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OUTLOOK FOR THE DANISH ECONOMY — JUNE 2021

Danish economy is heading for a mild boom

High growth is expected to continue in the coming years

Consumption rose sharply after reopening in March. Exports of goods have benefited from a global manufacturing upswing and now exceed the pre-pandemic level. Growth is expected to continue the coming years. The economy is expected to be in a mild boom in 2023.

The Government should be prepared to tighten fiscal policy

The recovery is supported by high private demand, and there are signs of bottlenecks building up in manufacturing, construction, and some parts of the service industries. The Government should be prepared to tighten fiscal policy more than already planned.

Need for measures to strengthen robustness in the housing market

Soaring house prices may lead to an acceleration in credit growth and increase the risk of large fluctuations in the housing market. Amortisation requirement for highly indebted households and a reduction of the interest deduction will reduce vulnerability of the housing market and strengthen the robustness of the economy.

PROJECTION

Danmarks Nationalbank is publishing an extraordinary projection in June due to the great impact of the coronavirus situation on significant parts of activities in society.

Outlook for the Danish economy

Rapid increase in activity since reopening in spring

The reopening of Danish society is in full swing. Many restrictions have been eased and the number of hospitalised coronavirus-infected persons has decreased significantly. The overall activity level has nearly recovered to the pre-pandemic level supported by a strong upswing in private demand.

Consumption has quickly recovered following the reopening of society, and housing market activity is high with many sales and large price increases. Concurrently, exports are supported by a global manufacturing upswing driven by a shift in consumption towards goods.

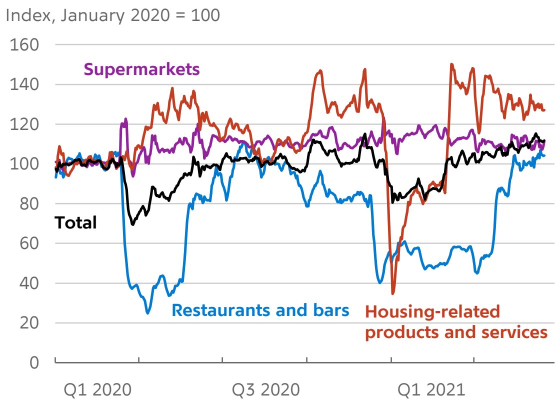
Nearly all industries have reopened, but activity in some service industries will still be directly or indirectly hampered by, for example, travel restrictions or restrictions on opening hours and distancing requirements over the summer. At the same time, activity is high in manufacturing and construction with signs of bottlenecks building up. There are thus large differences in activity across industries.

High private demand and more easing of restrictions over the summer provide a sound basis for the Danish economy returning to normal capacity utilisation at the end of the year. GDP is expected to increase by 3.3 per cent in 2021, and gradually enter a mild boom in the following years.

Signs that consumption patterns are reverting

Private consumption was hit hard again during the winter lockdown and was the main reason for the drop in GDP of 1.3 per cent in the 1st quarter of 2021. However, consumption quickly recovered in March, when parts of the retail trade were allowed to open, and card turnover was back to the pre-pandemic level already in the middle of March, see chart 1.

Large increase in card turnover after reopening Chart 1



Note: Data is seasonally adjusted and 7-day moving average. Card turnover is seasonally adjusted using a regression method.
Source: Nets Denmark A/S and own calculations.

During the pandemic, consumption has been highly limited by restrictions and fears of infection. At the same time, relief packages contributed to a continued increase in household income from wages and transfer incomes. In addition, household liquidity was supported by the disbursement of frozen holiday allowance[1]. Household savings therefore rose sharply and have provided a sound basis for a quick recovery of consumption.[2]

1 The disbursement of holiday pay is estimated to boost consumption by an overall amount of kr. 22.5 billion. As of 26 May, a total of kr. 52 billion has been disbursed after tax, and a marginal propensity to consume of 43 per cent has been assumed. See Henrik Yde Andersen, Spending when illiquid savings become liquid: evidence from Danish wage earners, *Danmarks Nationalbank Working Paper*, No. 161, September 2020 *(link)*.

