1. English Summary

1.1 The current economic outlook

In recent months, clear signs of a slowdown have emerged in many parts of the world, especially in Europe. Falling confidence and increased uncertainty in the financial markets point to some weakness in the second half of 2012 in primary Danish export markets.

It looks a little brighter in Denmark. Agreements from early summer on a tax reform and an investment window will, together with the kick start package, the energy agreement and the reimbursement of contributions to voluntary early retirement pensions (VERP) support growth and employment this year and next. The initiatives will have an increasing effect from the second half of 2012 and into 2013, where historically low interest rates due to Denmark's status as a 'safe haven' also contribute to increasing demand.

In the forecast, GDP growth is expected at 0.9 per cent this year and 1.7 per cent next year. These are fairly moderate growth rates, but the outlook for the Danish economy is better than the EU as a whole – and in particular in comparison to a number of southern euro area countries, *cf. figure 1.1*. This is also reflected in a relatively low unemployment level in Denmark, *cf. figure 1.2*.

Figure 1.1
Real GDP growth

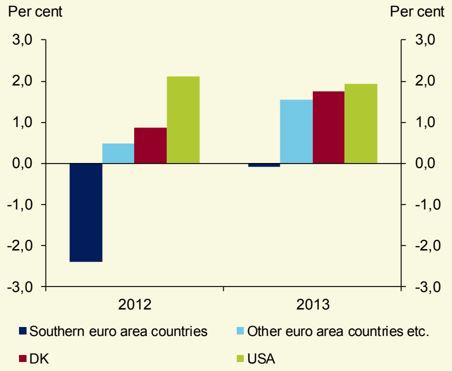
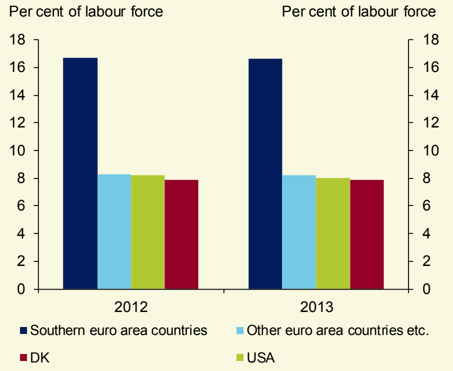


Figure 1.2
Unemployment



Note: Southern euro area countries are here defined as Greece, Italy, Spain, Portugal and Ireland. Other euro area countries etc. include United Kingdom and Sweden. Unemployment is measured according to the Eurostat's unemployment definition. which does not correspond to the Danish register based definition of gross unemployment.
Source: Statistics Denmark, European Commission's Spring Forecast 2012 and own estimates.

The relatively favourable position reflects that Denmark, in contrast to a number of other European countries, have had a certain fiscal room for manoeuvre, which has made it possible to support growth and employment within a responsible and credible fiscal policy, that fulfils the EU recommendation on an improvement of the structural balance of 1½ per cent of GDP from 2010 to 2013. Excluding the contribution of these extraordinary measures, GDP growth would have been only 0.3 per cent this year and 1.4 per cent next year, *cf. figure 1.3*. Employment would correspondingly have been approx. 11,000 persons lower in both years, *cf. figure 1.4*.

Figure 1.3
GDP growth with and without effects from fiscal policy and other economic policy measures from 2012

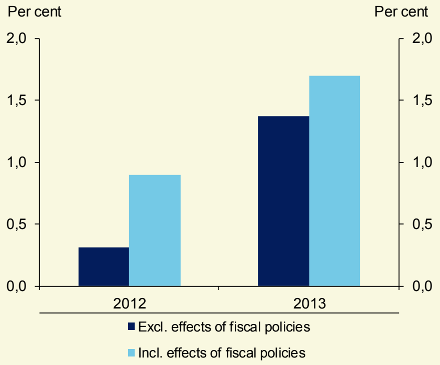
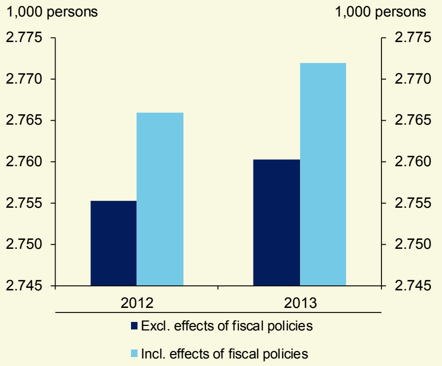


Figure 1.4
Employment with and without effects from fiscal policy and economic policy measures from 2012



Source: Own estimates.

Growth prospects are associated with extraordinary high uncertainty, mainly on the downside. The recovery of the global economy remains fragile with a particularly bleak outlook for a number of southern euro area countries, and high volatility in the financial markets reflects a considerable uncertainty. A number of measures have been agreed in order to improve the situation in these countries, but so far it has not been enough to secure lower interest rates, which could support growth and employment.

The widespread pessimism abroad has spill-over effects on the Danish economy and dampened confidence and expectations counteract the effect of the economic policy and the extraordinarily low interest rates. Overall, it is estimated that the negative impact of the international cycle has increased due to the continued uncertainty in the euro area and weaker growth prospects in the global economy.

The forecast is based on an assumption of a successful stabilisation of the situation, especially in the southern euro area countries, and that the fiscal policy in the United States in 2013 does not stop the ongoing recovery of the US economy. Furthermore, Denmark is assumed to maintain its status as a 'safe haven' until conditions in the financial markets have normalised. Finally, the forecast is based on the assumption that public consumption as well as local and regional investments are in line with budgets.

In the remainder of this summary, the main elements of the forecast are outlined, with emphasis on issues that are essential to the projection, followed by a description of fiscal policy and public finances. Finally, Denmark's status as a 'safe haven' is discussed.

1.2 The forecast

European economy is currently in a significant slowdown. The recovery after the setback in 2008-09 has stalled and business confidence has weakened significantly over the last year, *cf. figure 1.5* and *1.6*. The relatively weak signs of optimism at the beginning of the year have now turned into a more negative sentiment. At the same time, there are signs of increased turmoil in the financial markets, with an increased focus on the Spanish banking sector.

Figure 1.5
Real GDP

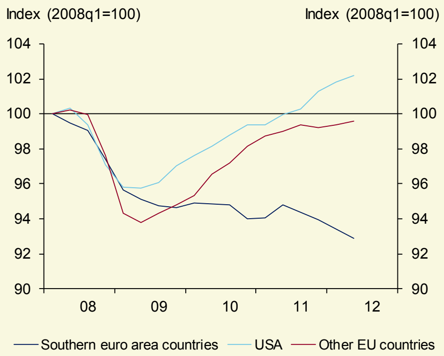
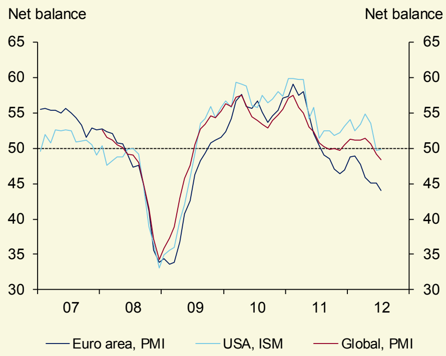


Figure 1.6
Business confidence



Note: In figure 1.5 the same grouping of countries is used as in figure 1.1.
Source: Reuters EcoWin, Bloomberg and own calculations.

