

# English summary

## 1. Short term forecast

Increasingly clear signs of an international upturn have emerged in the second half of 2003. The budding global recovery is supported by record-low monetary policy rates, reduced geo-political uncertainties and fiscal stimulus in the United States.

The international recovery is led by the United States, where the economy grew strongly in the third quarter. In the euro area signs of rising activity are also more promising than earlier this year and activity showed a moderate pick up in the third quarter.

The US economy is expected to grow by 2.8 per cent on average in 2003 and by 3.8 per cent in 2004, *cf. table 1.1*. This is an upward revision of 0.9 and 1.3 percentage points compared to the *Economic Survey* of August. The outlook for the United States reflects stronger private consumption and business investment related notably to high productivity growth, whereas the growth impact of the significant fiscal expansion and interest rate cuts gradually diminishes. A pick up in export growth, amplified by the improved cost competitiveness of US enterprises owing to the dollar's depreciation, also contributes to higher activity growth in the forecast period. In 2005 the growth rate is forecast at 3.3 per cent.

**Table 1.1. Present forecast and the previous forecast in selected areas**

	2002	2003		2004		2005	
		Aug.	Dec.	Aug.	Dec.		Dec.
		----- Per cent -----					
USA, GDP growth.....	2.5	2.1	2.8	2.5	3.8	3.3	
Euro area, GDP growth .....	0.9	0.6	0.4	2.1	1.8	2.3	
<i>Denmark:</i>							
GDP growth .....	2.1	1.4	0.4	2.3	2.1	2.3	
Consumer prices.....	2.4	2.3	2.1	1.9	1.8	1.7	
Hourly earnings, private sector .....	4.2	3.9	3.9	3.7	3.7	3.7	
Unemployment rate .....	5.0	5.9	5.9	5.6	6.0	5.5	

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

In spite of emerging signs of a recovery in the euro area, structural problems in both labour and product markets combined with low productivity growth continue to constrain actual and potential growth. The appreciation of the euro vis-à-vis the dollar has lowered the competitiveness of European companies, which dampens net exports. This year, GDP growth is therefore expected to stay low at around ½ per cent.

It seems likely that the uncertainty concerning future fiscal measures generated by the large public deficits in Germany and France has weakened private consumption and investment in those countries. In that case, and allowing for a possible impact on interest rates, the forthcoming fiscal consolidation in these countries may have a less negative effect on GDP-growth than under normal circumstances.

The growth rate in the euro area is expected to gradually rise to 1.8 per cent and 2.3 per cent in 2004 and 2005, respectively. Low interest rates and falling import prices should boost private consumption. As domestic and foreign demand recovers investment growth is also expected to pick up.

The risks in the international economy are still centred around the apparent savings-investment imbalances of the United States. A further large depreciation of the dollar vis-à-vis the euro could weaken the growth prospects for the euro area, but also allow for lower interest rates than otherwise.

The current meagre growth in the euro area has had a negative impact on the Danish economy. In Denmark, real GDP growth is expected to be 0.4 per cent in 2003, *cf. figure 1.1a*. The estimate of GDP-growth for 2003, which incorporates national accounts data up until the second quarter of 2003<sup>1</sup>, has been revised downward by 1.0 percentage points compared to the *Economic Survey, August 2003*. This is mainly due to a downward revision of growth in exports and fixed business investments. The forecast still foresees a moderate recovery in the last part of 2003 that gradually gathers force in the course of 2004.

Growth in 2004 is forecast at 2.1 per cent. Compared to the last survey this is a downward revision of 0.2 percentage points. The accelerating GDP growth is supported by fiscal stimulus from the income tax reductions as of January 2004 and the government's initiative to bring forward public investments. GDP growth is furthermore supported by low inter-

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<sup>1</sup> Recently released National Accounts data for the third quarter point to a further weakening in GDP due to falling exports and stocks. Private consumption and investments, however, showed a strong recovery.

est rates and the expected improvement in foreign demand. The recovery in 2004 is mainly driven by private consumption. High private sector savings gives households substantial leeway for increasing their spending.

As investment and exports gradually pick up the GDP growth rate is expected to increase to 2.3 per cent in 2005. Private consumption is also expected to continue to be a main contributor to activity growth in 2005.