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).

Consumption of services has been particularly hard hit by the restrictions, and consumption has instead been shifted towards goods. As more service industries have been allowed to reopen, the consumption of a number of services has increased sharply, resulting in a more even distribution of consumption between goods and services. This indicates that demand is largely returning to the pre-pandemic patterns.

Total card turnover increased further during the spring and is just above 10 per cent higher than before the pandemic at the beginning of June. The recovery of consumption means that imports of goods, in particular, have also recovered quickly.

Global industrial expansion has supported Danish exports of goods

The international economy has performed much better during the lockdown over the winter than in spring 2020. Fiscal and monetary policy have again supported households and companies, and the restrictions have been more targeted than in spring 2020. Especially manufacturing has been less affected this time.

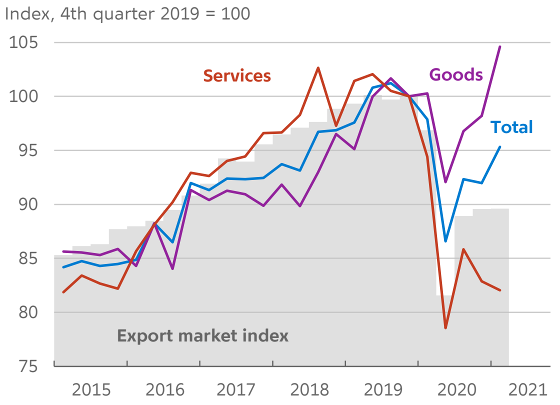
Like households in Denmark, foreign households have shifted their consumption towards goods, which has contributed to global manufacturing upswing. The manufacturing upswing supports world trade in goods, as the manufacturing industry is more integrated in international supply chains than service industries. In addition, confidence indicators show that the manufacturing upswing may be boosted by many companies needing to rebuild their stocks after disruptions in global supply chains and lockdown closures in 2020.

The global manufacturing upswing has provided a sound basis for Danish exports to continue to recover over the winter. Exports of goods increased by 10.6 per cent in the 1st quarter of 2021 and are thus above the pre-pandemic level, see chart 2. This increase contributed significantly to the overall Danish economy being hit less hard than in spring 2020. However, total exports are still weaker than before the pandemic, as parts of the service exports, such as travel and air transport, remain severely affected by restrictions.

Export growth appears to have slowed slightly in the 2nd quarter, and exports saw a nominal decrease of 3.1 per cent in April. However, real-time indicators show high exports to countries outside the EU through May, and confidence indicators abroad also show further increases in activity in Denmark's export markets with renewed growth in service industries.

Exports of goods are higher than before pandemic outbreak

Chart 2



Note: Exports are stated in volumes. The export market index covers imports in volumes of goods and services among Danish trading partners.
Source: Statistics Denmark, OECD and own calculations.

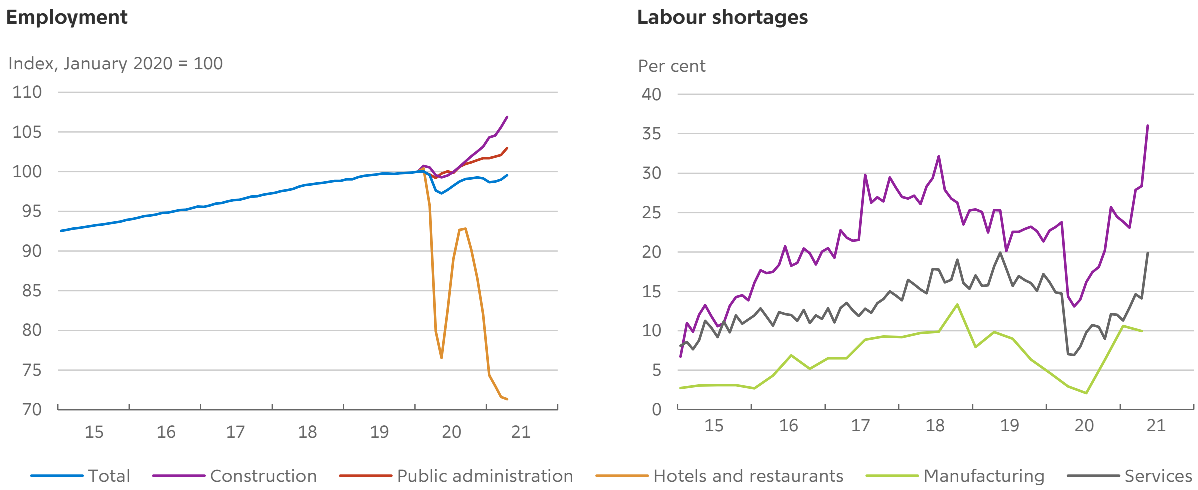
Moderate underlying price pressures despite higher commodity prices and supply chain disruptions

