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OUTLOOK FOR THE DANISH ECONOMY — MARCH 2021

Prospects of a rapid recovery once restrictions are eased

New lockdowns have hit the economy

The second wave of infection and new lockdowns have temporarily interrupted economic recovery and resulted in a new large loss of activity in large parts of the Danish and international economies during the winter. In other parts of the economy activity is high, for example in construction and the housing market.

Sound basis for rapid recovery

Vaccination of the population and reopening of society have begun. Large savings, disbursement of holiday pay funds and pent-up demand provide a sound basis for a sharp increase in activity when the economy is less constrained by restrictions. Activity is expected to have recovered towards the end of 2021.

The government must be ready to use both accelerator and brake

Great uncertainty still characterises the economic development, which may be markedly stronger or weaker than projected. It is therefore important to be ready to tighten or ease the planned fiscal policy.

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Highlights

GLOBAL ECONOMY

Increasing infection rates and new restrictions have resulted in a new decline in global activity over the winter and have delayed recovery. Compared with the first wave of infection, the restrictions in many countries have been more targeted this time, and global activity is therefore less severely affected.

DANISH ACTIVITY

The Danish economy has been hampered by restrictions, which have largely been just as extensive as those imposed last spring. Household consumption of services has especially been curtailed by the restrictions, while activity in the production industries has been less affected.

LABOUR MARKET

The latest lockdown of the economy has resulted in new decreases in employment and increased unemployment as well as an increase in the number of persons receiving wage compensation. However, the weakening of the labour market is significantly more subdued than in spring 2020.

HOUSING MARKET

Housing market activity is high. This has resulted in a marked decline in the number of homes for sale and a heavy increase in house prices. The increase is generally supported by low interest rates and rising incomes, but increased demand due to the pandemic also plays a role. There is considerable uncertainty about the future housing market development, which is being monitored closely.

GROWTH OUTLOOK

GDP is projected to increase by 1.4 per cent this year. The increase is kept down by the very low activity level in the 1st quarter of the year. Activity is expected to pick up sharply during the year as the population is being vaccinated and the economy is reopening. Aggregate activity is expected to have recovered towards the end of 2021.

RISK OUTLOOK

The pandemic still dominates the risk outlook, and the projection is based on a number of specific assumptions about the reopening. However, new spread of infection may prolong the period with significant restrictions. Conversely, a quicker normalisation of consumption and saving patterns in Denmark and abroad may cause activity to increase more sharply than expected.

Key economic variables

Real growth relative to the previous year, per cent	2020	2021	2022	2023
GDP (real), per cent	-3.3	1.4	4.5	2.2
Employment, 1,000 persons	2,981	3,000	3,014	3,035
Gross unemployment, 1,000 persons	132	126	121	118
Current account, per cent of GDP	7.3	6.9	6.7	7.0
Government balance, per cent of GDP	-1.6	-4.0	-1.3	-0.9
House prices[1], per cent year-on-year	4.3	9.7	3.0	2.3
Consumer prices, per cent year-on-year	0.4	1.1	1.2	1.6
Hourly wages[2] (manufacturing), per cent year-on-year	2.2	2.2	2.5	2.8

Source: Statistics Denmark and own calculations.
1. Nominal prices of single-family houses.
2. Statistics Denmark's implicit wage index.

> "Broad fiscal stimulus is inexpedient while there are restrictions. It may increase the pressure in those parts of the economy where activity is already high

Outlook and economic policy

New temporary decline in activity
The Danish and international economies have again been hit by fears of infection and severe restrictions that have hampered economic activity during the winter. In Denmark, the infection has been brought down again and a gradual reopening of the society has begun. Early indicators such as card turnover indicate that activity will increase rapidly when restrictions are relaxed.

The lockdown during the winter has led to a marked decline in total activity in the 1st quarter of 2021. In Denmark, household consumption has again been curtailed by restrictions, which largely were just as restrictive as in mid-March last year. However, card turnover has remained at a higher level than during the first lockdown, and unemployment has only seen a modest increase, see Chart 1.

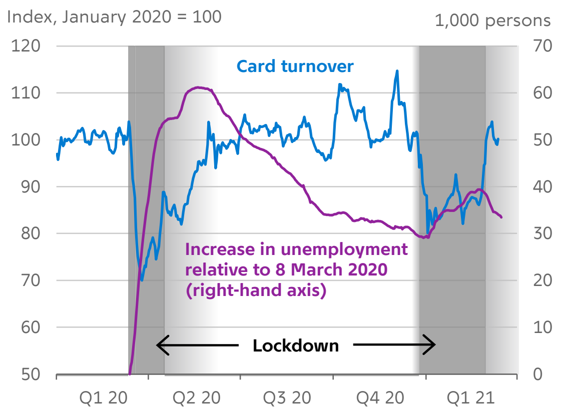
Danish exports of goods and shipping have also been least affected relative to spring last year. Restrictions abroad do not hamper foreign production and demand to the same extent as during the first wave of infection. Thus, foreign manufacturing industry and global trade in goods have in general increased continually during the recent wave of infections.

However, the emergence of virus mutations prolonged lockdowns in Denmark and abroad, and a larger part of the 1st quarter has been affected by severe restrictions than was the case during the first lockdown in the 2nd quarter of 2020. Based on a number of real-time indicators, GDP is projected to drop by between 3.5 and 4 per cent in the 1st quarter of 2021.

Multiple-speed economy
The restrictions imposed in response to the latest wave of infection have resulted in a multiple-speed economy. This pattern is also seen in many other countries. In some parts of the economy, activity is severely hampered by restrictions or fear of infection. This applies particularly to tourism and the contact-intensive service industries. With the severe restrictions in force since the turn of the year, large parts of the retail trade were also shut down, see Chart 2. In other parts of the economy, however, activity has either returned to or exceeded the pre-pandemic level. This applies to, for example, the

Activity is less affected by new lockdown, but is subdued for longer

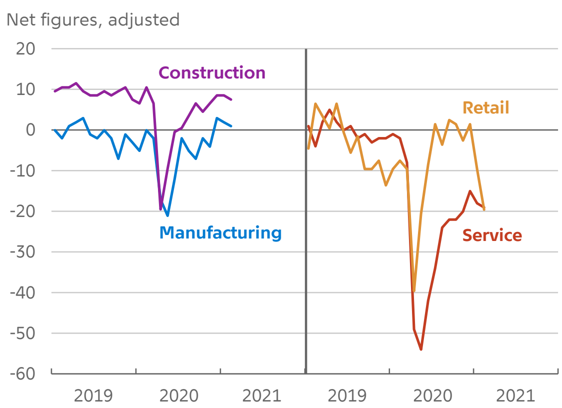
Chart 1



Note: Data are seasonally adjusted and with a seven-day moving average. Card turnover is seasonally adjusted using a regression model. Number of registered unemployed persons is seasonally adjusted with a course based on the average relative development in the number of registered unemployed persons in 2019.
Source: Nets Denmark A/S, Danish Agency for Labour Market and Recruitment and own calculations.

Retail and service particularly hard hit by second lockdown

Chart 2



Note: The tendency surveys of the industries are scaled in relation to their historical averages since 2000 = 0.
Source: Statistics Denmark, Eurostat and own calculations.

supermarket sector, the IT industry and parts of the manufacturing industry. There is also high demand in construction.

The housing market is also characterised by high demand. Here, high trading activity has resulted in a sharp decrease in the number of homes for sale and heavy price increases for both single-family houses and owner-occupied flats. A similar trend is seen in other countries. In Denmark, the price increases can largely be explained by the development in underlying conditions, including incomes and interest rates, and the housing burden remains low.

The asymmetrical activity level across industries is also evident in the labour market, where employment is low in transport, hotels, restaurants and culture. However, in construction employment is higher than before the pandemic and an increasing number of construction companies is reporting a shortage of labour.

Sound basis for recovery to take off once restrictions are eased

Activity increased rapidly in line with restrictions being lifted last year, and early indicators suggest that this will also be the case this time. Thus, card turnover has increased significantly after the partial reopening early March, and there is a good chance that activity will increase further as more restrictions are removed.

Firstly, several effective vaccines have been approved, and vaccination of the population is in progress in Denmark and abroad. The Danish authorities currently expect that all Danes who want a vaccine will have been vaccinated during the summer.

Secondly, the financial markets have been less affected by the second wave of the pandemic and the new restrictions relative to spring 2020. Interest rates remain low, and the markets expect them to remain low in the coming years.[1] This ensures low financing costs, which supports activity and the recovery.

Thirdly, compensation schemes and a favourable labour market development in the past six months have buoyed household incomes, and their disposable income has increased. In addition, a subdued consumer price development has contributed to a further strengthening of household purchasing power. The disbursement of the last weeks of holiday pay funds during the spring provides an additional activity boost.

Fourthly, household wealth has increased. The reason for this is twofold: firstly, as a result of price increases in both the equity and housing markets, and secondly due to limitations of household consumption opportunities in the past year having resulted in large involuntary savings.[2] With these savings, an accumulated demand can quickly be converted into increased consumption once restrictions and fear of infection hamper the economy to a lesser extent.

Prospects of rapid recovery during 2021

Activity is expected to pick up in the coming months in line with an expected lifting of the restrictions. It is assumed in the projection that most of the restrictions in Denmark will have been lifted during the 2nd quarter, when, according to the health authorities' plan, large parts of the population are expected to have been vaccinated, and the spread of infection is thus expected to have been heavily reduced. This will increase household consumption, and household savings and consumption patterns are expected to bounce back to their pre-pandemic level during 2022.

In turn, Danish export markets are expected to see a more gradual recovery, including as a result of a slower vaccine rollout abroad. This affects exports and thus investments. It is, in particular, expected to take time for the tourism industries to return to their pre-pandemic level. Recovery in domestic demand will gradually boost imports. As demand will recover more quickly domestically than abroad, the balance of payments surplus is expected to fall slightly this year.

Overall, real GDP growth is projected to be 1.4 per cent this year, rising to 4.5 per cent in 2022 and 2.2

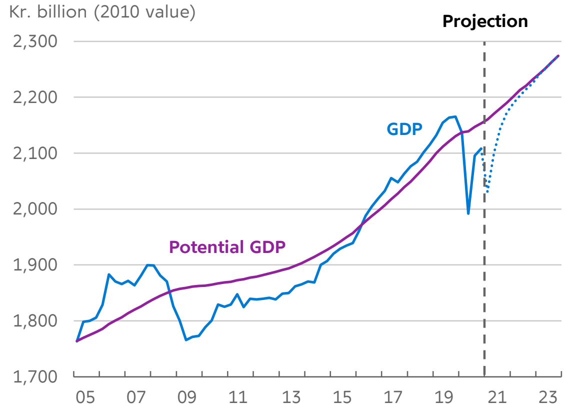
1 See Danmarks Nationalbank, Accomodative financial conditions support the real economy, *Danmarks Nationalbank Analysis (Monetary and financial trends)*, No. 6, March 2021.

