKK 286 million were used for prepayment of bond dept.

The Government's long-term liabilities in 2009 are now about DKK 2.7 billion in outstanding Government Bonds running for 1 to 8 years, a DKK 500 million loan from the Danish State and about DKK 670 million in other dept.

In 2010 it is expected that about DKK 1 billion Government dept will be financed by issuing new bonds.

Government bonds are registered with the Danish Securities Centre and listed on the Faroese securities market and on NASDAQ OMX Iceland hf. and NASDAQ OMX Copenhagen A/S.

5.7 The Municipalities

The Faroe Islands has 30 municipal councils that vary in population from 37 to 19,796 inhabitants.

In 1995, the Faroese Government appointed a committee to make a proposal for a new municipal system. The report was published in 1998. It recommended a system of seven to nine municipalities with clearer distinctions between the national government and the local municipalities.

There has been much discussion following the report, and the idea of merging municipalities is controversial, but sentiments seem to be moderating. Some municipalities have merged over the last few years, and other municipalities have decided to follow suit.

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

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

In 2009 a committee appointed by the Ministry of the Interior recommends in a report, that the number of municipalities should be 7. It is also recommended that the municipals take over the responsibility for public areas as care of elderly and the primary and lower-secondary schools. The Government has decided to reach this goal in before the end of 2012.

The municipalities' total income was about DKK 1.4 billion in 2008. Net expenditure on operations was DKK 1 billion. The net expenditure is divided in the following items: social security and health care 40%, construction work and goods and services 23%, education and culture 20%, and administration 17%. The municipalities' total investments were DKK 700 million. Interest expenses were DKK 30 million. The total municipal debt in 2008 was about DKK 520 million.

In the 2009 budget, expenses are on the same level as in 2008. Investments are set to about DKK 350 million (2008: DKK 595 million). The municipalities' deficit is expectet to be around DKK 130 million in 2009. With the present trend in the public income from taxes and duties, which is lower than expected, it is likely that the real expences also will be lower than indicated by the budget figures.

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

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

6. OUTLOOK

Overall, the Faroe Islands has a sound economy. In 2006, the Faroe Islands had a net worth of DKK 3.7 billion in foreign countries, and according to Statistics Faroe Islands and to estimations made by the Governmental Bank there has been a surplus on the balance of payments in total ever since. Therefore one might conclude that the Faroese financial balance towards foreign countries is very acceptable.

Faroese households seem to be fairly better off compared globally. By the end of 2008, the Government's and the municipalities' net liabilities were in total modest. Financial institutions and businesses own the majority of the net worth in foreign countries.

There are indicators that the GDP in current prices will decline with about 3% in 2009, only to increase again by 3% in 2010. If the increase in prices will be 2% next year, then it means that the Faroese economy in real terms will grow, albeit a small growth.

In the following section this conclusion is explained and its preconditions, which are the basis for the outlook.

Private consumption, which grew considerably from 2004 to 2007, was unusually high in 2007 and by autumn the same year it was slowing down, before the global financial crisis was full blown. Since then and up until the summer 2009, the consumption has dropped significantly and rapidly. Still, there are some signs, which might indicate that private consumption will not decline a great deal more. Private consumption is estimated to decline about 10% in 2009 and then increase with 2-3% in 2010. Estimates made by the households concerning future forecasts are important for consumer spending, and assessments of the indicators do not seem as poor as they did six months ago.

Public consumption is easier to estimate, especially since the Faroese Budget bill for 2010 is in the works. It seems to be widely accepted that the expenditure limit must be kept, which means that the Faroese Treasury's consumption must not exceed DKK 4,685 million in 2010. According to known plans, public consumption is estimated to increase by 1.5% in 2009 and 1.0% in 2010.

Private investments have really fluctuated during the past last year and are more difficult to predict. Access to financing, the interest rate level and the economic outlook of the businesses influence the need of the private companies to invest. It is estimated that private investments decreased significantly both in 2008 and 2009, but an increase in 2010 is expected. Although the interest rate on commercial loans went up this year, which could suggest that the loss potential is higher, the companies seem less pessimistic compared to six months ago.

