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OUTLOOK FOR THE DANISH ECONOMY — MARCH 2023

Declining but still high inflation

Pressure is easing in the Danish economy

The Danish economy is facing a slowdown, partly as a result of interest rate increases, which is feeding through to consumption. The slowdown will take pressure off the labour market and will bring the Danish economy close to a neutral cyclical situation from the end of this year.

Inflationary pressures shift from energy to wages

Inflation will fall markedly primarily as a result of falling energy prices, but higher wage increases will cause inflation to remain high. The same applies for the euro area. The risk of inflation taking hold is not averted.

A tight economic policy is required

It is essential that the high inflation is brought down. Monetary policy has been tightened significantly, and it is important that fiscal policy does not counteract monetary policy in bringing the inflation down. A tightening of fiscal policy may become needed if the risk of a wage-price spiral rises in Denmark.

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DOMESTIC INFLATIONARY PRESSURES

Energy price increases that so far have driven up inflation in Denmark are now declining. On the other hand, higher wage increases in Denmark increase domestic inflationary pressures. Inflation is expected to decline significantly in 2023, but is estimated to remain high over the projection horizon.

MONETARY TIGHTENING

High inflation has prompted central banks across the world to tighten monetary policy, resulting in sharp market rate increases. Monetary policy is already dampening activity in Denmark and will further dampen growth and inflation over the coming year.

LOWER DANISH DEMAND

The interest rate increases have led to significant price falls in the Danish housing market over the past year. In addition, consumption has declined as a result of a marked drop in purchasing power. The downturn in domestic demand is more pronounced than in the euro area. Growth has so far been underpinned by exports.

GROWTH SLOWDOWN IN 2023

As higher interest rates dampen growth in Denmark's export markets, this is expected to lead to a slowdown in the Danish economy. However, an unusual increase in the production of pharmaceuticals, most likely related to activities abroad, will raise Danish GDP in 2023.

NEUTRAL CAPACITY PRESSURES

The slowdown is expected to lead to increasing unemployment that will reduce pressure on the labour market. Most likely, the Danish economy will avert recession. However, this is conditional on inflation being brought down abroad without a global slump.

RISK OF WAGE-PRICE SPIRAL

The risk of inflation taking hold in a Danish wage-price spiral remains, even though inflation is on the way down. However, Danmarks Nationalbank assesses that the risk of a Danish wage-price spiral has been reduced since the summer of 2022.

Key economic variables

Real growth relative to the previous year, per cent	2022	2023	2024	2025
GDP (real), per cent	3.4	0.9	1.2	1.2
Employment, 1,000 persons	3,164	3,173	3,148	3,141
Gross unemployment, 1,000 persons	76	88	97	100
Balance of payments on current account, per cent of GDP	12.8	10.3	9.1	9.0
Government budget balance, per cent of GDP	1.0	1.5	1.9	1.5
House prices[1], per cent year-on-year	-0.4	-9.4	-0.3	2.9
Consumer prices, per cent year-on-year	8.5	4.0	3.6	3.0
Hourly wages[2] (manufacturing), per cent year-on-year	3.5	4.7	5.3	3.9

Source: Statistics Denmark and own calculations.
1. Nominal prices of single-family houses.
2. Danish Employers' Association pay roll costs, including inconvenience supplements for manufacturing.

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The government should be prepared to tighten fiscal policy at short notice if the risk of an independent Danish wage-price spiral rises.

Recommendations for economic policy

The Danish economy is facing a slowdown as a result of the sharp tightening of monetary policy in the USA, the euro area and Denmark, which is implemented to bring inflation down. The slowdown follows the past 18 months of economic boom in Denmark and three years marked by the pandemic and the war in Europe.

Prospect for slowdown and lower inflation
There is a clear decline in private spending and a sharp fall in house prices in Denmark due to higher interest rates and erosion of purchasing power resulting from very high inflation. In the euro area and the USA, private spending and the housing market have so far not seen the same marked decline. Overall, there is continued growth in activity abroad and so far, this underpins Danish exports resulting in continued increases in Danish production and employment over the winter. However, the momentum in the Danish economy is assessed to have declined recently, disregarding an unusually large increase in the production in the pharmaceutical industry, most likely related to activities abroad, that are included in the Danish gross domestic product, GDP.

GDP is expected to increase by 0.9 per cent in 2023, but this reflects a marked lift from production in the pharmaceutical industry, that will likely not affect employment or the capacity pressure in the Danish economy. Disregarding the recent sudden increase in pharmaceutical production, GDP is expected to fall a little through 2023 as the impact of central bank interest rate hikes intensifies and dampens growth in Denmark and abroad. The slowdown is a smaller yet broad-based, which will also result in a turnaround in the labour market, where employment will fall and unemployment rise.

The slowdown in the Danish economy is expected to reduce the pressure that has characterised the labour market over the past 18 months, and the economy is expected to be close to a neutral cyclical situation from the end of 2023. However, this expectation is based on the projections of a number of international organisations that central banks will manage to bring down inflation without pushing the world economy into a recession.

The outcome of the collective bargaining in the spring points to higher wage increases than those seen in collective bargaining rounds for the past many years. Although labour market pressures are easing, wage increases in the manufacturing industry are expected to increase to around 4.7 per cent in 2023. This will increase the price pressure stemming from domestic factors, such as Danish businesses' labour costs. On the other hand, price pressures driven by foreign factors, such as the prices of energy and other imported goods and services, are expected to ease, mainly as a result of lower energy prices.

