
Recent Economic and Monetary Trends

This review covers the period from mid-December 2009 to early March 2010

SUMMARY

The global economic recession has come to an end, and most countries are once again experiencing positive growth. In the industrialised economies, the recovery is fragile and is expected to be slow and modest. In the emerging and developing economies, the upswing is more firmly rooted, and in many cases growth is almost back at the pre-crisis level.

Particularly in the industrialised world the recovery is attributable to strongly expansionary economic policies that are inherently temporary. The extraordinary measures to ease monetary policy implemented with a view to mitigating the crisis are to some extent being rolled back. Curves for money-market interest rates and bond yields indicate that market participants expect the European Central Bank, ECB, and the Federal Reserve to keep interest rates stable for a while to come, whereas a number of smaller countries have raised their interest rates.

Government budget deficits are substantial in most countries, entailing rapid accumulation of debt. Many countries already have very large government debts relative to output. The International Monetary Fund, IMF, expects debt as a ratio of the gross domestic product, GDP, to reach 110 per cent by 2014 for the industrialised world taken as one. The need for fiscal consolidation is considerable. There is no longer any policy scope for choosing between consolidation and further fiscal stimulus to the economy. In most EU member states, the budget deficit will exceed 3 per cent this year, which means that these member states will be subject to the Stability and Growth Pact's excessive deficit procedure and will have to implement tightening measures – in many cases starting this year. In Greece, pronounced budget deficits and uncertainty about future fiscal policy have led to considerable widening of the government yield spreads to other euro area member states.

After a fall in GDP in volume terms of more than 7 per cent, the Danish economy saw moderately positive growth in the 2nd half of 2009. Private consumption is beginning to pick up, and sentiment in the housing market is improving, but remains fragile. Lending by banks to households increased in January. As in other countries, growth is expect-

ed to be weak in the coming years. Considerable spare capacity in the business sector points to a further increase in unemployment, which is not expected to peak until around a year from now.

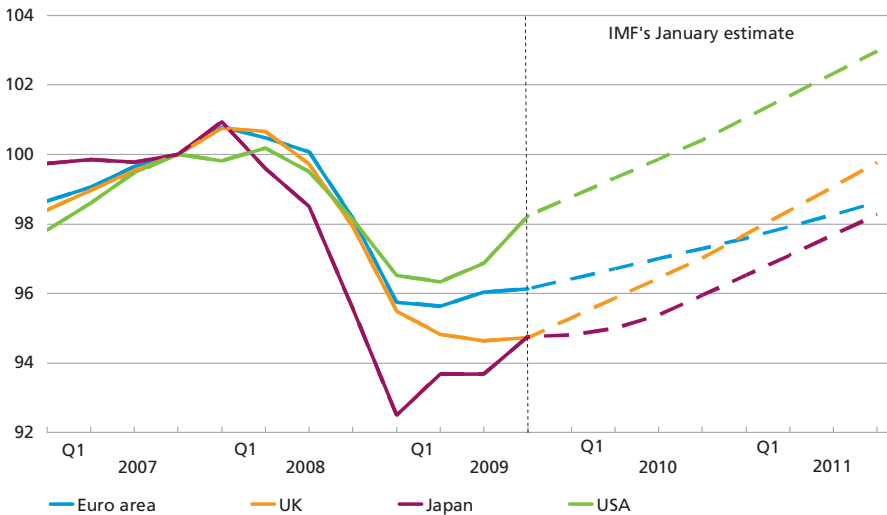
In Denmark, too, the crisis has had a significant negative impact on public finances. This year, a deficit of just over 5.5 per cent of GDP is expected. The deficit is not purely cyclical; there is also a structural deficit – in the range of 1.7 per cent of GDP according to the Ministry of Finance. The economic crisis has increased the structural deficit. The Danish government's Convergence Programme for 2009, published in February 2010, describes Denmark's fiscal challenges, but it remains to be seen precisely how they will be addressed in the coming years.

THE INTERNATIONAL ECONOMY

The recession in the world economy has made way for rising output. The recovery is slightly stronger than anticipated in the autumn. The turnaround is most pronounced in the emerging and developing economies, while the upswing in the industrialised countries is more moderate and still fragile. According to the latest IMF estimates, a continued, but tentative upswing is expected, with output not returning to the pre-crisis level until 2011, cf. Chart 1.

DEVELOPMENT IN GROSS DOMESTIC PRODUCT, GDP, IN VOLUME TERMS Chart 1

Index, Q4 2007 = 100

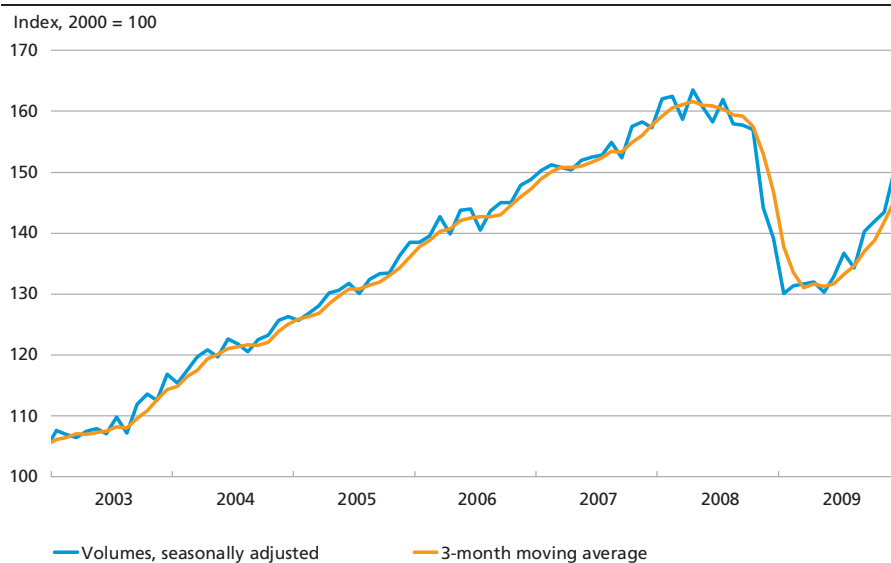


Note: GDP in volume terms, actual data up to and including the 4th quarter of 2009, projected on the basis of estimates from the IMF, *World Economic Outlook*, Update, January 2010. The 4th quarter of 2007 was the cyclical peak in the USA.

Source: Reuters EcoWin and IMF.

WORLD TRADE

Chart 2



Note: Mean value of total imports and exports in volumes. The most recent observations are from December 2009.
Source: Netherlands Bureau for Economic Policy Analysis.

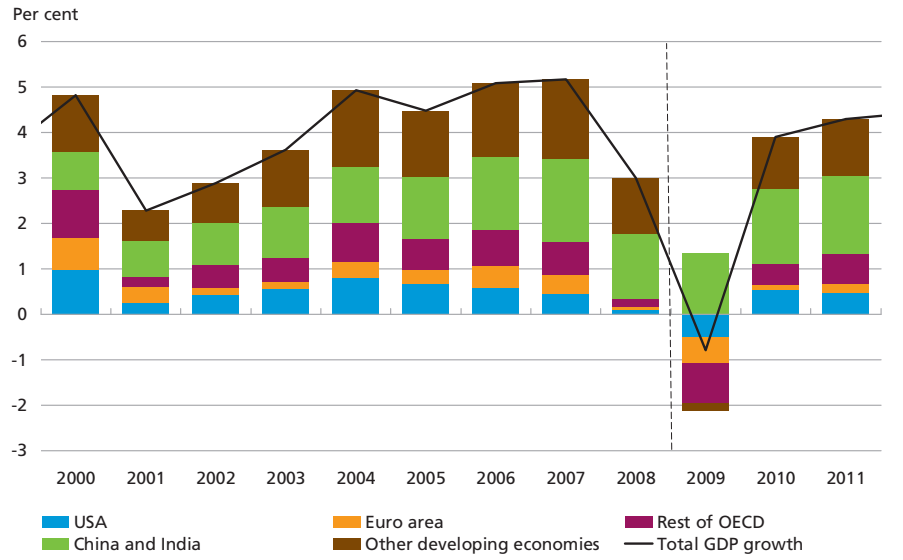
Towards the end of 2009, private consumption in several major industrialised countries had more or less returned to the level seen before the crisis. Fixed investments, including residential investments, had also picked up. Global trade increased after the sharp drop at the end of 2008, but remains well below the pre-crisis peak, cf. Chart 2.

Business confidence generally showed signs of improvement in both the industrialised world and the emerging economies in early 2010. In January, the US confidence index for the manufacturing sector rose to the highest level observed since 2004, and euro area confidence was back at the level seen in August 2007. Consumer confidence indices were also higher at the beginning of 2010 than they had been 12 months earlier.

The IMF estimates that global GDP fell by 0.8 per cent in 2009, compared with an increase of 3.0 per cent in 2008. China and India were the primary drivers of growth, while the industrialised world and the rest of the emerging and developing economies made negative contributions. The upswing in the world economy is expected chiefly to be fuelled by higher growth in the emerging and developing economies, which will contribute three quarters of the increase in global GDP in 2010-11. To this should be added more moderate growth in the industrialised world. The IMF expects global GDP to rise by 3.9 per cent in 2010 and by 4.3 per cent in 2011, cf. Chart 3.

CONTRIBUTIONS TO GROWTH IN GLOBAL GDP

Chart 3



Since early 2008, employment has dropped in the industrialised world. In the USA, 8.4 million jobs have been lost, while the corresponding figures are 3.4 million for the euro area, 1.3 million for Japan and 0.6 million for the UK. The expected growth in output in the coming years is not sufficiently strong to seriously boost employment.

