Economic Survey December 2010 – English Summary

Short term outlook

The international recovery has continued at a moderate pace over the summer. Overall, the recovery in industrialised countries has been faster than expected just over a year ago. Back then, the general expectation was almost zero growth in the euro area and very weak growth in the USA, *cf. figure 1.1a.*

The Danish economy is also making good progress and growth in 2010 has been stronger than expected. GDP has risen over the past five consecutive quarters and overall by almost 4 per cent since the bottom in the second quarter of 2009, *cf. figure 1.1b.*

Figure 1.1a

More optimistic growth prospects for 2010 in the euro area and USA

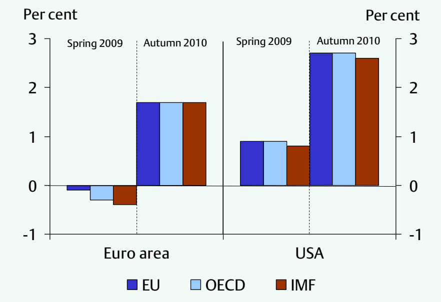
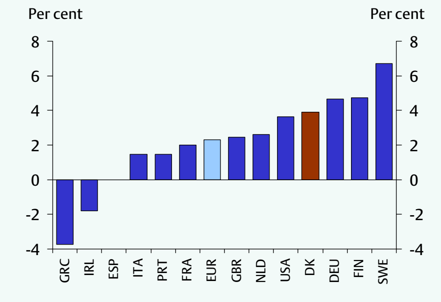


Figure 1.1b

Growth since the second quarter of 2009 in selected countries



Source: EU Commission, OECD, and IMF.

Within the EU there are wide variations in the strength with which countries seem to come out of the crisis. In Ireland and Greece and other southern European countries with large fiscal challenges, growth has been weak over the past year and in some cases negative, partly because of high interest rate spreads reflecting lack of confidence in the ability of these countries to meet their debt liabilities. At the same time, these countries have implemented quite significant tightening of fiscal policy to help restore creditworthiness.

In northern Europe, where the fiscal challenges are less severe, growth has been surprisingly high in the first three quarters of 2010. This is especially true for Germany and Sweden, which are the largest Danish export markets, *cf. figure 1.1b*. Outside the OECD, the pace of the expansion is also quite high, and many countries are beginning to tighten the economic policy for stabilisation reasons.

GDP growth in the euro area and the USA has stabilised labour markets, but unemployment has reached a high of approximately 10 per cent of the work force, *cf. figure 1.2a and b*. At the same time a large number of industrialised countries, not least several of the major economies, are subject to a "public debt crisis" that will require significant fiscal tightening in the coming years. The potential for reducing unemployment through additional fiscal and monetary policy easing is very limited, and these economies are particularly vulnerable to new economic downturns.

In both the euro area and the USA capacity utilisation has remained below normal levels and growth in demand has declined slightly in the latter part of 2010. It is not unusual to experience a phase with some growth moderation, when the effects of temporary growth promoting factors such as the reversal of the inventory cycle and the expansionary fiscal policy are to be replaced by more sustained private demand. At the same time, it is expected that the recovery in the industrialised economies will not be as strong as normally after a period of recession. One reason is the ongoing consolidation of balances in the private sector and the international debt crisis that creates great uncertainty in the already weakened financial markets, which may cause restrain in investment and consumption decisions.

Figure 1.2a

GDP is growing at a solid pace...

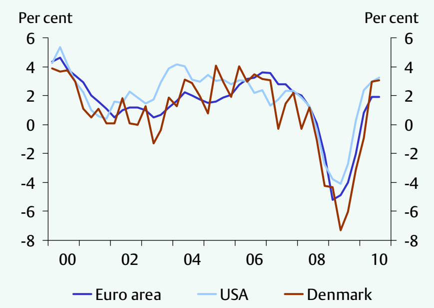
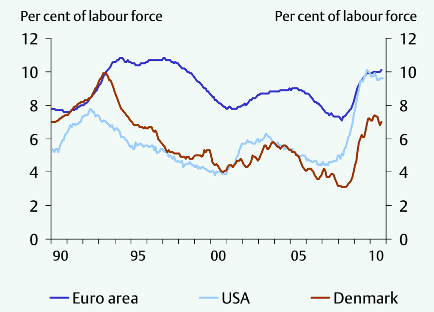


Figure 1.2b

... and the rise in unemployment has stopped



Note: Unemployment in figure 1.2b is based on the Labour Force Survey (LFS).
Source: Statistics Denmark, Eurostat, and Reuters EcoWin.

Denmark is a small, very interest rate sensitive economy, which has its own currency (with a fixed exchange rate policy vis-à-vis the euro). Thus, at the outset Denmark is more vulnerable to pressure from financial markets than for example the euro area countries. With the prospect of a public deficit of approximately DKK 85 bn ($4\frac{3}{4}$ per cent of GDP) next year, it is a central objective for economic policy to consolidate the public economy. The consolidation strengthens the credibility of economic policy and can be viewed as an investment in continued low interest rate differentials to Germany.

High credibility of fiscal policy and the fixed exchange rate policy prevents pressure on the Danish Krone, and it is a prerequisite in order for Denmark to continue to be a safe haven for international investors if uncertainty and financial turmoil arises from the international debt problems.

The consolidation of public finances requires, among other things, that growth in public consumption is reduced to a lower level than in the past 20 years including that the recurrent slippage of public expenditure is prevented. To strengthen expenditure management and ensure compliance with budget agreements, governance mechanisms have been reinforced both in the Fiscal Consolidation Agreement from May 2010 and in the central government fiscal bill for 2011.

GDP growth in Denmark has been somewhat higher than in the euro area over the last year and is estimated at 2 per cent annually in 2010, *cf. table 1.1*. This is more than expected in the August Survey. The upward revision follows from demand growing faster than previously assumed. It is especially exports that along with strong demand on export markets have risen more than expected. But also government consumption has increased more than assumed.

Tabel 1.1
Key figures for the Danish economy

	2008	2009	2010	2011	2012
Percentage change (chain-indexed prices)					
Private consumption	-0,6	-4,5	2,2	2,2	1,8
Public consumption	1,6	3,1	1,0	-0,3	0,3
Public investment	0,8	4,6	9,4	9,4	-8,1
Housing investment	-10,9	-16,9	-13,0	1,5	3,0
Business investment	-0,2	-15,8	-7,3	5,0	4,1
Stock investments (growth in per cent of GDP)	-0,6	-2,0	1,4	0,1	0,1
Export of goods and services	2,8	-9,7	4,5	3,8	3,9
Import of goods and services	2,7	-12,5	3,7	4,4	4,2
Gross domestic product (GDP)	**-1,1**	**-5,2**	**2,0**	**1,7**	**1,5**
Real disposable incomes	0,5	0,7	5,8	1,6	0,5
Per cent of GDP					
General government balance	3,3	-2,8	-3,6	-4,7	-3,4
Current account balance	2,7	3,6	4,5	3,9	3,8
Level, 1,000 persons					
Unemployment	52	98	116	121	116
- in per cent of total labour force	1,7	3,4	4,0	4,2	4,0
Unemployment (incl. activation)	74	131	166	172	164
- in per cent of total labour force	2,5	4,5	5,8	6,0	5,7
			Annual percentage change		
Employment	2,909	2,824	-1,9	0,0	0,1
Labour force	2,960	2,922	-1,3	0,2	-0,1
Percentage change					
Housing price, single family homes	-3,7	-12,8	3,0	2,0	0,0
Consumer price indices	3,4	1,3	2,3	1,7	1,7
Hourly earnings in the private sector	4,6	3,0	2,1	2,4	2,7

Source: Statistics Denmark, Danish Employers Federation, and own estimates and calculations.