Global manufacturing upswing has increased the demand for freight and commodities, and the repercussions from the lockdown during the first wave of the pandemic have created major disruptions in international supply chains. Many companies in both Denmark and abroad report a shortage of materials and long delivery times. High demand for intermediate consumption in manufacturing and supply chain problems have pushed up freight rates and prices of a range of commodities.

Higher energy prices have led to increases in Danish consumer prices, and the annual rate of increase in the EU Harmonised Index of Consumer Prices (HICP) rose to 1.9 per cent in May. Energy prices contribute to the annual rate of increase due to temporarily low oil prices in spring 2020, and this contribution will in all probability ebb away during the summer. In addition, price increases are also temporarily lifted by the increase in tobacco duties.

The underlying price pressure remains moderate, and higher commodity prices and freight rates have not yet passed through to core inflation, which,

Employment high in construction with signs of bottlenecks building up Chart 3



Note: Labour shortages are own seasonal adjustment.
Source: Statistics Denmark and own calculations.

measured with constant taxes, rose 0.6 per cent in May. Producer prices, excl. energy, have increased more heavily, but short-term fluctuations are typically absorbed in corporate profit margins. A larger pass-through to underlying consumer prices, require a pass-through to the wages formation.

Expectations of higher inflation have contributed to a moderate increase in long-term interest rates
Inflation has also risen abroad, among other things on the back of higher energy prices. Together with large-scale fiscal and monetary policy stimuli during the pandemic, higher inflation has contributed to a significant increase in market-based inflation expectations, but inflation expectations in Europe remain below the European Central Bank's inflation target.

Higher inflation expectations have resulted in higher yields on long-term government and mortgage bonds in Denmark. For example, the yield on newly issued 30-year fixed-rate mortgage loans with coupon at 0,5 per cent has risen by about 0.5 percentage points since January. The financial conditions support the recovery of the Danish economy, but they have become slightly less accommodative.

Progress on the labour market since the reopening
The number of registered unemployed in Denmark has fallen by almost 30,000 persons since the reopening of society in March, and, concurrently, the number of persons on wage compensation or under the short-time working scheme has been significantly reduced. However, at the beginning of June, the number of registered unemployment is still 10,000 persons up on pre-pandemic level.

The labour market is greatly characterised by the economy running at multiple speeds, see chart 3. In April, employment was still lower than before the pandemic in the hotels and restaurants, transportation and arts and leisure, while there has been significant progress in construction and parts of manufacturing and services, for example in information and communication, where labour shortages are now back at the same high levels as in the years before the pandemic.

Employment in public administration has also increased sharply and is now 27,000 persons up on the pre-pandemic level. The increase is especially due to a high activity related to testing and vaccination in the fight against the pandemic. In April, the number of employees was still 14,000 persons lower than before the pandemic.

The large shifts in employment during the pandemic, over time as well as across industries, reflect the Danish labour market generally being characterised by high flexibility. It contributes to ensuring that the Danish economy is capable of adapting rapidly to shifts in production and demand patterns. This flexibility has also been present during the pandemic[3], where the economic downturn has particularly hit industries with relatively high ongoing staff turnovers[4].