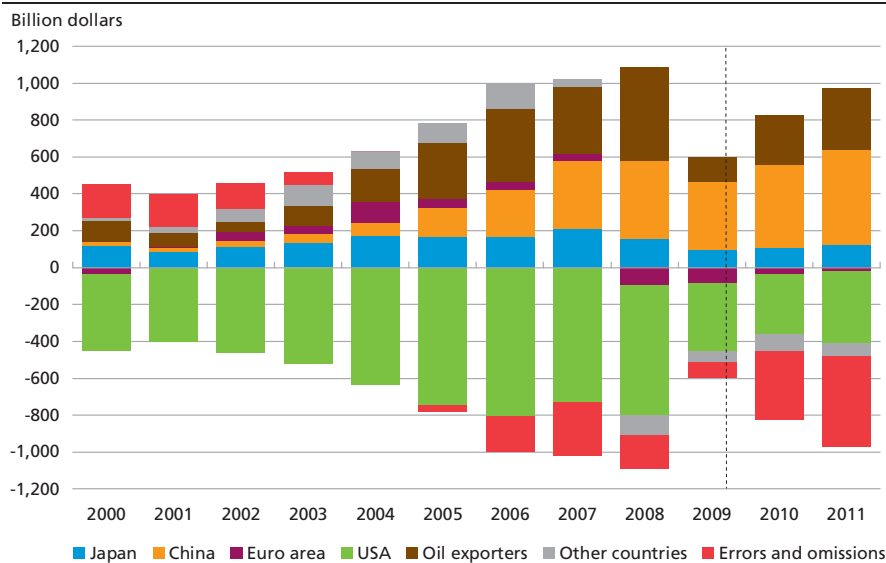
Larger savings and falling domestic demand in 2009 led to a substantial reduction of the US current-account deficit. The US deficit has chiefly been offset by surpluses in China, Japan and oil-exporting countries. The global economic imbalances accumulated prior to the crisis have thus been reduced considerably, but according to the IMF this is primarily a short-term cyclical effect. The imbalances are expected to become more pronounced in the coming years as the economic environment improves, cf. Chart 4.

Price developments

Consumer price inflation began to rise in the industrialised economies towards the end of 2009, mainly because the large energy price falls in 2008 dropped out of the year-on-year rate of increase. In January, consumer prices were 1.0 per cent higher in the euro area and 2.6 per cent higher in the USA than in the same month of 2009, while Japanese consumer prices continued to fall. Consumer prices excluding food and energy, i.e. core inflation, rose by 1.6 per cent in the USA and 0.9 per cent in the euro area in January. Following a decline, core inflation has stabilised at this level since the end of 2009, cf. Box 1, Chart 5.

GLOBAL IMBALANCES

Chart 4



Note: Current balances of payment, broken down by countries and regions. Estimates for 2010-11.

Source: IMF, *World Economic Outlook*, database.

Financial markets

The international money markets have come far in terms of normalisation. Market participants in the capital markets have turned their attention to the large government budget deficits and the risks associated with higher government debt.

The spread between collateralised and uncollateralised interest rates, which reflects the credit risk in the money markets, has been back at the pre-crisis level since the autumn of 2009, cf. Chart 6. In the USA, Europe and Japan, benchmark stock indices have been falling slightly since January, but in early March prices were up to 65 per cent above the trough in the spring of 2009. Long-term bond yields have been rising as growth prospects have improved since the beginning of 2009, particularly in the USA, and in March the yield on a 10-year US government bond was 3.6 per cent, corresponding to an increase of just over 30 basis points since early December.

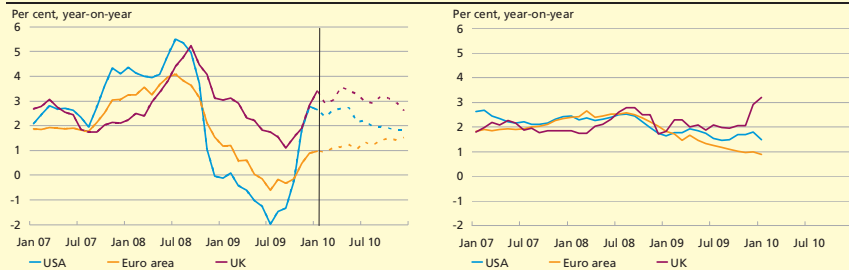
The euro depreciated by just over 10 per cent relative to the dollar from early December to early March. The underlying cause was that the yield spread between the USA and Germany developed to the advantage of the USA, cf. Chart 7, reflecting relatively better growth prospects in the USA. From mid-January to mid-February, the weakening of the euro vis-à-vis the dollar intensified, reflecting uncertainty about the Greek economy and concerns about a spill-over effect on other euro area

The economic and financial crisis has led to considerable easing of fiscal and monetary policies. This has generated concerns about rising inflation as the real economy improves. However, a number of factors point to inflation remaining dampened.

Consumer price inflation, measured by the year-on-year increase, has risen strongly since the autumn after having been negative or low during most of 2009. The fluctuations are mainly attributable to base effects of the massive fluctuations in energy prices throughout 2008. Inflation is stated relative to the corresponding month of the preceding year, and hence part of the inflation "calculation" is known beforehand. In November 2009, price levels from December 2008 to November 2009 are known, so in order to calculate inflation in December, only information about price developments from November to December 2009 is lacking. Assuming either unchanged prices or a given average monthly inflation rate, it is thus possible to calculate annual inflation by means of the "base effects". Chart 5 (left) shows that these effects subside from early 2010.

INFLATION AND BASE EFFECTS (LEFT) AND CORE INFLATION (RIGHT)

Chart 5



Note: The left-hand chart is a projection of inflation based on the average monthly core inflation rate over the last two years. Own seasonal adjustment for the UK.

Source: Reuters EcoWin and own calculations.

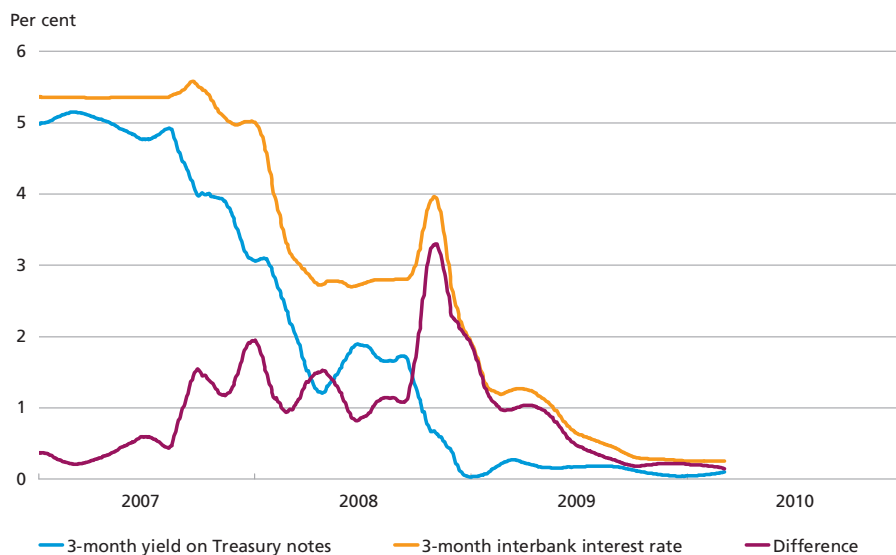
Core inflation (changes in consumer prices less energy and food prices) has fallen in the wake of the crisis in the last two years, except in the UK, cf. Chart 5 (right). There are several indications that it will remain low.

The strong decline in output since 2008 has widened the output gap and reduced capacity utilisation, which will dampen inflationary pressures in the coming years. There is also plenty of spare labour. Traditionally there has been a negative correlation between inflation and spare capacity in the labour market, but this trend has become weak since the mid-1990s. All sectors except the public sector have considerable spare capacity, but notably so industry and construction. This points to relatively low inflationary pressures from the labour markets by way of modest wage pressure.

member states, cf. below. The Danish krone traded at 5.49 dollars in early March, compared with 4.93 dollars in early December. The current exchange rate of the euro against the dollar is more or less the same as at the onset of the financial crisis in the summer of 2007. During the same period, the yen has appreciated by around 30 per cent vis-à-vis the dollar.

US MONEY-MARKET SPREAD

Chart 6



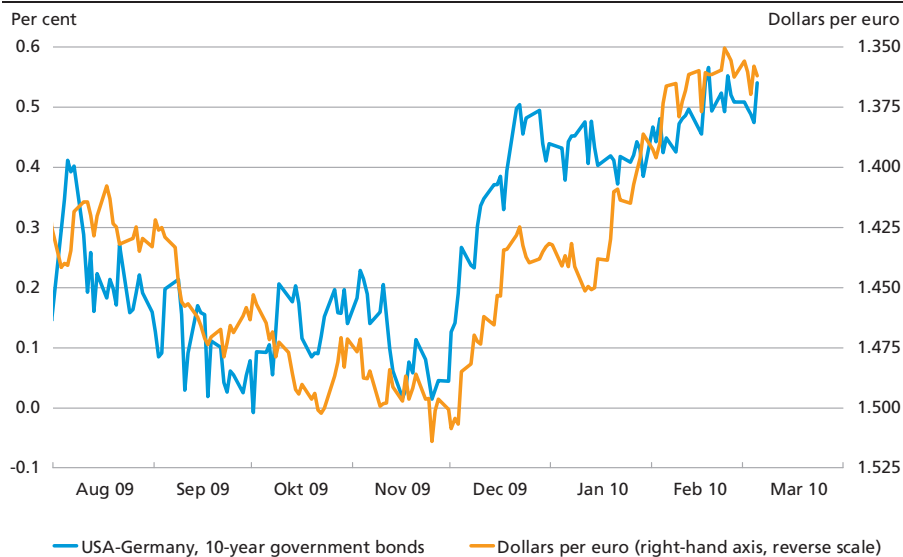
Note: 30-day moving averages.

Source: Reuters EcoWin.

The Swedish krona and the Swiss franc have both strengthened against the euro since early December, while the pound sterling has remained unchanged. By early March, the Swedish krona had appreciated by 7.5 per cent.

YIELD SPREAD, USA-GERMANY, AND DOLLARS PER EURO

Chart 7



Note: An increase in the exchange-rate curve indicates an appreciation of the dollar.

Source: Reuters EcoWin.

In January, Danmarks Nationalbank decided to provide a government-guaranteed loan to the IMF's Poverty Reduction and Growth Trust, PRGF. On 28 January 2010, Danmarks Nationalbank concluded an agreement for 200 million SDR with the IMF.

