

NEWS FROM NATIONALBANKEN

TIGHTER FISCAL POLICY IS REQUIRED

The Danish economy is recovering, and continued growth and increased employment are expected in the coming years. But if this development is to be sustained in the longer term, fiscal policy should be tightened now. That is the assessment of Danmarks Nationalbank in its most recent projection of the Danish economy until the end of 2017.

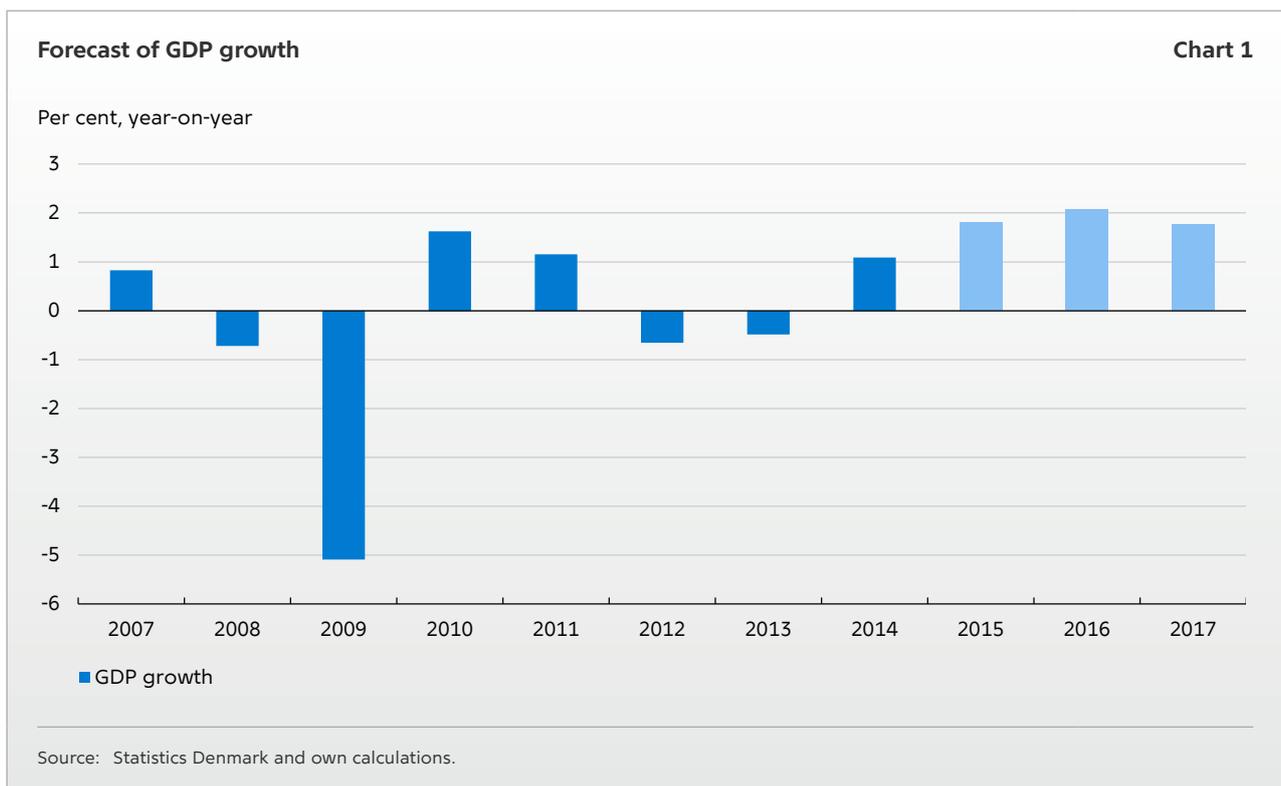
The need for tightening is accentuated because the government's most recent forecast indicates

that the state of the public finances is worse than anticipated.

In the projection, GDP growth in 2015 is adjusted downwards slightly due to the somewhat weaker development in especially exports and

Chart 1

Spare capacity remains in the economy. But the upswing is ongoing and hence it is time for fiscal policy tightening



private consumption in the 2nd quarter, but the outlook for the Danish economy basically remains unchanged. Low interest rates, low oil prices and a lower effective krone rate will contribute to driving private consumption and exports in the coming years. That is what Danmarks Nationalbank predicts, and consequently its expectations for GDP growth in 2016 and 2017 are maintained at approximately 2 per cent, cf. Chart 1.

The labour market is also picking up. More people have found employment over the last two years, and this development is expected to continue with 97,000 more persons finding jobs from 2014 to 2017. With such an increase in employment, spare resources in the labour market will be limited, and this makes demands on economic policy.

TIME FOR TIGHTENING

With the prospect of continued growth in the coming years and a strong labour market, Danmarks Nationalbank maintains its recommendation for fiscal policy tightening. Although there are still spare resources in the labour market, and wages may increase more than is the case today, the economy will reach a normal level in 2017. The decision has to be made now if the changes in fiscal policy are to have an impact by that time.