The economic progress to a large extent reflects the expansionary policy in Denmark and other countries. Fiscal policy in Denmark has been historically expansionary this year and last year, while interest rates have fallen to very low levels, which have contributed to an improvement of the housing market. Household real disposable incomes are expected to rise by almost 6 per cent this year and around 1½ per cent in 2011 after a weak development in 2007-2008. The strong income growth is mainly driven by the tax reform in the Spring Package 2.0 and the decline in short-term interest rates. At the same time growth is supported by an improvement in competitiveness during the past year. This is due to a weakening of the euro (and hence the effective exchange rate of the Danish Krone) and that the recovery of productivity after the crisis so far seems to be stronger in Denmark than in several other countries. However, it does not change the general assessment that competitiveness overall has weakened considerably since the millennium and that productivity growth in Denmark also has been modest compared with other countries, *cf. box 1.1*.

GDP growth in Denmark is expected at 1.7 per cent in 2011, which is in line with the projections in the August Survey. Growth is expected to gradually become more self-sustained so that the composition of demand shifts towards private demand and export, *cf. figure 1.3a*. In 2012, when the tightening of fiscal policy is gradually becoming more effective, GDP growth is projected to slow to 1½ per cent.

Figure 1.3a

Demand becomes more self-sustained and shifts to private demand

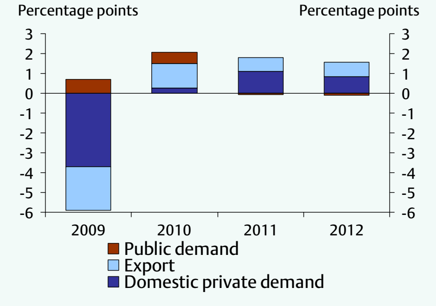
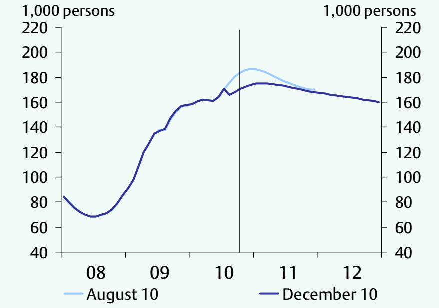


Figure 1.3b

Unemployment (incl. activation) is lower than expected



Source: Statistics Denmark and own calculations.

Growth in production and demand over the next couple of years is estimated to be high enough to ensure higher capacity utilisation and some slight growth in employment in 2011 and 2012. It reflects that the productivity level is close to being restored after the large cyclical decline up to and after the financial crisis. Meanwhile, the growth potential is limited in the coming years and probably not much higher than 1-1½ per cent annually until 2015. The moderate growth potential partly reflects that trend productivity growth is likely to be subdued, in line with developments in recent decades, but also that demographic trends will tend to reduce labour supply.

Overall, the major economic downturn has had significantly less impact on unemployment than expected. In October, unemployment (incl. activation) was around 13,000 persons (0,5 per cent of the labour force) lower than assumed in the projection in the August Survey, *cf. figure 1.3b*.

Box 1.1

Recent quarterly developments in productivity and wage competitiveness

After a weakening of productivity from 2006 to the early part of 2009, which primarily reflects that the decrease in employment resulting from the crisis occurred later than the fall in production, there has been a significant recovery in productivity since the summer of 2009, when production began to rise again, *cf. figure a*.

The recent recovery of productivity has been faster in Denmark than in many other countries, *cf. figure b*. However, productivity developments in Denmark were weaker in the previous years. Thus, developments in the last five quarters have not altered the general picture that productivity growth in Denmark since 1995 has been among the lowest in the OECD, *cf. figure d*.

The more rapid recovery of productivity - which is particularly pronounced in manufacturing - together with the weakening of the effective exchange rate has contributed to a strengthening of wage competitiveness (as measured by relative unit labour costs) since the middle of 2009, *cf. figure c*. Also, wage growth in manufacturing has come closer to that of other countries, and over the last year - unlike in the past – relative wage developments have not contributed negatively to competitiveness. With the improvement since the spring of 2009, competitiveness has now deteriorated by about 15 per cent compared to the level of 2000. The quarterly data however is often revised substantially, and are therefore subject to a great deal of uncertainty.

Figure a

The recovery of productivity in the Danish economy...

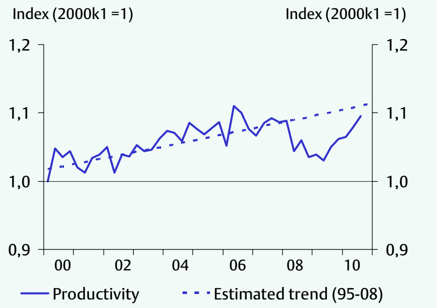


Figure b

... has occurred faster than in several other countries...

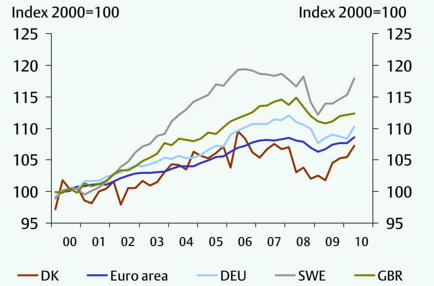


Figure c

... and helped reduce the loss of competitiveness since 2000...

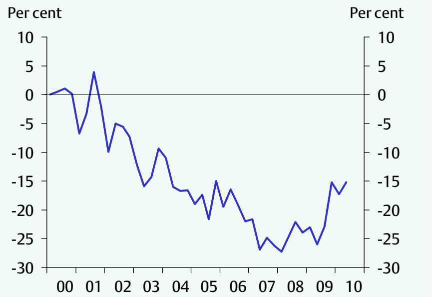
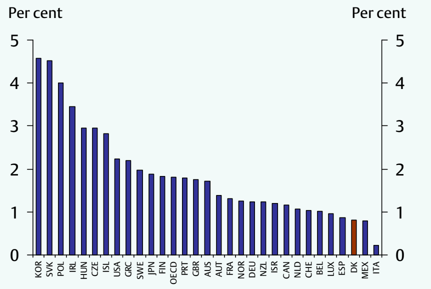


Figure d

... but in a longer perspective productivity growth in Denmark is still low.



Note: Figure a, b and d show hourly productivity for the total economy. Figure c shows the relative unit labour costs of manufacturing companies. Figure d shows the average productivity growth rate from 1995 to 2010. For 2010 recent quarterly statistics or the yearly estimates from the latest OECD Economic Outlook are used.
Source: Statistics Denmark, Eurostat, OECD, and own calculations.

If production and demand develop as expected, it is likely that unemployment can begin gradually to decline and that the downturn does not lead to higher structural unemployment.

Although long-term unemployment has risen rapidly since the trough in mid 2008, the level remains low in a historical context and not much larger than what can be expected in a normal cyclical situation. By comparison, long-term unemployed in 2004 when long-term unemployment last peaked was almost 50 per cent higher than current levels, *cf. figure 1.4a*. In addition, the shortening of the unemployment benefit period from four to two years – so that it is now in line with or slightly longer than in neighbouring countries – is expected to reduce long-term unemployment and the level of structural unemployment (incl. activation). The effects of the reform will manifest towards 2013 when the reform is fully phased in.