Economic policy

Massive easing of fiscal policy and substantial automatic budget deterioration as a result of the recession led to a pronounced increase in government budget deficits in the industrialised countries in 2009. The IMF expects these budget deficits to be reduced only slightly in 2010. Government debt will continue to rise in the coming years and will, in the assessment of the IMF, constitute almost 110 per cent of GDP by 2014.¹ For all practical purposes, the sizeable debt prevents any further fiscal easing and increases the risk of rising real interest rates and lower growth.

In the EU, the budget deficits of most member states are expected to exceed 3 per cent of GDP in 2010, which means that these member states will be subject to the Stability and Growth Pact's excessive deficit procedure. The EU's fiscal-policy recommendations will have to be implemented by most member states already this year, cf. Box 2. Greece's budget deficit increased to 12.7 per cent of GDP in 2009. The substantial fiscal problems have led to a pronounced widening of the yield spread between Greek and German government bonds since October 2009, cf. Chart 8. Increasing market focus on government debt also caused the yield spread for, among others, Portugal to widen. Unlike Greece, Ireland has implemented extensive fiscal consolidation measures, and hence the Irish yield spread to Germany has not been affected by the inadequate fiscal policy of Greece.

The notice of the Ecofin Council and the Eurogroup given on 16 February requires Greece to reduce its budget deficit by 4 per cent of GDP annually in the period 2010-12. Greece was given until 16 March to present a plan for implementing this fiscal objective and must have taken the necessary decisions by 15 May. The steps to be taken include reducing nominal wages and salaries, bonuses and pensions and introducing a hiring freeze in the public sector; freezing public transfer benefits and cutting down on the public-sector investment programme; introducing progressive taxation of investment income; abolishing exemptions in the tax system; taxing the incomes of the self-employed; raising property taxes; raising indirect taxes on alcohol, tobacco and energy; and raising VAT. By the end of 2010, Greece must, among other things, have reformed its healthcare and pension sectors in order to

¹ IMF, *Strategies for Fiscal Consolidation in the Post Crisis World*, February 2010.

EXCESSIVE DEFICIT PROCEDURE, EU STATUS

Box 2

The Stability and Growth Pact is at the core of the EU's monitoring of public finances in member states. A key element in this context is Article 126 of the Lisbon Treaty on excessive government deficits.

Under Article 126, EU member states must avoid excessive government deficits. In normal economic conditions, this means that the government deficit must not exceed 3.0 per cent of GDP and the government debt must not exceed 60 per cent of GDP.

The excessive deficit procedure was used extensively in 2009. 18 EU member states were subjected to the procedure, in addition to the two that had already been so, cf. Table 1. Another five member states (Estonia and Bulgaria will presumably be exempted) are likely to be subjected to the procedure in 2010 according to the most recent forecast from the European Commission (November 2009).

EU MEMBER STATES SUBJECT TO THE EXCESSIVE DEFICIT PROCEDURE Table 1

	Instrument applied (article of the Treaty)	Total and structural budget balance 2009*	Annual consolidation**	Start/time limit for remedial action
Euro area				
Greece	Notice (126.9)	-12.7 (-11.3)	≥3.5	10/12
Ireland	Recommendation (126.7)	-12.5 (-10.1)	2.0	10/14
Spain	Recommendation (126.7)	-11.2 (-9.3)	>1.5	10/13
Portugal.....	Recommendation (126.7)	-8.0 (-6.6)	1.25	10/13
France	Recommendation (126.7)	-8.3 (-7.0)	>1.0	10/13
Slovakia	Recommendation (126.7)	-6.3 (-6.2)	1.0	10/13
Malta	Recommendation (126.7)	-4.5 (-4.3)	0.75	09/11
Belgium	Recommendation (126.7)	-5.9 (-4.2)	0.75	10/12
Slovenia	Recommendation (126.7)	-6.3 (-4.7)	0.75	10/12
Netherlands	Recommendation (126.7)	-4.7 (-3.6)	0.75	11/13
Austria	Recommendation (126.7)	-4.3 (-3.3)	0.75	11/13
Italy	Recommendation (126.7)	-5.3 (-3.7)	≥0.5	10/12
Germany	Recommendation (126.7)	-3.4 (-1.9)	≥0.5	11/13
Non-euro area				
Latvia	Recommendation (104.7 ⁺)	-9.0 (-7.0)	≥ 2.75	10/12
Lithuania	Recommendation (126.7)	-9.8 (-8.0)	≥ 2.25	09/12
Romania	Recommendation (126.7)	-7.8 (-7.1)	1.75	10/12
UK	Recommendation (126.7)	-12.1 (-10.3)	1.75	10/14-15
Poland	Recommendation (104.7 ⁺)	-6.4 (-6.4)	≥ 1.25	10/12
Czech Republic	Recommendation (126.7)	-6.6 (-6.3)	1.0	10/13
Hungary	Recommendation (104.7 ⁺)	-4.1 (-2.1)	Total 0.5	10/11

Note: * Percentage of GDP, structural balance in brackets. ** Required annual adjustment of structural balance.
+ Article 104.7 of the Treaty of Nice corresponds to Article 126.7 of the Treaty of Lisbon. The structural balance is the deficit remaining when the economic situation normalises.

Source: Decisions of the Ecofin Council, European Commission's autumn forecast, November 2009, and Danish Ministry of Finance.

These member states have been subjected to the excessive deficit procedure in that the Ecofin Council, on a proposal from the Commission, has adopted a *recommendation* or *notice* to take measures to reduce the government deficit at a certain rate of annual structural consolidation within a specified time limit. The annual rates of structural consolidation vary from at least 3.5 per cent of GDP for Greece to a total of 0.5 per cent of GDP for Hungary. Most member states must already start their consolidation effort in 2010, and the deadlines for observing the reference value of 3 per cent vary from 2011 for Hungary and Malta to the fiscal year 2014/15 for the UK.

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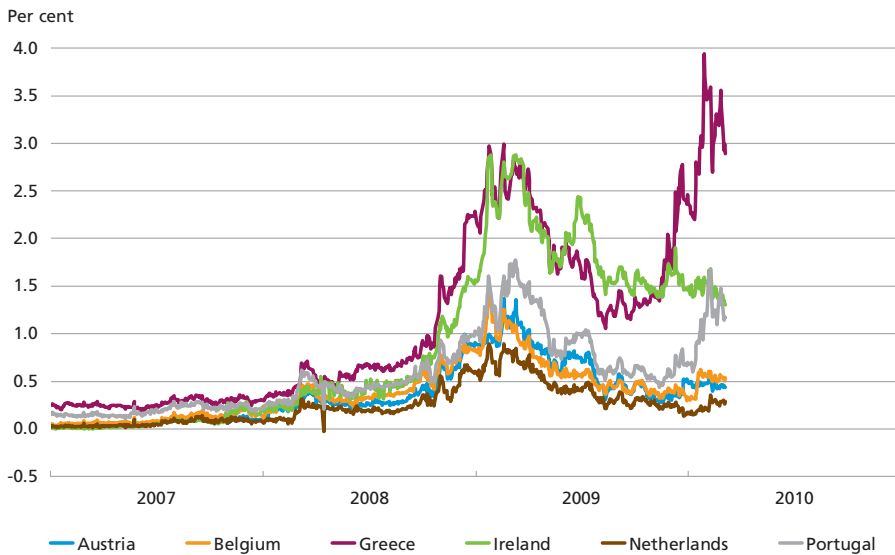
Box 2

Under Article 126 of the Lisbon Treaty, the Council may – on a proposal from the Commission – escalate the procedure if a member state fails to take the necessary steps to reduce its government deficit within a specified time limit. Under Article 126.6 the Council decides that an excessive deficit exists. At the same time a *recommendation* (Article 126.7) is typically issued to the member state in question to remedy its deficit within a specified time limit. If a member state fails to observe the recommendation, the Council (applying Article 126.9) may give *notice* to the relevant member state to remedy its deficit within a specified time limit. Unlike a *recommendation*, such *notice* is legally binding in all respects for the relevant member state(s). Only euro area member states can be given notice by the Council to remedy their budget deficits. If the notice given under Article 126.9 is not observed, sanctions (Article 126.11) may be imposed on the member state in question, e.g. to make a non-interest-bearing deposit with the EU or to pay a fine.

Most recently, on 16 February 2010, the Council gave *notice* to Greece to bring its government deficit below the reference value of 3.0 per cent of GDP by the end of 2012. The background was that the Council decided that Greece had not taken the necessary steps to reduce the government deficit in accordance with the recommendation previously issued (Article 126.7). The procedure relating to Greece has thus been seriously escalated and this is the first step towards possibly imposing sanctions under Article 126.11 if Greece fails to take the necessary steps to reduce its government deficit.

YIELD SPREADS BETWEEN SMALL EURO AREA MEMBER STATES AND GERMANY

Chart 8



Note: 10-year government bonds.

Source: Reuters EcoWin.

reduce future deterioration of government finances as a result of population ageing; limited employment in and reformed the remuneration system of the public sector; and strengthened and modernised tax collection and administration. In addition, fiscal-policy planning must be reformed in the longer term.

Monetary policy has remained expansionary in the major industrialised countries. Central banks in the USA, the euro area, the UK and Japan have kept their interest rates at a level of 0-1 per cent since the end of 2008. On the other hand, a number of the extraordinary monetary-policy measures introduced to supply liquidity and temporarily expand the range of securities eligible as collateral are being phased out in the USA and the euro area. In late January, the Federal Reserve decided to let the dollar swap lines made available to central banks worldwide during the financial crisis expire as these facilities were no longer required.

MONETARY AND EXCHANGE-RATE CONDITIONS

In recent months, the krone has been stable vis-à-vis the euro at a rate close to its central rate in ERM II.