Figure 1.1a. Real GDP growth in Denmark and the euro area

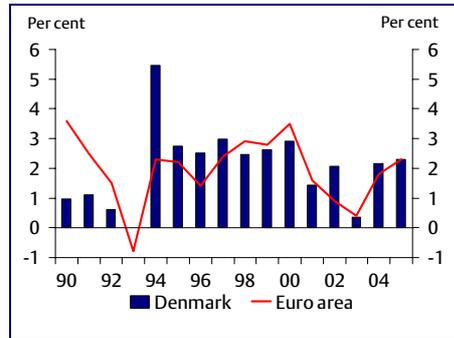
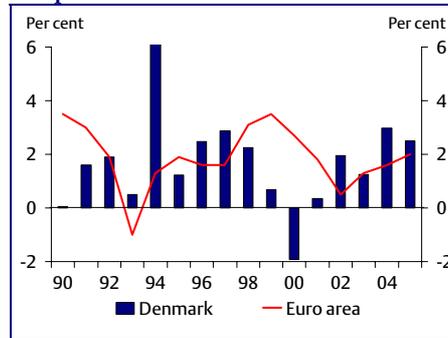


Figure 1.1b. Real growth in private consumption in Denmark and the euro area



Source: ADAM's databank, EU-Commission, and own calculations.

Unemployment, which has continued to rise in the last few months, is expected to peak in the beginning of 2004 followed by a fall during the year reflecting higher growth. The acceleration in both GDP and employment will further reduce unemployment in 2005.

In 2003 unemployment is expected to be above the estimated structural level, implying that labour market pressures have eased. In 2004 and 2005 labour market pressures may intensify again as unemployment moves rather close to its estimated structural level.

### Domestic demand

Real disposable income of households is expected to increase by around 1½ per cent in 2003, 3¼ per cent in 2004 and 2¼ per cent in 2005. The large increase in real disposable income in 2004 is mainly due to the tax cuts on labour income and the expected increase in employment.

Private consumption is expected to increase by 1.2 per cent annually in 2003, 3.0 per cent in 2004 and by 2.5 per cent in 2005. Private consumption thereby contributes significantly to domestic demand in the forecast period, *cf. table 1.3*. Vehicle purchases are set to fall by 17 per

cent in 2003 on average, but they have recently rebounded strongly and are projected to grow by 17 per cent in 2004 and 5 per cent in 2005.

Compared to the survey from August the growth rate of private consumption in 2003 is reduced by 0.1 percentage points, while it is unchanged in 2004.

The relatively strong growth in private consumption in 2004 is supported by the income tax cuts, a healthy savings position in the private sector, low interest rates and the impact of new flexible borrowing opportunities for house owners. The financial position of Danish households is fairly solid with total private savings and financial wealth at relatively high levels relative to GDP.

**Table 1.3. Use and supply of goods and services**

	2002	2000	2001	2002	2003	2004	2005
	Bill. Dkr.	----- Percentage changes from previous year -----					
Private consumption .....	653.9	-1.9	0.4	1.9	1.2	3.0	2.5
Public consumption .....	358.7	1.1	2.1	2.1	0.1	0.7	0.5
Public investment .....	24.2	5.6	13.3	-3.1	-2.9	3.2	2.0
Residential construction .....	54.8	9.9	-14.2	6.6	8.5	2.5	-0.5
Fixed business investment .....	189.9	8.5	4.8	-0.7	-3.1	1.0	3.1
Stock building <sup>1)</sup> .....	2.8	0.6	-0.3	-0.3	0.4	0.0	0.0
Total domestic demand .....	1284.2	1.9	0.9	1.2	0.8	2.0	2.0
Exports of goods and services ....	613.3	13.0	3.0	5.8	-0.4	3.9	4.6
Of which manufactures .....	300.6	11.1	1.6	5.5	-2.0	5.0	5.3
Imports of goods and services ...	532.3	11.3	1.9	4.2	0.6	3.8	4.1
Of which goods .....	386.3	9.0	0.5	3.9	0.4	4.0	3.9
Gross domestic product .....	1365.2	2.9	1.4	2.1	0.4	2.1	2.3
GDP at factor costs .....	1167.8	3.5	1.7	2.1	0.6	1.9	2.4
Of which in private non-agricultural sector .....	780.3	4.9	2.8	0.7	0.5	2.0	2.7
GDP per capita (1.000 Dkr.) ....	253.9	2.6	1.1	1.7	0.1	2.0	2.2

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.

