

Denmark in the shadow of Brexit

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On 23 June the UK will go to the polls to vote on its EU membership. Should the outcome of the referendum be an EU exit, Danish exports could be hit by lower demand and a weaker pound. However, the slowdown in exports is likely to be modest. A far greater threat would be if Brexit triggers a new negative demand shock in the rest of Europe. This would impact Danish exports, investment activity and household spending.

In case of a UK No to the agreement reached at the EU summit in mid-February, a difficult political process lies ahead, which may ultimately mean that the UK will leave the EU after a transition period – an actual Brexit. The political agreement reached as a result of the negotiations will obviously be decisive for the long-term macroeconomic effects. Short term, however, we expect the immediate uncertainty to reduce GDP growth by 2-3%, which will tip the UK into a mild recession. Read more about how Brexit looks set to impact the UK economy [here](#).

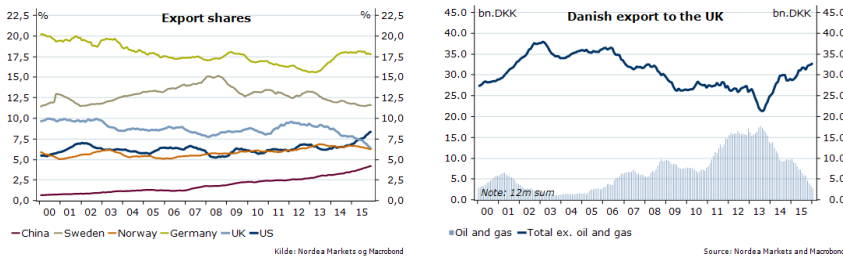
The effects of Brexit on the Danish economy will be multiple:

- Direct trade will slow. Especially Danish exports to the UK will be affected as a result of lower demand and a weaker pound, which will erode the competitiveness of Danish businesses.
- Heightened uncertainty over the future EU could cause businesses to hold back on investments and households to tighten their purse strings. This would hit the Danish economy directly and indirectly through lower exports to the rest of Europe.
- A cumbersome political negotiation process will shift the focus away from the structural reforms so badly needed in many EU countries. Longer term, it could reduce the structural growth potential in Europe.
- Financial market turbulence could trigger sharp equity market declines and a safe-haven flight to bond markets. Such movements could also spill over to the

Danish market and potentially lead to active monetary policy measures by the Danish central bank to defend its fixed exchange rate regime. Read more in [Brexit and the Danish krone](#).

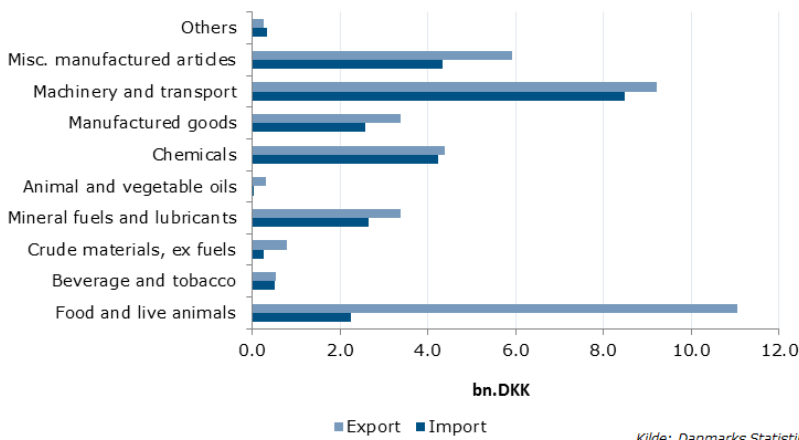
Direct impact on exports

In 2015 Denmark exported goods to the UK worth just under DKK 40bn, ranking the UK as Denmark's fourth-largest export market. The accompanying chart shows that the value of Danish exports since the 2012 peak has dropped more than DKK 20bn exclusively due to the marked decline in the value of oil and gas exports. Ex oil and gas, Danish exports to the UK have seen a steady increase since mid-2013.



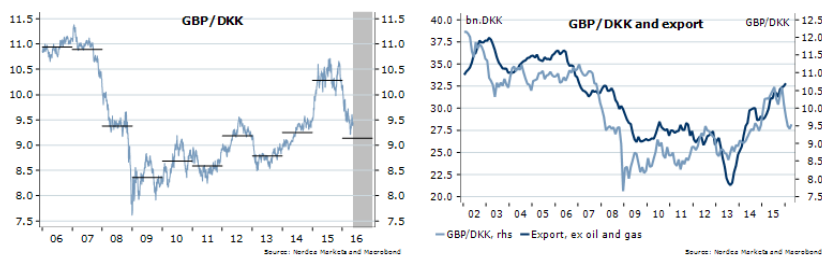
The key goods exported to the UK comprise agricultural products (DKK 11.1bn), machinery and transportation equipment (DKK 9.2bn) and processed products primarily through sub-deliveries (DKK 5.9bn).