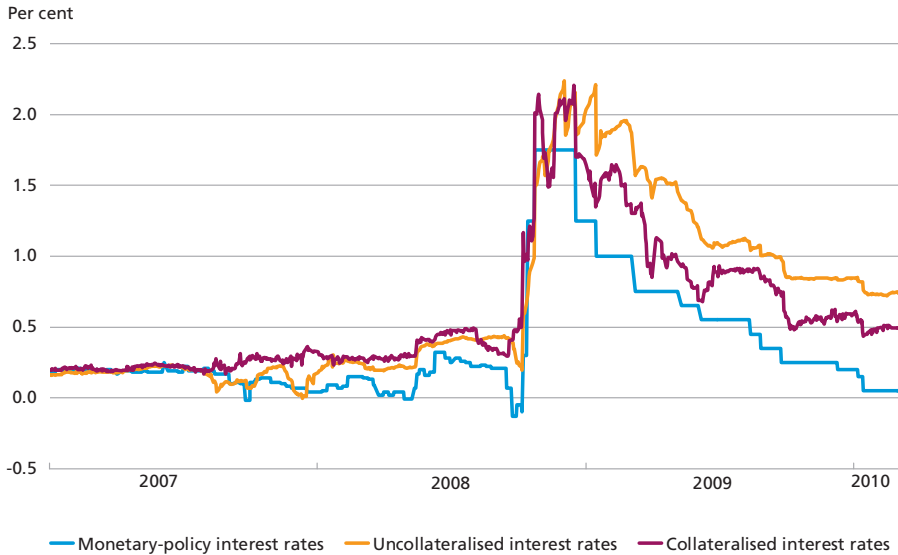
Danmarks Nationalbank lowered the lending rate, the rate of interest on certificates of deposit and the current-account rate by 0.05 percentage point on 11 December 2009 and 8 January 2010. Effective 15 January 2010, the lending rate, the rate of interest on certificates of deposit and the current-account rate were reduced by a further 0.10 percentage point to 1.05 per cent, 0.80 per cent and 0.70 per cent, respectively. The discount rate was reduced by 0.25 percentage point to 0.75 per cent on the same occasion.

The interest-rate reductions took place against the background of purchases of foreign exchange in the market. In total, Danmarks Nationalbank made intervention purchases for kr. 27 billion in the period from December 2009 to February 2010. At end-February, the foreign-exchange reserve was kr. 416 billion.

The spread between money-market interest rates in Denmark and in the euro area is somewhat wider than the spread between Danmarks Nationalbank's lending rate and the ECB's rate of interest on its main refinancing operations, which is 0.05 percentage point, cf. Chart 9. This reflects the ECB's extensive supply of liquidity to euro area banks, which has brought short-term money-market interest rates in the euro area substantially below the ECB's main refinancing rate, while money-market interest rates in Denmark are closer to Danmarks Nationalbank's lending rate. Normalisation of the liquidity situation could cause money-

SELECTED INTEREST-RATE SPREADS BETWEEN DENMARK AND THE EURO AREA

Chart 9



Note: The monetary-policy interest-rate spread is the difference between Danmarks Nationalbank's lending rate and the ECB's marginal rate in its main refinancing operations. The spread for uncollateralised interest rates is the difference between 3-month Cibur and Euribor. The spread for collateralised interest rates is based on a 3-month interest-rate swap at the overnight interest rate. The most recent observations are from 5 March 2010.

Source: Reuters EcoWin and Danmarks Nationalbank.

market interest rates in the euro area to rise, thereby reducing the spread between Denmark and the euro area.

Since the introduction of an interest-rate margin between Danmarks Nationalbank's lending rate and the rate of interest on certificates of deposit, banks and mortgage-credit institutes have gradually reduced their gross utilisation of Danmarks Nationalbank's monetary-policy facilities. Around the turn of the year, a temporary increase was, however, seen in connection with the settlement of auctions for mortgage-credit bonds to finance adjustable-rate loans in December.

Danmarks Nationalbank has not held any foreign-exchange auctions under the swap lines with the Federal Reserve and the ECB since 15 September 2009, and the banks and mortgage-credit institutes have not had any foreign-exchange loans at Danmarks Nationalbank since 25 November 2009. As the foreign-exchange markets have normalised, the banks have thus been able to meet their needs to borrow foreign exchange without the assistance of Danmarks Nationalbank. Like the swap lines between the Federal Reserve and a number of other central banks, Danmarks Nationalbank's swap line was not extended when it expired on 1 February 2010.

On 15 February, Danmarks Nationalbank expanded its temporary collateral base for loans by including bonds issued on the basis of loans with individual government guarantees from the Financial Stability Company (SPV bonds). The bonds must meet a number of criteria and be approved as collateral by Danmarks Nationalbank.

The capital markets and the banks' funding

Over the last year, various government measures have had a considerable impact on the banks' financing. The Financial Stability Act (Bank Rescue Package I) provides all depositors and other unsecured creditors with an unconditional government guarantee against losses up to and including 30 September 2010.¹ Subsequently, ordinary depositors will be covered by the deposit guarantee up to an amount corresponding to 100,000 euro, i.e. around kr. 750,000, for ordinary deposits and fully covered for special deposits, including pension savings.² The deposit guarantee will eliminate uncertainty for most depositors. The expiry of the government guarantee may lead to shifts of large deposits between banks.

To facilitate the transition to normal market conditions for other unsecured creditors, a transitional arrangement was adopted as part of the Credit Package (Bank Rescue Package II). Under this arrangement, banks may apply for individual government guarantees for specific issuances of non-subordinated unsecured debt and, in the case of financial institutions issuing SDOs, for junior covered bonds with a maturity of up to three years issued before 31 December 2010.³ The European Commission has approved the Credit Package under the EU rules on state aid. The approval is valid until 30 June 2010. So far, 14 banks have issued securities with individual government guarantees totalling kr. 59 billion.

It is essential that all Danish banks take the expiry of the general government guarantee into account in their financial planning. Total bank deposits from non-MFIs have remained more or less unchanged compared with the situation in the autumn of 2008. At the same time, the banks' lending to non-MFIs had declined. The gap between deposits and lending, i.e. the deposit gap, has thus been reduced, cf. Chart 10. Nevertheless, the deposit deficit remains substantial, and the banks are still heavily dependent on market-based financing. Since the autumn of 2008, the banks' financing has shifted in favour of longer maturities, cf. Chart 11, which reduces the need for refinancing and the exposure to market developments.

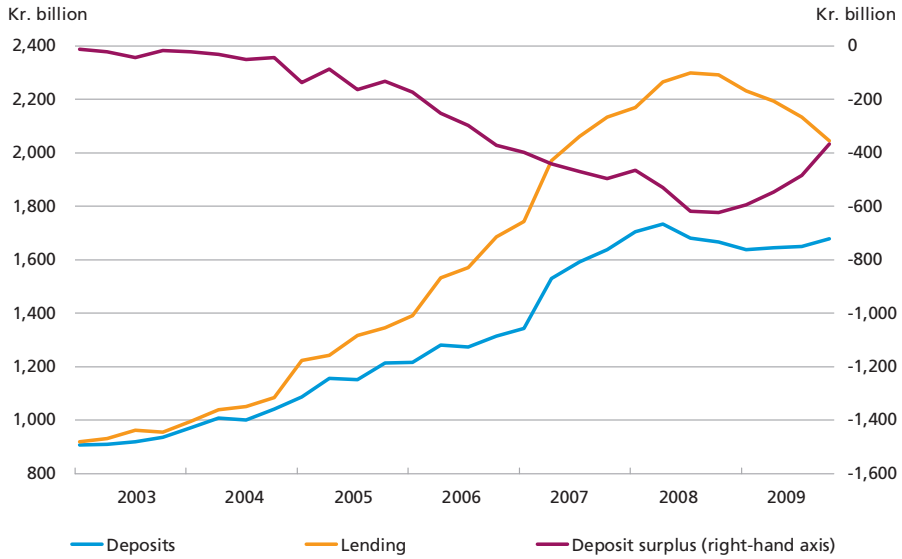
¹ The financial institutions in question must be members of the Private Contingency Association. For more details, see Box 1 in Danmarks Nationalbank, *Financial stability*, 2nd Half 2008.

² Until 30 September 2010, the deposit guarantee covers an amount corresponding to 50,000 euro, i.e. approximately kr. 375,000 for banks that are not members of the Private Contingency Association.

³ See Box 2 in Danmarks Nationalbank, *Financial stability*, 1st Half 2009.

DEPOSITS, LENDING AND DEPOSIT SURPLUS

Chart 10

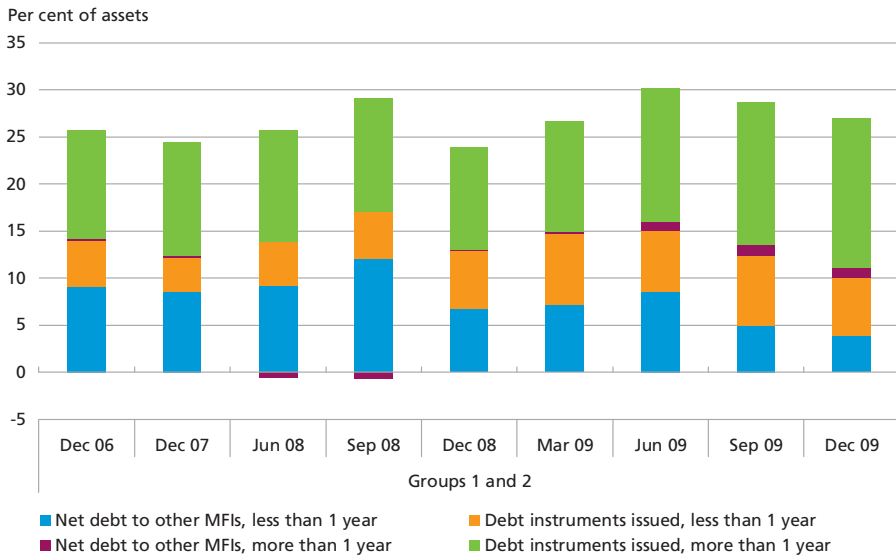


Note: The deposit surplus is calculated as the banks' deposits less lending to non-MFIs.

Source: Danmarks Nationalbank.

DANISH BANKS' NET DEBT TO OTHER CREDIT INSTITUTIONS AND DEBT INSTRUMENTS ISSUED

Chart 11



Note: Groups 1 and 2 refer to the Danish Financial Supervisory Authority's grouping of banks.

Source: Danmarks Nationalbank.

The deadline for government capital injections into banks and mortgage-credit institutes under the Credit Package expired on 31 December 2009. 43 applicants received a total of approximately kr. 46 billion under the Package.