The need for fiscal policy tightening is accentuated by the fact that the government's forecast for the structural budget now indicates a larger deficit than previously expected. The structural budget is the difference between government revenue and expenditure adjusted for cyclical fluctuations and other temporary factors such as taxes related to pension yields and natural re-

source production in the North Sea. According to the Budget Act, the structural budget may not exceed 0.5 per cent of GDP, but in the government's forecast it is estimated at 0.9 per cent in 2015.

Danmarks Nationalbank recommends gradually eliminating the structural deficit to ensure that fiscal policy does not stimulate the economy. At the same time, Danmarks Nationalbank encourages that the budgeted fiscal policy be maintained to prevent the structural budget from sliding after the presentation of the Finance Bill, as it has done in the past two years.

If the tightening measures are implemented too late, there is a risk that the economic upswing will become too strong and thus be followed by a sharp decline. We saw that in Denmark in the mid-2000s, when economic policy was not tightened in time, productivity could not keep up with the pace of wage increases, and there were clear indications of labour shortages and high industrial capacity utilisation. This amplified the economic downturn after the financial crisis and led to a strong decline in employment.

A key condition for keeping the upswing on track is that Danish firms have access to qualified labour, including from abroad if the skills required are not readily available in the Danish market. The unemployment benefit and pension reforms have already resulted in more people remaining on or entering the labour market. While the reforms need time to take full effect, it is also important that new reforms focus on ensuring an increased labour supply in the future.

For further information, see the article 'Current Economic and Monetary Trends' in the Monetary Review, 3rd Quarter 2015.

INCREASING DIFFERENCES IN HOUSING TAXES ACROSS THE COUNTRY

In the Copenhagen area, where house prices have risen considerably in recent years, housing taxes have not increased correspondingly. Relative to the property values, home-

owners are currently paying substantially less in Copenhagen than in other parts of Denmark, where price increases have been more moderate.

That is the conclusion of an analysis by Danmarks Nationalbank of variations in homeowners' real housing tax rates across Denmark.

The analysis focuses on the effective property value tax – i.e. tax payment relative to what the property is actually worth.

The result is very clear: while homeowners in the Copenhagen area get off with paying taxes of 3.8 per thousand of the property value on average, those living in western and southern Zealand must pay 6.8 per thousand, cf. Chart 2.

For example, a homeowner in Copenhagen will typically pay less in property value tax than a homeowner in western or southern Zealand, even though they both own homes with a value of kr. 2 million. With an original property value tax rate of 1.0 per cent in 2002, the property value tax for the home in Copenhagen amounts to approximately kr. 11,500, while the tax in western and southern Zealand is around kr. 17,500. The only reason why the homeowner in Copenhagen pays kr. 6,000 less is that the home in Copenhagen was worth substantially less in 2002 when a freeze was put on the property value tax. Since 2002, house prices

in Copenhagen have risen by 75 per cent, thereby eroding tax payments compared with western and southern Zealand, where house prices have increased by 14 per cent.