2 See Svend Greniman Andersen, Nicolai Risager Christensen and Rasmus Mose Jensen, High savings during corona were driven by restrictions rather than precautionary consumers, *Danmarks Nationalbank Economic Memo,* No. 2, February 2021 (memo available in Danish only).

per cent in 2023. The projection entails that overall activity will be back to the pre-pandemic level towards the end of 2021, see Chart 3. However, there will still be a slight lag in relation to the output potential, which is compatible with a stable price development. The output gap is not expected to have been closed until 2023, when the economy will thus have recovered from the recession. This development presupposes both that the extended lockdown has not significantly impacted the output potential and that the labour force quickly moves to where the demand pressure makes itself felt most sharply during the reopening.

Prospects of rapid recovery during 2021

Chart 3



Note: *Potential GDP* is the long-term level of sustainable real output in the economy without creating inflationary pressures.
Source: Statistics Denmark and own calculations.

Employment is expected to increase by about 50,000 persons from the 4th quarter of 2020 until the end of 2023 as activity gradually increases, while unemployment will decline by approximately 10,000 persons. The increase in employment is supported by reforms already adopted, which will gradually increase the labour force, including indexation of the statutory retirement age.

A more subdued development is expected in the housing market, where house prices will increase in line with incomes. Mortgage rates have risen since the turn of the year, which could dampen price increases. In addition, household consumption patterns are likely to return to the pre-pandemic pattern to a great extent in line with the economy again functioning without restrictions. However, a more permanent shift in housing demand cannot be ruled out.

Economic outlook is characterised by great uncertainty

The economic development is still characterised by great uncertainty. However, the risk outlook is more balanced now than before due to, in particular, the approval of several effective vaccines and the EU-UK trade agreement, which has reduced uncertainty about Brexit.

However, recovery may still be slower than expected. Activity is still strongly affected by the development in infection. The resurgence of infection or the emergence of new virus mutations that are more contagious, more difficult to treat (and more lethal) and/or resistant to vaccines poses a significant risk of the current restrictions being extended or new measures being introduced.

The number of bankruptcies and liquidations has been low in the past year relative to the scale of the economic downturn. Public relief packages in the form of liquidity measures and compensation schemes have contributed to this. However, the lockdown is a drain on corporate equity. The longer corporations remain shut down by restrictions, the greater the risk that otherwise healthy corporations will enter into liquidation proceedings and that unemployment will rise. The costs to society from the lockdown will therefore increase over time, and there is a risk of the costs of a long lockdown being very high.

The economic downturn and fiscal policy measures have significantly increased public debt across countries. Many countries already had high central government debt before the pandemic. If there is a lack of confidence in the long-term sustainability of public finances in these countries, this could lead to rising risk premiums and an inexpedient tightening of fiscal policy.

The recovery may also be stronger than expected, both abroad and in Denmark: Household savings have risen to historically high levels in Denmark and many other countries. If consumption and savings patterns normalise earlier than expected, this could significantly boost activity growth. A rapid rollout of vaccines globally may also increase the rate of recovery. Finally, large fiscal policy packages in, for example, the United States may give significant impetus to activity globally. Both in Denmark and abroad, a sharp increase in demand may lead to temporary capacity pressure in some industries and a subsequent uneven economic cycle. The risk of capacity pressure increases if labor market adjustment is sluggish.

The housing market development is also characterised by great uncertainty. One reason for the uncertainty is the current low interest rate environment, in which a given interest rate increase will result in a relatively larger increase in the debt service on a housing loan than if interest rates were higher. This may increase interest rate sensitivity in the housing market. In addition, households' increased attention to their housing needs during the pandemic may have led to more permanent changes in housing demand towards, for example, larger homes, which may buoy price increases for an extended period of time. This will increase the risk that the housing market price formation will also be driven more by self-reinforcing expectations of future price increases, resulting in possible abrupt price corrections. The market for owner-occupied flats in the large cities is particularly vulnerable, as prices were already high before the pandemic in this part of the housing sector.

Important to be ready to tighten or ease planned fiscal policy

To support Danish corporations and employees, a number of temporary relief packages have been reintroduced during the period with restrictions. The relief packages reduce the risk of the temporary lockdown resulting in a more prolonged economic downturn. However, the support schemes are expensive and hamper the business dynamics that result in growth of competitive corporations and closures of less productive corporations. It is therefore important that the support schemes are phased out in line with the reopening of society, as was also the case during last summer.

The large-scale lockdown and the support schemes result in temporary hibernation of parts of the economy. This is possible for a limited period of time, but the costs of the lockdown are high and increasing over time. If the lockdown lasts for a very long period, this may result in the liquidation of many corporations, rising unemployment and a large drop in demand. In such case, there may be a need for a much more accommodative fiscal policy in the coming years.

Economic policy

The temporary support for corporations and households that are affected by restrictions should be phased out in line with the restrictions being eased.

Broad fiscal policy stimulus is inexpedient as long as the economy is subject to restrictions. This may result in an uneven economic cycle across industries.

Great uncertainty still characterises the economic development, which may be markedly stronger or weaker than projected. It is therefore important to be ready to tighten or ease the planned fiscal policy.

However, general fiscal policy stimulus is inexpedient as long as the economy is subject to restrictions. The easing will only be of limited benefit to the industries in which activity is hampered by restrictions. Conversely, the easing may result in capacity pressure and the build-up of imbalances in those industries in which activity is already high, for example construction. Broad fiscal policy stimulus should therefore wait until the economy is subject to fewer restrictions, and fiscal policy should only be eased if necessary.

Recovery may be both significantly slower or quicker than expected, and it is therefore important to be ready to make fiscal policy adjustments, i.e. to be ready to both tighten or ease the planned fiscal policy depending on the rate of recovery. Capacity pressure may especially occur in those parts of the economy where activity is already high. Targeted measures may therefore be necessary to reduce the pressure in these industries. In the construction industry, this may, for example, be an abolition of the Housing Job Scheme ('*BoligJobordningen*') .

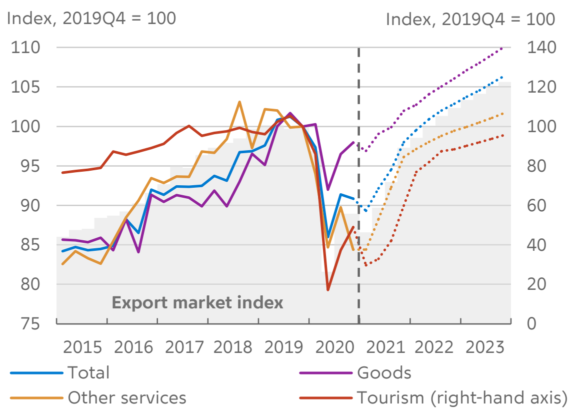
Danish economy – trends

Danish exports less affected by new lockdowns abroad during winter

The global economic downturn hit Danish exports hard in 2020. Overall, exports fell by 8.5 per cent in terms of volumes, and especially exports of services have been impacted by the economic downturn, see Chart 4. The risk of infection and stringent travel restrictions across countries throughout most of the year resulted in a marked drop in tourism, which was 50 per cent down in the 4th quarter against the same quarter of the previous year.

Danish exports of goods also fell in 2020, but significantly less than exports of services. The main reason for this is that global trade in goods has been less affected by the pandemic, but the composition of Danish exports of goods is also a factor. To a large extent, Danish exports of goods consist of products that are less sensitive to fluctuations in foreign activity, including agricultural products, pharmaceuticals and green technologies.[3] The composition means that the decrease in Danish exports of goods was significantly lower than in many other countries.

Exports of services severely affected by pandemic Chart 4



Note: Exports in volumes. *Export market index* covers imports of goods and services in volumes among Danish trading partners.The development up to 2020 is based on the OECD's *Economic Outlook*.
Source: Statistics Denmark and own calculations.

The new lockdowns in Danish export markets hit exports in the 1st quarter, but there is much to suggest that the effect is lower than during the first lockdown last spring. The confidence indicators point towards continued progress in global commodity trading, and manufacturing industry export orders have not dropped to the same extent as in spring 2020. The many goods that are still freighted between the continents are expected to buoy Danish shipping. However, tourism exports will remain in a slump until travel restrictions and behaviour in both Denmark and abroad have normalised. This may have longer prospects and, in the projection, tourism exports have been projected to remain 5 per cent below the level in the 4th quarter of 2019 at the end of 2023, one reason being slower vaccine rollout abroad and another being that more extensive use of digital meetings may have put a damper on, for example, business trips.

Restrictions on consumption, lower corporate investments and production shutdowns abroad also made themselves felt on imports in 2020, which fell by about 6 per cent. However, imports of goods recovered quickly in line with an increase in demand during the year, and in the 4th quarter imports of goods, excl. energy, ships and aircraft, were 5 per cent up on the same quarter in 2019. Consumption restrictions have, in turn, put a damper on imports in the 1st quarter of 2021. However, imports are expected to pick up again in line with the reopening of the economy boosting demand.

The current account surplus fell to 7.3 per cent of GDP in 2020, primarily as a result of a lower service trade surplus, see Chart 5. Especially construction services and other business services dragged down the surplus. However, the development is

3 See Adrian Michael Bay Schmith and Helle Eis Christensen, Large drop in Danish exports, but the composition might ease the fall, *Danmarks Nationalbank Economic Memo*, No. 8, June 2020 (memo available in Danish only).

not unambiguously related to the pandemic, as net revenues from these services also decreased before the outbreak of the pandemic. The current account surplus is expected to remain high until the end of 2023.

