

English summary

1. Short term forecast

The international slowdown has been more prolonged than initially expected and an upswing is not likely to begin before the second half of 2003. A recovery of the international economy is expected to gather further momentum in 2004.

Economic growth in USA was in 2002 stimulated by large expansions in both monetary and fiscal policy, which also has a positive effect on growth in 2003.

The expansion has supported private consumption and investment and postponed the needed adjustment in macroeconomic balances in USA. These balance sheet problems, which due to the large fiscal expansions now primarily concern the public sector, makes it unlikely for activity in USA to rise markedly in 2004. As a result the growth rate of GDP is expected to stay around 2½ per cent for both 2003 and 2004, *cf. table 1.1.*

Table 1.1. A comparison between the present forecast and the previous forecast in selected areas

	2002		2003		2004	
	Dec.	May	Dec.	May	Dec.	May
	----- Per cent -----					
GDP growth USA	2.3	2.4	2.3	2.4	2.8	2.5
GDP growth EU	1.0	1.1	2.0	1.3	2.6	2.4
<i>Denmark:</i>						
GDP growth	1.5	1.6	1.8	1.6	2.1	2.4
Consumer prices.....	2.4	2.4	2.0	2.3	1.8	1.9
Hourly earnings, private sector	4.1	4.1	3.9	3.9	3.7	3.7
Unemployment rate	5.1	5.0	5.4	5.6	5.2	5.3

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

In Europe structural problems on both labour and product markets have constrained growth rates to around 1 per cent in 2002. In addition

to structural unemployment the euro area has had low productivity growth in recent years. Hence, the growth rate of GDP in EU is not likely to rise much above 1 percent in 2003. For 2004 the growth rate is estimated to reach 2.4 per cent in EU primarily due to expansionary monetary policy.

Denmark has been weathering the international downturn relatively well and the underlying macroeconomic development continues to be sound.

In Denmark, real GDP growth is expected to remain at 1.6 per cent in 2003, *cf. figure 1.1a*. The estimate of GDP-growth for 2003 has been revised downward by 0.2 percentage points compared to the Economic Survey, December 2002. This is mainly due to a downward revision of growth in private consumption and fixed business investments.

Growth in 2004 is forecasted at 2.4 per cent which is a little above the estimated potential growth rate. Compared to the last survey this is an upward revision of 0.3 percentage points. This improved outlook for GDP growth is mostly due to fiscal stimulus of the agreed tax package and the current expansionary monetary conditions, which are expected to have a lagged effect on output in 2004.

Figure 1.1a. Real GDP growth in Denmark and EU.

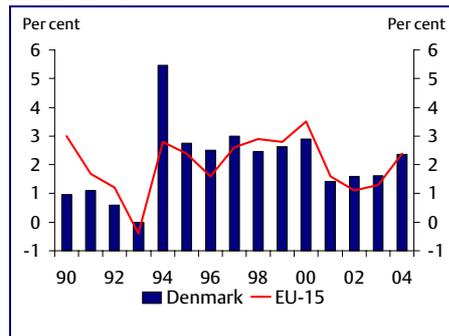
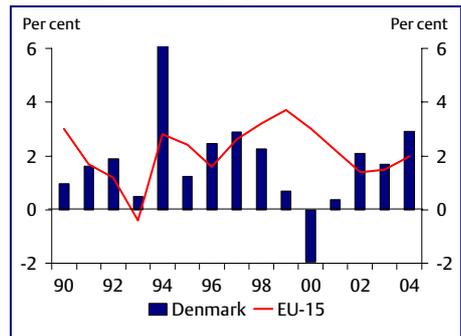


Figure 1.1b. Growth in private consumption in Denmark and EU.



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

Output growth in Denmark has been supported by relatively strong productivity growth, which on average in the last 5-6 years has been well above productivity growth in the euro area, *cf. table 1.2*. This has to some extent offset the relative high growth in labour costs in Denmark and kept the Danish inflation rate in line with the euro area.

Table 1.2. Growth in wages, productivity and prices

	1998-2002		2002	
	Denmark	Euro area	Denmark	Euro area
	----- Average annual growth, per cent -----			
Compensation per employee	3,9	2,6	3,5	2,9
Productivity ¹⁾	1,7	0,8	2,1	0,5
Consumer prices	2,2	1,8	2,4	2,3

1) Value added per employee, total economy.

Source: OECD, EU Commission and own calculations.

Domestic demand

Private consumption is expected to increase by 1.7 per cent annually in 2003 and by 2.9 per cent in 2004, thereby contributing significantly to domestic demand in the forecast period, *cf. figure 1.1b*.

Compared to the survey from December the growth rate of private consumption in 2003 is revised down by 0.5 percentage points. This revision follows from weak car sales in the first part of 2003 and car registrations are now expected to fall by 15 per cent in 2003 compared to the 2002 level, *cf. box 1.1*.

The relatively strong growth in private consumption growth in 2004 is among other things due to an expected continuation of relatively high growth in retail sales and renewed pickup in car registrations.

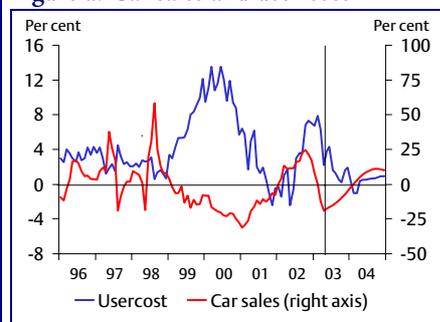
Real disposable income of households is expected to increase by 2¾ per cent in 2003 and 3½ per cent in 2004¹. The large rise of real disposable income in 2004 is among other things due to the tax cut on labour income and the expected pickup in production and employment in 2004. The financial situation of Danish households is fairly robust with total private savings and financial wealth at relatively high levels.

Real public consumption is assumed to grow by 0.7 per cent in both 2003 and 2004 in line with the medium term strategy, *cf. table 1.3*. The estimate of public consumption in 2004 has been lowered by 0.3 percentage points compared to the last survey, *see section 2*. Public investment is estimated to remain unchanged in 2003 and increase by 2.0 per cent in 2004.

