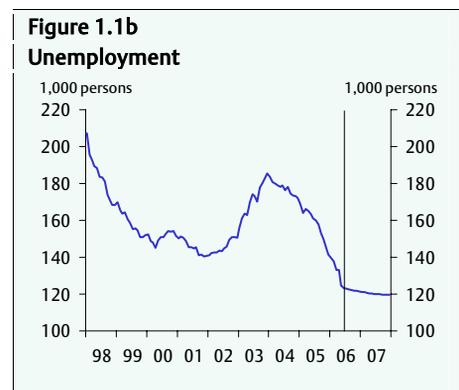
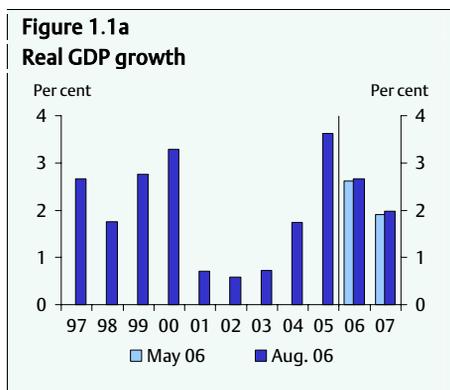


Economic Survey August 2006 – English Summary

1. Short term outlook

In several respects, the upswing in the Danish economy is stronger than expected in the May survey: private sector employment has increased strongly, unemployment has declined at an unabated pace, and domestic demand has increased more than previously expected. Imports too have increased more rapidly than expected in May, and the net external contribution to growth is increasingly negative. Strong growth in business investment is contributing to a broad-based expansion. On balance, GDP growth forecasts are broadly in line with projections in the May survey, *see figure 1.1a*.



In June, most political parties representing a broad majority in parliament agreed on a welfare reform package¹ that comprises a gradual increase in the formal age of retirement from the labour force, earlier study completion, immigration and labour market policies, and increased investments in the future (notably research and education). The agreement will raise the labour force significantly in the medium and long term and improve the sustainability of public finances.

The expectation is still for a soft landing toward a more balanced growth path although wage inflation is expected to increase.

The expansion of total demand has been driven by low interest rates, buoyant house price increases, the impact on real disposable income of tax reductions in 2004 and strong international growth.

¹ The reform package and its impact on public finances is described in more detail in the documents *Agreement on future prosperity and welfare and investments in the future* and *Agreement on future immigration* on the Ministry's homepage <http://www.fm.dk/1024/visNyhed.asp?artikelID=8608>.

In 2005, output grew by 3.6 per cent, the highest growth rate for several years², see figure 1.1a. During the last 12 months unemployment has declined by roughly 40,000 persons to 123,100 in June (4¼ per cent of the labour force on the national definition), a record low for more than thirty years. Since the peak in December 2003, unemployment has declined by approximately 62,000 persons (2¼ per cent of the labour force).

In late 2005, Denmark's net foreign asset position turned positive and is expected to stand at roughly 6 per cent of GDP by the end of 2007. In 2005, the public budget surplus reached 3.9 per cent of GDP, the largest among the EU countries.

Growth is expected to continue at a solid but more moderate pace of 2.7 per cent in 2006 and 2.0 per cent in 2007. This is 0.1 percentage points more than expected for both years in the May projection, see figure 1.1a and *table 1.1*. The projected gradual moderation of activity growth reflects already high capacity utilization and rising, although still relatively low interest rates, and more moderate house price increases that are expected to dampen private consumption growth.

Employment is expected to increase by 33,000 persons from 2005 to 2006, 1.2 per cent of total employment, and by further 7,000 persons from 2006 to 2007. Employment growth takes place in the private sector with zero growth expected for public employment.

Unemployment is expected to reach a record low of 120,000 persons in 2007 (4.1 per cent of the labour force, national definition; 3.6 per cent on the harmonized Eurostat definition), *cf. figure 1.1b*. This is approximately 1 percentage point lower than the estimated structural level of unemployment. Real wage growth is expected to pick up accordingly.

House prices increased rapidly in 2005 through the second quarter of 2006, which has stimulated activity in the construction of private dwellings.

Key vulnerabilities to the projected soft landing and overall balanced developments include global imbalances that may pose risks to global growth. On the domestic side, the anticipated levelling off of house price increases may not materialize and labour shortages may intensify, leading to significant increases in wage growth either in connection with the upcoming central wage negotiations in the first quarter 2007 or subsequently at the decentralized negotiations at the plant level.

² In July 2005, Statistics Denmark substantially revised the methods and data used in the national accounts, including a shift to chain-weighting. For recent years, the differences in growth rates between the chain-weighted and the 2000-fixed price data are normally modest. For 2005, GDP growth chain-weighted was 3.2 per cent. Unless otherwise stated, the real growth rates shown in this Survey are based on data in fixed 2000-prices which are published (in electronic form) on Statistics Denmark's homepage.