The Danish labour market is flexible in the sense that there are no greater barriers for businesses when they want to hire and lay off employees. This contributes to many job openings, including for young people and the unemployed, and it also underpins adaptability of companies to new conditions. If flexibility is weakened, for example if it becomes more costly to lay off employees, there is a risk that youth unemployment and long-term unemployment will increase. This may make it harder to reduce unemployment again.

Figure 1.4a

Long-term unemployment since the mid 1990s

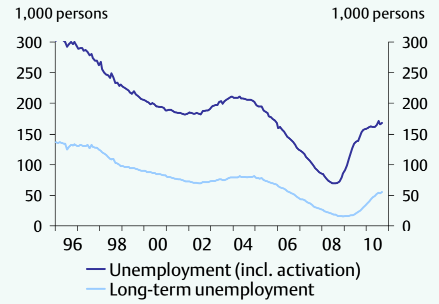
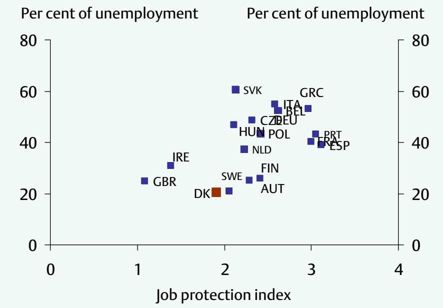


Figure 1.4b

Long-term unemployment and job protection across countries



Note: Long-term unemployment is measured as full-time persons in unemployment or in activation who have been unemployed for more than 80 per cent of the last 12 months. Unemployment in the most recent year is measured as periods of unemployment, activation or holiday pay. The number of unemployment persons receiving unemployment insurance benefits is based on the CRAM and AMFORA statistics prior to 1999 while the subsequent years are based on the RAM and population statistics. Cash benefit unemployment rate is calculated on the basis of CRAM and AMFORA until 2007. The years from 2008 and onwards are based on a special data extraction from Statistics Denmark. Figure 1.4b shows long-term unemployment in EU member states as the average share of total unemployment in 1998-2008 compared to a weighted index for job protection rules. Low scores indicate low employment protection, while high scores indicate high employment protection.

Source: CRAM, AMFORA, RAM, Population statistics, OECD, and own calculations.

Expansionary fiscal policy during the crisis and fiscal consolidation from 2011

Fiscal policy was eased by around 3½ per cent of GDP from 2008 to 2010 (measured by the direct revenues that enters into the estimation of the fiscal effect), *cf. figure 1.6a*. The expansionary measures were mainly on the expenditure side, partly reflecting a significant increase in public consumption.

Figure 1.6a
Fiscal easing compared to 2008 (direct revenues)

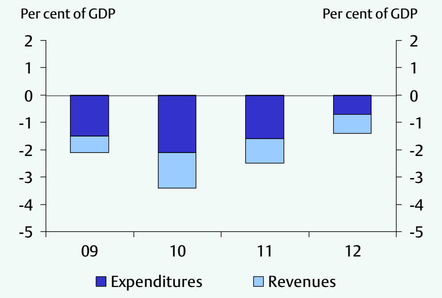
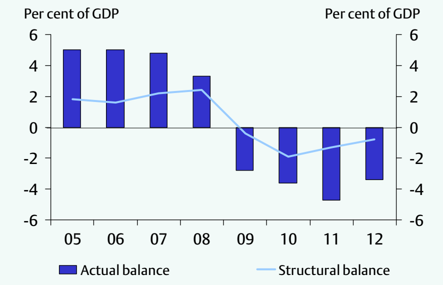


Figure 1.6b
Actual and structural balance



Source: Statistics Denmark and own estimates.

The expansionary measures in 2009 and 2010 have been larger than in other OECD countries, while the planned consolidation over the next few years is relatively mild. The consolidation over the next years is around half the size of the expansionary measures implemented during the crisis. The fiscal consolidation in Denmark will ensure a strengthening of public finances by 1½ per cent of GDP up to 2013. In other EU countries the planned consolidation is on average around 4 per cent of GDP, i.e. a fiscal consolidation that is up to three times larger than in Denmark. This reflects that Denmark's initial fiscal position is challenging, but not quite as challenging as in many other countries.

The fiscal consolidation is estimated to strengthen the structural fiscal balance from -1.9 per cent of GDP in 2010 to -0.8 per cent of GDP in 2010, i.e. by around 2/3 of the total required improvement until 2013 that is stipulated in the EU Council recommendation. The Fiscal Consolidation Agreement from May 2010 contains concrete initiatives to ensure the fulfilment of the EU recommendation. The actual deficit is expected to be higher than 3 per cent of GDP in the years 2010-2012, *cf. figure 1.6b*.

In 2011, fiscal policy as a whole – i.e. including the expansionary measures during the crisis – will increase the activity level significantly, while the effect on growth is expected to be rather neutral. Fiscal policy will therefore not weaken the upswing in the short term, despite the planned consolidation. The expansionary fiscal policy from 2009 to 2011, i.e. including the fiscal tightening next year, will in total lead to a GDP level that is 2¼ per cent higher, and an employment level that is around 60,000 persons higher, than if fiscal policy were neutral in the years from 2009 to 2011, *cf. figure 1.7a*. This reflects that the lagged effects of the expansionary measures in 2009 and 2010 more than offset the effects of the consolidation measures planned for 2011[1]. The figure does not include the initiatives to ensure financial stability, which have prevented a deeper set-back in the Danish economy. Including these financial crisis measures the effect of the economic policies would be larger, but the total effect is uncertain.

Figure1.7a

Contribution to GDP level and employment from fiscal policy and lower interest rates since 2008

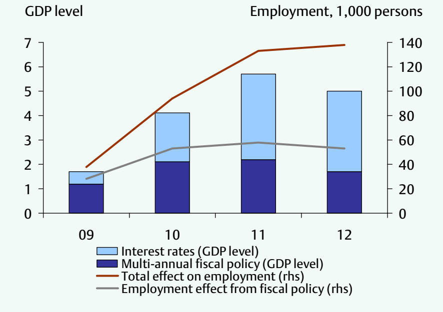
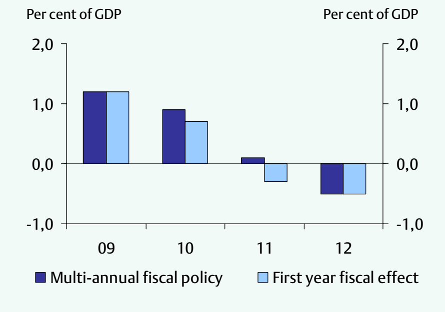


Figure1.7b

Contributions to growth from fiscal policy



Source: Own estimates.

In 2011, the first year fiscal effect is estimated to -0.3 per cent of GDP, *cf. figure 1.7b*. Thus, the negative impact on activity stemming from the fiscal policy next year is moderate and less than expected in the August Survey. The adjustment reflects higher growth in public investments in 2011 than previously expected, which more than offsets the effect of less growth in public consumption. Public investments have been adjusted downwards by DKK 5½ bn in 2010 and by DKK 3¾ bn in 2011 primarily due to expected shifts from 2010 to 2011 in municipal and regional investments. The estimated effect on activity in 2011 assumes that the tight expenditure frameworks for public consumption are respected, so that growth in real public consumption is negative next year, following the relatively large excesses of the agreed framework in 2009 and to a smaller degree in 2010, *cf. box 1.2*.

