



Economic Briefing & Forecast for the Falkland Islands

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Executive Summary

The world in 2009 experienced the deepest slump since World War II. Global output fell, but a meltdown was averted. The recovery remains weak and fragile. Demand in major economies remains sluggish, and unemployment hovers at double digits in many countries which means low wage and income growth will depress consumer spending. Meantime, emerging economies which did not suffer a financial crisis and remain fundamentally strong continue to support the global recovery. It is becoming clear that the centre of economic gravity will continue to shift from the United States and Western Europe to Asia and Latin America as the new decade unfolds. This presents challenges and opportunities for the Falklands in terms of inward investments as well as in establishing new trading partnerships.

Based on preliminary estimates, the Falkland economy may have declined by 9% last year with two of the three key economic drivers (i.e., fisheries and tourism) experiencing an output drop (primarily in Illex and loligo) and a slump in tourist arrivals. But the output contraction was concentrated mainly on the poor squid harvest rather than the immediate impact of the global recession (except in tourism). Finfish catch in 2009 still improved overall, although higher value fish are moving much more slowly. Agriculture, on the other hand, scraped by owing to a modest increase in lamb exports and a rebound in wool prices. Generally, local household spending and the domestic services sector were hurt less partly spurred by government deficit spending. Retailers reported domestic consumers are tightening their belts and are being more cost conscious. Inflation in essential goods and services has instilled more conscious buying decisions.

Forecasting into 2010 poses certain challenges. The global economy is in a slow recovery, but it may also run out of steam. A gloomier global forecast for 2010 is premised on few signs of job recovery, mounting incidence of possible sovereign debt crises (in PIGS), recurring corrections in the equity and commodity markets, and the ticking time bombs under the dollar and the euro.

- Fishing: Persistently weak demand is expected for fisheries exports, but output volumes will likely experience a rebound. A return to significant profitability in 2010-11 for fisheries is rather unlikely.
- Agriculture: Wool and meat exports were being initially impacted by poor weather and lamb/sheep recruitment in the current summer season. But the abattoir is now back on track with production numbers. Prices for mid micron wool should remain stable and may even improve, but the sector will remain flat in 2010 with wool offsetting and possible slump in meat exports.
- Tourism: The market is likely to experience a contraction with reduced number of cruise vessels sailing to the Falklands (NSL cancellations considered). Indications are the cruise sector will be down by 15-20% with lower than expected arrivals. MPA tourists and local travellers may help alleviate the adverse trend.
- Other Sectors: Most businesses expect 2010 to still be a difficult year as government maintains spending cuts and a smaller capital budget. But the retail, construction and hospitality industries will benefit from the ongoing de-mining, oil drilling, and MPA runway extension project. The labour situation

will remain tight. A weaker pound sterling, and creeping oil price inflation will contribute to higher local living and housing costs.

Implications for Public Finance

- FIG faces a tighter financial environment in restoring fiscal balance. The challenge lies in raising revenues (via taxation and licence fees) amidst low consumer confidence and business profitability.
- A prudent fiscal position will have to consider both service cuts, as well as new revenue measures to bridge the current budget shortfall.
- While the capital markets remain volatile, FIG could benefit from better returns on investments abroad if base rates rise in the second half of the year.
- A rebound in Illex licence fee intake may be reasonably anticipated. Same from the loligo catch. This represents higher cash flow to the Treasury.
- FIG could contract out services in building maintenance and business services, construction and vehicle servicing as alternatives for stimulating the private sector to the extent it could potentially minimise FIG costs.
- FIG could develop a prioritisation and rationing mechanism for planned capital expenditures for the duration of the MTFP commencing with the 2011-2012 budget.
- Continual monitoring of the global economy and early detection of inflationary pressure and revenue declines will allow a clearer view to be formed by the next budget round.

Current Global Environment

The world in 2009 experienced the deepest slump since World War II, an extraordinary year not only for how much global output fell, but also how a meltdown was averted. World governments, particularly in developed countries, responded to the financial crisis by slashing interest rates, injecting trillions into their economies and boosting countercyclical spending. The world, therefore, escaped the threat of spiralling into a prolonged slump. And the global economy today is emerging from one of the deepest recessions. But the depth of the world recession has left the global economy seriously scarred. Even as profitability returns too many firms, industrial production and trade levels have yet to regain their pre-crisis levels, and unemployment has reached double digits in many countries (and continues to rise in some) which means low wage and income growth will depress consumer spending.

