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COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Article 9 of
Council Regulation (EC) No 1466/97 of 7 July 1997**

On the updated convergence programme of Denmark, 2008-2015

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Denmark, submitted on 8 December 2008, and its addendum, submitted on 19 December 2008, and has adopted a recommendation for a Council opinion on it.

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

- (1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");
- (2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme).

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)². The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of €170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance

¹ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

² Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability and convergence programmes.

2.2. The assessment in the Council opinion on the previous update

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007-2010, as follows. “The overall conclusion is that the programme aims at maintaining a sound budgetary position fully respecting the MTO throughout the period, consistent with the objective of long-term fiscal sustainability. Foreseeing high, albeit rapidly declining, surpluses over the programme period, the budgetary targets appear to be on the cautious side, in view of the better-than-expected 2007 outcome and the most recent projections. The risk to long-term sustainability is assessed to be low. For the present, the most important policy challenge is to address labour shortages and looming cost pressures through a mix of structural and macroeconomic policies. Further measures need to be identified and implemented to stimulate labour supply. Meanwhile, the fiscal stance should be considered carefully so as to avoid pro-cyclicality. Therefore, containing public consumption expenditure growth, as foreseen in the programme, remains of high priority”.

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**in accordance with the third paragraph of Article 9 of
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On the updated convergence programme of Denmark, 2008-2015

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies³, and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [10 March 2009] the Council examined the updated convergence programme of Denmark, which covers the period 2008 to 2015.
- (2) Following a protracted upswing, Denmark's economic slowdown in 2008 has been rapid and pronounced, driven mainly by the cooling housing market and mounting financial turmoil. Going forward, weaker demand, both domestically and internationally, will further exacerbate the downturn. With deteriorating external conditions, ensuring financial stability and an orderly correction in the housing market will be particularly challenging. In the short- and medium-term, the downturn and anticipated developments in asset and energy prices will have significant adverse implications for public finances. Specifically, downward pressure is expected on revenue from the pension yield tax, corporate taxes and from the estimated declining extraction of oil and gas in the North Sea. Warranted by a fiscally sound point of departure, the budget adopted for 2009 entails a discretionary fiscal expansion of around 1 percentage point of GDP, including permanent income tax cuts amounting to ½% of GDP. Pressure on the Danish krone and drains on foreign exchange reserves forced the Danish central bank to increase interest rates in October 2008. As the ECB cut interest rates, this led to a widening of the policy interest rate spread with the euro. The Danish central bank subsequently cut policy interest rates at the end of 2008 and early 2009, following ECB interest rate cuts, and implemented additional cuts, leading to a gradual narrowing of the spread. However, the spread remains high at 1 percentage point against 0.35 percentage point before the crisis.
- (3) Based on the underlying macroeconomic scenario, real GDP growth is projected to fall from 0.2% in 2008 to -0.2% in 2009, recover subsequently to 0.7% in 2010, and

³ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

average 1.7% over the rest of the programme period. The recovery in 2011-2012 reflects technical assumptions of output and unemployment gaps closing in 2012 as calculated by the Danish authorities using national methodologies. The underlying assumption is that capacity utilisation gradually increases to a normal level, supported by an emerging recovery abroad as well as low interest rates. Assessed against currently available information⁴, the scenario appears to be based on favourable growth assumptions. In 2009, the slowdown in domestic demand appears underestimated in light of the most recent developments. From 2011 onward, growth appears on the high side in the light of historical productivity growth and estimated potential growth. Inflation is foreseen to decrease substantially in 2009 to 1.3%, and fluctuate around a level just below 2% over the rest of the programme period. The cause of the fluctuations is unclear but the projected development in the GDP deflator appears realistic.