[1] The Danish Economic Council makes a similar estimate in the latest semi-annual report on the Danish economy. The Economic Council's estimate on the effect on the GDP level is 2½ per cent, and the effect on employment is estimated to 70,000 persons, *cf. English summary of Danish Economy, Autumn 2010 (www.dors.dk)*.

Box 1.2

Assumptions regarding public consumption

The estimate for public consumption in 2010 has been adjusted upwards by DKK 5 bn compared to the August Survey. Based on indications by the Local Government Denmark (KL) and Danish Regions, an additional consumption of DKK 4½ bn is expected in 2010. At the same time, additional expenses of just over DKK ½ bn is expected for activation measures in 2010. Real growth in public consumption is thus estimated to DKK 5 bn or close to 1 per cent in 2010, while zero growth was assumed in the August Survey, *cf. figure a*.

In line with the estimate in August and the Fiscal Consolidation Agreement, public consumption is expected at DKK 518.6 bn in 2011, which is in line with the Budget for 2011 and an assessment of the municipal and regional budgets for 2011. Since the consumption expenditures in 2010 exceeded the agreed level and therefore is too high, real growth in public consumption in 2011 has been adjusted downward from 0.6 per cent to -0.3 per cent. From 2009 to 2011 public consumption is expected to grow by some ¾ per cent.

In 2012, public consumption is expected to grow by 0.3 per cent, in line with the Fiscal Consolidation Agreement.

When the Fiscal Consolidation Agreement was made, public consumption was expected to grow by ½ per cent in 2011 and ¼ per cent in 2012 – i.e. close to ½ per cent on average. This corresponds in broad terms to the growth in public consumption that the previous government planned for 2005-2010. The downward adjustment of the real growth rate in 2011 reflects that expenditures have increased more than planned and agreed upon in 2010. For 2013 the Fiscal Consolidation Agreement implies a reduction of public consumption by ¼ per cent.

In 2013, real public consumption is broadly in line with the expected level in the 2015 plan from 2007, *cf. figure b*. Public consumption will, however, constitute a larger share of the economy than intended in the 2015 plan, since growth in cyclically-adjusted GDP has been lower than expected before the financial crisis and because of the low growth in productivity over the previous years.

Figure a

Higher real growth in 2010 followed by unchanged level in 2011

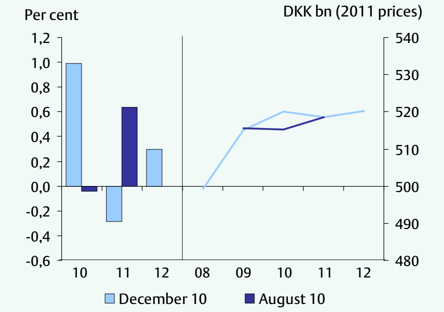
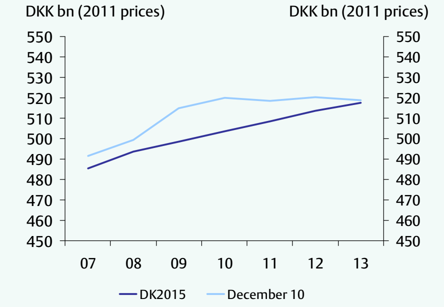


Figure b

Real public consumption compared to 2015 plan from 2007



Source: *Towards new goals – Denmark 2015*, *Economic Survey, August 2010* and own estimates.

The fiscal policy planning should be seen in light of the significant fall in interest rates since the autumn of 2008 to a historical low level. The fall in interest rates supports the housing market and contributes to the increase in households' real disposable incomes, which is expected at 5¾ per cent this year and just over 1½ per cent next year. In total, fiscal policy and the fall in interest rates since 2008 is expected to contribute to growth in 2011 by around 1¼ percentage point. This reflects, that falling interest rates normally has the biggest effect on activity after 1-2 years. The effect is also supported by improved conditions in the financial sector.

The tightening of fiscal policy that will be carried out in Denmark and in other countries – and the necessary tightening of monetary polices that will start when a self-sustained upswing is more evident – is therefore expected to start having an impact from 2012. Model simulations indicate that the isolated growth contribution from economic policy may go from the before mentioned 1¼ per cent in 2011 to a negative contribution of around ¾ per cent in 2012 and some years after. This reflects both a moderate rise in interest rates and a rising impact from the stricter line in fiscal policies.

Moreover, the fiscal consolidation in other countries will have a dampening effect on demand in Denmark. The planned consolidation abroad may give negative contributions to GDP growth in Denmark by 0.3 per cent in 2012 and the following years. The size and timing of the effects are quite uncertain, but the overall assessment is, that economic policies in the industrialised part of the world will dampen demand over a number of years from 2012, also because interest rates are expected to rise in line with rising resource utilisation.

The Fiscal Consolidation Agreement and public finances in the 2015 plan

The public finance consolidation from 2011 will ensure full confidence in the fixed exchange rate regime and strengthen the fiscal room of manoeuvre in the longer term. The fiscal tightening from 2011 will also be offset by the fall in interest rates that continues to support demand. For a small, interest-sensitive economy as the Danish, which is not in the euro area, it is particularly important, that the confidence in economic policy prevails.

With the measures in the Fiscal Consolidation Agreement public finances are back on the track in the 2015 plan (in structural terms) – but with a higher debt level and a higher tax burden and expenditure level than earlier expected.

After the high real growth in public consumption of just over 3 per cent in 2009, the requirement in the Fiscal Consolidation Agreement of keeping public expenditures at bay in 2011-2013 implies that real public expenditure in 2013 will be broadly on the same level as expected in the 2015 plan. But the financial crisis and the low growth in productivity over the last years have weakened potential GDP and thus the funding base for public expenditures. Public wages has also increased relatively much in 2008 and 2009.

With the Fiscal Consolidation Agreement public consumption expenditures are expected to decrease from 28¾ per cent of cyclically adjusted GDP in 2010 to some 27¾ per cent of cyclically adjusted GDP in 2013, but they are expected to stay over the target of 26½ per cent of GDP in 2015 from the 2015 plan. The share of GDP in 2013 is close to ½ per cent of GDP or around DKK 10 bn more than in the Covergence Programme 2008.

When public finances generally can be said to be back on the track from the 2015 plan, it reflects the lower growth in other expenditures and the increased tax revenues included in the Fiscal Consolidation Agreement. In addition, the structural reforms agreed upon since 2009 is estimated to meet around 80 per cent (DKK 11 bn) of the initial requirement for structural reforms in the 2015 plan of around DKK 14 bn. Proposals have been made concerning the Danish Students' Grants and Loans Scheme (SU) and early retirement (disability pension) scheme, estimated to strengthen public finances by around DKK 1¼ bn in 2015 and by a permanent effect of DKK 3-4 bn, *cf. box 1.3*.

Box 1.3

Status for the reform requirement in the 2015 plan and the development in fiscal sustainability

The 2015 plan *Towards new goals – Denmark 2015* was published in August 2007. In light of the new priorities included in the plan, the prerequisite for a sustainable fiscal policy was that structural reforms strengthened the public finances by 0.8 per cent (around DKK 14 bn) up to 2015. The new priorities included a "Quality Fund" for increased public investments, new ambitious energy and climate targets, increased public consumption and a continued tax freeze up to 2015.

