1. English Summary

1.1 The current economic outlook

The Danish economy is still muted by the international slowdown. In the remainder of the year and into 2013, however, growth is expected to pick up due to expansionary effects from very low interest rates, the government's "kick-start" package and the reimbursement of voluntary early retirement pension (VERP) contributions, as well as a significant strengthening of consumer confidence in the beginning of this year. GDP is estimated to grow by just over 1 per cent this year and 1½ per cent next year, in line with the December Survey, *cf. figure 1.1*. Growth is not yet strong enough to bring along a significant improvement in the labour market. Employment is, however, expected to increase moderately by 3-4,000 persons this year and next year, *cf. figure 1.2*.

The assessment of growth prospects for Denmark reflects some improvement of global economic conditions since the turn of the year. In late 2011, the outlook was characterised by extraordinarily high uncertainty concerning the handling of the sovereign debt crisis in several European countries, and there were widespread fears of an escalation of the crisis as a result of renewed turmoil in the financial markets. A number of initiatives were launched in order to stem the crisis, including new credit facilities in the European Central Bank (ECB) and the adoption of a new framework for strengthened fiscal policy coordination in the EU, and in the beginning of 2012 confidence and equity markets improved and global trade picked up.

Figure 1.1
GDP growth

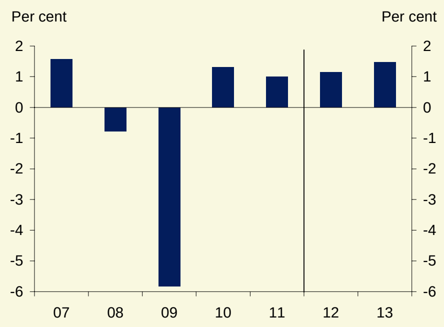
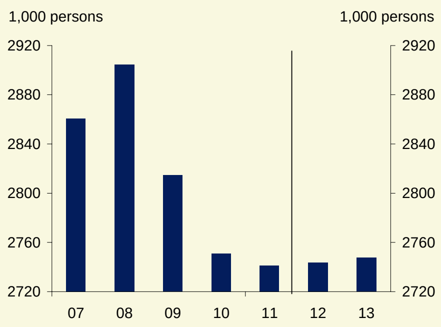


Figure 1.2
Employment



Source: Statistics Denmark and own calculations.

However, significant uncertainties remain regarding the strength of the recovery in the global economy, especially in the euro area. The immediate effect of the ECB's new credit facilities may be petering out, and confidence indicators and equity markets in the euro area have weakened recently. The uncertain political situation following the parliamentary elections in Greece has caused concern regarding the political will to adhere to agreements made, and the possibility of a Greek exit from the euro area is discussed openly. Spanish public finances and the state of the country's banking sector have also been at the centre of attention lately.

On this background, there is a risk that a confidence crisis will flare up with increased turmoil in financial markets and a stronger cautiousness among consumers and businesses in European economies. Another risk is related to developments in the oil price, which is relatively high taking into account the current cyclical position. Increased demand from emerging economies may push the price up further. Finally, there is uncertainty associated with the fiscal policy in the United States in 2013, where the current legislation implies a disproportionately severe tightening – the so-called "fiscal cliff".

In the forecast presented in this *Economic Survey*, it is assumed that the debt and confidence crisis in the European economy does not worsen significantly and that the fiscal policy in the United States does not put a halt to the ongoing recovery.

Public finance credibility is a key prerequisite for economic recovery. So far, Denmark has benefitted from a status as a "safe haven" among investors. This has ensured low interest rates and thereby supported a still fragile housing market. The Government's 2020-plan, *Denmark at work*, is designed so that credibility can be maintained through sound public finances, while the potential for growth and employment is strengthened. This applies both in the short term, where strengthened competitiveness is at focus, and in the longer term, where developments in productivity and labour supply are the main constraints on growth.

1.2 The forecast

International institutions have a more optimistic view on the global economic outlook now than in the beginning of 2012, when forecasts were influenced by a widely-shared sentiment of crisis.

Particularly in the USA growth is now predicted to be slightly higher than expected earlier this year. The USA has come further in the adjustment process after the crisis and there are clear signs of progress and continued recovery of the economy, *cf. figure 1.3*. Stock prices are not far from the level before the financial crisis, and unemployment is falling.

Growth in the world economy is, however, still driven by a number of emerging markets, especially in Asia. Compared to previous global crises, these countries have recovered quickly, partly due to improved macroeconomic and financial frameworks.

Figure 1.3
GDP, level

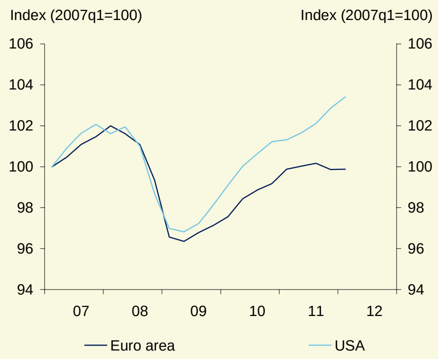
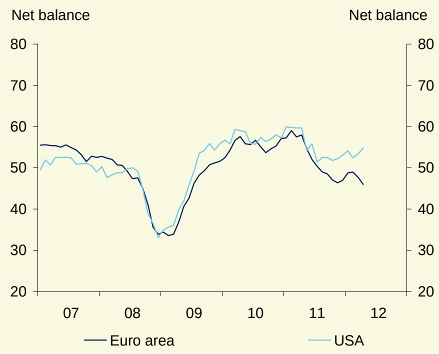


Figure 1.4
Business confidence (PMI)



Source: Eurostat and Reuters EcoWin.

The situation in several euro area countries is still quite uncertain. In many countries, production decreased further in the first quarter of this year and consumer and business confidence deteriorated again in spring, *cf. figure 1.4*. At the same time, unemployment is still rising in the euro area. Yet, current prospects for the euro area are considered to be better than a few months ago primarily due to developments in Germany, where growth was relatively high at the beginning of this year. In several other euro area countries, GDP is expected to continue falling this year and growth is expected to be limited or moderate next year. Growth is also expected to be weak in Sweden this year.

In most countries, the weak growth prospects for 2012 primarily reflect a low level of activity by the end of 2011 and a further weakening in the beginning of this year, after which the situation is expected to improve. However, growth is likely to return only gradually and the recovery is expected to be slow and uneven in the coming years. A number of countries are facing significant fiscal consolidation in order to restore confidence in economic polices. Many countries have announced or launched significant fiscal tightening, including Italy and Spain, where growth prospects are very bleak.

The private sector, and especially households, is also facing consolidation in most European countries. In the years prior to the financial crisis in 2008-2009 debt levels increased, which partly relates to housing financing in an overheated housing market. In the coming years, the adjustment of public and private debt will dampen both consumption and investments in the euro area.

