

Update on the economic
outlook and public finances

Amended budget proposal 2012

Ministry of Economic and the Interior
Ministry of Finance

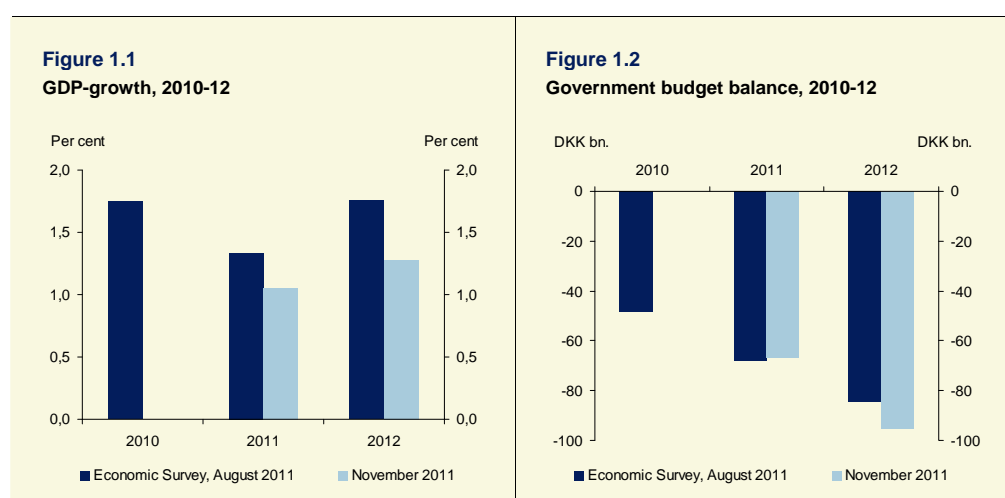
November 2011

1. Short-term outlook and public finances in the baseline

The financial turmoil associated with the international debt crisis has continued during recent months. Equity prices have fallen, especially for banks, and risk premia in the financial markets have increased. Key data for the international economy have weakened, and the IMF, OECD and the EU Commission have reduced or announced downward revisions to their growth forecasts.

The increased uncertainty about the international economic outlook is also reflected in declining confidence among Danish companies and households. In addition, private consumption in particular has been disappointingly weak in Denmark during the first half of 2011. In this light, a somewhat weaker development in the Danish economy is expected both this year and next year, compared to the August forecast, cf. *Economic Survey, August 2011*.

In late October the countries in the European Union made a series of agreements aimed at addressing the debt crisis in certain euro area countries and ensuring financial stability. In a number of areas concrete initiatives need to be fleshed out over the coming months, and it remains uncertain how the financial markets will receive the rescue plans. It is important that the agreements are implemented as planned.



Source: Economic Survey, August 2011, and own calculations.

This interim status for the economic outlook and public finances provides an updated assessment of overall developments in demand and output as well as employment and unemployment, but it is not a detailed new forecast. The update is based on the budget proposal for 2012, which for technical reasons the government reissued on 12 October 2011. The government's proposals and priorities in the budget for 2012, including the kick-start stimulus package for the Danish economy, are not included in the baseline, but are described in section 2 below. A full-scale economic forecast is expected to be published in December.

Based on the new information concerning the Danish and international economy annual GDP growth is estimated at 1.1 per cent in 2011 and 1.3 per cent in 2012¹. Compared to the August survey the expected GDP growth has been revised downwards by approximately ¼ percentage points in 2011 and ½ percentage points in 2012, cf. *figure 1.1* and *table 1.1*. Lower growth in exports and restrained private consumption are among the main reasons for the weaker economic outlook.

Table 1.1
Selected key data for the Danish economy

	2010	2011		2012	
		August	November	August	November
Percentage change, volumes					
GDP	1.8	1.3	1.1	1.8	1.3
Private consumption	2.3	0.3	-0.6	2.4	1.5
Exports of goods and services	3.8	5.7	5.7	3.6	2.7
Level					
Gross unemployment ¹ (1,000 persons)	164	162	164	161	167
Gross unemployment ¹ (per cent of labour force)	5.7	5.6	5.7	5.6	5.8
Employment (1,000 persons)	2,764	2,762	2,758	2,769	2,761
Level					
Budget balance (DKK bn)	-48	-68	-67	-85	-95
Budget balance (per cent of GDP)	-2.8	-3.8	-3.8	-4.6	-5.1

1) National definition.