New crisis initiatives have been launched, including a rescue plan for Spain, and the European Central Bank (ECB) has signalled that further interventions will be made, if necessary, in order to ensure stability in the financial markets. This may dampen the turmoil during the autumn, but overall growth prospects for the euro area have weakened, and significant progress is not assumed to take place before next year.

The situation in the US is generally better. This partly reflects that the consolidation, which European banks are still facing, is about to be brought to an end in the US. However, there is still considerable uncertainty about the fiscal policy next year, with the current legislation implying a very sharp fiscal tightening. A clarification of the fiscal policy is not expected until after the presidential election in November, and the uncertainty will affect the US economy throughout the second half of the year. The US economy could also be affected by deterioration in the euro area. On this background, the progress in the US is expected to be less robust than previously assumed.

A number of emerging economies have also lost momentum lately, including Brazil, India and China. However, emerging economies are still important drivers of growth in the world economy.

The weakened international prospects weigh down the outlook for Danish exports, which is already impaired by a loss of wage competitiveness over a number of years. The growth in Danish economy this year and next year is expected to be predominantly driven by domestic demand, supported by the fiscal policy. Exports – which was the sole driver of GDP growth in 2011 – does not contribute this year and only moderately next year, *cf. figure 1.7*.

Growth in domestic demand is not only driven by fiscal policy and other activity-supporting economic policies. The historically low interest rates are also of great importance. Denmark's status as a 'safe haven' for financial investments has become even more pronounced in recent months and interest rates have decreased further.

This, coupled with relatively high inflation, implies that the average real interest rate after tax is now negative for the first time since the early 1980s, *cf. figure 1.8*. A negative real interest rate generally promotes consumption and investments, but should currently be seen as a sign of crisis and as a reflection of extraordinary circumstances.

Figure 1.7
Growth contribution to GDP

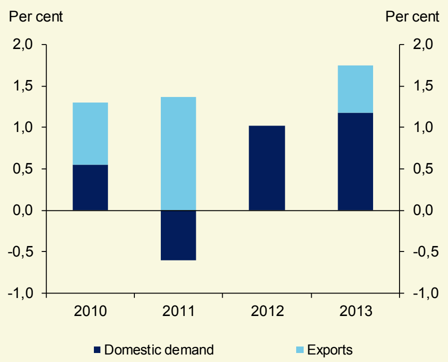
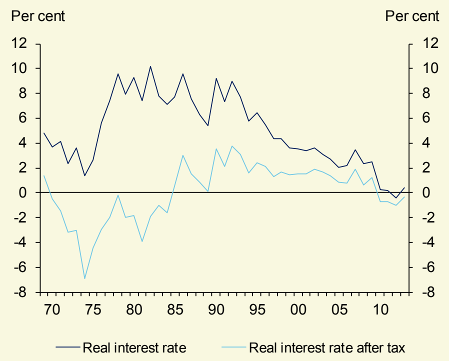


Figure 1.8
Real interest rate



Note: The real interest rate in figure 1.8 is measured on an annual basis as the average bond yield minus the actual consumer price inflation. The real interest rate after taxes is based on the tax rate for negative net capital income. The real interest rates in 2012 and 2013 are estimates.
Source: Statistics Denmark and own estimates.

In the current situation, the low interest rates are accompanied by a large general uncertainty in the international economy. This dampens the propensity to consume and invest also in Denmark. In light of the increased uncertainty, banks and mortgage lenders have tightened credit conditions, expanded interest margins, and increased fees and administrative costs. The higher risk premium implies that the lower interest rates do not have full impact on the real economy.

Business investments have been at a very low level in recent years, since idle production capacity has reduced the need for investments. This has, on the other hand, led to a large savings surplus in non-financial companies, implying a significant growth potential in business investments going forward as expectations of future economic development improves. Already this year business investments are expected to improve compared to recent years, *cf. figure 1.9*.

Business investments are supported by the investment window, which implies that companies can write off 115 per cent of (some) investments in the rest of 2012 and in 2013. Growth in investments this year and next is also supported by railway investments and investments induced by the energy agreement. Construction work in connection with the Fehmarn Belt link and the expansion of the Copenhagen Metro also contributes to the higher investment activity.

Figure 1.9
Business and public investments

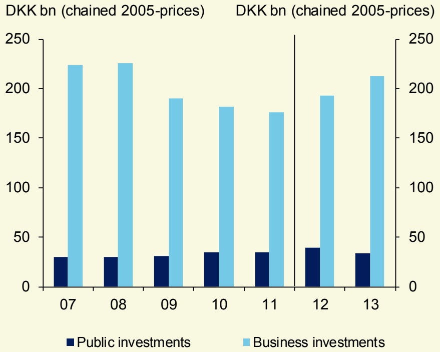
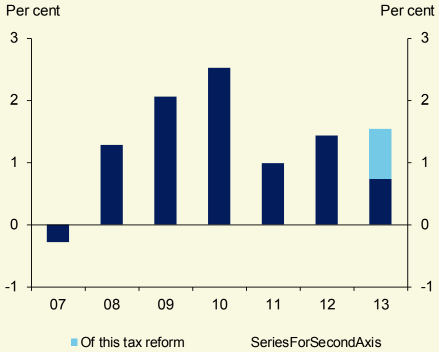


Figure 1.10
Growth in real household disposable income



Note: In figure 1.9 business investments include publicly initiated investments carried out by private companies, including construction work in connection with the Fehmarn Belt link and the Copenhagen Metro Cityring. Figure 1.10 shows the households' adjusted disposable incomes. The purchasing power of households is also affected by the reimbursement of VERP contributions in 2012.

Source: Statistics Denmark and own calculations.

Private consumption has been subdued due to household cautiousness in recent years. Households have improved their balance sheets after a period with rising indebtedness in the years before the crisis and weak developments in the labour market and greater uncertainty has dampened the desire for consumption. The reimbursement of VERP contributions and the tax reform strengthen households' purchasing power significantly this year and next, and may thus contribute to growth in private consumption.

Reflecting the actual repayments in April-July, the estimate for the total reimbursement of VERP contributions has been adjusted upwards from DKK 17½ bn to DKK 24 bn. Based on historical experience with on-off repayments and due to the strengthened consumer confidence up until summer, the effect on private consumption is expected to become more evident in the second half of 2012 and into 2013. The potential for growth in private consumption in 2013 is strengthened further by the tax reform, which increases the households' real disposable income by close to DKK 7 bn (0.7 percentage points), *cf. figure 1.10*. The tax agreement is fully financed, but the financing elements are phased in more slowly than the tax cuts, thereby increasing the households' real disposable income in the short term.

The housing market is still subdued. However, house prices appear to have stabilised and is expected to increase moderately from next year, *cf. figure 1.11*. After the housing bubble in 2006-2007, house prices have adjusted to a level in line with the historical trend and both short-term and long-term mortgage rates have fallen to historically low levels. The agreement on the tax reform helps to clarify the future economy of homeowners, since property taxes and the tax value of interest rate deductions is maintained in line with current legislation until 2020. However, the housing market is expected to remain sluggish due to the large supply of houses.