Prospects of significant increase in consumption

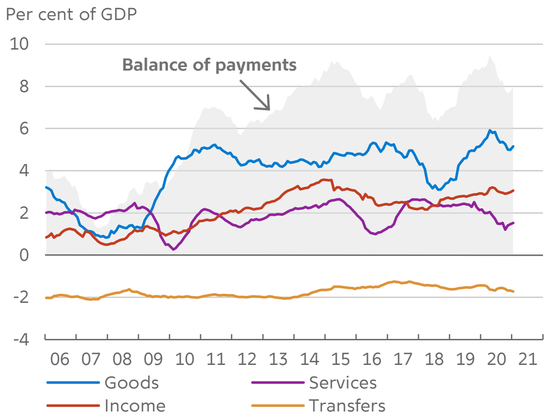
Consumption recovered during the 2nd half of 2020, first as a result of the gradual reopening of the economy and then as a result of the disbursement of frozen holiday pay funds in October. In addition, the prospect of changed motor vehicle taxes resulted in a large increase in motor vehicle acquisitions up to the turn of the year. However, new restrictions and increasing infection towards the end of the year meant that household consumption was 2.4 per cent lower in the 4th quarter of 2020 than in the same quarter in the previous year.

The new restrictions during the winter have again limited household consumption opportunities. However, the decrease in the Danes' card turnover is lower than during the shutdown in spring 2020. This indicates that both households and corporations have been better prepared for this lockdown. For example, household use of online shopping has been significantly higher in the first two months of 2021 than was the case in March and April last year, see Chart 6. However, a larger part of the 1st quarter of this year has been affected by extensive consumption restrictions than was the case in the 2nd quarter last year. Added to this is a marked slowdown in car sales. Overall, there are consequently prospects of a new significant decrease in consumption in the 1st quarter of 2021.

With the rollout of vaccines, there are prospects of an economy that is largely without restrictions in the course of the year. There is a sound basis for a significant increase in consumption in line with the expected removal of the restrictions. Firstly, the households' faith in the future is greater than during the last lockdown, and the appetite for spending appears to be high based on the first indications from the card turnover after the reopening of parts of the retail trade at the beginning of March. Secondly, household incomes have been supported by compensation schemes during the pandemic, while subdued price increases have increased household purchasing power. Thirdly, limited consumption opportunities have forced

Lower balance of payments surplus

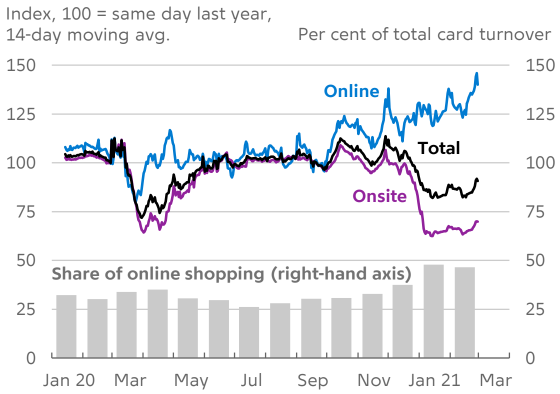
Chart 5



Source: Statistics Denmark and own calculations.

Increased online shopping buoyed card turnover

Chart 6

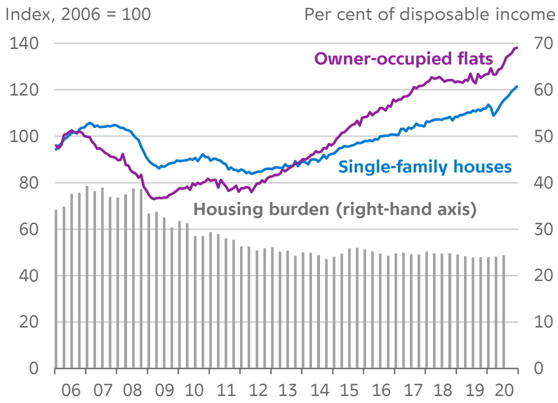


Note: *Online* covers online purchases, automatic card payments as well as mail and telephone orders. Last observation is 28 February 2021.

Source: Nets Denmark A/S and own calculations.

households to increase their savings significantly.[4] Household savings have resulted in an increase in household bank deposits, which increased by kr. 50 billion in 2020.[5] Combined with the disbursement of the last two weeks of holiday pay funds at the end of March, this provides a foundation for a marked increase in consumption after the expected easing of the restrictions.

Rising house prices, but housing burden remains low Chart 7



Note: The house prices are seasonally adjusted. *Housing burden* indicates the stylised financing costs, including administration margins, extra brokerage fees and housing taxes on the purchase of a single-family house of 140 square metres as a share of the average income.
Source: Statistics Denmark and own calculations.

Housing market boom continues despite new restrictions

House prices increased significantly during 2020, and in December the price of single-family houses was 8.5 per cent higher than in the same month of the previous year, see Chart 7. The current lockdown has not resulted in a significant housing market slowdown, which was the case in spring 2020. Instead, trading activity has remained high in the first months of 2021, while household expectations for the price development on the housing market are back at the pre-pandemic level. The high turnover of houses has resulted in a heavy decline in the number of houses for sale.

The increases in house prices can generally be attributed to a favourable development in the fundamentals. Interest rates are low, disposable household income has risen, and there are prospects of a further increase in income once the recovery picks up again. In addition, the pandemic may have led to a shift towards increased housing consumption, partly, as a result of greater focus on own housing conditions among households during the lockdowns, and partly because of other consumption opportunities being hampered.

The development of house prices is expected to become more subdued in future. Mortgage rates have risen since the turn of the year, which takes some of the steam out of the housing market. Mortgage rates remain very low, and, all things being equal, a given change in interest rates will have a greater relative impact on mortgage debt service than if interest rates were higher. The pass-through on house prices may thus also become higher. In addition, household consumption patterns are widely assumed to normalise when the economy again functions without restrictions, and house prices are subsequently expected to follow the development in incomes. This year, house prices are expected to rise by 9.7 per cent. The annual increase in 2021 reflects, in particular, the heavy price increases towards the end of 2020 and the first part of 2021. In the 4th quarter of 2021, the year-on-year increase is expected to constitute 6.5 per cent.

Although the housing market is currently hot, the situation is different from the years before the financial crisis, when price increases were heavier over a longer period of time and were driven by rising debt and speculation in future price increases. The housing burden, i.e. the financing costs of buying a

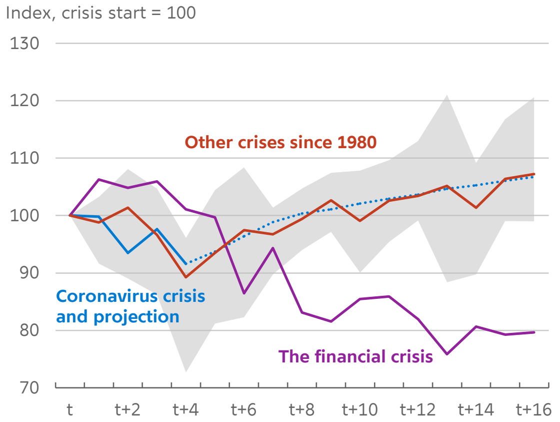
4 See Svend Greniman Andersen, Nicolai Risager Christensen and Rasmus Mose Jensen, High savings during corona were driven by restrictions rather than precautionary consumers, *Danmarks Nationalbank Economic Memo*, No. 2, February 2021 (memo available in Danish only).

5 See Danmarks Nationalbank, Accomodative financial conditions support the real economy, *Danmarks Nationalbank Analysis (Monetary and financial trends)*, No. 6, March 2021.

home as a share of the average disposable household income, was also significantly higher in the mid-2000s, while it is currently low. In addition, more stringent regulation of lending has been introduced, including with the introduction of the Growth Guidelines (‘*Vækstvejledningen*’) from 2016 and the change in the Good Practice *(‘God Skik’)* rules from 2018, which have made homeowners more robust. Furthermore, the new housing tax rules, which will be implemented in 2024, will contribute to stabilising fluctuations in house prices.

Residential investments kept a high level during 2020 and are expected to remain high in the coming years. The investments are supported by the development in the housing market, increasing household purchasing power and the political agreement on refurbishments in the social housing sector (Green Housing Agreement).

Steady recovery of corporate investments is expected Chart 8



Note: t indicates the quarter immediately before the outbreak of the crisis. The grey area covers the highest and lowest investment levels in the given quarter for the following crises: the EMU crisis, dotcom, 1990, the package of Danish austerity measures known as ‘*kartoffelkuren*’ and the 2nd oil crisis.
Source: Statistics Denmark and own calculations.

Gradual recovery in investments

Overall business investments fell by 3.4 per cent in 2020. Especially during the lockdown in spring, investments decreased significantly due to great uncertainty and prospects of lower future earnings.[6] Business investments recovered partly during the summer. Rising infection towards the end of the year and the lockdown in the economy over the winter have led to new declines in business investment. However, corporations are generally more optimistic now than was the case last spring, and investment plans in the manufacturing industry are at a higher level. This reflects, for example, less pronounced uncertainty due to the vaccines, high capacity utilisation, high volumes of orders and general growth in the manufacturing industry abroad.

Business investments are expected to increase in line with a return of demand, and idle capacity will decrease, see Chart 8. The pandemic is thus not expected to result in a long-term decline in investments, as was the case in the years following the financial crisis. One reason for this is that corporations were well equipped to face an economic slowdown before the outbreak of the pandemic after having consolidated themselves over a number of years. The permanent footprint of lower investments on the production potential of the economy is thus forecast to be smaller than after the financial crisis.

Prospects of public deficits in the coming years

The economic downturn and the high costs of relief packages are expected to result in a public deficit of approximately kr. 35 billion in 2020, equal to 1.6 per cent of GDP. The deficit is limited seen in the light of the size of the downturn and the scope of the relief packages. This is mainly due to large revenue from the pension yield tax (PAL) of approximately kr. 45 billion and extraordinary tax revenues from the disbursement of the frozen holiday pay funds.

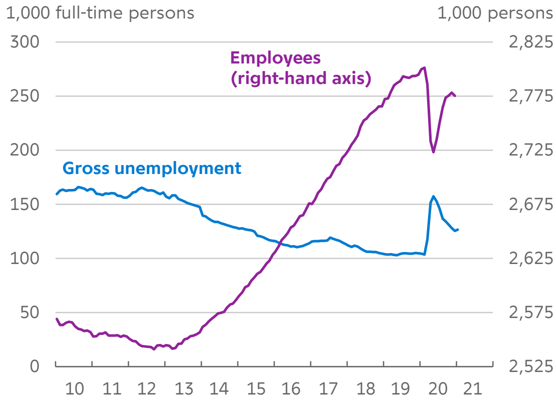
The EMU debt is forecast to rise to approximately 41 per cent of GDP in 2020 against 33 per cent in 2019. The sharp increase in debt should primarily be seen in the light of the central government having issued debt to be able to provide liquidity support

6 See Mikkel Bess, Erik Grenestam, Alessandro Tang-Andersen Martinello and Jesper Pedersen, Uncertainty and the real economy: Evidence from Denmark, *Danmarks Nationalbank Working Paper*, No. 165, November 2020.

to corporations in the form of loans and deferred tax payments, which must subsequently be repaid. The fall in GDP and the government budget deficit also contribute to increasing the EMU debt as a percentage of GDP, but to a lesser extent. From an international perspective, the debt remains low. Combined with a long history of fiscal policy discipline, this contributes to Denmark having the highest possible credit rating with all the major credit rating agencies. This results in low interest expenses and considerable room for manoeuvre in terms of fiscal policy.