The Job Plan and the initiatives to reduce sickness absence from 2008 as well as the tax reform from 2009 fulfilled around DKK 7 bn of the initial requirement in the 2015 plan.

In *Denmark's Convergence Programme 2009* (CP09) the fiscal sustainability was weakened due to rising debts and a weakened revenue base following the financial crisis as well as higher public consumption expenditures. To ensure fiscal balance in 2015, the CP09-projection included a requirement of new initiatives for DKK 31 bn up to 2015. Included in this was consolidation measures for DKK 24 up to 2013 and further DKK 7 bn in 2014-15, that technically was assumed by fulfilling the remaining reform requirement in the 2015 plan (i.e. the initial DKK 14 bn minus the implemented contributions from the tax reform and the Job Plan etc.), *cf. table a*.

With the Fiscal Consolidation Agreement there has been agreed on measures to strengthen public finances by around DKK 24 bn up to 2013 and DKK 26 bn in 2015. In order to ensure balance in 2015 further measures for around DKK 5 bn remain. That includes around DKK 3 bn that reflects the initial reform requirement in the 2015 plan, which remains after the reform of the unemployment benefits, *cf. table a*.

Table a

Requirements for structural balance towards 2015, CP09 and now

DKK bn	Expected in CP09	Fiscal Consolidation Agreement 2013	Fiscal Consolidation Agreement 2015	Remaining requirement
Consolidation measures	24	24	22	2
Reform requirements	7		4	3
Total	31		26	5

Status for the reform requirement in the 2015 plan

Of the total DKK 14 bn reform requirement in the original 2015 plan around DKK 11 bn was implemented with the Job Plan, the Spring Package 2.0 and the unemployment benefit reform etc. in the Fiscal Consolidation Agreement, *cf. table b*. In November 2010, a proposal was made for a reform of the Danish Students' Grants and Loans Scheme (SU), with an objective to make young people finish their education and enter the labour market earlier. A proposal has also been made for an early retirement (disability pension) reform, with an objective that people under the age of 40 should not be awarded disability pension for life. The proposals are estimated to strengthen the structural balance by around DKK 1¼ bn in 2015 and by DKK 3-4 bn in permanent effects.

Table b

Status for the reform requirement in the 2015 plan

	DKK bn
Requirement in the 2015 plan	**14**
2008: Job Plan etc.	2
2009: Spring Package 2.0	5
2010: Fiscal Consolidation Agreement – employment effects	4
Implemented reforms	**11**
SU proposal, effect in 2015	¼ (permanent effect: 1)
Proposal on early retirement, effect in 2015	1 (permanent effect: 2-3)

Growth in public consumption cannot continue as up to now

Over the last decades public consumption expenditures have had a tendency of increasing more than planned and agreed. With the prospect of a downward pressure on public finances for many years due to demographics and decreasing revenues from the North Sea, this cannot continue. A central structural political challenge will be to ensure that consumption expenditures will not increase more than agreed and than assumed in the medium term plans. Against this background, there have been introduced new governance mechanisms in municipalities and regions in order to secure better compliance with agreements, *cf. box 1.4*.

Box 1.4

New governance mechanisms

In order to support the objective of keeping public expenditures unchanged, mechanisms have been introduced to strengthen expenditure management in municipalities and regions. The mechanisms are introduced with the 2011 Budget. With the new mechanisms in place, evaluation of future developments in public consumption can not be based on historical evidence. For the municipalities, the mechanisms imply:

- The block grant for municipalities can be cut by up to DKK 3 bn per year, if actual expenditures or budgeted expenditures in municipal budgets increase more than agreed upon.
- Increased sanctions for the municipalities that increase taxes in a situation where the municipalities as a whole do not comply with the agreement on municipal taxation.

In the case of a budget slippage in the municipalities, 60 per cent of the off-setting of the slippage will take place individually, affecting the municipalities that exceed their budgets, while the rest take place collectively.

The municipalities are also required to make politically approved semiannual accounts in order to strengthen the economic management and the budget process in each municipality. Combined with the conditional block grants the semi-annual accounts will support the municipalities' cooperation on complying with the agreed frameworks in both budgets and accounts.

For the regions and the hospitals, the Economy Agreement for 2011 increases the focus on better management. The agreement contains concrete elements to improve the financial management and monitoring.

Since 1980, real public consumption has increased by 1.7 per cent per year on average. Growth was close to ¾ per cent per year in the 1980s, 2¼ per cent per year in the 1990s and 1¾ pct. in the 2000s, *cf. figure 1.8a*. Public consumption expenditures now constitute a larger share of the economy (cyclically adjusted GDP) than ever before. Public consumption is ¾ percentage point higher than the last peak in 1982, *cf. figure 1.8b*.

Figure 1.8a
Real growth in public consumption

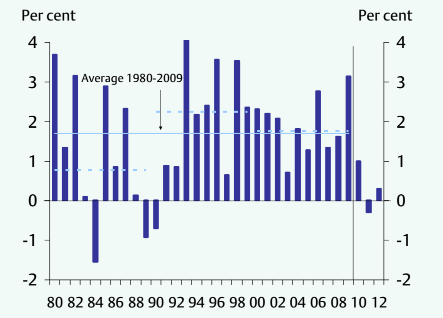
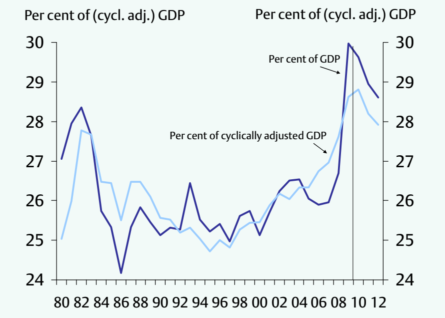


Figure 1.8b
Public consumption in per cent of (cyclically adjusted) GDP



Source: Statistics Denmark and own estimates.

Growth in public consumption has led to an increase in public employment from 670,000 persons in 1980 to 820,000 in 2001 and 843,000 in 2010. Growth in public employment has been more muted in the 2000s, especially compared to the development in total employment, *cf. figure 1.9a*. However, this mirrors that consumption growth in the 2000s to a large part was due to increased spending on goods and services from the private sector.

Denmark is the OECD country where public consumption expenditures constitute the largest share of GDP, *cf. figure 1.9b*.

Figure 1.9a
Public employment

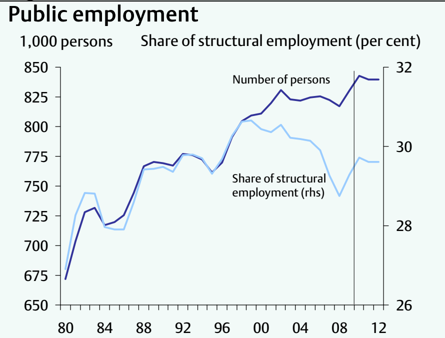
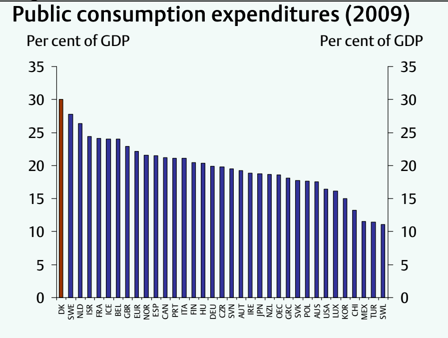


Figure 1.9b
Public consumption expenditures (2009)



Source: OECD. Own estimate for Denmark.