Table 1.1**Key figures compared to the May projection**

	2006		2007	
	May	August	May	August
Real growth, per cent				
Gross domestic product	2.6	2.7	1.9	2.0
Private consumption	2.5	3.1	1.8	2.0
Public consumption	0.5	1.1	0.5	1.0
Export market, manufactures	6.8	6.9	5.6	5.6
Per cent of GDP				
Public budget balance	2.8	3.1	2.9	2.8
Current account	2.3	1.6	2.5	1.7
1,000 persons				
Unemployment	131	127	125	120
Per cent increase				
House prices, single-family house	17.0	22.0	5.0	6.0
Consumer prices	2.0	2.0	1.8	1.8
Hourly compensation, private sector	3.4	3.6	4.2	4.2
Yield on 10-year government bonds	4.0	4.0	4.3	4.4
Oil price, \$ per barrel	70.0	70.0	63.0	63.0
Exchange rate, Dkr. per \$	6.1	6.0	6.1	5.9
Oil price, Dkr. per barrel	427.2	418.3	382.7	370.2

Source: Statistics Denmark and Ministry of Finance.

Public finances are expected to benefit from stronger activity and higher revenues from oil and gas production. The budget surplus was 3.9 per cent of GDP in 2005.³ The surplus is expected to fall back to 3.1 and 2.8 per cent of GDP in 2006 and 2007, respectively. The projected decline in the surplus from 2005 to 2006 is mainly a result of lower expected revenue from the highly volatile pension yield tax and from 2006 to 2007 a result of lower revenues from the North Sea due to the assumed decline in energy prices.

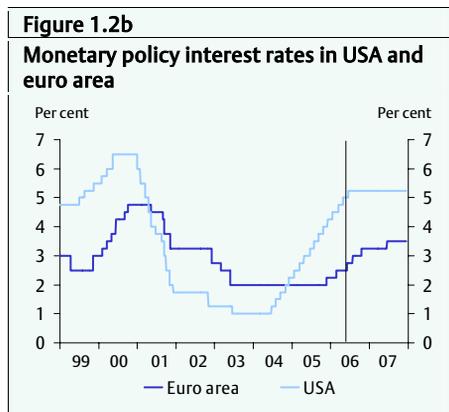
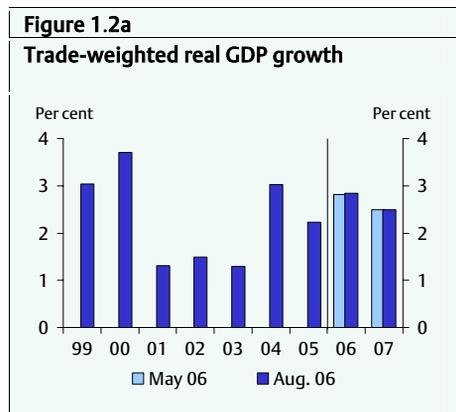
On average the structural budget surplus is estimated at approximately 1¼ per cent of GDP in 2004 through 2007, i.e. in the high end of the operational target range in force in recent years, which calls for an average surplus in the range of ½-1½ per cent of GDP through 2010, cf. *Convergence Programme for Denmark 2005*.

³ The data are based on the new national accounts introduced in the summer of 2005, in which the labour market supplementary pension scheme ATP has been reclassified from the public to the private sector. The revised treatment of ATP has lowered the general government balance by around 1 per cent of GDP in the official statistics. The altered statistical treatment of ATP is purely technical and does neither affect the assessment of fiscal policy challenges, nor the sustainability of public finances.

The international environment and its impact on the Danish economy

Global growth is expected to continue at a strong pace of 4.7 per cent in 2006 and 4.3 per cent in 2007 in real terms. The forecast has been revised up by 0.1 percentage points in 2006 mainly due to stronger growth in China but also in some European countries, in particular Sweden, Norway, and United Kingdom. For the US, signs of more moderate growth are emerging.

For Denmark's trading partners, average growth is estimated to gain pace from 2005 to 2006 which is in line with the May projection, *cf. figure 1.2a*.



Growth is expected to pick up somewhat in the euro area in 2006 to 2.1 per cent and ease in 2007 to 1.8 per cent. The projected growth rate in the euro area is driven by stronger domestic demand and solid export growth.

After disappointing activity growth in the euro area of 1.3 per cent in 2005, growth picked up to 0.6 per cent (q/q) in the first quarter of 2006 and to 0.9 per cent in the second quarter (flash-estimates) and unemployment has declined further. The expansion was driven by growth in private consumption and exports. Both European consumer confidence and the European Sentiment Indicator (SEI) are higher than long-run historical averages, although lower than in the previous peak in 2000. The appreciation of the euro against the dollar dampens export growth.

In Germany, the quarterly national accounts suggest that GDP growth has picked up in early 2006 supported by the economic reforms that were agreed upon in 2005. It is probable that the planned hike in the German VAT rate in 2007 will bring activity in 2007 forward to 2006 and fiscal consolidation will dampen growth slightly afterwards.

The ECB raised its key policy interest rate in June and August by a total of ½ percentage point, *cf. figure 1.2b*. The Danish key policy rate has been held close to the re-

financing rate of the ECB as a consequence of the fixed exchange rate policy vis-à-vis the euro.