Low activity, lockdown and support of the economy in the first part of the year result in a significant government budget deficit this year. Overall, the deficit is forecast to be around kr. 95 billion, equal to 4 per cent of GDP. The balance will improve in 2022 and 2023 in line with the economy emerging from covid-19 and getting back into gear, and the deficits are expected to be around 1.3 per cent and 0.9 per cent of GDP, respectively.

Labour market has been put in reverse Chart 9



Source: Statistics Denmark and own calculations.

Labour market recovery put on hold
The first lockdown in 2020 hit the labour market hard, and employment fell by just under 80,000 persons, while gross unemployment increased by 50,000 persons. Both employment and unemployment recovered rapidly in line with the gradual reopening of society in late spring, and just over two thirds of the job losses had been recovered already in November. Part of the recovery is due to rising public sector employment, and in December private sector employment was still 40,000 persons lower than before the pandemic.

The latest lockdown this year has put labour market recovery in reverse, see Chart 9. However, the decline is significantly more subdued than in the spring. During the first two months of the year, the statement of daily registered unemployed persons (adjusted for the season etc.) has increased by around 10,000 persons, and it is also expected that employment has fallen again. During the lockdown in spring 2020, registered unemployed persons rose by more than 50,000 persons during the first two months.

The subdued reaction on the labour market is presumably due to several conditions. Firstly, the employment level has already adapted itself to a virus situation. Employment is thus higher in the construction industry and in the public sector, while it is lower in the industries which are particularly affected by restrictions. Secondly, many corporations are better prepared for a lockdown situation, for example with the possibility of online shopping and click-and-collect. Thirdly, there is less uncertainty about the future this time. Vaccination of the population is under way, and the experience from last spring indicates that there is a return of activity when the restrictions are lifted and the virus is under control. This may encourage corporations to retain their workforce to a greater extent.

The reversal of the economic cycle has generally resulted in lower pressure on the labour market. The labour market gap, which is a measure of how much employment can rise without the occurrence of inflationary pressure, has widened to 15,000. However, this does not mean that there may not be pressure on parts of the labour market. The reason for this is twofold: firstly, some work requires special competences, and secondly it takes time to reskill unemployed labour. The higher demand in the construction industry and in parts of the manufacturing industry has resulted in an increasing number of corporations experiencing a labour shortage that is hampering their production, see Chart 10.

In line with the expected lifting of the restrictions that is keeping demand low, employment is expected to rise again and unemployment to fall. Towards the end of 2023, employment is projected to increase by 50,000 persons, while unemployment will decrease by about 10,000 persons. One of the factors behind the increase in employment is an increased supply of labour as a result of already adopted reforms. This increases the employment potential, and the labour market gap is projected to have been closed by the end of 2023.

Wage increases will pick up in line with labour market normalisation

Wage increases generally recovered across the industries in the 4th quarter, see Chart 11. The rising wage increases follow two quarters of weak wage rises as a result of a decline in demand and generally lower labour market pressure. The wage growth rate was particularly low in industries exposed to competition. One reason for the low wage growth is a highly subdued development in wages among foreign competitors. The highest wage increases are currently seen in the construction industry, which has only been affected by restrictions to a lesser degree. The labour shortage is, in fact, most prevalent among construction corporations.

Like in the private sector, wage developments in the public sector have been subdued in recent years. Viewed over a longer period of time, private and public sector wages grow at the same rate, as public sector wages are regulated relative to those in the private sector. The new collective agreements in the public sector will entail modest wage growth in the coming three years.

Even though the wage development has been subdued during 2020, the even lower rate of increase in consumer prices has meant that most employees experienced good growth in their purchasing power in 2020.

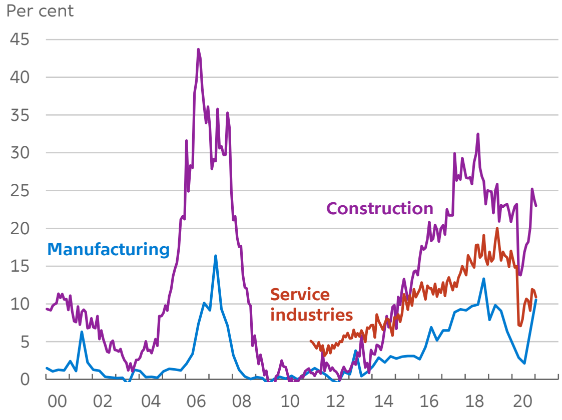
The wage increases are projected to increase gradually in line with the expected improvement of the labour market in the coming years. However, with the prospect of higher consumer price increases, the growth in employee purchasing power will weaken slightly relative to previous years.

Consumer price increases will pick up in coming years

Since July, consumer price increases have been around 0.4 per cent, measured by the EU's harmonised index of consumer prices (HICP), see Chart 12. The price development thus remains very subdued and weaker than before the pandemic, even though increased excise duties on tobacco have lifted the HICP's annual rate of increase since June. The weak price development is mainly due to the sharp fall in

Increasing labour shortage in construction and in manufacturing industry

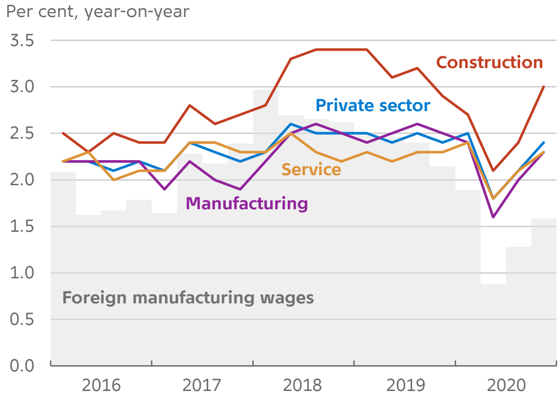
Chart 10



Note: Seasonally adjusted data.
Source: Statistics Denmark and own calculations.

Subdued wage increases

Chart 11



Note: The Danish wage increases are based on the Confederation of Danish Employers' (DA) statistics on economic trends. *Foreign manufacturing wages* are based on wage indices in the manufacturing industry for 25 countries weighted together with the weights of the real effective krone price index.
Source: Statistics Denmark, OECD, Confederation of Danish Employers (DA) and own calculations.

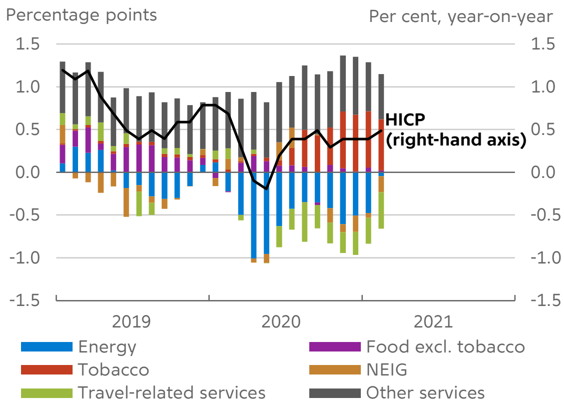
the oil price in early 2020, which resulted in a fall in energy prices, but prices of travel-related services, including hotels, package holidays and plane tickets, have also seen a weak development.[7]

In the coming period, the price development will be affected by a number of opposing factors. In the short term, the price increases will remain subdued as a result of large parts of the economy being subject to restrictions and a weak underlying price pressure from producer prices. In addition, import prices are kept in check by a strengthened effective krone rate, which makes foreign products cheaper. More-over, the consumption pattern in 2020 resulted in significant changes in the consumer price weights, which is expected to dampen the overall price development target over the year. One reason for this is that the seasonally adjusted travel-related services are now weighted lower. The typical price increases for these services over the summer will thus have less impact on the overall price index.

Conversely, the consumer price index will be lifted by the oil price having risen again. Furthermore, capacity pressure on container freight has resulted in marked increases in freight rates in recent months. This may result in rising prices of imported goods. However, the importing corporations are expected to absorb the fluctuations in freight rates in their profit margins to a significant degree. In the slightly longer term, rising demand will contribute to increased price pressure, while increases in excise duties on tobacco will again lift prices in 2022. Overall, the annual rate of increase in consumer prices is expected to be 1.1 per cent this year, rising to 1.2 per cent in 2022 and 1.6 per cent in 2023.

Price growth rate dampened by energy and travel-related services

Chart 12



Note: *HICP* is the EU's harmonised index of consumer prices. *Travel-related services* cover passenger transport by air, package tours and overnight accommodation facilities, including hotels etc. *NEIG* is non-energy industrial goods.
Source: Statistics Denmark, CPB World Trade Monitor and own calculations.

Continued great uncertainty connected with the pandemic

The uncertainty about growth prospects is significant and is highly dominated by the development in the pandemic. This has most recently been illustrated by the hard lockdown of several economies over the winter of 2020-21, resulting in a new temporary decline in activity and in economic recovery being put on hold. In the short term, this year's growth will greatly depend on the speed of the ongoing reopening, see Box 1.

7 The lockdown of many trades and industries has made it more difficult to calculate the price development, which is subject to greater uncertainty than normally. Several price observations have not been possible to measure, and have instead been estimated. This applies to, for example, plane tickets and package tours as well as restaurants and culture etc.

Three scenarios for reopening of Danish economy

Box 1

To illustrate and quantify the economic downturn during the second lockdown and the uncertainty about the subsequent reopening, three GDP growth scenarios have been established.