The Minister of Taxation has tabled a bill to amend the Danish rule on "blue-stamped" bonds with effect from 27 January 2010, thereby introducing a general tax liability on private individuals' capital gains and losses on claims, e.g. bonds, mortgage deeds and debt certificates. So far, private individuals who have acquired claims in Danish kroner at a nominal rate of interest exceeding the minimum coupon rate have only been taxed on the interest income. The amendments will eliminate the differences in the taxation of bonds denominated in Danish kroner and in foreign exchange. Private individuals' existing portfolios of blue-stamped bonds will still be comprised by the existing tax rules.

The banks' and mortgage-credit institutes' interest rates and credit developments

The yield on 1-year non-callable fixed-rate bullet bonds ("fixed bullets") used for financing adjustable-rate loans averaged 1.8 per cent in the auctions in November-December 2009. This is around 3.4 percentage points lower than in December 2008. The total amount in the auctions was around kr. 550 billion, and the process was smooth. Borrowers can thus benefit from substantially lower interest costs in 2010. In the first few months of 2010, the yield on short-term Danish mortgage-credit bonds has declined further to a level on the low side of 1.5 per cent in early March, cf. Chart 12. In contrast, the yield on long-term Danish mortgage-credit bonds remains broadly unchanged at around 5 per cent.

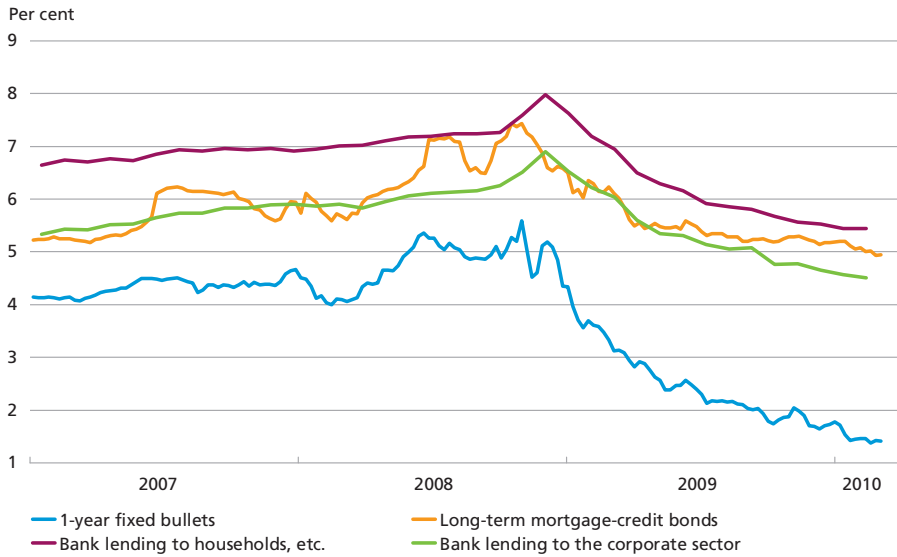
The banks' deposit and lending rates have fallen as Danmarks Nationalbank has reduced its monetary-policy interest rates. Since October 2009, retail lending rates have fallen more or less in parallel with Danmarks Nationalbank's lending rates.

The banks' interest-rate margin vis-à-vis households has narrowed further so that it is now back at the pre-crisis level, cf. Chart 13. On the other hand, the interest-rate margin vis-à-vis the corporate sector has remained unchanged at a level around 1 percentage point higher than before the onset of the financial crisis.

According to Danmarks Nationalbank's most recent lending survey, the banks and mortgage-credit institutes maintained their credit policies vis-à-vis both private individuals and the corporate sector in the 4th quarter of 2009. Credit policies thus remained unchanged in the last three quarters of 2009, having been tightened substantially in late 2008 and early 2009. The institutions do not expect to change their credit policies in the 1st quarter of 2010.

YIELDS ON MORTGAGE-CREDIT BONDS AND LENDING BY BANKS

Chart 12

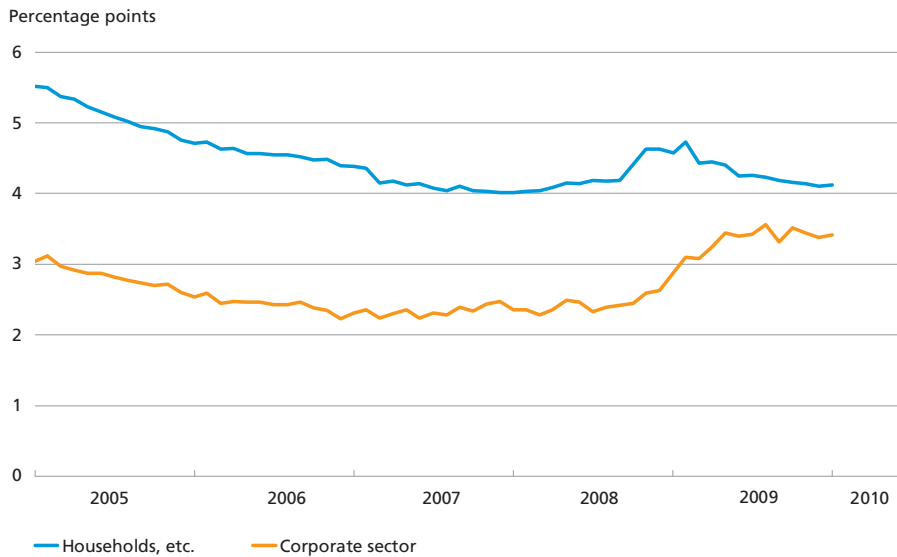


Note: The 1-year yield on fixed bullets is a weekly average. The yield on long-term mortgage-credit bonds is the average yield to maturity based on 30-year callable mortgage-credit bonds, calculated on a weekly basis. The banks' lending rates are monthly averages of outstanding business. Households, etc. also comprises sole proprietorships, including farms. The corporate sector comprises non-financial corporations. The most recent observations are from 5 March 2010 and January 2010, respectively.

Source: Nordea Analytics, Association of Danish Mortgage Banks and Danmarks Nationalbank.

THE BANKS' INTEREST-RATE MARGINS

Chart 13

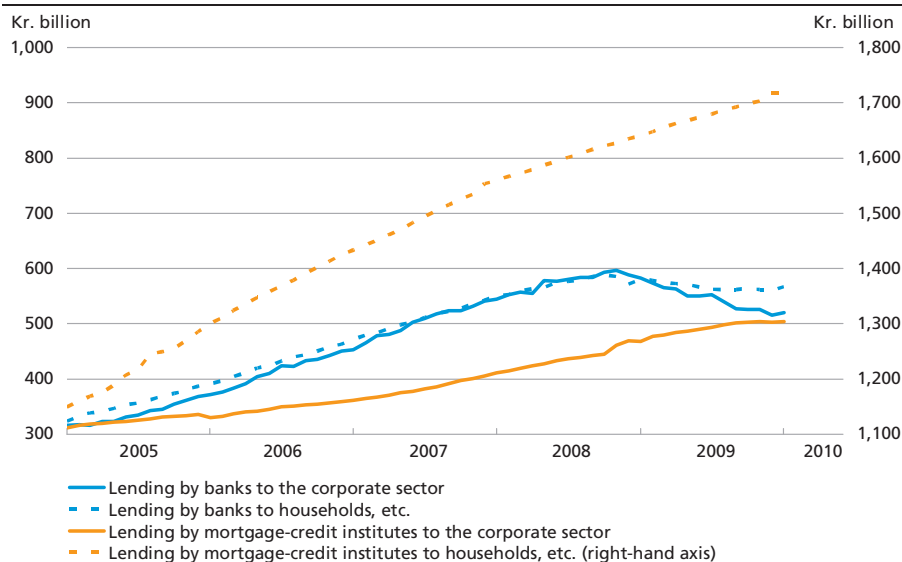


Note: The interest-rate margin is stated as the difference between the banks' average lending and deposit rates. The most recent observations are from January 2010. Households, etc. also comprises sole proprietorships, including farms. The corporate sector comprises non-financial corporations.

Source: Danmarks Nationalbank.

LENDING BY BANKS AND MORTGAGE-CREDIT INSTITUTES TO HOUSEHOLDS AND THE CORPORATE SECTOR

Chart 14



Note: Seasonally adjusted data. Outstanding lending by banks and mortgage-credit institutes domiciled in Denmark. The most recent observations are from January 2009. Households, etc. also comprises sole proprietorships, including farms. The corporate sector comprises non-financial corporations.

Source: Danmarks Nationalbank.

The banks' seasonally adjusted lending to the corporate sector dropped sharply in 2009, cf. Chart 14, but rose in January 2010. The mortgage-credit institutes' lending to the corporate sector was stable in the last months of 2009 and early 2010, having risen steadily since the beginning of 2006.

The banks' lending to households increased in early 2010 after having remained stable since mid-2009. At the same time, lending by mortgage-credit institutes to households has continued to rise. The trend for households to shift from bank loans to mortgage-credit loans thus continued. Both banks and mortgage-credit institutes reported rising demand from households in the 4th quarter of 2009 and expect further increases in the 1st quarter of 2010. This supports the view that the economy is beginning to recover.

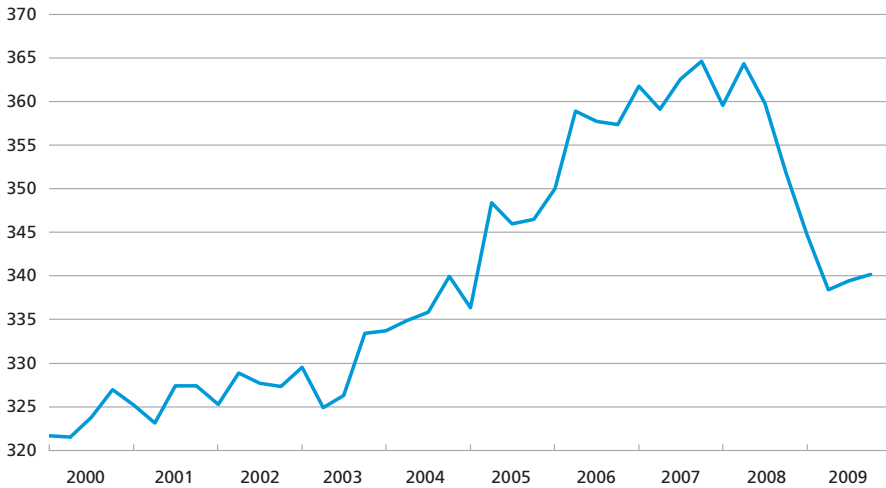
THE DANISH ECONOMY

The 2nd half of 2009 saw renewed growth in the Danish economy, albeit at a modest pace. This means that the recession has come to an end. The upswing comes after a fall in GDP in volume terms of more than 7 per cent, cf. Chart 15. Hence, business enterprises still have considerable unused capacity. Private consumption is rising, but the economic recov-

GROSS DOMESTIC PRODUCT IN VOLUME TERMS

Chart 15

Billion 2000 kroner



Note: Chained values. The most recent observation is from the 4th quarter of 2009.