The ECB is assumed to tighten monetary policy further and raise the policy rate to 3.25 percent during 2006, more or less in line with the projections in May. At its last council meeting, the ECB indicated that monetary policy is relatively lax and that the ECB will be monitoring inflation developments closely. Against the background of increasing inflation and GDP growth in the euro area, the ECB is assumed to raise the key interest rate by a further 25 basis points in 2007 implying a marginal upward revision in the short term interest rate in 2007 compared with the May projection.

Projected growth for the United States is unchanged since the May survey. Headline consumer price inflation is relatively high at approximately 4 per cent and core inflation has increased in recent months to 2.5 per cent. Signs are emerging that activity may continue at a more modest pace; private consumption growth is slowing and the unemployment rate rose from in July. Activity growth is expected to slow down in 2006 and 2007 to 3.2 per cent and 2.7 per cent, respectively.

The Federal Reserve raised the federal funds target rate by $\frac{1}{4}$ percentage points in June. After a period with relatively predictable monetary tightening, the stance of monetary policy in the near future seems somewhat more uncertain.

The Federal Reserve is projected to raise the target rate by a further $\frac{1}{4}$ percentage points in the autumn of 2006 against the backdrop of still relatively high inflation. Consequently, short term interest rates have been revised up compared to the May survey. The gap between the actual interest rate and an estimated Taylor interest rate is closing, suggesting that monetary policy is reverting to a stance more in line with conventional relationships between policy rates, output and inflation.

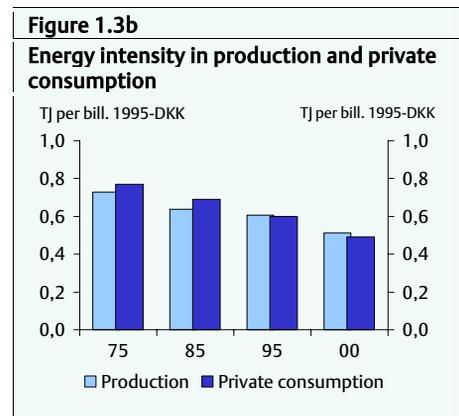
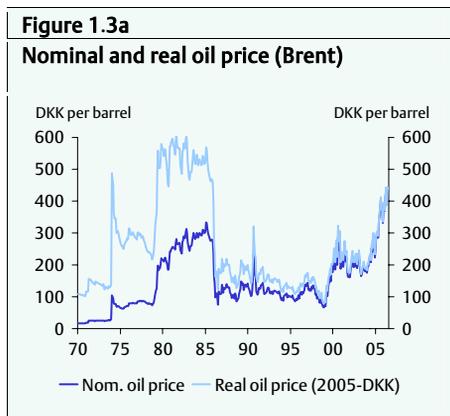
US 10-year bond yields have decreased slightly since the May survey. The yield curve has flattened, indicating market expectations of moderate future inflation and more modest growth.

Long-term interest rates are expected to follow the assumed increase in the policy target rate in 2007, and the projection for the 10-year bond yield has been raised accordingly.

The oil price has continued its previous rise through the first half-year of 2006 up until early August partly as a result of the geopolitical situation, the shutdown of the oil field Prudhoe Bay in Alaska, and the strong demand for oil, *cf. figure 1.3a*. The price peaked at above 75 \$ per barrel but has decreased somewhat since. The expectation in the futures market is still at 70 \$ per barrel as in the May survey. The projection for the oil price is therefore unchanged. For 2007 the oil price (Brent) is assumed to decrease by 10 per cent to 63 \$ per barrel, moving gradually towards the

International Energy Agency's forecast for a long term price of around 40 \$ per barrel.

In recent years, Denmark has been a net exporter of energy, and higher oil prices tend to strengthen both the budget balance and the current account. Private demand will be negatively affected by high oil prices, but due to a reduction in the energy intensity in both production and private consumption over the last three decades, cf. figure 1.3b, and high excise duties in end-user energy prices, the impact of crude oil price changes on overall inflation is comparatively modest. Furthermore, oil prices in real terms (i.e., relative to consumer prices) are still lower than in the early 1980s, when the crude oil price corresponded to some 600 Dkr. or 100 \$ per barrel in today's terms, cf. figure 1.3a.



The dollar has depreciated somewhat against the euro. The assumed dollar exchange rate has been revised down in 2006 from 6.10 Dkr. per dollar in May to 5.98 Dkr./dollar in the current forecast and in 2007 from 6.08 Dkr./dollar in May to 5.87 Dkr./dollar.

On balance, the changes in the forecast of the international environment since the May projection do not materially affect the overall growth forecast.