Increased preferences for housing have contributed to rising house prices

Since summer 2020, the housing market has been characterised by many sales and heavily increasing prices. Nationwide, prices already increased by 15 per cent for single-family houses and 14 per cent for owner-occupied flats from the 2nd quarter of 2020 to the 2nd quarter of 2021.[5] The many sales have reduced the number of homes put up for sale and reduced the time-on-market. Large price increases in the housing market is a trend seen in many countries.

The rising house prices have been supported by rising incomes during the pandemic, which have been underpinned by relief packages, among other factors. At the same time, interest rates have been low and falling, although they have risen moderately again since the New Year. However, house prices have risen more than what can be explained by the development in incomes and interest rates.[6]

The heavy price increases and the declining number of houses for sale are assessed to be driven greatly by many households having given higher priority to their housing situation during the pandemic. Many households have spent more time in their own homes as a result of the pandemic, which has probably resulted in increased demand for more garden and space for home office.

Increased preferences for housing will in itself increase prices. The shift in preferences can additionally lead to a time shift in the decision of purchases and sales. The shift may have brought forward the decisions to buy among households that were in any case considering changing homes in the coming years. At the same time, households that were considering selling their homes in the immediate future may have been more reluctant to put their homes on the market. That is consistent with many sales and marked decline in the number of houses put up for sale.

Increased attention to housing needs must be expected to be most pronounced in and around the larger cities, where the extent of people working from home and the risk of infection have been higher due to a greater population density. This may help explain that price increases have been highest in the Capital Region.

The price increases have been close to the levels preceding the financial crisis. At that time, there are clear signs, that price developments were characterised by expectations of future price increases. In general, it is difficult to measure the degree of speculative price formation. Indicators of speculative behaviour, such as Danmarks Nationalbank's bubble test, show no clear signs at present and thus, does not seem to be the primary driver of price developments. At the same time, the housing burden is low and mortgage lending to households has so far increased in line with household incomes and has thus not kept pace with the increases in house prices.

Accommodative fiscal and monetary policy continues to support recovery abroad

Recovery in Denmark and abroad is expected to continue as vaccination programmes are being fully

3 See the Danish Ministry of Finance, Chapter 2: Labour market mobility, *Economic Survey*, May 2021.

4 See Filip Rozsypal, Worker flows and reallocation in covid-19 exposed sectors in the Danish economy, *Danmarks Nationalbank Economic Memo*, No. 3, June 2020.

5 For the 2nd quarter of 2021 figures from Statistics Denmark are extrapolated using figures from Boligsiden for April and May.

6 See Simon Thinggard Hetland, Simon Juul Hviid, Jesper Pedersen and Adrian Michael Bay Schmith, Boligmarkedet under og efter pandemien (Housing market during and after the pandemic), *Danmarks Nationalbank Analysis*, No. 16, June 2021 (currently only available in Danish).

rolled out. The rollout of vaccination programmes is assumed to prevent new, large-scale lockdowns, and the economies are not assumed to be significantly hampered by restrictions or fears of infection once the vaccination programmes have been fully rolled out. On this basis, production and demand patterns are assumed largely to return to the pre-pandemic patterns. At the same time, growth will also be supported by large-scale fiscal stimuli abroad in the coming years.

Central banks in Europe and in the United States have signalled, that they will maintain their accommodative monetary policy for some time yet, as they assess that the recent rise in inflation is temporary and that there is still slack in the labour market. Market expectations indicate that pressure on commodity prices will ease relatively quickly as pressure on the supply chains of the manufacturing industry is expected to ease off as production and demand patterns normalise.[7]

The international organisations expect a relatively strong recovery in activity in the world economy. The Organisation for Economic Co-operation and Development (OECD) expects global GDP growth of 5.8 per cent in 2021 and 4.4 per cent in 2022. In 2021, growth is expected to be driven by the marked recovery in the United States, where the rollout of vaccination programmes has been rapid and where large-scale fiscal policy relief packages have been implemented, including income transfers to the population. In 2022, growth will be driven more by Europe, where the recovery has been delayed due to slower vaccination programme rollout and the resurgence of infection and new lockdowns in several countries.

