



FINANSMINISTERIET

# The Danish Economy 2002

June 2002





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# THE DANISH ECONOMY

JUNE 2002

## The Danish Economy, June 2002

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## Preface

This booklet gives a broad description of the Danish economy, the economic policies pursued, and a number of economic issues related to our EU membership. With the upcoming Danish EU Presidency in the 2nd half of 2002 I hope that it will prove useful reading.

When the government took office in late 2001 it pledged to maintain fiscal discipline and to continue the process of bringing down public debt in order to prepare for the impact of future demographic changes. Also, bringing about an adequate increase in the labour supply is an important task, and the government has set itself an ambitious goal in this respect.

Though Denmark does not participate in the euro, we participate fully in the economic political cooperation in EU. The Danish economy is doing well and Denmark fulfils the criteria in the Stability and Growth Pact as well as the convergence criteria for membership of the euro, both with a fairly comfortable margin.

Especially for a small, open economy, such as the Danish economy, free trade and economic cooperation are essential preconditions for achieving a high standard of living. Securing enlargement is the overriding priority for the Danish EU Presidency. Among other things, successful economic integration with the Central and Eastern European countries carries the promise of longer-term gains and enhanced economic performance to the benefit of all countries.



Thor Pedersen  
Minister of Finance

A handwritten signature in black ink that reads "Thor Pedersen". The signature is written in a cursive, flowing style with a long, thin tail extending downwards from the end.



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# 1. Introduction

## 1.1. Population, geography and climate

Denmark is a small country with 5.4 million inhabitants and an area of 43,000 square kilometres. The population density is 126 inhabitants per square kilometre and 85 per cent of the population live in urban areas.

Denmark is situated north of Germany, south of Norway and southwest of Sweden, cf. the maps on the two next pages. The Danish language belongs to the Germanic languages and is closely related to Norwegian and Swedish.

As in other highly developed countries, the natural population growth is small in Denmark and the net reproduction rate is below 1,000 (around 850). In recent years, population growth has amounted to 0.4 per cent annually, of which more than half is due to net immigration.

Denmark became a member of EU in 1973, along with UK and Ireland. Among the other Nordic countries, Sweden and Finland became members in 1995 while Norway and Iceland are not members.

Like UK and Sweden, Denmark does not participate in the single European currency, the euro, but in contrast with UK and Sweden, Denmark has a longstanding firm policy of a fixed exchange rate *vis-à-vis* the euro (previously the D-mark).

The two North Atlantic parts of the Kingdom of Denmark, Greenland and the Faroe Islands - who both have home rule - are not members of EU.

Greenland is the largest island in the world and occupies an area of 2.2 million square kilometres. However, 85 per cent of the area is covered with ice and the number of inhabitants is only 56,000. The Faroe Islands have 47,000 inhabitants and occupy an area of 1,400 square kilometres.



## Denmark in the World



Denmark



The largest province of Denmark is the peninsula Jutland, which borders in the south on Germany. Besides, Denmark consists of two larger islands, Zeeland and Funen, eight smaller islands and around seventy small, inhabited islands. The capital, Copenhagen, is situated on the eastern side of Zeeland, separated from the southern part of Sweden only by a narrow sound (*Øresund*).

Since 2000, Copenhagen and the southern part of Sweden have been connected by a bridge/tunnel. Furthermore, in 1998 a bridge between Zeeland and Funen over the Great Belt was completed. Thus, today you can drive by car or train from Jutland (and Germany) to Sweden without having to sail. The two bridges are among the longest bridges in the world.

The Danish landscape is flat or with small hills. The highest point is less than 200 meters above sea level and there are no rocks - apart from the island of *Bornholm*, which is situated southeast of the southern part of Sweden. Almost two thirds of the country is cultivated.

The climate is temperate coastal. Thanks to the Gulf Stream, the winters are relatively mild considering the latitude. Thus, the average temperature in January and February is zero degrees C. In summer, the daily temperature is around twenty degrees C. However, the latitude means a big difference between the length of the day in mid-winter (seven hours) and mid-summer (seventeen and a half hour). Due to the climate and the relatively long and dark winters, housing accommodation plays an important role for the Danes. This is reflected in the fact that the stock of dwellings per capita is relatively large in Denmark.

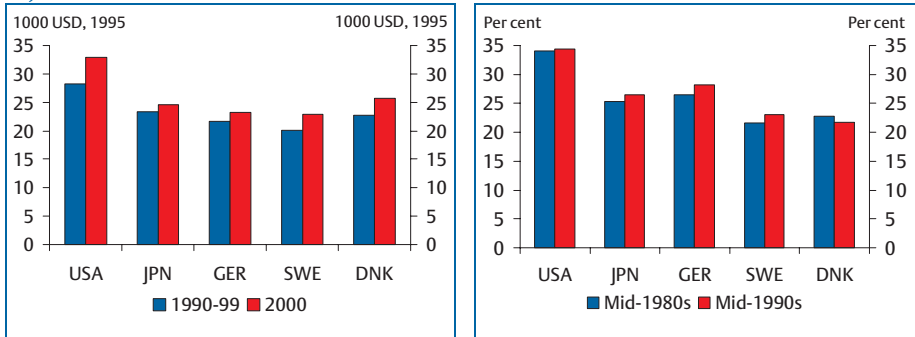
## 1.2. Economic and industrial conditions

### The welfare society

Denmark is a relatively wealthy country, cf. *figure 1.1a*. The economy is open and dependent on foreign trade. GDP per capita is the fourth highest in Europe. Like the other Nordic countries, Denmark is a welfare society with a relatively even distribution of income, cf. *figure 1.1b*, a tight social security net, a relatively large public sector, and a heavy tax burden, cf. *figure 1.2*.

In *table 1.1*, GDP per capita in Denmark and some other countries is split up into four components: productivity (measured per hour), participation rate, employment rate and working time. The figures show that the relatively high level of GDP per capita in Denmark can be attributed to the high employment rate, while the productivity level is about average of neighbouring countries and average working time is lower than in most other countries.

**Figure 1.1a. GDP per capita (PPP-adjusted)** **Figure 1.1b. Inequality of the income distribution**



Note: In this and the following figures, JPN, GER, SWE, and DNK mean Japan, Germany, Sweden, and Denmark, respectively. Figure b shows the Gini-coefficient.

Source: OECD.

The size of the public sector in Denmark is influenced by the fact that several services like education and health services are almost entirely supplied by the public sector while that kind of services in some other highly developed countries to a larger extent is produced by the private sector - partly financed through insurance schemes (*e.g.* health insurance). Also, Denmark has a relatively large number of - mostly government financed - childcare institutions and extensive public care facilities for the elderly. This should be seen in light of a fairly high participation rate for women.

Further, the high tax burden in Denmark - simply measured as the ratio of total taxes to GDP - is influenced by the fact that social transfers are taxable while they in some other countries are tax-free. When adjusting for such factors the tax burden in Denmark is not significantly higher than in a number of other continental European countries. However, the Danish tax system - and the combination of taxes and public expenditure - involves a greater degree of redistributing than in most countries.

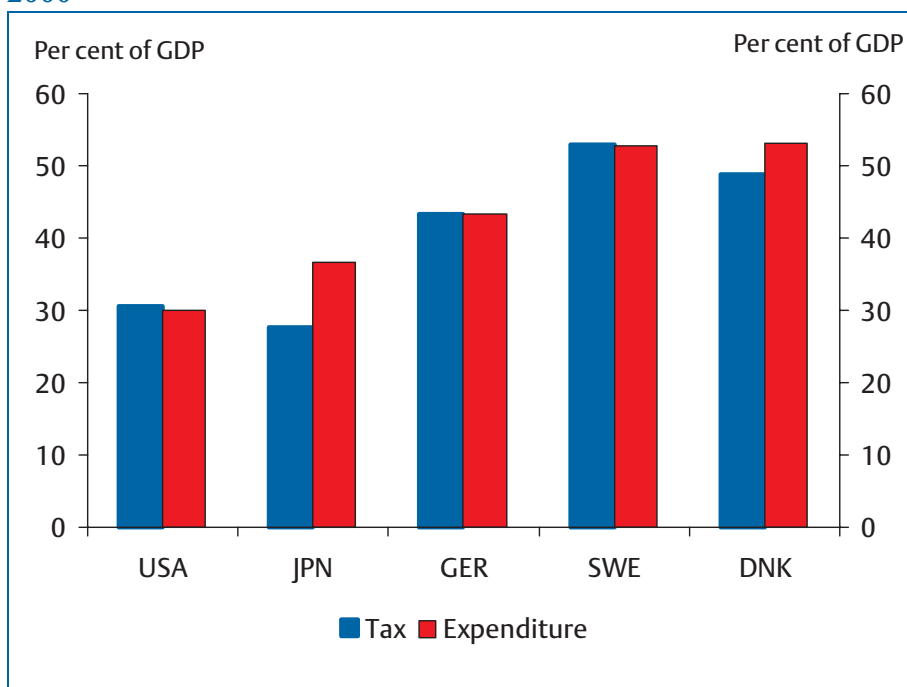
**Table 1.1. Contributions to GDP per capita from productivity, participation, employment, and working hours, Denmark=100. 1998**

	Productivity (per hour) <sup>1)</sup>	Participation <sup>2)</sup>	Employment <sup>3)</sup>	Working hours <sup>4)</sup>	<i>GDP per capita</i>
USA .....	112	95	101	120	129
Japan .....	77	99	102	121	94
Germany .....	101	89	95	103	88
France.....	115	81	92	105	89
Sweden .....	95	88	99	102	85
Netherlands.	111	93	101	90	94
Belgium.....	122	79	93	107	95
Denmark.....	100	100	100	100	100

- 1) GDP per hour worked.
- 2) Labour force per capita.
- 3) Employment per person in the labour force.
- 4) Annual hours worked per person employed.

Note: GDP is PPP-adjusted.

Source: OECD and own calculations.

**Figure 1.2. Taxes and expenditures in Denmark and other countries, 2000**

Source: OECD and Statistics Denmark.

The present Danish liberal/conservative Government, which took office in November 2001, has introduced a tax freeze as a means to controlling public expenditure and to bring about a gradual reduction of the tax burden.

### The labour market

The overall participation rate in Denmark is around 80 per cent. This is a relatively high participation rate compared to other countries, cf. *figure 1.3a*, reflecting high labour market participation for women and young (part-time employed) persons. On the other hand, the male participation rate in Denmark is a little lower than in many other countries.

Figure 1.3a. Participation rate. 2000

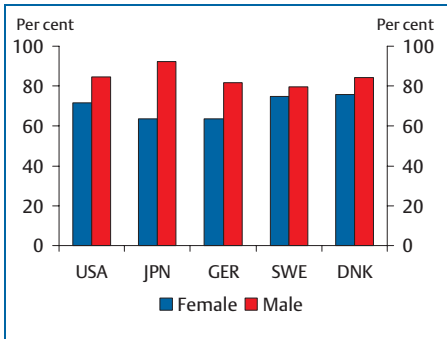
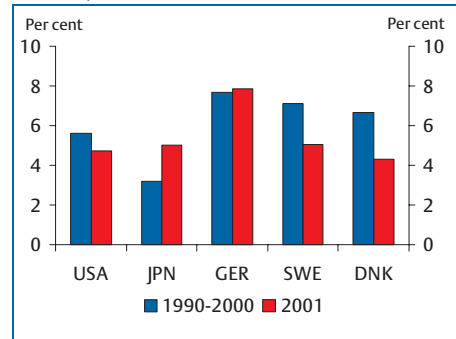


Figure 1.3b. Unemployment rate (standardised)



Note: The participation rates are for persons aged 15 to 64.

Source: OECD.

Some 15 per cent of the female labour force and around 10 per cent of the male labour force are part-time employed. The official full time working time in most of the labour market is thirty-seven hours a week with six weeks of vacation per year.

In Denmark, wage and employment conditions are traditionally to a large extent determined by collective agreements between the labour market partners. This should be seen in light of the fact that the degree of organization is relatively high with around 80 per cent of employees being members of a trade union.

### Box 1.1. Basic and special features of Denmark

#### *Population and area*

Population 5,370,000 (2002) of which 1/3 are residents in the Greater Copenhagen area, around 1/3 in towns of more than 10,000 residents and around 1/3 in smaller towns and rural areas. Denmark covers an area of 43,000 square kilometres and has a population density of 126 inhabitants per square km (excluding Greenland and the Faroe Islands).

7.8 per cent of the Danish population are immigrants or (first generation) descendants of immigrants, of whom 4.5 percentage points originate from less developed countries.

#### *Government*

Constitutional monarchy since 1849. One chamber (*Folketinget*) parliamentary system since 1953. The *Folketing* has 179 members of whom two are elected in Greenland and two in the Faroe Islands. The proportional method is used in elections for all three layers of government (national, county and municipality).