¹ Figures are adjusted for special factors concerning pension funds.

Box 1.1. Car sales and user costs.

Car registrations have decreased markedly in 2003 and in the first four months of 2004 the annual growth rate is on average around -23 per cent, *cf. figure a*. The drop in car sales is among other things related to the rise in the user costs of cars. This relationship between user cost and car sales could also be observed in 1999-2000, where a substantial surge in user cost may have contributed to a significant decrease in car sales.

Figure a. Car sales and user cost

The increase in user costs was in both cases caused by high oil prices translating into price increases on petrol, which constitutes around a third of the total user cost index.

As oil price developments and user costs normalize in the remaining part of 2003 the annual growth rate in car sales is expected to increase moderately to around -15 per cent on average in 2003. This development is expected to continue into 2004.

Note: Car registrations are measured as a 3-months moving average of the annual growth rate. User costs of cars are calculated as the sum of the costs related to financing, depreciation, use (i.e. repairs, maintenance, petrol and insurance) and taxes.

Source: Statistics Denmark and own calculations.

Table 1.3. Use and supply of goods and services

	2002	1999	2000	2001	2002	2003	2004
	Bill. Dkr.	----- Percentage changes from previous year -----					
Private consumption	654.1	0.7	-1.9	0.4	2.1	1.7	2.9
Government consumption	355.0	2.0	1.1	2.1	1.0	0.7	0.7
Government investment	23.3	4.4	5.6	13.3	-8.6	0.0	2.0
Residential construction	53.4	-1.0	9.9	-14.2	4.0	2.0	4.0
Fixed business investment	190.6	1.9	8.5	4.8	0.2	1.3	4.0
Stock building ¹⁾	1.8	-1.1	0.6	-0.3	-0.3	0.2	0.0
Total domestic demand	1278.3	0.1	1.9	0.9	1.0	1.6	2.6
Exports of goods and services	600.6	12.3	13.0	3.0	3.6	3.5	4.5
Of which manufactures	291.1	8.5	11.8	2.8	4.6	4.3	6.0
Imports of goods and services	520.6	5.5	11.3	1.9	2.5	3.7	5.3
Of which goods	386.0	5.5	9.0	0.5	3.8	4.0	5.5
Gross domestic product	1358.3	2.6	2.9	1.4	1.6	1.6	2.4
GDP at factor costs	1162.4	3.0	3.5	1.7	1.6	1.6	2.3
Of which in private non-agricultural sector	778.8	3.4	4.9	2.8	1.0	1.6	2.8
GDP per capita (1.000 Dkr.)	252.7	2.3	2.6	1.1	1.3	1.3	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: ADAM's databank and own calculations.

The increase in the real estate price of owner-occupied one family houses are expected to increase by 2.5 and 2.0 per cent in 2003 and 2004 respectively, after an increase of 2.7 per cent in 2002. Property prices are thus increasing in line with consumer prices.

Residential investment is expected to rise by 2 per cent in 2003 and 4 per cent in 2004. The gradual rise in residential investment growth follows from the low interest rates and increasing real disposable income. A number of political initiatives increasing the number of municipal housing projects and the construction of private dwellings will also contribute to an increase in residential investments in 2003 and 2004.

Business investments are expected to increase in 2003 by 1¼ per cent after a period of stagnating business investment in 2002. The estimate for 2003 has been revised downwards by 0.9 percentage points compared to the survey in December. The revision in 2003 is a consequence of the postponement of the expected upturn in the international economy. However, low interest rates will continue to support the growth of business investment in 2003. In 2004 a renewed pick up in production growth is expected to increase growth in business investments to 4.0 per cent.

Following a decrease in inventory investment of 0.3 per cent of GDP in 2002, inventory changes are expected to be positive, contributing around 0.2 percentage points to GDP growth in 2003. In 2004 no contribution from inventory changes to GDP growth is expected.

Figure 1.2a. Total investments in Denmark and EU

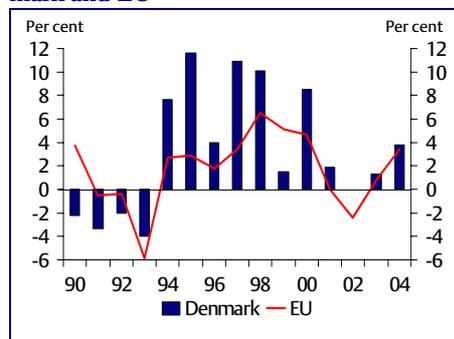
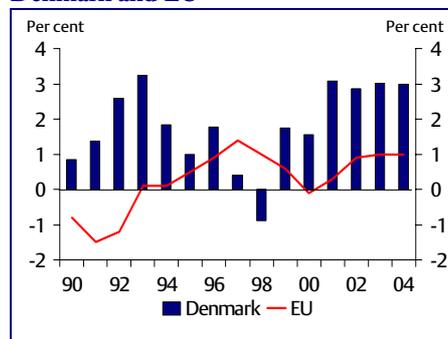


Figure 1.2b. External current account in Denmark and EU



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

International trade

The real growth rate in exports of goods and services is expected to remain stable around 3.5 per cent between 2002 and 2003. In 2004 growth is expected to increase to 4,5 per cent due to a more favourable international economic environment.

Compared with the last survey the forecast for export growth is reduced and especially in 2004 the growth rate has been downward revised. The adjustment reflects partly lower export market growth and partly exchange rate movements.

Exports of manufactured goods are expected to increase by 4.5 per cent in 2003 – unchanged compared with 2002 – and by 6.0 per cent in 2004. In a historical perspective pressures on production capacity can in large part explain the development in export performance of manufactured goods, *cf. box 1.2*. Available production capacity, due to a combination of fairly strong productivity increases and slow growth in domestic demand, has contributed to export growth having been quite resilient to the international slowdown. This has given the manufacturing sector the opportunity to gain market shares and thereby to some extent offset the negative trade effects of slowing international demand. In 2004 renewed pressures on capacity and the lower dollar exchange rate is expected to lead to a loss of market shares.