Figure 1.5
GDP abroad (trade weighted), real growth

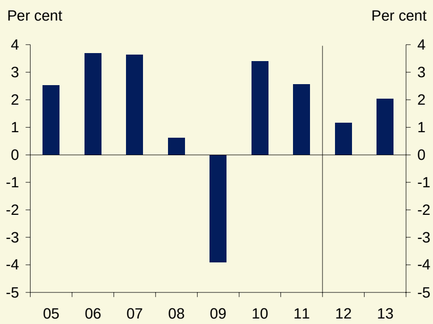
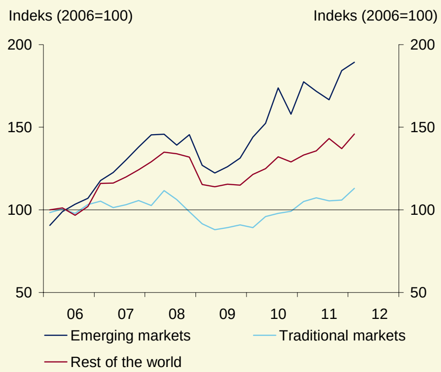


Figure 1.6
Manufacturing exports to traditional markets and emerging markets (values)



Note: Emerging markets cover: South Africa, Turkey, Indonesia, Mexico, Brazil, Russia, India and China. Traditional markets cover EU countries as well as Norway, Iceland, United States, Canada, Japan, Switzerland, Australia and New Zealand. The latest observation (for 2012q1) is the average for January and February 2012. Manufacturing exports exclude transport equipment, which e.g. covers oil rigs.

Source: Reuters EcoWin, European Commission, Statistics Denmark and own estimates.

Overall, GDP abroad (trade weighted) is expected to grow by 1¼ per cent this year and by 2 per cent next year, *cf. figure 1.5*. This is a downward adjustment of almost ½ percentage points in 2012 compared to the December Survey, where the growth estimates for other countries were based on international organisations' forecasts from last autumn, while the estimate for 2013 is broadly unchanged.

Export market growth for Danish manufactures has been adjusted downwards correspondingly in 2012 and amounts to a modest 2¾ per cent this year and 5 per cent next year. This contributes to a weak development in Danish manufacturing exports, especially this year.

Danish manufacturing exports have performed relatively well during the international setback. This partly reflects significant growth in exports of medicines, but also that Danish industries have gained foothold in emerging markets, *cf. figure 1.6*.

Denmark's wage competitiveness is still a significant barrier for Danish manufacturing exports and a loss of market shares is expected in both 2012 and 2013. In the collective wage agreements this spring, the parties have agreed on fairly small increases in wage costs, and wage growth is expected to be less than abroad.

Figure 1.7
Development in wage competitiveness (accumulated) since 2000 (measured by relative unit labour costs)

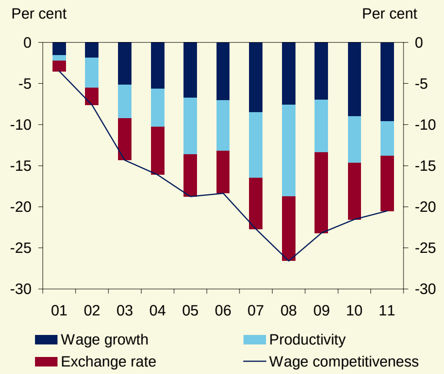
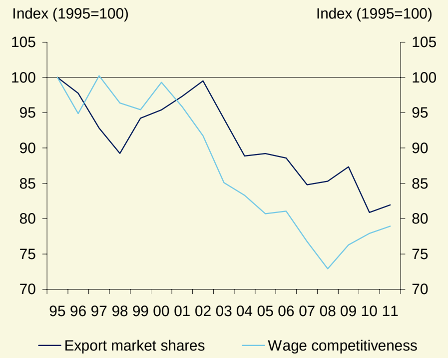


Figure 1.8
Market shares and wage competitiveness



Source: OECD, Eurostat, Reuters EcoWin, Statistics Denmark and own calculations.

Over a longer period of time, however, wage growth has been higher in Denmark than abroad and Denmark has accumulated a large loss of wage competitiveness (a total of 20 per cent), because productivity growth has been fairly weak and too small to offset the relatively high domestic wage growth, *cf. figure 1.7*.

Thus, there is a risk that the competitiveness of many companies is not strong enough for them to fully translate the coming years' expected increase in global demand to increased sales. This would delay the recovery of the Danish economy.

The weakening of wage competitiveness has already contributed to a loss of market shares over the last 10-15 years, *cf. figure 1.8*. In general, a continuous loss of market shares is expected, since a number of countries is opening up to more international trade and participates in the competition on Danish export markets. But the trend will be more or less pronounced depending on the Danish competitiveness.

Services exports, which to a large degree consist of shipping, where the share of wage costs is very small, seem to have entered 2012 on a strong note. That underpins total exports, which are expected to grow by just under 2 per cent this year and by 3¼ per cent next year – broadly in line with the estimates in the December Survey.

Figure 1.9
Consumer confidence

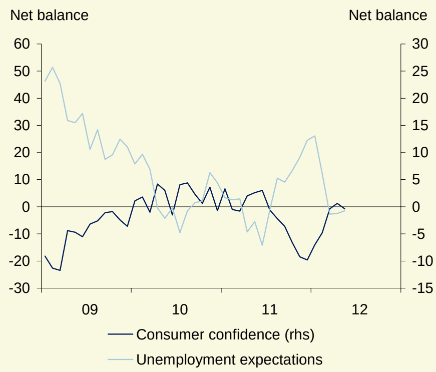
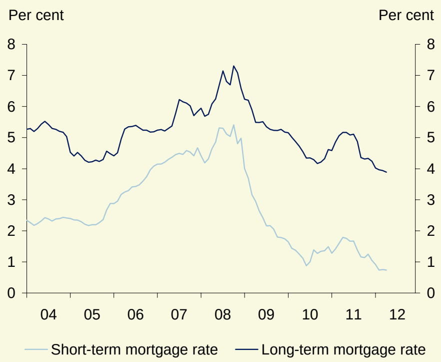


Figure 1.10
Mortgage rates



Source: Statistics Denmark and own calculations.

Private domestic demand is expected to gradually gain more momentum this year and next. Private consumption increased in the last quarter of last year and is expected to grow further in the first half of this year. The improvement of consumer confidence in spring suggests increased propensity to consume, *cf. figure 1.9*, and combined with the reimbursement of VERP-contributions and very low interest rates this creates a basis for additional growth this year. The reimbursement of VERP-contributions will take place until October and already by mid-May a total of DKK 16¼ bn had been disbursed. This is quite close to the assumption of a total disbursement in 2012 of just over DKK 17½ bn.

Since 2009, private consumption has been muted and the household savings ratio high, reflecting the need for consolidation following losses in housing assets and financial assets after the crisis. Households are currently adjusting their debts, and the savings ratio is expected to decline gradually over the forecast period.

The housing market is still very sluggish and house prices have declined further in the beginning of the year, although most of the price adjustment following the housing price bubble in 2004-06 has probably taken place already. In spring, mortgage rates have dipped to the lowest level ever, *cf. figure 1.10*, and the very low interest rates are expected to lead to a stabilisation and gradual strengthening of the housing market and housing prices, which may support private consumption. Due to developments in the beginning of the year, however, house prices on annual average are expected to decline by 5½ per cent this year. House prices are expected to grow broadly in line with consumer prices next year.