Trade with the UK, 2015



Direct impact on Danish exports modest

Our baseline scenario assumes that Brexit will trigger an immediate 5-7% weakening of the pound. With the depreciation that has already materialised, the pound will in 2016 on average be around 10% weaker versus the Danish krone than the 2015 average.



The accompanying chart shows a relatively strong correlation between the value of Danish exports to the UK and the GBP/DKK cross over the past nearly 15 years. Judged by this simple correlation, a permanent drop in GBP/DKK to around 9.0 would imply a decline in exports of DKK 5-6bn due partly to loss of competitiveness and partly to the effect of lower demand.

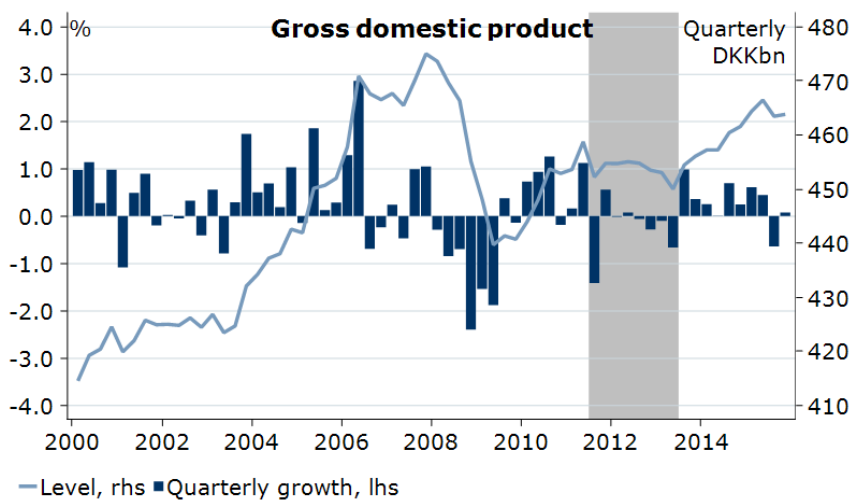
We arrive at roughly the same conclusion by performing a partial analysis of the price and the demand effect, respectively. The pound accounts for 5.7% of the trade-weighted krone index, which could be permanently lifted by just under 0.7% as a result of Brexit. Viewed in isolation, this would cause Danish exports to shrink by some DKK 2bn given loss of competitiveness. Add to this the effect of overall lower demand in the UK economy. Imports currently account for around one-third of the UK GDP, and with a Danish import share of just over 1%, an overall contraction in growth of 3% would reduce the value of Danish exports by around DKK 2bn. With the effect of weakened competitiveness, this suggests that total Danish exports to the UK could decline by around DKK 4bn in case of Brexit.*

Spill-over effects could be the biggest

An isolated decline in Danish exports of DKK 4-6bn corresponds to a drop in the value of total Danish exports of some 0.5% or around 0.25% of GDP over a two-year period. Although Brexit is only assumed to have a marginal

direct effect on general economic activity in Denmark, the overall impact could prove much bigger if Brexit results in decelerating growth across Europe. At present, EU countries account for 60% of Danish exports, and slowing growth across the board triggered by mounting uncertainty could therefore potentially hit the Danish economy considerably harder.

The size of spill-over effects is very hard to estimate but is perhaps comparable to the demand shock that hit Denmark during the sovereign debt crisis in 2011. At the time, uncertainties over the debt situation in Southern Europe strongly contributed to the Danish economy dipping into a state of recession that lasted for nearly two years. A repeat of the same pattern is a likely scenario if, because of Brexit, businesses scale back investments and exports are hit by decelerating demand across Europe. This could further spill over to Danish consumer spending if the employment situation deteriorates and uncertainties over the economic outlook increase in general.



Source: Nordea Markets and Macrobond

*The calculation is based on the assumption that Danish products in the UK market have average price and income elasticity – meaning that the demand for Danish products slows at the same pace as the rest of the UK economy. And that the effect of krone firming versus the pound will hit Danish exports in the same way as would an average change in the krone index.

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