This recovery remains weak and fragile. Demand in the rich economies remains sluggish, especially in those with highly indebted households and broken banking systems. Banks still suffering from huge losses are not prone to lend more, particularly those hit by the weak property markets. Private spending is still constrained, while the prospects of continuous and extended fiscal stimulus are doubtful as major economies are at risk of governments overborrowing and inflationary spending.

Meantime, emerging economies which did not suffer a financial crisis and remain fundamentally strong (e.g., China, India, Brazil, etc.), continue to support the global recovery. It is becoming clear that the centre of economic gravity will continue to

shift from the United States and Western Europe to Asia and Latin America well into the new decade and beyond. While another recession cannot be ruled out, the globalisation trend will continue and even accelerate, with companies from everywhere competing for everything: markets, customers, talent, technology, financing and raw materials. This presents challenges and opportunities for the Falklands in terms of inward investments as well as in establishing new trading partnerships.

The Falkland Economy in a Snapshot

The Falkland economy may have shrunk by 9% (based on preliminary estimates) in 2009 with two of the three key economic lynchpins (i.e., fisheries and tourism) experiencing an output contraction (primarily in Illex and loligo) and a slump in tourist arrivals. But the general output contraction was more a function of the poor fish harvest rather than the immediate effects of the global recession (except in tourism).

Fisheries

Major ITQ fishing firms reported losses as loligo catch volumes dropped significantly and sales prices failed to rise as a result of weak markets in Southern Europe. Last year was a dismal year for Illex -- virtually nil caught in the Falklands and barely 60,000MT in Argentina. However, this was buffered by higher inventories and other squid sources. Loligo also posted a lower catch of 31,000MT compared with the normal 40,000-50,000MT. There are indications prices are flat or slightly lower than last year. Price elasticity which used to be there before the recession is not around this time. There are indications that the letter of credit problems seem to have been overcome and demand for rock cod is fairly good. Finfish catch in 2009 improved by 8% overall. But higher value fish (red cod, hake, kingclip, etc.) are moving much more slowly posing cashflow issues for some fishing companies. Bunker fuel price is also an ongoing concern.

Agriculture

Agriculture, on the other hand, scraped by owing to a modest increase in lamb exports and a rebound in wool prices. There is a shortage of wool available to processors due to droughts in Australia, prompting Aussie farmers to shift to meat exports. Chinese demand is keeping the wool market buoyant. Hence, the wool market is expected to at least stay firm at this current level. But better wool prices now are of little value if wool was sold some time ago. Some farmers are looking towards selling on contract which may be a good strategy to ensure they lock into current prices. Locally, bad weather has had a big impact on the livestock numbers on many farms. Several farms also changed hands, but only one resulted in a new family moving into Camp.

Tourism

FITB reported a small gain in the 2009/10 cruise season arrivals (62,500), but this is expected to drop substantially to 45,000 in 2011/12 due to the HFO ban below 60 degrees South. This year's projected 67,000 arrivals will most likely be missed. As of Feb 9th, actual cruise arrivals have reached only 33,525 or 53% of the season

target. So far, about 10 trips have been cancelled representing 13,000 passengers and £293,000 in foregone passenger tax, Customs and harbour dues, with only 20,400 expected arrivals remaining for the rest of the season. The actual vessel calls at Stanley are down from the 2008/2009 season with about 97 calls in contrast to 110 at the same period last year. Camp landings also appear to be significantly down.

Lack of awareness in the key markets continue to hamper better sales (due to small budgets) especially when other destinations are putting more effort into raising their profile. Another and more important factor is that tour groups have pulled out this year as many could not fill the tours.

Services

Retailers reported that overall, domestic consumers are tightening their belts and are being more cost conscious. In Stanley, inflationary costs for essential goods and services have instilled more conscious buying decisions. On the wholesale side, there has been a drop in business from eating places and pubs in terms of smaller sales volumes. In business services, the requirements for professional industry development are reaching a critical level with both accountants and legal services not meeting current demand. Generally, local household consumption and the domestic services sector were hurt less partly spurred by government deficit spending.