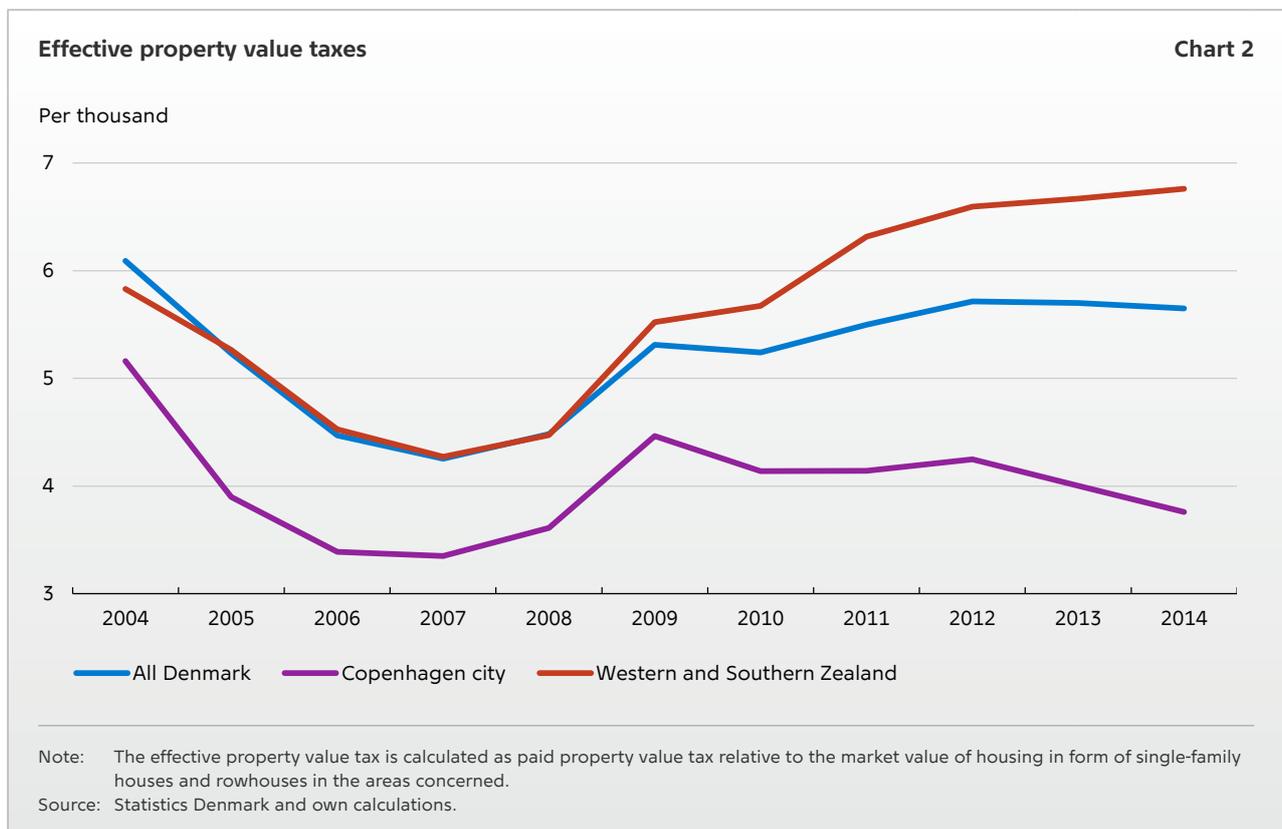
A CAUSE OF INSTABILITY

The mechanism behind this development is simple: in 2002, a freeze was put on property value tax. Therefore, the size of tax payments does not keep up with the market. So the more prices rise, the lower the tax will be relative to the value, and vice versa: taxes make up a higher share of the value where prices are stable or even declining.

As a consequence, the property value tax itself contributes to amplifying fluctuations in the housing market. The more a property is worth, the lower the tax relative to the property value, which in turn contributes to increasing the property value further. Danmarks Nationalbank assesses

Chart 2

The effective housing tax rates are rising in the Danish regions with the weakest growth in house prices. Conversely, the fall was most pronounced in the regions with the strongest price increases during the housing bubble in the mid-2000s.



that this particular mechanism contributed to the development of an actual housing bubble in the period 2005-2007.

At the same time, the assessment is that the probability that it may happen again is higher as long as properties continue to be taxed independently of their actual value.

Unfortunately the risk of a new bubble is also amplified by the other element of housing taxes, i.e. the land tax.

This does not mirror price developments either, albeit for other reasons: the well-known technical problems of the value-assessment system itself, and the rule that the Folketing (Danish Parliament) sets a cap on the maximum increase in land taxes every year. This curbs taxes in those areas – especially Copenhagen, northern Zealand and larger cities – where the rise in land values is most pronounced.

HIGHER PRICE INCREASES

Over the last year, house prices have soared. On average, the price of single family houses has

risen by 6 per cent, while the figure for owner-occupied flats is 10 per cent.

This should be viewed in the light of the low level of interest rates and the upswing in the Danish economy. Price increases have been particularly strong in the Copenhagen area. In Danmarks Nationalbank's assessment, there is a risk that price increases have become self-reinforcing, meaning that they are very much determined by expectations of even higher prices in the future.

Consequently, Danmarks Nationalbank recommends that housing taxes be changed so that the tax payable increases when property values rise and decreases when values fall. This would help support stability in the housing market and thus in the economy overall. Whether the overall housing taxes are to be higher or lower is a political priority.

For further information see the article 'Recent developments in the Housing Market' in the Monetary Review, 3rd Quarter 2015.