Source: Statistics Denmark.

ery is expected to be slow in the coming years, so unemployment will continue to rise for some time yet, cf. the forecast for the Danish economy on p. 35.

GDP in volume terms showed quarterly growth rates of 0.3 and 0.2 per cent, respectively, in the 3rd and 4th quarters of 2009. For the full year, GDP in volume terms fell by 5.1 per cent relative to the preceding year. Growth in the 2nd half of 2009 was driven by rising public and private consumption, while investments and exports fell.

Private consumption is buoyed up by growth in disposable incomes as a result of wage increases and tax cuts. In addition, homeowners with variable-rate mortgages will be paying less in interest. Household wealth after tax rose slightly from the 2nd to the 3rd quarter, mainly on account of rising stock indices. This increase is, however, not sufficient to reverse the previous strong fall. Total household wealth is still a good 16 per cent below the peak just over a year ago. Housing wealth, for which data is available one quarter further ahead, rose marginally in the 4th quarter. This is the first increase in two and a half years.

Retail turnover fell in January. The number of Dankort transactions does not point to private consumption having picked up further in the first months of 2010. Dankort transactions can be used as an indicator of retail turnover, which in turn is an indicator of private consumption, cf. the article Dankort Payments and Retail Sales on p. 109.

Confidence indicators

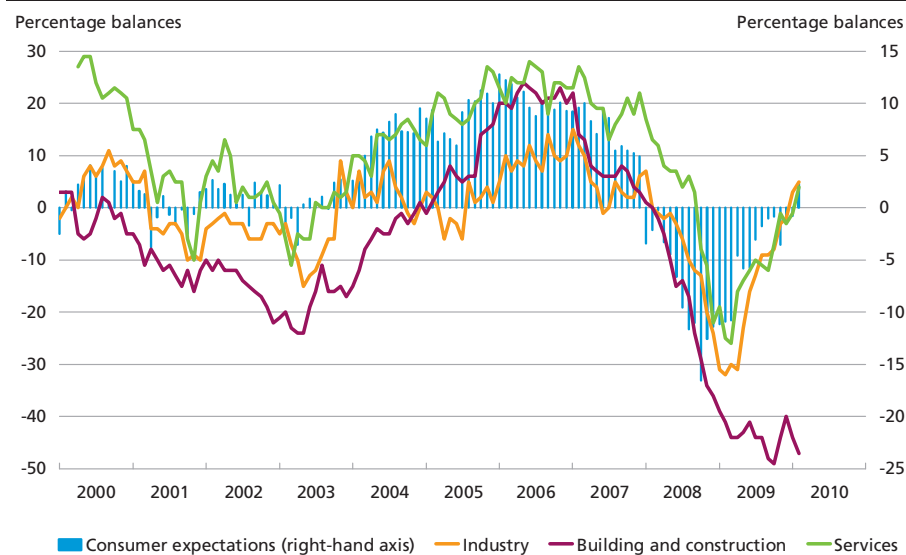
Confidence indicators generally support the view that the Danish economy is beginning to recover.

Industry expectations have risen over the last year and were marginally positive in the first months of the year, cf. Chart 16. The confidence indicator is close to its long-term average. This same applies to the confidence indicator for the services sector, whereas expectations remain strongly negative in the construction sector, one of the sectors most severely affected by the crisis. This reflects not only the very cyclical nature of this sector, but also the exceptionally high level of construction activity in the boom years.

Seasonally adjusted industrial production, excluding ships etc., continued to fall towards the end of the year, to a level more than 20 per cent below the peak in the summer of 2008. In January, industrial production grew by 3.5 per cent. The order intake from the domestic market is still on a downward trend, while orders from the export markets are increasing.

Consumer confidence has been rising over the past six months and was positive in the first two months of 2010, but so far the impact on retail sales has been modest. In January, retail sales, adjusted for seasonal fluctuations and the number of trading days, were 1.5 per cent lower than in January 2009. Sales of passenger cars have been going up over the last year. All in all, the indicators point to a slow recovery.

CONSUMER EXPECTATIONS AND BUSINESS CONFIDENCE INDICATORS Chart 16



Note: The most recent observations are from February 2010.

Source: Statistics Denmark.

The housing market

According to the seasonally adjusted data from the Association of Danish Mortgage Banks, prices for single-family and terraced houses rose slightly in Denmark overall from the 3rd to the 4th quarter, but remained almost 8 per cent below the level one year earlier. The prices of owner-occupied flats also rose. These increases follow a couple of years with falling nominal house prices. There are, however, considerable regional differences.

The supply of homes for sale is still high. According to the statistics from the Association of Danish Mortgage Banks, the number of sales increased by more than 30 per cent from the 1st to the 2nd half of 2009, but from a low level.

All in all it thus looks as if the housing market is slowly improving and that prices have stabilised at the current low interest rates. The strong growth in real disposable incomes supports the housing market, and households take a more positive approach to future developments than previously. Nevertheless, uncertainty also prevails as to how robust the development is to the ongoing rise in unemployment and normalisation of the level of interest rates.

Foreign trade and balance of payments

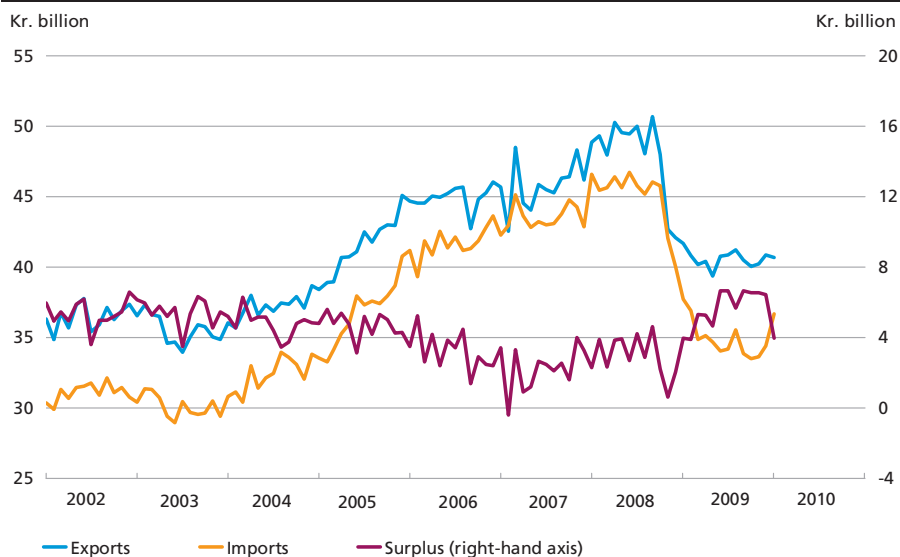
Exports of Danish goods have been flat for the past six months, having fallen previously, cf. Chart 17. Exports of services continued to decrease, particularly due to a fall in sea freight. The weak development in domestic demand meant that imports of goods fell throughout 2009, but at a much slower pace than in late 2008. In January 2010, imports rose. The result has been an increase in the trade surplus to a seasonally adjusted level of just over kr. 6 billion per month, although it was slightly lower in January.

The current-account surplus has been increasing over the past two years, reaching kr. 66 billion in 2009, cf. Chart 18. The development in the current-account balance is strongly affected by cyclical differences between Denmark and abroad. The improvement is in line with the pattern of slower growth in domestic demand in Denmark than abroad since 2007. The capacity pressures in the preceding years meant that an increased share of domestic demand had to be met via imports. Today there is ample spare capacity to meet demand via domestic output, if competitive.

The large current-account surplus mainly reflects a substantial improvement in investment income, an item that is subject to considerable compilation uncertainty, cf. the article *New Method for Estimation of Investment Income on the Balance of Payments* on p. 101.

FOREIGN TRADE

Chart 17

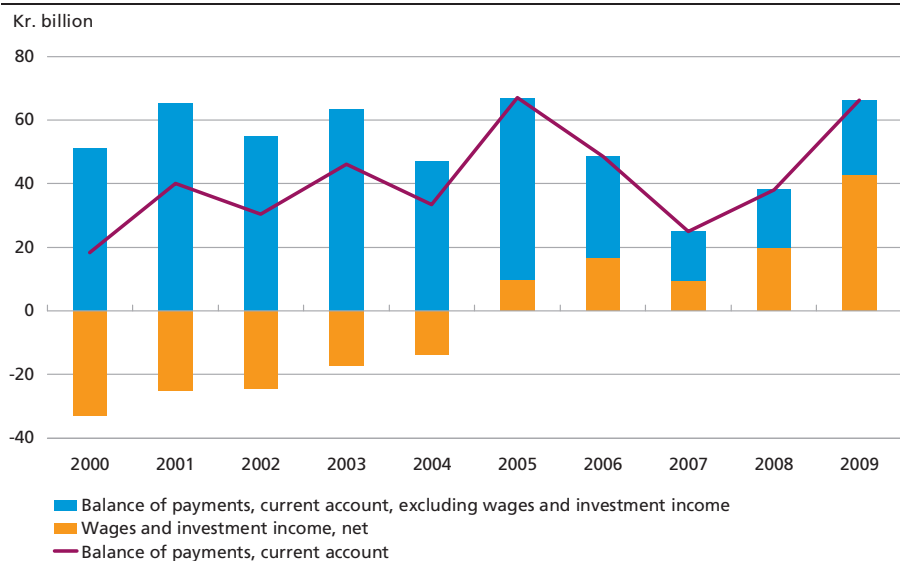


Note: Data for trade in goods. The most recent observations are from January 2010.
Source: Statistics Denmark.

Over the past six months, Denmark's export markets have improved and global trade is beginning to pick up again. This has not yet been reflected in Danish industrial exports, which are traditionally less cyclical than those of other countries. Moreover, weakened competitiveness

BALANCE OF PAYMENTS, CURRENT ACCOUNT

Chart 18



Note: "Wages and investment income, net" is a sub-item on the current account of the balance of payments.
Source: Statistics Denmark.

could make it more difficult for Danish business enterprises to keep up with market growth in the export markets. The industrial sector still has a weak order intake and a weak assessment of orders from export markets, but sentiment is improving. In recent years, Danish export growth has trailed behind that of several comparable countries. For an analysis of the development in market shares, see the article *Manufactured Exports and Wage Competitiveness* on p. 43.

Denmark's external debt was subject to extraordinary revision in connection with the release of data for the 3rd quarter, *inter alia* with a view to ensuring better consistency with the current account of the balance of payments. The revision reduced the foreign debt by almost kr. 80 billion. Combined with sustained current-account surpluses and valuation gains, this means that Denmark has gone from having foreign debt to having wealth of kr. 42 billion. The portfolios of foreign shares held by Danish investors are substantially larger than the Danish portfolios held by non-residents. This entails a gain when stock indices rise.

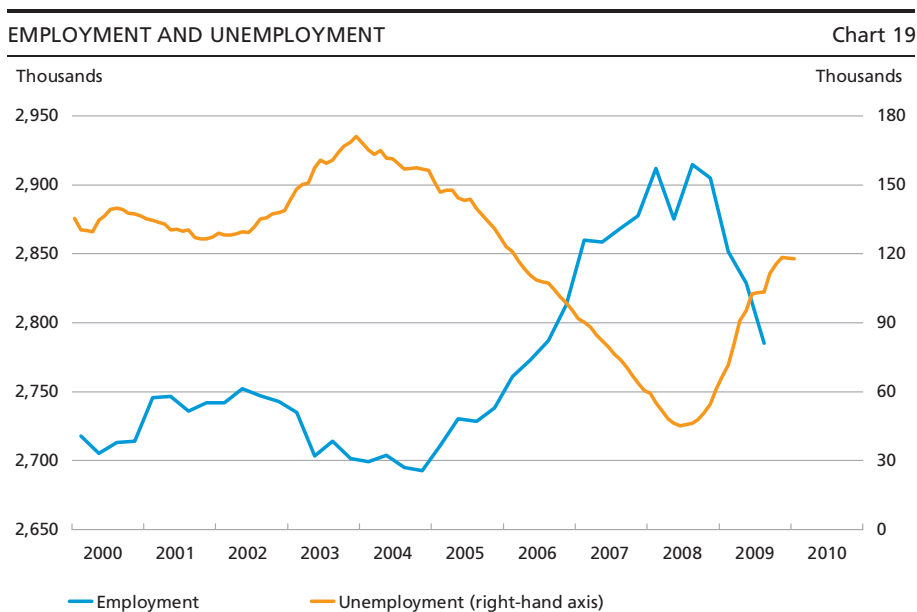
The labour market

The unemployment rate has been flat for the last three months. In January, seasonally adjusted registered unemployment was 118,000 persons, corresponding to 4.2 per cent of the labour force. In addition, approximately 40,000 people were on activation schemes. The stabilisation in unemployment figures is not likely to last. According to the broader definition in the random-sample labour-force survey, the unemployment rate is 6.8 per cent. Whichever method is used, the recent development pattern remains the same.

The number of announced lay-offs has been 2,000 per month in recent months. Since announced lay-offs account for only a small share of the actual number of redundancies, caution should be exercised when using these as an indicator of unemployment trends. The number of new jobs advertised on the Internet has stabilised at around 15,000 per month, less than half the number advertised during the latter part of the upswing.

Rising unemployment could mean that more people are affected by unemployment, and that spells of unemployment lengthen. At the beginning of the recession, the former mainly applied, but since early 2009 the duration of unemployment spells has also increased.

The most recent upswing led to a surge in employment. From 2003 until the peak at the end of 2008, employment as reported in the national accounts rose by more than 200,000 to reach an all-time high of more than 2.9 million, cf. Chart 19. Approximately half of this increase has been lost over the last year, up to and including the 3rd quarter of



Note: Unemployment according to the national definition. The most recent observations are from the 3rd quarter of 2009 for employment and January 2010 for unemployment.

Source: Statistics Denmark.

2009. Employment has predominantly been falling in the private sector, mainly in industry and construction, while public-sector employment has grown.

Wages and prices

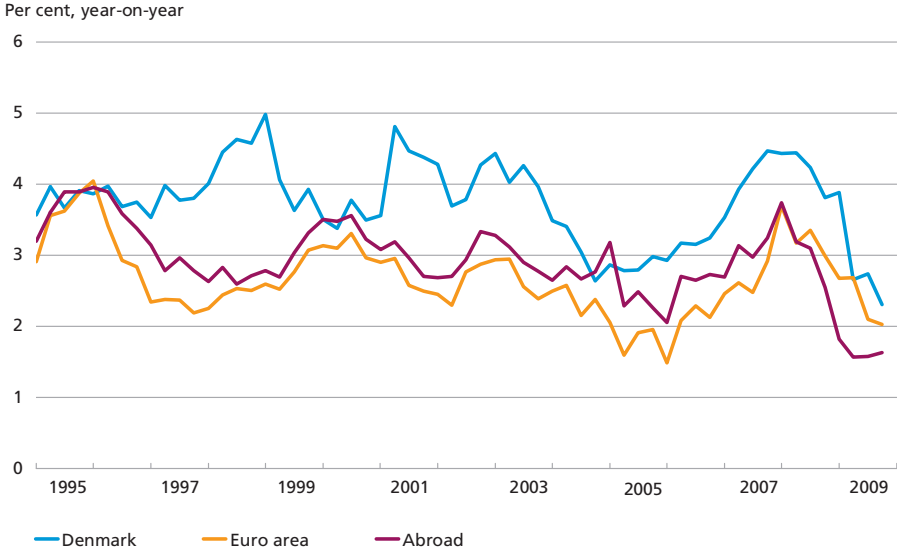
Private-sector wage inflation has been declining in recent quarters. In the sectors covered by collective agreements with the Confederation of Danish Employers, DA, hourly wages rose by 2.3 per cent in the 4th quarter compared with the same period of 2008. The rate of increase was a little higher for white-collar workers than for blue-collar workers. The decline in wage inflation has been particularly pronounced in the construction sector, where the annual rate of wage increase was only 0.5 per cent in the 4th quarter.

In central and local government wage inflation was substantially higher than in the DA sectors. Over time, public-sector wages and salaries match those of the private sector, and the rate of increase is therefore expected to decline sharply in the coming quarters. Moderate growth in consumer prices entails that many groups of the population still experience growth in real wages.

Wage inflation in the competitive industrial sector has been higher than abroad for some time, cf. Chart 20. Viewed over a longer horizon, productivity development has been weak in Denmark, particularly when

WAGE INFLATION, INDUSTRY

Chart 20



Note: Hourly wages for manufacturing workers. "Abroad" and "Euro area" are weighted using the weights in the krone-rate index. The most recent observations are from the 4th quarter of 2009.

Source: OECD, Confederation of Danish Employers and own calculations.

compared with other countries, cf. Box 3. Productivity development has been negative in recent years. This is a cyclical phenomenon. Stronger productivity growth is expected over the next few years, but there is much to catch up on after a prolonged period in which wages have been growing at a faster pace than productivity. In other words, unit labour costs have been rising.

The annual rate of increase in the Danish Harmonised Index of Consumer Prices, HICP, was 1.9 per cent in January and 1.8 per cent in February, compared with 1.2 per cent in December. The rising rate of inflation in the first two months of 2010 is mainly attributable to higher indirect taxes on a number of goods, including tobacco, sugar and energy.

Price inflation has been curbed by falling food prices over the last year. The moderate development in food prices is a result of strong price drops in the global commodity exchanges. Energy prices have risen by just under 8 per cent over the last year. Core inflation, i.e. inflation excluding energy and food, has been around 1.5 per cent in the past six months.

Domestic market-determined inflation, IMI, has shown a pronounced fall in recent months, standing at 2.2 per cent in February. IMI captures increases in consumer prices that are attributable to wages and profits in Danish business enterprises. Strong growth in unit labour costs as a result of weak productivity exerts upward pressure on domestic inflation.

PRODUCTIVITY DEVELOPMENT IN DENMARK

Box 3

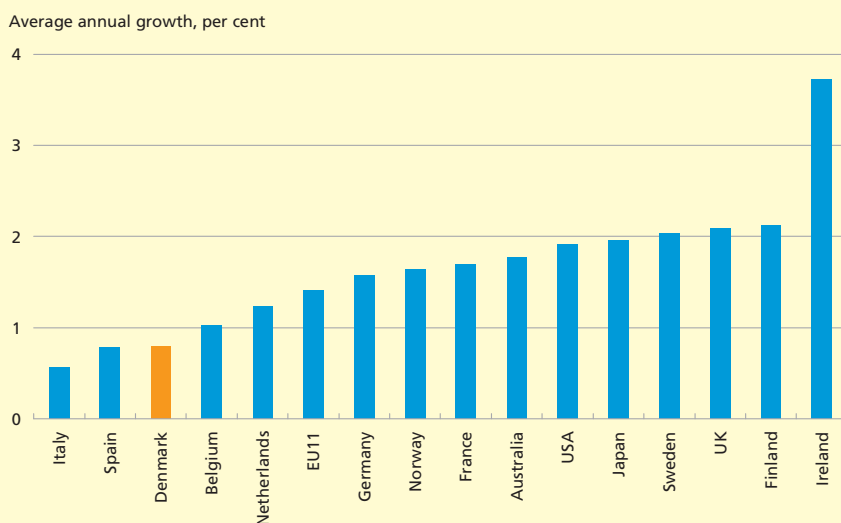
The volume of output in a given country is determined partly by labour input, i.e. the number of hours worked, partly by productivity. The price at which the country's products can be sold abroad relative to the price of imports also plays a role. This is measured by the terms of trade. Improved terms of trade increase the purchasing power in society, thereby creating wealth in excess of that resulting from the output volume. For a number of years, Denmark enjoyed improving terms of trade, but the curve has stagnated in recent years.