Growth in real public consumption is assumed to be 0.7 and 0.5 per cent in 2004 and 2005 in line with the medium term strategy. In 2003 the growth rate is assumed at 0.1 per cent provided that central and local government expenditures are kept in line with budgets. Public investment is estimated to decline by 2.9 per cent in 2003. In 2004 public investments is expected to increase by 3.2 per cent and 2.0 per cent, respectively.

The price of owner-occupied single-family homes is expected to increase by 2.0 and 1.5 per cent in 2004 and 2005, respectively, following an increase of 3.5 per cent in 2003. Real estate prices have risen more than consumer prices due, in part, to the fall in interest rates in 2003. The expected slowdown in property prices in 2004 and 2005 partly reflects the assumed rise in interest rates in the years ahead.

Residential investments are expected to rise by 8.5 and 2.5 per cent in 2003 and 2004, respectively. The rise in residential investment growth follows from low interest rates and higher real disposable incomes. A number of political initiatives bringing forward investments in municipal housing projects from 2004 to 2003 as well as the construction of private dwellings contribute to a higher expected growth rate of residential investments in 2003. Following the high level in 2003 and 2004, residential investment is expected to decrease by 0.5 per cent in 2005.

Business investments are set to fall by 3.1 per cent in 2003. With growth rates of 1.0 and 3.1 per cent in 2004 and 2005, respectively, business investments are expected to recover in the following years. The fall in business investments in 2003 partly reflects the deterioration in the international economy and possibly the geo-political uncertainties in the first half of 2003. As economic activity gathers momentum, business investments are expected to rise in 2004 and gain further strength in 2005 due to higher growth in domestic and foreign demand.

Figure 1.2a. Total investments in Denmark and the euro area

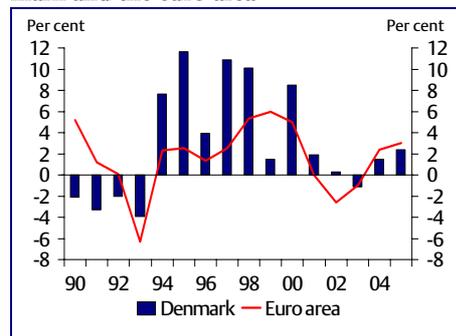
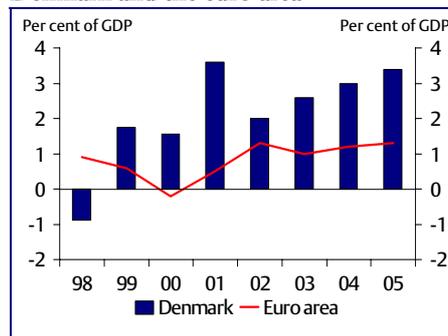


Figure 1.2b. External current account in Denmark and the euro area



Source: ADAM's databank, EU-Commission, and own calculations.

Following a decrease in inventory investments of 0.3 per cent of GDP in 2002, inventory changes are expected to be positive in 2003, contributing around 0.4 percentage points to GDP growth. In 2004 and

uting around 0.4 percentage points to GDP growth. In 2004 and 2005 no contribution from inventory changes to GDP growth is foreseen.

### **International trade**

Exports of goods and services are expected to decline by  $\frac{1}{2}$  per cent in 2003 due to the international slowdown. In 2004 and 2005 growth is expected to rebound to 4 and  $4\frac{1}{2}$  per cent, respectively, due to a more favourable international economic environment. Compared to the last survey the forecast for export growth is reduced by  $3\frac{3}{4}$  percentage points in 2003. The adjustment primarily reflects lower-than-expected exports of manufactured goods and tourist services in the second and third quarters of 2003.

Exports of manufactured goods are expected to decrease by  $1\frac{1}{4}$  per cent in 2003 but to increase by 5 and  $5\frac{1}{4}$  per cent in 2004 and 2005.