Note.: In the revised numbers on public finances published by Statistics Denmark on 1 November 2011 the budget deficit amounted to just above DKK 47 billion in 2010.

Source: Statistics Denmark, Economic Survey, August 2011, and own calculations.

The outlook for 2011 assumes a broadly unchanged level of GDP in the second half of 2011, while the expected GDP growth in 2012 implies a renewed gradual recovery in economic activity. This requires that the uncertainty that has weighed down on financial markets in recent months will be reduced gradually. The current uncertainty has likely resulted in the postponement of larger consumption and investment decisions by households and firms.

The rescue package agreed upon by the EU countries in late October is a step in the right direction, but uncertainty remains high and some time will pass before the negative effects of the turmoil can be overcome, in relation to restoring financial sector credit, confidence in banks and economic growth.

¹ This general update of the economic outlook and public finances is based on the August Economic Survey and essential new information, including national accounts for the second quarter of 2011, indicators for the third quarter and IMF's World Economic Outlook published in September.

A gradual recovery of growth in 2012 is supported by the very accommodative monetary stance and the currently large savings surplus in the private sector, which implies a significant potential for demand growth. The savings surplus, amounting to approximately 8 per cent of GDP in 2010, reflects that both households and companies have been consolidating balance sheets since the onset of the crisis. At the same time the expansionary fiscal measures that have been implemented since 2008 continue to support the Danish economy. In addition, interest-rate expectations are lowered compared to the August Survey, and the extraordinarily low interest rates support the expected, renewed growth in demand and production in 2012.

Growth can be both higher and lower than in the scenario outlined here. In particular there is a risk of a more pronounced slowdown in the short term if financial uncertainty flares up again or leads to more marked restraint in consumption, investment and credit². On the other hand there is also potential for higher growth in 2012 if confidence in the financial system returns quickly, and countries ensure a responsible economic policy, including reforms that support growth potential and public finances, and if households and businesses thereby regain confidence and increase consumption and investments.

The downward revision of growth prospects contributes to larger government deficits than estimated in the August Survey. However in 2011 an upward adjustment in the estimated revenues from pension taxes, particularly due to rising bond prices, pulls in the opposite direction. It is now estimated that the public deficit in 2011 will amount to DKK 67 billion (3.8 per cent of GDP) and DKK 95 billion in 2012 (5.1 per cent of GDP) including one-off reimbursements of contributions to the voluntary early retirement scheme accounting for 1.1 per cent of GDP of the deficit forecast for 2012. Compared to the August Survey the budget balance is improved slightly in 2011 and weakened by around DKK 10 billion in 2012, *cf. figure 1.2*.

Public finances in Denmark are very sensitive to changes in the cyclical conditions and developments in financial markets, so there is considerable uncertainty about the actual budget balance. As a rule of thumb, if GDP growth is lowered by one percentage point then the budget balance is expected to be reduced on average by $\frac{3}{4}$ per cent of GDP or in the order of DKK 15 billion. The effect may be higher if developments on the financial markets lead to lower revenues from pension taxes or the developments in the oil price reduce the revenues from oil and gas production in the North Sea.

The structural deficits in 2011 and 2012 – i.e. the government deficit adjusted for cyclical effects and other temporary factors – are considered to be largely unaffected by this update of the economic prospects and (actual) public finances.

² In a scenario in which continued unrest lowers growth abroad and weakens confidence at home so that GDP grows only by 0,6 percent this year and 0,3 next year, the gross unemployment rate would rise to 6.6 per cent in 2012 while the public deficit could widen to some 6.4 per cent of GDP.