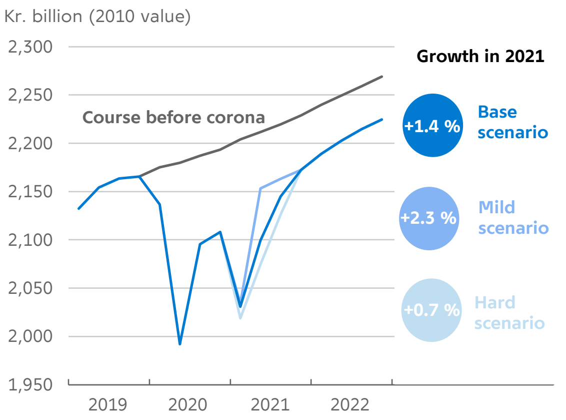
The economic downturn during the lockdown has been quantified using real-time indicators and Danmarks Nationalbank's input-output model.[1] The scenarios are based solely on different assumptions about the speed of reopening. This means that the activity level in the 4th quarter of 2021 and onwards is the same in all three scenarios. Annual growth in 2021 varies between 0.7 and 2.3 per cent in the three scenarios, with 1.4 per cent as the central forecast, see the chart below. As the GDP level in 2022 is the same in all three scenarios, the growth rate will be lower in 2022 if the speed of reopening is high in 2021. In specific terms, the annual growth rate in 2022 will be 3.6 per cent in the mild scenario and 5.2 per cent in the hard scenario, with 4.5 per cent as the central forecast. The key assumptions behind the forecasts are accounted for below.

The reopening was commenced at the beginning of February 2021 with the reopening of primary schools for the youngest classes and has continued with the opening of, among others, parts of the retail trade from 1 March. The three scenarios are based on the following assumptions for the further course of the reopening:

- *The base scenario* assumes that the restrictions will be eased further in the beginning of April, after which they will continue to be gradually eased so that, the restrictions will have been reduced to the same level as in early autumn 2020 by the end of May when all risk groups are expected to have been vaccinated. A further normalisation of the Danish economy and the international economy will follow at the beginning of the 3rd quarter.
- *The mild scenario* assumes that the restrictions will be further eased in mid-March, after which they will continue to be eased quickly so that, by mid-April, they will have been reduced to the same level as in early autumn 2020. A further normalisation of the Danish economy and the international economy will follow at the end of the 2nd quarter.
- *The hard scenario* assumes that the restrictions will not be eased further until the end of April, so that they will not have been reduced to the same level as in early autumn 2020 untill during July. A further normalisation of the Danish economy and the international economy will follow at the end of the 3rd quarter.

The scenarios do not specify the restrictions which will be eased and only illustrate the uncertainty surrounding the annual growth rates in 2021 and 2022 as a result of the speed of the reopening during spring and summer. The growth may be significantly stronger or weaker, e.g. if the vaccines are rolled out more quickly globally or if new virus mutations result in new lockdowns in the autumn.

Three scenarios for Danish economy



Source: Statistics Denmark and own calculations.

1. See Adrian Michael Bay Schmith, Morten Werner and Rasmus Rold Sørensen, Using input-output methods and high frequency indicators in assessment of GDP in 2020, *Danmarks Nationalbank Economic Memo*, No. 12, July 2020 (memo available in Danish only).

Key economic variables

Table 1

Real growth relative to the previous period, per cent	2020	2021	2022	2023	2020 Q2	2020 Q3	2020 Q4
GDP	-3.3	1.4	4.5	2.2	-6.8	5.2	0.6
Private consumption[1]	-3.1	1.3	7.7	2.5	-4.6	4.0	1.2
Public consumption	-0.1	1.4	0.8	1.1	-1.9	0.9	5.9
Residential investments	5.4	1.6	2.2	1.3	-0.6	1.4	-0.4
Public investments	17.9	6.3	3.6	0.0	-3.5	3.3	29.3
Business investments	-3.4	1.8	5.2	3.2	-6.3	4.4	-6.2
Inventory investments, etc.[2]	-0.1	0.0	0.0	0.0	-1.6	1.7	-0.4
Exports	-8.5	2.3	8.4	3.7	-11.7	6.3	-0.6
Industrial exports	-2.0	2.6	5.8	4.3	-8.0	3.2	2.0
Imports	-5.6	2.9	9.7	3.5	-10.0	5.8	1.8
Employment, 1,000 persons	2,981	3,000	3,014	3,035	2,942	2,981	2,993
Gross unemployment, 1,000 persons	132	126	121	118	154	139	128
Current account, per cent of GDP	7.3	6.9	6.7	7.0	7.7	7.2	6.0
Government balance, per cent of GDP	-1.6	-4.0	-1.3	-0.9	-4.3	-0.8	-0.3
House prices[3], per cent year-on-year	4.3	9.7	3.0	2.3	2.0	4.8	7.6
Consumer prices (HICP), per cent year-on-year	0.3	1.1	1.2	1.6	0.0	0.4	0.4
Hourly wages[4] (manufacturing), per cent year-on-year	2.2	2.2	2.5	2.8	2.1	1.9	1.9

Source: Statistics Denmark and own calculations.
1. Includes both households and non-profit institutions serving households (NPISH).
2. Contribution to GDP growth (this item comprises inventory investments, valuables and statistical discrepancy).
3. Nominal prices of single-family houses.
4. Statistics Denmark's implicit wage index.

International economy – trends

New wave of infection delays recovery of global economy
Towards the end of 2020, infection rates increased again across countries. Some places saw a particularly sharp rise in infection rates as a result of new and more contagious mutations of the coronavirus. These mutations have spread to other countries and resulted in the introduction of new restrictions aimed at curtailing the spread of infection.

Despite extensive restrictions, there was only a limited drop in economic activity in the 4th quarter of 2020. In the euro area, GDP fell by 0.7 per cent quarter-on-quarter after a strong recovery in the 3rd quarter, see Chart 13.

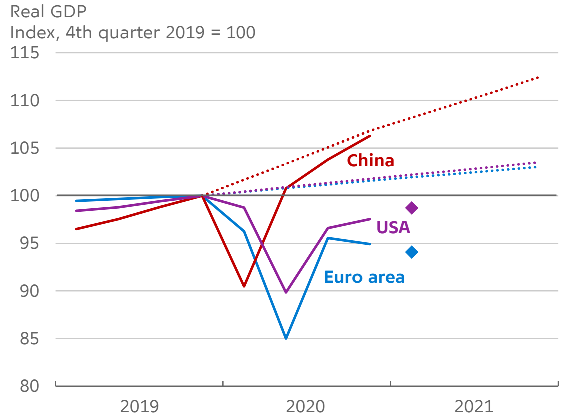
However, the development in the 4th quarter should be seen in conjunction with some countries only tightening their restrictions in December and with activity already being at a low level. The economic indicators also suggest that growth will be negative in the 1st quarter of 2021 in most of the advanced economies because restrictions continue to hamper activity in large parts of the economy.

While the GDP level in the euro area and the United States is still 5 per cent and 2.5 per cent, respectively, lower than before the coronavirus outbreak, China has now more than recovered the decline in its GDP. In China, GDP increased by 2.3 per cent last year, making China one of the few countries in the world with positive economic growth in 2020. The growth in China is especially driven by the industrial sector and increased exports due to higher demand for, among other products, personal protective equipment and electronic products.

Since the reopening after the first wave of infection in 2020, global trade in goods has generally been increasing, see Chart 14. The increase reflects, among other factors, that the trade-intensive industry has been less affected during the second wave of infection. In addition, the shutdown of a number of service industries has resulted in a marked shift in consumption from certain services towards goods, which has contributed to boosting the trade in goods. The development in new export orders indicates that growth in global trade in goods continued towards the turn of the year, albeit at a lower pace. Conversely, there are not yet any signs of a recovery in trade in services, such as tourism.

New wave of infection delays recovery in the euro area and USA

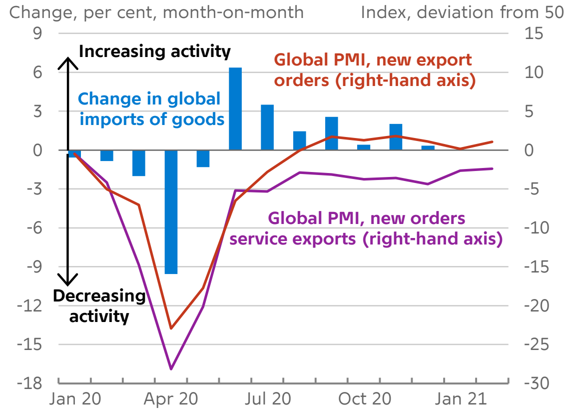
Chart 13



Note: The blue and purple dots indicate the latest GDP forecasts for the 1st quarter of 2021 in the euro area and the United States, respectively. The European Commission's forecast is shown for the euro area. The forecast from the Congressional Budget Office (CBO) is shown for the United States. The dotted lines indicate the IMF's forecast from January 2020 before the coronavirus outbreak.
Source: Macrobond, IMF, European Commission, CBO and own calculations.

Recovery in global trade in goods

Chart 14



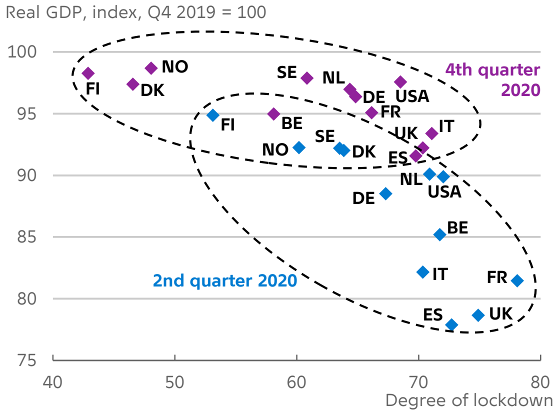
Note: Data on global imports of goods are up to and including December 2020.
Source: Macrobond and own calculations.

Many countries are currently seeing a two-speed economic development
In recent months, parts of the economy in many countries have been shut down to the same extent as during the first wave of infection. However, the overall level of activity in the societies, for example measured by Google's mobility indicator, has generally been less affected relative to the 1st half of 2020. There is consequently not the same clear negative correlation between restrictions and GDP across countries as previously, see Chart 15. The reason is probably that, this time, the restrictions are more targeted at the most contact-intensive industries in the service sector, and that corporations and consumers have learned to adapt to the new conditions.

In the United States, there has been growth in the service sector in recent months, despite high infection rates in many places. The development in the United States thus differs markedly from the development in the euro area, where business confidence has pointed towards declining activity since September, see Chart 16. This should be seen in the light of the fact that the restrictions have generally been more lenient in the United States, albeit with significant differences across the individual states. Furthermore, it is ultimately the effect of the restrictions on the behaviour of the population that determines the activity level. The correlation between restrictions and, for example, mobility has generally been weaker in the United States than in the euro area countries.