Danish economy heading for a mild boom

The reopening of Danish society is estimated to lead to GDP growth of between 2.5 and 3 per cent in the 2nd quarter of 2021. Growth is estimated to be driven by private consumption.[8] The activity level will thus be nearly back to the pre-pandemic level, and most of the backlog in relation to normal capacity utilisation will have been recouped.

The recovery is expected to continue in the 2nd half of the year, so that the economy will be back to normal capacity utilisation by the end of 2021. Growth will primarily be driven by exports supported by the recovery abroad. The increase in exports is expected to come mainly from service exports as demand abroad shifts back towards services again. At the same time, high activity and high capacity utilisation in the export-dependent manufacturing industry are expected to result in a rapid turnaround in corporate investments.

Consumption will continue to contribute to high growth in 2022. The consumption ratio is expected to return to the same pre-pandemic level as consumption patterns are normalised. Growth in consumption is subsequently estimated to ease off and develop in line with an increase in household income. High public consumption due to testing and vaccination will increase growth sharply in 2021, but this part of public consumption will be dampened in 2022, when no significant need is expected for testing and vaccination activity.

Overall GDP growth is estimated at 3.3 per cent this year and 3.7 per cent in 2022, see table 1. As activity returns to normal capacity utilisation in Denmark and abroad, growth is estimated to slow to 2.2 per cent in 2023, when the economy has entered a moderate boom with a output gap between 0.5 and 1 per cent, see chart 4.

The balance of payments surplus is expected to fall to 7.1 per cent of GDP in 2021, as the rapid recovery of domestic demand is expected to result in high growth in imports. As the consumption ratio normalises, growth in imports will dampen and the balance of payments surplus will increase to 7.6 per cent of GDP in 2023.

Employment is expected to increase by almost 100,000 persons towards the end of 2023. The recovery is generally expected to be strongest in the industries that have been hit hard during the lockdowns, but some industries may, for example,

7 See the International Monetary Fund, IMF blog, *Four factors behind the metals price rally (link)*.

8 The projection is based on published statistics up until and including 16 June 2021.

be affected by increased online shopping or less business travel. Employment growth is estimated to reduce gross unemployment to just below 110,000 persons, which is close to the structural level, while employment is estimated to be slightly higher than the structural level. Consequently, there will gradually be less slack in the labour market, and wage increases in the manufacturing industry are expected to increase from 2.3 per cent in 2021 to 2.9 per cent in 2023.

Inflation, measured by the EU Harmonised Index of Consumer Prices (HICP), is estimated to increase to 1.3 per cent in 2021 as a result of higher energy prices. The contribution from energy prices is expected to decrease in 2022, but higher wage growth is expected to increase inflation to 1.5 per cent in 2022 and 1.6 per cent in 2023.

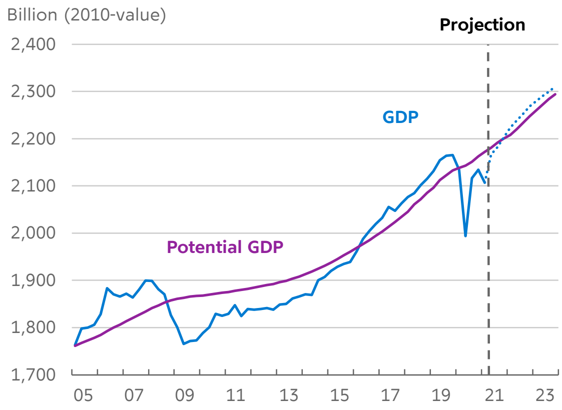
The unusual price increases on the housing market during the pandemic leave uncertainty about future developments elevated the coming years. The uncertainty is especially related to the extent to which increased preferences are fully reflected in house prices, and whether the increased preferences are temporary or permanent, for example if the extent of working from home remains higher after the pandemic.

In the projection, it is assumed that preferences are not yet fully reflected in prices and will continue to contribute to relatively high price increases the rest of the year. Furthermore, it is assumed, that half of the increase in preferences is temporary, implying a slowdown in price increases the following year, such that price increases will be lower than income growth.

