

# Economic Survey May 2005

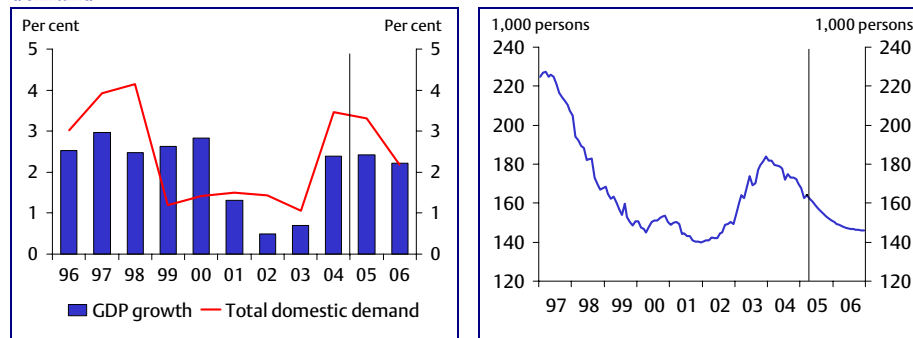
## English summary

### 1. Short term outlook

The recovery in the Danish economy has now been proceeding for some 18 months, primarily driven by a revival in domestic demand, *cf. figure 1.1a*. Private consumption and housing investment have grown fairly rapidly, supported by low interest rates as well as income tax reductions and other initiatives in the so-called Spring Package<sup>1</sup>. Business investment has also expanded in 2004, while export growth has been more subdued and below export market growth.

The pick-up in activity has led to a turnaround in the labour market. After declining in 2002 and 2003, employment trends turned positive in 2004. Unemployment has declined by about 20,000 persons (0.7 percent of the labour force) from December 2003 to March 2005, *cf. figure 1.1b*.

Figure 1.1a. GDP-growth and domestic demand Figure 1.1b. Unemployment



Source: Statistics Denmark and own calculations.

<sup>1</sup> For details on the Spring Package, see e.g. the Danish *Convergence Programme, 2004*.

The Danish economy has thus weathered the post-2000 international downturn reasonably well, with unemployment remaining relatively low, the current account staying in surplus, and public finances remaining healthy.

GDP growth is expected to remain above estimated potential growth in 2005 and 2006. As in the December Survey, the growth rate in 2005 is expected to stay at 2.4 per cent, *cf. figure 1.1a*. In 2006, GDP-growth is expected to moderate slightly to 2.2 per cent. The 2006 estimate is revised slightly upwards compared to the December survey.

Overall, the growth prospects are in line with the December projection, although the composition has shifted somewhat towards stronger domestic demand and a lower growth contribution from exports.

The continued expansion in 2005 and 2006 is supported by low interest rates, in part through their impact on housing wealth. In addition, the lagged effects of demand-supportive policies in 2004, primarily the tax reductions, should support high activity in 2005. Policy initiatives have particularly benefited private consumption and the housing market. In line with rising capacity utilization and favourable financing conditions, business investment is also set to contribute significantly to growth.

**Table 1.1. Key figures compared to the December projection**

	2004	2005		2006	
		Dec.	May	Dec.	May
USA, GDP growth .....	4.4	3.0	3.6	2.9	3.0
Euro area, GDP growth .....	2.1	2.0	1.6	2.2	2.1
Trading partners, GDP growth .....	7.5	7.3	6.5	7.0	6.8
<i>Denmark:</i>					
GDP growth .....	2.4	2.4	2.4	2.1	2.2
Consumer prices .....	1.2	2.0	1.5	1.8	1.9
Hourly earnings, private sector .....	2.8	3.6	3.1	3.9	3.7
Unemployment rate .....	6.1	5.4	5.5	5.1	5.1

Note: GDP-growth among Denmark's trading partners is weighted according to their share in Danish exports.

Source: Statistics Denmark, EU Commission, Ecowin, and own calculations.

### **The international environment and its impact on the Danish economy**

In 2004, global growth was the highest in many years – around 5 per cent. Activity has been buoyant in USA and parts of Asia, but activity in

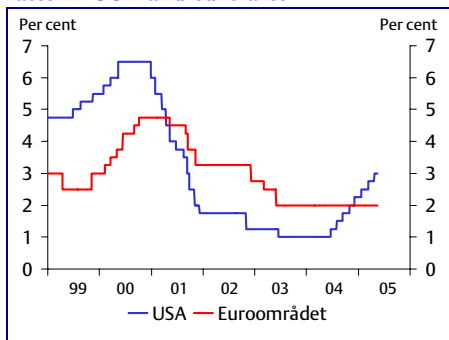
the euro area remains subdued. The appreciation of the euro vis-à-vis the dollar has dampened export growth moderately and may have restrained business investment. So far, the hoped-for positive terms-of-trade and interest rate effects on consumer spending have not come through clearly.