The gradual increase in demand is expected to lead to an acceleration in imports. Thus, the growth in imports of goods and services is expected to pick up from  $\frac{1}{2}$  per cent in 2003 to  $3\frac{3}{4}$  and 4 per cent in 2004 and 2005, respectively. The terms of trade have developed quite favourably in 2003, but are expected to worsen in 2005.

As a result, the surplus on the external current account is expected to increase from  $2\frac{1}{2}$  per cent of GDP in 2003 to  $3\frac{1}{2}$  per cent of GDP in 2005, *cf. figure 1.2b*. Consequently, net foreign liabilities will be reduced from 22 per cent of GDP in 2002 to around  $11\frac{1}{2}$  per cent of GDP in 2005, excluding hard-to-predict valuation effects in 2004 and 2005.

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

Employment is expected to fall by 35.000 persons in 2003, *cf. table 1.4*. In 2004 employment is expected to rise by 8.000 persons and by 19.000 persons in 2005. The change in employment in 2003 has been revised downwards by 18.000 persons compared to the Survey from August, and the rise in employment in 2004 is revised downwards by 7.000 persons.

As public employment is assumed to be unchanged in 2003 the fall in employment is entirely due to falling private sector employment. In 2004 private and public employment is expected to increase by 5.000 and 3.000 persons respectively and in 2005 private employment is expected to rise by 16.000 persons and public employment by some 2.500 persons.

Compared to the survey in August private employment is revised downward by 18.000 persons in 2003 and 8.000 persons in 2004. This revision reflects lower growth than expected in 2003.

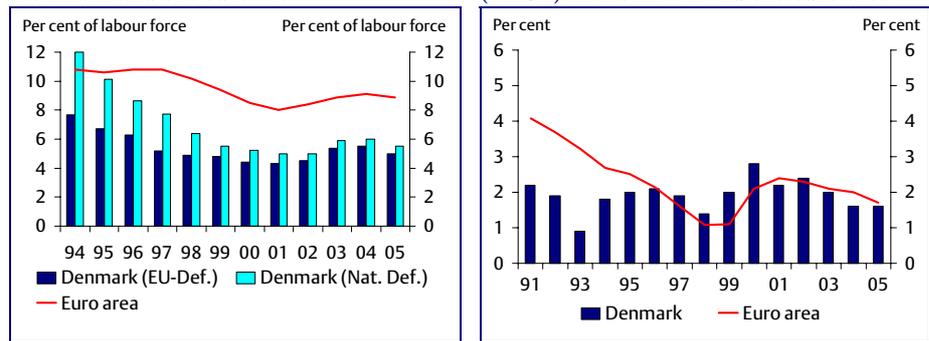
The labour force is expected to fall by around 10.000 persons in 2003 and to grow by 12.000 persons in 2004. This is in total a reduction of 18.000 persons in 2003 compared to the Survey in August and an upward adjustment by 4.000 persons in 2004. This revision follows from a recorded fall in the labour participation rate among younger people in 2003 which in some respect reflects a contribution from business cycles to the change in the labour force. A rebound in the labour force is expected in 2004 and 2005 as activity picks up and the employment outlook brightens.

The prospects for employment and labour force imply an increase in unemployment from expected 170.000 persons in 2003 to 173.000 persons in 2004. Average unemployment in 2004 has been revised upward by 10.000 persons compared to the Survey in August.

As in August unemployment is expected to fall during 2004 although from a higher level at the end of 2003 than expected in August. Unemployment is expected to continue to fall in 2005 to around 160.000 persons.

This implies that the unemployment rate will increase from 5.5 per cent (standardised figures) in 2003 to 5.6 per cent in 2004 and then fall again to 5.1 per cent in 2005, *cf. figure 1.3a.*

**Figure 1.3a. Unemployment rates in Denmark and the euro area**      **Figure 1.3b. Consumer price inflation (HICP) in Denmark and the euro area**



Source: ADAM's databank, EU-Commission, and own calculations.