Box 1.2. Capacity constraints and export of manufactured goods

Between 1996 and 1998 the Danish manufacturing industry lost 13 per cent of its market shares, *cf. table a*. This appears to be the result of mostly insufficient capacity during the 1990's where domestic demand expanded strongly. After 1998 a large part of this loss of market shares has been gained again in line with lower growth in domestic demand and in spite of growing relative wages.

Table a. Market shares and wage competitiveness

	1996	1997	1998	1999	2000	2001	2002	2003	2004
	----- Per cent -----								
Export markets growth .	7.1	10.6	10.0	6.2	12.4	0.7	1.0	4.5	7.5
Export in manufac.....	3.0	6.2	5.3	8.5	11.8	2.8	4.6	4.3	6.0
Market shares	-4.1	-4.4	-4.7	2.3	-0.6	2.1	3.6	-0.2	-1.5
Acc. market shares	-4.1	-8.5	-13.2	-10.9	-11.5	-9.4	-5.8	-6.0	-7.5
<i>Of which:</i>									
- Relative wages	-0.1	-0.3	-1.0	-2.0	-2.9	-3.9	-5.1	-6.2	-7.2
- Effective krone rate	0.4	1.5	1.5	2.4	4.2	4.7	5.0	4.5	4.5
- Capacity etc.	-4.4	-9.7	-13.8	-11.3	-12.8	-10.2	-5.8	-4.3	-4.8
Wage competitiveness...	0.8	2.2	-2.6	-0.4	3.1	-2.2	-2.3	-3.5	-0.8

Source: EU-Commission, OECD and own calculations.

The gradual increase in domestic demand growth is expected to lead to an acceleration in imports. Thus, the growth in imports of goods and services are expected to rise from 3.2 per cent in 2002 to 4.3 per cent and 6.8 per cent in 2003 and 2004, respectively.

As a result the surplus on the external current account is expected to remain stable at around 3.0 per cent of GDP from 2002 to 2004, *cf. figure 1.2b*. Consequently, net foreign liabilities will be reduced from 18.4 per cent of GDP in 2002 to 14.7 per cent and 11.1 per cent of GDP in 2003 and 2004, excluding hard-to-predict valuation effects.

Employment, unemployment and labour force

Overall employment is expected to fall in 2003 by 5.000 persons after a reduction of 14.000 persons in 2002, *cf. table 1.4*. In 2004 a rebound in employment is expected as employment rises by 19.000 persons.

Employment in 2003 has been revised downwards by 8.000 persons compared to the Survey from December. The revision in 2003 follows from the change in the production growth forecast. A large part of the employment increase that was previously expected to occur in 2003 has now been shifted to 2004, where the employment estimate is revised up by 6.000 persons.

Private sector employment is expected to fall by 8.000 persons in 2003 and increase by 16.000 persons in 2004. Public employment is assumed to rise by 3.000 persons in 2003 in line with the fiscal budget and agreements with the municipalities. In 2004 an increase of the same size is assumed.

The labour force is expected to grow by 13.000 persons in 2003 and 11.000 persons in 2004. This is in total 4.000 persons more compared to the Survey in December. This is partly a technical effect due to a drop in activation and education schemes.

According to the population accounting almost everybody in Denmark is earning or receiving some sort of income. Hence, further increases in the labour supply have to be mirrored by a reduction in the number of benefit receivers, *cf. box 1.3*.

Table 1.4. Key figures of the Danish economy

	1999	2000	2001	2002	2003	2004
	---- Percentage changes from previous year ----					
Real GDP	2.6	2.9	1.4	1.6	1.6	2.4
Trade-weighted GDP abroad	3.0	3.7	1.3	1.5	1.7	2.7
Markets for Danish manufactures	6.3	12.3	0.1	0.3	4.5	7.5
International competitiveness	-0.4	3.1	-2.2	-2.3	-3.5	-0.8
Export of manufactures, volume	8.5	11.8	2.8	4.6	4.3	6.0
Hourly wages	4.8	3.6	4.2	4.1	3.9	3.7
Consumer price index	2.5	2.9	2.4	2.4	2.3	1.9
Real estate prices for one-family houses	6.9	6.5	6.0	2.7	2.5	2.0
Merchandise export prices	-0.6	6.9	2.5	-0.5	0.6	0.0
Merchandise import prices	-3.9	7.0	1.5	0.0	0.3	0.2
Merchandise terms of trade	3.4	-0.1	1.0	-0.5	0.3	-0.2
Productivity in private non-agricultural sector	2.6	3.2	3.2	1.5	2.2	2.1
Real disposable income of households ¹⁾	-0.4	1.3	2.6	0.8	0.7	4.3
<i>Labour market:</i>						
Labour force (thousands)	2.874	2.884	2.895	2.881	2.894	2.905
Employment (thousands)	2.716	2.734	2.750	2.736	2.731	2.750
Of which in private sector	1.896	1.913	1.921	1.897	1.888	1.904
in public sector	820	821	829	839	842	845
Percentage change in total employment	1.3	0.7	0.6	-0.5	-0.2	0.7
Unemployment (thousands)	158	150	145	145	163	155
Early retirements (thousands)	149	156	159	169	181	191
Persons on leave (thousands)	32	26	22	16	4	3
Unemployment rate (per cent)	5.5	5.2	5.0	5.0	5.6	5.3
Unemployment rate, EU-def. (per cent)	4.8	4.4	4.3	4.5	5.1	4.8
<i>Long term bond yields, exchange rate:</i>						
10-year government bonds	4.9	5.6	5.1	5.1	4.4	5.1
30-year mortgage credit bond	6.8	7.4	7.1	6.3	5.3	5.9
The effective krone rate (1980=100)	99.6	95.6	96.8	97.7	100.3	100.4
<i>Balance of payments:</i>						
Goods and services (bill. Dkr.)	57.8	76.6	85.7	80.0	85.7	87.6
Current account (bill. Dkr.)	21.2	19.9	40.7	39.4	42.4	43.8
Current account in per cent of GDP	1.8	1.6	3.1	2.9	3.0	3.0
Net foreign debt, ult. (bill. Dkr.)	163.0	189.0	228.0	249.4	207.0	163.2
Net foreign debt in per cent of GDP	13.5	14.8	17.2	18.4	14.7	11.1
<i>Public finances:</i>						
Government net lending (bill. Dkr.) ²⁾	38.8	31.7	36.6	26.0	18.1	21.6
Government net lending in per cent of GDP ²⁾	3.2	2.5	2.8	1.9	1.3	1.5
General government gross debt, ult. (bill. Dkr.) ...	639.7	606.3	601.4	614.6	595.3	595.0
General government gross debt ult. in per cent of GDP	53.0	47.3	45.4	45.2	42.4	40.5
Tax burden (per cent of GDP) ²⁾	51.5	49.5	49.8	49.2	48.6	48.5
Expenditures (per cent of GDP)	55.4	53.8	54.2	54.3	54.0	53.5