Structural deficit rises to 7 per cent of GDP if the growth in public consumption continues

It is a crucial assumption in the 2015 plan, which forms the overall framework for fiscal policy, that growth in public consumption will be more muted going forward. If public consumption from 2014 grows at the same pace as over the last 30 years (close to 1¾ per cent per year in real terms), the <u>structural</u> deficit will rise to up to 3 per cent of GDP (DKK 55 bn) in 2020 and 7 per cent of GDP (DKK 125 bn) in 2030, *cf. figure 1.10a*.

The growth in consumption could actually lead to an even more unsustainable path, since the high public deficits and debt would lead to higher interest rates, lower investments and GDP growth and increased public interest expenditures. The illustrated calculation therefore shows the direct effects of continued high growth in public consumption, even when it is assumed that the upswing in the Danish economy can be maintained and the cycle normalises towards 2015. The projection also assumes that the structural unemployment is kept stable at 3½ per cent of the labour force.

Figure 1.10a
Fiscal balance towards 2030 with real growth in public consumption in line with the last 30 years

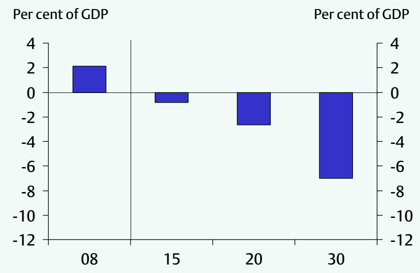
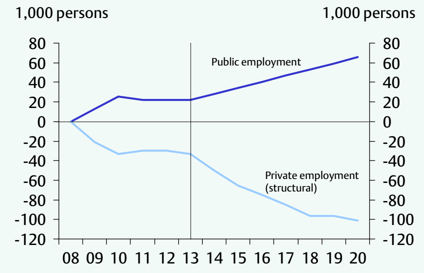


Figure 1.10b
Public and private employment with real growth in public expenditures as in last 30 years, change compared to 2008



Note: The projection in figure 1.10b reflects the forecast in *Economic Survey*, december 2010 and the Fiscal Consolidation Agreement up to 2013, and then a projection with growth in public consumption and public employment in line with average for 1980-2009. The projection is otherwise based on the Convergence Programme 2009.
Source: Own estimates.

A continuation of the growth in public consumption would also imply that the number of public employees continues to increase towards 2020, *cf figure 1.10b*. The private sector's prospects of recruiting labour and the companies' competitiveness would thus come under pressure. This is reflect the decreasing labour force up to 2020 (where the Welfare Agreement still has limited impact) and that the public sector will take up a rising share of the labour force. In the projection, which is clearly unsustainable, private employment drops by 100,000 persons from 2008 up to 2020 (structurally). This puts the financing of the welfare state under increased strain.

Even with more muted growth in public consumption, challenges are considerable

Both in the 2010 plan from 2001 and the current 2015 plan from 2007, a more moderate growth in public consumption has been a key objective. Even with structural balance in 2015 and slower real growth in public consumption of ¾ per cent in

2014-2015 and around 1 per cent (technical assumption) from 2016-2020, the deficit is set to rise in the longer term, *cf. Denmark's Convergence Programme 2009*.

The 2015 plan's target of long-term sustainability in public finances implies that public debt stabilises in the longer term, measured in per cent of GDP. The requirement of fiscal sustainability does not in itself put particular limitations on the profile of the fiscal balance over time, or at which level net debt in the longer term will stabilise. The criteria of long-term sustainability does for example not ensure that the fiscal balance and debt fulfils the requirements in the EU's Stability and Growth Pact and the convergence criteria for entering the euro area (fiscal deficit lower than 3 per cent of GDP and gross debt lower than 60 per cent of GDP).

On this background, the requirement of fiscal sustainability in the 2015 plan has been supplemented by a requirement of structural fiscal balance in 2015.

The prospect is, however, an underlying weakening of public finances for some decades after 2015 due to demographics and decreasing revenues from the energy-production in the North Sea, targets in the climate and energy policy etc. In the projection, the outlook is therefore set for rising deficits, debt and interest expenditures up to the middle of the century.

In the *Convergence Programme 2009*, the fiscal deficit rises to around 1 per cent of GDP in 2020 and close to 3 per cent of GDP in 2040, *cf. figure 1.11a*. At the same, fiscal net debt rises to close to 50 per cent of GDP in 2050, *cf. figure 1.11b*. Even in a projection with fiscal balance in 2015 and only half as high growth in public consumption compared to the last 20-30 years, there are still significant fiscal challenges over the next decades.

Figure 1.11a
Structural balance up to 2060

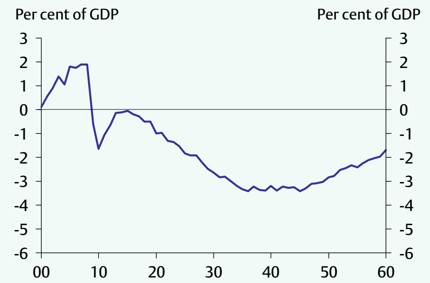
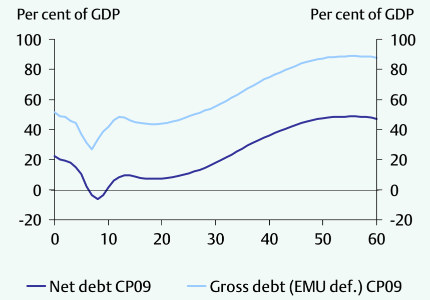


Figure 1.11b
Public gross debt (EMU definition) and net debt up to 2060



Source: Denmark's Convergence Programme, 2009.

Summary of the forecast

The Danish economy is on its way out of the crisis. In the 3rd quarter of 2010 real **GDP** increased for the fifth successive quarter, and GDP had grown by almost 4 per cent since the trough in the 2nd quarter of 2009. In the 3rd quarter growth was driven by exports, not least due to the high growth in Sweden and Germany, and by private consumption.

Indicators point to a moderate development in the 4th quarter and GDP is expected to grow by 2.0 per cent in 2010 following a fall of 5.2 per cent in 2009. In 2011 and 2012 growth is expected at 1¾ and 1½ per cent respectively, slightly more than the estimated potential growth rate of 1¼ per cent on average in the two years.

Growth is expected to become more self-sustained, so that growth in private production and demand increases, while consumption and investments in the public sector is restrained due to the necessary consolidation of public finances.

The estimated GDP-growth in 2010 has been adjusted upwards by 0.6 percentage points compared to the Economic Survey, august 2010, while the estimate for 2011 has been adjusted slightly downwards by 0.1 percentage points. The adjustment in 2010 is due to higher growth in business investments including inventories, as well as higher growth in exports and public consumption.

Households' real disposable **income** is projected to increase by 5¾ per cent in 2010, despite the reduction in labour force and employment, due to tax cuts, low interest rates, and a high annual adjustment of public income transfer rates. In 2011 real disposable incomes are expected to strengthen by 1½ per cent due to continued low interest rates and a stabilisation of the work force and employment. In 2012, a continued, moderate growth in incomes of ½ per cent is expected, due to growth in real wages. In both 2011 and 2012 higher taxes pulls in the opposite direction.