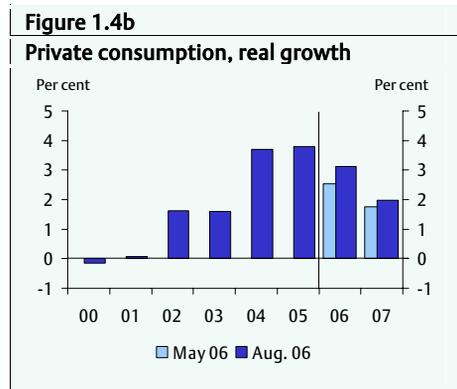
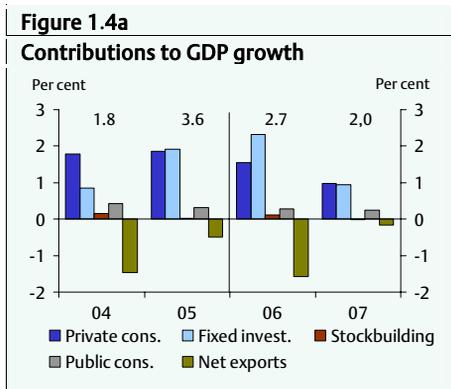
Domestic developments

Private consumption grew by 4.0 per cent in real terms in the first quarter this year according to flash-estimates, more than expected in the May survey. The growth in private consumption reflects the growth in household's real disposable incomes and increase in wealth as a result of strong growth in house prices and the solid increase in employment.

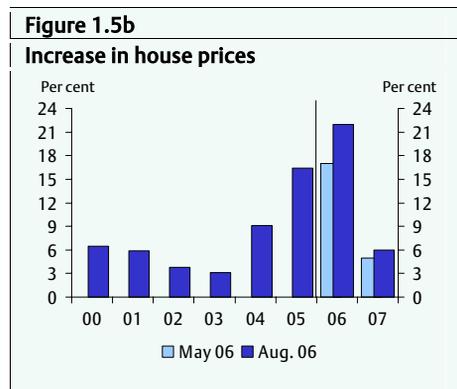
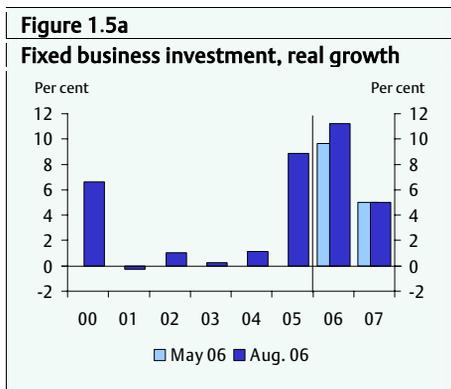
Against the backdrop of strong international growth and sustained expansion in domestic demand, the economy is expected to grow at above-potential rates in 2006-07.

After picking up in 2005, export growth is projected to subside in 2006 and 2007 due to high capacity utilization and weaker competitiveness, although manufacturing export growth is expected to remain solid in 2006.

The growth in private consumption has been revised upwards to 3.1 per cent in 2006 and to 2.0 per cent in 2007 due to the strong growth in the first quarter of 2006 and expected wealth effects from higher than expected house prices. A decline in consumption growth is expected as a result of increasing interest rates and a marked slowdown in house price increases, *cf. figure 1.4a* and *figure 4.1b*. In addition, household savings are projected to become very low in the course of 2006.



Fixed business investments grew by 8.9 per cent in 2005, and investments in machines, equipments and software grew by 33 per cent on an annual basis in the first quarter 2006. The growth rate of fixed business investments has been revised upwards by 1½ percentage points to roughly 11 per cent, while the forecast for 2007 is unchanged at 5 per cent, *cf. figure 1.5a*.



Business investment is expected to be driven mainly by investments in machinery and equipment. Due to mitigated activity growth and higher real interest rates, the growth in fixed business investment is expected to abate in 2007.

Prices of owner-occupied single-family homes increased markedly through 2005 in part due to persistently low interest rates and the growth in households' real disposable incomes. The brisk house price increases continued in the first and second quarter 2006 at well above 20 per cent on an annual basis according to Statistics Denmark and the Association of Danish Mortgage Banks (ADMB).⁴ In consequence, the forecast for price increases for owner-occupied single-family homes has been revised up by 5 percentage points to 22 per cent in 2006 and by 1 percentage points in 2007 to 6 per cent, *cf. figure 1.5b*.