On this basis, the prices of single-family homes are estimated to increase by approximately 14 per cent in 2021 and then slow to approximately 6 per cent in 2022 and 1 per cent in 2023. This means that, by the end of 2023, prices will still be 14 per cent above the expected development before the pandemic, see chart 5.[9]

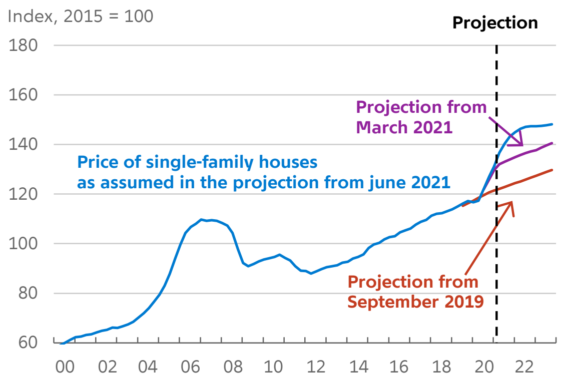
Pandemic still causes great

The economy is heading for a mild boom Chart 4



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.

House prices remain higher than estimated before the pandemic Chart 5



Source: Statistics Denmark and own calculations.

9 See Danmarks Nationalbank, Slightly lower growth in the coming years, *Danmarks Nationalbank Analysis (Outlook for the Danish economy*, No. 20, September 2019 *(link)*.

uncertainty about the outlook

The development in the pandemic still gives rise to great uncertainty about the growth outlook in a number of areas, although the vaccination programme rollout has reduced the risks. New mutations or short duration of protection from vaccines may lead to new major outbreaks of infection and consequently restrictions or increased testing and vaccination activity for a longer period than assumed. Prolonged restrictions will weaken the speed of recovery and could, in a worst-case scenario, result in new declines in activity if the pandemic leads to new lockdowns.

New or extended restrictions may also mean that demand patterns will normalise at a slower pace and that tendencies to bottlenecks in manufacturing and construction are reinforced. At the same time, continued high testing and vaccination activity may take up labour market resources, which may put pressure on other parts of the labour market, for example in the restaurant industry.

Inflation may also be higher than expected if inflation expectations or capacity pressures in labour markets lead to higher wage increases. Especially in the United States, many companies are already reporting labour shortages, despite that employment is still below the pre-pandemic level. Higher inflation may lead to an increase in interest rates and a tightening of financial conditions, which will dampen growth in Denmark and abroad. Moreover, interest rate rises may create uncertainty in countries and companies that already have high debts.

The recovery may also be stronger than expected. More pent-up demand during the lockdown could be released by households in Denmark having historically high savings than assumed in the projection. In addition, the price increases in the housing market over the past year have significantly boosted the home equity of households, and the conditions for increased credit growth for consumption are therefore present. Foreign households also have high savings and pent-up demand, which can support Danish exports.

Continued increases in house prices may lead to a rapid acceleration in credit growth, which mainly poses a risk in and around large cities, where price increases and credit growth are already highest. Higher indebted households will make the Danish economy more vulnerable to economic downturns, and prior accumulation of debt was one of the reasons why it took many years to recover from the financial crisis. The stronger and more sustained the increase in house prices is, the greater the risk that the price development may contribute to build-up of imbalances in the Danish economy.

The Government should prepare tightening fiscal policy more than planned

The economic policy pursued has contributed greatly to supporting companies and households during the lockdowns. Activity has recovered quickly after the reopening of society with large increases in private demand. At the same time, there are signs of bottlenecks building up in manufacturing and construction.

It is therefore appropriate that the extraordinary compensation schemes from the lockdown are phased out in accordance with the Expert Group's recommendations[10], and that the Government does not envisage extending the temporary increase in the Housing Job Scheme (*BoligJobordningen*) to 2022.

With an outlook for a mild boom, there is no need for other stimulus measures. The funds set aside for handling covid-19 and further fiscal stimulus *(Ramme til håndtering af covid-19 og yderligere stimulus)* should not be used in order to increase aggregate demand. The funds should instead be saved and used if the need occurs.