Business investments are expected to grow this year and next year following significant drops in 2009 and 2010. A number of government-initiated investments taking place in the private sector, including investments in the Fehmarn Belt link and the Copenhagen Metro City Ring as well as investments related to the energy agreement, will support business investments this year and next. However, there is still considerable spare capacity, which reduces the need to increase investments and the investment ratio remains low in both years.

Figure 1.11
Change in business investments and public investments

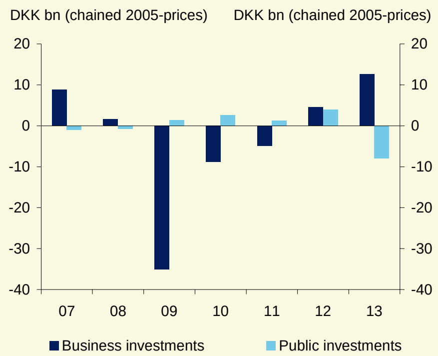
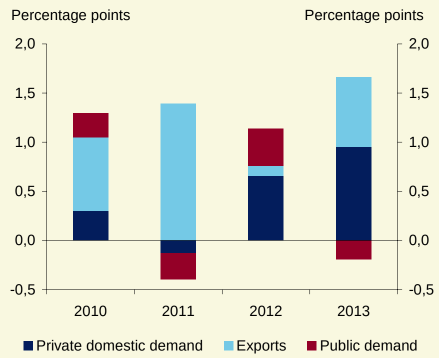


Figure 1.12
Growth contributions to GDP



Note: Growth contributions in figure 1.12 are calculated by the so-called input-output-based method, where the contribution from e.g. exports is adjusted for both direct and indirect import content. Numbers may not add up to total because of rounding. Private domestic demand includes publicly initiated investments taking place in the private sector, including construction related to the Fehmarn Belt link and the Copenhagen Metro City Ring.
Source: Statistics Denmark and own calculations.

Economic policy contributes significantly to private domestic demand this year due to the very low interest rates, the reimbursement of VERP-contributions, the HousingJob-plan and large public business investments. The moving forward of public investments as part of the "Kick-start "-package will also contribute to growth this year. Public investments are assumed to be at a more normal level next year, as private business investments are expected to contribute more to growth in total investments, *cf. figure 1.11*.

Growth in public consumption is expected to be limited in the coming years. In 2012, however, estimated real growth has been revised upwards compared to the December Survey, which reflects a somewhat lower actual consumption level in municipalities and regions compared to the budgeted level last year, while public consumption in 2012 is based on budgets. Against this background, GDP growth this year is primarily driven by consumption and investment in the private sector, but there is also a significant contribution from public demand, *cf. figure 1.12*. The contribution from exports is expected to be very limited this year after being the sole contributor to growth in 2011. In 2013 exports is expected to become a growth driver again, thereby making growth more self-sustaining.

Figure 1.13
Output gap

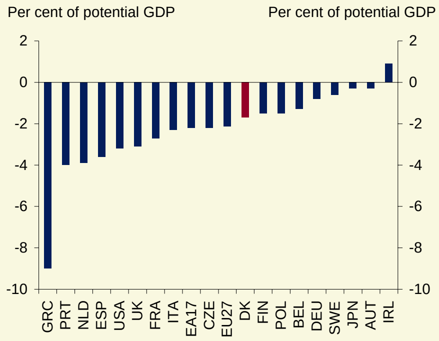
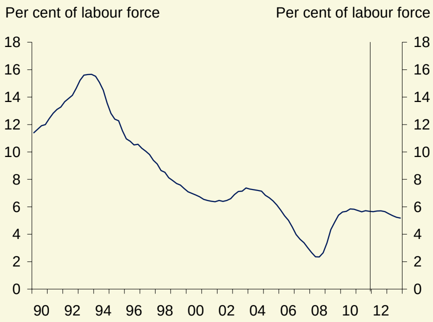


Figure 1.14
Gross unemployment



Source: OECD, European Commission, Statistics Denmark and own calculations.

Overall,growth prospects for the Danish economy remain subdued, but marginally better than assessed in December. The projections imply a slow recovery, and with growth rates of just over 1 per cent this year and 1½ per cent next year there will still be significant spare capacity in the economy. Compared with the euro area as a whole, and countries like USA and the UK, the output gap is smaller in Denmark, *cf. figure 1.13*.

Private employment surprised positively in late 2011. However, the projected growth in 2012 and 2013 is not expected to be strong enough to improve private employment significantly and total employment is projected to remain broadly unchanged in the forecast period, *cf. table 1.1*.

Unemployment has remained stable in spring 2012, contrary to expectations in the December Survey where unemployment was projected to increase. Unemployment is still expected to increase towards autumn due to the very subdued activity in the second half of 2011 and in the beginning of this year. Thereafter, gross unemployment is expected to fall towards the end of 2013.

The crisis-related increase in unemployment has continued to surprise by being relatively subdued. Both gross and net unemployment has increased significantly since the trough in 2008, but not as much as expected and the unemployment level is still quite low in a historical perspective, *cf. figure 1.14*. One reason is that the decline in employment to a large extent reflects fewer cross-border workers and an increased number of students outside the workforce.

Youth unemployment has also increased during the crisis, but is not particularly high in a historical perspective, neither in absolute terms nor compared to unemployment rates for other age-groups. This also applies for long-term unemployment among young people. However, there is a particular risk that young people affected by unemployment for a longer period do not get a solid foothold in the labour market. The Government's 2020-plan therefore includes a number of initiatives aimed at reducing youth unemployment.

Despite the expected growth in both private consumption and private investments, the consumption and investment levels will remain relatively low in a historical perspective, *cf. figure 1.15*. Private financial savings are therefore expected to remain high in the coming years.

The savings surplus in the private sector more than offsets the public sector deficit, implying large current account surpluses, *cf. figure 1.16*. A part of the surplus relates to interests and dividends from abroad, which have increased significantly in recent years. Thus, the large current account surplus mainly reflects weak domestic demand and Denmark's net external asset position. The surplus is not an indication of Danish companies' competitiveness.

The public finance deficit in 2012 is affected by the reimbursement of VERP-contributions, which correspond to 1 per cent of GDP. The deficit is expected at 3¾ per cent of GDP this year, compared to just below 2 per cent of GDP last year. In 2013, when public finances are no longer affected by the disbursement of VERP-contributions and the public investment level is normalised, the public finance deficit is expected to be reduced to just over 1¾ per cent of GDP and the structural budget balance to be in balance.