Statutory elections every four years or, in the case of Parliament, when decided by the prime minister. A Government cannot stay in office against a majority in Parliament. A minimum of 2 per cent (main rule) of the votes is required for a party to become represented in Parliament. No single party has had an absolute majority in Parliament since the beginning of the twentieth century. Since 1980, there has on average been a general election every third year.

All Governments since 1980 have been coalition Governments and almost all of them minority Governments. For the time being eight parties are represented in parliament. The present Government (a minority Government) consists of the Liberal Party (*Venstre*) and the Conservative Party (*Det Konservative Folkeparti*).

The second layer of government consists of sixteen counties with an average population of 335,000. The third layer consists of 275 municipalities with an average population of 20,000. Traditionally, the Danish system of government is rather decentralized. Thus, local governments spending accounts for approximately 57 per cent of total government spending and local governments collect about 33 per cent of the total tax revenue (local taxes are mainly income taxes).

#### *International relations*

Denmark became a member of the European Economic Community (EEC), now the European Union (EU), in 1973. Denmark does not participate in the euro. In accordance with the EU directives on the financial markets Denmark has free capital movements. Denmark is a member of NATO, UN, the OSCE, the European Council, the Nordic Council, the OECD, the WTO, the IMF, the IBRD, and the EBRD.

*For more detailed information about Denmark please see [www.denmark.dk](http://www.denmark.dk).*

Especially for blue-collar workers, the (agreed) rules concerning hiring and firing are flexible, which should be seen in light of the relatively easy access to unemployment benefits. This combination allows for a low degree of insider-outsider barriers. The replacement rate is relatively high for low-income groups. On the other hand, the replacement rate for wage earners with higher incomes is lower than in some other continental European countries.

From 2004, the eligibility age for the central government financed old age pension is sixty-five years - against sixty-seven at present. However, the average retirement age is around sixty-two years due to among other things the possibility of receiving early retirement benefits from the age of sixty. The general government finances the early retirement scheme, but the members of the scheme contribute to a small extent. The early retirement scheme was reformed in 1998 with the aim to increase the average retirement age. This is desirable in light of the ageing of the population.

Unemployment has been reduced to a historically low level of 5 per cent of the labour force. (National definition. According to an internationally standardised definition, the number is somewhat lower, cf. *figure 1.3b*). This has been the result of a fairly strong economic growth during the 1990s and structural improvements in the labour market.

As described in chapter 5, Denmark fulfils the Lisbon employment criteria. However, it is the aim of the Government to bring about a further increase in the participation and employment rates in the coming years, cf. chapter 4 on the medium term outlook.

### **Industrial structure**

Traditionally the main occupation in Denmark was agriculture. As late as in the beginning of the twentieth century, forty per cent of the population was occupied in agriculture. Today, the share of agriculture in total employment has fallen to 3-4 per cent. This does not deviate much from other highly developed countries, cf. *figure 1.4*.

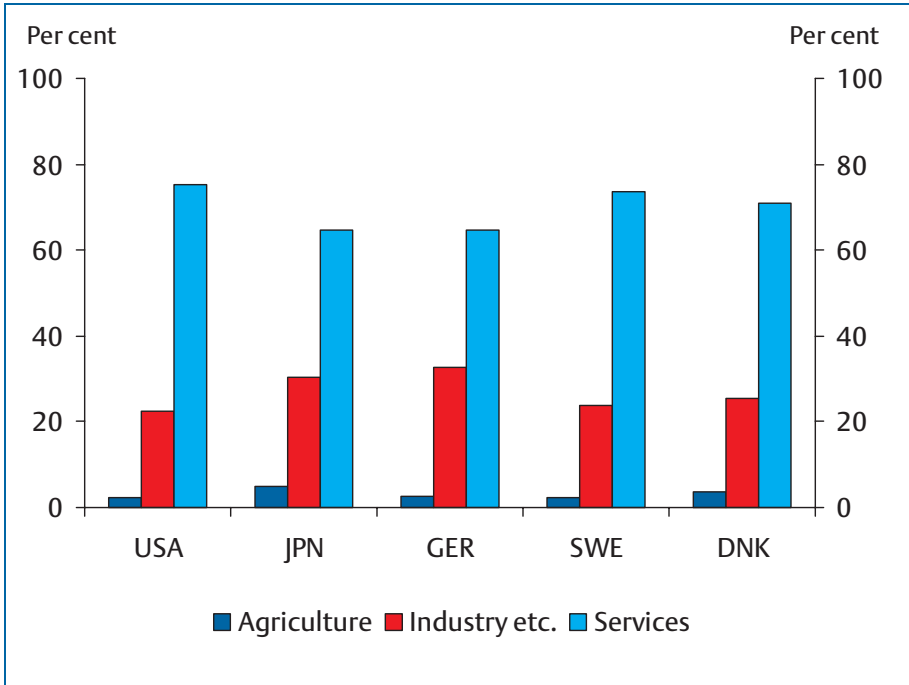
Productivity in Danish agriculture is rather high. Two thirds of agricultural production is exported and agricultural products still constitute 12 per cent of total exports of goods. The main product is pork and there are



13 million pigs in Denmark. A number of important industrial branches - such as slaughterhouses, dairies, canneries, breweries, skin and fur production and pharmaceutical and biochemical firms - are traditionally related to agriculture.

Manufacturing industry accounts for 16-17 per cent of total employment - a share which has been somewhat declining in recent years. The largest branches are iron and metal goods (including machinery), food and beverages, wood, paper and graphical products, and chemicals (including medicine). The share of building and construction in total employment is 5-6 per cent.

**Figure 1.4. The distribution of employment in Denmark and other countries. 2001**



Note: Services comprise private and public services.  
Source: OECD.

The largest share of employment is in private services, which constitute almost 40 per cent of total employment - of which 20 percentage points are in wholesale and retail sale and restaurants etc., 6-7 percentage points

are in transport and communication and 12 percentage points in financial and business services.

Sea transportation - especially between foreign harbours - plays a relatively important role and the Danish merchant fleet per capita is one of the biggest in the world.

The share of employment in private services has been increasing in recent years, due mainly to the developments of employment in business services, which among other things comprise computer and various consulting firms. On the other hand, the employment share of the financial sector has decreased due to productivity gains - that have been stronger than the increase in demand for the products - as a result of the application of modern information technology and mergers.

Public administration and services account for around 30 per cent of total employment, of which 23 percentage points are in social institutions, education and health services. The share of public employment has increased only little in the last twenty years.

Small and medium sized firms dominate industry. Thus, around 35 per cent of employment in manufacturing industry takes place in firms with less than fifty employees - of which one-fourth in firms with less than ten employees.

### **Foreign trade**

Exports of goods and services amount to around 45 per cent of GDP, of which 31 percentage points are goods.

Manufactures constitute three-fourths of the total value of exports of goods. The largest group of products is machinery and equipment (27 per cent of total exports of goods). The second largest group is chemicals (12 per cent). Important separate products are furniture, medicine (including insulin preparations), wind turbines, computer equipment, optical fibres, cellular phones, hearing aids, and loudspeakers.

Products like furniture, television and radio sets, stereophonic equipment, cutlery, table service, and silver are renowned for a beautiful design and good craftsmanship ("*Danish design*").

As mentioned, exports of agricultural products amount to 12 per cent of total exports of goods. The dominating product is pork. Other important agricultural products are cereals and vegetables, cheese and canned food. Among other primary goods can be mentioned fish and pelts (5 per cent of total exports of goods).

In the 1970s, exploitation of the deposits of oil and natural gas in the Danish part of the North Sea started off. Since then, a strong growth of production of oil and natural gas has taken place. From the end of the 1990s Denmark has been more than self sufficient in energy. Thus, in 2001 there was a net export of energy amounting to ½ per cent of GDP.

Almost two thirds of the Danish exports of goods goes to other EU-countries. Exports to the EU candidate countries are still relatively small (less than 5 per cent of total exports of goods). However, these exports have grown fast in recent years, cf. chapter 6. Around 80 per cent of Danish exports of goods go to European countries. The most important European export market outside the EU is Norway (a little less than 6 per cent). The most important markets outside Europe are USA (6 per cent) and Japan (4 per cent).

Exports of services are rather significant and amount to a almost 14 per cent of GDP. Important elements are sea and land transportation, tourism and advisory and consulting by engineer, architect and building firms.

Raw materials like minerals and metals are scarce or non-existing in Denmark. Consequently, almost half of imports of goods consists of raw materials and semi-manufactured goods.

Consumer goods amount to one fourth of total imports of goods. Some consumer durables are not produced at all in Denmark - or only to a limited extent. For instance, Denmark has no production of passenger cars. Machinery and other capital goods constitute around 14 per cent of imports of goods. Total imports of goods amounts to 28 per cent of GDP.

Total imports of services - *i.a.* tourism - amounts to 10 per cent of GDP.

The distribution of imports on countries does not differ much from that of exports.

For a number of years, exports of goods and services have exceeded imports of goods and services by a considerable amount. Thus, there is a large surplus on the balance of goods and services. In 2001, the surplus was more than 6 per cent of GDP.

### **Development assistance and other transfers**

Denmark pays a rather substantial amount of net transfers to other countries - especially dividends and interest payments on foreign debt. In 2001, dividends and interest payments on foreign debt amounted to more than 2 per cent of GDP. Other important items are foreign aid and net payments to the EU.

Foreign aid is a high priority area. Danish official development assistance amounts to around 1 per cent of GNP in 2002 - also after a small recent adjustment. This more than fulfils the UN recommendation of official development assistance higher than 0.7 per cent of GNP.

Denmark is among the foremost countries in the world with respect to development assistance and poverty reduction in the developing countries. The development assistance ensures critical investments in education and health, infrastructure, and the development of a private sector. In addition Denmark supports the trade policy interests and capacity of the developing countries and is engaged in conflict prevention. In the coming years Danish development assistance will increasingly be focused upon poverty alleviation, women and environmental protection.

Internationally, Denmark works for increased development assistance in accordance with the UN target of providing 0.7 per cent of GNP in development assistance. Denmark therefore supported the recent EU agreement to increase its total development assistance from 0.33 per cent today to collectively an EU average of 0.39 per cent by 2006.

### **Balance of payments and foreign debt**

Since 1990, Denmark has run a surplus on the external current account (with the exception of 1998). In 2001, the surplus amounted to 2.6 per cent of GDP. In the thirty years preceding 1990, there was a chronic

deficit on the external current account. This was considered the most serious economic problem in that period.

The deficits in the years up to 1990 accumulated to a rather large foreign debt. Net foreign liabilities peaked in 1988 when they amounted to more than 40 per cent of GDP. Since, net foreign liabilities have fallen considerably and they are expected to be reduced to 10 per cent of GDP by the end of 2003 and to be completely removed in the period 2005 to 2010.

The main reason for the considerable improvement of the external balance during the 1990s is the reforms of income taxation and the fixed exchange rate policy.

The tax reforms have brought about a significant reduction of the tax value of interest deductions of households, from up to 73 per cent for higher incomes before 1987 to around 33 per cent in 2001, thus containing an excessively large stimulus to private sector borrowing.

This development has been underpinned by the fixed exchange rate policy, which was introduced in 1982. The fixed exchange rate policy has been a crucial element in making Denmark a low-inflation economy. Low inflation has in addition to macroeconomic stability contributed considerably to a reduction of the distortions stemming from deductions of interest payments of households in a nominal income tax system. Earlier, the combination of high inflation and a high tax value of interest deductions implied a negative real after tax interest rate of households.

## 2. Economic developments

### 2.1. Structural improvements in the last twenty years

In the last twenty years substantial structural and macroeconomic improvements of the Danish economy have been achieved:

- Inflation is low (around 2 per cent annually).
- The interest rate differential *vis-à-vis* Germany is small (around ¼ percentage point).
- Unemployment is low (4-5 per cent of the labour force).
- There is a surplus on general government finances (2-3 per cent of GDP).
- The general government gross debt has declined markedly (from 80 per cent of GDP in 1993 to 45 per cent by the end of 2001, well below the Maastricht-criterion of 60 per cent of GDP).
- Net foreign debt has been reduced significantly (from more than 40 per cent of GDP in 1988 to 17 per cent by the end of 2001).