Due to rising incomes **private consumption** is projected to expand by 2¼ per cent both in 2010 and 2011, following a fall of 4½ per cent in 2009. The savings rate is expected to stop rising, and in 2012 private consumption is expected to grow by 1¾ per cent, which is slightly more than growth in incomes. Households' assets are estimated to have grown robustly in the course of 2010 due to a rise in stock prices and house prices. In 2011 and 2012 assets are expected to be broadly stable in real terms.

On the back of the sharp rise in incomes and the fall in interest rates, the price of **single-family houses** is expected to rise by 3 per cent in 2010 and 2 per cent in 2011 after falling by close to 13 per cent in 2009. In 2012, when interest rates are expected to rise moderately, prices of owner-occupied houses are expected to be stabile.

Residential investments are projected to fall by 13 per cent in 2010, primarily due falling investments in the course of 2009. The stabilization in the housing market and the current low level of new housing constructions, as well as an increase in subsidised housing is expected to lead to a moderate increase in residential investments of 1½ per cent in 2011 and 3 per cent in 2012. The residential investments reached a historical high level of just over 6½ per cent of GDP in 2007. The estimated level of residential investments in 2010 corresponds to the level in the mid-1990s. This reflects a high level of repairs and improvement of houses, while the level of new construction is very low.

Fixed business investments are projected to fall by just over 7 per cent in 2010, after dropping by almost 16 per cent in 2009. In 2011 and 2012, a 4-5 per cent increase is expected due to the rise in production in the private business sector and higher capacity utilisation.

Export market growth for Danish manufactures is expected at almost 7 per cent in 2010. This is 1½ percentage point higher than expected in the August Survey due to higher growth in key export markets like Germany and Sweden. In 2011 and 2012 market growth is expected at 6 per cent.

Competitiveness (measured by the difference in wage growth in Denmark and abroad adjusted for exchange rate fluctuations) is expected to have improved in 2010 due to the weakening of the real effective exchange rate, and then to be broadly unchanged in 2011 and 2012, following a quite large deterioration in previous years. Wage growth in the two years is expected to be close to the wage growth abroad.

On this background, **manufacturing exports** are expected to rise by 6 per cent in 2010, after falling by 13 per cent in 2009. Manufacturing exports is expected to grow by around 4½ per cent in both 2011 and 2012. The estimates imply a continued, but smaller loss of market shares following a significant loss of market shares in 2009. **Total exports** of goods and services are expected to increase in real terms by 4½ per cent in 2010 and almost 4 per cent in both 2011 and 2012, after falling by just over 10 per cent in 2009.

The turnaround in demand will lead to a rise in **imports** of goods and services by 3¾ per cent in 2010 and 4-4½ per cent in both 2011 and 2012, after falling by 12½ per cent in 2009.

The **current account** surplus is expected to be close to DKK 80 bn or 4½ per cent of GDP in 2010. In 2011, the surplus is expected to fall to DKK 69 bn (almost 4 per cent of GDP), and a similar surplus is expected in 2012. Compared to the August Survey, the estimated surplus in 2010 and 2011 has been revised upwards by DKK 17 and 8 bn respectively, due to higher growth in exports and an improvement in terms-of-trade.

Employment has broadly stabilised in 2010. On an annual basis employment is projected to decline by 54,000 persons (1.9 per cent) especially due to the decline in the course of 2009. Employment is expected to be unchanged in 2011 and then to rise moderately by 4,000 (0.1 per cent) persons in 2012. Productivity is expected to rise quite sharply in 2010 after declining in 2008-2009, and in 2012 a major share of the cyclical productivity loss from previous years are expected to have been caught up. This is important for the international competitiveness of Danish enterprises. Despite the significant cyclical recovery of productivity, the growth in productivity has been relatively weak since the mid-1990s.

The **labour force** is estimated to fall by 37,000 persons (1.3 per cent) in 2010, primarily due to the fall through 2009. The reduction of the labour force is partly explained by a (historical) tendency for young people to enter into the education system when job opportunities deteriorate, as well as a reduced number of foreign workers, and a rising number of elderly due to demographics. In 2011, the labour force is expected to rise by 6,000 persons (0.2 per cent), while it is expected to be stabile in 2012.

The estimated fall in employment and labour force in 2010 has been adjusted downwards by 30,000 (1.1 per cent) and 24,000 persons (0.8 per cent) compared to the August Survey due to a revision of the national accounts.

The **unemployment** has developed more favourably than expected, and the estimated annual average for the registered unemployment in 2010 has been revised downwards by 5,000 persons to 116,000 persons (4 per cent of the labour force), compared to 98,000 persons (3.4 per cent) in 2009. In 2011, registered unemployment is expected at 121,000 persons (4½ per cent), while the unemployment level in 2012 is expected to fall to the same level as in 2010. Gross unemployment (including people in activation measures) is also lower than previously expected, and the estimate has been adjusted downwards to 166,000 persons in 2010 and 172,000 persons in 2011 (close to 6 per cent of the labour force). Gross employment is expected to fall to 164,000 persons (5.7 per cent) in 2012. The estimates imply that unemployment starts falling in the first half of 2011.

Private sector **wage growth** is expected at 2.1 per cent in 2010 and 2.4 per cent in 2011 following 3.0 per cent in 2009 and 4.6 per cent in 2008. In 2012, wage growth is expected to increase to 2.7 per cent partly due to the slightly lower unemployment.

Consumer price inflation is estimated at 2.3 per cent in 2010, following 1.3 per cent in 2009. The rise in inflation in 2010 primarily reflects the rise in oil prices and higher indirect taxes as part of the financing of the tax reform. In 2011, consumer price inflation is expected to fall to 1.7 per cent due to lower contributions from indirect taxes and energy, and inflation is expected to be unchanged in 2012. Since June 2008, inflation has been higher in Denmark than in the euro area, and the difference has increased a little the last few months.

The **public finance** deficit is projected at 3.6 per cent of GDP in 2010. In 2011, the deficit is expected to rise to 4.7 per cent of GDP, while it is expected to fall to 3.4 per cent of GDP in 2012. The profile reflects large fluctuations in revenues from pension yield taxation, and adjusted for this, the deficit is gradually decreasing. The size of public deficits should be seen in light of the economic crisis in 2008-2009 and the expansionary fiscal policies in 2009 and 2010, as well as the consolidation of the public finances starting in 2011.

The estimated deficit in 2010 has been adjusted downwards by 1.0 per cent of GDP primarily due to higher revenue from pension yield taxation. For 2011, the deficit has been adjusted slightly upwards, by 0.3 per cent of GDP.

The **structural deficit** (cyclically adjusted and adjusted for temporary fluctuations in for example pension yield taxes and revenues from extraction of oil in the North Sea) is estimated at 1.9 per cent of GDP in 2010. The consolidation of the public finances is estimated to imply a strengthening of the structural balance to a deficit of 1.3 per cent of GDP in 2011 and 0.8 per cent of GDP in 2012. The structural balance is thus strengthened by around 1 per cent of GDP from 2010 to 2012, which corresponds to 2/3 of the required consolidation in the EU Council recommendation of an improvement of the structural balance by 1½ per cent of GDP from 2010 to 2013.

Public gross debt (EMU definition) stood at 41½ per cent of GDP by the end of 2009 and is expected to increase to 47 per cent of GDP by the end of 2012. **Public net** debt, including both assets and liabilities, is expected at 7¼ per cent of GDP by the end of 2012.