Residential investments are estimated to decline by just over 4 per cent this year. This reflects, however, an exceptional high level of construction of social housing last year, which supported housing construction. Both this year and next year main repairs are supported by activities under the auspices of the National Building Fund – and this year also by the HousingJob-plan – and next year the low interest rates and an improvement of the housing market is expected to lead to some growth in private construction. On this background, housing investments are expected to increase by 5 per cent next year.

Figure 1.11
House prices

Figure 1.12
Gross unemployment

Source: Statistics Denmark and own calculations.

The subdued growth outlook for the Danish economy implies that there will still be significant spare capacity in the economy this year and next year. The output gap – ie. the difference between actual and potential output – is expected to widen to approx. -2½ per cent of GDP this year. Thereafter, the output gap is expected to narrow gradually and the Danish economy to recover slowly. In the 2020-plan from May, it is assumed that the output gap will be closing up until 2018, *cf. Denmark at work – challenges for the Danish economy towards 2020.*

The growth in production and demand is expected to lead to an improvement on the labour market from 2013, when employment is estimated to rise particularly towards the end of the year. Employment is supported by relatively moderate wage developments, which, however, do not make up for the loss of wage competitiveness accumulated over a number of years. Wage competitiveness was improved in 2009-11, mainly due to relatively high and cyclically related productivity growth and a depreciating currency. But from 2000 to 2011 wage competitiveness has weakened significantly overall, which will dampen the recovery of the Danish economy.

The employment growth implies a fall in gross unemployment of 16,000 persons in the course of 2013. This is more than assumed in the December Survey, which only included the effect of the kick start package and the reimbursement of VERP contributions, *cf. figure 1.12*. Net unemployment – which does not include the number of persons in activation measures – is expected to increase moderately, but this is due entirely to a decrease in the number of people in activation measures due to a more focused activation strategy. Estimates of people in activation do not include measures that have been launched recently, including in the budget proposal for 2013, but have not yet been adopted.

Although growth is expected in both private consumption and private investments, the consumption and investment ratios will still be relatively low in a historical perspective, *cf. figure 1.13*. Thus, private financial savings is also expected to be relatively high. The high savings should be seen in light of the substantial increase in debts in the years preceding the crisis, which implies that the private sector – and households in particular – has had to adjust the debt level relative to income and asset values.

Figure 1.13
Households' consumption ratio and companies' investment ratio

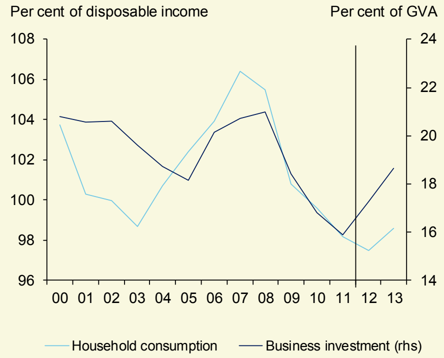
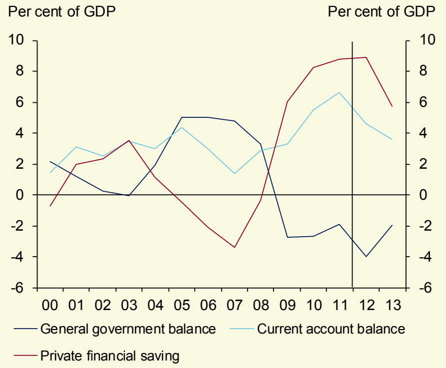


Figure 1.14
Savings balances



Note: In figure 1.13 the consumption ratio is based on the national accounts definition, i.e. nominal private consumption as a share of households' disposable incomes. The income definition does not reflect all income, and a level over 100 does therefore not imply that there is no saving.
Source: Statistics Denmark and own estimates.

The savings surplus in the private sector more than offsets the general government deficit. Thus, Denmark consumes and invests less than total income, which is also reflected in the large current account surpluses, *cf. figure 1.14*. A portion of the balance of payments surplus relates to net interests and net dividends from abroad, which has increased significantly in recent years, partly as a result of an increasing predominance of investments out of Denmark in the last decade. The present large current account surpluses primarily reflect weak domestic demand and Denmark's net foreign assets. Thus, the surpluses are not a reflection of strong wage competitiveness among Danish companies.

The public finance deficit in 2012 is affected by the repayment of VERP-contributions corresponding to 1¼ per cent of GDP. The deficit is expected to amount to close to 4 per cent of GDP in 2012 and close to 2 per cent of GDP in 2013.

Key figures from the forecast are shown in *table 1.1*, while *table 1.2* (in appendix) compares selected estimates for 2012 and 2013 with corresponding estimates from *Economic Survey*, May 2012. Compared to the December and May Surveys the international outlook has deteriorated, which in itself dampens growth. On the other hand, in early summer a number of growth-promoting measures were agreed, which have an increasing effect in the remaining part of the year and into 2013. On this background, the estimated GDP growth has been adjusted downward for 2012 compared to the May Survey, while the estimate for next year has been revised upwards.

Table 1.1
Key figures

	2010	2011	2012	2013
Real growth, per cent				
Private consumption	1.9	-0.8	1.0	2.3
Public consumption	0.3	-1.3	1.5	0.1
Public investment	8.5	5.2	7.5	-11.5
Residential construction	-7.4	8.8	-4.3	5.0
Fixed business investments	-4.6	-3.3	9.8	10.3
Stock building (per cent of GDP)	1.0	0.3	0.1	0.1
Exports of goods and services	3.2	7.0	1.0	2.9
Imports of goods and services	3.5	5.2	3.6	4.2
Gross domestic product (GDP)	1.3	0.8	0.9	1.7
Level, per cent of GDP				
General government balance	-2.7	-1.9	-4.0	-1.9
Current account	5.5	6.6	4.6	3.6
Level, 1,000 persons				
Net unemployment	114	109	118	126
-per cent of labour force	3,9	3,8	4.1	4.3
Gross unemployment	164	162	164	158
-per cent of labour force	5,7	5,6	5.7	5.4
Employment	2,775	2,767	2,766	2,772
Labour force	2,889	2,876	2,884	2,898
Growth, per cent				
Price index (single-family homes)	2.7	-2.8	-3.5	2.5
Consumer price index	2.3	2.8	2.4	2.0
Hourly wages, private sector	2.7	1.2	1.9	2.1

1.3 Fiscal policy and public finances

Fiscal policy and other economic policy measures in 2012 and 2013 are planned in order to support growth and employment in both years, while the structural fiscal deficit is reduced by 1½ per cent of GDP from 2010 to 2013 in accordance with the EU recommendation. Fulfilling the recommendation helps to underpin credibility of fiscal policy and low interest rates.

Effects on activity from planned fiscal policy in 2012 and 2013

The growth contribution from fiscal policy and other economic policy measures in 2012 and 2013 is estimated at 0.6 per cent of GDP in 2012 and 0.3 per cent of GDP in 2013, *cf. figure 1.15* (measured by multi-annual effects). In addition to fiscal policy, the estimates of the activity effects include off-budget initiatives, which are listed as private investments in the national accounts. This includes measures taken to increase energy and climate investments as well as renovation of social housing etc.