Figure 2.1a. Macroeconomic indicators

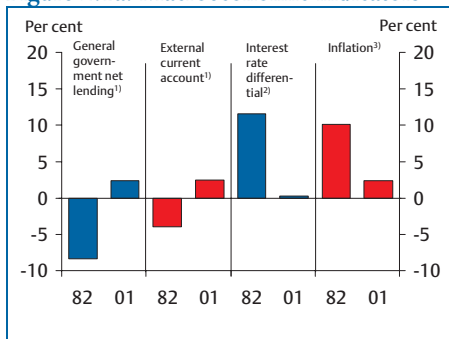
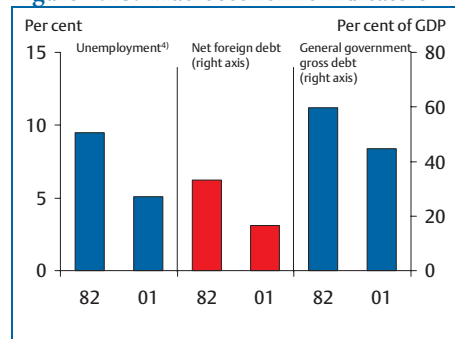


Figure 2.1b. Macroeconomic indicators



Notes: 1) Per cent of GDP. 2) Percentage points. Ten year government bonds, differential to Germany. 3) Increase in the consumer price index from the year before. 4) Per cent of the labour force, national definition.

The main factors behind these considerable structural improvements have been a wide range of structural policies:

- Introduction (in 1982) of the fixed exchange rate policy, from 1999 *vis-à-vis* the euro.
- Reforms of the income tax system (from 1987 and onwards) leading to a reduction of the marginal tax rate on earned and capital income and broadening of the tax base. Also, a reduction of the corporate tax rate and reduction of duties on goods especially sensitive to border trade. Enhanced use of economic instruments in environmental policy.
- Reforms of the labour market consisting of numerous measures, including a tightening of availability criteria, intensification of active employment measures and a shortening of the maximum unemployment benefit period. Persons under the age of twenty-five have a right and a duty to get a job or start an education after six months of unemployment.
- Introduction (from around 1990) of (collectively bargained) funded labour market pension schemes for also blue-collar workers.
- Liberalization of international capital movements (from the beginning of the 1980s) and liberalization of the real mortgage credit system (from around 1990).

The main consideration of today's economic policy is to consolidate the overall macroeconomic balance and continue the structural improvements. It is especially important to bring about an increase in the labour force and private employment and to maintain a surplus in the general government finances of 1½-2½ per cent of GDP thus ensuring long-term sustainability of fiscal policy - as a result cutting the level of the gross debt ratio by around half by 2010. This is an element in the preparation for the ageing of the population, cf. chapter 3.

The fairly strong growth of the Danish economy during the 1990s has led to a high capacity utilization. At present, pressures on the labour and property markets are causing some concern that wage increases will be too high compared to abroad. This calls for a sufficiently tight fiscal policy. Together with the tax freeze, this demands a close monitoring of public

spending in order to create room for expenses on areas of high priority such as health, education and general welfare.

## 2.2. Growth moderation in recent years

Since 2000, economic growth in Denmark has slowed down. As mentioned, capacity utilization is high and there are only few idle resources. Besides, the demographic contribution to the labour force is becoming somewhat negative. In addition, there is only a limited scope for a further increase in the already relatively high participation rate.

On the demand side, the shift towards slower growth in private consumption took place already in 1999 due among other things to the so-called *Whitsun package*, with effect for the period from 1999 to 2002. An important element of this package was to reduce further the tax value of interest deductions of households (as mentioned before) to around 33 per cent in 2001 compared to around 46 per cent in 1998. Besides a structural improvement of the income tax system, the aim was to dampen domestic demand by promoting private savings in order to avoid overheating of the economy and restore the external current account, which as mentioned showed a deficit in 1998.

While private consumption was contained as a result, GDP growth in 1999 and 2000 was sustained by a continued strong increase in exports due to a still favourable international environment. Also, in 2000 investment in buildings increased sharply due to repair works in the wake of the hurricane in December 1999. The size of the restoration is estimated at  $\frac{3}{4}$  per cent of annual GDP. Also other parts of investment grew strongly in 2000.

In 2001, GDP-growth dropped to 0.9 per cent compared to 3.0 per cent in 2000. The main explanation is that growth of exports declined markedly due to the international slowdown. Furthermore, investment in dwellings and other buildings dropped sharply following the extraordinarily high level in 2000. Private consumption showed a moderate increase of 0.6 per cent after nearly stagnation in the two preceding years.

In spite of the rather slow growth of production in 2001 unemployment showed a small further decline to 5.1 per cent of the labour force. This was due to an only modest increase in productivity as well as in the labour

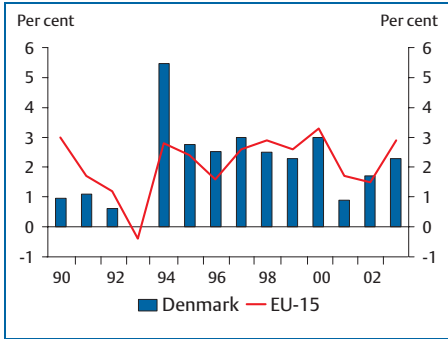


force. Thus, productivity in the private non-agricultural sector improved by only 1.1 per cent. However, this should be seen in light of the rather strong increase in productivity in 2000 of 3.7 per cent. For the two years as a whole, the productivity increase in the private non-agricultural sector was well in line with long-term and recent trends.

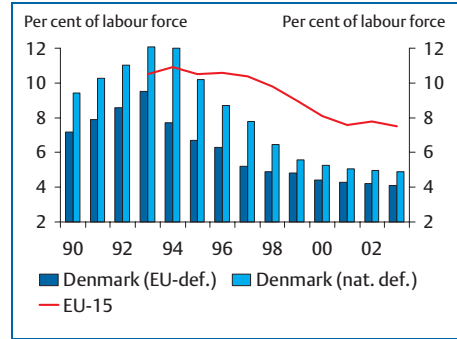
### 2.3. The short term outlook

After the relatively slow increase in production and employment in 2001, growth is expected to pick up gradually during 2002 and 2003 due to more favourable prospects for international growth and a stronger private consumption. Thus, in 2002 and 2003, growth of real GDP is estimated at 1.7 per cent and 2.3 per cent respectively, cf. *figure 2.2a.* and *table 2.1.*

**Figure 2.2a. Real GDP growth in Denmark and EU**



**Figure 2.2b. Unemployment rate (EU-definition) in Denmark and EU**



This will lead to a renewed increase in private employment. Thus, total employment - in spite of a slowdown of growth in public employment - is expected to go up by 0.5 per cent in 2003 following a growth of 0.3 per cent in 2002. Productivity in the private non-agricultural sector is expected to increase by 2-2½ per cent in both 2002 and 2003, broadly in line with past trends.

The labour force is expected to grow by 0.2 per cent in 2002 and by 0.4 per cent in 2003, cf. *table 2.2.* The expected increase in the labour force from 2000 to 2003 corresponds to one third of the 2010 strategy target, cf. chapter 4.

Consequently, the unemployment rate is expected to fall to 4.2 per cent in 2002 and 4.1 per cent in 2003 (EU-definition - national figures are 5.0 and 4.9 per cent, respectively), cf. *figure 2.2b*.

The unemployment gap - the difference between the expected unemployment rates and the estimated level of structural unemployment - is negative in both 2002 and 2003 with a tendency to a slightly increasing gap next year. This indicates that the labour market will remain tight throughout the forecast period.

Against that background, hourly wages in the private sector are expected to grow by 4 per cent in both 2002 and 2003, which is somewhat faster than abroad.

Consumer price inflation is estimated at 2.2 per cent in 2002 and 2.0 per cent in 2003, cf. *figure 2.4a*, close to the medium term target of the ECB of 2 per cent annually.

**Table 2.1. Use and supply of goods and services**

	2001	1998	1999	2000	2001	2002	2003
	Bill. Dkr.	-- Percentage changes from previous year --					
Private consumption .....	630.4	2.3	0.2	-0.3	0.6	1.8	2.3
Government consumption .....	343.0	3.1	1.8	0.6	1.4	1.3	0.7
Government investment .....	23.5	-2.8	2.5	6.7	3.5	2.0	2.0
Residential construction .....	53.0	4.2	2.5	11.0	-13.1	2.0	2.5
Fixed business investment .....	207.3	13.5	0.4	11.1	3.2	1.6	3.8
Stock building <sup>1)</sup> .....	0.3	-0.1	-1.3	0.2	0.4	0.0	0.0
Total domestic demand .....	1257.6	4.0	-0.5	2.6	1.1	1.6	2.2
Exports of goods and services ..	608.9	4.3	10.8	11.5	3.1	3.7	5.5
Imports of goods and service ..	523.1	8.9	3.3	11.2	3.8	3.6	5.4
Gross domestic product .....	1343.3	2.5	2.3	3.0	0.9	1.7	2.3

1) The volumes indicate the volume changes in stock building in per cent of volume GDP in the preceding year, both in 1995-prices.

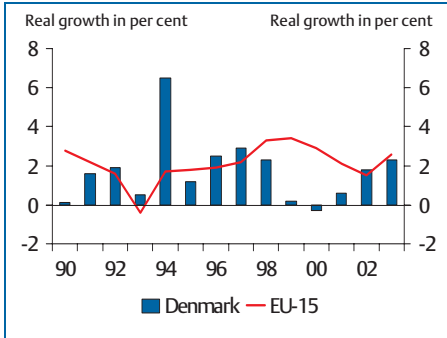
Source: Economic Survey, May 2002 (Ministry of Finance).

Real disposable income of households is expected to increase by 1.4 per cent in 2002 and 1.8 per cent in 2003 (adjusted for special factors concerning pension funds). For the total private sector the increase in (adjusted) real disposable income in the two years is estimated at 2.2 per cent and 2.5 per cent, respectively.

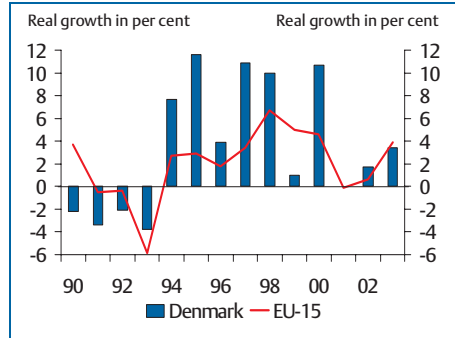
Private consumption is expected to increase by 1.8 per cent in 2002 and by 2.3 per cent in 2003, cf. *figure 2.3a*. The estimate is based on a small increase in the household consumption ratio. As mentioned, private consumption was almost stagnating in the three preceding years when the consumption ratio dropped by 3 percentage points.

Public consumption is expected to show real growth of 1.3 per cent in 2002. The estimate is based on the Finance Act for 2002, which was passed by Parliament in March 2002, and an agreed reduction of the budgeted expenditure of counties and municipalities.

**Figure 2.3a. Private consumption expenditure in Denmark and EU**



**Figure 2.3b. Total investment in Denmark and EU**



In 2003, real public consumption is assumed to grow by 0.7 per cent. Thus, for 2002 and 2003 as a whole growth of public consumption is expected to fulfil the medium term target of an average growth of 1 per cent annually up to 2005.

As expected, increases in property prices showed a significant slowdown in the fourth quarter of 2001 and the first quarter of 2002. In both 2002 and 2003, the increase in real estate price of owner-occupied one family houses is expected to be 2.5 per cent following an increase of 5.7 per cent in 2001.

Housing investment is expected to increase by 2-2½ per cent in both 2002 and 2003 following a fall of 13 per cent in 2001 reflecting a normalisation after the repair works due to the hurricane in December 1999. A pickup in the number of municipal housing projects is expected and

this will contribute to the growth of housing investment in 2002 and 2003.

Business investment is expected to increase 1½ per cent in 2002 and 4 per cent in 2003 after a growth of 3 per cent in 2001, cf. *figure 2.3b*. The assessment of investment growth is due to, among other things, the low interest rate and the expected upturn in market conditions.