Overall, inflation is expected to fall significantly to 4.0 per cent this year, mainly as a result of falling prices on consumer energy. By contrast, the shift towards higher domestic inflationary pressures means that it will take some time to reduce in particular core inflation, which excludes energy and unprocessed food. Core inflation is estimated to remain high throughout the projection period. The same development is seen in the euro area, and the increases in Danish wages and consumer prices are expected to be broadly in line with those in the euro area over the coming years as a whole.

Fiscal policy should not add to inflation
A tight economic policy is required to bring down inflation. Due to Denmark's fixed exchange rate regime, monetary policy in the euro area has the main role in maintaining stable price and wage developments. Fiscal policy in Denmark should address deviations in the cyclical situation between Denmark and the euro area, e.g. if capacity pressures in the Danish economy are significantly greater than in the euro area or if there is an elevated risk of an independent Danish wage-price spiral.[1]

1 See Morten Spange, Monetary and fiscal policy in Denmark, *Danmarks Nationalbank Analysis*, No. 12, October 2022.

Monetary policy in the euro area has been tightened significantly since September and further tightening is expected. This contributes to significantly dampening growth in the euro area and in Denmark.

Currently, Denmark and the euro area are facing the same challenges in terms of bringing down inflation with an outlook of wage increases that are inconsistent with stable low inflation over the longer term. There is no prospect of significant differences in the cyclical situation between Denmark and the euro area that should be addressed separately through fiscal policy. But it is important that fiscal policy does not counteract monetary policy in bringing inflation down, and there is no room to increase the pressure in the economy. Therefore, any new fiscal measures that increase capacity pressures in the economy must at least be matched by measures that dampen the pressure elsewhere correspondingly.

In the summer of 2022, Danmarks Nationalbank recommended that fiscal policy should contribute to dampening capacity pressures by just under 1 per cent of GDP in 2023 in addition to what was contained in the Finance Bill. This was due to the increased risk of a wage-price spiral in Denmark resulting from a markedly greater pressure on the labour market than in the euro area. Danmarks Nationalbank currently considers that there is still a risk of an independent Danish wage-price spiral, but it has decreased since the summer of 2022. This also means that the need for a rapid and significant tightening of fiscal policy is as such also reduced.

The results of the Danish collective agreements and the signs that labour market pressures are reduced provide greater certainty that wages in Denmark will not increase significantly more than in the euro area. The reported shortage of labour has declined markedly since September, and there is a more pronounced decline in private consumption in Denmark than in the euro area. At the same time, house prices are falling faster in Denmark than in the euro area. The decline in private consumption in Denmark may indicate that the after-effects of corona measures as for instance the disbursements of frozen holiday allowance etc. are diminishing.

The risk of inflation taking hold in a wage-price spiral has not been averted. Therefore, an extensive tightening of fiscal policy may be required if the risk of an independent wage-price inflation increases. This may happen e.g. if local wage negotiations result in significantly higher wage increases than agreed in the collective bargainings or if Danish businesses pass on higher wage costs to consumer prices to a greater extent than businesses in the euro area. The Government should therefore be prepared to tighten fiscal policy at short notice.

Danmarks Nationalbank's recommendations for economic policy

A tight economic policy is required to bring down inflation. It is important that fiscal policy does not counteract monetary policy in bringing inflation down.

Any compensation for rising consumer prices must remain activity-neutral and retain incentives to minimise, for example, energy consumption.

The housing tax reform must proceed according to plan as it is a significant contribution to healthier structures in the housing market.

Any compensation for rising prices must maintain the incentive to curb consumption

Political aspirations to compensate selected population groups for rising prices should remain activity-neutral to ensure that the measures will not increase capacity pressures in the economy. At the same time, they should maintain the incentive to reduce energy consumption. Accordingly, subsidies or tax reductions designed to mitigate the impacts of high energy prices should be avoided, as they will simply support energy consumption and may further increase energy prices. Targeted, temporary transfers are a more appropriate short-term tool, while still keeping in mind that repeated disbursements must not weaken the incentive to shift away from expensive sources of energy.

The measures already adopted have largely followed the above principles, and fewer compensation schemes have been introduced than in many other European countries. However, the temporary reduction in the electricity tax in the first half of 2023 is not an appropriate way to compensate households and businesses. In addition, the latest agreement on new inflation relief is hardly activity-neutral, even though the proposal is fully financed, as the taxation of higher-than-normal profits is likely to have a lower activity impact than payments to households with liquidity constraints. At the same time, it will not be expedient to offer liquidity support to businesses once again by deferring payment deadlines on withholding tax and labour market contributions. In the absence of market failures, businesses are best financed on market terms on the basis of a credit rating.

The housing tax reform should go ahead as planned

It is important that the housing tax reform in 2024 proceeds according to plan as it is a significant contribution to healthier structures in the housing market. The reform ensures that housing taxes will again rise and fall with house prices, contributing to reducing fluctuations in house prices, with a spill-over stabilising effect on the rest of the economy. If the housing tax reform had been in place before the pandemic, the current price declines in the housing market would likely not be as pronounced, just as the price increases through 2020 and 2021 would also not have been as high.

THIS IS AN EXTRACT

The full English version will be available as soon as possible. Until then, the Danish version can be found here: (*link*).

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The analysis consists of a Danish and an English version. In case of doubt regarding the correctness of the translation the Danish version is considered to be binding.

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