In Germany, relatively high savings and a gradual restoration of competitiveness since unification have led to expectations for a recovery driven by both exports and domestic demand. Consumer spending has been restrained, however, and the anticipated recovery has been repeatedly postponed. It remains unclear when the recovery will set in, but when it happens, the recent structural reforms should help to prolong the upturn by facilitating a more permanent reduction in unemployment.

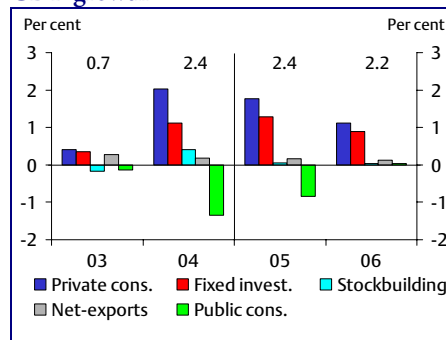
In 2005 and 2006 GDP growth in the euro area is expected to remain relatively weak, while growth momentum outside the euro area should remain strong. High oil prices will presumably shave off the top of global growth, but the expansion is set to continue.

Inflationary pressures in the euro area appear quite subdued, and the ECB has taken no steps to tighten its fairly easy monetary stance, *cf. figure 1.2a*. In the light of less positive growth prospects and consequently lower inflation pressures, an assumed gradual tightening of monetary policies in the euro area has been postponed compared to the December survey.

**Figure 1.2a. Monetary policy interest rates in USA and euro area**



**Figure 1.2b. Contributions to Danish GDP growth**



Source: Statistics Denmark, Ecwin and own calculations.

On balance, the changes to the international environment since the December survey point to a small upward revision to GDP growth in

2006 especially due to lower interest rates, *cf. box 1.1*. The interest rate effects outweigh the negative growth impact from lower export market growth and higher oil prices.

### Box 1.1. Calculated effects of revised external assumptions

On balance, the revisions to the assumptions concerning export market growth, oil prices, interest rates, import prices and competitors' export prices since December are neutral in terms of activity growth in 2005 and point to an upward adjustment for 2006, *cf. table a*.

The lower export market growth pulls down GDP growth in both years, while higher competitor prices and higher import prices on balance have a small positive effect on GDP in 2005. The isolated effect of lower interest rates on GDP growth in 2005 and 2006 are 0.1 and 0.6 percentage points, respectively.

Table a. Calculated effects on Danish GDP of changed assumptions

	2005	2006
	----- Percentage points -----	
Export market growth <sup>1)</sup> .....	-0,1	-0,1
Foreign prices, incl. exchange rates .....	0,1	-0,0
Prices on energy <sup>2)</sup> .....	-0,0	-0,1
Foreign interest rates .....	0,1	0,6
Total .....	0,0	0,4

1) Including the effects of higher oil prices on export market growth

2) Excluding the effects of higher oil prices on export market growth.

Source: Own calculations on the macroeconomic model ADAM.

A marked reduction of the global imbalances related to large fiscal deficits and current account imbalances among major economies does not appear to be in sight. These imbalances may restrain medium-term growth prospects and add to the fiscal and economic challenges associated with prospective demographic shifts. Reducing the large U.S. imbalances will require higher savings and lower domestic demand growth in a transitional phase. In addition, a possibly weakening desire to accumulate dollar assets notably in Asia could entail pressure on the dollar and a more pronounced increase in long-term interest rates than assumed in the forecast.

### Domestic demand

The strong growth in domestic demand stems mainly from private consumption, which increased by 4.3 per cent in 2004. Higher private consumption is supported by strong growth in household real disposable

income boosted by lower income taxes and the suspension of the so-called Special Pension contributions in 2004 and 2005.

Consumption growth is expected to remain strong at 3.7 per cent in 2005 as spending gradually adjust to the higher level of real disposable incomes *cf. table 1.2*. The private savings rate remains high, and fairly strong consumer spending is underpinned also by low interest rates, rising house prices and new flexible borrowing opportunities for owners of real estate.

In 2006 private consumption growth is expected to decelerate to 2.3 per cent, in part because the suspension of the Special Pension contributions is assumed to end.

In spite of increased household borrowing, the overall financial position of households appears generally healthy and total private savings are at a comparatively high level relative to GDP.