**Table 1.4. Key figures of the Danish economy**

	2000	2001	2002	2003	2004	2005
	---- Percentage changes from previous year ----					
Real GDP .....	2.9	1.4	2.1	0.4	2.1	2.3
Trade-weighted GDP abroad .....	3.7	1.3	1.5	1.3	2.5	2.8
Markets for Danish manufactures .....	13.0	0.1	1.4	4.2	7.6	7.1
International competitiveness .....	2.9	-2.2	-2.3	-4.6	-1.6	-0.9
Export of manufactures, volume .....	11.1	1.6	5.5	-2.0	5.0	5.3
Hourly wages .....	3.6	4.2	4.2	3.9	3.7	3.7
Consumer price index .....	3.0	2.3	2.4	2.1	1.8	1.7
Real estate prices for one-family houses .....	6.5	6.0	2.7	3.5	2.0	1.5
Merchandise export prices .....	6.9	2.5	-0.5	-0.5	0.0	0.1
Merchandise import prices .....	7.0	1.5	0.0	-1.8	0.0	0.9
Merchandise terms of trade .....	-0.1	1.0	-0.5	1.3	-0.1	-0.7
Productivity in private non-agricultural sector .....	3.2	3.2	1.6	2.4	1.9	1.9
Real disposable income of households <sup>1)</sup> .....	-0.2	1.2	2.8	1.6	3.2	2.2
<i>Labour market:</i>						
Labour force (thousands) .....	2,884	2,895	2,885	2,875	2,886	2,892
Employment (thousands) .....	2,734	2,750	2,740	2,705	2,713	2,731
Of which in private sector .....	1,913	1,921	1,900	1,865	1,870	1,886
in public sector .....	821	829	840	840	843	845
Percentage change in total employment .....	0.7	0.6	-0.4	-1.3	0.3	0.7
Unemployment (thousands) .....	150	145	145	170	173	160
Early retirements (thousands) .....	156	159	169	179	188	176
Persons on leave (thousands) .....	26	22	17	5	3	3
Unemployment rate (per cent) .....	5.2	5.0	5.0	5.9	6.0	5.5
Unemployment rate, EU-def. (per cent) .....	4.4	4.3	4.5	5.5	5.6	5.1
<i>Long term bond yields, exchange rate:</i>						
10-year government bonds .....	6.7	5.8	5.2	4.3	4.7	5.1
30-year mortgage credit bond .....	7.4	6.7	6.3	5.5	5.6	5.9
The effective krone rate (1980=100) .....	95.6	96.8	97.8	101.3	101.9	101.9
<i>Balance of payments:</i>						
Goods and services (bill. Dkr.) .....	76.6	85.7	81.0	94.3	101.0	107.0
Current account (bill. Dkr.) .....	19.9	40.5	27.6	37.0	44.0	51.0
Current account in per cent of GDP .....	1.6	3.1	2.0	2.6	3.0	3.4
Net foreign debt, ult. (bill. Dkr.) .....	189.0	238.0	301.0	272.0	228.1	177.0
Net foreign debt in per cent of GDP .....	14.8	18.0	22.0	19.5	15.7	11.6
<i>Public finances:</i>						
Government net lending (bill. Dkr.) <sup>2)</sup> .....	31.7	37.9	20.6	18.5	20.7	21.5
Government net lending in per cent of GDP <sup>2)</sup> .....	2.5	2.9	1.6	1.3	1.4	1.4
General government gross debt, ult. (bill. Dkr.) ....	606.3	601.4	621.6	597.1	590.0	582.1
General government gross debt ult. in per cent of GDP .....	47.3	45.4	45.5	42.8	40.6	38.3
Tax burden (per cent of GDP) <sup>2)</sup> .....	49.5	49.9	48.7	49.1	48.6	48.0
Expenditures (per cent of GDP) .....	53.8	54.2	54.4	54.6	54.0	53.1

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.

### Wage- and price 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 and 2005. Compared to the survey in August the estimates are unchanged. Despite the expected slight decline in wage growth, hourly compensation of employees in Denmark increases faster than the average of the other EU-countries. In recent years, this has more or less been offset by higher productivity growth in Denmark.

Consumer price inflation is estimated at 2.1 per cent in 2003, *cf. figure 1.3b*. In 2004 and 2005 the inflation rate falls to 1.8 per cent and 1.7 per cent respectively. The inflation forecasts in 2003 and 2004 are slightly lower than in the August *Survey* due to a weaker dollar and lower import prices.