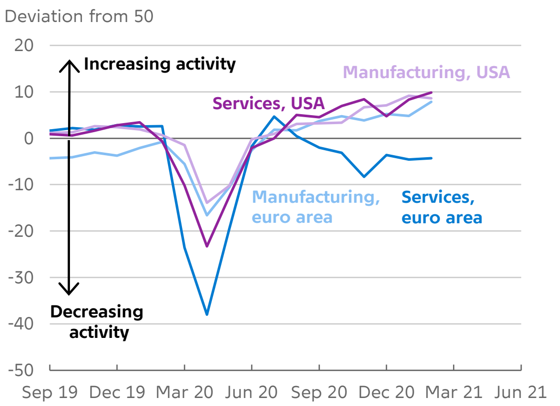
Phasing-out of restrictions will boost private consumption
Retail sales have fallen again in the euro area in line with new restrictions limiting access to physical stores. Since October, retail sales have decreased by approximately 9 per cent, which is, however, somewhat lower than the overall decline seen during the first wave of infection in March and April 2020. This means that retail sales are now approximately 5 per cent lower than before the coronavirus outbreak. Instead, in the United States, retail sales increased significantly at the beginning of the year, supported by, among other factors, a new fiscal policy relief package that includes higher unemployment benefits and new cash payments to citizens, which were disbursed at the beginning of the year.[8]

So far, the second wave of infection has resulted in a lower fall in GDP than the first wave Chart 15



Note: The chart shows the average of the University of Oxford's Stringency Index in the 2nd quarter and 4th quarter, respectively, as well as the GDP level across countries.
Source: Macrobond and own calculations.

Business confidence in the euro area shows a two-speed economy Chart 16

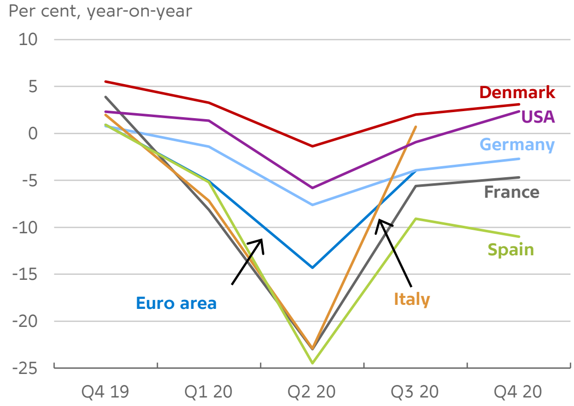


Note: The chart shows the Purchasing Managers' Index (PMI) in different sectors.
Source: Macrobond.

8 The US relief package adopted in December included cash payments of 600 dollars to people with low and middle incomes.

Retail sales in the euro area and the United States are also supported by services having been substituted by certain consumer goods, such as electronics and furniture, during the pandemic. At the same time, household savings, which increased significantly during the first wave of infection, remain markedly higher than before the coronavirus outbreak. According to an analysis from the European Central Bank (ECB), higher savings in the euro area were significantly driven by limited consumer spending opportunities and are thus less an expression of greater consumer caution.[9] The savings can therefore provide a solid starting point for a strong recovery in consumption when the restrictions are lifted. In the United States, private consumption will be further supported by new major fiscal policy stimuli in 2021. However, deferred consumption is very unlikely to be fully recovered because it is concentrated in the experience economy, where the amount of leisure time also puts a limit on consumption.

Prospects of limited short-term increase in investments Chart 17



Note: Data for the euro area are exclusive of Ireland because of high quarterly fluctuations due to investment activities by multinationals.
Source: Macrobond and own calculations.

Investments have been affected by great economic uncertainty

Great uncertainty and lockdown measures contributed to a sharp decline in investments in 2020 across countries, see Chart 17. In both the euro area and the United States, investments particularly fell in the industries that have been hardest hit by restrictions, such as the transport sector.

Capacity utilisation has increased again in many corporations after the first wave of infection, but it remains at a lower level than before the coronavirus outbreak. This points towards a lower need for new investments in the coming period. The continued great uncertainty also means that many corporations will probably postpone their investments for a little longer. However, there are prospects of a marked increase in public investments based on the announced recovery plans in the euro area.

Fiscal policy stimuli are supporting the economy

In 2020, public debt increased significantly across countries due to large fiscal policy relief packages and large expenses for combating covid-19. In the coming year, fiscal policy will remain very accommodative in most countries to support the recovery. In the advanced economies, the debt ratio is expected to increase to a slightly higher rate in 2021 and then to stabilise at a somewhat higher level than before the coronavirus outbreak, see Chart 18.

So far, many of the extraordinary measures from 2020 have been extended because restrictions continue to create difficult conditions for corporations and households. In the United States, a new relief package of 900 billion dollars (about 4 per cent of GDP) was adopted in December, including new cash payments to the population and temporarily higher unemployment benefits.[10] In addition,

9 See Maarten Dossche and Stylianos Zlatanos, COVID-19 and the increase in household savings: precautionary or forced?, *ECB Economic Bulletin,* Issue 6/2020. For a corresponding analysis for Denmark, see Svend G. Andersen, Nicolai R. Christensen and Rasmus Mose Jensen, High savings during corona were driven by restrictions rather than precautionary consumers, *Danmarks Nationalbank Economic Memo,* No. 2, February 2021 (memo available in Danish only).

10 The relief package from December 2020 contains 300 dollars a week in supplementary unemployment benefit from the end of 2020 and 11 weeks ahead, i.e. the higher benefit will basically continue until mid-March. The amount comes on top of the regular unemployment benefit, which averages around 370 dollars a week. During the first wave of infection, the supplementary benefit was 600 dollars until the scheme expired in July 2020. However, it was subsequently extended for six weeks with 300 dollars a week.

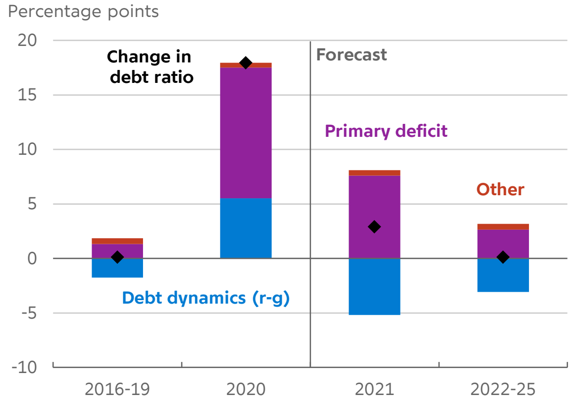
Congress has recently approved a new major relief package of approximately 1,900 billion dollars (about 9 per cent of GDP). The relief package includes new cash payments of up to 1,400 dollars per citizen and temporarily higher unemployment benefits until September. The new stimuli will especially support activity in 2021.

In recent years, the low level of interest rates has contributed to keeping financing costs down, even though public debt has risen. In the coming years, the growth rate is expected to be higher than the interest rates, which means that debt ratios can fundamentally be kept stable even if the countries run public budget deficits. However, changes in interest rate and growth prospects may change the debt dynamics of the individual countries and increase pressure on public finances.

In early March, the European Commission announced that the escape clause attached to the fiscal policy rules in the EU is expected to be extended up to and including 2022. When the rules are reactivated Member States must, as a general rule, gradually reduce their deficit and debt, which will give rise to a tightening of fiscal policy in the subsequent years. However, as a general rule, Member States will not receive EU recommendations to tighten their fiscal policy until the GDP level is back to the same level as before the coronavirus outbreak.

Public debt will stabilise at a higher level in advanced economies in the coming years

Chart 18



Note: The chart shows the change in a weighted average debt ratio for advanced economies. *Debt dynamics (r-g)* refers to the difference between the interest rate for central government debt (r) and GDP growth (g).
Source: IMF.

Stable development of labour markets during second wave of infection

During 2020, unemployment in the euro area only rose slightly, despite a significant shock to the job-intensive service sector. Unemployment has been falling again since August and was in January at 8.1 per cent. The low increase in unemployment reflects extensive use of wage compensation schemes, where large parts of the labour force worked reduced working hours or were sent home completely, without this affecting their employment situation. The declining demand for labour during the first wave of infection was thus not fully reflected in the unemployment figures.

The second wave of infection does not appear to have had major employment consequences so far either. New restrictions in Germany meant that the number of applications for funds under the public support scheme in connection with reduced working hours (*Kurzarbeit*) has increased again during the last months, but the increase was somewhat more limited than during the first wave of infection. At the same time, recent applications have been more concentrated in the hotel and restaurant industry and those parts of the retail trade which have been shut down.

In the United States, the recovery in the service sector since the first wave of infection has contributed to a rapid improvement in the labour market. The rate of unemployment has thus fallen significantly since April last year and was 6.2 per cent in February. However, this is still nearly twice as high as before the coronavirus outbreak. As a result of the pandemic, especially the contact-intensive service industries, such as hotels and restaurants, still have markedly lower employment than before the coronavirus outbreak, see Chart 19.

The fall in US unemployment since April should also be seen in the light of the fact that the labour force has fallen by approximately 4 million people, corresponding to a drop of 2.5 per cent.

Labour markets are more severely affected by the pandemic in those countries in which contact-intensive industries, such as tourism, account for a significant proportion of total employment. In the euro area, this applies to, among others, Italy and Spain, where the tourism industry accounts for more than 10 per cent of total employment. Therefore, these countries generally have a greater risk of more long-term unemployed and a more sluggish recovery. At the same time, unemployment has generally increased more among certain groups, including young people, people with short-cycle education and weak links to the labour market.

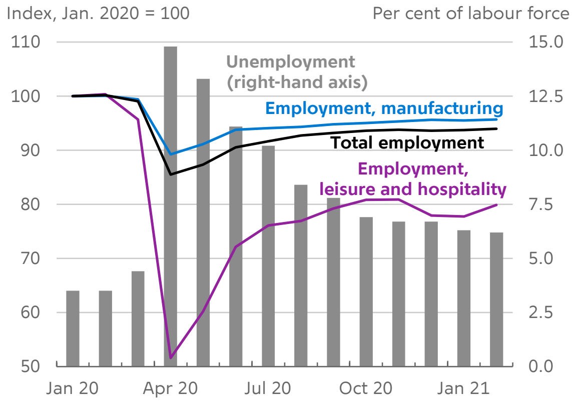
The development in the labour markets means that the pressure on salaries and wages remains subdued. This is particularly the case in the industries that have been hard hit by restrictions.