- (4) For 2008, the general government surplus is estimated at 3.1% of GDP in the Commission services' January 2009 interim forecast, close to the target of 3.0% of GDP set in the previous update of the convergence programme. Due to the lagged reaction of the labour market to the downturn, employment and wage growth remained robust for most of the year, resulting in higher income tax revenue and lower social expenditure than foreseen. Meanwhile, the financial crisis led to markedly lower revenue from the pension yield tax and corporate taxes. Moreover, expenditure exceeded the projection due to higher intermediate consumption expenditure and a one-off capital transfer to households as part of the 2007 reform of the pension yield tax.
- (5) For 2009, the programme foresees a balanced general government budget, against a projection of a deficit of 0.3% of GDP in the Commission services' interim forecast, implying a negative swing of 3 percentage points of GDP. Automatic stabilisers account for about 1 percentage point of the overall decline. In addition to the discretionary fiscal expansion of about 1 percentage point of GDP, including income tax cuts of 0.5 percentage point of GDP, the decline in energy and asset prices is anticipated to reduce particularly volatile revenues by around 1½ percentage points of GDP compared with trend levels. While projecting a structural surplus, the change in the structural balance, based on the cyclically-adjusted balance recalculated by the Commission services using the commonly agreed methodology and on the Commission service's definition of one-off and other temporary measures, estimated at around 2½ percentage points of GDP, indicates a markedly expansionary fiscal stance⁵.
- (6) A further deterioration in the headline balance is foreseen for 2010, partly due to automatic stabilisers, but mainly due to another planned one-off capital transfer to households as part of the 2007 reform of the pension yield tax. The programme aims to achieve its medium-term objective (MTO) of structural surpluses, i.e. cyclically adjusted net of one-off and other temporary measures, in the range of ¾ - 1¾% of GDP until 2010. After 2010, Denmark is revising its MTO downwards to a structural balance as a minimum, which it plans to maintain and achieve until 2015. The MTO respects the minimum benchmark of a deficit around ½% of GDP and adequately

⁴ The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then. .

⁵ Differences in the definition of one-offs and temporary measures imply that estimates for the structural balance are not readily comparable with the Commission services' January 2009 forecast.

reflects the debt ratio and the average potential growth in the long run. Consequently, the new objective is assessed to be appropriate and in line with the Stability and Growth Pact. The programme projects the general government balance to return to a small surplus in 2011. This largely hinges on the technical assumptions of output and unemployment gaps closing in 2012, resulting in a cyclically determined revenue increase. The targets are based on a scenario requiring unspecified structural reform measures to improve the general government balance permanently by 0.7% of GDP toward 2015 to ensure fiscal sustainability according to the national methodology. Over the programme period, the structural surplus calculated according to the commonly agreed methodology is foreseen to decrease by around 3½ percentage points of GDP, but stay in positive territory. In addition to the financial stability measures taken in autumn 2008 and outlined in the update, the Credit Package of 18 January 2009 implies temporary hybrid capital injections of up to DKK 100 billion (5½% of GDP) from mid-2009, which will have an immediate impact on the debt developments of the update and a potential impact on the general government balance over the programme period.

- (7) The budgetary outcomes projected in the programme are subject to several risks. The downside risks due to favourable growth assumptions and uncertainty about measures to deliver the structural reforms required are not outweighed, despite the positive budgetary track record, by upside risks linked to potentially higher revenues in the event of higher energy prices and lower interest rates. Moreover, measures launched to address financial stability entail a significant increase in risk exposure.
- (8) The long-term budgetary impact of ageing is lower than on average in the EU, notably thanks to the recent pension reform. Moreover, the budgetary position in 2008 as projected in the programme, with a large structural surplus, contributes to the reduction of gross debt. Maintaining high primary surpluses over the medium term would contribute to limiting the risks to the sustainability of public finances, which are currently at a low level.
- (9) As reflected in its budgetary track record, Denmark has benefited from a relatively strong fiscal framework, notable for its wide coverage and the transparency and visibility of its fiscal rules. General government consumption expenditure has, however, been prone to exceeding targets. Recent initiatives involving economic sanctions could enhance incentives for local governments to adhere to agreed targets. Furthermore, some actions have been initiated to strengthen focus on cost-effectiveness of public spending. Nevertheless, further measures will be needed to curb expenditure growth in line with the Government's targets.
- (10) With a view to support financial stability, the Danish authorities have adopted a range of measures including amending the regulatory framework of the pension and life-insurance sector, the Financial Stability Act of October 2008 and the Credit Package mentioned above. The Financial Stability Act effectively provides an unlimited government-backed guarantee for unsecured creditors until 30 September 2010, where participating banks cover claims up to DKK 35 billion (2% of GDP), and the state cover any exceeding claims. From 1 October 2010 a deposit insurance threshold of DKK 750,000 is foreseen. The Credit Package addresses the mounting pressure on the solvency of banks and mortgage institutions in order to contribute to a normalisation of lending policy.
- (11) In line with the EERP agreed in December by the European Council, Denmark proceeded to implement a discretionary fiscal expansion of around 1 percentage point