Figure 1.15
Household consumption ratio and business investment ratio

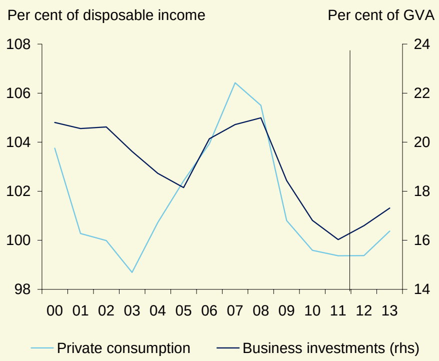
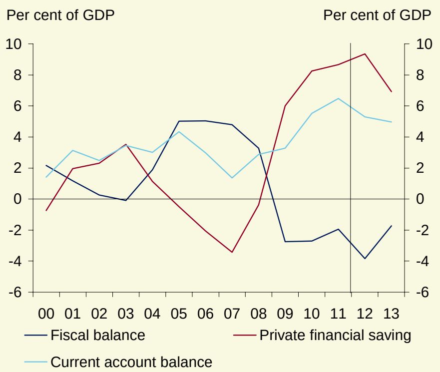


Figure 1.16
Savings balances



Note: In figure 1.15 the calculation of the consumption ratio is based on the national accounts definition, i.e. nominal private consumption relative to households' disposable gross income. The income definition does not reflect all income, and a consumption ratio over 100 does therefore not imply that there is no saving.

Source: Statistics Denmark and own calculations.

Table 1.1
Key figures

	2010	2011	2012	2013
Real growth, per cent				
Private consumption	1.9	-0.5	1.2	2.0
Public consumption	0.3	-1.0	1.3	0.3
Public investment	8.5	3.8	11.3	-20.2
Residential construction	-7.4	8.7	-0.5	3.0
Fixed business investments	-4.6	-2.7	2.6	7.0
Stock building (per cent of GDP)	1.0	0.4	0.1	0.1
Exports of goods and services	3.2	6.8	1.9	3.2
Imports of goods and services	3.5	5.2	3.1	3.7
Gross domestic product (GDP)	1.3	1.0	1.1	1.5
Level, per cent of GDP				
General government net lending	-2.7	-1.9	-3.8	-1.7
Current account	5.5	6.5	5.3	5.0
Level, 1,000 persons				
Gross unemployment	164	162	162	152
Net unemployment	114	109	114	119
Employment	2,751	2,741	2,744	2,748
Labour force	2,865	2,850	2,858	2,866
Growth, per cent				
House prices (single-family homes)	2.7	-2.9	-5.5	1.5
Consumer price index	2.3	2.8	2.5	1.7
Hourly wages, private sector	2.7	1.2	1.9	2.1

1.3 Public finances and fiscal challenges in Denmark

The overall objective of the economic policy is to continue a responsible strategy and to support growth and employment in both the short term and in the longer term.

The structural budget balance, which is an estimate of the public balance adjusted for cyclical effects and temporary factors, was reduced from -1½ per cent of GDP in 2010 to -½ per cent of GDP in 2011. With the planned fiscal policy, structural budget balance is expected at -¾ per cent of GDP in 2012 and to be in balance 2013. Thus, fiscal policy is planned to restore public finances and to improve the overall structural budget balance in line with the EU recommendation, i.e. with 1½ per cent of GDP from 2010 to 2013.

The actual public finance deficit is estimated at DKK 35 bn in 2011 (close to 2 per cent of GDP) which is significantly lower than expected in *Economic Survey*, December 2011, *cf. figure 1.17*. The lower deficit mainly reflects approx. DKK 25 bn higher revenue from pension taxes than anticipated in the December Survey, due to developments in the financial markets.

In 2012 the deficit is expected at approx. DKK 70 bn (3.8 per cent of GDP). The weakening of the actual balance from 2011 to 2012 partly reflects the reimbursement of VERP-contributions as part of the pension reform and the moving forward of public investments as part of the "kick-start" package. Adding to this is lower revenues from the pension tax after the extraordinarily high level in 2011.

Figure 1.17
Actual and structural balance

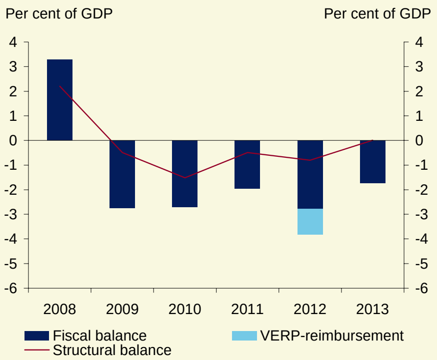
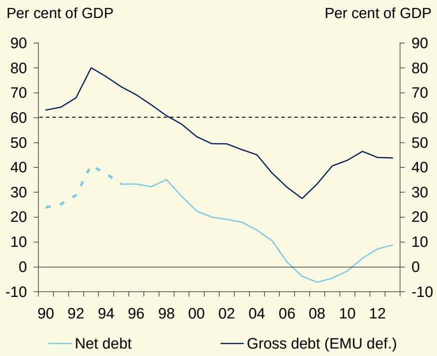


Figure 1.18
Gross debt (EMU definition) and net debt



Note: Data for net debt is not available for the years prior to 1995. In the period 1990-1994 the development in net debt has been assumed to follow the development in gross debt.
Source: Statistics Denmark and own calculations.

In 2013, the deficit is expected to decrease to DKK 32½ bn (1.7 per cent of GDP). The improvement should be seen in light of the expiry of the VERP-disbursements and a structural improvement of public finances by ¾ per cent of GDP, partly as a result of previously adopted tax increases and a normalisation of public investments.

The public finance deficit in the years up to 2013 implies that the public net debt position is reversed from a small net worth in 2010 (1.6 per cent of GDP) to a net debt of 9 per cent of GDP in 2013, *cf. figure 1.18*. The gross debt (EMU-definition) is estimated to be broadly unchanged at close to 44 per cent from 2010 to 2013 and remains therefore well below the EU reference value of 60 per cent. The public debt is still low in a historical and international context.

Effects on activity from the planned fiscal policy in 2012 and 2013

The fiscal policy has been planned to support employment while reducing the structural deficit from 2010 to 2013 in line with the EU recommendation. The government has made a number of initiatives in order to support the economy in the short term, *cf. box 1.1*.

The budget bill for 2012 includes a “kickstart” of the Danish economy, which supports the economy in the short term, particularly through the moving forward of investments. Fiscal policy in 2012 is estimated to increase activity by ½ per cent measured by the single-year fiscal effect, *cf. figure1.19*. The fiscal effect includes the reimbursement of the VERP-contributions, which is estimated to increase activity by ¼ per cent.

In addition, part of the investments in the “kickstart”-package are made by private entities, and do not affect public finances. This includes investments derived from the energy agreement and renovation of subsidised housing under the auspices of the National Building Fund (LBF).

Box 1.1
Initiatives supporting growth and employment in 2012 and 2013

- Kickstart of the Danish economy by moving forward investments etc., estimated to strengthen employment by 8,000 persons in both 2012 and 2013.
- Reimbursement of VERP-contributions, estimated to increase employment by approx. 2,500-3,000 persons in both 2012 and 2013.
- The Development Package, which strengthens the financing possibilities in small and medium sized enterprises.
- Agreement on a national energy plan for 2012-2020, which involves a green transformation of the economy (is included in the “kickstart”-package in 2012 and2013).
- A Budget Law, which helps maintain low interest rates.

New initiatives
- Youth Package, which will reduce youth unemployment.
- Social Housing Agreement, which increases investments for renovation of subsidised (social) housing in order to support employment in the years 2013-15.