Subdued price pressure in the euro area despite sharp rise in inflation in January

Inflation in the euro area and the United States is still lower than in the period leading up to the coronavirus outbreak and well below the inflation target of 2 per cent. However, price increases have picked up in the euro area early in the new year. Inflation thus increased sharply in January to 0.9 per cent from -0.3 per cent in December, measured by the rate of increase in the harmonised index of consumer prices (HICP), see Chart 20. The inflation rate was unchanged at 0.9 per cent in February.

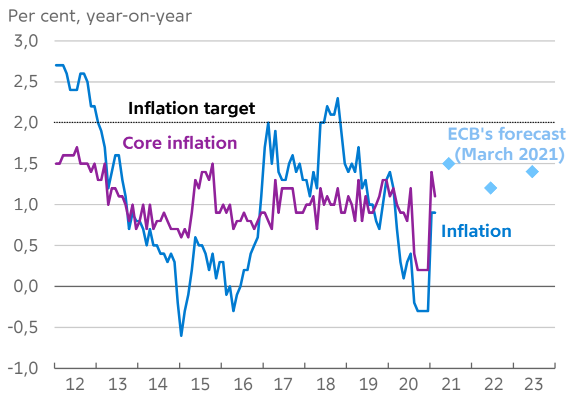
However, part of the increase in January will be transient, as it especially reflects some temporary conditions in Germany, including the expiry of the temporary VAT reduction[11], a new carbon tax and an increase in the minimum wage. In addition, winter sales in France, Italy and Belgium have been postponed and have therefore not dragged down prices, as would usually be the case. The same development could be seen last summer, when there was a similar delay in the summer sales. The sharp rise in inflation in the euro area should also be seen in conjunction with the weights in the HICP index having been updated, based on the consumption pattern during the pandemic.[12] Lower consumption of transport and travel, among other things, has reduced their weights

Partial recovery in US labour market Chart 19



Note: The *leisure and hospitality* category comprises hotels, restaurants, cultural institutions and other parts of the experience economy.
Source: Macrobond.

Temporary drivers are pushing up inflation in the euro area Chart 20



Source: Macrobond and ECB.

11 In Germany, VAT on food products was reduced to 5 per cent from 7 per cent and on other goods to 16 per cent from 19 per cent from July to December 2020.

12 Under normal circumstances, the weights are updated in January each year and based on household consumption expenditures from two years earlier, i.e. the weights in 2021 were based on consumption data from 2019.

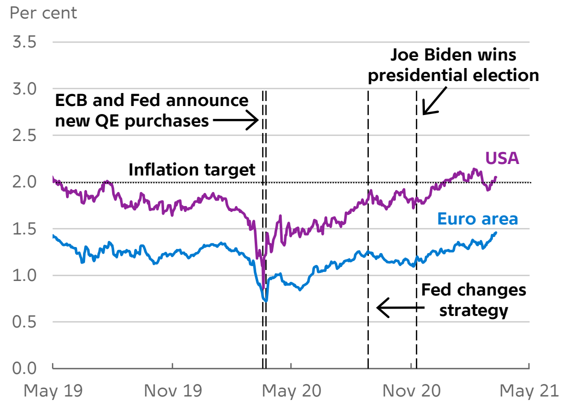
in the HICP index, thus easing the downward pressure on inflation from sharp price drops in these product groups.

In its latest March forecast, the ECB expected inflation to rise to 1.5 per cent in 2021 due to temporary factors. In 2023, the inflation rate is expected to be 1.4 per cent.

In the USA, the annual increase in consumer prices, measured by the rate of increase in the Personal Consumption Expenditures (PCE) deflator, was 1.5 per cent in January.[13] Inflation is dampened by, among other factors, energy prices, which are still lower than before the outbreak of the coronavirus pandemic. The Federal Reserve (the Fed) forecast in its latest December forecast that inflation would rise to the inflation target of 2 per cent over the coming years.

Market-based inflation expectations in the euro area and the United States have risen steadily since May, and they are now back at the inflation target in the United States, while they remain well below in the euro area, see Chart 21. The increase in the United States reflects a combination of multiple factors, including the Fed's new monetary policy strategy[14], better growth prospects after positive news about vaccines and the prospect of a new large fiscal policy relief package. There is normally a close correlation between inflation expectations in the United States and the euro area. Events in the United States may therefore also have had a rub-off effect on inflation expectations in the euro area. In addition, market expectations have historically developed in line with the oil price, which has increased since the beginning of May and, in particular, in recent months.

Inflation expectations have increased significantly in USA Chart 21



Note: Market-based inflation expectations in the euro area are based on a 5-year/5-year inflation swap. For the United States, a 5-year/5-year break-even inflation rate is shown, which is the spread between nominal and inflation-indexed government bond yields.
Source: Macrobond and Refinitiv Eikon.

Prospects of strong recovery in 2nd half of 2021, but uncertainty remains high

Global growth prospects are still closely linked to the development in infection rates. In the short term, restrictions are limiting activity in large parts of the economy in many countries, but, concurrently, the rollout of vaccines creates an expectation that the global economy will return to a more normal state of affairs during the 2nd half of 2021. Overall, the OECD therefore expects global economic growth of 5.6 per cent in 2021, see Chart 22.

In 2021, the economies will still be supported by accommodative fiscal and monetary policies and favourable financial conditions. Especially in the United States, new fiscal policy stimuli are expected to support economic activity, which also has a positive effect on growth in the rest of the world. According to the OECD, the new relief package could potentially boost US GDP by 3-4 per cent in the coming year. In the EU, the new recovery package is expected to lift the GDP level in the EU by 1-2 per cent per year over the coming years.[15]

13 The Fed's preferred inflation target is core PCE inflation, i.e. PCE inflation exclusive of energy and food.

14 The Fed announced an update of its monetary policy strategy in August 2020, which entails that the Fed is aiming for an inflation rate of 2 per cent on average over a period of time. This means that if inflation is below 2 per cent in a period, it must correspondingly be above 2 per cent for some time.

15 European Commission's estimate. The first payments from the facility may be disbursed from mid-2021 if all approval processes proceed smoothly.

Like the rest of the world, the development in many emerging market economies is still affected by the pandemic. In most of these countries, the rollout of vaccines is taking longer than in the advanced economies, and it will therefore probably take longer before the restrictions can be lifted completely. However, the outlook for the emerging market economies as a whole has improved since the autumn, which is primarily due to favourable developments in China and India. Conversely, countries with a relatively large tourism industry face the prospect of a more sluggish recovery.

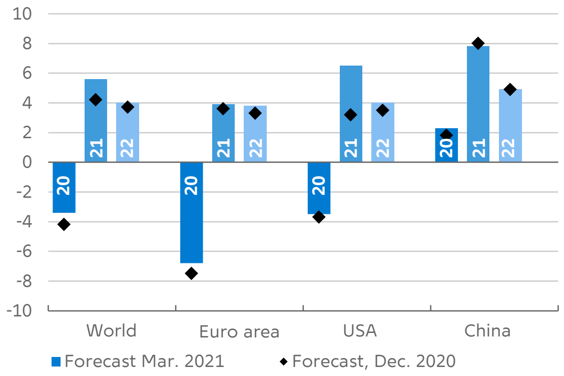
The global economic outlook is still characterised by very great uncertainty. In many advanced economies, the infection curves appear to have been broken, but the speed of the vaccine rollout will probably be the decisive factor for when the economy will again function without restrictions. Delays in national vaccine plans may therefore result in a more protracted recovery process. This could potentially drag down growth significantly in 2021. Conversely, the increase in activity may also come sooner than expected when the restrictions are phased out, for example due to high fiscal policy stimuli and deferred consumption during the pandemic. It also entails a risk of an uneven economic cycle in some countries.

The long period with restrictions will unavoidably leave its mark on some parts of the economy. In a survey conducted among leading corporations in the euro area, 20 per cent of the respondents state that they are facing permanent changes in demand as a result of the pandemic.[16] One of the findings of the survey is that new consumption habits formed during the pandemic will continue when the restrictions are lifted. This may, for example, be more extensive use of digital solutions, which may result in, for example, less business travel and lower demand in physical stores. Even though the changed behaviour benefits other corporations and potentially increases productivity, the lower demand in some sectors creates a risk of more bankruptcies and liquidations as well as higher unemployment in the short term.

In the trade policy area, uncertainty about Brexit was significantly reduced after the EU and the UK struck a trade agreement at the end of 2020. Moreover, the political situation in the United States has become more predictable following the presidential election, and it may also have a positive rub-off effect on the rule-based international cooperation. However, trade policy tensions between the United States and China still pose a risk to the global economic development.

Prospects of recovery with high global growth in coming years Chart 22

Real GDP growth, per cent, year-on-year



Note: The OECD's growth estimate for the world has been calculated using nominal GDP weights based on purchasing power parities (PPP).
Source: OECD, *Interim Economic Outlook*, March 2021.

ECB has extended its asset purchase programme

In December, the ECB decided to increase the total threshold for its pandemic emergency purchase programme (PEPP) by a further 500 billion euro to a total of 1,850 billion euro. The decision was made based on the economic impact of the resurgence of the coronavirus pandemic. The ECB also extended the time frame for the programme by six months, so that it now runs until the end of March 2022. In addition, the ECB decided that repayments on the bonds will be reinvested up to and including the end of 2023. The ECB also eased the terms and conditions for the extraordinary targeted longer-term refinancing operations (TLTRO) and extended

16 See Eduardo Maqui and Richard Morris, The long-term effects of the pandemic: insights from a survey of leading companies, *ECB Economic Bulletin,* No. 8, 2020.

the time frame for access to these favourable loans until June 2022.

The announcement of the extension was expected by market analysts and had a limited effect on government yields compared with the first announcement of PEPP in March 2020. Overall, however, PEPP has had a significant effect on government yields. According to the ECB's estimates, the bond purchases during the pandemic have reduced the 10-year government yield in the euro area by approximately 45 basis points.[17] The ECB also points out that the pass-through is higher, as the flexibility of PEPP has allowed the ECB to purchase government bonds issued by the countries which have had the greatest needs in relation to the financial conditions at any given time. The country distribution of the purchases has thus been adjusted on an ongoing basis. In line with market conditions having improved, relatively fewer Italian securities, for example, have been purchased in recent months relative to March-May last year, see Chart 23.