Public investments are at pretty much at a stand still in 2009 and will increase by about 4% in 2010. The municipalities seem to lessen their investments, while the Government increases its investments.

There is a drop in exports in 2009. Although it is difficult to assess exports in general, exports value is not expected to further decrease according to current outlooks.

The unemployment rate has continued to rise during 2009 and with the current trend it is likely that the average unemployment rate will be 3.5%. With a 3% growth in GDP in current prices in 2010 and perhaps a 1 per cent growth in real terms, it is not unlikely to see certain

reluctance from companies at hiring people. Therefore, the unemployment rate may increase further to 4-5% on average in 2010.

Currently, one of the biggest challenges in the Faroese economy is to agree on a public finance policy to provide for more stability, now when the public sector including the municipalities are running with large deficits. Another challenge is the administration of the fishery and fishing industry, as the fishery sector is experiencing significant problems in operations, because of the shortage in fish stock, low selling prices and high oil prices.

7. LINKS²⁴

THE PARLIAMENT

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

THE GOVERNMENT

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

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

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

Fiskimálaráðið

Ministry of Fisheries

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

Mentamálaráðið –

Ministry of Education and Culture

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

Almannaráðið –

Ministry of Social Affairs

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

Heilsumálaráðið –

Ministry of Health Affairs

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

Uttanríkisráðið –

Ministry of Foreign Affairs

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

Innlendismálaráðið –

Ministry of the Interior

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

GOVERNMENT INSTITUTIONS

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

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

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

Landsgrannskoðanin –

The National Audit Office

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

Havstovan –

Faroe Marine Research Institute

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

ALS – The Unemployment Fund

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

THE HIGH COMMISSIONER

Ríkisumboðsmaðurin -

The High Commissioner of The Faroe Islands

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

MUNICIPAL COMPANIES

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

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

²⁴ Information on some of these homepages is in Faroese.

BANKS

Føroya Banki	http://www.foroyabanki.fo/
Eik	http://www.eik.fo/
Norðoya Sparikassi	http://www.ns.fo/
Suðuroyar Sparikassi	http://www.sparsu.fo/

INDUSTRY

Vinnuhúsið - House of Industry	http://www.industry.fo/
Virðisbrævamarknaður Føroya (VMF) – The Faroese Securities Market	http://vmf.fo/
Jarðfeingi – Faroese Earth and Energy Directorate	http://www.jarðfeingi.fo/

TRANSPORT AND COMMUNICATION

Strandfaraskip Landsins – The Public Transport Company	http://www.ssl.fo/
Atlantic Airways	http://www.atlantic.fo/
Smyril Line	http://www.smyril-line.com/
Fjarskiftiseftirlitið – Postal and Telecom Surveillance Authority	http://www.fse.fo/
Føroya Tele Faroese Telecom	http://www.ft.fo/
Vodafone	https://www.vodafone.fo/
Postverk Føroya – The Postal Service	http://www.postverk.fo/

INSURANCE COMPANIES

Tryggingarfelagið Føroyar – The Faroe Insurance Company	https://www.trygging.fo/
Trygd	http://www.trygd.fo/
Lív - The Faroese Life Assurance Company	http://www.liv.fo/
Betri Pensjón – Better Pension	https://www.betri.fo/

BUSINESS INFORMATION

Faroe Business Report	http://www.faroebusinessreport.com/
fishin.fo	http://www.fishin.fo/
Faroeislands.com Tourist Guide	http://www.faroeislands.com/
Føroya Vinnuskra – Faroe Islands Business Directory	http://www.vinnuskra.fo/
Nummar.fo - Faroese Telephone Directory	http://www.nummar.fo/
finn.fo - Faroese Telephone Directory	http://www.finn.fo/

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

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



Landsbanki Føroya

GOVERNMENTAL BANK

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