The reduced growth prospects also imply lower employment and higher unemployment in 2012 than estimated in the August Survey. Gross unemployment is now expected to peak around summer 2012 – at a level similar to the peak in summer 2010. This amounts to an average estimated gross unemployment of 167,000 persons in 2012 (5.8 per cent of the labour force), an upward revision of 6,000 persons compared to the August Survey. Unemployment is higher than the estimated structural level – but comparatively low in a longer-term historical perspective.

Although the current budget deficits are substantial and the financial sector is under renewed pressure, the Danish economy is in a position to face the challenges in the near future. The yield spread to Germany on government bonds remains low, public net debt is close to zero, and the EMU debt of approximately 45 per cent of GDP is below the 60 per cent of GDP limit in the Stability and Growth Pact. In addition there is a substantial surplus on the current account and net foreign assets, and the foreign exchange reserve has increased to over 25 per cent of GDP. Rating agencies currently have stable outlooks for the Danish creditworthiness, and Denmark has the highest credit rating (AAA).

At the same time, the state has issued bonds, which co-finance a deposit in the National Bank of Denmark of approximately DKK 240 billion (almost 14 per cent of GDP), compared to an average over the period 2000-2007 of around 4½ per cent of GDP. Part of the additional deposits can contribute to financing public deficits in periods with unstable financial markets and also provides some potential for assuring financial sector stability, without the necessity of issuing new government bonds in the short term. A credible consolidation of public finances towards 2020 in accordance with the Government Coalition Agreement supports continued confidence in fiscal policies and thereby underpins a certain degree of economic policy scope in the short term.

2. Public finances and fiscal policy 2012

The government's proposed budget for 2012, including the amendments now put forward, provides a foundation for responsible economic policies that create the basis for growth and employment. The government wants to restore progress in the Danish economy while securing fiscal sustainability so that Denmark is led responsibly through the crisis.

After the financial crisis and under the previous government, Denmark received a recommendation from the EU to reduce the deficit to below 3 per cent of GDP in 2013 and to strengthen the structural budget balance by 1½ per cent of GDP in the period 2011-2013. The government will meet the EU recommendation. The priorities for 2012 and 2013 are planned in accordance with the recommendation.

“Kick-start”

In order to support growth and employment, the government will bring forward investment plans amounting to nearly DKK 11 billion in 2012 and DKK 8 billion

in 2013 (a total of 1 per cent of GDP). The fiscal stimulus package (“kick-start”) is expected to increase employment by about 9,000 persons (0.3 per cent) in 2012 and about 12,000 persons (0.4 per cent) in 2013.

In addition to public investments in e.g. highways, schools and hospitals, the kick-start includes renovation of social housing as well as planned investments in production of sustainable energy etc. (which are related to the energy and climate strategy to be agreed upon in coming political talks) and a toll ring in Copenhagen, *cf. table 2.1*. These investments do not affect public finances, because they are carried out by The Social Housing Fund or by private entities such as energy companies and other companies.

Table 2.1
New investments and investments brought forward to 2012 and 2013

DKK billion	2012	2013	2012-13
Roads, railways and coastal protection	1.6	-0.8	0.8 ¹⁾
Municipal investments in schools, day-care centres etc.	3.9	1.0	4.9 ¹⁾
Regional investments in hospitals, new equipment etc.	1.8	-	1.8 ¹⁾
Renovation of social housing (under the auspices of The Social Housing Fund)	2.1	1.6	3.7
Energy investments	1.3	5.4	6.7
Investments in the Copenhagen toll ring	-	0.8	0.8
Total investments	10.7	8.0	18.7

1) Public investments that have been brought forward are offset by a reduction in the public investment level from 2014-2020.

The government's priorities for the 2012 budget bill

In total the government's priorities for the budget bill include new initiatives for approx. DKK 8 billion (0.4 per cent of GDP) in 2012 and DKK 12.3 billion (0.7 per cent of GDP) in 2013, *cf. table 2.2*.