Use and supply of goods and services								
	2005	2002	2003	2004	2005	2006	2007	
	Bill. kr.	Real growth, per cent						
Private consumption	752,9	1,6	1,6	3,7	3,8	3,1	2,0	
Public consumption	402,0	2,3	0,2	1,7	1,2	1,1	1,0	
Public investment	27,6	-6,5	-7,2	12,4	4,4	8,1	-10,0	
Residential construction	86,8	0,8	11,6	10,6	12,4	10,0	6,0	
Fixed business investment	209,2	1,0	0,3	1,1	8,9	11,2	5,0	
Stock building ¹⁾	0,3	0,3	-0,7	0,1	0,0	0,1	0,0	
Total domestic demand	1478,8	1,8	0,6	3,4	4,3	4,4	2,2	
Exports of goods and services	750,5	4,6	-1,1	2,6	8,7	6,5	3,4	
of which manufactures	329,4	6,4	-2,1	2,9	8,9	8,7	4,7	
Total demand	2229,3	2,7	0,0	3,1	5,8	5,1	2,6	
Imports of goods and services	674,7	8,0	-1,7	6,4	10,6	10,3	3,8	
of which goods	456,6	7,0	-3,1	7,8	7,8	12,4	4,1	
Net exports ¹⁾	75,7	-1,1	0,2	-1,5	-0,5	-1,6	-0,2	
Gross domestic product	1554,5	0,6	0,7	1,7	3,6	2,7	2,0	
Gross value added	1318,8	0,4	0,7	1,1	3,2	2,5	1,9	
of which in private non-agricultural sector ²⁾	833,1	-0,1	0,6	0,6	4,4	3,3	2,5	
GDP per capita (1,000 Dkr.)	286,8	0,3	0,4	1,5	3,3	2,4	1,7	

1) The percentages indicate the contribution to GDP growth in 2000-prices.
 2) Excluding oil, gas, shipping, and housing.
 Source: Statistics Denmark and own calculations.

A significant slowing down of house price increases are expected in the second part of 2006 and 2007 due to higher interest rates and already elevated house prices, especially in the greater Copenhagen area. Houses for sale are now on the market for

⁴ The ADMB statistic measures the house price at the time of signing the mortgage loans. This may well lag the time of signing the contract note by several months and the ADMB statistic may therefore not show the prices on houses actually sold in the second quarter. Most observers expect house price increases to have subsided recently. Statistics Denmark publish house price increases measured as the price at the time of signing the contract note, but the figures are published 4 to 5 month after the end of the quarter.

longer than before. House prices are projected to increase by 2 per cent through 2007 (6 per cent from 2006 to 2007).

After strong growth of 11-12 per cent on average over the years 2003 to 2005, residential investment growth is expected at 10 per cent in 2006 and to moderate to 6 per cent in 2007, *cf. table 1.2*. The strong growth reflects a marked increase in private residential construction. The forecast has been revised upward by 2 and 1 percentage points for 2006 and 2007, respectively, owing to the stimulus of notably the upwards revision of real estate prices.

Stock-building is expected to contribute 0.1 percentage point to GDP growth in 2006 and remain roughly unchanged in 2007.

In 2005 the growth rate of real public consumption was 1.2 per cent. Real public consumption growth has been revised upwards by roughly ½ percentage point in both 2006 and 2007 to around 1 per cent in both years. This follows from the agreement in June concerning local government finances for 2007, which affect spending in both 2006 and 2007, and the welfare reform package, which contributes by ½ percentage points to government consumption growth in 2007, *see below*. The growth in public consumption is still less than the average growth in government consumption through the 1990s, and the share of government consumption to GDP (in nominal terms) is set to decline.

International trade and the current account

Exports increased strongly in 2005 and were positively affected by strong export market growth and a small depreciation of the effective exchange rate of the Danish krone⁵. In the first half of 2006 goods exports grew strongly, especially to the UK, Norway, and Sweden.

Manufacturing export growth where particularly strong in the second quarter after a decline in the first quarter and is projected at roughly 9 per cent in 2006 also due to an expected increase in export market growth. In 2007 manufacturing export growth is projected to abate to 4.7 per cent due the expected slowdown in global growth and to some extent a loss of wage competitiveness due to higher wage increases than in Denmark's main trading partners.

Imports grew by 8 per cent in real terms (SA) in the first quarter of 2006. A rough estimate suggests that approximately half of this increase was due to the purchase of fuel (bunkering) and provisions by Danish ships and airplanes and expenditures for repair, partly explained by the merger in the shipping industry in the second half of 2005.

⁵ The statistical basis for overall assessment of developments in exports and imports of goods and services is affected by technical factors concerning the services items.

In 2006, imports of goods and services are expected to grow at the same pace of 10 per cent as in 2005 with imports of goods increasing by a notable 12½ per cent, reflecting both the growth and composition of domestic demand, including strong investment growth. For 2007, import growth is projected to subside to around 4 per cent as demand growth recedes.

The terms of trade are projected to be roughly constant throughout the forecast period.

Overall, net foreign trade is expected to impact negatively on GDP growth in 2006 by 1.6 per cent of GDP compared with -0.5 per cent in 2005 – but is projected to have only a minor negative impact in 2007.

Denmark's net foreign asset position turned positive in late 2005 and Denmark is now a net lender. The current account surplus relative to GDP is expected to decrease by approximately 1½ percentage points from 2005 to 2006 to roughly 1½ per cent of GDP in 2006 and not to deteriorate further in 2007. The net foreign asset position is projected at 6.1 per cent of GDP by the end of 2007.

Employment, unemployment and labour force

Employment growth amounted to 0.7 per cent in 2005. In the first half of this year employment grew significantly more than expected in the May survey.