The tax freeze contributes to a slightly lower inflation rate in the forecast period due to the freeze of indirect taxes set in nominal terms. The fall in excise taxes on soft drinks, cigarettes and alcohol will furthermore reduce the inflation rate by 0.15 percentage points in 2004.

The inflation outlook indicates that the Danish inflation rate continues to stay around the European Central Bank's medium term inflation target of below but close to 2 per cent. Danish medium-term inflation is tied to the euro area's inflation objective through the fixed exchange rate against the euro.

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

	2003		2004		2005
	Aug.	Dec.	Aug.	Dec.	Dec.
-----Percentage changes from previous year -----					
Private consumption .....	1.3	1.2	3.0	3.0	2.5
Total government demand .....	-0.3	-0.1	0.8	0.9	0.6
of which government consumption .....	-0.2	0.1	0.7	0.7	0.5
of which government investment .....	-2.9	-2.9	2.0	3.2	2.0
Residential construction .....	5.0	8.5	2.0	2.5	-0.5
Fixed business investment .....	0.6	-3.1	3.6	1.0	3.1
Domestic demand exc. stock building ....	0.9	0.4	2.5	2.0	2.0
Changes in stock building <sup>1)</sup> .....	0.3	0.4	0.1	0.0	0.0
Total domestic demand .....	1.2	0.8	2.5	2.0	2.0
Exports of goods and services .....	2.9	-0.4	4.5	3.9	4.6
Of which manufactures .....	3.7	-2.0	5.5	5.0	5.3
Total demand .....	1.8	0.4	3.2	2.6	2.8
Imports of goods and services .....	2.8	0.6	5.4	3.8	4.1
Of which goods <sup>2)</sup> .....	4.1	2.9	5.6	4.3	4.1
Gross domestic product .....	1.4	0.4	2.3	2.1	2.3
GDP at factor costs .....	1.4	0.6	2.2	1.9	2.4
Of which in non-agricultural sector <sup>3)</sup> .....	1.5	0.5	2.4	2.0	2.7
-----Changes in thousand persons -----					
Labour force .....	8	-10	8	12	6
Employment .....	-17	-35	15	8	18
of which in the private sector .....	-17	-35	12	5	16
of which in the public sector .....	0	0	3	3	3
Unemployment .....	25	25	-7	4	-13
-----Percentage changes from previous year -----					
Merchandise export prices .....	0.1	-0.5	0.3	0.0	0.1
Merchandise import prices .....	-0.3	-1.8	0.4	0.0	0.9
Merchandise terms of trade .....	0.4	1.3	-0.1	-0.1	-0.7
Real estate prices for one-family houses ..	3.5	3.5	1.5	2.0	1.5
Consumer price index .....	2.3	2.1	1.9	1.8	1.7
Hourly earnings .....	3.9	3.9	3.7	3.7	3.7
Real disposable income, private sector .....	2.0	0.2	1.8	2.8	3.5
Real disposable income, households .....	2.3	1.6	2.6	3.2	2.2
Productivity in non-agricultural sector ....	2.5	2.4	1.7	1.9	1.9
-----Per cent -----					
Savings ratio in the private sector .....	29.4	27.7	29.1	27.6	28.3
10-year government bond .....	4.2	4.3	4.8	4.7	5.1
30-year government bond .....	5.3	5.5	5.7	5.6	5.9

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.

Source: Statistics Denmark and own calculations.