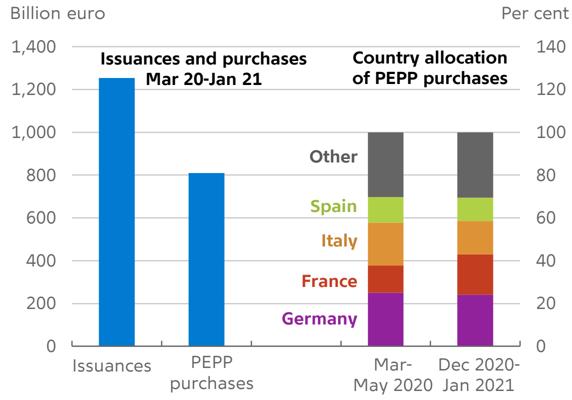
At the recent monetary policy meeting in March, the ECB announced that the monthly purchase of bonds in PEPP will be increased significantly in the next quarter to preserve the favourable financing conditions. The ECB's total bond purchases from March 2020 to January 2021 under PEPP amounted to approximately 800 billion euro, equal to 65 per cent of the net issuances in the euro area.

Government yields have increased

10-year government bond yields increased sharply at the beginning of the new year, with the US yield rising to over 1.5 per cent at the end of February for the first time in more than a year, see Chart 24. In the euro area and the United States, the development reflects both the rise in inflation expectations and market expectations of higher growth due to the prospect of new fiscal policy easing in the United States and the rollout of vaccines. In Italy, however, the government yield fell in the wake of the news that former ECB President Mario Draghi would form a new government. This resulted in a narrowing of the yield spread to Germany.

ECB continuously adjusts its purchases across countries

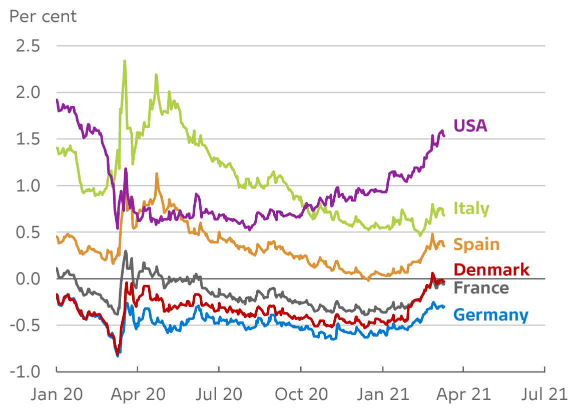
Chart 23



Note: Net issuances in euro-denominated bonds in the euro area and the ECB's purchases (on secondary markets) under PEPP from March 2020 to January 2021. *Country allocation of PEPP purchases* are of securities issued by the public sector.
Source: ECB.

Government yields increased early in the new year

Chart 24



Note: 10-year government bond yields.
Source: Macrobond.

17 The 10-year government yield in the euro area is GDP-weighted. The estimate is based on the interest rate elasticity of the ECB's public sector purchase programme (PSPP). See John Hutchinson and Simon Mee, The impact of the ECB's monetary policy measures taken in response to the COVID-19 crisis, *ECB Economic Bulletin,* No. 5, 2020.

The slope of US and German yield curves, measured as the difference in 10-year and 2-year government bond yields, has become significantly steeper. This is typically an indication that the financial markets expect an economic upswing and rising inflation.

Equity markets have continued to rise
The equity markets have shown sharp price increases since the steep fall in spring 2020. In the United States and Denmark, the benchmark stock indices are at record levels, see Chart 25. In the euro area, however, equity prices are only back to pre-coronavirus levels. The increases are supported by a number of measures, including large-scale monetary and fiscal policy measures, and the roll-out of vaccines in Europe and the United States.

One of the reasons why the European index has risen less than the US index since the end of March is differences in the sector composition of the two indices. The US index has a greater weight of technology and health corporations, which are both sectors that have performed well during the crisis. The European index has a relatively higher number of industrial corporations which were especially hard hit by the lockdowns during the first wave of the coronavirus.

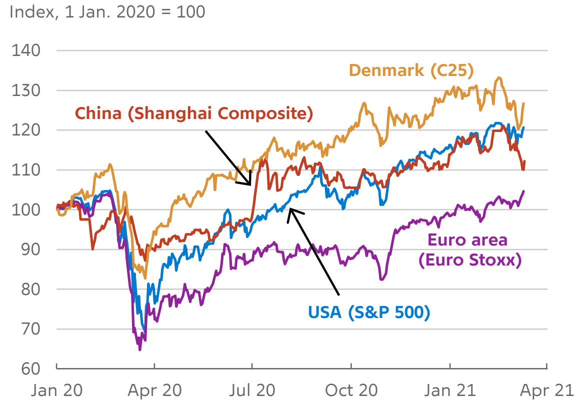
Dollar weakened and euro strengthened
The effective dollar rate has weakened markedly since the end of March 2020. At the end of the year, the dollar reached its weakest level in nearly three years, but it is still a long way from the level in the financial and sovereign debt crisis years. The weakening should be seen in the light of a number of factors, including the very accommodative monetary policy in the United States, less uncertainty after the presidential election and retreating risk aversion, which made the dollar rise in March 2020.

The effective euro rate strengthened sharply during 2020, reaching its highest level since the financial crisis. The strengthening was triggered by more positive growth prospects following the adoption of the EU Recovery Fund in summer 2020 and the prospect of vaccines against the coronavirus, among other factors.

Pound sterling was strengthened against the euro after the agreement between the UK and the EU fell into place at the end of 2020. The strengthening of pound sterling has continued into the new year, reflecting, for example, a significantly faster vaccine rollout in the UK than in the rest of Europe.

Equity markets in USA and Denmark are at record levels

Chart 25



Source: Macrobond.

Appendix: Assumptions in and revisions of projection for Danish economy

The projection has been prepared using the macroeconomic model MONA and is based on the available economic statistics, including Statistics Denmark's quarterly national accounts for the 4th quarter of 2020. The projection is based on statistics published up to and including 10 March 2021. The projection also involves a number of assumptions concerning the international economy, financial conditions and fiscal policy.

International economy
Export market growth is assumed to be 2.9 per cent in 2021, 9.8 per cent in 2022 and 3.9 per cent in 2023. The growth in 2021 is lower than previously assumed, whereas it is higher in 2022 (-1.2 percentage points in 2021 and 3.4 percentage points in 2022), reflecting the latest forecasts from the OECD, the IMF and the European Commission. The downward adjustment reflects a major economic downturn in the 1st half of 2021, while the higher growth in 2022 should be seen in conjunction with the weaker point of departure.

Wage increases abroad are assumed to be moderate in the coming years, and price increases abroad are also assumed to be modest.

Interest rates, exchange rates and oil prices
Developments in short-term and long-term interest rates in the projection are based on the expectations of future developments that can be derived from the yield curve in the financial markets. The 3-month money market interest rate, measured by the CITA swap rate, is expected to be negative throughout the projection period and to remain largely unchanged at the current level of -0.4 per cent.

The average bond yield is an average of yields to maturity for outstanding government and mortgage bonds. It is expected to be flat at 0.3 per cent in 2021 and then rise to 0.4 per cent and 0.6 per cent in 2022 and 2023, respectively.

In the projection, the effective krone rate and the dollar rate are assumed to remain constant at their current levels.

By mid-March 2021, the oil price was around 65 dollars per barrel. The oil price is assumed to develop in line with futures prices, decreasing gradually to just under 60 dollars per barrel by the end of 2023.

Fiscal policy assumptions
The projection is based on preliminary national accounts data on public sector consumption and investments as well as the planned fiscal policy in *Economic Survey, December 2020*, and *Updated 2025 development, August 2020*.

Real public consumption is expected to increase by 1.4 per cent this year, 0.8 per cent in 2022 and 1.1 per cent in 2023. Public investment is expected to increase by 6.3 per cent in 2021, 3.6 per cent in 2022 and 0 per cent in 2023, see Table A.1.

Revisions in relation to the previous projection
The projected GDP growth has been adjusted downwards by -1.5 percentage points this year relative to the previous projection, but adjusted upwards by 1.2 percentage points in 2022. The downward adjustment in 2021 should be seen in conjunction with the lockdown of the Danish economy and the international economy at the beginning of the year. The projected rate of increase in consumer prices (HICP) is adjusted downwards by 0.2 percentage points in 2022.

Overview of projection assumptions

Table A.1

	2020	2021	2022	2023
International economy:				
Export market growth, per cent year-on-year	-10.9	2.9	9.8	3.9
Foreign price[1], per cent year-on-year	-2.2	0.7	1.5	1.6
Foreign hourly wages, per cent year-on-year	1.4	1.8	2.3	2.6
Financial conditions etc.:				
3-month money market interest rate, per cent p.a.	-0.6	-0.4	-0.5	-0.4
Average bond yield, per cent p.a.	0.3	0.3	0.4	0.6
Effective krone rate, 1980 = 100	104.1	104.6	104.6	104.6
Dollar exchange rate, DKK per USD	6.5	6.2	6.2	6.2
Oil price, Brent, USD per barrel	41.8	64.6	61.2	58.4
Fiscal policy:				
Public consumption, per cent year-on-year	-0.1	1.4	0.8	1.1
Public investment, per cent year-on-year	17.9	6.3	3.6	0.0
Public sector employment, 1,000 persons	833	845	835	839

1. Weighted import price for all countries to which Denmark has exports. The projection assumes the same growth rates for the weighted export prices in the countries from which Denmark imports.

Changes in the projection

Table A.2

	GDP			Consumer prices (HICP)		
Per cent, year-on-year	2020	2021	2022	2020	2021	2022
Projection from December	-3.9	2.9	3.3	0.3	1.1	1.4
Contribution to revised forecast from:						
Export market growth	-0.1	-0.4	0.8	0.0	0.0	-0.1
Development in interest rates	0.0	0.0	0.0	0.0	0.0	0.0
Exchange rates	0.0	0.1	0.1	0.0	0.0	0.0
Oil prices	0.0	0.0	0.0	0.0	0.5	0.1
Other factors	0.7	-1.1	0.5	0.0	-0.5	-0.3
This projection	-3.3	1.4	4.5	0.3	1.1	1.2

Note: The transition from the previous to this projection may not add up due to rounding.

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DANMARKS NATIONALBANK
LANGELINIE ALLÉ 47
DK-2100 COPENHAGEN Ø
WWW.NATIONALBANKEN.DK

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DANMARKS NATIONALBANK

CONTACT

Ole Mikkelsen
Communications and Press Officer

omi@nationalbanken.dk
+45 3363 6027

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