Employment growth in 2006 has been raised by 7,000 persons, and employment is expected to increase by a total of 33,000 persons, corresponding to 1.2 per cent. For 2007, the projected increase in employment is adjusted upward by 1,000 persons to 7,000 persons, *cf. figure 1.6a* and *table 1.3*. The more modest increase in employment projected for 2007 follows from the anticipation of more moderate output growth.

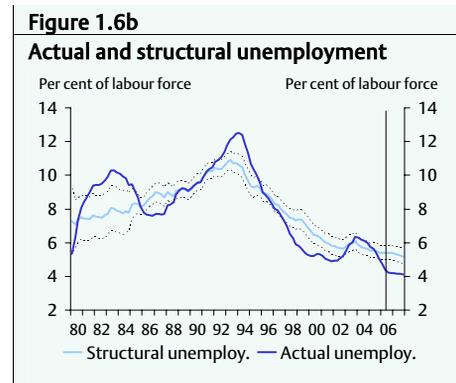
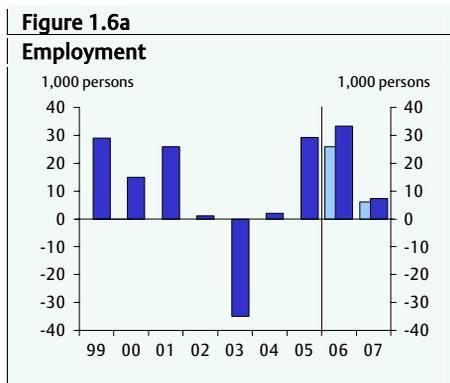
Total employment growth is driven by higher private sector employment while public sector employment is assumed to remain unchanged.

The labour force has increased recently but is projected to remain more or less constant in the forecast period. Demographic developments impact negatively on labour force growth while positive contributions are expected from the cyclical upswing in labour force participation together with the impact of various labour market reforms. The welfare reform package agreed upon in June will have a modest impact on the labour force in 2007 partly due to an expected increase in foreigners working in Denmark.

Unemployment is expected to decrease from 157,000 persons in 2005 (5.4 per cent of the labour force, national definition; 4.8 per cent, Eurostat definition) to 127,000 persons in 2006 and 120,000 persons in 2007 (4.1 per cent of the labour force; 3.6 per cent, Eurostat definition). For 2007, the projection has been revised downwards by 5,000 persons.

	2005 level	Avg. 1991- 2005	2005	2006		2007	
				May	Aug.	May	Aug.
	1,000 persons			Change, 1,000 persons			
Private sector	1,923	6	31	26	33	6	7
Public sector	816	3	-1	0	0	0	0
Total employment	2,739	9	29	26	33	6	7
Labour force	2,896	1	10	0	3	0	1
Unemployment	157	-8	-19	-26	-30	-6	-7

The projection implies that unemployment will remain below the estimated structural level of unemployment throughout the projection period leading to labour market pressures and further wage growth increases, although the decline in the unemployment rate is expected to slow down, *cf. figure 1.6b*.



Wage and price inflation

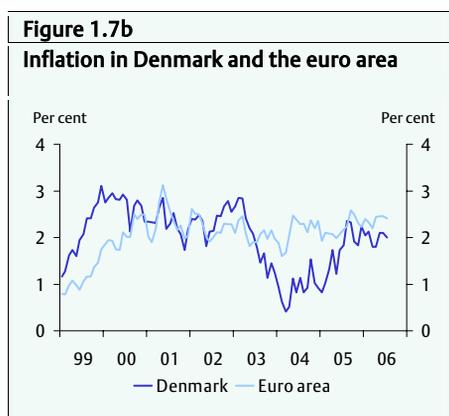
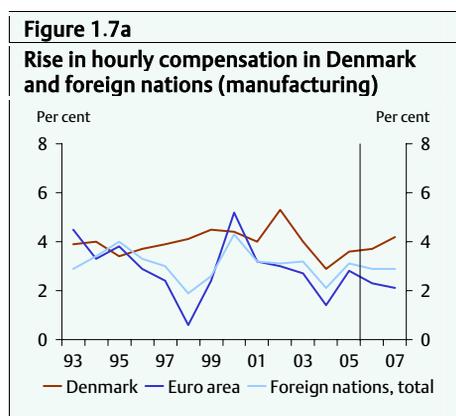
Wage growth in the non-financial, non-farm private sector increased by approximately $\frac{1}{2}$ percentage points on an annual basis in the second quarter this year compared with the first quarter, thereby reaching 3.3 per cent. In the construction sector, wage growth went up to 4.4 per cent, an increase of 1.0 percentage point compared with the first quarter. In the manufacturing industry, the increase in wage growth was more modest as wage growth reached 3.1 per cent.

As expected in the May survey, wage pressures thus seem to be building up, notably in the construction sector where labour shortages are pronounced. Approximately 40 per cent of the firms in construction report labour shortages, the highest level since the mid-1980s. Wage growth in manufacturing and in services is currently more moderate.