of GDP with the adoption of the 2009 budget, including permanent measures that enhance work incentives (income tax cuts) and improve the growth potential (investment in R&D). Part of the expansion is due to large public sector wage increases, which are expected to sustain private consumption. A green transport infrastructure plan agreed on 29 January 2009 is foreseen to provide a further fiscal stimulus of DKK 5 billion (¼% of GDP) spread over 2009 and 2010. These measures are related to the Lisbon medium-term reform agenda as reviewed by the Commission on 28 January 2009.

- (12) Based on the information in the programme update, the structural balance is foreseen to deteriorate by 2½ percentage points in 2009 and a further 1 percentage point over the remaining programme period. In part, the decline reflects lower revenue from particularly volatile and transitory sources. In view of the fiscally sound point of departure and the strong automatic stabilisers at play, the planned expansionary fiscal stance appears to be an adequate response to the economic downturn. Throughout the programme period, the budgetary projections indicate that Denmark's fiscal position is fully in line with the criteria of the Stability and Growth Pact.
- (13) The programme update provides all required and most of the optional data⁶.

The overall conclusion is that, at the current juncture and given the comfortable fiscal position, the overall fiscal stance is considered adequate in view of the discretionary fiscal expansion of around 1 percentage point of GDP in 2009. The programme foresees a reduction in the general government surplus by around 3 percentage points of GDP in 2009 and about 1¼ percentage point further in 2010, also as a consequence of the relatively strong automatic stabilisers. The programme's growth assumptions are favourable. The budgetary targets aim to achieve the MTO throughout the programme period, thus maintaining a sufficient safety margin to the reference value. Following a period of high budgetary surpluses, benefiting from a relatively strong fiscal framework, general government gross debt has declined to a low level.

In view of the above assessment, Denmark is invited to

- (i) implement the planned measures in line with the EERP;
- (ii) identify the required structural reform measures to achieve budgetary targets in the outer years.

⁶ In particular, the total revenue and total expenditure figures and some subcomponents do not correspond to the harmonised definitions, complicating the assessment. Moreover, a specification of the stock-flow adjustment is missing among the optional data.