Labour input in the economy is to some extent determined by demographic developments. The greater the share of the population that is active in the labour market and the more hours people work, the greater the output is, all other things being equal. Demographics thus have an impact on wealth. In the coming decades the age groups from which the labour force is recruited will shrink relative to the population as a whole. In a long-term perspective, however, wealth is primarily governed not by demographics and hours worked but by productivity¹.

Average hourly productivity in Denmark grew by less than 1 per cent annually in the period 1995-2009, cf. Chart 21. Recent years have seen negative growth in hourly productivity, placing Denmark among the weakest-performing OECD countries in this respect. In 1966-94 hourly productivity in Denmark rose by more than 3 per cent a year on average, i.e. three times the rate seen in the last 15 years. If the situation does not improve, Denmark's wealth will lag further behind that of comparable countries.

ANNUAL GROWTH IN HOURLY PRODUCTIVITY 1995-2008

Chart 21



Note: Hourly productivity is calculated as GDP for the entire economy at constant prices divided by the annual number of hours worked in the economy as a whole.

Source: OECD, Statistics Denmark.

Growth in hourly productivity can be broken down into contributions from a better general level of education/training (labour quality), a larger and better capital stock per hour worked (capital intensity) and technical and organisational advances (total factor productivity). For the market-related part of the economy, Statistics Denmark has provided such a breakdown of contributions to hourly productivity since 1966. It is seen that especially the contribution from total factor productivity has fallen.

Total factor productivity is the share of productivity that cannot be attributed to more or better resources. It comprises all other conditions contributing to increasing labour productivity, including work planning and technological advances not immediately included in the data for the capital stock. Total factor productivity can only be measured indirectly.

Enhanced competition and less regulation of product markets promote economic growth. Denmark is among the OECD countries with least regulation of product markets. All other things being equal, this should boost growth in total factor productivity. The same applies to the flexible Danish labour market, in which costs and legal barriers to firing and hiring employees are below the OECD average². However, the Danish labour-market model is very expensive, especially in downturns.

Denmark is among the industrialised countries to spend most on education per student³. This applies to both basic schooling and further education, and also to research³. Public expenditure for research and development has increased since the mid-1990s, to 1 per cent of GDP at present.

Denmark is faced with considerable challenges if wealth is to be boosted in an ever more competitive world. Nevertheless, it is difficult to point to a single factor behind Denmark's poor productivity performance. In several areas traditionally seen to be conducive to productivity, Denmark is in fact well positioned in an international context. Despite extensive spending in many areas the results have not yet materialised.

¹ See Danmarks Nationalbank, *Monetary Review*, 3rd Quarter 2008, pp. 119-129.

² OECD, *Employment Outlook*, 2009.

³ OECD, *Education at a glance*, 2009.

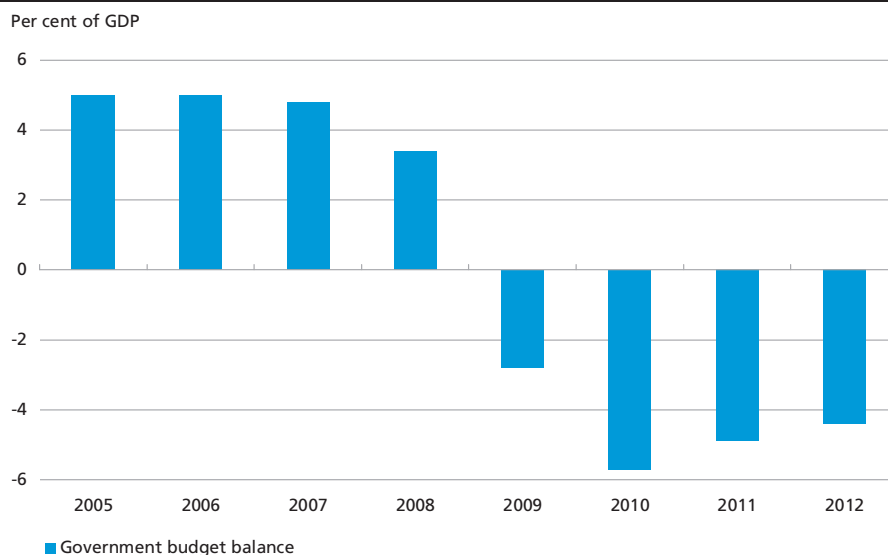
Economic policy

The global crisis has added to the economic challenges faced by Denmark. Output has fallen by 7 per cent, and the large government surpluses in 2005-08 have made way for substantial deficits. In 2010, the budget deficit is expected to be kr. 97 billion, corresponding to just over 5.5 per cent of GDP, cf. Chart 22. Part of the weakening is attributable to the economic slowdown and can thus be expected to be temporary. However, the underlying structural balance has also deteriorated, partly on account of the very accommodative fiscal policy conducted in order to mitigate the impact of the crisis on unemployment and employment. In addition, the future growth path – potential growth – is weaker than before the crisis, reflecting a prolonged period in which the capital stock has grown more slowly.

If no further initiatives are taken, the Ministry of Finance expects a structural deficit in the range of 1.7 per cent of GDP in 2010. This deficit will not vanish even if the economic situation normalises. The deficit represents a significant deterioration relative to the situation before the crisis, when a structural surplus of 1 per cent of GDP was expected in 2010. A structural deficit means that an adaptation burden is being postponed.

GOVERNMENT BUDGET BALANCE

Chart 22



Note: Data for 2010-12 is based on Danmarks Nationalbank's estimates.
Source: Statistics Denmark and Danmarks Nationalbank.

Due to the size of the government deficit and thus the accumulation of debt, as well as the related increase in interest expenditure, Denmark will have to start along the path of consolidation, although the output gap remains large. Experience from other countries shows that the situation can soon deteriorate even if the starting point is relatively good.

During 2010, Denmark is likely to be subjected to the excessive deficit procedure under the Stability and Growth Pact. This means that the Ecofin Council will issue a recommendation urging Denmark to reduce its deficit to a maximum of 3 per cent of GDP within a few years. Judging from the recommendations issued to other EU member states in a similar position, it will presumably be suggested that the structural balance be reduced by an average of 0.5 per cent of GDP annually in the period 2011-13. It would be wise to base Denmark's fiscal policy on the rules applying within the EU as this will create a sound stability-oriented framework for economic policy and reduce the risk that the yield spread to abroad widens.

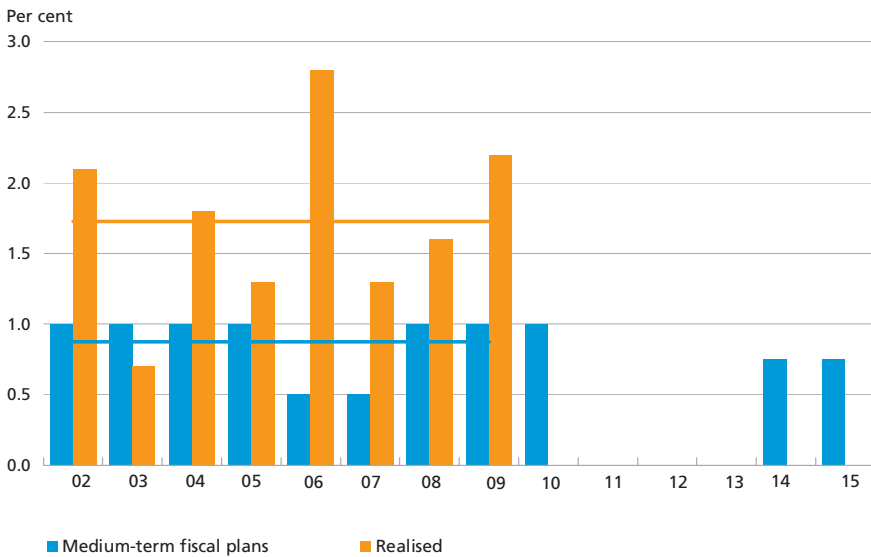
The fiscal-policy challenges are described in the Danish government's Convergence Programme 2009, which was published in February 2010. As previously, the aim is to achieve structural balance by 2015. This requires fiscal consolidation of kr. 31 billion. Kr. 13 billion can presumably be achieved by keeping real growth in public consumption at zero in 2011-13 and then at 0.75 per cent in 2014-15. This leaves a further consolidation requirement of kr. 18 billion, of which kr. 11 billion is expected to be found by reducing other operational costs and the remaining kr. 7 billion by introducing reforms to increase the job supply.

Both the 2010 plan from 2001 and the 2015 plan from 2007 contained targets for annual real growth in public expenditure. With a single exception, the limits have been exceeded every year, and in many cases by a considerable margin. Average real consumption growth in 2002-09 was 1.7 per cent, cf. Chart 23. There are consistent strong underlying pressures to increase public expenditure. The zero-growth target from 2011 onwards is very ambitious and requires far greater political determination to rein in public spending if it is to be met.

Should the ambitious spending policies prove impossible to realise, the tax freeze cannot be upheld in its present form. The tax freeze means that the revenue side of the budget cannot contribute to fiscal consolidation. At any rate, this option must be deemed to be limited. Denmark is already one of the world's most heavily taxed countries, and all tax bases are under pressure. In a small, open economy there are limits to how much taxes can be raised before the net impact on proceeds becomes low or even negative as a result of cross-border shopping, relocation of business enterprises, negative impacts on the job supply, etc.

In terms of both expenditure and revenue, the magnitude of the challenges ahead means that it would be of no avail to consider easing fiscal policy further. This would only make the consolidation task more difficult. If it is postponed, even greater tightening measures would be required in the future.

REAL GROWTH IN PUBLIC CONSUMPTION, PLANNED AND REALISED Chart 23



Note: The yellow line shows the average annual real growth in public consumption in 2002-09, while the blue line shows the average planned consumption growth in the same period.

Source: Planned real growth in public consumption in 2002-07 was sourced from the government's 2010 plan, in 2008-10 from the government's 2015 plan and in 2011-15 from Denmark's Convergence Programme 2009.