The quarterly wage indicators do not measure irregular payments like bonuses and may therefore understate the true wage increases if, for example, bonuses are procyclical. The yearly statistics from the Danish Confederation of Employers includes irregular payments and displayed annual wage increase in 2005 of 3.6 per cent compared with 2.8 per cent according to the quarterly indicators, suggesting that this might play a role. Wage growth may therefore be stronger than indicated by the quarterly figures.

The projected widening of the unemployment gap and increasing labour market shortages is expected to lead to higher wage growth reaching 4.2 per cent in 2007, unchanged from the May Survey.

The gap between hourly compensation of employees in the manufacturing sector in Denmark and the main trading partners is expected to widen, reversing the trend in recent years, *cf. figure 1.7a*. Consequently, wage competitiveness is expected to deteriorate somewhat as an assumed appreciation of the effective exchange rate adds to the widening wage differential.



The inflation rate has fluctuated around 2 per cent since mid-2005 after picking up from a historically low level in 2004, *cf. figure 1.7b*. Inflation remains slightly below inflation in the euro area. Oil price increases have had a larger impact on inflation in the euro area than in Denmark, but core inflation in Denmark is likewise slightly below core inflation in the euro area.

Table 1.4**Key figures for the Danish economy**

	2002	2003	2004	2005	2006	2007
Percentage change from previous year						
Real GDP	0.6	0.7	1.7	3.6	2.7	2.0
Trade-weighted GDP abroad	1.5	1.3	3.0	2.2	2.8	2.5
Markets for Danish manufactures	1.4	2.1	6.2	5.3	6.9	5.6
International competitiveness	-2.9	-4.2	-1.7	-0.3	-0.8	-1.6
Export of manufactures, volume	6.4	-2.1	2.9	8.9	8.7	4.7
Hourly wages	4.2	3.7	2.8	3.6	3.6	4.2
Consumer price index	2.4	2.1	1.2	1.8	2.0	1.8
Price index for single-family houses	3.8	3.1	9.1	16.4	22.0	6.0
Merchandise export prices	-1.0	-1.1	1.1	4.2	4.3	1.0
Merchandise import prices	-2.5	-0.3	1.0	4.0	3.8	0.7
Merchandise terms of trade	1.4	-0.9	0.1	0.2	0.5	0.3
Productivity in private non-agricultural sector	0.7	2.0	1.3	1.9	1.2	2.1
Real disposable income of households ¹⁾	-0.2	3.7	2.6	1.6	2.0	2.2
Labour market:						
Labour force (thousands)	2,888	2,878	2,886	2,896	2,899	2,900
Employment (thousands)	2,743	2,708	2,710	2,739	2,772	2,780
Of which in private sector	1,910	1,886	1,893	1,923	1,957	1,964
in public sector	833	822	817	816	816	816
Percentage change in total employment	0.0	-1.3	0.1	1.1	1.2	0.3
Unemployment (thousands)	145	171	176	157	127	120
Early retirements 60-64 year (thous.)	114	120	127	135	142	149
Unemployment rate (per cent)	5.0	5.9	6.1	5.4	4.4	4.1
Unemployment rate, EU-def. (per cent)	4.6	5.4	5.5	4.8	3.9	3.6
Long term bond yields, exchange rate:						
10-year government bonds	5.1	4.3	4.3	3.4	4.0	4.4
30-year mortgage credit bond	6.3	5.4	5.3	4.4	5.4	5.7
The effective krone rate (1980=100)	97.7	101.2	102.2	101.6	101.6	102.0
Balance of payments:						
Goods and services (bill. Dkr.)	80.1	85.6	72.0	75.7	56.3	56.0
Current account (bill. Dkr.)	34.1	45.8	33.3	46.3	26.7	28.4
Current account in per cent of GDP	2.5	3.2	2.3	3.0	1.6	1.7
Net foreign assets, ultimo (bill. Dkr.)	-225.3	-170.3	-124.1	25.0	73.5	103.5
Net foreign assets in per cent of GDP	-16.4	-12.1	-8.5	1.6	4.5	6.1
Public finances:						
Government net lending (bill. Dkr.) ²⁾	3.2	-1.0	24.8	61.2	50.1	47.8
Government net lending per cent of GDP ²⁾	0.2	-0.1	1.7	3.9	3.1	2.8
General government gross debt, year-end, bill. Dkr.	643.0	625.1	624.9	557.6	468.2	418.9
General government gross debt, year-end, per cent of GDP	46.8	44.4	42.6	35.9	28.6	24.6
Tax burden (per cent of GDP) ¹⁾	48.0	47.8	49.0	49.7	48.0	47.5
Expenditures (per cent of GDP)	53.8	53.8	53.7	51.6	50.5	49.9

1) Adjusted for special factors concerning pension funds.

2) Excluding the labour market supplementary pension scheme ATP.

The inflation rate is forecast at 2.0 per cent in 2006 and 1.8 per cent in 2007, unchanged from the May survey. The projected increase in inflation in 2006 compared to 2005 is due to growing import and energy prices and domestic inflation pressures as output is expected to be above potential. Oil prices are assumed to decline gradually in 2007 and the following years towards the long run reference scenario estimated at by the International Energy Agency (IEA). Inflation excluding energy is expected to increase from 1.6 per cent in 2006 to 2.2 per cent in 2007.