Figure 1.19
Contribution to GDP-growth from fiscal policy.

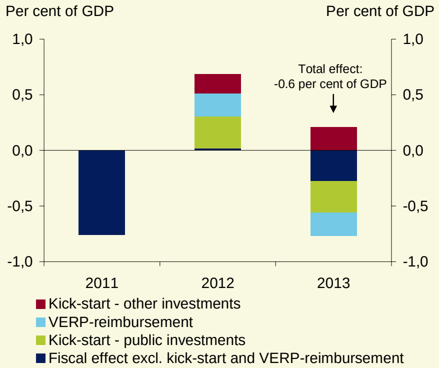
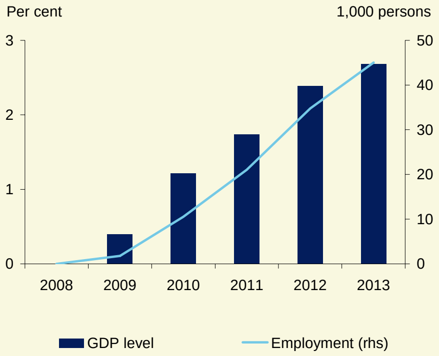


Figure 1.20
Effects on activity level from lower interest rates since 2008



Note: Figure1.19 illustrates the single-year fiscal effect as well as effects calculated on the ADAM model. The effect of the expiration of Special Pension reimbursements is included in "Fiscal effect excl. kickstart and VERP reimbursements". In figure 1.20 the effect from interest rates on GDP and employment is calculated in comparison to a scenario where interest rates are unchanged since 2008.
Source: Own calculations.

The overall fiscal policy for 2013 will include the agreements on municipal and regional economy, the budget bill proposal in August and a subsequent budget agreement. In the forecast, fiscal policy in 2013 is based on technical assumptions drawing on the Budget Bill for 2012.

The assumed fiscal policy in 2013 should be seen in light of the "kickstart"-package's effect on investments in the energy sector, the expected increase in economic growth and the fulfilment of the EU-recommendation. Activity is also supported in 2013 by continued high investment activity in connection with the construction of the Copenhagen Metro City Ring and the Fehmarn Belt link, which are registered as private investments and therefore not included in the fiscal policy. In addition, the estimated multi-annual effects of fiscal policy in 2012 are estimated to contribute positively to the activity level in 2013.

The consolidation of public finances in 2011-2013 – including compliance with the EU recommendation – and the 2020 reform strategy will help safeguard the high credibility of the economic policy and thereby maintain the low interest rates in Denmark. The low interest rates will help stabilise the housing market and increase the economic activity. The historical low interest rate level is estimated to secure in the order of 45,000 jobs in 2013, *cf. figure 1.20*.

With the Social Housing Agreement in May 2012, investments in subsidised (social) housing will increase, providing a positive contribution to growth and employment in 2013. The Housing Agreement was, however, agreed upon after the forecast's cut-off date, and is therefore not included in estimates for investment, GDP and employment.

Handling fiscal challenges up to 2020[1]

The 2020-plan, *Denmark at work*, lays down the overall framework for the economic policy towards 2020. The 2020-plan is based on a reform strategy that will help increase labour supply, create jobs and secure the basis for future growth and welfare. By complying with the EU recommendation up to 2013, strengthening the expenditure management, and implementing the pension's reform, which was adopted in Parliament in December, important steps have been taken to ensure sound public finances until 2020. But public finances are under pressure in the coming years. Up to 2020 the structural budget balance is weakened due to demographics and declining revenues from oil and gas extraction in the North Sea. In addition, net interest expenditures are expected to increase in light of rising interest rates from the current very low level and a predominantly cyclical rise in the share of public debt to GDP.

Box 1.2
Denmark at work: Reforms and priorities in the economic policy towards 2020

The objective of the reforms is to increase labour supply by 60,000 jobs and to strengthen public finances by DKK 14 bn in 2020. The reform plans include:
- Tax reform (DKK 3 bn).
- Reform of disability pensions and subsidised flex-jobs (DKK 2 bn).
- Faster completion of educations (DKK 2 bn).
- Other reforms (DKK 3 bn).
- Tripartite negotiations (DKK 4 bn).

Besides the contribution from reforms of DKK 14 bn, the plan contains further financing from:
- Savings on defence (DKK 2 bn).
- Reduction of Denmark's contribution to the EU (DKK 1 bn).
- By modernising and streamlining the public sector, public expenditures for at least DKK 5 bn will be reprioritised up to 2020.

In total, DKK 22 bn is provided by reforms and prioritisation. It is crucial that a continuous prioritisation of expenditure needs is made within the framework of government consumption, in order to ensure the best possible use of resources. The DKK 5 bn will be realised by increased focus on effects, results and mutual learning, by digitalisation, use of welfare technology and public-private cooperation.

The DKK 22 bn from reforms and other reprioritisations will be spent as follows:
- Public consumption can grow by around 0.8 per cent per year in 2014-20 while ensuring structural budget balance in 2020 (DKK 9 bn).
- Meeting targets for the education system (DKK 2bn).
- Initiatives to promote growth and employment, improvements of public welfare and green transformation (DKK 6 bn).
- Re-prioritisation of public expenditures on prioritised purposes (DKK 5 bn).

Source: *Denmark at work*, May 2012.

[1] The numbers in this section refers to the 2020 projection in *Denmark at work*, May 2012 and *Denmark's Convergence Programme 2012*, April 2012, which includes an update of the forecast in the *Economic Survey*, December 2011 and Statistics Denmark's and DREAM's population projection 2011.

Figure 1.21
Actual and structural balance in *Denmark at work*

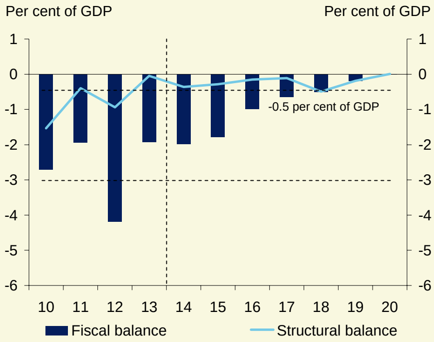
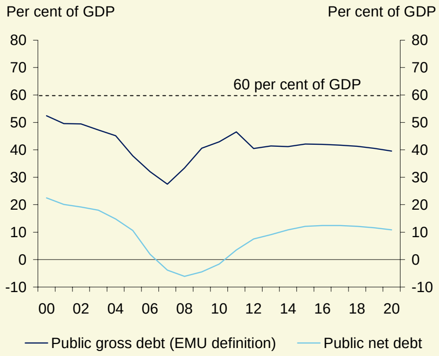


Figure 1.22
Gross public debt (EMU definition) and net debt in *Denmark at work*



Source: *Denmark at work,* May 2012.

In the absence of new initiatives and in order to ensure structural balance in 2020, there is only room for around 0.6 per cent real growth in public consumption in 2014-2020, *cf. Denmark at work* (Danish version only). In the 2020-plan *Denmark at work* room is made for higher growth in public consumption and investments in growth, employment, education, welfare and green transformation, *cf. box 1.2*.