**Table 2.2. Key figures of the Danish economy**

	1998	1999	2000	2001	2002	2003
	- Percentage changes from previous year -					
Trade-weighted GDP abroad .....	3.0	2.9	3.6	1.5	1.8	3.1
International competitiveness .....	-3.0	-0.6	3.0	-2.5	-1.2	-1.5
Export of manufactures, volume .....	5.3	7.5	12.8	3.5	2.8	6.3
Hourly wages .....	4.0	4.8	3.6	4.2	4.0	4.0
Consumer price index .....	1.8	2.5	3.0	2.4	2.2	2.0
Real estate prices for one-family houses .....	8.8	6.9	6.5	5.7	2.5	2.5
Productivity, private non-agricultural sector ..	1.2	2.3	3.7	1.1	2.0	2.3
Real disposable income, private sector .....	0.7	-0.3	3.9	1.0	2.7	1.9
<i>Labour market:</i>						
Labour force (thousands) .....	2834	2843	2856	2864	2870	2881
Employment (thousands) .....	2651	2685	2705	2719	2727	2740
Of which in private sector .....	1839	1863	1882	1892	1895	1905
in public sector .....	812	821	823	827	832	835
Percentage change in total employment .....	1.7	1.3	0.8	0.5	0.3	0.5
Unemployment (thousands) .....	183	158	150	145	143	141
Unemployment rate (per cent) .....	6.4	5.6	5.3	5.1	5.0	4.9
Unemployment rate, EU-def. (per cent) .....	5.2	5.2	4.4	4.3	4.2	4.1
<i>Long term bond yields, exchange rate:</i>						
10-year government bonds .....	4.9	4.9	5.6	5.1	5.4	5.6
30-year mortgage credit bond .....	6.5	6.8	7.4	7.1	6.6	6.8
The effective krone rate (1980=100) .....	101.3	99.6	95.6	96.8	97.0	97.6
External current account in per cent of GDP	-0.9	1.7	1.6	2.6	2.7	2.9
Net foreign liabilities in percent of GDP .....	25.9	13.3	13.7	16.6	13.3	9.8
Government net lending in per cent of GDP	1.1	3.1	2.5	2.8	2.2	2.8
General gvnt. gross debt in per cent of GDP .	56.2	52.7	46.8	44.7	42.9	39.4
Tax burden (per cent of GDP) .....	50.1	51.2	48.8	48.9	48.0	48.0
Expenditures (per cent of GDP) .....	56.7	55.2	53.2	53.3	52.5	51.6

1) For the years 1999-2001 the net savings in the special pension fond are included in government net lending (app. 0.5 pct. of GDP).

Source: See table 2.1.

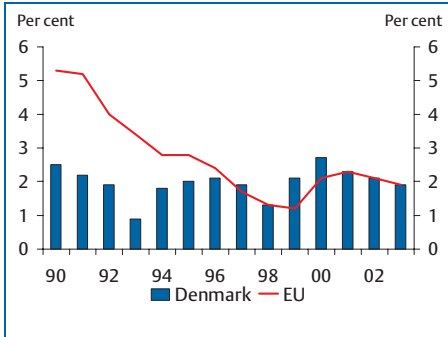
The pick up in international growth is expected to lead to an increased real growth in exports of goods and services from 3.7 per cent in 2002 to 5.5 per cent in 2003.

The acceleration of internal and external demand is expected to bring about a stronger increase in imports of 5.4 per cent in 2003, compared to an estimated import growth in 2002 of 3.6 per cent.

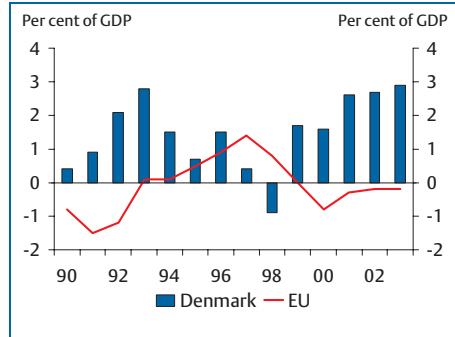
The surplus on the external current account is expected to go up to 2.9 per cent of GDP in 2003 following a surplus of 2.6 and 2.7 per cent of GDP in 2001 and 2002, cf. *figure 2.4b*. Consequently, net foreign liabilities will be reduced to 9.8 per cent of GDP by the end of 2003 compared to 16.6 per cent by the end of 2001.

In the period from 2001 to 2003 the surplus on the external current account will be of broadly the same magnitude as the surplus on general government finances (cf. section 3.3). Consequently, private sector savings are sufficient to finance private investment. Even if the savings ratio of households is small compared to other countries, total private sector is well in balance. This means that the risk of significant adjustments in savings patterns is considered to be small.

**Figure 2.4a. Consumer price inflation (HICP) in Denmark and EU**



**Figure 2.4b. External current account in Denmark and EU**



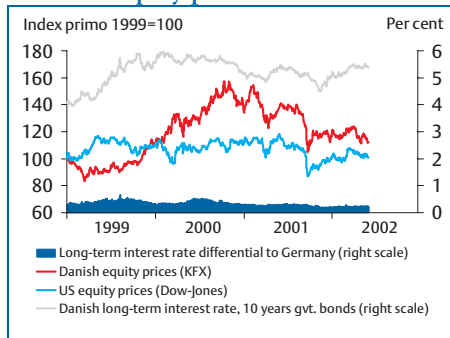
**Financial markets**

The fixed exchange rate policy and the stable developments of the Danish economy imply that Danish interest rates move in parallel to interest rates in Germany and the other countries in the euro area. Both the short-term and long-term interest rate differentials *vis-à-vis* Germany have been at a

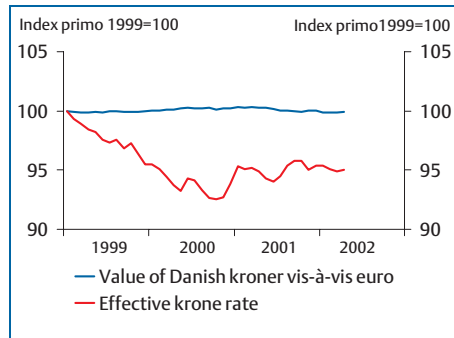
rather stable level of 0.2-0.3 percentage points in the last couple of years, cf. *figure 2.5a*.

Thus, Danish long-term and - especially - short-term rates showed a decline in 2001. In 2002 and 2003 a gradual increase in interest rates is expected as a consequence of a tightening of monetary policy of the ECB and in USA during the international upswing.

**Figure 2.5a. Interest rate, interest differential and equity prices**



**Figure 2.5b. Value of the Danish krone**



The low level of short-term rates especially in the second half of 2001 has implied that house owners to a large extent have refinanced mortgage loans using floating rate mortgages. The traditional sort of loans has a long-term - *i.e.* twenty or thirty years - fixed interest rate. The new type of mortgage loans still has the long maturity, but the interest rate is adjusted every year - or every third or fifth year (adjustable rate mortgage loans) - according to developments of market rates for mortgage bonds with short maturity.

The refinancing has reduced interest expenditure of households and stimulated the real estate market and housing investment. Another effect is that Danish house owners today are more exposed to changes in short-term interest rates than previously because the new type of loans has to be refinanced e.g. every third year.

Like in most other countries, Danish equity prices declined in 2001 - especially after September 11 - and showed a new increase in the fourth quarter of 2001 cf. *figure 2.5a*. In many countries, equity prices again reached the level of September 10, 2001. However, the Danish equity

prices did not quite match this, which should be seen in light of the fact that equity prices in Denmark generally had increased stronger in the couple of years before.

Recently, equity prices in Denmark (as in other countries) have shown a new decline and the present level is around 10 per cent lower than just before September 11, 2001. It is expected that Danish equity prices will show some increase in the forecast period.

The rate of the Danish krone *vis-à-vis* the euro has been almost constant in the last year, cf. *figure 2.5b*. The same holds for the effective rate of the Danish krone. The fall of the effective rate of the krone during 1999 and 2000 was due to the increase of US dollars, British pounds and Swedish kroner *vis-à-vis* the euro in that period.

## 3. Economic policy and public finances

### 3.1. The Government platform

According to the Government platform *Growth, Welfare - Renewal* of the present liberal/conservative Government, there are four cornerstones in the Government's economic policy:

1. The fixed exchange rate policy will continue. The Danish *kroner* will continue to be bound to the euro within the current narrow margin, and Denmark's economic policy will continue to take that fact into account.
2. Fiscal and budgetary policy will be organised with a view to ensuring a reduction of the public debt and interest expenditure towards 2010.
3. There must be a robust surplus on the balance of payments, so that foreign debt can be eliminated as quickly as possible.
4. Inflation and interest rates must be kept at low levels.

The Government adheres to the same general medium term strategy as the former Government. However, in many respects the Government platform constitutes a new strategy with a slim-lining of administrative public expenditure and a reinforced focus on improving cost efficiency, widening public-private sector interaction and extended options for consumers of public services to choose between producers and products.

Furthermore, reinforced privatisation of public or semi-public institutions and enhanced competition in network industries is expected. Subsidies are expected to be reconsidered and slim-lined and replaced by some simplifications of business taxation.



### **The tax freeze**

An important element of the Government platform is the introduction of a firm tax freeze. The starting point of the tax freeze is that no direct or indirect tax will be increased.

However, the tax freeze does not exclude a necessary restructuring of the tax system. If there are compelling reasons to introduce a new tax or raise an existing one, the revenue resulting from this rise will go fully towards reducing another indirect or direct tax. The same principle will be applied if it becomes desirable, for environmental reasons, to introduce a new environmental tax or raise an existing one. If Denmark is forced to lower a tax as a result of EU decisions or international agreements, there may be compensated for this reduction by increasing other direct or indirect taxes. Such changes will be required to leave the net revenue from taxes unchanged. Changes in taxes already adopted fall outside the tax freeze.

The tax freeze also extends to municipalities and counties whose tax rates increased during the 1990s. It will be ensured that increases in local and county taxation do not alter the aggregate level of taxation.

If the Government obtain the necessary room for manoeuvre, it will present a proposal for a reduction of income taxes, to be effective starting 1 January 2004.

As of 1 January 2004 the so-called "24 hour rule" will be repealed and travellers to Denmark will be allowed to pass borders to other EU countries without limits on the amount of goods they bring with them. To prevent a rise in cross-border trade the Government will present a bill providing for reductions in a number of taxes on liquor, tobacco and other typical cross-border trade articles. These tax rates are to be reduced over a number of years.

### **3.2. The role of counties and municipalities**

In Denmark decisions on public spending and taxation are relatively decentralized. Thus, counties and municipalities - within the legal framework set by the central government - have the freedom to determine expenditure and taxation. Local taxes are mainly - almost proportional - income taxes. However, there are tight restrictions on counties' and mu-

municipalities' access to borrow. Consequently, their budgets must be broadly in balance.

The counties and municipalities spend more than half of total public spending (13 per cent and 44 per cent, respectively). However, the central government finances a large part hereof through refunds and so-called block grants. Thus, counties' and municipalities' share of total public financing is "only" one third. The total county and municipal income tax rate is on average 32.5 per cent.

As a consequence of the size of local authorities budgets, the central government has for a number of years endeavoured to influence these budgets through negotiations. The negotiations between the central government and the local authorities are normally concluded by an agreement in June the year before the year in question. The agreement has to be confirmed by parliament.

In recent years the aim of the Governments has been to dampen the increase in the spending and taxation of local authorities. There has been a tendency to a stronger growth of spending and taxation of local authorities than agreed with the central government.

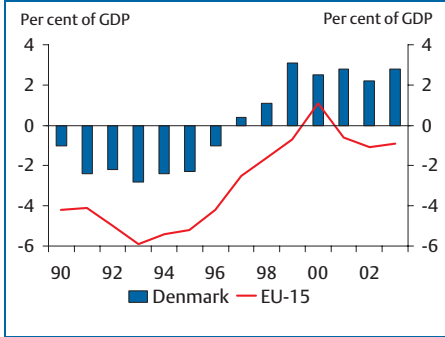
### **3.3. Fiscal stance and government finances in 2002 and 2003**

The general government surplus is estimated at 2.2 per cent of GDP in 2002 and 2.8 per cent in 2003, cf. *figure 3.1a*.

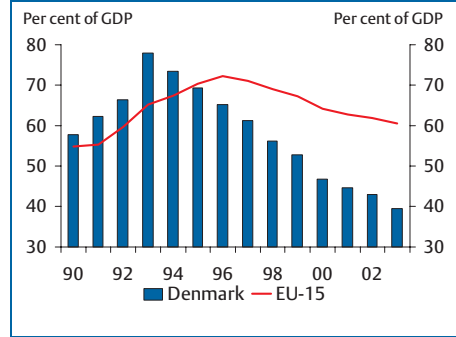
Gross public debt is expected to decline to 39.4 per cent of GDP by the end of 2003 compared to 42.9 per cent by the end of 2002, cf. *figure 3.1b*.

Fiscal policy in 2002 is based on the revised budgets of the local governments and the 2002 central government budget bill.

**Figure 3.1a. General government surplus in Denmark and EU**



**Figure 3.1b. Gross public debt ratio in Denmark and EU**



The fiscal effect, which measures the first year impact of discretionary fiscal policy changes on GDP, is estimated at 0.2 in 2002, cf. *table 3.1*, corresponding to the fiscal effect in the 2002 draft budget bill.