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).

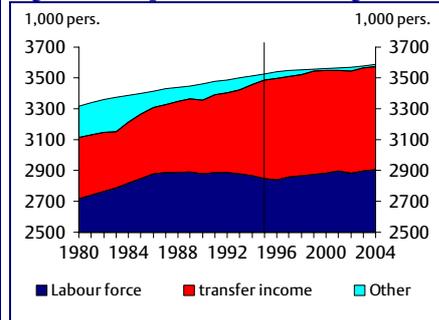
Source: Statistics Denmark and own calculations.

Box 1.3. Population accounting

Subtracting the labour force and the number of persons receiving public transfers from the working age population provides a residual which gives a rough indication of the consistence between the different statistical sources (covering the labour force and the receivers of transfer income) in the past and the projections in the short-term forecast.

In 2002 according to the new National Account figures there was an increase in “others” of approximately 12.000 persons. This is a break with the long run trend showing a decreasing number of people not participating in the labour force or receiving some kind of benefit outside the labour force, cf. figure a. The development in 2002 covers a fall in the labour force not met by a proportional rise in benefit receivers. This indicates that either the fall in the labour force in 2002 is primarily due to the state of the business cycle or that the level of employment is underestimated or perhaps a certain amount of time must pass before changes in the labour force can be seen in the statistics for transfer receivers.

Figure a. “Population accounting”, levels



Contrary to the assessment in December now the number of benefit receivers rises in both 2003 and 2004. At the same time the labour force is growing at rates reducing the number of “others” in both years. Opposite movements in labour force and benefit receivers has not been the common long run tendency. This could indicate that either the growth in the labour force is too strong (from 2002-2004) or that the level of the labour force in 2002 is too low.

Note: Transfer income covers age related pensions, disability pensions, early retirement schemes, maternity and parental leave, social security benefit, rehabilitation, activation measures etc.). “Others” are found by subtracting the labour force and the number of public transfer receivers from the population aged 15 to 64 years. The vertical line marks a break in data due to the new employment statistics in the national account. 2003-2004 are forecasts.

Source: ADAM's databank and own calculations.

The prospects for employment and labour force imply an increase in unemployment from 145.000 persons in 2002 to 163.000 persons in 2003. Average unemployment in 2003 has been revised upwards by 8.000 persons compared to the Survey in December.

Unemployment is expected to start falling later this year and for 2004 a reduction in unemployment to around 155.000 persons is assumed. This is an upward revision of 5.000 persons compared to December.

This implies that the unemployment rate will increase from 4.5 per cent (standardised figures) in 2002 to 5.1 per cent in 2003 and then fall

again to 4.8 per cent in 2004, *cf. figure 1.3a*.² Though unemployment is expected to increase from 2002 to 2003 the level is still relatively low in a historical perspective and also compared to the average employment rate in the EU.

The actual unemployment rate in 2003 is exceeding the estimated structural unemployment rate indicating diminishing pressure on capacity in the labour market. However, as activity picks up in 2004 the unemployment rate is expected to fall a bit below the structural level.

Figure 1.3a. Unemployment rates in Denmark and EU

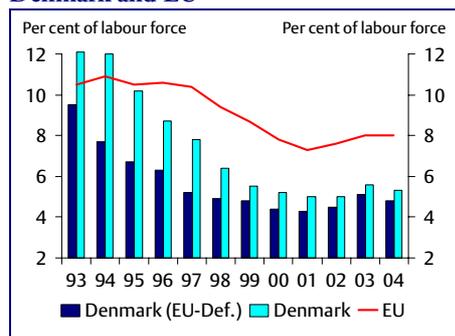
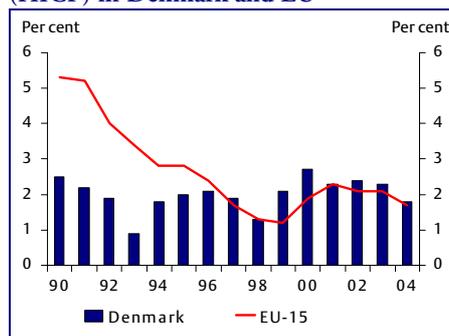


Figure 1.3b. Consumer price inflation (HICP) in Denmark and EU



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

Wages and inflation

Hourly wages in the private sector are expected to grow by 3.9 per cent in 2003 and 3.7 per cent in 2004. Compared to the survey in December the estimates are unchanged. Despite the expected gradual decline in the growth of wages the hourly compensation of employees in Denmark remains higher than the average of the other EU-countries.

Consumer price inflation is estimated at 2.3 per cent in 2003 and 1.9 per cent in 2004, *cf. figure 1.3b*. The estimate for 2003 has been revised upwards by 0.3 percentage point primarily due to higher than expected prices on services and energy. The high inflation rate on services in the first quarter of 2003 is to large extent due to one-off increases in user-charges and cuts in subsidies. The inflation effect of this will gradually diminish during 2003. Thus, the inflation in services is expected to normalise in 2004.

² In national figures the unemployment rate will be 5.6 and 5.3 per cent in 2003 and 2004, respectively.