The Government can, to advantage, prepare for how economic policy is to dampen capacity pressure further if more widespread bottlenecks develop in the labour market. Scrapping the Housing Job Scheme would, for example, be an obvious measure aimed at dampening demand in construction, where activity is already high.

10 See Torben M. Andersen, Michael Svarer and Philipp Schröder, *Report from the Economic Expert Group on the phasing out of relief packages II,* Danish Ministry of Finance, May 2021 *(link in Danish only)* .

Good time to strengthen robustness of the housing market

It is important to prevent unsustainable risk build-up in households, and it is currently a good time to implement structural improvements in the housing market.

Firstly, it is essential to have mechanisms built into housing taxation that reduce fluctuations in house prices. In this connection, the introduction of the new stabilising housing taxation from 2024 is important.

Amortisation requirement for the most highly indebted homeowners will contribute to increasing the robustness of households. A reduction of the tax value of interest rate deductibility will reduce the incentive to raise debt, thus contributing to reducing vulnerability in the housing market. It is desirable to improve these structures and now is a good time, as interest rates are low, and the economy is heading for a mild boom. Amortisation requirements and reduction of interest rate deduction are expected to reduce the risk of the housing market being characterised by more speculative price formation.

Economic policy

The Government should phase out relief packages in accordance with the Expert group recommendations. The relief packages are expensive, hamper business dynamics and tie up resources in the labour market.

The Government should prepare to tighten fiscal policy more than planned, as the economy is heading for a mild boom, and there are emerging signs of bottlenecks in parts of the labour market.

A reduction of the tax value of the interest rate deduction will reduce the incentive for borrowing, and the current low level of interest rates makes it a favourable time to reduce the tax value. The introduction of the new stabilising housing tax in 2024 is also of central importance to ensuring a more resilient housing market in the long term.

A repayment requirement for the most highly indebted homeowners could reduce vulnerability in the housing market.

Key economic variables

Table 1

Real growth relative to the previous period, per cent	2020	2021	2022	2023	2020 Q3	2020 Q4	2021 Q1
GDP	-2.7	3.3	3.7	2.2	6.2	0.8	-1.3
Private consumption[1]	-2.0	2.7	6.4	2.5	5.7	1.0	-4.8
Public consumption	-0.1	3.8	-0.9	1.2	0.7	5.2	-2.2
Residential investments	6.9	8.5	1.3	-1.9	2.4	4.4	3.4
Public investments	8.3	2.5	3.3	7.1	3.3	18.0	-14.4
Corporate investments	-1.2	1.1	4.9	2.8	4.5	-4.2	2.1
Inventory investments etc.[2]	-0.2	0.0	0.0	0.0	1.6	0.0	-0.9
Exports	-7.7	7.8	4.9	3.3	7.0	0.0	6.2
Industrial exports	-1.8	10.8	1.4	3.6	4.7	2.1	11.5
Imports	-4.8	7.8	5.2	3.2	6.1	2.3	1.6
Employment, 1,000 persons	2,981	3,008	3,044	3,071	2,979	2,994	2,975
Gross unemployment, 1,000 persons	133	118	111	109	139	129	129
Balance of payments on current account[3], per cent of GDP	8.2	7.1	7.3	7.6	8.2	7.5	8.8
Government budget balance[3], per cent of GDP	-0,5	-2.2	0.4	0.8	1.4	-2.5	-3.5
House prices[4], per cent year-on-year	4.5	14.2	6.2	0.8	5.0	8.4	12.5
Consumer prices (HICP), per cent year-on-year	0.3	1.3	1.5	1.6	0.4	0.4	0.5
Hourly wages[5] (manufacturing industry), per cent year-on-year	2.2	2.3	2.8	2.9	2.0	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. The most recent revision of the balance of payments and government finances has not been incorporated in the latest quarterly national accounts and is therefore not included in the analysis data on which the projection is based. The figures in the table for 2020 are in accordance with the latest revision.
4. Nominal prices of single-family houses.
5. Statistics Denmark's implicit wage index.

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