Figure 1.15
Growth contributions from fiscal policy and other economic policy initiatives

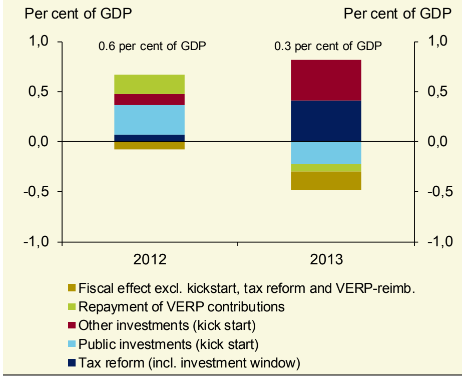
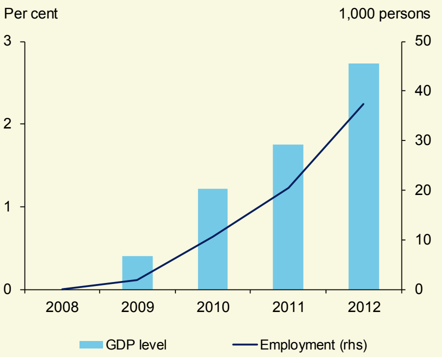


Figure 1.16
Effect on activity level from lower interest rates since 2008



Note: Figure 1.15 illustrates the growth contribution from public spending (as measured by the multi-annual fiscal effect), repayment of VERP contributions, the effect of the investment window as well as "other investments", which covers renovation of social housing under the auspices of the National Building Fund for Social Housing, investments due to the energy agreement and climate investments in the wastewater sector. In figure 1.16 the effect from interest rates on GDP and employment has been estimated using the ADAM model (Annual Danish Aggregate Model) compared to a situation where interest rates were at the same level as in 2008.

Source: Statistics Denmark and own calculations.

In 2012, the growth contribution particularly reflects the frontloading of public investments in the kick start package and the repayment of VERP contributions, while in 2013 contributions especially come from the agreements from early summer on a tax reform and the investment window, *cf. box 1.1*. Additional contributions come from the kick start's investments in renovation of social housing under the auspices of the National Building Fund for Social Housing as well as investments due to the energy agreement.

Agreements made in early summer – which in addition to the tax reform and the investment window from June also includes the housing agreement from May and increased climate investments in the wastewater sector – imply that the growth contribution from fiscal policy and other initiatives in 2013 have been revised upwards to a positive effect of 0.3 per cent of GDP, compared to a negative contribution of -0.5 per cent of GDP in the May Survey.

Meanwhile, the overall focus on maintaining a responsible and credible fiscal policy – including the consolidation of public finances in 2011-2013 and the 2020 reform strategy – has supported Denmark's status as a "safe haven" during the renewed financial turmoil over the past year. This has contributed to very low interest rates. The fall in interest rates since the financial crisis escalated in 2008 is estimated to support employment corresponding to approx. 35,000-40,000 persons this year, while the level of GDP is estimated to be 2½ -3 per cent higher than if interest rates were unchanged compared to 2008, *cf. figure 1.16*.

Box 1.1
Effects on activity from the agreements on the tax reform and the investment window

The agreements on the tax reform and the investment window from June support the economy in the short term, and the effect on employment is estimated to be at approx. 1,000 persons in 2012 and approx. 7,500 persons in 2013. Of these, most of the employment effect (1,000 in 2012 and 6,500 in 2013) comes from the investment window, which implies that companies can write off 115 per cent of (some) investments in the rest of 2012 and in 2013. The investment window is estimated to increase business investments in the order of DKK 15-20 bn in 2012 and 2013. However, there is considerable uncertainty regarding the effect in 2012 and 2013, as there is limited experience with this type of initiatives.

The lowering of taxes in the tax reform is implemented faster than the financing elements, but the bringing forward of taxes on capital pensions results in additional revenues in 2013 (and beyond). This frontloading of tax revenue has the character of a periodical revenue shift over time, which has no effect on activity – neither in 2013. Thus, the tax reform can help to increase activity in the short term and have an estimated positive effect on the fiscal balance in 2013, while the structural balance is broadly unchanged in 2013.

The new initiatives taken over the past year to support the economy are generally estimated to increase employment by 10,500 persons this year and 21,000 persons next year, *cf. box 1.2*. Of this, the kick start package will increase employment by 7,000 persons in 2012 and 8,000 persons in 2013. The underlying tightening of fiscal policy, which was already in the pipeline, and which is still planned in order to comply with the EU recommendation, is expected to weaken employment by around 9,500 persons in 2013. In total, the fiscal policy and the range of other initiatives are thus expected to strengthen employment with 10,500 persons this year and 11,500 persons next year.

The economic policy initiatives support growth in private and public demand in both 2012 and in 2013, and employment is thus expected to be broadly stable this year and to grow moderately next year. The economic policy thereby contributes to support the Danish labour market during the current slowdown in economic growth.

Box 1.2

Employment effects of the last year's initiatives to support the Danish economy

A number of initiatives have been implemented in order to support employment in the short term. The initiatives are estimated to increase employment by 10,500 jobs this year and 21,000 jobs next year, *cf. table a*

- The kick start package is estimated to create 7,000 jobs in 2012 and 8,000 jobs in 2013. The kick start includes the bringing forward of public investments and also renovation of public housing (under the auspices of the National Building Fund for Social Housing), investments due to the energy agreement and investments in better and cheaper public transport (June 2012).
- The repayment of VERP-contributions in 2012 to persons that leave the VERP scheme is estimated to increase employment by 2,500 persons in both 2012 and 2013.
- The Housing Agreement (May 2012), which increases the investment funds for the National Building Fund for Social Housing by approx. DKK 4 bn in 2012, is estimated to increase employment by 1,500 persons in 2013.
- The agreements on a tax reform and on an investment window (June 2012) support employment by a total of 1,000 persons in 2012 and 7,500 persons in 2013.
- The budget agreement with municipalities for 2013 (June 2012) includes a boost of climate investments in the wastewater sector by DKK 2.5 bn per year. This will create 2,000 jobs in 2013.

The specification reflects the new initiatives taken by the government since autumn 2011 adding to the already adopted fiscal policy. The calculation therefore excludes the employment effect of the underlying fiscal tightening, which was already planned, and which is still planned in order to comply with the EU recommendation – including tax and expenditure policy in the the fiscal consolidation agreement, with subsequent changes in the Budget Bill for 2012.

Table a

Effects on employment in 2012 and 2013 from initiatives to support the Danish economy

1,000 persons (full-time equivalents)	**2012**	**2013**
Kick start	7	8
Repayment of VERP contributions	2½	2½
Housing Agreement	-	1½
Agreement on tax reform	1	7½
- of this: agreement on investment window	1	6½
Climate investments in the wastewater sector	-	2
Total effect on employment	**10½**	**21**

Note: The employment effect of the underlying tightening of fiscal policy is not included in the table. Including the total effects from fiscal policy and other measures in 2012 and 2013 the total effect on employment corresponds to 10,500 persons in 2012 and 11,500 persons in 2013.
Source: Own estimates.