The fall in consumer price inflation from 2003 to 2004 also reflects lower growth of unit labour costs due to expected lower wage inflation. The fall in excise taxes on soft drinks, cigarettes and alcohol reduces the inflation rate in 2004 by 0.1 percentage point.

The inflation outlook indicates that the Danish inflation rate continues to stay around the European Central Bank's medium term inflation target of 2 per cent. Because of the fixed exchange rate policy vis-à-vis the euro this target also applies to Denmark.

Table 1.5. A comparison between the present and the previous forecast

	2003		2004	
	December	May	December	May
	----- Percentage changes from previous year -----			
Private consumption	2.2	1.7	2.4	2.9
Total government demand	0.6	0.7	1.1	0.7
of which government consumption	0.7	0.7	1.0	0.7
of which government investment	0.0	0.0	2.0	2.0
Residential construction	1.0	2.0	2.0	4.0
Fixed business investment	2.2	1.3	3.4	3.8
Domestic demand exc. stock building ...	1.8	1.3	2.3	2.5
Changes in stock building ¹⁾	0.0	0.2	0.0	0.0
Total domestic demand	1.9	1.6	2.3	2.6
Exports of goods and services	3.8	3.5	5.8	4.5
Of which manufactures	5.2	4.3	7.4	6.0
Total demand	2.5	2.2	3.5	3.2
Imports of goods and services	4.3	3.7	6.8	5.3
Of which goods ²⁾	4.9	4.0	6.8	5.5
Gross domestic product	1.8	1.6	2.1	2.4
GDP at factor costs	1.9	1.6	2.1	2.3
Of which in non-agricultural sector	2.2	1.6	2.5	2.8
	----- Changes in thousand persons -----			
Labour force	12	13	8	11
Employment	3	-5	13	19
of which in the private sector	0	-8	9	16
of which in the public sector	3	3	4	3
Unemployment	9	18	-5	-8

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

2) Excluding production of oil and gas and maritime. (Continues)

Table 1.5. A comparison between the present and the previous forecast (continued)

	2003		2004	
	December	May	December	May
	----- Percentage changes from previous year -----			
Merchandise export prices	0.6	0.6	1.0	0.0
Merchandise import prices	0.6	0.3	0.7	0.2
Merchandise terms of trade	0.0	0.3	0.4	-0.2
Real estate prices for one-family houses ..	2.0	2.5	1.5	2.0
Consumer price index	2.0	2.3	1.8	1.9
Hourly earnings	4.0	4.0	3.7	3.7
Real disposable income, private sector	2.2	2.4	1.7	2.5
Productivity in non-agricultural sector	2.3	2.2	2.1	2.1
	----- Per cent -----			
Savings ratio in the private sector	29.3	29.1	28.8	28.9
10-year government bond	4.9	4.4	5.3	5.1
30-year government bond	6.2	5.3	6.6	5.9
	----- Bill. Dkr. -----			
Current account	29.0	42.4	30.0	43.8
Government net lending	24.6	18.1	33.5	21.6
Unemployment (thousands)	155	163	150	155
	----- Per cent -----			
GDP growth in OECD countries	2.5	1.7	3.0	2.7
International market growth	6.5	4.5	8.4	7.5
Dollar exchange rate (Dkr. Per US\$)	7.6	6.9	7.6	6.9
Price of oil (Us-dollar per barrel)	26	26	25	24
Price of oil (Dkr. per barrel)	197.9	180.7	190.3	166.8

Source: Statistics Denmark and own calculations.

2. The fiscal stance and government finances.

The general government surplus was 1.9 per cent of GDP in 2002 and is estimated at 1.3 per cent of GDP in 2003 and 1.5 per cent of GDP in 2004 *cf. figure 2.1a*.

Gross public debt is expected to decline to 40.8 per cent of GDP by the end of 2004 compared to 45.2 per cent by the end of 2002, *cf. figure 2.1b*.

Figure 2.1a. General government surplus in Denmark and EU.

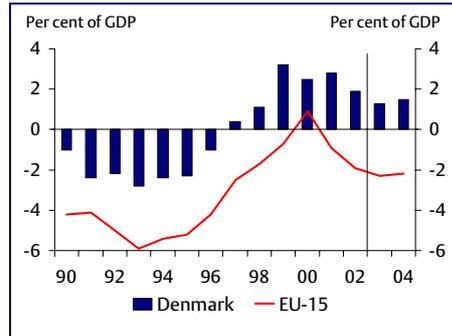
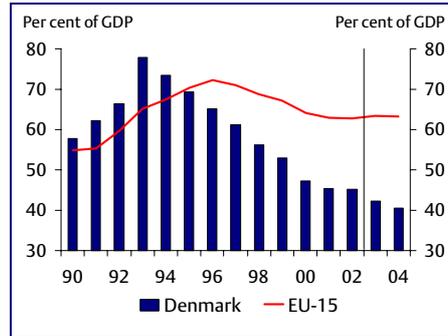


Figure 2.1b. Gross public debt ratio in Denmark and EU.



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

For 2002 the national account figures indicate an upward revision of the surplus of 0.4 per cent of GDP for 2002, compared to the Survey in December. For 2003 and 2004 the projections imply a downward revision of 0.4 and 0.7 percentage points of GDP, respectively.

For 2003 the adjustment of the government surplus is mainly due to cyclical effects induced by the downward revision of the international economy. For 2004 an increase in early retirement and income tax reliefs, *cf. box 2.1*, also contributes to the downward adjustment of the projections for the government surplus.

Box 2.1 Lower taxation of labour income

In March 2003 the government and the Danish People's Party's agreed on lowering the taxation of labour income. The tax reduction consists of two elements:

- The middle income tax bracket is raised by DKK 12.000 annually from 2004 until 2007, i.e. by a total of DKK 48.000.
- An earned income tax credit of 2.5 percent of labour market income with a ceiling corresponding the new middle income tax bracket is introduced. The maximum tax credit is in 2007 DKK 6.800. The tax credit is deductible against the local government tax, i.e. the tax value is on average 33,3 pct.

The gross (i.e. excluding the impact on labour supply) revenue loss from the tax cut is DKK 5,7 billion in 2004 increasing to DKK 9,6 billion in 2007, *cf. table a*. Combined with a slightly reduced planned growth rate in public consumption in 2004 and 2005, the revenue loss is partly offset by a reduction in the real growth of public consumption, while the remaining revenue loss corresponds to the previous reserves for tax reliefs in the 2010-plan.

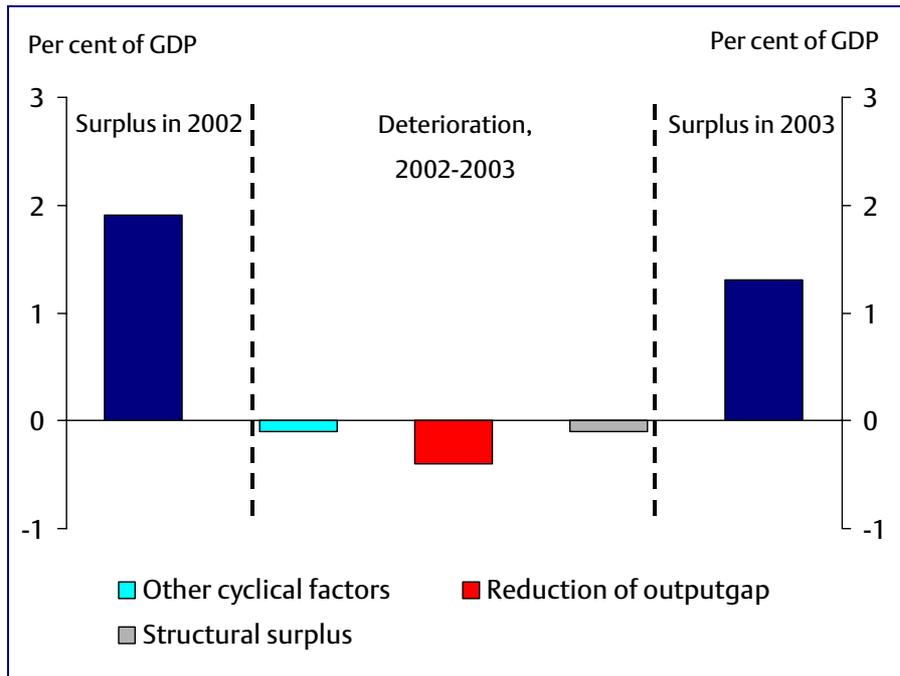
Table a. Revenue effect of labour income tax cut

Billion DKK	2004	2005	2006	2007
Total	-5,7	-7,2	-8,5	-9,6
- Higher middle income tax bracket.....	-1,4	-2,7	-3,8	-4,8
- Earned income tax credit.....	-4,3	-4,5	-4,7	-4,8

The tax reduction contributes to increased labour supply. The average marginal tax rate for employed are reduced by 1.9 percentage points. The after-tax replacement rate for persons below the APW is reduced by 1-3 percentage points. The effect is estimated to increase the participation and average hours worked equivalent to 10-12.000 fulltime employed. The agreement also includes a discretionary spending increase of DKK 1 billion.

The projected decline in the government surplus from 1.9 per cent of GDP in 2002 to 1.3 per cent of GDP in 2003 surplus is mainly due to the cyclical reduction of the output gap, but there is also a minor contribution from a deterioration of the structural government surplus, *cf. figure 2.2*.

Figure 2.2. Change in the government surplus from 2002 to 2003, per cent of GDP



Source: Own calculations.

The fiscal effect, which measures the first year impact of discretionary fiscal policy changes on GDP, is estimated at 0.1 per cent in 2003, *cf. table 2.1.*

Fiscal policy for 2004 is based on technical assumptions mainly in line with the target in the Governments 2010-plan and the tax reductions, which contributes to GDP-growth in 2004. The expenditure policy is expected to have a neutral impact on GDP-growth in 2004. The precise tightness of fiscal policy for 2004 is to be determined in August as part of the government budget proposal for 2004.

GDP-growth is also influenced by lagged fiscal policy measures in previous years including continued structural effects from the saving incentives due to the adjustment of income taxation adopted in June 1998 (*Whitsun package*). The cumulated activity effect of economic policy and structural saving effects are overall expected to dry out in 2003. However, the reduction of the interest rates are expected to increase the GDP-growth by 0.3 per cent in 2002 and 0.5 per cent 2003.

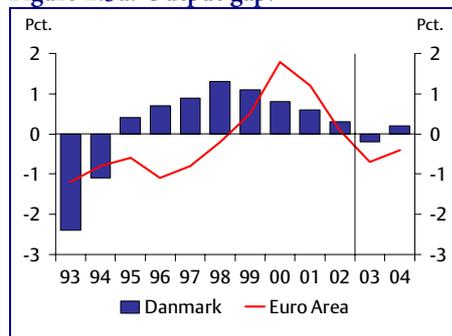
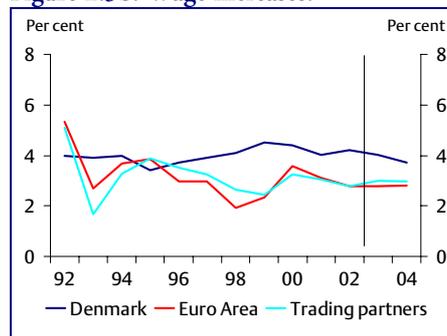
Table 2.1. Activity effect of fiscal policy and structural saving effects

	1998	1999	2000	2001	2002	2003
	----- Per cent -----					
Fiscal effect	0.0	0.2	-0.1	0.5	0.1	0.1
	----- Percentage points -----					
Cumulated activity effect of economic policy ...	-0.7	-1.2	-1.1	-0.2	-0.1	0.0
Effects of interest rates	1.0	1.1	0.8	-0.1	0.4	0.5

Source: Statistics Denmark and own calculations.

This level of fiscal tightness is considered appropriate in view of the current cyclical position of the Danish economy, 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 considered in the context of sharp interest rate cuts internationally during 2001 and the renewed decline of interest rates during 2002 and the spring of 2003, a low level of unemployment in spite of the moderate rise in the unemployment since the spring of 2002, and a still relatively high level of capacity utilization. The estimated level of the output gap is expected to be negative for 2003 but positive again for 2004, *cf. figure 2.3a*. The annual wage increases are expected to be higher than abroad even though the spread is expected to be narrowed in 2003 and 2004, *cf. figure 2.3b*.

Figure 2.3a. Output gap.**Figure 2.3b. Wage increases.**

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

3. Medium-term projection to 2010

Introduction

The medium-term projection is a technical update of the scenario presented in *Convergence Programme for Denmark 2002* (CP2002). The projection includes the effects of the tax agreement (May 2003), the Fiscal Bill for 2003 and new forecasts for accession to early retirement schemes etc. The projection is based on the short-term economic forecasts to 2004, cf. box 3.1.

Box 3.1. Revised assumptions compared to CP2002

The medium-term projection is based on the scenario presented in CP2002, with growth in real public consumption of ½ per cent p.a. between 2006 and 2010, and maintains the same requirements to structural reforms on the labour market. The scenario is updated in the following areas:

- Inclusion of the Fiscal Bill for 2003.
- New short term forecasts to 2004.
- New agreement about lower tax on earned income from 2004 onwards, May 2003.
- New estimates for accession to early retirement etc. until 2010.

As a starting point the overall objectives for structural labour market improvements are unchanged. This implies that the rise in (structural) employment until 2010, which is considered to require additional initiatives – the so-called non-implemented employment increase – is the same as in CP2002 apart from the impact on effective labour supply due to the tax agreement decided upon in April, which was not included in the earlier projections.

The update implies modest changes in the overall assessment. With the new assumptions about employment fiscal policy still broadly complies with a sustainable fiscal framework.

The requirement is that (structural) employment increases by 53,000 persons from 2003 to 2010 compared to a neutral scenario which includes the estimated contributions from already implemented reforms and the drop in the inflow to early retirement in recent years etc. The contribution from new initiatives is about 9,000 persons less than in CP2002 as a result of the tax agreement.

Public finances are weakened compared to CP2002, but the changes are limited compared to former revisions and given the uncertainties involved in the calculations. The changes are among other things due to

reduced growth in the labour force, which is related to higher accession to the early-retirement benefit schemes, *cf. box 3.2*.

Box 3.2. Consequences of changed assumptions - main results

- Employment growth from 2003 to 2010 is reduced by 14,000 persons. Only 2/3 of this adjustment shows as a weakening of public finances, since the rest is countered by an increase in average working hours due to the tax agreement.
- New initiatives are assumed to increase employment by 53,000 persons. This is, as a result of the tax agreement, 9,000 persons less than in CP2002.
- The tax agreement and the tax freeze imply a total reduction of taxation of approx. 1¼ per cent of GDP (2003-level) from 2003 to 2010. This is about ¼ per cent of GDP more than in CP2002.
- Growth in real public consumption amount to 0.7 and 0.6 per cent in 2004 and 2005, respectively, compared to 1 per cent in both years in former projections. Between 2006 and 2010 it amounts to ½ per cent a year just like previous projections.
- Fiscal policy is considered to be broadly sustainable. The average surplus on public finances from 2003 to 2010 is within the target range of 1½ to 2½ percent of GDP. The calculated measure of fiscal sustainability shows a small deficit in the amount of 0.1 per cent of GDP. This is a reduction of 0.2 per cent of GDP compared to CP2002.

The overall medium-term target is a sustainable fiscal policy. This implies that the general government surplus must be large enough to finance the expected future increase in net public expenditures due to ageing and to ensure a sustainable development in general government debt, without triggering a need for fiscal tightening at some later point.

The labour market

The labour force is assumed to increase by 26,000 people between 2003 and 2010, while structural unemployment is set to fall gradually from about 5½ per cent of the labour force in 2003 to 4½ per cent in 2010, or by 26,000 people. This implies an increase in structural employment of some 52,000 people from 2003 to 2010.

The rise in employment should, as a starting point, be seen in the light that the demographic development technically generates a fall in employment of some 40,000 people until 2010. Lower unemployment rate and rising participation rates must therefore contribute a total of 92,000 people. Rising participation rates gives the largest contribution of some 66,000 people, *cf. table 3.1*. Thus, the assumed increase in structural employment is 14,000 persons lower than in CP2002.

Table 3.1. Increase in structural employment from 2003 to 2010

	CP2002	May 2003
	----- 1,000 persons -----	
Demographic contribution	-40	-40
Implemented increase in structural employment.....	5	-1
Non-implemented increase in structural employment.....	62	53
Total increase in structural employment.....	66	52

Source: Own calculations.

Employment is estimated to be roughly unchanged between 2003 and 2010 in the absence of additional structural measures. This implies that a rise in participation rates for each cohort, gender etc., and falling structural unemployment is likely to contribute 39,000 people by virtue of already adopted measures.

The development in employment in the absence of additional structural measures should be seen in the light of lower inflow to early retirement schemes in recent years and reforms of the pre-early retirement scheme, the early retirement scheme and the disability pension scheme. Moreover, the calculations include the estimated effects of the expanded maternity leave, the initiatives outlined in *More people into employment* and the tax agreement.

In CP2002 it was projected that employment could increase by some 5,000 persons from 2003 to 2010 in the absence of additional structural measures. Thus, the new projection imply a reduction of the implemented increase in structural employment by 6,000 persons, even though the tax agreement is estimated to increase labour market participation by some 3,500 persons. The weaker employment growth is primarily due to a larger underlying increase in the inflow to early retirement than anticipated in CP2002, *cf. table 3.2*.

If the medium-term objectives are to be fulfilled, an additional contribution of some 53,000 people will be needed, the majority due to higher participation rates. This is 9,000 persons fewer than in CP2002 and should be seen in the light of the estimated contributions from the tax agreement. The non-implemented increase in structural employment includes possible contributions from, for instance, better integration of immigrants in the labour market, a faster flow through the education system and efforts to improve labour market attachment for senior workers.