**Table 3.1. Activity effect of overall economic policy**

	1997	1998	1999	2000	2001	2002
	----- Per cent -----					
Revenues .....	-0.3	-0.4	-0.2	-0.1	-0.2	0.1
Expenditures .....	-0.1	0.5	0.4	0.0	0.3	0.1
Fiscal effect .....	-0.5	0.1	0.3	-0.1	0.1	0.2
	----- Percentage points -----					
Cumulated activity effect of fiscal policy .....	-0.7	-0.7	-0.5	-0.6	-0.3	-0.1
Structural saving effects.	0.0	-0.4	-0.6	-0.5	-0.4	-0.1

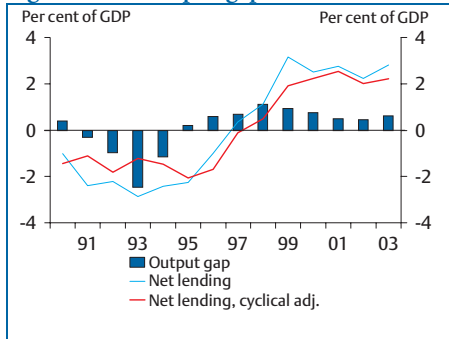
GDP-growth is also influenced by fiscal policy measures undertaken in previous years. The cumulated activity effect of fiscal policy including continued structural effects on saving incentives due to the adjustment of income taxation adopted in June 1998 (*Whitsun package*) are expected to dampen activity by 0.2 per cent. Thus, in light of the uncertainty associated with the cumulative effects, the overall economic policy is broadly neutral in 2002.

This level of fiscal tightness is appropriate considering the current cyclical position of the Danish economy, also taking into account that fiscal policy must be conducted given the monetary policy implied by the fixed exchange rate in the ERM II. The fixed exchange rate implies that monetary policy is effectively determined by the ECB.

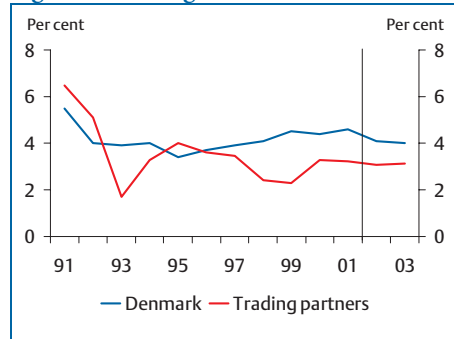
Thus, the fiscal stance should be seen in the context of sizeable interest rate cuts internationally during 2001, a level of unemployment at a historically low level and a relatively high level of capacity utilization. The estimated level of the output gap is still positive, cf. *figure 3.2a*, and wage increases are approximately 1 percentage point higher than abroad, cf. *figure 3.2b*.

An expected high capacity utilisation also in 2003 and the risk of capacity problems suggest that economic policies must continue to be cautious. Against this background the fiscal policy stance in 2003 is assumed to be neutral.

**Figure 3.2a. Output gap**



**Figure 3.2b. Wage increases**



### 3.4. Fiscal sustainability and the ageing of the population

Dealing with the challenges from the future demographic changes is an important element in economic policy formulation. As most other highly developed countries, Denmark is facing a significant increase in the share of elderly in the population beyond 2010. This will put public finances under pressure. Assessing this pressure is an important element in determining the long-run sustainability of public finances.

An indicator of fiscal sustainability is calculated. In light of the uncertainty of such calculations, it must be concluded that Danish fiscal policy is broadly sustainable, cf. *table 3.2*.

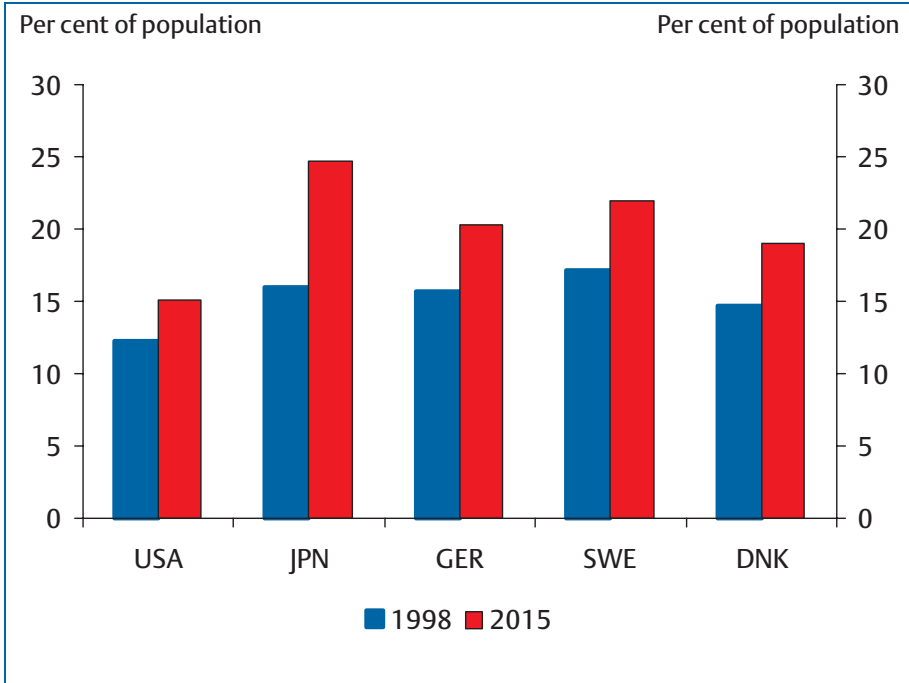
The future increase in the share of elderly people in the population is less pronounced than in many other highly developed countries, cf. *figure 3.3*.

**Table 3.2. Long-term requirements on public finances**

Per cent of GDP	2002	2003
Increase in future net obligations <sup>1)</sup> .....	1.6	1.7
Surplus in social funds .....	1.0	0.8
Requirements on public finances .....	2.6	2.5
Structural surplus .....	2.0	2.2
Structural surplus less requirements .....	-0.6	-0.3

- 1) Calculated as the present value of *i.a.* the following items: a) Effects on public expenditure and receipts of the future demographic changes. b) Effects of a future shift to net disbursements from private pension funds. c) Decreasing revenue from corporate taxes due to the present high level and an expected future decline in production of oil and natural gas.

**Figure 3.3. Developments of the share of elderly (65+) in the population in Denmark and other countries**



The pressure on public finances from the increasing share of elderly after 2010 will make itself felt on both the expenditure and the revenue side of public budgets. Spending on e.g. old age pensions, old people’s homes and health care will increase. At the same time, the demographic tendency towards a declining labour force and employment will imply less

revenue from taxation. However, revenue from taxation of disbursements from private pension funds will increase.

Due to considerations for future generations, it is necessary to have a rather large surplus on public finances in these years in order to bring about a significant reduction in the public debt. This is necessary to prevent a future increase in the tax burden or a reduction of public services.

The calculations of fiscal sustainability are summarized in table 3.2. The estimated size of the necessary surplus on general government finances in 2002 amounts to 2.6 per cent of GDP. The increase in net obligations due to the future demographic shift etc. is estimated at 1.6 per cent of GDP. Hereto is added 1.0 per cent of GDP corresponding to the part of the total surplus that stems from the surplus in public pension funds. These funds are actuarially earmarked for future pensions. Therefore, they cannot contribute to the financing of general government spending.

The actual surplus on general government finances in 2002 and 2003 is estimated at 2.2 and 2.8 per cent of GDP, respectively. In the two years, the structural surplus is estimated at 2.0 and 2.2 per cent of GDP, respectively.

Thus, when adjusted for the estimated future requirements and for the cyclical component of the surplus, there is a small deficit of 0.6 per cent of GDP in 2002 and 0.3 per cent of GDP in 2003. As mentioned, in light of the uncertainty of such calculations, the public finances against this background must be considered as broadly sustainable.

In the medium term, fiscal sustainability requires a surplus on general government finances between 1½ and 2½ per cent of GDP. The indication of the goal as an interval is due to the uncertainty of the estimates.

### 3.5. Monetary policy

The primary objective of the Danish monetary policy is to maintain a stable rate of exchange *vis-à-vis* the euro within the band of  $\pm 2\frac{1}{4}$  per cent of the ERM II-arrangement.

As mentioned, Denmark does not participate in the euro as a consequence of the “no” at the referendum on September 28, 2000. The share

of “no”-votes amounted to 53.2 per cent of total votes. The turnout was 87.6 per cent.

As a consequence of the pegging of the Danish krone to the euro, interest rate developments in Denmark are normally in close parallel to those in Germany and the other euro countries. Both the short and the long-term interest rate differential to Germany have been rather stable in recent years and amount to about 0.3 percentage points.

The cyclical position of the Danish economy today is more in line with the euro countries than during 1982-1998. Therefore, the monetary policy of the European Central Bank is well suited to the present needs of the Danish economy.

Though Denmark is not a member of the single currency, Denmark participates fully in the economic political cooperation in EU. Thus, an important aim of Danish economic policy is to continue to fulfil the criteria in the Stability and Growth Pact as well as the convergence criteria for membership of the euro.

### **3.6. Structural policies and sustainable development**

As mentioned, the efforts in structural policies in the last twenty years have been a major factor behind the relatively favourable position of the Danish economy today. It is the intention of the Government to continue these efforts and thereby further growth, employment, and wealth including e.g. sustainable public finances and a healthy environment.

An important element in today's structural policy is the efforts mentioned above to make the public sector more efficient.

The Government has prepared an ambitious strategy aiming at increased economic growth. The Government wishes to stimulate economic performance by improving the overall general framework in the business environment. As mentioned, subsidies are expected to be slim-lined and replaced by some simplifications of business taxation.

An important target in the growth strategy is to enhance competition in a number of markets, for instance through liberalisation of network industries. Further, the Government wishes to promote productivity of private

business through endeavours to enhance the efforts, including effectiveness and profitability of investment in new technology and research. Also, the Government wishes to increase co-operation in private and public research activities. The administrative burdens will be reduced in order to stimulate entrepreneurship. Provided the necessary room for manoeuvre is present, a reduction of income taxes, cf. chapter 4, will contribute positively to higher growth.

Already, a number of initiatives have been taken. Research expenditures on activities co-financed with public institutions are deductible by 150 per cent. Taxation rules on stock options have been improved to help innovative firms during the start-up phase. The time limit on deductibility of losses and deficits for companies has been removed.

In order to reach the medium term goals, it is of great importance that the labour force and private employment show the presupposed growth. Work must pay. The Government endeavours to ensure that more people go from passively receiving benefits to active participation and to secure a better integration of immigrants. Young people should finish their studies earlier. People already in the labour market must be motivated to work more and to postpone their retirement. The Government wants to extend the special Youth Scheme to people aged twenty-five to twenty-nine.

In autumn 2002 the Government will - after consultations with the labour market partners during the summer - submit an action plan called "More People Into Work".

In June 2002 Denmark's National strategy for Sustainable Development has been finalised. Through a number of policies and social programmes the Strategy aims at ensuring a sound economic and socially balanced development which respects the limits of nature and the environment and which does not affect human health negatively.

### **Environmental policy**

The Government will pursue an active environment policy to ensure a clean environment for future generations. Denmark will continue to live up to the commitments set out in international environmental agreements. The goal is that Denmark can continue to be among the industrialised countries that take the lead in pollution reduction.



The ambitious environmental objectives must be achieved in the economically most effective way. The Government will develop an environment policy that combines a clear responsibility for the environment with realistic international cooperation to reduce pollution where return on investments is highest.

The Government has established an Institute of Environmental Appraisal working through research at a high international standard, to create an overview of the current and long-term environmental situation both in Denmark and globally, to assess the effectiveness of environmental initiatives, and to disseminate this knowledge and insight to the general public and political decision-makers.

With a view to getting the best value from the environmental efforts a report on “green market economy” will be prepared, analysing the possibilities of applying more market-oriented tools in practice to promote a better environment.

The Government will seek to strengthen the international environmental cooperation. The possibilities for so-called “joint implementation” must be utilised to ensure that CO<sub>2</sub> reductions abroad paid for with Danish money are included in Denmark’s CO<sub>2</sub>-accounts and fulfilment of our international CO<sub>2</sub> obligations. The Government will work towards environmental taxes being agreed at the international level. The first step should be the introduction of common minimum rates for environmental taxes in the EU.

## 4. Prospects in the medium term

Evaluation of the medium term outlook is an important element of the basis for economic policy decision-making.

The updated official medium term projections through 2010 were published in January 2002. The projections herein up to 2005 form the basis for the updated Danish convergence programme which Denmark submitted to EU in the same month.

The Government's main goals for the developments up to 2010 are:

- A stable exchange rate of the Danish krone *vis-à-vis* the euro.
- Tax freeze.
- Solid surplus on general government finances in order to secure fiscal sustainability and a halving of the public gross debt ratio from 2000 to 2010.
- Increase in employment through higher participation and lower unemployment.
- Reduction of tax rates on earned income, conditional on macro-economic room for manoeuvre.
- Real growth of public consumption of 1 per cent annually up to 2005 and ½ per cent annually from 2006 to 2010.
- Outsourcing and increased efficiency in the public sector.
- Low and stable inflation around 2 per cent annually.
- Healthy conditions for private savings which together with a surplus on public finances will bring about a gradual reduction of the net foreign debt.

Surplus on general government finances and reduction of the debt ratio will secure that the Danish economy is well prepared to meet the challenges from the ageing of the population.

