

De Økonomiske Råd 
Formandskabet

DANISH ECONOMY
AUTUMN 2020
SUMMARY AND
RECOMMENDATIONS

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The first chapter of the report comments on current economic policy issues, such as the current fiscal policy, support packages, the fiscal framework in the National Budget Act as well as climate policy.

Chapters II and III present projections for the Danish economy. The short-term forecast suggests a relatively fast recovery, with the prospect of a normalization of economic activity towards 2022. The long-term projection shows that the fiscal policy is more than sustainable. The sustainability, however, depends crucially on the assumptions made about retirement behavior.

Chapter IV takes a closer look at both fundamental and practical aspects of fiscal policy as a stabilization tool, while Chapter V focuses on the interrelationship between epidemiology and economy.

ENGLISH SUMMARY

This report from the Chairmanship of the Danish Economic Council consists of five chapters that, to varying degrees, all play against the backdrop of the current coronavirus pandemic.

The coronavirus pandemic led to a sudden fall in economic activity during the spring of 2020. Due to the fear of uncontrolled spread of the virus in the community, substantial restrictions and lockdowns were put into place. This led to the implementation of extraordinary support packages aimed at businesses, employees at risk of losing their jobs and self-employed people. Moreover, the fear of infection affected consumption patterns, even after the easing of many of the restrictions.

The restrictions were aimed at reducing the spread of the virus. The immediate effect of hard restrictions, such as a lockdown, is a fall in economic activity. However, to the extent that the restrictions successfully suppress the spread of the virus, they form the basis of the normalization of demand, e.g., the return of demand for contact-intensive services that was depressed due to a high infection risk.

A prerequisite for a relatively swift normalization of economic activity is control over the virus. However, the tools to control the spread are not limited to hard lockdowns, such as the one used during the spring. An important element of the health strategy is the extent and organization of testing and contact tracing. In a longer-term perspective, the normalization of economic activity depends on whether, and in that case, when, an effective vaccine or treatment is developed.

The outlook for the Danish economy crucially depends on how the coronavirus pandemic advances both domestically and in the rest of the world. Even though a relatively swift recovery of economic activity is possible, there is a high risk of a worse outcome regarding health, the economy and the stress on public finances.

The crisis is not limited to the healthcare sector or health authorities. The pandemic also challenges the political-economic toolbox. The comprehensive support packages along with the general decline in economic activity and increased expenses, related to, e.g., testing and treatment, have led to a large budget deficit, which has led to the temporary suspension of the budget deficit limit. Fortunately, Denmark entered the pandemic with sound public finances, which has allowed the

treasury to absorb a substantial share of the derived socioeconomic losses. The size of the final bill is, however, still unknown.

The report is not an exhaustive account of the effect of the coronavirus pandemic on the Danish economy, but it touches on many of the key aspects.

Chapter I synthesizes the assessments and recommendations related to current economic policy issues based on the subsequent four chapters and previous reports from the Chairmanship.

Chapter II contains a projection for the Danish economy and public finances towards 2025. The chapter also includes the Chairmanship's assessments of the planned fiscal policy as well as the development of public finances in relation to the prescribed limit instituted in the National Budget Act.

Chapter III contains a long-term projection for the Danish economy with a focus on the government budget and the sustainability of the fiscal policy.

Chapter IV takes a closer look at the use of fiscal policy to stabilize the economy.

Chapter V considers the interrelationship between epidemiology and the economy.

CHAPTER I: ECONOMIC POLICY

Chapter I summarizes the assessments of and recommendations for economic policy based on the analyses in the report's four subsequent chapters as well as previous reports.