**Table 1.2. Use and supply of goods and services**

	2004	2001	2002	2003	2004	2005	2006
	Bill.Dkr.	----- Real growth, per cent -----					
Private consumption .....	695,3	-0,2	0,6	0,9	4,3	3,7	2,3
Public consumption .....	385,6	2,7	2,1	1,0	0,7	0,6	0,5
Public investment .....	25,1	10,6	-5,0	-0,3	6,6	4,7	1,0
Residential construction .....	72,6	-7,3	6,0	11,2	10,8	3,0	2,0
Fixed business investment .....	189,8	5,9	2,3	-0,7	2,9	6,1	4,3
Stock building <sup>1)</sup> .....	4,1	-0,7	0,0	-0,2	0,4	0,1	0,0
Total domestic demand .....	1372,6	0,8	1,4	0,9	3,9	3,4	2,2
Exports of goods and services .....	629,3	4,4	4,8	-1,6	4,0	4,0	4,8
Of which manufactures .....	300,7	5,1	5,4	-3,2	3,9	4,0	5,0
Imports of goods and services .....	555,4	3,5	7,3	-1,4	7,4	6,1	4,8
Of which goods .....	408,2	3,3	6,6	-2,4	7,4	6,3	5,3
Gross domestic product .....	1446,5	1,3	0,5	0,7	2,4	2,4	2,2
GDP at factor costs .....	1236,2	1,4	0,3	0,8	1,9	2,2	2,1
Of which in private non- agricultural sector .....	805,9	2,1	0,1	0,5	1,5	2,6	2,6
GDP per capita (1,000 Dkr.) .....	267,8	0,9	0,2	0,4	2,2	2,3	2,1

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

Source: Statistics Denmark and own calculations.

Real public consumption is estimated to grow by 0.6 per cent in 2005, *cf. section 1.2*. The projection is unchanged compared to the December survey. Fiscal policy for 2006 has not yet been determined. The projection technically assumes 0.5 per cent growth in public consumption in line with medium-term objectives.

Public investment is set to increase by 4.7 per cent in 2005. The relatively high growth in both 2004 and 2005 reflects, in particular, the initiatives taken in 2003 and 2004 to frontload public investment. Against this background, real public investment growth is assumed to abate to 1 per cent in 2006.

After strong growth in 2003 and 2004 residential investment is expected to decelerate in 2005 and 2006 with growth rates at 3 and 2 per cent, respectively. The forecast for 2005 and 2006 has been revised upward by 5 and 1 percentage points, respectively. This revision follows from a revised growth profile in investments in municipal housing and the stimulus from lower interest rates and higher real estate prices.

Price increases for owner-occupied single-family homes are expected to stay at around 9 per cent this year. This is an upward revision of 4 percentage points compared to the December projection, mainly reflecting lower interest rates. The rise in housing prices also reflects the introduction of new flexible mortgage loans where repayments on the principal may be postponed for up to 10 years. House prices are expected to decelerate to some 6 per cent in 2006, mainly as a result of the assumed prospective tightening of monetary policy.

Business investment, which rebounded in 2004, is expected to grow at around 6 per cent in 2005. Business investment growth is revised upwards by 1.3 percentage points, primarily due to lower interest rates. In 2006, the growth of business investment should moderate to around 4 per cent.

Following an increase in stock building, which resulted in a GDP growth contribution of 0.4 per cent in 2004, a further positive contribution to GDP-growth of 0.1 percentage point is expected in 2005. In 2006 stock building is assumed to add no further to GDP growth.

### **International trade and the current account**

Relatively weak activity in the euro area, particularly in Germany, Italy, Holland and Portugal, as well as a loss of market shares are expected to dampen export growth in the near future. Export growth is thus expected to be fairly modest in 2005 at 4 per cent, rising to 4.8 per cent in 2006 in line with a better outlook for key markets, especially Germany.

The export forecast for 2005 has been lowered significantly since the last survey, essentially owing to the disappointing growth in the euro area.

Imports are boosted by the continued upswing in private consumption and investment. Import growth is expected to be about 6.0 and 4.8 per cent in 2005 and 2006, respectively, which are roughly unchanged since the previous forecast. The impact from stronger domestic demand is offset by lower export growth, which reduces imports of intermediate inputs in the export sectors.

Overall, net foreign trade contributes negatively to GDP growth by 0.8 percentage points in 2005, but has a broadly neutral effect in 2006.

The shift in the composition of demand from foreign to domestic sources leads to a downward revision to the trade and the current account balances in both 2005 and 2006. However, the external surplus is still expected to increase from 2005 (2.1 per cent of GDP) to 2006 (2.5 per cent of GDP), as domestic demand growth moderates and export market growth improves.

### **Employment, unemployment and labour force**

Employment rose by 3,000 persons (0.1 per cent) from 2003 to 2004. Solid domestic demand has bolstered employment in both construction and private services. However, with modest growth in exports, employment has declined in manufacturing.

The dichotomy between growing employment in the service sectors and declining employment in manufacturing is set to continue in the forecast period, although at a slower pace in 2006. Employment is projected to show fairly strong growth in 2005 and 2006, *cf. table 1.3 and figure 1.3a.*

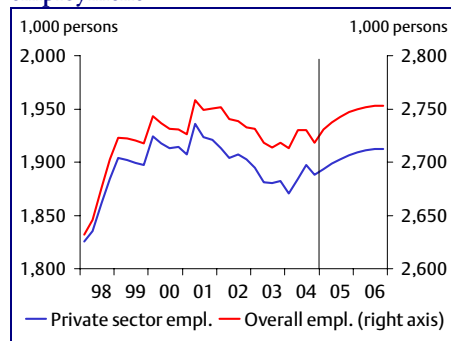
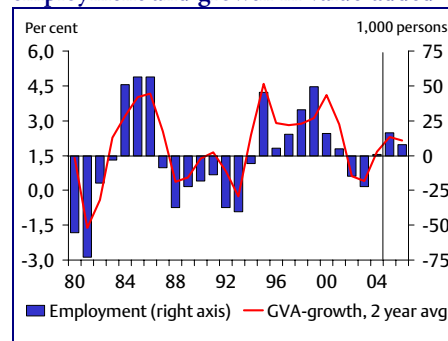
**Table 1.3. Employment, labour force, and unemployment**

	2004 level	2004	2005		2006	
			Dec.	May	Dec.	May
		----- Change, 1,000 persons -----				
Private sector .....	1,885	1	18	15	8	11
Public sector .....	838	2	3	2	3	2
Total employment ....	2,722	3	20	17	10	13
Labour force .....	2899	8	1	-1	2	2
Unemployment .....	176	6	-19	-18	-8	-11

Note: Due to rounding the individual changes may not sum to the total.

Source: ADAM's databank and own calculations.

The more pronounced increase in employment in 2005 compared to 2004 reflects the usual delay from the rebound in activity to the pick-up in hiring of new employees, *cf. figure 1.3b*.

**Figure 1.3a. Total and private-sector employment****Figure 1.3b. Annual change in employment and growth in value-added**

Note: In figure 1.3b growth in gross value added (GVA) in the private sector is shown as a 2-year moving average.

Source: Statistics Denmark and own calculations.

The most recent information points to an increase in the labour force by 8,000 persons in 2004. The increase in 2004 is a little higher than foreseen in the December survey. In 2005 and 2006 the labour force is broadly unchanged compared to 2004, reflecting offsetting effects of cyclical factors, demographics and labour market reforms.

During 2004 and the early months of 2005, registered unemployment declined by around 20,000 persons (0.7 percent of the labour force). With the projected rise in employment in 2005 and 2006 unemployment



is expected to decrease further. On an annual basis, the number of unemployed should decline from 176,000 persons in 2004 to 158,000 persons in 2005 and 147,000 persons in 2006, *cf. figure 1.4a*. For 2005 this is a small upward revision (by 0.1 percent of the labour force) compared to the outlook in December, reflecting fewer participants in active labour market schemes than assumed. The outlook for 2006 is unchanged.

During 2005 and 2006, the unemployment rate is expected to fall below the estimated structural level of unemployment indicating that labour market pressures could begin to be felt, *cf. figure 1.4b*.

Figure 1.4a. Unemployment

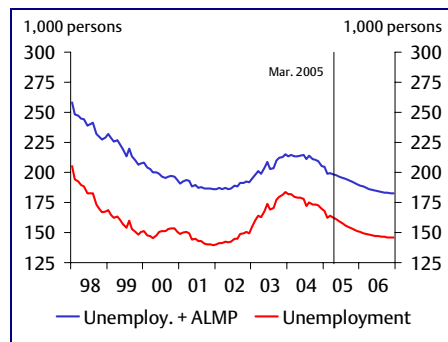
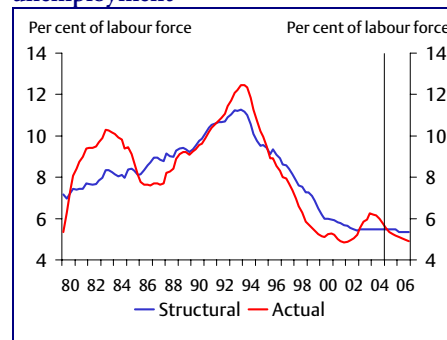


Figure 1.4b. Actual and structural unemployment



Note: In figure 1.4b growth in gross value added in the private sector is shown as a 2-year moving average.

Source: Statistics Denmark and own calculations.

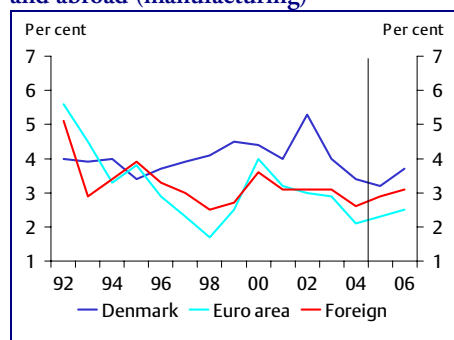
### Wage- and price inflation

The unemployment rate has been above the estimated structural level in 2003 and 2004, thus dampening wage growth. Hourly wage growth has declined from 4.2 per cent in 2002 to 2.8 per cent in 2004. Wage growth is expected to remain moderate at around 3 per cent in 2005. A gradual pickup is expected to around 3.7 per cent in 2006. The rise in wage inflation stems from emerging pressures on the labour market in 2005 and 2006 and higher price inflation. The anticipated wage increases for 2005 and 2006 are somewhat lower than predicted in the December projection. However, real wage increases remain more or less unchanged.

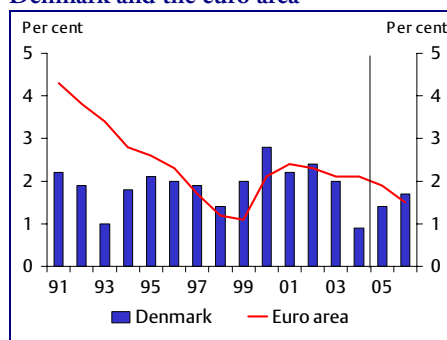
Despite a decline in wage growth in 2003 and 2004, hourly compensation of employees in the manufacturing sector continues to grow faster than abroad, *cf. figure 1.5a*.

In the public sector new wage contracts were agreed this spring pointing to a combined wage increase of around 10 per cent over the three-year contract period.

**Figure 1.5a. Wage increases in Denmark and abroad (manufacturing)**



**Figure 1.5b. Inflation (HICP) in Denmark and the euro area**



Note: The foreign increases in hourly wage costs in figure 1.5a are weighed according to their share in the effective nominal exchange rate index for the krone.

Source: DA, EU-Commission, BLS, OECD and own calculations.

Notwithstanding higher oil prices, inflation as measured by the harmonised consumer price index (HICP) declined markedly in 2004 to 0.9 per cent, *cf. figure 1.5b*. The low level of inflation can be attributed to a reduction in excise duties on soft drinks, falling import prices and decelerating wage growth.

Inflation is expected to rise to 1.5 per cent in 2005. This is downward revision of 0.5 percentage points compared to the projection in December. The more moderate outlook for inflation is due to lower-than-expected inflation in the first part of 2005 and the downward revision of wage increases in 2005. The higher oil prices will generate some upward pressure on the inflation rate especially in 2005, but the effect should be offset by moderate domestic inflation.

Inflation is projected to accelerate to 1.7 per cent in 2006. This slight acceleration is mainly due to growing domestic inflation pressures, as output is expected to be above potential in 2006.

The inflation rate continues to stay around the European Central Bank's medium term inflation target of below but close to 2 per cent.

Table 1.5. Key figures for the Danish economy

	2001	2002	2003	2004	2005	2006
	----- Percentage change from previous year -----					
Real GDP .....	1,3	0,5	0,7	2,4	2,4	2,2
Trade-weighted GDP abroad .....	1,3	1,5	1,3	3,0	2,6	2,7
Markets for Danish manufactures .....	0,1	1,4	4,1	7,5	6,5	6,8
International competitiveness .....	-2,2	-3,0	-4,2	-1,9	-1,1	-0,8
Export of manufactures, volume .....	5,1	5,4	-3,2	3,9	4,0	5,0
Hourly wages .....	4,2	4,2	3,7	2,8	3,1	3,7
Consumer price index .....	2,4	2,4	2,1	1,2	1,5	1,9
Price index for single-family houses .....	5,9	3,8	3,1	9,1	9,0	6,0
Merchandise export prices .....	0,1	-1,2	0,3	1,6	2,7	1,7
Merchandise import prices .....	-1,2	-1,5	-1,8	1,5	2,3	2,0
Merchandise terms of trade .....	1,3	0,3	2,1	0,0	0,4	-0,3
Productivity in private non-agricultural sector .....	2,0	1,4	1,9	1,3	1,7	1,9
Real disposable income of households <sup>1)</sup> .....	0,8	1,7	2,6	4,6	1,7	-0,1
<i>Labour market:</i>						
Labour force (thousands) .....	2.891	2.886	2.891	2.899	2.898	2.899
Employment (thousands) .....	2.746	2.741	2.720	2.723	2.739	2.752
Of which in private sector .....	1.922	1.907	1.885	1.885	1.900	1.911
in public sector .....	824	834	836	838	839	841
Percentage change in total employment .....	0,4	-0,2	-0,8	0,1	0,6	0,5
Unemployment (thousands) .....	145	145	171	176	158	147
Early retirements (thousands) .....	159	165	175	181	169	153
Persons on leave (thousands) .....	22	17	5	4	3	3
Unemployment rate (per cent) .....	5,0	5,0	5,9	6,1	5,5	5,1
Unemployment rate, EU-def. (per cent) .....	4,3	4,6	5,6	5,4	4,9	4,5
<i>Long term bond yields, exchange rate:</i>						
10-year government bonds .....	5,1	5,1	4,3	4,3	3,8	4,4
30-year mortgage credit bond .....	6,7	6,3	5,4	5,3	4,6	5,1
The effective krone rate (1980=100) .....	96,8	97,7	101,2	102,2	102,5	102,5
<i>Balance of payments:</i>						
Goods and services (bill. Dkr.) .....	85,5	76,9	86,1	73,9	69,5	73,5
Current account (bill. Dkr.) .....	40,1	30,3	46,1	37,0	32,5	39,0
Current account in per cent of GDP .....	3,0	2,2	3,3	2,6	2,1	2,5
Net foreign debt, ult. (bill. Dkr.) .....	224,0	227,0	178,0	166,0	138,5	99,5
Net foreign debt in per cent of GDP .....	16,9	16,8	12,8	11,5	9,2	6,3
<i>Public finances:</i>						
Government net lending (bill. Dkr.) <sup>2)</sup> .....	37,5	21,2	14,6	33,7	38,8	36,4
Government net lending, per cent of GDP <sup>2)</sup> .....	2,8	1,6	1,0	2,3	2,6	2,3
General government gross debt, year-end, bill. Dkr. ....	633,2	642,8	624,8	618,4	561,7	544,4
General government gross debt, year-end, per cent of GDP .....	47,9	47,6	44,9	42,8	37,1	34,6
Tax burden (per cent of GDP) <sup>2)</sup> .....	50,0	49,3	49,0	49,7	49,1	48,5
Expenditures (per cent of GDP) .....	54,4	55,0	55,2	54,9	53,3	52,7

1) Adjusted for special factors concerning pension funds.

2) For the years 1999-2001 government net lending and the tax burden include the net savings respectively gross savings in the Special Pension fund (app. ½ per cent of GDP).

Source: Statistics Denmark and own calculations.

**Table 1.6. May projection and changes since December**

	2005		2006	
	Dec.	May	Dec.	May
	----- Real growth from previous year -----			
Private consumption .....	3,2	3,7	2,0	2,3
Total government demand.....	0,9	0,9	0,6	0,6
of which government consumption.....	0,6	0,6	0,5	0,5
of which government investment .....	4,7	4,7	1,0	1,0
Residential construction .....	-2,0	3,0	1,0	2,0
Fixed business investment .....	4,8	6,1	4,4	4,3
Domestic demand exc. stock building.....	2,6	3,3	2,0	2,2
Changes in stock building <sup>1)</sup> .....	0,1	0,1	0,0	0,0
Total domestic demand .....	2,7	3,4	2,0	2,2
Exports of goods and services .....	5,4	4,0	4,9	4,8
Of which manufactures .....	5,5	3,9	5,1	4,9
Total demand .....	3,6	3,6	3,0	3,0
Imports of goods and services.....	6,1	6,1	5,0	4,8
Of which goods <sup>2)</sup> .....	6,5	6,4	5,2	5,0
Gross domestic product .....	2,4	2,4	2,1	2,2
GDP at factor costs.....	2,3	2,2	2,0	2,1
Of which in non-agricultural sector <sup>3)</sup> .....	2,7	2,6	2,4	2,6
	----- Change, 1,000 persons -----			
Labour force .....	1	-1	2	2
Employment .....	20	17	10	13
of which in the private sector .....	18	15	8	11
of which in the public sector .....	3	2	3	2
Unemployment.....	-19	-18	-8	-11

1) The volumes indicate volume changes in stock building in per cent of volume GDP in the preceding year.