The expansionary **fiscal policy** in 2009 and 2010 works with rising strength into 2011 and will offset the effect of the fiscal consolidation in 2011. Adding to this is the effect of lower interest rates since 2008. The total growth contribution from fiscal policies, interest rates etc. since 2009 is estimated to 1¼ per cent in 2011. Included in this estimate is a negative contribution to growth from the fiscal consolidation in 2011 – measures by the one-year fiscal effect – of 0.3 per cent of GDP. In 2012, when growth is expected to become more self-sustained, the total contribution from fiscal policies and changes in interest rates, is expected at -¾ per cent, one-third of which stems from higher interest rates.

Table1.2

Key figures for the Danish economy

	2007	2008	2009	2010	2011	2012
Percentage change from previous year						
Real GDP	1.6	-1.1	-5.2	2.0	1.7	1.5
Trade-weighted GDP abroad	2.8	1.3	-0.4	2.4	2.1	2.2
Markets for Danish manufactures	8.3	1.6	-10.7	6.9	5.8	6.3
International competitiveness	-3.5	-3.7	-3.8	3.0	-0.2	-0.1
Export of manufactures, volume	2.2	4.6	-13.0	5.9	4.5	4.7
Hourly wages	4.1	4.6	3.0	2.1	2.4	2.7
Consumer price index	1.7	3.4	1.3	2.3	1.7	1.7
Price index for single-family houses	4.9	-3.7	-12.8	3.0	2.0	0.0
Merchandise export prices	2.2	7.1	-6.1	4.6	2.2	1.6
Merchandise import prices	1.8	6.6	-9.0	4.8	2.9	1.7
Merchandise terms of trade	0.5	0.4	3.2	-0.1	-0.7	-0.1
Productivity in private non-agricultural sector	-0.1	-1.9	-2.4	4.9	3.5	2.8
Real disposable income of households[1)]	-0.8	0.5	0.7[2)]	5.8	1.6	0.5
Labour market						
Labour force (thousands)	2,939	2,960	2,922	2,885	2,891	2,889
Employment (thousands)	2,861	2,909	2,824	2,769	2,770	2,774
Of which in private sector	2,038	2,097	1,994	1,927	1,930	1,934
in public sector	823	812	830	843	840	840
Percentage change in total employment	2.8	1.7	-2.9	-1.9	0.0	0.1
Gross unemployment (thousands)	103	74	131	166	172	164
Unemployment (thousands)	78	52	98	116	121	116
Unemployment rate (per cent)	2.7	1.7	3.4	4.0	4.2	4.0
Unemployment rate, EU-def. (per cent)	3.8	3.3	6.0	7.4	7.4	7.2
Long term bond yields, exchange rate						
10-year government bonds	4.3	4.3	3.6	2.9	3.4	4.0
30-year mortgage credit bond	5.4	6.1	5.5	4.5	4.9	5.5
The effective krone rate (1980=100)	103.2	105.8	107.8	104.1	104.2	104.2
Balance of payments						
Goods and services (bn DKK)	38.7	55.2	63.2	90.9	88.0	90.9
Current account (bn DKK)	23.0	46.2	59.0	79.0	69.0	71.1
Current account (per cent of GDP)	1.4	2.7	3.6	4.5	3.9	3.8
Net foreign assets. ultimo (bn DKK)	-96.0	-104.3	74.3	165.6	235.3	307.1
Net foreign assets (per cent of GDP)	-5.7	-6.0	4.5	9.5	13.1	16.6
Public finances						
Government net lending (bn DKK)	81.4	56.9	-46.5	-62.6	-83.9	-62.5
Government net lending (per cent of GDP)	4.8	3.3	-2.8	-3.6	-4.7	-3.4
General government gross debt, year-end, (bn DKK)	462.8	593.8	688.1	752.8	785.3	868.3
General government gross debt, year-end, (per cent of GDP)	27.3	34.1	41.5	43.3	43.8	47.0
Tax burden (per cent of GDP)	49.1	48.2	48.2	48.1	46.4	47.0
Expenditures (per cent of GDP)	50.0	51.0	57.2	57.3	56.6	55.7

1) Adjusted.
2) Including the disbursement of SP-savings, real disposable income grew by 4.5 per cent in 2009.

Table 1.3

Key figures compared to the August Survey

	2010		2011		2012
	Aug.	**Dec.**	**Aug.**	**Dec.**	**Dec.**
Percentage change from previous year					
Private consumption	2.5	2.2	2.2	2.2	1.8
Total public demand	1.8	1.6	-0.6	0.5	-0.4
- public consumption	0.0	1.0	0.6	-0.3	0.3
- public investment	25.9	9.4	-13.5	9.4	-8.1
Residential construction	-8.2	-13.0	1.5	1.5	3.0
Fixed business investments	-8.2	-7.3	5.0	5.0	4.1
Final domestic demand	0.6	0.6	1.6	1.9	1.4
Stock building (cont. to GDP growth)	1.0	1.4	0.4	0.1	0.1
Total domestic demand	1.4	1.6	2.0	1.9	1.5
Exports of goods and services	3.0	4.5	3.9	3.8	3.9
- of which manufactures	4.0	5.9	4.5	4.5	4.7
Total demand	2.0	2.6	2.6	2.6	2.3
Imports of goods and services	3.2	3.7	4.4	4.4	4.2
- of which goods	3.0	4.0	4.0	4.1	3.7
GDP	1.4	2.0	1.8	1.7	1.5
Gross value added	1.3	1.6	1.8	2.0	1.6
- of which private sector	2.2	2.1	2.8	3.4	2.6
Change in 1,000 persons					
Labour force	-61	-37	6	6	-1
Employment	-84	-54	2	0	4
Of which in private sector	-86	-67	1	3	4
in public sector	2	13	1	-3	0
Unemployment	23	18	4	6	-6
Growth, per cent					
Merchandise export prices	3.7	4.6	2.2	2.2	1.6
Merchandise import prices	3.4	4.8	2.4	2.9	1.7
Merchandise terms of trade	0.3	-0.1	-0.2	-0.7	-0.1
House prices, single-family house	0.7	3.0	2.0	2.0	0.0
Consumer prices	2.2	2.3	1.7	1.7	1.7
Hourly compensation, private sector	2.2	2.1	2.4	2.4	2.7
Real disposable income, private sector	3.1	3.2	2.8	3.2	0.4
Real disposable income of households	5.9	5.8	2.5	1.6	0.5
Productivity in private non-agricultural sector	5.9	4.9	2.7	3.5	2.8
Per cent per year					
Interest rate 1-year flex loan	1.2	1.3	2.2	1.7	2.3
10-year government bonds	3.2	2.9	3.6	3.4	4.0
30-year mortgage credit bond	4.7	4.5	5.3	4.9	5.5
Balances					
Current account (bn DKK)	62.0	79.0	61.4	69.0	71.1
Government net lending (bn DKK)	-80.1	-62.6	-78.7	-83.9	-62.5
External assumptions					
Trade-weighted GDP abroad, per cent	1.8	2.4	2.1	2.1	2.2
Markets for Danish manufactures, per cent	5.3	6.9	5.8	5.8	6.3
Exchange rate, DKK per $	5.7	5.6	5.8	5.4	5.4
Oil price, $ per barrel	77.0	79.2	80.6	89.2	93.1