The frontloading of public investments in accordance with the kick start package is expected to proceed as planned. The preliminary national accounts for the 1st quarter of 2012 showed a significant fall in public investments compared to the 4th quarter of 2011, but the seasonally adjusted quarterly figures for public investments are very volatile and subject to considerable uncertainty. Based on preliminary estimates from responsible ministries, governmental investments, including the frontloading of road investments, are expected to proceed as projected in the May Economic Survey. Meanwhile, preliminary accounts for the first half of 2012 indicate a construction level in municipalities and regions in line with the budget, *cf. box 1.3*.

Box 1.3
Status for investments in the kick start package

With the kick start package public investments in roads, schools and hospitals etc. for a total of DKK 7¼ bn are brought forward to 2012 and 2013. The kick start also includes investments of approx. DKK 10½ bn in public enterprises and companies, including investments in railways, renovation of social housing as well as investments due to the *Agreement on Danish Energy Policy 2012-2020* and *Agreement on fare reductions and investments to improve public transport*. Overall, the kick start is estimated to support employment by 7,000 persons in 2012 and 8,000 persons in 2013.

In general, the kick start package progresses as expected in November 2011. However, according to a new report from the National Building Fund for Social Housing, the bringing forward of renovation of social housing has not proceeded as quickly as expected. This implies that investments in the kick start package are reduced from DKK 18¾ bn to 17¾ bn in 2012-2013. The effect on employment is adjusted slightly downwards from 8,000 to 7,000 persons in 2012 compared to the assessment in the *Economic Survey*, May 2012. The employment effect is unchanged in 2013.

- In the Ministry of Transport's domain, the frontloading of road projects proceed as planned, while close to DKK ¼ bn of the bringing forward in the railway area has been postponed from 2012 to 2013 due to developments in the improvement of the Copenhagen-Ringsted railway.
- Preliminary accounts for the first half of 2012 underpin that municipalities and regions may reach the budgeted construction level in 2012.
- The National Building Fund for Social Housing has announced concrete projects amounting to the budgeted frames for the frontloaded investments, but final commitment have not yet been submitted for broadly half of the budgeted frame. This implies that the renovation activity is adjusted downwards by DKK 1 bn in 2012. With the assumed profile, the estimated renovation activity is unchanged in 2013, while activity in 2014 and 2015 is revised upwards by approx. DKK ½ bn in both years.
- With *The Agreement on the Danish Energy Policy 2012-2020*, March 2012, the conditions for investments in renewable energy and energy efficiency are improved. The agreement is expected to broadly reflect the level of investment in 2012-2013, which was assumed in the kick-start.
- With the *Agreement on fare reductions and investments to improve public transport*, June 2012, agreed investments will ensure more frequent metro departures and the establishment of so-called Super Highways for bikes.

Public finances in 2012 and 2013

According to preliminary national accounts, the fiscal deficit amounted to approx. DKK 34½ bn in 2011, equivalent to just below 2 per cent of GDP. The lower deficit in 2011 than in 2010 reflects a fiscal tightening in 2011 of just over 1 per cent of GDP (measured by direct revenues). In both 2010 and 2011 the deficit was reduced by extraordinarily high revenues from pension yield taxes of just over 2 per cent of GDP in both years.

In 2012, the fiscal deficit is estimated at approx. DKK 73½ bn or 4 per cent of GDP. The increase in the deficit from 2011 to 2012 partly reflects the repayment of VERP contributions as part of the retirement reform, which is estimated to weaken the fiscal balance by approx. 1½ per cent of GDP in 2012, *cf. box 1.4*. The deficit in 2012 should also be seen in light of the frontloading of public investments in the kick start package and a slightly weaker economic situation in the wake of the European debt crisis. The revenue from the pension yield tax is, on the other hand, estimated to 2.4 per cent of GDP in 2012, which is significantly more than the estimated structural level.

The estimated fiscal balance in 2012 is partly based on local governments' budgets for 2012. Preliminary accounting information for municipalities and regions indicate a relatively low level of service expenditures in the first half of the year, but the figures are not a dependable indicator for the total public consumption expenditures in 2012. For many years there has been a tendency for the municipal service expenditures to exceed budgets, but in 2011 service expenditures in the municipal and regional accounts were approx. DKK 8 bn lower than budgeted. The preliminary information for the first half of 2012 thereby confirms the impression that municipalities and regions stay within budgets to a greater extent than earlier – reflecting recent years' measures to strengthen expenditure control, including the introduction of individual sanctions.

Figure 1.17
Actual and structural fiscal balance

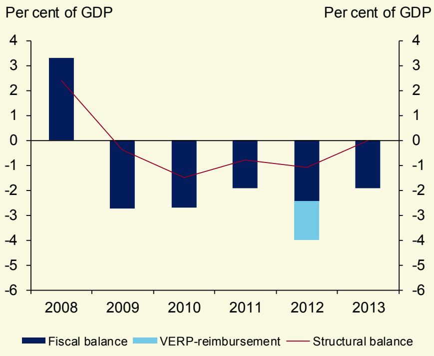
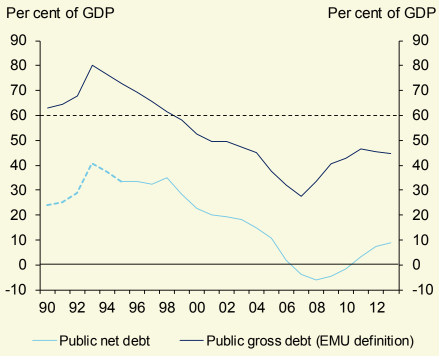


Figure 1.18
Gross public debt (EMU definition) and net debt



Source: Statistics Denmark and own estimates.

Box 1.4

Estimated the effects of the repayment of VERP contributions

Following the retirement reform it is possible to opt out from the voluntary early retirement scheme and have previous retirement contributions reimbursed tax free in the period from 2 April to 1 October 2012. By 17 August 2012 a total of DKK 21.6 bn had been reimbursed and consequently the estimate of the total repayment has been revised upwards from approx. DKK 17½ bn to approx. DKK 24 bn. It is assumed that around DKK 8½ bn will be spent on private consumption in 2012 and 2013, corresponding to roughly one third of the total repayment. The remaining funds are assumed used for retirement savings, free savings and debt reduction.

Table a	2012	2013
Repayment of VERP contributions, DKK bn		
Repayment	24	-
Direct effect on fiscal balance incl. reduced tax revenue	28	-
Effect on consumption	5½	3
Effect on activity and employment		
GDP level (per cent)	0.2	0.1
GDP growth (percentage points)	0.2	-0.1
Employment (1,000 persons)	2½	2½

The estimated effect on consumption is equivalent to the results from a calculation made on the ADAM-model, where households' disposable income is increased by the repayments less the assumed deposits into tax deductible retirement savings amounting to DKK 10½ bn. This is in line with a number of surveys on how the repayments are (expected to be) used. The results from the surveys vary considerably with the consumption share ranging from 16 to 48 per cent, though most fall in the interval 25-40 per cent. Note that respondents may not take into account that increased consumption attributed to the VERP repayment may partially displace other consumption. On the other hand, the retirement reform may in itself increase consumption since individuals who opt out of the VERP scheme typically have a longer expected working life and thus higher lifetime income and lower required annual savings.