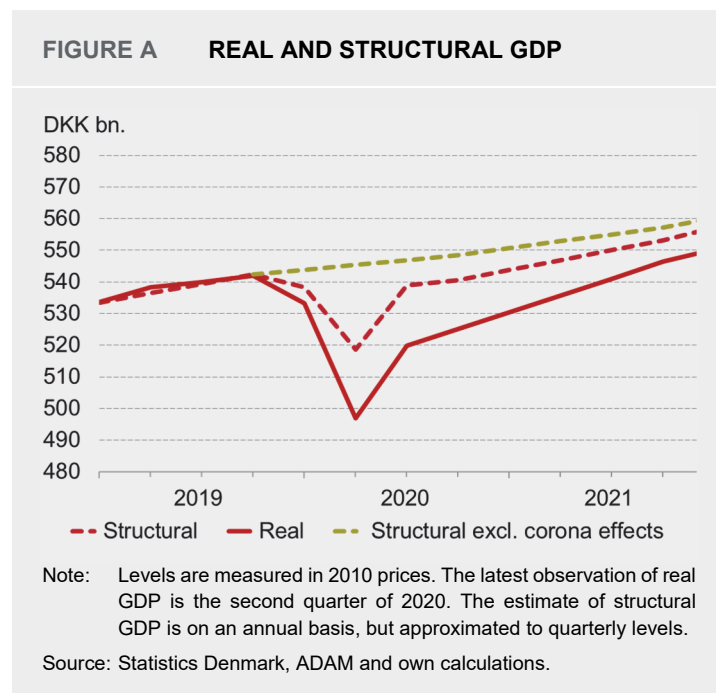
The first set of assessments focuses on policies related to the coronavirus pandemic. One assessment is that the termination of the general support initiatives targeted at Danish businesses and the self-employed, which were introduced during the lockdown of Denmark in the spring of 2020, is a sensible policy. The support initiatives are problematic because they only provide help to existing firms, which deters new firms from entering and growing the market. Some general support initiatives remain in place; however, they are limited to firms directly affected by restrictions. Thus, the remaining support initiatives should be terminated as restrictions are phased out.

The chapter also contains an assessment of the fundamentals that should form the basis of the green transformation of the economy. Targeted taxes, such as a uniform tax on greenhouse gas emissions across all sectors, are the best way to achieve the objectives of the climate policy because they efficiently affect the behavior of businesses and households. Such a tax implies that prices more closely reflect the climate costs of production and consumption, while allowing each individual household and firm to determine their most appropriate response. Thus, the tax leads to the desired emission reductions in a flexible and cost effective way.

Finally, the chapter also contains assessments of fiscal policy, public finances and pension reforms based on the analyses in the reports four subsequent chapters. These assessments are described below.

CHAPTER II: ECONOMIC OUTLOOK AND PUBLIC FINANCES

Chapter II presents a projection for the Danish economy and Danish public finances towards 2025.



In the spring of 2020, the Coronavirus pandemic hit the Danish economy. Although, a wide range of fiscal support packages have helped cushion the fall, economic activity fell sharply. In the second quarter of 2020, GDP fell to a level almost 8½ per cent lower than in the final quarter of 2019. The fall in the number of people infected following the lockdown led to the gradual easing of the restrictions, which increased economic activity. This also led to the phase out of many of the general support packages. In the projection, GDP will increase by roughly 4½ per cent in the third quarter of 2020. Thus, the estimated GDP in the third quarter is 4 per cent lower than in the fourth quarter of 2019. As seen in Figure A, the projection implies that GDP will return to its 2019 level during 2021.

Figure A highlights the assumption that the Coronavirus pandemic reduced the productive potential of the economy as measured by structural GDP. This primarily results from lower investment spending by businesses as well as reduced production possibilities due to restrictions. Real GDP is, however, below its structural level in the projection over the coming years, which results in a negative output gap. In the projection, the output gap gradually narrows to -1½ per cent by the end of 2021.

Although fiscal support packages were in place during the spring, unemployment still increased by more than 60,000 people between February and May. However, unemployment started falling during the summer months despite the rollback of the support packages. Since late summer, however, the number of people infected has increased, which has led to the reinstatement of some restrictions. This recent development is expected to end the downward trend in unemployment for the rest of the year. Thus, it is estimated that 130,000 people will be unemployed by the end of 2020.

The economic outlook depends strongly on the assumptions made about the future course of the pandemic. The projection assumes that the pandemic does not worsen significantly compared to the end of September 2020. Further, the projection assumes the development of an effective vaccine or treatment during 2021 that allows the economy to return to its pre-pandemic path in the longer run.

Due to fiscal support packages, higher public consumption and increased public investment, fiscal policy is currently very expansionary. This weakens the structural balance by around 1 per cent of GDP from 2019 to 2021. Given the expectation of a relatively quick recovery of the economy, including unemployment, the Chairmanship finds no further need to ease fiscal policy at this point.