Forecast for 2010

Forecasting into 2010 poses certain challenges. The global economy is in a recovery mode, but may also run out of steam. While most deep recessions are usually followed by a vigorous recovery, this one is still walking on a fine line. The World Bank forecasts global output growth of 2.7% in 2010 (IMF by 3.9%), firming up to 3.2% in 2011 after a 2.2% drop in 2009. And world trade will rebound by 4-4.5% this year and 6-6.5% in 2011 (after shrinking by 14.5% in 2009). But the waning growth impact of the over \$2 trillion fiscal stimulus, uncertainties over private sector confidence and further demand growth coming from Asia may lead to a possible risk of a second round in bank failures.

Global Summary Forecast, 2010 (World Bank & IMF)

	2010 Forecast
1. Real GDP	3.3%*
2. Real GDP (PPP)	4.0%
3. Exports	6.2%
4. Imports	6.5%

* Average of WB & IMF estimates.

A gloomier forecast (presented below) is premised on few signs of job recovery, mounting incidence of possible sovereign debt crises (PIGS in the euro zone),

recurring corrections in the equity and commodity markets, and the ticking time bombs under the dollar and the euro.

Outlook for the Falkland Economy

The economy in general is expected to expand by 5.3% in real terms with public sector output rising by 10.7%, followed by utilities (up 8.7%) and fisheries (up 8.1%), and agriculture (up 6.9%). However, housing, construction and mining will grow at a slower pace by about 2% each. Tourism will contract due to poor cruise ship arrivals, along with hospitality & trade, as well as communications, finance, business services and real estate sectors. FIG, the islands' leading employer (30% of total), will continue to prop up the local labour market from incurring further job losses and provide the consumption base on which the economy rests (40-45% of GDP), provided it sticks to its budget targets.

Fisheries

- Persistently weak demand is expected for fisheries exports. The likelihood of a return to significant profitability in 2010-11 for fisheries is rather restrained.
- But there are pockets of good news. Illex and loligo catch may again trend towards normal levels of output. Rock cod catches and demand at present are improving, albeit with no massive upturn from 2009 expected.
- Although prices should be moving up in reaction to the sharp decline in squid availability, the impact of the economic crisis on demand for squid in Spain puts an effective brake on any price increases. Loligo catch, during the pre-season survey, are very high but concentrated in the south. This is expected to reduce to average levels as the season progresses.
- Illex catches on the high season have not been bad and prices are quite reasonable. Also, demand expectations are higher for Illex fishing licences, as the Koreans are now returning to pick up licences.

Agriculture

- Wool and meat exports are being impacted by poor weather and lamb/sheep recruitment in the current summer season. Prices for mid micron wool should remain stable and may even improve, but the sector will remain flat in 2010 with wool offsetting and possible slump in meat exports.

Tourism

- The tourist sector is likely to experience a contraction in 2010 as indicated by the reduced number of cruise vessels that have sailed to the Falklands (NCL cancellations considered). Indications are the cruise sector will be down by 15-20% due to lower than expected arrivals.
- The tourism slump will also have adverse effects on the retail trade and hospitality sectors. Poor arrival numbers during the ongoing season will be felt particularly in Camp.
- However, MPA tourists and Stanley residents potentially could make up some of the shortfall in overseas tourist stays in lodges. But Camp lodges could

encourage local tourism in partnership with the Tourism Board and FIGAS, an area identified in EDS and TDS as a business stabilizer.