All else equal GDP is estimated to increase by 0.2 per cent in 2012 and 0.1 per cent in 2013 due to the VERP repayments, while employment is estimated to increase by approx. 2,500 persons each year.

The repayment and reduced tax revenue due to higher payments into tax deductible pension schemes weaken the public balance directly by approx. DKK 28 bn in 2012. This does not include indirect effects from increased taxes due to higher consumption and employment.

The upward revision of the VERP repayments may also improve the public balance in the longer term, as the projected expenditure on early retirement decreases, when more people opt out. However, a large part of the upward adjustment of the estimated repayment reflects repayments to a number of individuals who were not eligible for early retirement but had not yet transferred their contributions to other retirement schemes. The repayments to these individuals do not imply fewer early retirees than previously estimated. The effect on the number of future early retirees depends among other things on the age distribution and the number of individuals opting out of the scheme. This will be known by the end of the year.

Source: The National Labour Market Authority and own calculations.

The fiscal policy for 2013 is planned so that public finances are brought towards balance, and consolidated in line with the EU recommendation. The EU recommendation implies an improvement of the structural fiscal balance by 1½ per cent of GDP over the years 2011-2013. The dampening effects on activity from the budgetary improvements in 2013 is, as already mentioned, offset by a number of economic policy initiatives, which have been taken in order to support growth and employment. The initiatives include the tax reform and the investment window as well as the housing agreement from May and increased climate investments in the wastewater sector.

In 2013, the fiscal deficit is estimated to approx. DKK 36½ bn or 1.9 per cent of GDP. The EU recommendation's requirement of a reduction of the actual government deficit to below 3 per cent of GDP by 2013 is thus complied with.

The estimate for 2013 includes a one-off revenue of DKK 5 bn due to the estimated restructuring of funds in existing capital pension schemes in 2013 on top of the agreement on a tax reform from June. The included one-off revenue of DKK 5 bn from the restructuring of existing capital pensions is subject to considerable uncertainty. The fiscal balance in 2013 may therefore be significantly improved if a larger share chooses to convert their existing capital pension scheme.

The possibility of a higher one-off revenue in 2013 does not, however, increase the fiscal room for manoeuvre, since the revenues do not affect the estimate of the structural balance in 2013 or fiscal sustainability. The tax reform agreement states that a possible larger than expected one-off revenue in 2013 will be used to reduce public debt. This is crucial, since this ensures lower interest expenditures, which help to counter the revenue loss arising in subsequent years if a larger share of tax payments is moved forward to 2013.

The fiscal deficits towards 2013 imply an increase in net public debt from 3¼ per cent of GDP by the end of 2011 to approx. 9 per cent of GDP in 2013, *cf. figure 1.18*. The gross public debt (EMU definition) is, however, expected to decline slightly from 46½ per cent of GDP by the end of 2011 to approx. 44 ¾ per cent of GDP in 2013, remaining below the EU limit of 60 per cent of GDP. The decrease in gross public debt should be seen in light of a reduction of the government's deposit in Danmarks Nationalbank by DKK 85 bn in 2012 and 2013.

Handling of fiscal challenges up to 2020

A reform strategy towards 2020 was presented in May 2012 in the 2020-plan *Denmark at work– challenges for the Danish economy towards 2020* to help increase labour supply, create jobs and build the foundations for future growth and prosperity. The 2020-plan meets the key fiscal targets in the government platform – including the targets of at least structural balance by 2020 and long run fiscal sustainability.

The 2020-plan is based on a precautionary principle, which means that public spending can only be increased when the required funding is in place.

In early summer the government has made agreements on a tax reform and a reform of disability pensions and flex job. Tripartite negotiations with the social partners were concluded without an agreement.

The agreement on a tax reform from June 2012 lowers tax on labour significantly and is estimated to increase employment by approximately 16,000 persons in the longer term. The tax agreement also contains expenditure reductions of DKK 1 bn on contributions to the EU budget and DKK 2.7 bn on defense spending. Overall the tax reform is estimated to improve public finances by DKK 2.7 bn in the long run. The tax reform's improvement of public finances is, according to the agreement, predisposed to increase the annual growth in public consumption.

The agreement on a reform of disability pensions and flex job from June 2012 entail, inter alia, that persons under the age of 40 are not to be granted disability pension and the introduction of a special resource program with a coherent effort designed to help more people return to the labour market. In addition, the reform includes a targeting of the flex job scheme and restructures the subsidy to the flex job scheme.

The agreement on a reform of disability pension and flex job is estimated to strengthen public finances by DKK 1.9 bn by 2020, which is agreed to be used on education and research expenditure. The net contribution of DKK 1.9 bn reflects a funding contribution amounting to DKK 3.2 bn from the effects of the reform on employment, tax revenue and social transfers, while increased expenditure on the special resource program etc. amounts to DKK 1.3 bn. As a result of the reform, public spending is therefore increased by a total of DKK 3.2 bn in 2020.

The 2020-plan envisages further reforms to strengthen public finances by another DKK 5 bn by 2020. Out of this, DKK 2 bn is to be achieved through earlier study completion. In addition, reforms of integration, international recruitment, preventive measures in health care, sick leave, cash benefits etc. are assumed to strengthen public finances by DKK 3 bn in 2020. In the coming parliamentary session the government will present a series of concrete reform proposals. Another DKK 5 bn from modernising the public sector is predisposed for public consumption.

1.4 Denmark's status as a 'safe haven'

In periods of financial turmoil, investors will usually seek towards safer assets that are considered to be virtually riskless. Investors therefore sell assets if they believe that the value of the asset is uncertain. The proceeds from the sale are used to purchase assets that are considered safer.

In the current European debt crisis this has resulted in a decline in demand for government bonds from a number of southern euro area countries, who have experienced increases in the interest rate on government bonds. Conversely, countries such as Denmark have experienced a growing demand, particularly for government bonds – because they are considered safe – and this has driven down interest rates. Countries experiencing rising demand for their assets in uncertain times are often referred to as 'safe havens'.

Since 2009 foreign investors have gradually increased their holdings of Danish government and mortgage bonds, and demand for Danish bonds has risen again in recent months as a result of the renewed turmoil in financial markets, *cf. figure 1.19*. Meanwhile, Danish investors have sold their holdings of foreign assets, which has also contributed to driving down interest rates. Denmark is currently in the extraordinary situation that the yield spread to Germany on government bonds is negative, *cf. figure 1.20*.