The main figures of the projections are shown in *table 4.1*.

**Table 4.1 Main elements of the medium term projection**

	1993 - 00	2001 - 10
	----- Average annual growth rate in per cent -----	
Real GDP .....	2.7	1.8
Private consumption deflator.....	2.3	1.8
Hourly wage .....	3.7	3.9
	2000	2010
	----- 1,000 persons -----	
Employment .....	2,705	2,792
- Private sector .....	1,882	1,932
- Public sector .....	823	860
Labour force .....	2,856	2,922
Unemployment .....	150	130
	----- Per cent of GDP -----	
General government net lending .....	2.5	2.1
External current account .....	1.6	3.5
Public consumption .....	25.1	25.4
Public gross debt .....	46.8	24.4
Net foreign debt .....	13.7	-16.3

Note: The medium term projection is based on the short term forecast from January 2002. The new short term forecast from May 2002 (cf. section 2.3) differs a little (in 2001-2003) from the January forecast. However, the deviations do not alter the medium term conclusions.

Source: Economic Survey, January 2002 (Ministry of Finance).

The average annual real growth of GDP up to 2010 is moderate - 1.8 per cent - compared to historical standards. This is due to the fact that demographic developments imply a rather small potential growth of the labour force. Besides, the scope for a further reduction of the present low level of unemployment is limited, cf. *figure 4.1a*.

It is assumed that a higher participation rate will bring about an increase in the labour force of 5 per cent up to 2010 compared to a situation with unchanged participation in the different age and ethnic groups. More than half of this increase in the participation rate may be realised as a result of already decided and implemented reforms as shown by the re-

duction of influx to early retirement in recent years. This leaves a need for further structural improvements on the labour market, including a better integration of immigrants.

Figure 4.1a. Unemployment rate

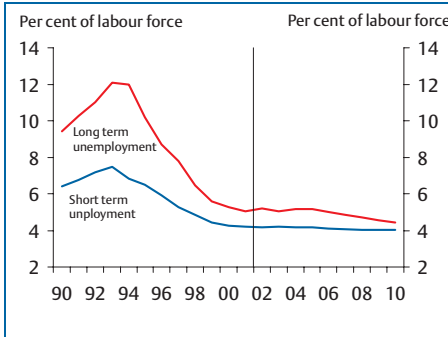
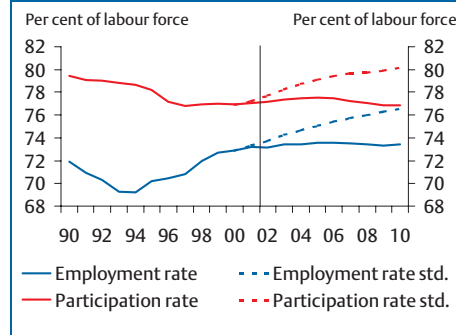


Figure 4.1b. Participation and employment rates<sup>1)</sup>



- 1) The standardised participation rate and employment rate are calculated based on the demographic composition in 2000 with regard to sex, age and origin.

In the medium term projection, the net foreign debt is removed, and in 2010 Denmark would own net financial foreign assets corresponding to 15 per cent of GDP, cf. *figure 4.2a*.

Figure 4.2a. Balance of payment and net foreign liabilities

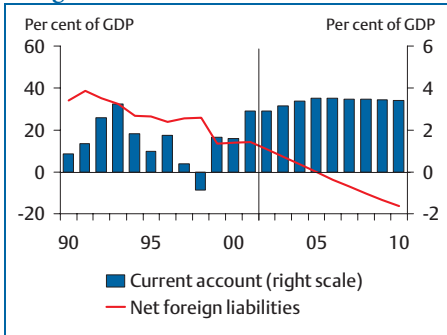
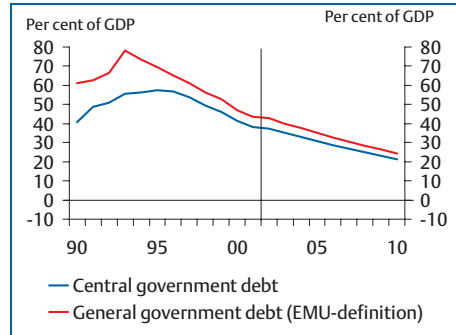


Figure 4.2b. Public debt





# 5. Denmark and the EU

## 5.1. Introduction

Denmark has been a member of the European community since 1973. Today, almost three decades later the Danish economy is highly integrated with the other EU countries.

- 2/3 of Danish international trade is with EU partners.
- The Danish economy has to a very high degree converged to the euro area economy.
- The Danish krone is fixed *vis-à-vis* the euro with a narrow  $\pm 2.25$  per cent band according to the ERM II agreement.
- Denmark participates fully in the coordination of economic policies within the EU, though Denmark does not participate in the euro.

## 5.2. The Danish economy in the European Union

The Danish economy accounted for 2.1 per cent of the total GDP of EU in 2001, whereas the Danish population is only 1.4 per cent of the total EU population. Measured by GDP per capita (PPP adjusted), Denmark has one of the highest standards of living among the EU countries. Danish GDP per capita is approximately 20 per cent higher than the EU average. Furthermore, the Danish income distribution is among the most even of all OECD countries, which in particular reflects that a large part of income is redistributed through the public sector.

The structure of the Danish economy is similar to the rest of the EU, though agriculture and services account for a slightly higher proportion of the total gross value added than the general EU level. Notably, employment in the agricultural sector is less than the EU average. Thus, the productivity of Danish agriculture is relatively high.

**Table 5.1. Gross value added and employment by sector, 2000**

	Gross value added		Employment	
	Denmark	EU	Denmark	EU
Agriculture .....	2.6	2.1	3.7	4.3
Industry <sup>1)</sup> .....	20.8	22.8	25.3	29.0
Construction ....	4.5	5.4	-	-
Services .....	72.2	69.6	71.0	66.8

1) Including construction in the employment data.

Source: Various editions of *Statistics in Focus*, Eurostat.

## Trade

The Danish economy is a small open economy. The sum of exports and imports of goods amounts to almost 60 per cent of GDP. In particular, two thirds of Danish trade is with other EU countries.

**Table 5.2. Commodity trade of EU countries. 2000**

	Total trade	Non-EU	EU	Euro area
	Per cent of GDP	Per cent of total trade		
Austria .....	69	36	64	58
Belgium .....	156	29	71	59
<i>Denmark</i> .....	59	35	65	44
Finland .....	66	47	53	32
France .....	46	39	61	49
Germany .....	56	47	53	41
Greece .....	36	47	53	45
Ireland .....	133	41	59	31
Italy .....	44	45	55	46
Netherlands ....	96	40	60	47
Portugal .....	61	23	77	67
Spain .....	47	34	66	56
Sweden .....	70	40	60	44
UK .....	44	49	51	47
EU .....	56	42	58	47

Note: Trade is defined as the sum of imports and exports of goods.

Source: OECD, International trade by commodity statistics, 2001.

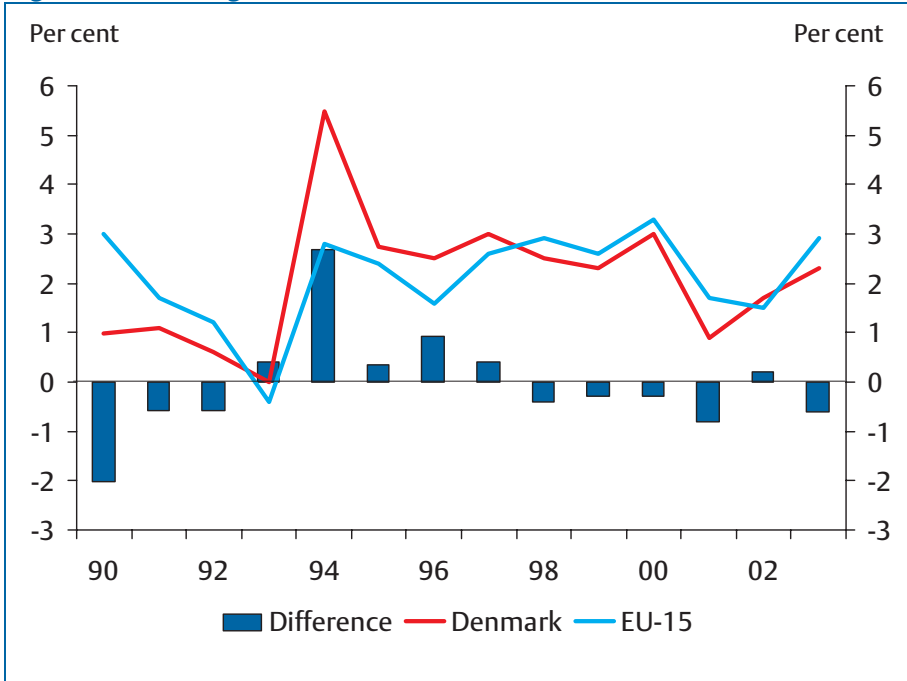
## Economic performance

GDP growth rates have converged across Europe during the 1990s. The correlation of growth rates in all EU countries has been above 80 per cent since 1993. This is significantly higher than in the 1980s.

The favourable business cycle during the 1990s arrived earlier and with stronger impact in Denmark than in other European countries, cf. *figure*

5.1. In particular, the Danish economy grew faster than the EU average in 1994. Since 1995, however, the growth differential has remained less than one percentage point per year.

Figure 5.1. GDP growth in the EU and Denmark



### EU budget

The total expenditure budget of the European Union was 1 per cent of EU GDP in 2000, cf. *table 5.3*. Almost half of the expenditure is due to the Common Agricultural Policy, i.e. refunds and aid to agriculture. The share of agriculture has declined since 1994. An increasing share of the budget - one third in 2000 - is directed at structural operations, e.g. infrastructure and regional aid. In nominal terms, the budget has increased by an average of 5.5 per cent per year over the period shown. However, EU expenditure as per cent of public expenditure in the member states has remained at the same level throughout the period.



**Table 5.3. Distribution of EU expenditure**

	1994	2000
	----- Per cent -----	
Agriculture .....	55.7	48.6
Structural operations .....	26.2	33.1
Internal policies .....	6.5	6.4
External expenditure .....	5.7	6.3
Administration .....	5.9	5.6
Total expenditure .....	100.0	100.0
	----- Per cent of GDP -----	
Total expenditure .....	1.0	1.0

Source: EU Commission, 2001.

The EU budget is financed by payments from the Member States. The major sources are payments based on national income and VAT revenues, cf. *table 5.4*. Both the GNP- and VAT-based payments contribute around 40 per cent. The importance of the former has increased in recent years. Finally, a minor source of finance for the EU budget is due to customs duties and agricultural levies.

**Table 5.4. Distribution of EU revenue**

	1994	2000
	----- Per cent -----	
Customs duties etc. ....	21	17
VAT-based .....	58	40
GNP-based .....	21	43
Total payments .....	100	100

Source: EU Commission, 2001.

The Danish contribution to the budget is around 2.1 per cent, which corresponds to the Danish share of EU GDP. Denmark has a positive - but small, i.e. 0.1 per cent of GNP - net financial balance *vis-à-vis* the EU in 2000. However, benefits from EU membership due to economic and political integration are not reflected in financial balances.

### 5.3. Denmark and the economic cooperation within the EU

Economic coordination within the EU is strongly supported by the Government.

Economic policy has for the last two decades been based on the same principles as those agreed within the EMU. Since 1982 - with different

Governments - Denmark has pursued a fixed exchange rate regime *vis-à-vis* the euro (and earlier the D-mark) and a stability oriented fiscal policy. At the same time, structural reforms have been implemented in order to ensure sustainable low unemployment, low inflation and surpluses on both the public balance and the external current account, cf. chapter 3.

The positive development is also influenced by the overall average of economic policies in the EU at large. During the last part of the 1990s the Danish economy achieved a higher growth momentum due to the fall of the European interest rate level following the process of reducing public deficits and inflation in all EU countries. At the same time, the higher degree of economic convergence and the creation of the euro have reduced the risk of exchange rate instability in the region. This does not only lead to lower interest rates, but is also a precondition for a stable economic environment in small open economies such as the Danish.

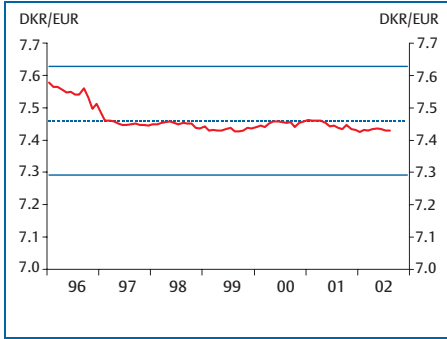
### **Denmark and the euro**

Denmark does not participate in the euro. In 2000, the Government and a large majority of Parliament recommended cancellation of the EMU opt-out but the proposal was rejected in a referendum.