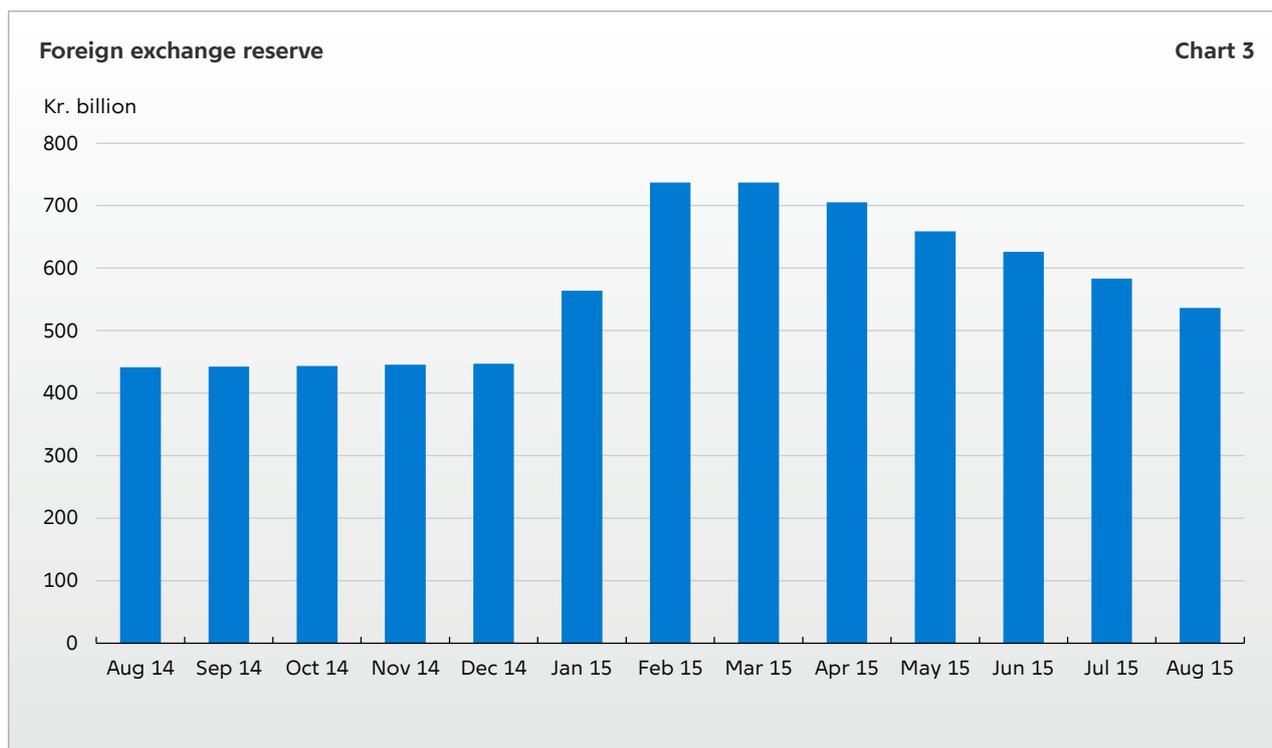
THE FOREIGN EXCHANGE MARKET IS RETURNING TO NORMAL

Following the strong pressure on the krone at the beginning of the year, the foreign exchange market has been gradually normalised in recent months. Since March, Danmarks Nationalbank has sold foreign exchange in the market for a considerable amount, and as from October, government bonds will be issued again.

Danmarks Nationalbank's monetary policy has one clear purpose: keeping the krone stable against the euro. In order to keep the exchange rate of the krone stable, Danmarks Nationalbank intervened in the foreign exchange market by selling kroner for a historically large amount in connection with the pressure on the krone. At the same time, the key monetary policy interest rate, the rate of interest on certificates of deposit, was reduced in increments to minus 0.75 per cent,

which is unusually low. Finally, the sale of government bonds was suspended, leaving a smaller product range for those who wanted to purchase Danish kroner in the form of government securities.

These unusual steps were necessary in the unusual situation, and they had the desired effect: The krone remained stable close to its central rate, and the interest in purchasing kroner began to taper off towards the end of February. Subsequently, the situation in relation to the krone has gradually normalised, and the sectors that had purchased kroner at the beginning of the year have generally been selling in the ensuing months. Against this backdrop, Danmarks Nationalbank sold foreign exchange in the market for kr. 191 billion until and including August. While



there was a rapid increase in the foreign exchange reserve during the pressure on the krone, the subsequent adjustment took place at a more measured pace, cf. Chart 3.

Alongside the normalisation of the foreign exchange market, steps have been taken towards normalising monetary policy. The Ministry of Finance has consequently decided – on the recommendation of Danmarks Nationalbank – to start issuing government bonds again as from October 2015. At the same time, the limits on the deposits banks are allowed to make in their current accounts with Danmarks Nationalbank have been reduced after they were temporarily increased during the pressure on the krone. At present, the current account interest rate is 0.0 per cent, which is higher than the rate of interest on certificates of deposit. It is therefore natural that the banks prefer to place their liquidity in their current

Chart 3

The foreign exchange reserve increased rapidly during the pressure on the krone in January and February. It has subsequently fallen at a somewhat more measured pace.

accounts. But in order to ensure that the rate of interest on certificates of deposit remains the key interest rate, the banks must place a sufficient amount of their liquidity in certificates of deposit rather than keeping it in current accounts.

Developments since January have shown that Danmarks Nationalbank has the necessary tools to defend the fixed exchange rate policy, whether the pressure on the krone goes one way or the other.

For further information, see the article 'Current Economic and Monetary Trends' in the Monetary Review, 3rd Quarter 2015.