Figure 1.19
Holdings of Danish bonds by non-residents

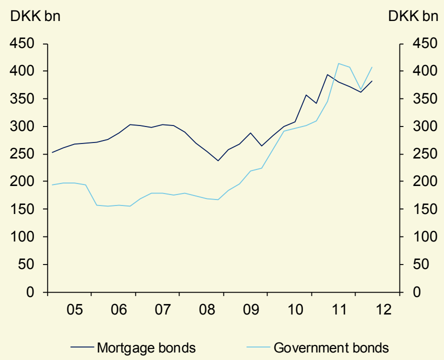
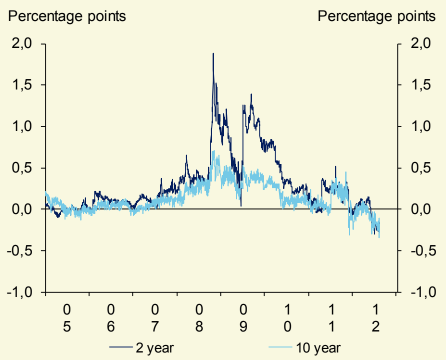


Figure 1.20
Yield spread between Danish and German government bonds



Note: In figure 1.19 the figures for the second quarter 2012 are estimated on the basis of acquisitions and sales.
Source: Danmarks Nationalbank, Reuters EcoWin and own calculations.

The status as 'safe haven' is difficult to achieve and it requires first and foremost a credible economic policy. That requires a long period of time with a stable framework for economic policies in place, and where confidence is gradually gained in that policies will stick to the planned course.

The status as 'safe haven' is on the other hand easy to lose. Just one (sufficiently large) misstep in economic policy is required for investors to change their perception of the degree of security linked to the value of assets from a country. Thus there is a considerable degree of asymmetry in the way the status as 'safe haven' is achieved and may be lost again.

It is uncertain at which point a misstep is so large that the status as 'safe haven' is lost. Consequently it is essential to maintain a credible economic policy that supports the course of action that has been laid out. It is among other things therefore important that Denmark lives up to international agreements as implemented in the framework for economic policy under the budget law. Thus, it is important that Denmark meets the EU recommendation of improving the structural balance by 1½ per cent of GDP from 2010 to 2013 and that the structural deficit in future is kept above the threshold in the budget law of -½ per cent of GDP.

During the European debt crisis Denmark has maintained the highest credit rating from the international rating agencies, whereas 8 of the EU15 countries have been downgraded in recent years, half of them from the highest credit rating, *cf. figure 1.21*. Also the world's largest economy, the United States, has been downgraded. Thus, Denmark belongs to a confined and – compared to before the crisis – significantly diminished group of countries with the highest credit rating.

Denmark's high creditworthiness is linked to relatively sound public finances. Denmark has come longer than most other countries in coping with the challenges to public finances, which in particular arise from demographic developments and the aging population. Also Denmark still has relatively low public debt compared to other countries and the increase in debt since 2005 has been relatively smaller, *cf. figure 1.22*.

Figure 1.21
Credit ratings

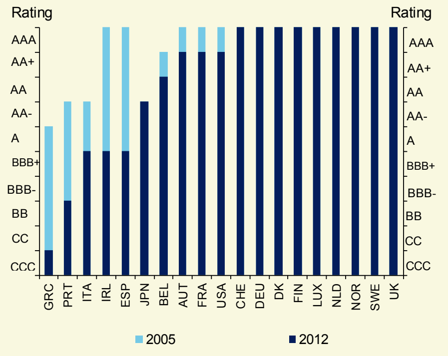
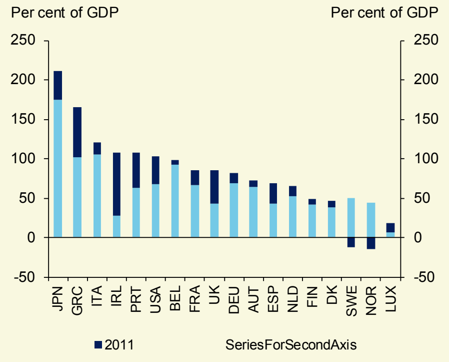


Figure 1.22
Gross public debt



Note: In figure 1.21 ratings are from Standard & Poor's. In figure 1.22 the number for 2011 shows the change in gross public debt since 2005. For Sweden and Norway the debt-to-GDP ratio declined.
Source: Standard & Poor's, Eurostat and own calculations.

Denmark also ranks well compared to other countries as regards a number of other key economic indicators, such as unemployment, inflation, inflation stability and the current account balance. Part of the reason for this is a long history of stability-oriented economic policy that reduces volatility and hence uncertainty in the economy. That is, among other things, advantageous when making investment decisions.

In Denmark, economic policy is planned so that there is a large degree of certainty about the economic course of action with no sudden and unforeseeable shifts. As part of the stability-oriented economic policy, Denmark has since 1982 consistently pursued a fixed exchange rate policy, where currency fluctuations have been kept within a very narrow band. This has helped to anchor inflation expectations at a low and stable level and reduce the exchange rate volatility faced by exporters to the euro area. On this background inflation and exchange rate risks are very limited.

During the current crisis the euro has depreciated and as the Danish krone follows the euro, the krone has also lost value against for example the British pound and the Swedish krona. However, the underlying strength of the krone is likely to have improved, reflected among other things in the significant increase in the foreign-exchange reserve since 2008, *cf. figure 1.23*. The increase in the foreign exchange reserve is due to capital inflows related to the acquisition of Danish bonds.

Figure 1.23
Denmark's foreign exchange reserve

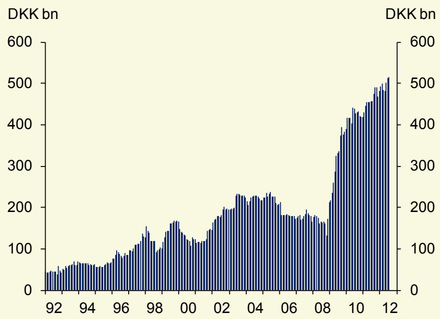
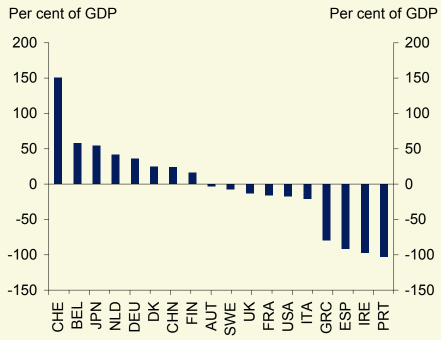


Figure 1.24
Net foreign assets, 2011



Note: Data for 2010 for the United States in figure 1.24.
Source: Danmarks Nationalbank, Eurostat, IMF and own calculations.

'Safe havens' are usually characterised by having strong, independent currencies that are unlikely to lose value. This applies for instance to the yen and the Swiss franc, as Japan and Switzerland are among the world's largest creditors, *cf. figure 1.24*. Among the euro area countries Germany, the Netherlands and Finland also hold net external assets, which may support these countries' status as a 'safe haven'. The strength of the U.S. dollar should primarily reflects the fact that the dollar is the most traded and the predominant reserve currency in the world.

Even small events can cause reactions in financial markets – including changes in external conditions that do not necessarily reflect fundamental alterations in the economy. In such situations, the interest rate can increase quite substantially in a short period of time, while the subsequent adjustment to normal interest rate levels often occurs gradually.

As a small, open economy, Denmark is particularly sensitive to sudden shifts in capital flows, which may increase the interest rate paid by Danish households and companies. This underlines the need for a responsible economic policy that supports continued foreign confidence in the Danish economy. Experience shows that pressure on the krone can arise rapidly and that the yield spread will widen in such periods. Even small changes in the interest rate can have significant consequences for the real economy. A widening of the yield spread corresponding to that experienced in 2008 will for example reduce GDP by up to 1 per cent in 2013 and reduce employment by about 7,000 people when the full effect is realised, *cf. box 1.5*.