TABLE A KEY FIGURES OF THE OUTLOOK FOR THE DANISH ECONOMY

	2019	2019	2020	2021	2025 ^{a)}
	DKK bn.	Real growth rate, per cent.			
Private consumption	1,076	1.4	-3.6	3.7	3.7
Public sector consumption	557	1.2	2.1	2.0	0.7
Gross fixed capital formation	513	2.8	-2.3	3.6	0.7
consisting of:					
Public sector investment	77	0.3	7.5	3.4	1.0
Residential investment	115	6.2	3.4	3.1	0.7
Business fixed investment	321	2.3	-6.4	3.8	0.6
Stockbuilding ^{b)}	18	-0.3	0.1	-0.3	-0.1
Total domestic demand	2,163	1.3	-1.6	2.9	2.2
Exports of goods and services	1,362	5.0	-12.4	9.0	5.5
Imports of goods and services	1,190	2.4	-10.1	7.7	5.6
GDP	2,335	2.8	-3.6	3.8	2.3
Key indicators					
Consumer prices, percentage change ^{c)}		0.8	0.4	1.3	1.2
Unemployment, per cent ^{d)}		2.9	4.1	4.0	2.8
General gov. budget balance, DKK bn.		88	-93	-53	-10
General gov. budget balance, per cent of GDP		3.8	-4.1	-2.2	-0.4
Hourly wage costs, percentage change		2.5	2.0	1.9	2.7
Terms of trade, change in percentage points		-0.1	0.4	-0.4	-0.4
10-year Danish government bond rate, per cent		-0.2	-0.3	-0.3	0.6
Employment gap, per cent ^{e)}		0.5	-1.5	-1.4	0.0

a) The column shows projected average annual growth from 2021 to 2025 for all variables except unemployment, the current account, the general government balance, the 10-year Danish government bond rate and the output gap. For these variables, the column shows the projected value in 2025.

b) Contribution to GDP growth in percentage points.

c) Implicit private consumption deflator.

d) Percentage of total labour force. National definition.

e) Percentage of structural employment. National definition.

Source: Statistics Denmark, National Accounts and own calculations.

The combination of the economic downturn and expansionary fiscal policy will lead to government budget deficits for the coming years. The expected structural balance in 2021 has a deficit of around $\frac{3}{4}$ per cent of GDP. Thus, the deficit exceeds the limit of $\frac{1}{2}$ per cent of GDP prescribed by the National Budget Act. The structural balance is, however, calculated with considerable uncertainty due to uncertainty about the effects of the epidemic on the productive potential of the economy. Given this uncertainty, the Chairmanship does not find a deficit that exceeds the limit by $\frac{1}{4}$ per cent of GDP in a single year to be problematic. Thus, the expected deficit alone does not merit a tightening of fiscal policy.

In the coming years, expected structural balance deficits are around $\frac{1}{2}$ per cent of GDP. In addition, the projection implies there will be a failure to meet the medium-term target of a balanced budget in 2025. The expected budget balance deficits will be close to the deficit limit of the National Budget Act in the coming years. In principle, this implies that there is no scope for further easing of fiscal policy should such a need arise.

If the Danish economy is considered to be affected by exceptional circumstances, such as a deep recession, the fiscal framework does contain some flexibility that allows the deficit to temporarily exceed the limit. However, there is a need to clarify the precise circumstances under which the deficit can exceed the limit. The Chairmanship has previously discussed the possibility of enhancing flexibility in the fiscal framework; cf. *Danish Economy, autumn 2019*.

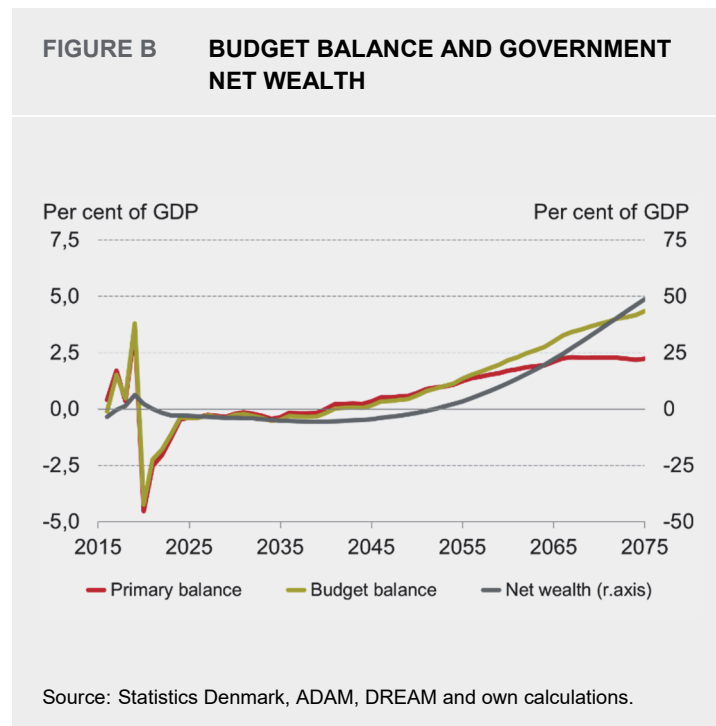
An alternative to enhancing the flexibility of the framework is to lower the deficit limit in the National Budget Act. With the structural balance expected to display deficits over the coming ten years or more, the Chairmanship assesses that a loosening of the deficit limit from $\frac{1}{2}$ to 1 per cent of GDP is relevant. Importantly, the recommendation to loosen the deficit limit is not a recommendation to ease fiscal policy in the current situation.

