

Denmark

GDP has expanded strongly during 2006 and is now well above potential. With a continuing housing boom and strong external demand, labour shortages have become very clear. Domestic firms are losing market share, and wages have started to accelerate, in particular in the construction sector.

Although short-term interest rates are rising, monetary conditions are still too stimulative, making more critical the need to avoid fiscal slippages in 2007. Efforts to expand labour supply should continue, and measures to cool down aggregate demand should be ready in case wages and prices start overheating.

Following GDP growth of 3% in 2005, the economy gained further momentum during 2006. All components of demand are expanding. Private consumption is being driven up by incomes and wealth. Residential investment is expanding at double-digit rates on the back of exceptionally strong house prices increases. Business investments are growing even more rapidly. Export orders have soared during 2006 to a level well above previous historic heights. Nevertheless, net exports are falling because imports are rising even faster than exports. Since early 2005, employment has been increasing steadily at a rate of 1½ per cent, coupled with a slight increase in average hours worked. Unemployment has fallen to the lowest level in three decades, despite increasing labour market participation. In construction, labour shortages are now surpassing their mid-1980s peak, while order books are exceptionally thick and still growing. In both manufacturing and services, there is a clear preponderance of firms expecting still rising demand and employment. In sum, the economy is booming. Consequently, wage and cost pressures are strengthening although, as usual, average earnings only respond with some lag. Consumer price inflation has been fluctuating around 2% since mid 2005.

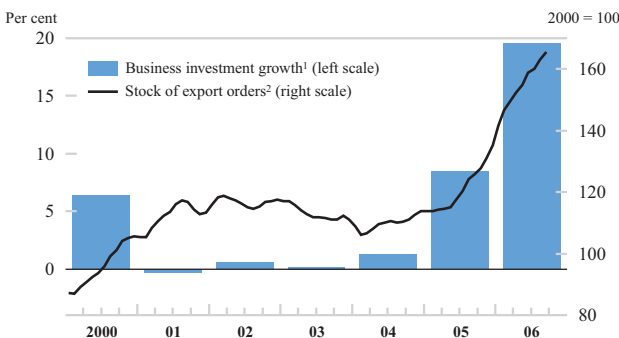
Expansion is heightening labour shortages

Short-term interest rates have increased considerably over the past year. Some further rises can be expected, although the European Central Bank's policy rate is expected to remain below 4% during 2007. Even with moderate rate increases, household debt servicing costs would go up appreciably as about half of homeowners have some form of flexible rate mortgage, and an associated slight fall in house prices would reinforce the resulting consumption slowdown via wealth effects. Such a scenario could imply some welcome cooling of domestic demand. However, while house prices seem overvalued, a genuine market correction may continue to be delayed by strong employment and earnings growth. In any case, with house prices much above construction costs, residential investment seems likely to continue strongly. Moreover, the gradual withdrawal of monetary stimulus partly reflects a strengthening economy notably

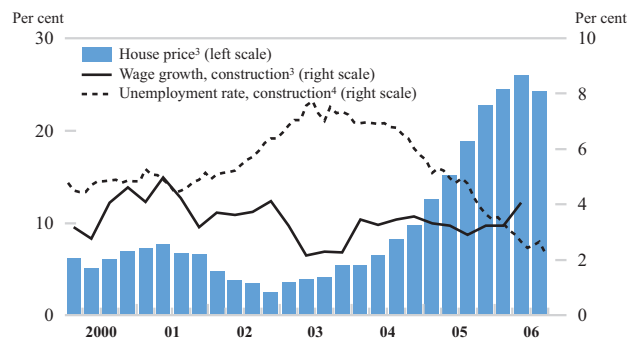
Despite interest hikes, all demand components are set to continue strong

Denmark

Export and business investments soar



Construction wages react to the housing boom



1. First half for 2006.

2. Manufacturing, 3 months moving average, current prices.

3. Year-on-year percentage change.

4. Among persons with unemployment insurance. This tends to be higher than the Labour Force Survey concept used for the aggregate economy.