		2007	2008	2009	2010	2011	2012	2015
Real GDP (% change)	CP Dec 2008	1.6	0.2	-0.2	0.7	1.9	1.7	1.6
	COM Jan 2009	1.6	-0.6	-1.0	0.6	n.a.	n.a.	n.a.
	CP Dec 2007	2.0	1.3	1.1	0.5	n.a.	n.a.	n.a.
HICP inflation (%)	CP Dec 2008	1.7	3.6	1.3	2.1	1.4	1.8	1.8
	COM Jan 2009	1.7	3.6	1.6	1.9	n.a.	n.a.	n.a.
	CP Dec 2007	1.7	2.4	1.6	1.9	n.a.	n.a.	n.a.
Output gap ¹ (% of potential GDP)	CP Dec 2008	1.4	0.0	-1.4	-1.8	-1.2	-0.8	-0.5
	COM Jan 2009 ²	1.8	-0.1	-2.1	-2.4	n.a.	n.a.	n.a.
	CP Dec 2007	1.0	0.3	-0.4	-1.5	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	CP Dec 2008	0.7	1.7	1.8	2.3	2.6	2.6	1.8
	COM Jan 2009	0.7	1.7	1.5	1.5	n.a.	n.a.	n.a.
	CP Dec 2007	1.7	1.3	1.9	2.2	n.a.	n.a.	n.a.
General government revenue ^{4,6} (% of GDP)	CP Dec 2008	54.5	53.2	51.2	51.5	52.1	51.8	51.5
	COM Jan 2009	55.4	54.8	52.8	53.4	n.a.	n.a.	n.a.
	CP Dec 2007	53.4	52.9	52.0	51.7	n.a.	n.a.	n.a.
General government expenditure ^{4,6} (% of GDP)	CP Dec 2008	49.9	50.2	51.2	52.8	51.8	51.7	51.6
	COM Jan 2009	50.9	51.6	53.1	54.9	n.a.	n.a.	n.a.
	CP Dec 2007	49.6	49.8	50.0	50.5	n.a.	n.a.	n.a.
General government balance ⁶ (% of GDP)	CP Dec 2008	4.5	3.0	0.0	-1.2	0.3	0.1	-0.1
	COM Jan 2009	4.5	3.1	-0.3	-1.5	n.a.	n.a.	n.a.
	CP Dec 2007	3.8	3.0	2.0	1.2	n.a.	n.a.	n.a.
Primary balance (% of GDP)	CP Dec 2008	6.1	4.2	1.5	0.2	1.6	1.3	0.7
	COM Jan 2009	6.1	4.5	1.2	0.0	n.a.	n.a.	n.a.
	CP Dec 2007	5.2	4.2	3.0	2.1	n.a.	n.a.	n.a.
Cyclically-adjusted balance ¹ (% of GDP)	CP Dec 2008	3.6	3.0	0.9	0.0	1.1	0.6	0.2
	COM Jan 2009	3.3	3.2	1.0	0.1	n.a.	n.a.	n.a.
	CP Dec 2007	3.1	2.8	2.3	2.2	n.a.	n.a.	n.a.
Structural balance ^{3,5} (% of GDP)	CP Dec 2008	3.7	4.0	2.6	1.7	1.3	0.6	0.2
	COM Jan 2009	3.3	3.8	1.1	0.9	n.a.	n.a.	n.a.
	CP Dec 2007	3.5	3.4	2.5	2.5	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	CP Dec 2008	26.3	30.3	27.9	26.3	25.4	24.6	22.6
	COM Jan 2009	26.3	30.3	28.4	27.0	n.a.	n.a.	n.a.
	CP Dec 2007	25.6	21.6	19.2	18.6	n.a.	n.a.	n.a.

Notes:

¹ Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

² Based on estimated potential growth of 1.8%, 1.4%, 1.0% and 0.9% respectively in the period 2007-2010.

³ Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are -1.0% of GDP in 2008, -1.7% in 2009 and 2010, and -0.2% in 2011, all deficit-reducing/surplus-increasing, according to the most recent programme, and -0.5% of GDP in 2008, -0.2% in 2009 and -0.8% in 2010, all deficit-reducing/surplus-increasing, according to the Commission services' January 2009 Interim economic forecast.

⁴ The programme data for revenue and expenditure differ from the data reported to Eurostat, following the harmonised approach (cf. Commission Regulation No. 1500/2000), on which the Commission services' forecast is based. The difference relates primarily to the treatment of public sales of goods and services and of the consumption of fixed capital. The balance is, however, unaffected.

⁵ Using the recalculated cyclically-adjusted balance, based on the information in the programme, and the definition of one-offs and other temporary measures applied by the Commission services, the structural balance would be 3.6% of GDP in 2008 and 1.1 in 2009, and 0.9 in 2010.

⁶ For 2007, the figures differ from those reported to Eurostat in the October 2008 EDP notification. The figures used reflect more recent, revised data published by Statistics Denmark, which has not yet been validated by Eurostat.

Source:

Convergence programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations