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

	2003		2004		2005
	Aug.	Dec.	Aug.	Dec.	Dec.
	----- Percentage changes from previous year -----				
Merchandise export prices .....	0.1	-0.5	0.3	0.0	0.1
Merchandise import prices .....	-0.3	-1.8	0.4	0.0	0.9
Merchandise terms of trade .....	0.4	1.3	-0.1	-0.1	-0.7
Real estate prices for one-family houses ..	3.5	3.5	1.5	2.0	1.5
Consumer price index .....	2.3	2.1	1.9	1.8	1.7
Hourly earnings .....	3.9	3.9	3.7	3.7	3.7
Real disposable income, private sector .....	2.0	0.2	1.8	2.8	3.5
Real disposable income of households .....	2.3	1.6	2.6	3.2	2.2
Productivity in non-agricultural sector .....	2.5	2.4	1.7	1.9	1.9
	----- Per cent -----				
Savings ratio in the private sector .....	29.4	27.7	29.1	27.6	28.3
10-year government bond .....	4.2	4.3	4.8	4.7	5.1
30-year government bond .....	5.3	5.5	5.7	5.6	5.9
	----- Bill. Dkr. -----				
Current account .....	43.5	37.0	46.0	44.0	51.0
Government net lending .....	16.6	18.5	18.7	20.7	21.5
Unemployment (thousands) .....	170	170	163	173	160
	----- Per cent -----				
GDP growth in OECD countries .....	1.5	1.3	2.5	2.5	2.8
International market growth .....	4.0	4.2	7.5	7.6	7.1
Dollar exchange rate (Dkr. Per US\$) .....	6.6	6.6	6.6	6.3	6.3
Price of oil (Us-dollar per barrel) .....	27.5	28.5	25.0	26.5	25.0
Price of oil (Dkr. per barrel) .....	182.3	188.4	164.5	167.2	157.8

Source: Statistics Denmark and own calculations.

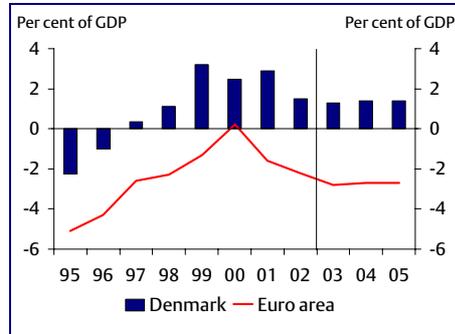
## 2. The fiscal stance and government finances

The general government surplus is estimated to decline from 1.6 per cent of GDP in 2002 to 1.3 per cent of GDP in 2003 due to adverse cyclical factors. With the expected strengthening of activity, the surplus is expected to edge up to 1.4 per cent of GDP in 2004, despite the scheduled first phase of income tax reductions. The surplus is projected to remain unchanged at 1.4 per cent of GDP in 2005, *cf. table 1.4 and figure 2.1a*.

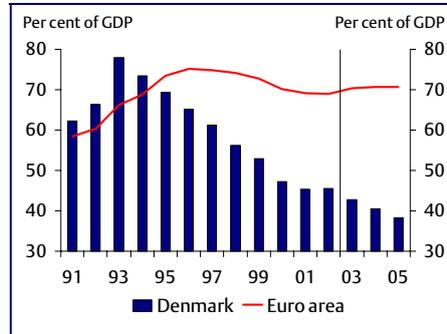
The surplus estimates for 2003-04 have been revised slightly upwards since the August survey (by 0.1 percent of GDP in each year), despite lower activity and employment estimates. The improvement owes notably to higher projected revenues from the tax on pension fund investment returns in line with more buoyant equity markets, and to higher corporate tax revenues, notably from oil and gas extraction activities in the Danish North Sea.

General government gross debt (EMU definition) is projected to decline from 45.5 per cent of GDP at end-2002 to 38.3 per cent of GDP by end-2005, *cf. figure 2.1b*.

**Figure 2.1a. General government surplus in Denmark and the euro area**



**Figure 2.1b. Gross public debt ratio in Denmark and the euro area**



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

The structural surplus is estimated at 2.1 per cent of GDP in 2003, up from 1.6 per cent of GDP in 2002. The structural improvement mainly reflects lower net interest expenditures and, to a lesser extent, discretionary fiscal policy, *cf. figure 2.2*, notably the assumption of near-zero real public consumption growth.

The structural surplus is set to edge down to 1.8 per cent of GDP in 2004 and 1.6 per cent of GDP in 2005. The decline mainly reflects income tax reductions, which more than off-set the positive effects from declining net interest payments and low growth in real public consumption<sup>2</sup>.