Table 2.2
New initiatives and financing

DKK billion (2012 price level)	2012	2013
New initiatives	8.0	7.3
Priorities/reserves concerning 2013	-	5.0
Total new initiatives	8.0	12.3
Taxes and excise duties (permanent effect)	3.1	5.1
Review of business tax expenditures and subsidies	-	2.0
Other budget improvements	2.1	3.4
Reserves on the original budget proposal for 2012	2.8	1.8
Total financing	8.0	12.3

In line with the government's precautionary principle all expenditures are fully financed "krone-for-krone", partly through increased revenues and budget improvements, partly through already committed reserves and funds.

The new initiatives include the elimination of the so-called start and introductory benefits and the cash benefit ceiling. In addition, the government's priorities include additional funds for research, education, targeted employment initiatives, health care, etc.

In line with the coalition agreement the government will increase taxes by a total of DKK 5 billion to finance the high priority public expenditures. In addition, a review of business tax expenditures and subsidies amounts to DKK 2 billion in 2013.

The increased revenues will provide sustainable funding of new initiatives and will also help to support the government's objective to enhance public health. In this vein, excise taxes are raised for e.g. unhealthy foods, cigarettes, beer and wine.

Besides increasing public revenues the government will implement a number of other budget improvements, including reprioritisation of public expenditures and the abolition in 2013 of the tax allowance for housing services and repairs ("BoligJob-ordningen"). Furthermore the government's priorities imply that already-included reserves on the budget proposal for 2012 are allocated for specific purposes.

Overall, the government's budget priorities include financing elements for a total of DKK 8.0 billion in 2012. Of this the (permanent) revenues from taxes and excise duties amount to DKK 3.1 billion, other budget improvements amount to DKK 2.1 billion and allocation of reserves in the initial budget proposal amount to DKK 2.8 billion. In 2013 funding elements total DKK 12.3 billion.

Concerning 2013 the government's priorities include a reserve of DKK 5 billion aimed at e.g. health care, education, research, innovation, etc.

Public finances

Including the kick-start, the estimated structural budget balance deteriorates slightly in 2012, *cf. table 2.3*. Overall, the structural deficit is still expected to be reduced from 1.7 per cent of GDP in 2010 to 1.1 per cent of GDP in 2012 and 0.2 per cent of GDP in 2013. This is in line with the recommendation from the EU to improve the structural fiscal balance by 1½ per cent of GDP until 2013. To some extent, the dampening impact of the tightening of the structural balance in 2013 is countervailed by the kick-start's increase in investments outside the public budget (from about 0.2 percent of GDP in 2012 to 0.5 percent in 2013).

Table 2.3
Structural budget balance 2010-13

	2010	2011	2012	2013	Reduction 2010-13
Budget proposal 2012, August 2011	-1.7	-1.0	-0.9	-0.2	1½
Amended budget proposal 2012 incl. 'kick start', November 2011	-1.7	-1.0	-1.1	-0.2	1½

As for the actual balance, the expected deficit in 2012 will amount to DKK 96 billion when including the amended budget proposal, the fiscal stimulus package ("kick-start") and the municipal and regional budgets. The fiscal stimulus package increases the deficit by DKK 2½ billion. This effect is partially counterbalanced by reduced expenses in the budgets of municipalities and regions in 2012.

With the amended budget proposal for 2012 the government has balanced the need to strengthen growth and employment with the necessity of ensuring sound public finances, *cf. box 2.1*.

Box 2.1
Fiscal policy and public finances

- The structural budget deficit of 1.7 per cent of GDP in 2010 is reduced to 1.1 per cent of GDP in 2012 and 0.2 per cent of GDP in 2013.
- The actual budget deficit is expected to amount to around DKK 96 billion in 2012.
- The kick-start stimulus package increases employment by about 9,000 persons (0.3 per cent) in 2012 and about 12,000 persons (0.4 per cent) in 2013.
- GDP is strengthened by about 0.4 per cent in 2012 and 0.5 per cent in 2013 as a result of the kick-start.
- Other than the kick-start stimulus package the proposed budget is expected to have an approximately neutral effect on growth and employment in 2012.