With the reforms in the 2020 plan, private employment increases by approx. 130,000 persons from 2011 to 2020. In the same period, public employment is assumed to increase by about 20,000 persons. Furthermore, an increase in working hours adds to the increase in employment. From 2011 to 2020 employment is thus expected to increase by a total of 180,000 persons, *cf. Denmark at work*.

The 2020 projection fulfils the key fiscal objectives, which are part of the Government Platform's nine targets for the Danish economy in the longer term – including notably the target of structural budget balance in 2020 and fiscal sustainability. A sustainable and credible fiscal policy is crucial in order for low interest rates to continue to support economic growth. By consolidating public finances, the room for manoeuvre in the economic policy can be maintained in the future. In the projection the structural budget balance is close to zero every year up to 2020, *cf. figure 1.21*. At the same time, the structural budget deficit in the years 2014-2020 keeps a certain safety margin to the balance requirement of the Budget Law and the Fiscal Compact, which implies that the annual structural budget deficit may not exceed ½ per cent of GDP.

In the projection, public debt increases moderately towards 2015 and decreases thereafter. The gross debt (EMU definition) amounts to 40 per cent of GDP in 2020, while the public net debt amounts to close to 11 per cent of GDP, *cf. figure 1.22*. Thus, there is a wide safety margin to the EU's Stability and Growth Pact's reference value for gross public debt of 60 per cent of GDP.

1.4 Accumulation of debt and consolidation

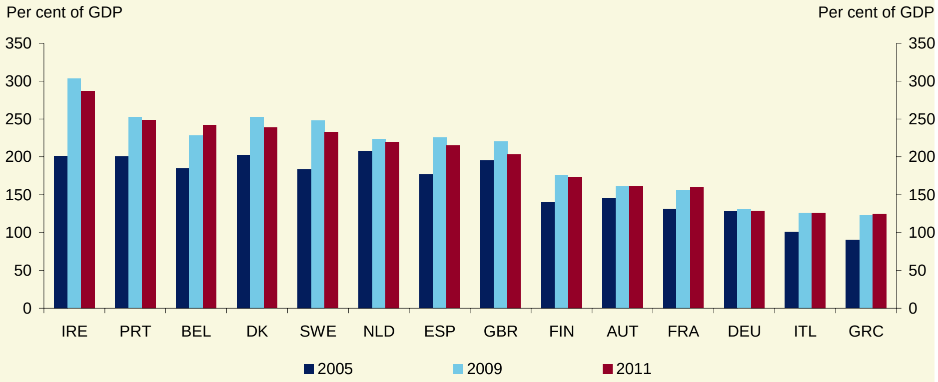
Although a gradual recovery is expected this year and next under the assumption that the significant downside risks do not materialise, a long way remains in many countries before the economic situation can be described as normalised. To a large degree, this reflects a continued need for consolidation in the private sector following a period up until the financial crisis with very loose credit conditions. From around 2005 and up to the financial crisis and the downturn in the global economy, the private sector debt increased significantly in many countries, *cf. figure 1.23*.

This was also the case in Denmark, where growth in lending to both households and businesses reached around 15 per cent on an annual basis, *cf. figure 1.24*. The strong growth in lending led to an increase in private sector debt from around 200 per cent of GDP in 2005 to just over 250 per cent of GDP in late 2009 when the debt ratio peaked.

The increased debt level is partly related to very low interest rates in a period when capacity utilisation was rising and the housing market overheated in many countries. Particularly household gross debt increased significantly these years.

Credit is very important for economic activity and well-developed countries typically have a higher gross debt to GDP ratio – especially among households – than less developed countries. However, debt levels vary widely across countries and depend partly on institutional factors, including rules for mortgages, pension savings and businesses' ways to raise capital (e.g. bank loans compared to issuing shares).

Figure 1.23
Private debt as share of GDP



Note: Debt quotas are calculated at the end of the year. For Austria, the first observation is 2006q1.
Source: ECB, Eurostat and own calculations.

Figure 1.24
Credit growth

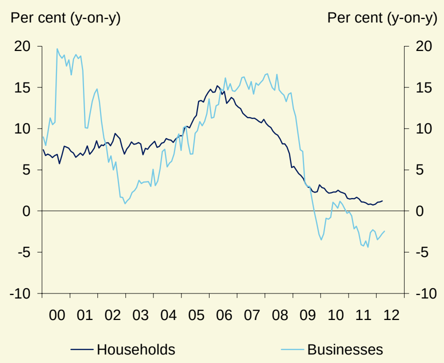
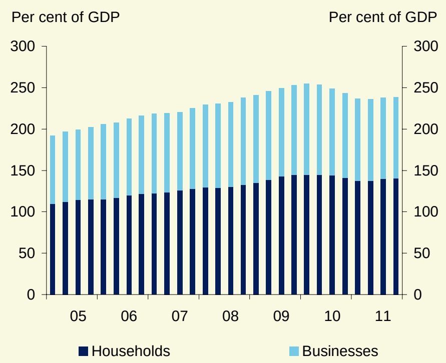


Figure 1.25
Private debt in Denmark



Source: Danmarks Nationalbank and own calculations.

A high level of debt is not necessarily problematic. But a strong increase in debt as in the period from 2005 until the financial crisis may reflect an unsustainable overheating, which requires a subsequent period where debt levels are reduced. The increased indebtedness in the years leading up to the crisis means that in many countries, the private sector, and households in particular, will reduce their debt levels in the coming years. The need for adjustment should be seen in light of several factors:

- Fall in asset prices, following a period where overoptimistic expectations may have driven asset prices, including housing prices.
- Tighter credit conditions, since assets serving as collateral have lost value, and banks have had to tighten lending, partly as a result of tougher capital requirements.
- Lower income expectations due to more subdued growth expectations.
- Greater uncertainty has made households and businesses more reluctant with regard to consumption and investment.

Based on historical evidence, studies show that periods of deleveraging typically last 6-7 years, *cf. box 1.3*. Denmark belongs to a group of countries where this adjustment is currently ongoing. Thus, the debt ratio declined by about 15 percentage points since its peak in 2009, which should be seen in light of an increase in the debt ratio of just over 50 per cent of GDP from 2005 to 2009. The deleveraging primarily reflects declining investments in businesses, but households have also started the adjustment process, *cf. figure 1.25*. If the debt ratio is reduced at the same pace in coming years, the debt to GDP ratio will reach the 2005 level within the next 5 years.

Box 1.3

Deleveraging – how long is the way back to a normal cyclical situation?

A period of strongly increasing debt levels will normally require a subsequent period of deleveraging (in relation to income and asset values).The deleveraging may be voluntary in terms of lower consumption / investment and thus greater savings, or it may be forced by credit constraints.

The deleveraging amplifies the decrease in consumption and investment that usually occurs during a cyclical downturn. Economic growth can therefore be more subdued than usual in a period of deleveraging, and as long as the adjustment takes place, there will be a dampening effect on activity, which prolongs the recession. Historical evidence indicates that the period of deleveraging lasts on average 6-7 years, cf. IMF, *World Economic Outlook*, April 2012, the McKinsey Global Institute, *Debt and Deleveraging*, January 2010, and C. Reinhart & K. Rogoff, *This Time is Different*, 2009.