A number of policies contribute to dampen inflation: the nominal tax freeze for excise duties and lower parental co-payment for day care institutions, and the gradual elimination of airport passenger duty. Overall, the inflation rate continues to remain broadly in line with the European Central Bank's medium term inflation target of below but close to 2 per cent.

2. The fiscal stance and government finances

Fiscal policy is estimated to have a slightly positive impact on activity in 2005 and 2006 – measured by the so-called first-year fiscal effect – and a slightly negative impact in 2007⁶. For 2005 and 2006 fiscal policy is slightly more expansive than projected in the May survey mainly due to stronger growth in public consumption.

Due to the fixed exchange rate vis-à-vis the euro, the short-term (and long-term) interest rates in Denmark are closely tied to those of the euro area. As the cyclical position of the Danish economy is ahead of the euro area, *cf. figure 2.1a*, the monetary stance of the ECB may turn out to be somewhat easy in relation to Danish cyclical conditions.

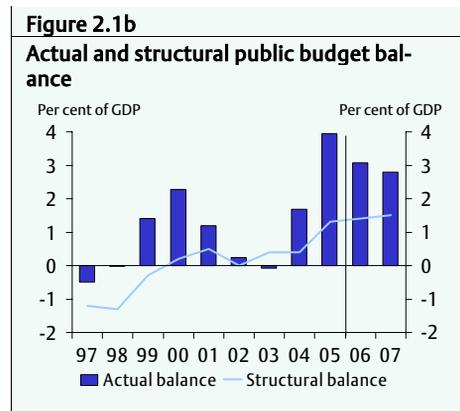
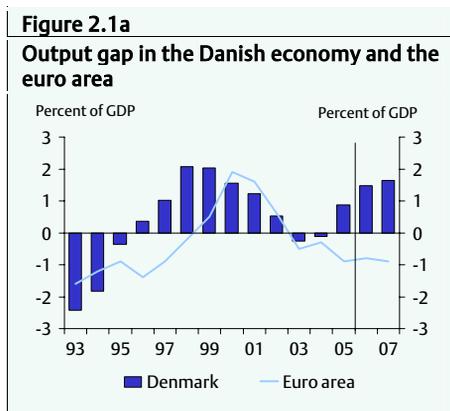
An assumed reduction in public investments by 10 per cent contributes to a tightening of fiscal policy in 2007 with an estimated impact on growth of -0.1 per cent, while the agreement on the welfare reform package adds a stimulus of 0.1 per cent of GDP in 2007 in terms of expenditures to be used mainly for investments in research and education to meet the challenges of globalization. The allocation of the expenditures is to be negotiated in the autumn 2006. The reduction in public investments in 2007 should be seen in light of the substantial increase in public investments in 2006, particular local government investments in connection with the structural reform of local government (one-off expenditures related to merging of municipalities).

As a share of GDP, public consumption is expected to decrease by approximately 0.5 percentage points from 2006 to 2007. For 2006 real public consumption growth has been revised upwards by 0.6 percentage points to 1.1 per cent. For 2007 real public consumption growth has been revised upwards by ½ percentage points to 1 per cent reflecting the agreement on the welfare reform package.

⁶ The extension of the suspension of SP-contributions in 2006 and 2007 is estimated to increase GDP, *ceteris paribus*, by around 0.1 per cent in 2006. SP is classified as a private scheme and hence changes to SP are not included in the estimated fiscal stance.

Resources available for public services have increased on average by 1.3 per cent in real terms from 2001 to 2005. It is somewhat more than planned in the previous government's plan from 2001 for the Danish economy, the "2010 plan", and subsequent updates. In nominal terms, expenditures have increased in line with nominal GDP from 2001 to 2005.

In particular, expenditures on goods and services bought from private suppliers have increased over the period in real terms, for instance an increase in the use of substitutes (temporary employment) and consultant services and an increase in private suppliers in connection with free choice of public or private suppliers in public services. The growth in resources has mainly taken place at the level of local government, while resources at the central government level have been broadly constant. In addition, nominal expenditures at the level of local government used for direct services have increased slightly faster in relative terms than private consumption (in nominal terms) in the period 2001 to 2005.



The public budget surplus reached roughly 3.9 per cent of GDP for 2005. For 2006 the surplus is revised upwards by 0.3 and for 2007 downwards by 0.1 percentage points to 3.1 and 2.8 per cent of GDP, respectively, due to several effects working in opposite direction in both years but with different net effects; higher revenues from income taxes and VAT and lower unemployment, while stronger growth in public consumption and lower projected revenues from the pension yield tax than expected in May implies an overall marginal reduction in the public surplus.

On average the structural budget surplus is estimated to be at approximately 1¼ per cent of GDP in 2004 through 2007, *i.e.*, in the high end of operational target range in force in recent years, which calls for an average structural surplus in the range of ½-1½ per cent of GDP through 2010, *cf.* *Convergence Programme for Denmark 2005*.