2) Excluding energy, ships and planes.

3) Excluding housing, sea transportation and imputed financial services. (Table continues).

**Table 1.6. May projection and changes since December (continued)**

	2005		2006	
	Dec.	May	Dec.	May
	Percentage changes from previous year			
Merchandise export prices .....	1,6	2,7	-0,6	1,7
Merchandise import prices.....	1,1	2,3	-0,3	2,0
Merchandise terms of trade .....	0,4	0,4	-0,4	-0,3
Property prices, single-family houses .....	5,0	9,0	3,0	6,0
Consumer price index .....	2,0	1,5	1,8	1,9
Hourly earnings .....	3,6	3,1	3,9	3,7
Real disposable income, private sector .....	2,9	3,4	2,6	3,2
Real disposable income, households (ADAM).....	0,9	1,7	0,5	-0,1
Productivity in non-agricultural sector .....	1,7	1,7	1,8	1,9
	----- Per cent -----			
Savings ratio in the private sector .....	29,6	27,9	30,0	28,5
10-year government bond .....	5,0	3,8	5,2	4,4
30-year government bond .....	5,8	4,6	6,3	5,1
	----- Bill. Dkr. -----			
Current account .....	46,4	32,5	53,4	39,0
Government net lending .....	25,5	38,8	26,8	36,4
Unemployment (thousands) .....	155	158	148	147
GDP growth in OECD countries .....	2,8	2,6	2,8	2,7
International market growth .....	7,3	6,5	7,0	6,8
Dollar exchange rate (Dkr. per US dollar) ..	5,8	5,7	5,8	5,8
Price of oil (US dollar per barrel) .....	42,5	50,5	37,5	50,5
Price of oil (Dkr. per barrel) .....	245,7	289,9	216,8	290,9

Source: Statistics Denmark and own calculations.

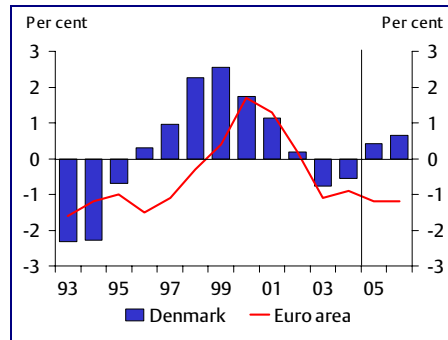
## 2. The fiscal stance and government finances

Fiscal policy is estimated to add to activity growth by around 0.5 percentage points in 2004 (compared to a neutral policy stance). In addition, the temporary suspension of SP-contributions and a series of (non-fiscal) initiatives to stimulate housing investment each entail an estimated stimulus of 0.1 percentage points in 2004. Hence, economic policy in 2004 has been fairly expansionary and should contribute to increased activity and employment also during the projection years.

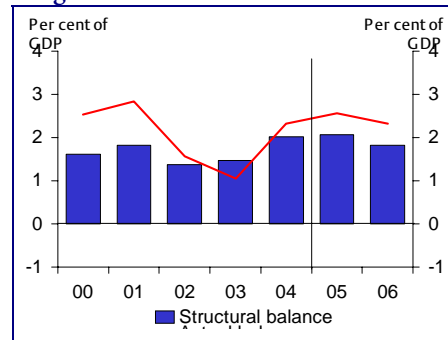
The necessary room for the supportive fiscal policy stance, in terms of public finances and the current account, has essentially been achieved through the structural reforms and fiscal consolidation undertaken in previous periods of economic expansion.

Owing to above-potential growth in 2004 to 2006, the output gap is expected to close and labour market pressures to pick up during the course of 2005 and 2006, *cf. figure 2.1a*.

**Figure 2.1a. Outputgap in Denmark and the euro area**



**Figure 2.1b. Actual and structural public budget balance**



Source: Statistics Denmark, EU-Commission, and own calculations.

Due to the fixed exchange rate against the euro, the short-term (and long-term) interest rates in Denmark are closely tied to the euro area. The cyclical position of the Danish economy is ahead of the euro area and the monetary stance of the ECB may turn out to be relatively easy compared to Danish cyclical conditions.

On the basis of revised fiscal assumptions, the fiscal stance is estimated to have a broadly neutral impact on economic activity in 2005. This neutral stance should be seen in the light of the substantial growth stimulus from low interest rates and the 2004 policy initiatives, while the unemployment rate is expected to decline and approach the estimated structural rate.