A reduction of the deficit limit will allow for an easing of the medium-term target of a balanced budget in 2025. In addition, a lower limit will widen the gap between the expected deficit level and the limit over the coming years. The benefits of widening the gap are similar to the case of increased flexibility. First, it reduces the risk of a required tightening of the current fiscal policy because the structural balance turns out worse than expected. Second, it improves the possibility of easing fiscal policy if needed, e.g., because of a recession.

CHAPTER III: FISCAL SUSTAINABILITY

Chapter III presents a long-term projection for the Danish economy building on the medium-term projection for 2025 presented in Chapter II. The long-term projection focuses on public finances in order to evaluate whether Danish fiscal policy is sustainable under assumptions made about, among other things, future demographic changes.

Figure B shows that, under the assumptions of the projection, the structural budget is close to balance until around 2040.



The decades leading up to 2040 are marked by demographic headwinds as small generations succeed large ones in the labour market. The forecasts, however, highlight the existence of various counteracting changes to the economy. First, already instituted reforms result in higher projected retirement ages. Second, larger savings-based pension payments imply increasing tax revenues. Third, the projected increase in private consumption caused by increased wealth accumulation leads to increasing VAT revenues. After 2040, the projected budget shows increasing surpluses because of steadily increasing re-

retirement ages, a reversal of the demographic trend toward larger labour market cohorts and eventually increasing interest income from rising government net wealth.

According to the projection, Danish fiscal policy is overly sustainable, with a sustainability indicator (S2) of 1.6 per cent of GDP. This implies that the primary budget could deteriorate permanently by 1.6 per cent without causing debt to explode in the long run. This is a minor decrease of 0.2 percentage points in the S2 indicator compared to the Danish Economic Council's autumn 2019 long-term projection. The main reason for the decrease is a change in the projected functional income distribution, leading to a lower labour share, which, on average, is more heavily taxed than capital. The coronavirus pandemic increases government debt, which decreases the indicator by 0.1 percentage points in the projection.

The gross EMU debt is close to the debt ceiling of 60 per cent of GDP around 2040 in the projection. However, the EMU debt primarily results from large offsetting government assets, and the net debt is only around 6 per cent of GDP. While an ideal system of fiscal rules could include restrictions on debt accumulation, the present ceiling is inappropriate for Denmark as it potentially prevents optimal intertemporal budget smoothing.

The budget balance projected in the report is somewhat more positive than the latest long-term projection from August 2020 by the Danish Government. The government also projects an overly sustainable fiscal policy with an S2 indicator of 1 per cent of GDP. However, the budget balance is less positive in all years. The main difference is that the government assumes a smaller effect of healthy ageing when projecting future public healthcare expenditures.

The chapter presents an analysis of the growth in government consumption from 1966 to 2019. During the period, government consumption growth developed almost exactly in accordance with the assumptions employed in the future projection, i.e., in line with demographic trends and productivity growth. There are, however, large differences between various sub-periods and between various types of government consumption. Over the period 1995 to 2019, health expenditure grew at a higher rate, while educational and cultural expenditure grew at a lower rate than was implied in the projection.

In 2020 the Danish Parliament is to confirm an increase in the eligibility age for the old age pensions. The chapter examines the consequences for fiscal sustainability of various adjustments to the current system of incrementally increasing retirement ages. Stopping the indexation of

old age pensions at 70 years will make fiscal policy unsustainable, whereas milder forms of indexation may be sustainable.

CHAPTER IV: BUSINESS CYCLES AND FISCAL POLICY

Chapter IV presents principles to guide fiscal policy. Fiscal policy can contribute to macroeconomic stabilization through both automatic stabilizers and discretionary measures. The automatic stabilizers arise because income transfers increase during an economic downturn while tax revenues fall. This mechanism mitigates the fall in aggregate demand during an economic downturn. The automatic stabilizers can be expected to have a large impact on aggregate demand in Denmark.

An accurate and timely assessment of the current state of the economy as well as its future development is a prerequisite for pursuing discretionary fiscal policy in an appropriate manner. The level of aggregate activity is, however, observed with considerable uncertainty and is subject to major revisions for a long period after the first estimate is made public. Moreover, there may be a considerable time lag between the moment when a shock hits the economy leading to public intervention and the moment when the measures actually come into effect.