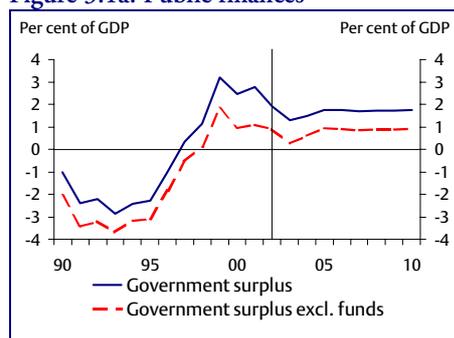
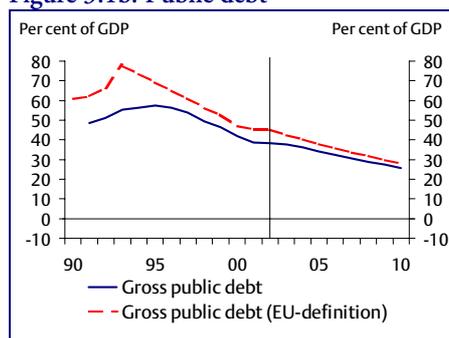
Table 3.2. Increase in structural employment from 2003 to 2010

	CP2002	May 2003
	----- 1,000 persons -----	
Demographic contribution	-40	-40
Early retirement	39	23
“More people into employment”	10	10
Tax agreement.....	-	3,5
Others.....	-4	2,5
Implemented increase in structural employment.....	5	-1
Non-implemented increase in participation rates	41	32
Non-implemented reduction in structural unemployment....	21	21
Total increase in structural employment	66	52

Source: Own calculations.

Public finances and fiscal sustainability

The projected increase in private employment and assumed fiscal policy implies that the surplus on general government balance on average can amount to approx. 1.7 per cent of GDP, *cf. figure 3.1a*. This is within the target range of 1½-2½ per cent of GDP until 2010, which is estimated to be largely sufficient in order to maintain fiscal sustainability. The surpluses imply a reduction of public debt (EMU-definition) from 43 per cent of GDP in 2003 to 28 per cent of GDP in 2010, *cf. figure 3.1b*.

Figure 3.1a. Public finances**Figure 3.1b. Public debt**

Source: ADAM's databank and own calculations.

If the non-implemented rise in employment is achieved, the level of fiscal sustainability can be calculated to a deficit of 0.1 per cent of GDP in the projection. Fiscal policy and labour market improvements thus make sure that fiscal burdens are not passed on to future generations.

The rise in employment assumed to take place in the absence of new labour market initiatives in itself gives fiscal leeway in the amount of 0.7 per cent of GDP compared to the anticipated baseline (demographic scenario), which does not include the impact on public finances from the tax freeze, lower tax on earned income, abolition of the 24-hour rule and the assumed improvements in real service standards, *cf. table 3.3*. Hence, additional structural measures are needed in order to maintain fiscal sustainability.

Table 3.3. Contribution to fiscal sustainability in 2003

	CP2002	May 2003
	----- Per cent of GDP -----	
Sustainability indicator, demographic scenario	-0.1	-0.1
Fiscal leeway due to implemented employment requirements	0.7	0.7
Tax freeze.....	-0.6	-0.6
Lower tax on earned income etc.	-0.4	-0.6
Abolition of the 24-hour rule	-	-0.1
Real growth in public service standards.....	-0.5	-0.4
Sustainability indicator, implemented scenario	-0.9	-1.0
Fiscal leeway due to non-implemented employment requirements	1.0	0.9
Sustainability indicator in medium term prospects .	0.1	-0.1

Source: Own calculations.

In the absence of these additional structural measures a fiscal adjustment of around 1 per cent of GDP or higher participation rates, contributing to a similar public finance improvement, after 2010 is needed. This is somewhat more than in CP2002 due to reduced growth in structural employment, a smaller surplus on the structural general government balance and the revenue effect of the abolition of the 24-hour rule, which was assumed financed in CP2002.

Economic outlook until 2010

Real GDP is estimated to grow by approx 1.9 per cent a year on average during the period from 2003 to 2010, *cf. table 3.3*. The slowdown compared with the 1995-2003 period mainly reflects that the plunge in unemployment during that period cannot be repeated. Further, average annual working hours are expected to decrease somewhat – contrary to the period since 1995 – due to the latest wage agreements and the demographic transition towards more younger and elderly in the labour force.

Table 3.4. Main economic figures, 1995-2010

	1995-03	2004-05	2006-10	2003-10
	----- Avg. growth p.a., per cent -----			
Real GDP	2.3	2.2	1.9	1.9
Private consumption deflator.....	2.3	1.8	1.7	1.8
Hourly earnings in private sector.	4.0	3.7	3.8	3.8
	--- 1.000 persons, level in end year --- - Change -			
Employment	2,731	2,756	2,790	59
- Private sector.....	1,888	1,908	1,932	44
- Public sector	842	848	858	15
Labour force.....	2,894	2,908	2,920	26
Unemployment.....	163	152	130	-33
Structural employment.....	2,738	2,757	2,790	52
Structural unemployment.....	156	151	130	-26
	-- Per cent of GDP. Level in end year - - Change -			
Budget balance.....	1.3	1.8	1.7	0.5
Current account balance.....	3.0	3.2	3.5	0.5
Public gross (EMU) debt.....	42.5	38.1	28.1	-14.4
Foreign debt.....	14.7	7.5	-9.4	-24.1

Source: ADAM's databank and own calculations.

The assumptions for the labour market and fiscal policy imply that the (structural) general government balance, on average, will show a surplus of 1.7 per cent of GDP during the period from 2003 to 2010. The projected surpluses will reduce general government debt from 43 per cent of GDP in 2003 to 28 per cent GDP in 2010.

An unchanged surplus on the balance of goods and services and falling net interest payments improves the current account during the projection period. A sustained surplus contributes to a significant reduction in foreign debt, which, disregarding typically significant value adjustments, can be turned into a net asset position during the period from 2005 to 2010.