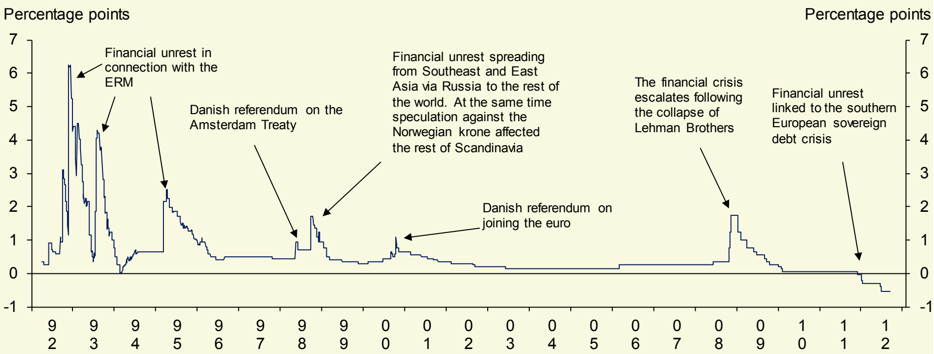
Box 1.5

Denmark as a 'safe haven'

Denmark has in recent years gained the position as a 'safe haven'. This should particularly be seen in light of confidence in the public economy, surplus on the current account and a considerable foreign exchange reserve. In the forecast, it is assumed that Denmark maintains its status as a 'safe haven' until conditions on financial markets are normalised. Fixed exchange rate regimes are potentially vulnerable to flight to 'safe havens' in times of financial turmoil. Divestment of securities causes a downward pressure on the currency, and it may be necessary to use foreign exchange reserves or raise interest rates to defend the currency. In earlier periods of financial unrest Denmark experienced such pressure on the krone, *cf. figure a*. As a consequence Danmarks Nationalbank has at times had to raise the interest rate to defend the krone within the framework of the fixed exchange rate policy. This occurred for example during the ERM crisis in 1992-93 and the ruble crisis in 1998 as well as in autumn 2008 when the financial crisis escalated.

Figure a

Monetary policy interest rate spread between Denmark and the euro area



Note: The interest rate spread is calculated as the difference between Danmarks Nationalbank's lending rate and the ECB refinancing rate. Before 1999 the euro area interest rate is based on the German repo rate.

Source: Danmarks Nationalbank, Bundesbank, ECB, Reuters EcoWin and own calculations.

Box 1.5 (continued)
Denmark as a ‘safe haven’

Pressure on the krone has occurred even at times when the Danish economy was fundamentally sound. Thus, the interest rate hikes did not necessarily reflect lack of confidence in the Danish economy, and interest rate spreads have also narrowed again as anxiety on financial markets subsided. If another event occurs, which again leads to an increased interest rate spread, Danish growth and employment will be affected. An example may be based on the widening of interest spreads in the wake of the collapse of Lehman Brothers, where the spread on monetary policy interest rates expanded to 2 percentage points and the yield spread between Danish and German 10-year government bonds reached 0.5 percentage points. A similar widening of the interest rate spread at present and a subsequent decrease would reduce GDP by up to 1 per cent in 2013 and reduce employment by approximately 7,000 persons, when the effect of the temporary changes in interest rates is fully passed through. Thus, even small changes in interest rates may have serious implications for the real economy. In addition to this comes a heightened risk of a further deterioration in consumer and business confidence, which could lead to even larger reductions in growth and employment.

1.5 Appendix

Table 1.2

Key numbers in the forecast for 2012 and 2013 compared with the May Survey

	2012		2013	
	May	**August**	**May**	**August**
Real growth, percentage change from previous year				
Private consumption	1.2	1.0	2.0	2.3
Total public demand	2.1	2.0	-1.4	-0.8
- public consumption	1.3	1.5	0.3	0.1
- public investment	11.3	7.5	-20.2	-11.5
Residential construction	-0.5	-4.3	3.0	5.0
Fixed business investments	2.6	9.8	7.0	10.3
Final domestic demand	1.7	2.2	1.5	2.4
Stock building (per cent of GDP)	0.1	0.1	0.1	0.1
Total domestic demand	1.7	2.2	1.6	2.4
Exports of goods and services	1.9	1.0	3.2	2.9
- of which manufactures	2.5	1.9	3.9	3.6
Total demand	1.8	1.8	2.2	2.6
Imports of goods and services	3.1	3.6	3.7	4.2
- of which goods	2.5	3.6	3.1	3.8
GDP	1.1	0.9	1.5	1.7
Gross value added	1.1	0.8	1.4	1.6
- of which private sector	1.8	1.3	2.2	2.7
Change in 1,000 persons				
Labour force	8	8	8	14
Employment	3	-1	4	6
-of which in private sector	-3	-3	1	5
-of which in public sector	6	2	3	1
Gross unemployment	0	2	-10	-6
Net unemployment	6	9	5	8

Table 1.2 (continued)
Key numbers in the forecast for 2012 and 2013 compared with the May Survey

	2012		2013	
	May	August	May	August
Percentage change from previous year				
Merchandise export prices	2.4	3.2	1.3	1.4
Merchandise import prices	2.8	3.7	1.2	1.7
Merchandise terms of trade	-0.3	-0.5	0.0	-0.4
House prices, single-family house	-5.5	-3.5	1.5	2.5
Consumer prices	2.5	2.4	1.7	2.0
Hourly compensation, private sector	1.9	1.9	2.1	2.1
Real disposable income, private sector	1.2	0.3	0.9	1.1
Real disposable income of households[1)]	-0.1	1.4	1.1	1.5
Productivity in private non-agricultural sector	1.9	1.4	2.1	2.2
Per cent per year				
Interest rate 1-year adjustable rate loan	1.1	0.5	1.8	0.9
10-year government bonds	2.2	1.6	2.6	2.0
30-year mortgage credit bond	4.1	3.8	4.1	3.7
Savings and labour market balances				
Current account (bn DKK)	97.2	84.1	93.7	66.8
Government net lending (bn DKK)	-70.4	-73.4	-32.6	-36.5
Gross unemployment (thousands)	162	164	152	158
Gross unemployment (per cent of labour force)	5.7	5.7	5.3	5.4
Net unemployment (thousands)	114	118	119	126
Net unemployment (per cent of labour force)	4.0	4.1	4.1	4.3
External assumptions				
Trade-weighted GDP abroad, per cent	1.2	1.2	2.0	1.8
Markets for Danish manufactures, per cent[2)]	2.7	2.4	4.9	4.5
Exchange rate, DKK per $	5.7	5.9	5.6	6.1
Oil price, $ per barrel	117.9	109.1	117.3	107.0
Oil price, DKK per barrel	666.4	644.7	662.0	651.3

1) Since the May Survey the deflator on incomes has been changed from the consumer price index to the deflator on private consumption from the national accounts. The comparable figures from the Economic Survey, May 2012 are adjusted according to the new approach.

2) Adjusted income. Excluding the reimbursement of VERP-contributions in 2012 and 2013.