Denmark has previously experienced a prolonged cyclical downturn in 1987-1994 after a period of increasing consumption, strong credit growth and an overheated housing market. The boom was followed by a financial crisis and for a period of seven years households reduced the ratio of their debt to the value of their financial assets, *cf. figure a*.

The accumulation of debt and subsequent adjustment in recent years has followed the same pattern as during the financial crisis in the late 1980s, *cf. figure b*. However, the level of the debt ratio is lower due to the build-up of pension assets and a reduction of the possibility of tax deduction of interest payments, which has made building up debt less attractive. If the pattern from the late 1980s is followed, some years still remain where a share of the income will be used on deleveraging. The comparison should, however, be interpreted with caution as the level of shareholdings is significantly higher and may cause some fluctuations in the later period, which is not necessarily an expression of indebtedness, but rather that asset values change due to fluctuations in share prices.

Figure a

Debt as share of financial assets

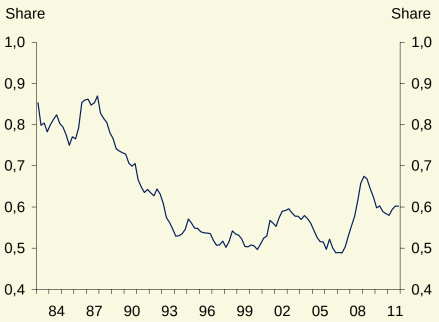
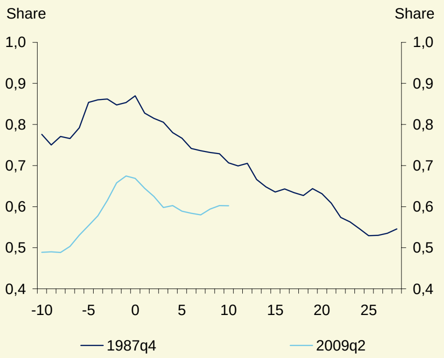


Figure b

Comparison of the deleveraging in 1987-1994



Note: Figure b illustrates the development in the ratio between household debt and financial assets in the quarters before and after the peaks in the 4th quarter of 1987 and the 2nd quarter of 2009.

Source: Danmarks Nationalbank.

In most European countries, the private debt to GDP ratio is at the same level as in 2009. In these countries the private sector has not yet started the adjustment process. There are, however, notable exceptions. In the USA and in the United Kingdom private gross debt was lower at the end of 2011 than before the crisis, and the private sector in Germany has neither accumulated debt relative to incomes nor had a need to subsequently reduce the debt level.

The deleveraging in the Danish economy will dampen the consumption ratio in the coming years. In other words, the consumption ratio is expected to remain lower than before the crisis, where the ratio was relatively high, *cf. figure 1.26*. Weak private demand implies that production will remain below potential output in the coming years. The normalisation of the cyclical conditions is slow, and the output gap is expected to remain negative by the end of the forecast period. The estimated negative output gap of approx. 2 per cent of GDP in 2013 is closed gradually towards 2018 in the medium-term projection in the 2020 plan, *Denmark at work*.

Private consumption decreased steeply in Denmark already in the beginning of the crisis, *cf. figure 1.27*. The large drop in 2008 and 2009 reflects a rapid reduction of an unsustainable high capacity utilisation. Other countries with a relatively large increase in debt have also experienced large drops in private consumption, which underscores that indebtedness increases the sensitivities of the economy. This is linked to a greater propensity to consume among debtors. If this group, voluntarily or involuntary, reduces its debt, it may lead to a fall in aggregate demand.

Figure 1.26
Consumption ratio

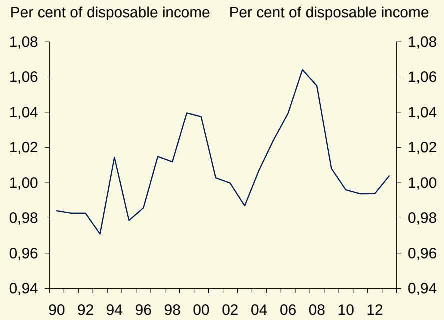
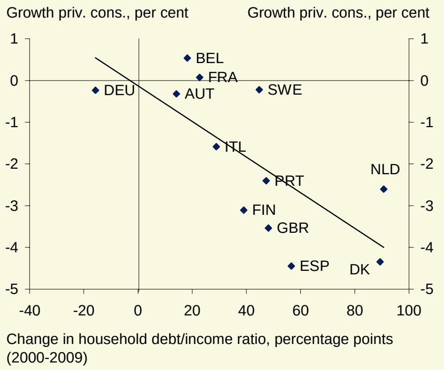


Figure 1.27
Private consumption and debt



Note: The calculation of the consumption ratio is based on the national accounts definition, i.e. nominal private consumption as share of gross disposable income. In figure 1.27, growth in private consumption relates to 2009.

Source: Statistics Denmark and own calculations.

1.5 Recovery and risks

The forecast is based on an assumption of continued recovery of the international economy and that the negative effects of the sovereign debt crisis eventually peter out. The economic outlook for Denmark remains highly uncertain – especially due to the negative risks of a resurgence of the European debt crisis, which will imply lower export market growth, *cf. figure 1.28*.

A more positive scenario is also possible in which the international economy gradually gains momentum – as assumed in the forecast – and where a shift in confidence in Denmark lifts private consumption more than assumed in the forecast. Previous recovery phases have been characterised by high growth in private consumption, *cf. figure 1.29*. In this section, scenarios for the development in the Danish economy are presented based on these alternative assumptions.

The main risk for the outlook relates to intensified financial turmoil. As a result of various initiatives taken to stem the crisis, conditions in the financial markets have improved since late 2011. These initiatives seem to be working, but there has still been turmoil concerning the Spanish economy, which should partly be seen in light of a decline in the immediate effects from ECB's new credit facilities from December. Meanwhile, the situation in Greece is still unclear. Renewed turmoil could lead to rising interest rates on government debt in the most indebted euro area countries, tighter credit conditions and rising risk premia, so that businesses must pay a higher interest rate to finance their investments.

Figure 1.28
Export market growth in case of an aggravated debt crisis

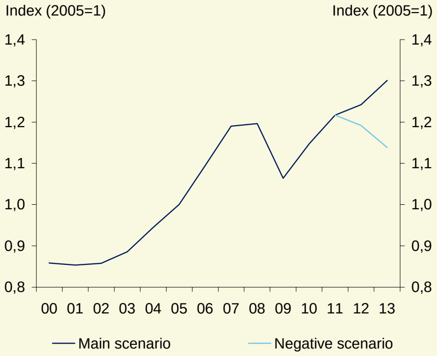
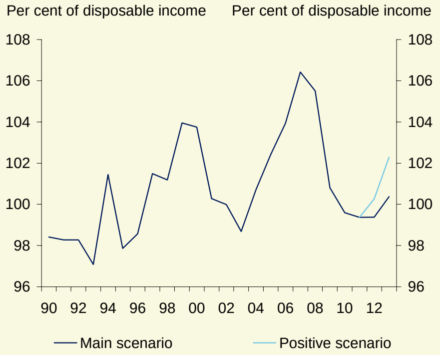


Figure 1.29
Private consumption ratio in case of a positive shift in sentiment



Note: Figure 1.28 illustrates a weighed measure of developments in the export market for manufactures. The risk scenario is based on the negative scenario in OECD's *Economic Outlook 90*. The calculation of the consumption ratio is based on the national accounts definition, i.e. nominal private consumption as share of gross disposable income.
Source: OECD, Statistics Denmark and own calculations.