Other Sectors

- Most businesses expect 2010 to still be a difficult year as government maintains spending cuts and a smaller capital budget.
- However, retail trade, construction and hospitality industries are all poised to benefit from the ongoing de-mining, oil drilling, and the contract engineers and 300 workers in the MPA runway extension project. This offsets the absence of wage and salary increases in government (comprising 30% of the labour market).
- But the labour situation will remain tight both in Camp and Stanley. No relief is expected despite the annual immigration quota of 44 PRP slots.
- There is concern and uncertainty in the air and sea links. Service cutbacks will impact negatively on the long-stay tourism market as well.
- A weaker pound sterling, and creeping oil price inflation will contribute to higher import costs, meaning higher living costs and housing expenditure for local households.
- Generally, credit markets will remain stagnant both at home and abroad for operating businesses and while the banking and financial industries are on the mend.
- Local mortgage, however, is an exception and is growing slowly. New home construction will rise in lock step.
- Construction will benefit from any FIG policy to alleviate the housing situation. Oil-driven demand is providing a boost to the private rental housing market.
- However, by the second half of 2010, foreign central banks will probably raise their base (prime) lending rates which along with ongoing banking recovery may lead to a positive uplift in liquidity and credit markets. This will help the fisheries and wool industries if this eases availability of credit lines to traditional Falkland export customers.
- Or if pursued aggressively to combat inflation, this may stymie the emerging green shoots of economic recovery as well.

Implications for Public Finance

- A tighter financial environment faces FIG with respect to restoring fiscal balance. The challenge lies in raising further revenues (via taxation and licence fees) in a backdrop of low consumer confidence and business profitability.
- FIG may have to take precautionary measures to achieve a prudent fiscal position by considering both service cuts as well as new revenue measures to bridge this current budget shortfall.
- Also, there is uncertainty over sustaining capital appreciation and returns from investments overseas. More volatility is expected. FIG may benefit from better returns on investments abroad if base rates rise in the second half of 2010. This of course depends on how the portfolio is allocated among fixed and variable interest-earning investments and its exposure to the stock

markets in the developed and emerging markets (which are performing differently).

- A rebound in Illex licence fee collections is anticipated in 2010. Same with the loligo catch.
- There may be scope for FIG contracting out services in building maintenance and business services, construction and vehicle servicing as alternatives for stimulating the private sector to the extent it could potentially minimise FIG costs.
- FIG could develop a prioritisation mechanism for planned capital expenditures for the duration of the MTFP commencing with 2011-2012 budget.
- Lastly, continual monitoring of the global economy and early detection of inflationary pressure and revenue declines, if any, will allow a clearer view to be formed by the next budget round.

Preliminary GDP Estimates, 2008 – 2009 and 2010 Forecast (Constant Prices)

	2007 Constant	2008E Constant	% Growth '07/'08	2008E Pct Share	2009E Constant	% Growth 08 to '09	2009E Pct Share	2010F Constant	% Growth '09 to '10	2010E Pct Share
Agriculture	2,308,592	1,522,600	-34.0%	1.4%	1,584,504	4.1%	1.6%	1,694,003	6.9%	1.6%
Fishing (all private sector)	65,379,868	60,897,391	-6.9%	56.7%	49,900,401	-18.1%	51.1%	53,956,391	8.1%	52.5%
Mining, Quarrying & Manufacturing	2,117,043	2,133,027	0.8%	2.0%	2,149,131	0.8%	2.2%	2,190,861	1.9%	2.1%
Utilities	837,744	844,201	0.8%	0.8%	850,707	0.8%	0.9%	925,041	8.7%	0.9%
Construction	6,315,705	6,532,021	3.4%	6.1%	6,643,884	1.7%	6.8%	6,772,891	1.9%	6.6%
Hospitality & Transport	7,808,732	8,081,316	3.5%	7.5%	8,222,366	1.7%	8.4%	7,863,136	-4.4%	7.7%
Government (incl. Health & Education)	10,197,903	12,348,766	21.1%	11.5%	12,983,694	5.1%	13.3%	14,378,452	10.7%	14.0%
Housing & Other Services	3,068,430	3,145,160	2.5%	2.9%	3,208,084	2.0%	3.3%	3,270,377	1.9%	3.2%
Communication, Finance, Business Svcs, Real Estate, etc.	11,216,064	11,857,270	5.7%	11.0%	12,026,736	1.4%	12.3%	11,676,443	-2.9%	11.4%
TOTAL GDP	109,250,081	107,361,751	-1.7%	100.0%	97,569,506	-9.1%	100.0%	102,727,596	5.3%	100.0%
Non-Fishery GDP	42,904,070	46,464,360	8.3%	43.3%	44,965,772	-3.2%	48.9%	48,771,205	8.5%	47.5%