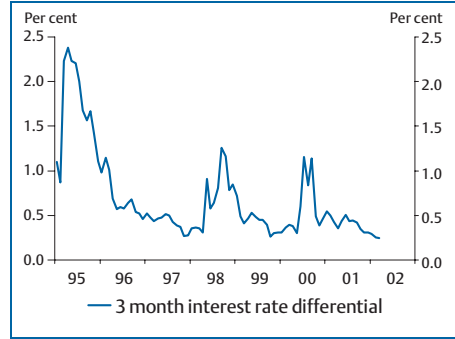
Denmark participates in the ERM II agreement, which links currencies of member states outside the euro to the euro. Due to the high degree of convergence the krone is linked to the euro with a  $\pm 2.25$  per cent fluctuation band, which is narrower than the standard  $\pm 15$  per cent ERM II band. The exchange rate has been stable *vis-à-vis* the euro over recent years, cf. *figure 5.2a*. The interest rate differential to the euro area has at the same time been low, though some widening occurred during financial market turbulences and after the no-vote to the euro in September 2000, cf. *figure 5.2b*.

Effectively, the macroeconomic policy framework thus closely reflects that of the euro area members.

**Figure 5.2a. Danish krone *vis-à-vis* the euro. 1995-2002**



**Figure 5.2b. Interest rate differential to Germany. 1995-2002**



Note: Prior to 1999, the euro is represented by the Kroner/D-Mark exchange rate converted by the official conversion rate.

Source: Ecowin.

As a consequence, the Parliament passed legislation in 1999 that enables enterprises to present accounts, issue share capital and perform bookkeeping in euros. This will keep firms on more equal footing with competitors in euro countries. Furthermore, the financial sector has developed various types of euro products to both firms and households. As a result, euro-denominated mortgage loans have become increasingly popular in recent years.

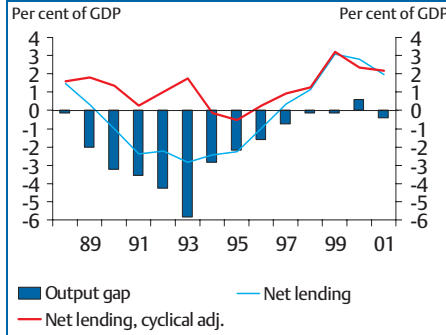
### Stability and Growth Pact

Denmark complies comfortably with the requirements of the Stability and Growth Pact and has had a surplus on general public finances since 1997. In recent years, the surplus has been 2-3 per cent of GDP, cf. *figure 5.3a*. In comparison, the EU as whole had a budget deficit of 1.1 per cent of GDP in 2001 and surplus is not expected until 2004, cf. *figure 5.3b*.

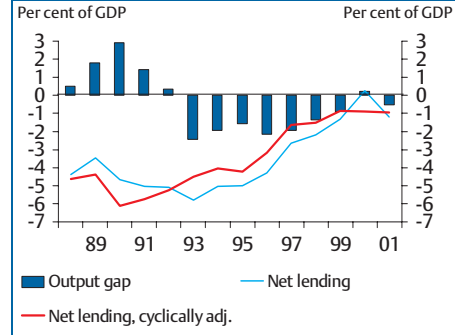
Fiscal policy is - as described in chapter 4 - aimed at reducing public debt with a view also to contribute to a stable business cycle in the medium term. Traditionally, this objective has been achieved by means of higher degree of correlation between public finances and output gap than in the euro area as a whole, cf. *figure 5.3a* and *5.3b*. This is partly because of the relatively large automatic stabilisers of fiscal policy due to a large public sector in Denmark, including a high tax level, but also a relatively generous benefit system compared to other EU countries. However, discretion-

ary measures have also been taken in order to stabilise the economy in the medium term, and the cyclically adjusted balance has broadly followed the development of the business cycles.

**Figure 5.3a. Fiscal policy and output gap in Denmark. 1993-2001**



**Figure 5.3b. Fiscal policy and output gap in euro area. 1993-2001**



Source: OECD Economic Outlook 71.

### Broad Economic Policy Guidelines

Long-term sustainability of public finances is an integral part of the Broad Economic Policy Guidelines (BEPG) and a high priority of the Government. Denmark has taken several steps in order to meet the future challenges of an increasing number of elderly people and a shrinking labour force, cf. chapter 3.

### Structural reforms

The special European Council in Lisbon in 2000 reinforced the process in Member States of stimulating overall EU economic performance, cf. *box 5.1*.

The Government intends to improve the general framework for companies to create growth. Thus, an ambitious growth strategy has been launched. This strategy aims at:

- supporting entrepreneurship through creation of better incentives to work,
- securing optimal use of knowledge and resources,
- enhancing competition, and
- reaping benefits of globalisation.

The increased focus on competition on product markets and network industries is partly due to the fact that the price level adjusted for indirect taxes is about 4 per cent higher than the EU average. An explanatory factor is lack of competition in some sectors. Thus, authorities have strengthened efforts to identify sectors with limited competition. Furthermore, penalties for violation of competition legislation have been increased.

### Box 5.1. The Lisbon commitment

The European Council in Lisbon identified a number of measures being crucial to achieve higher growth and employment (The Lisbon process also addresses other issues, such as sustainable environmental policies). Firstly, the countries are encouraged to use and support new technologies. Secondly, a fruitful environment for research and innovation is supported. Thirdly, the efficiency of the internal product, capital and financial markets has high priority. Finally, labour market participation rates should be increased.

The Council has specified certain targets for labour market policies, cf. *table a*. At the general level, the participation rate should increase from 63 per cent in 2000 to around 70 per cent in 2010. To facilitate achievement of this target, the Council has set intermediate targets of increasing the overall participation rates of women and people in the age group 55-64 years to 60 and 50 per cent respectively. The member states have committed themselves to these goals. Hence, the targets are important guidelines for national economic policy.

**Table a. Lisbon criteria and current performance**

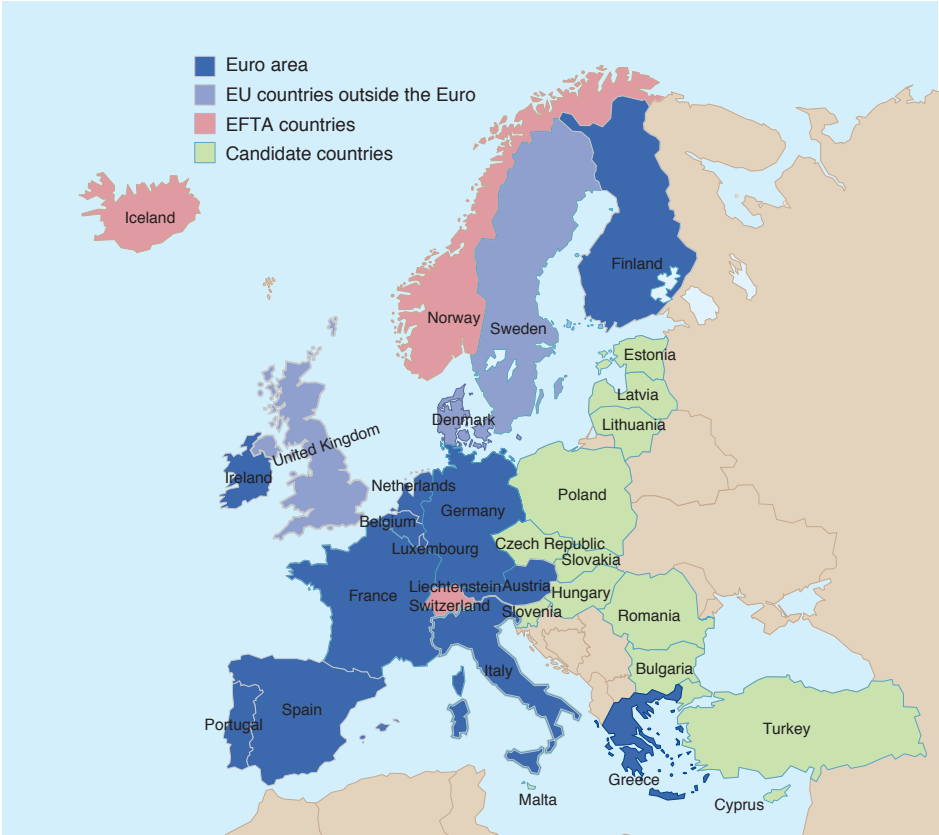
	2000	2001	2010 target
<i>Real GDP per capita, PPS, US=100:</i>			
EU .....	69.5	70.2 <sup>1)</sup>	
Denmark .....	84.0	84.9 <sup>1)</sup>	
<i>Real GDP growth:</i>			
EU .....	3.3	1.2 <sup>2)</sup>	
Denmark .....	3.0	0.9 <sup>2)</sup>	
<i>Productivity per person, US=100:</i>			
EU .....	84.6	83.7 <sup>1)</sup>	
Denmark .....	86.0	85.8 <sup>1)</sup>	
<i>Employment rate, total:</i>			
EU .....	63.2	64.0	70.0
Denmark .....	76.3	76.2	
<i>Employment rate, female:</i>			
EU .....	54.0	54.9	60.0
Denmark .....	71.6	72.0	
<i>Employment rate, 55-64 years:</i>			
EU .....	37.8	38.6	50.0
Denmark .....	55.7	58.0	
<i>Households with internet access:</i>			
EU .....	28.4	37.7	100.0
Denmark .....	51.6	58.6	

1) Eurostat forecast. 2) European Economy, 2/2002.

Source: Eurostat.

Denmark already fulfils the labour market objectives and the Government has ambitions to further increase participation and employment rates in coming years. Furthermore, Denmark is among the leading countries with regard to other objectives, such as IT access and income equality.

## Denmark in Europe



## 6. Denmark and the CEE candidate countries

The top priority of the Danish presidency is the enlargement of the EU. The enlargement will create a united Europe.

Both the EU members and the new members will benefit from the enlargement. The relations between the two groups of countries will strengthen, including trade relations.<sup>1</sup> The increase in competition will improve the effectiveness of enterprises in both the EU and the candidate countries.

Like the rest of the EU members and the new member states, Denmark will benefit from this process.

### 6.1. Trade relations between Denmark and Central and Eastern European candidate countries

Trade with the Central and Eastern European candidate countries<sup>2,3</sup> (CEE 10) has grown during the 1990s.

In 1992 1.8 per cent of overall Danish exports of goods was exported to CEE 10 while these countries accounted for 2 per cent of overall imports.

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<sup>1</sup> The migration between Denmark and the new member states may also increase. In 1998 0.17 per cent of the population in Denmark consisted of citizens from the Central and Eastern European countries (T. Boeri and H. Brücker: *The impact of Eastern Enlargement on Employment and Wages in the EU Member States*. European Integration Consortium. Berlin and Milan (2000)). Denmark has informed that it intends to open its labour market to the candidate countries from the time they become EU members.

<sup>2</sup> With the CEE 10 defined as: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Romania, Bulgaria and Slovenia.

<sup>3</sup> Also Cyprus, Malta and Turkey have applied for membership of the EU.

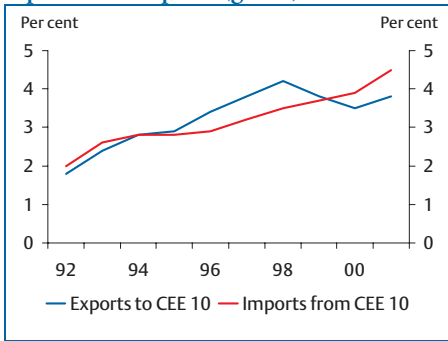


By 2001 these figures had grown to 3.8 per cent and 4.5 per cent, respectively, cf. *figure 6.1a*.

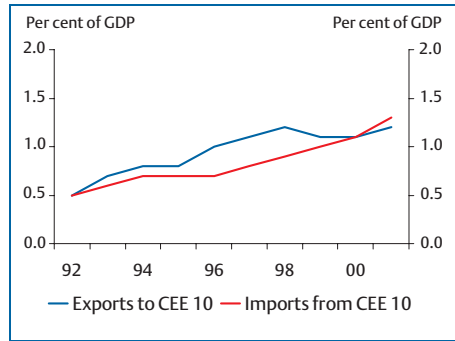
In that same year 64.4 per cent of exports of goods went to the EU countries while 69.7 per cent of imports came from the EU.

As a percentage of GDP the exports to and imports from the CEE 10 have grown from both amounting to 0.5 per cent of GDP in 1992 to 1.2 and 1.3 per cent in 2001, respectively.

**Figure 6.1a. Exports to and imports from CEE 10 as percentage of overall Danish exports and imports (goods)**



**Figure 6.1b. Exports to and imports from CEE 10 (goods) as percentage of Danish GDP**



Source: Statistics Denmark and own calculations.