Since banks hold many government bonds, rising interest rates weaken banks' balance sheets. This increases the risk of a tightening of the banks' credit policy and thus a reduction in bank lending. This worsens the real economy, which in turn hurts public finances. If the rising deficits are not handled, it may lead to a further increase in interest rates. Thus, countries risk ending up in a negative spiral. A decline in global equity markets could also occur, reducing private assets.

Such a resurgence of the financial turmoil would affect Danish growth prospects. A negative scenario has been constructed, assuming that financial market conditions deteriorate. In this scenario, Danish exports are assumed to fall by around 1-2 per cent in both 2012 and 2013 due to a fall in demand in key export markets. In addition, bank lending is assumed to drop, and stock prices and house prices to decrease, which means that private consumption could fall by up to ½ per cent in 2012 and to only grow moderately in 2013. In the scenario, business investments fall by almost 3 per cent. The scenario is an update of the risk scenario in the *Economic Survey*, December 2011. In the scenario, no countries are assumed to leave the euro area. Should such an event occur, the euro area countries would be in a new situation, where the economic consequences are unknown and not included in the described risk scenario.

The more negative development in both exports and in domestic demand implies that GDP growth in the risk scenario is reduced to approx. -0.4 per cent in 2012 and -0.3 per cent in 2013, *cf. table 1.2*. Unemployment would be 18,000 persons higher than in the main scenario in 2012 and 43,000 persons higher in 2013. This negative scenario would imply a public finance deficit in the order of 4.7 per cent of GDP in 2012 and 3.7 per cent of GDP in 2013.

Table 1.2

Key figures for the main scenario and two alternative scenarios

	May 2012		Negative scenario: Escalating European debt crisis		Positive scenario: Increase in private consumption ratio	
	2012	2013	2012	2013	2012	2013
Real GDP growth (per cent)	1.1	1.5	-0.4	-0.3	1.4	1.8
Gross unemployment (1,000 persons)	162	152	180	195	159	145
Fiscal balance (per cent of GDP)	-3.8	-1.7	-4.7	-3.7	-3.6	-1.2
Fiscal balance (DKK bn)	-70	-33	-85	-67	-66	-23

Source: Own calculations on the ADAM-model.

Developments could also turn out better than expected. Historically, a shift in sentiment, where households are starting to consume a larger share of their income has often occurred in connection with cyclical turning points. The possibility of an increase in the consumption ratio should also be seen in the light of the large pent-up of purchasing power, which reflects the households' consolidation since the beginning of the crisis. At the same time consumer confidence has already recovered somewhat. A more positive development in private consumption could also be triggered by a larger than expected reimbursement of VERP-contributions and if a larger share of the reimbursements is spent on private consumption. The reimbursements are made until October, and by mid-May total payments were already close to the expected total amount in 2012 of just over DKK 17½ bn.

A more positive scenario depends on no deterioration of external conditions, since this will have a negative impact on Danish economy and make a positive shift in sentiment unlikely. A boost in private consumption corresponding to the increase in the consumption ratio in previous turning points could increase GDP growth by 0.3 percentage points this year and next year. Unemployment would be 3,000 persons lower in 2012 and 7,000 persons lower in 2013.

1.6 Appendix

Table 1.3

Selected estimates for 2012 and 2013 compared with the December Survey

	2012		2013	
	December	**May**	**December**	**May**
Percentage change from previous year				
Private consumption	0.8	1.2	2.0	2.0
Total public demand	1.6	2.1	-1.7	-1.4
- public consumption	0.6	1.3	0.3	0.3
- public investment	13.9	11.3	-23.6	-20.2
Residential construction	1.0	-0.5	3.0	3.0
Fixed business investments	2.6	2.6	6.6	7.0
Final domestic demand	1.3	1.7	1.4	1.5
Stock building (per cent of GDP)	0.0	0.1	0.0	0.1
Total domestic demand	1.3	1.7	1.4	1.6
Exports of goods and services	1.9	1.9	3.2	3.2
- of which manufactures	3.0	2.5	3.9	3.9
Total demand	1.5	1.8	2.1	2.2
Imports of goods and services	2.5	3.1	3.5	3.7
- of which goods	2.4	2.5	2.9	3.1
GDP	1.0	1.1	1.4	1.5
Gross value added	0.9	1.1	1.4	1.4
- of which private sector	1.5	1.8	2.2	2.2
Change in 1,000 persons				
Labour force	9	8	9	8
Employment	-4	3	4	4
Of which in private sector	-8	-3	1	1
in public sector	4	6	3	3
Gross unemployment	9	0	-9	-10
Net unemployment	12	6	5	5

Table 1.3 (continued)
Selected estimates for 2012 and 2013 compared with the December Survey

	2012		2013	
	December	May	December	May
Percentage change from previous year				
Merchandise export prices	1.5	2.4	0.8	1.3
Merchandise import prices	1.7	2.8	1.0	1.2
Merchandise terms of trade	-0.2	-0.3	-0.2	0.0
House prices, single-family house	-2.3	-5.5	1.9	1.5
Consumer prices	1.9	2.5	1.6	1.7
Hourly compensation, private sector	2.1	1.9	2.3	2.1
Real disposable income, private sector	1.1	1.0	-0.3	0.7
Real disposable income of households[1)]	1.3	-0.3	1.0	1.0
Productivity in private non-agricultural sector	1.9	1.9	2.1	2.1
Per cent per year				
Interest rate 1-year adjustable rate loan	1.4	1.1	2.4	1.8
10-year government bonds	2.9	2.2	3.5	2.6
30-year mortgage credit bond	4.4	4.1	5.0	4.1
Balances				
Current account (bn DKK)	97.2	97.2	96.0	93.7
Government net lending (bn DKK)	-100.7	-70.4	-48.2	-32.6
Gross unemployment (thousands)	172	162	163	152
Net unemployment (thousands)	122	114	126	119
External assumptions				
Trade-weighted GDP abroad, per cent	1.6	1.2	2.1	2.0
Markets for Danish manufactures, per cent[2)]	3.6	2.7	5.0	4.9
Exchange rate, DKK per $	5.5	5.7	5.5	5.6
Oil price, $ per barrel	108.8	117.9	111.3	117.3
Oil price, DKK per barrel	602.3	666.4	616.2	662.0

1) Adjusted income. Including the reimbursement of VERP-contributions, growth in 2012 is 1.2 per cent.

2) 10 new countries have been added to the export market growth calculation compared to the *Economic Survey*, December 2011. The estimates from the *Economic Survey*, December 2011 have been updated with the larger group of countries.