Due to uncertainty about the state of the economy and the impact of discretionary measures, the government should avoid attempts to fine-tune the level of economic activity. The automatic stabilizers on the other hand come into force quickly and are well targeted.

Large fluctuations in economic activity can justify discretionary measures, i.e., if the economic setback is so severe that activity and employment fall markedly even after accounting for the impact of the automatic stabilizers. In that case, three criteria should guide active fiscal policy:

- There must be a clear distinction between measures aimed at short-run stabilization and measures with a structural purpose
- Ideally, the measures should be implemented and affect the economy as quickly as possible after the need is recognized
- The measures should be effective, i.e., deliver large activity effects relative to resource costs

The decision about whether to adopt structural policy measures should be based solely on the consideration of whether long-term social benefits exceed the cost. However, during a downturn, for example, it may

be beneficial to bring forward already planned tax cuts or future public investments.

Changes in aggregate activity affect different industries and socioeconomic groups very differently. The relevance of different fiscal policies depends on how the downturn affects different groups.

An increase in public consumption, for instance, affects employment in public administration, education and health. This is likely to increase employment among women. An increase in public investment in construction or housing, on the other hand, is likely to increase employment in the construction sector, which increases employment among men with vocational training.

Fiscal measures that aim at increasing private consumption through higher disposable income will particularly increase activity in the trade and transport sector. This sector is characterized by an even gender distribution and a high proportion of employees with a short education. In addition, a relatively large proportion of employees in this sector are non-Western immigrants or descendants of immigrants.

CHAPTER V: EPIDEMIOLOGY AND THE ECONOMY

During the late summer, there was a large increase in both the number of people infected and hospitalized with coronavirus in Denmark. The outbreak of coronavirus has significant health and economic consequences. Chapter V focuses on the interrelationship between epidemiology and the economy. The discussions in the chapter are relevant both for the remainder of the current pandemic as well as any future epidemics.

The virus outbreak in itself leads to a significant drop in economic activity, partly because households are reluctant to consume in fear of being infected. This is especially the case for contact-intensive industries. In Denmark, as in most other countries, restrictions and measures have been introduced with the purpose of limiting activities that may be associated with the spread of coronavirus. These measures magnify the decline in economic activity.

There are three main strategies available in response to a virus outbreak. Under a *containment* strategy, the aim is to eradicate the virus. A rigorous containment strategy has proven difficult in the case of coronavirus, partly because a large proportion of those infected do not

show symptoms and because the virus is imported from other countries. If containment is not possible or is too costly, an alternative is a *suppression* strategy. In contrast to containment, the purpose is not to eradicate the virus, but to keep the spread of the virus at a low level, e.g., until a vaccination is available. Finally, it is also an option to use a *mitigation* strategy, where it is accepted that the virus spreads widely in society, but in a controlled manner in order to limit the health costs of the outbreak, such as congestion in the healthcare system. With a mitigation strategy, it is tacitly accepted that a larger number of people become infected. While this entails costs there are also potential benefits as it may result in immunity being built up in society.

The assessment of the appropriateness of the three strategies depends on several epidemiological and economic conditions. Currently, there is substantial uncertainty regarding these conditions. Suppression or containment may be beneficial if, e.g., the virus is very deadly and a vaccine is expected within a limited time span. The uncertainty regarding long-term sequelae of COVID-19 also suggests choosing a cautious strategy to contain or suppress the virus. In turn, this may require a comprehensive testing capacity in order to identify infected people, effectively trace close contacts, control and monitor people entering from abroad and broadly monitor society and impose controlled periodic shutdowns of parts of the economy. All of these elements may entail non-trivial economic costs.

Under some conditions, it may instead be beneficial to opt for the mitigation strategy. If recovered people develop antibodies that give long-lasting protection against new infections, the strategy may result in herd immunity in society. From the point where society achieves herd immunity, the number of people currently infected decreases over time, because of the low number of susceptible people. The benefits of the mitigation strategy are lower if the achieved immunity is short lasting. Mitigation, on the other hand, becomes more advantageous the better are the possibilities of protecting vulnerable people from being infected and/or the worse are the prospects of a vaccine becoming available in the near future and the harder it is to avoid importing the virus from abroad.

In the early stages of the epidemic, the Danish government tried to contain the virus. Afterwards it switched to a strategy of mitigation and then again to a suppression strategy, referred to as "hammer and dance". The "hammer" consists of the early lockdown, which aimed to reduce the broad spread of the virus. "The dance" is the current phase, where the use of targeted measures, such as tracing close contacts of infected people and implementing local restrictions, ideally contain local outbreaks.