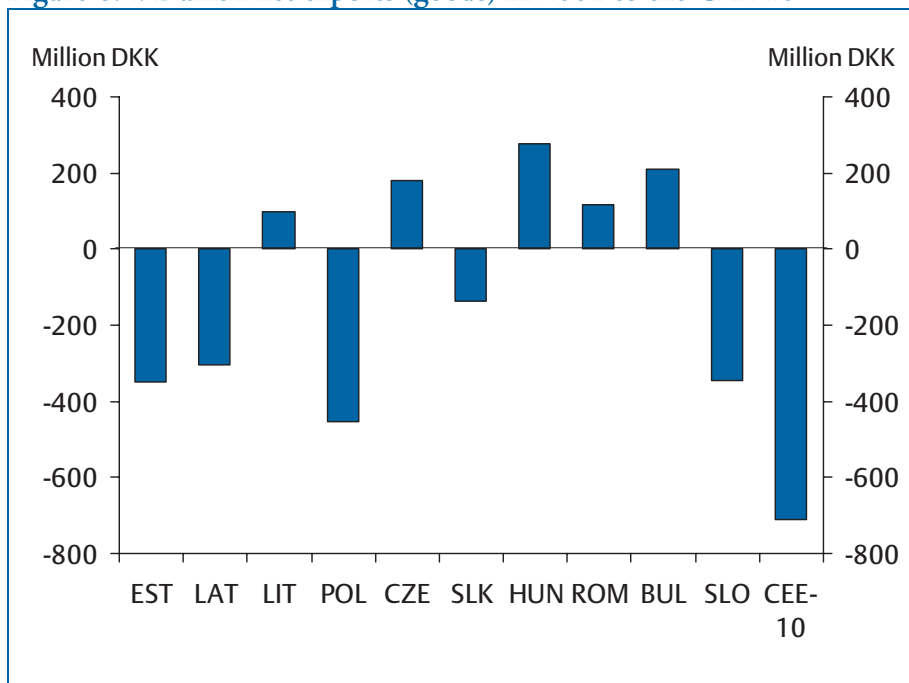
Altogether, the value of Danish exports of goods to the CEE 10 countries in 2001 was a little less than that of imports. In total, the value of exports to the CEE 10 countries amounted to DKK 16.3 billion while the value of its imports from these countries amounted to DKK 17 billion. This left Denmark with an almost balanced net export of DKK - 0.7 billion towards the CEE 10 countries, cf. *figure 6.2*.

Net exports in 2001 was positive with respect to Lithuania, the Czech Republic, Hungary, Rumania and Bulgaria, while Denmark was a net importer with respect to the other five CEE countries.

Of exports to the CEE 10 countries almost half, 44 per cent, was exported to Poland. Also Lithuania and the Czech Republic accounted for a relatively large part of exports to the CEE 10, 12 and 11 per cent respectively, cf. *figure 6.3a*.

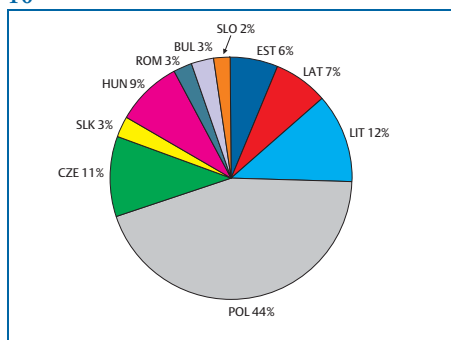
As with exports, the largest share of imports came from Poland from which Denmark imported 45 per cent of its imports from the CEE 10 countries, cf. *figure 6.3b*.

**Figure 6.2. Danish net exports (goods) in 2001 to the CEE 10**

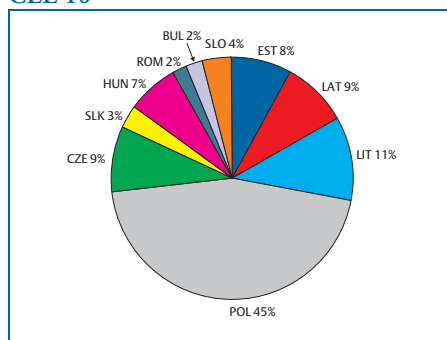


Source: Statistics Denmark and own calculations.

**Figure 6.3a. Danish exports to the CEE 10**



**Figure 6.3b. Danish imports from the CEE 10**



Source: Statistics Denmark and own calculations.

The trade between Denmark and CEE 10 is to a large extent intra-industrial. This is seen by the figures in *table 6.1* where the trade is split into SITC divisions.

A relatively large part of exports to and imports from the CEE 10 countries consists of manufactured goods, miscellaneous manufactured articles, and machinery and transport equipment. In fact 65 per cent of exports to CEE 10 consisted of manufactured goods and articles, and machinery and transport equipment while 71 per cent of imports from CEE 10 consisted of these goods.

**Table 6.1. Danish trade with CEE 10 split into SITC divisions. 2001**

	Exports	Imports
	Per cent	
Food and live animals .....	12.8	5.2
Beverages and tobacco .....	0.9	0.2
Crude materials, inedible, except fuels .....	2.8	4.4
Mineral fuels, lubricants and related materials .....	1.6	11.6
Animal and vegetable oil, fats and waxes .....	0.3	0.0
Chemicals and related products .....	16.2	4.1
Manufactured goods, chiefly semi-manufactured ...	21.5	20.8
Machinery and transport equipment .....	27.7	20.1
Miscellaneous manufactured articles .....	15.8	30.1
Commodities and transactions not classified elsewhere in the SITC .....	0.4	3.5

Source: Statistics Denmark and own calculations.

Looking at the trade between Denmark and the CEE 10 countries in absolute terms it turns out that Denmark is a net importer of miscellaneous manufactured articles, which among other goods covers furniture and parts thereof, clothing and footwear. Denmark is also a net importer of mineral fuels, lubricants and related materials. On the other hand, Denmark is a net exporter of food and live animals, chemicals and related products, and machinery and transport equipment to the CEE 10 countries.

## 6.2. Foreign direct investment in the Central and Eastern European countries

The latest data for direct investments (FDI) in the Central and Eastern European countries collected by *Danmarks Nationalbank* cover the situation at the end of 2000.<sup>4</sup>

The stock figures show that companies and institutions by the end of year 2000 had invested approximately DKK 19.1 billion in Central and Eastern Europe where Central and Eastern Europe is defined as Poland, Czech Republic, Hungary, Estonia, Latvia and Lithuania and other<sup>5</sup>. The FDI in EU countries was approximately 60 per cent of the total Danish FDI while the Central and Eastern European countries accounted for 3.7 per cent.

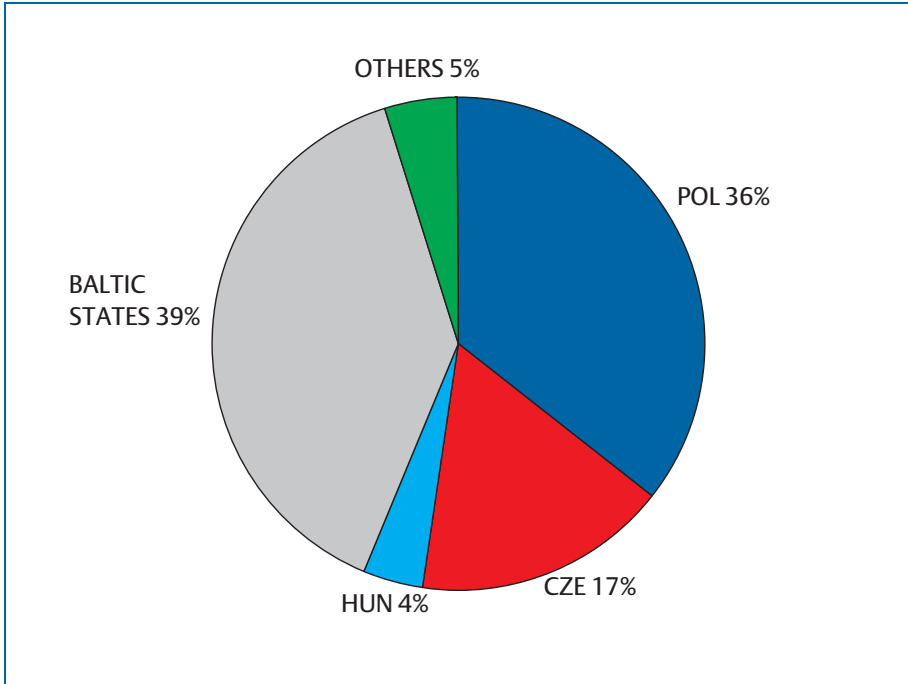
Of the DKK 19.1 billion, 36 per cent was invested in Poland and 39 per cent in Estonia, Latvia and Lithuania. Also the Czech Republic was well represented by 17 per cent of the FDI in Central and Eastern Europe, cf. *figure 6.4*.

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<sup>4</sup> *Direct investments, end-2000, Danmarks Nationalbank, Særlige opgørelser, nr. 4-20, november 2001.*

<sup>5</sup> *Other* covers Albania, Bosnia-Herzegovina, Bulgaria, Belarus, Croatia, Moldavia, Macedonia, Rumania, Slovenia, Slovakia, Ukraine and Yugoslavia. Danish FDI in Russia is estimated at DKK 0.8 billion by end 2000.

**Figure 6.4. Danish FDI in Central and Eastern Europe. end 2000**



Source: Danmarks Nationalbank and own calculations.

### **6.3. Assistance to the countries of Central and Eastern Europe**

Since the fall of the Berlin Wall in 1989 Denmark has given considerable bilateral support to the reform efforts of the countries of Central and Eastern Europe. A cornerstone of this support has been bilateral assistance schemes and during the last twelve years Denmark has all in all contributed DKK 12 billion or EUR 1.6 billion (2001 incl.) to this purpose of which  $\frac{3}{4}$  to the candidate countries. Denmark also participates in multi-lateral assistance through international organisations especially the EU.

The assistance to the Central and Eastern European countries gives priority to the Baltic Sea Region. An area of utmost importance is the assistance to the EU candidate countries of the region, Estonia, Latvia, Lithuania, and Poland in their preparation for membership. To the other EU candidate countries in Central and Eastern Europe, Denmark also offers pre-accession assistance according to their specific needs. The assistance aims at strengthening the administrative capacity and the adoption

of new legislation in order to comply with EU rules and regulations, the EU acquis.

To avoid the creation of new barriers in Europe assistance is also given to the European CIS countries with focus on the Russian Baltic Sea regions of St. Petersburg, Kaliningrad and Pskov.

The most important focus of the Danish assistance is environmental protection. First of all the environmental assistance contributes to complying with the EU acquis in the Central and Eastern European countries - but Denmark is also fully aware of the concrete environmental problems in the countries and their consequences for i.a. the Baltic Sea, and therefore has contributed a substantial share of the environmental assistance to the solution of these problems.

The projects under the EU preparation programme run by the Ministry of Foreign Affairs focus on aligning the final parts of the candidate countries' legislation with the EU acquis. It is equally important to assist the candidate countries in establishing the necessary institutions to administer the EU regulations, for instance directorates for paying agricultural aid to the farmers.

Finally an effort is undertaken to strengthen the framework conditions for trade and industry.

### **The Investment Fund for Central and Eastern Europe**

The Investment Fund for Central and Eastern Europe (*IØ*) is an independent self-governing entity. The board of directors and the managing director are appointed by the Minister of Foreign Affairs.

The Fund works as a partner of the Danish enterprises and the local enterprises in joint ventures by offering equity capital and/or loans and through board membership. Both small and large projects are eligible for financing from the Fund. A prerequisite, however, is that the project has to be partly financed by a Danish business and that the project is evaluated as being commercially viable.

When a project has become self-supporting the Fund will withdraw from it and typically sell its shares with a first right of refusal to the other partners.

By end 2001 the Fund was involved in projects in most Central and Eastern European countries such as Bulgaria, Croatia, the Czech Republic, Estonia, Latvia and Lithuania, Hungary, Poland, Rumania and Slovakia. All together the Fund has experience from 307 projects in 16 countries.

In 1995 the Environmental Investment Facility for Central and Eastern Europe (*MIØ*) was established under the Investment Fund for Central and Eastern Europe.

The particular purpose of this facility is creating a better external environment and better occupational health and safety conditions in Central and Eastern European countries. The purpose is also to ensure the transfer and creation of the necessary environmental technology.

So far this facility has been involved in projects in the Czech Republic, Estonia, Latvia and Lithuania, Hungary, Poland, Romania, Russia, and Slovakia.

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With a view to the Danish EU Presidency in the 2nd half of 2002 the aim of this booklet is:

- To provide some background information on economic developments and economic policy in Denmark
- To describe the relations between Denmark and the other EU countries and the candidate countries