The growth in real public consumption was 0.7 per cent in 2004 according to preliminary data. As in December, the growth for 2005 is assumed to be 0.6 per cent, based on the Fiscal Bill for 2005 and local government budgets.

Fiscal policy for 2006 has not been determined yet. In line with medium term objectives, fiscal policy in 2006 is presumed to entail real public

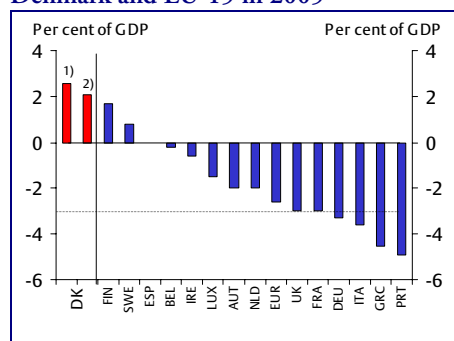
consumption growth of 0.5 per cent as well as unchanged tax rates in accordance with the Tax Freeze.

The projections for the general government surplus are revised upwards considerably since the December forecast. The surplus estimate for 2005 is revised up by 0.9 to 2.6 per cent of GDP, while the surplus for 2006 is revised up by 0.6 to 2.3 per cent of GDP, cf. figure 2.1b.

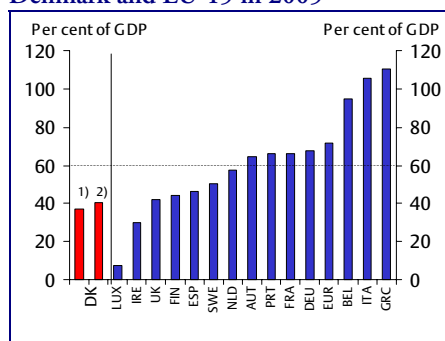
The revisions mainly reflect a stronger than expected surplus in 2004. According to Statistics Denmark, the preliminary data point to a general government surplus of 2.3 per cent of GDP in 2004, 0.8 per cent of GDP higher than estimated in the December Survey. This upward revision is a result of, notably, larger revenues from income taxes, indirect taxes and taxes on pension investment returns.

According to the EU Commission's latest projections, the budget surplus in Denmark is currently among the highest in the EU, cf. figure 2.2a.

**Figure 2.2a. Public budget balance in Denmark and EU-15 in 2005**



**Figure 2.2b. Gross public debt ratio in Denmark and EU-15 in 2005**



1) *Economic Survey, May 2005*. National accounts definition (incl. the labour market supplementary pensions, ATP).

2) EU-Commission, *Economic Forecast, Spring 2005*.

Source: Statistics Denmark, EU-Commission, and own calculations.

General government gross debt (EMU definition) is projected to decline from 42¾ per cent of GDP by the end of 2004 to 34¾ per cent of GDP by the end of 2006. Gross public debt is thus among the lowest in the EU, cf. figure 2.2b. In most EU-countries, the long-term challenge related to aging seems more pronounced than in Denmark.



The structural budget surplus is estimated at 2.0 per cent of GDP in 2004 and 2.1 per cent of GDP in 2005. The structural budget surplus is estimated at 1.8 per cent of GDP for 2006, based on the aforementioned fiscal policy assumptions, the reintroduction of SP-contributions, and other assumptions. The structural surplus is consistent with the medium-term fiscal objective of an average surplus of 1½ to 2½ per cent of GDP through 2010.

Given the medium-term assumptions for expenditure growth through 2010 and further policy initiatives to raise structural employment by some 60,000 persons (roughly 2 percent), the structural budget surplus is estimated at 2.0 per cent of GDP on average for 2003-2010.

#### **Revised assessment of fiscal sustainability**

When assessing fiscal sustainability and policy requirements, the relevant measure of the fiscal position is the balance on central and local government budgets. In 2006, the estimated structural balance of central and local governments is some 0.3 percentage points of GDP higher than in the December forecast.

Seen in isolation, the higher surplus improves fiscal sustainability by 0.3 percent of GDP compared to the December forecast, where the so called sustainability indicator was calculated at -0.1 percent of GDP.

Since the December survey, the population projection has been revised based on improved data and methodology. As a consequence, the projected balance of the central and local governments is lowered by what corresponds to an annual amount of about 0.2 percent of GDP due to higher pension outlays. The calculation assumes that the formal retirement age remains unchanged and uses the standard Finance Ministry assumptions on interest rates and nominal GDP growth (cf. the *Danish Convergence Programme 2004*).

The improved structural balance of central and local governments in the forecast years thus compensates for the adverse long-term impact of the revised population projection.