Source: Statistics Denmark, Association of Danish Mortgage Banks and OECD Analytical database.

Denmark: Demand, output and prices

	2003	2004	2005	2006	2007	2008
	Current prices DKK billion	Percentage changes, volume (2000 prices)				
Private consumption	675.6	3.4	4.1	4.4	2.5	2.2
Government consumption	371.1	1.5	1.3	1.1	1.3	1.0
Gross fixed capital formation	276.1	4.5	9.1	11.9	6.0	4.7
Final domestic demand	1 322.9	3.1	4.4	5.1	3.0	2.5
Stockbuilding ¹	0.7	0.2	-0.2	0.1	0.0	0.0
Total domestic demand	1 323.5	3.3	4.1	5.4	3.0	2.5
Exports of goods and services	634.7	2.7	8.4	12.3	7.0	6.1
Imports of goods and services	549.1	6.4	11.8	16.9	7.9	8.0
Net exports ¹	85.6	-1.3	-1.0	-1.5	-0.3	-0.8
GDP at market prices	1 409.2	1.9	3.0	3.5	2.6	1.6
GDP deflator	—	2.2	2.8	2.0	2.3	2.9
<i>Memorandum items</i>						
Consumer price index	—	1.2	1.8	2.0	2.1	2.6
Private consumption deflator	—	1.7	2.0	2.2	2.0	2.6
Unemployment rate ²	—	5.5	4.8	3.8	3.3	3.3
Household saving ratio ³	—	1.0	-2.8	-2.2	-1.1	-0.9
General government financial balance ⁴	—	1.9	4.6	3.4	3.2	3.2
Current account balance ⁴	—	2.3	2.9	1.3	1.8	1.3

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see OECD Economic Outlook Sources and Methods, (<http://www.oecd.org/eco/sources-and-methods>).

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

2. Based on the Labour Force Survey, being ½-1 percentage point below the claimant-count unemployment rate.

3. As a percentage of disposable income, net of household consumption of fixed capital.

4. As a percentage of GDP.

Source: OECD Economic Outlook 80 database.

StatLink: <http://dx.doi.org/10.1787/026476753265>

in the northern part of the euro area. With Germany alone accounting for 17% of Danish exports, the overall external environment remains stimulative, and in such a context, business investment would also be sustained.

Fiscal policy is not helping to contain demand

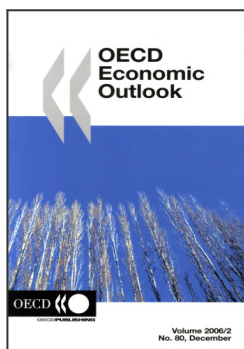
The budget surplus has risen to above 3% of GDP, mainly reflecting buoyant revenues from North Sea oil and gas production and the tax on accrued earnings in pension funds. Both of these revenue sources have little connection with household disposable income. Incorporating these features, official estimates indicate that discretionary fiscal policy added ¼ percentage point to GDP growth in 2006, as public consumption continues to grow in excess of initial targets. For 2007, discretionary fiscal policy will at best be neutral, which is less ambitious than in earlier booms.

GDP growth remains well above potential

With demand growing unabated, GDP is projected to continue expanding strongly during 2007 until still-stronger supply constraints and a loss of competitiveness bring growth below its potential rate from some time in 2008 on. Despite the low level of unemployment, more of the inactive could still be brought into work, and accelerating wages may elicit some more working hours. But growth in domestic demand may continue to outpace supply, leading to rising inflationary pressures, which cannot be completely offset by additional imports. Inflation is projected to approach 3% in 2008.

The risk of overheating is pertinent

The main risk is that the benign wage and cost increases seen to date do not last and that the reaction, when it comes, will be stronger than included in this projection. The resulting loss of competitiveness, weakening of exports and employment could then trigger a genuine correction of house prices so that domestic and foreign demand weakens simultaneously. A severe and perhaps prolonged downturn could follow as a worst-case scenario.



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