The fiscal effect, which measures the first year impact on GDP from discretionary fiscal policy, is estimated at 0.4 per cent in 2004, *cf. table 2.1*. The positive demand effects stem notably from the 2004 income tax reductions, lower indirect taxes (on spirits, cigarettes, soft drinks etc.) and the effects of the tax freeze, which for given nominal tax rates in Danish kroner terms implies lower specific excise duties and property value taxes in real terms. At the same time, lower interest rates are expected to boost GDP-growth by 0.7 percentage points in 2004 and by 0.4 percentage

<sup>2</sup> The decline in the structural surplus in 2005 also owes to technical factors, including the composition of demand. In 2005, the slow growth of private consumption relative to GDP implies comparatively low revenue growth from indirect taxes. The structural balance calculation does not take into account such compositional effects.

points in 2005<sup>3</sup>. Hence, the combined effects of fiscal policy and past interest rate reductions contribute significantly to boost demand and activity growth in 2004.

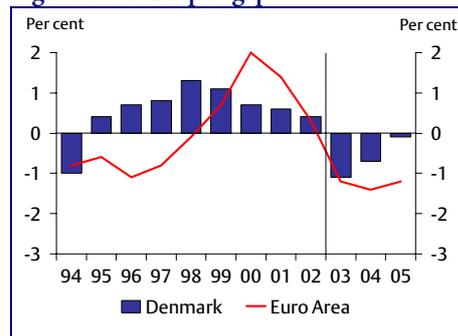
**Table 2.1. Activity effect of fiscal policy and structural saving effects**

	1999	2000	2001	2002	2003	2004
	----- Per cent -----					
Fiscal effect.....	0.2	-0.1	0.5	0.3	-0.1	0.4
	----- Percentage points -----					
Cumulated activity effect of economic policy....	-1.1	-1.1	-0.2	-0.1	-0.3	0.2
Effects of interest rates.....	1.1	0.8	-0.1	0.3	0.5	1.0

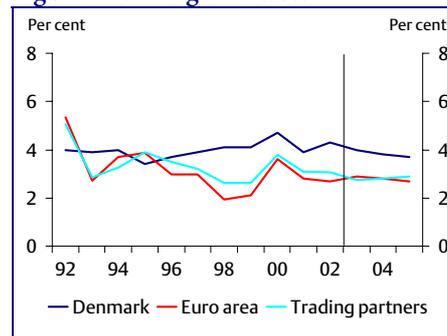
Source: Statistics Denmark and own calculations.

The estimated level of the output gap is expected to be around -1 per cent of GDP in 2003, *cf. figure 2.2a*. The annual wage increases are higher than abroad even though the spread is expected to narrow, *cf. figure 2.2b*. Given the estimated output gap in 2003, the positive fiscal policy impact appears appropriate in relation to the cyclical position. Since the output gap is projected to narrow and broadly close by 2005, business cycle considerations do not justify a more expansionary fiscal stance in 2004.

**Figure 2.2a. Output gap**



**Figure 2.2b. Wage increases**



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

<sup>3</sup> With the assumed increase in interest rates underlying the forecasts, the contribution of interest rate changes to GDP growth in 2005 is reduced to 0.1 per cent of GDP.

A cornerstone of the Danish medium-term economic policy strategy is that fiscal policy must be sustainable. Fiscal sustainability implies that the tax and expenditure policies and assumptions towards 2010 can be sustained subsequently, with no need for further policy adjustment to prevent public debt from rising beyond bounds<sup>4</sup>.

Fiscal policy is estimated to be sustainable given the stated targets and assumptions for employment, public services and taxes towards 2010.

Sustainability requires in particular:

- *Tight expenditure control.* The projection assumes real public consumption growth of 0.5 percent per year from 2005 to 2010.
- *Structural reforms to raise employment.* New measures that can raise (structural) employment by 50-55,000 persons (roughly 2 percent) are needed. The government is working on initiatives to improve the labour market attachment of immigrants, speed up students' flow through the education system, and reducing sick leave. A Welfare Commission has been established, which has to analyze – and make concrete proposals for – reforms, that can strengthen labour supply and employment.

In 2003-05 the general government structural surplus remains within the target range of 1½ to 2½ percent of GDP for the average surplus to 2010, which is estimated to be consistent with fiscal sustainability.

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<sup>4</sup> The sustainability of fiscal policy is based on specific policy targets and assumptions for employment, public-sector services and taxes towards 2010, whereas stylised “policy-neutral” assumptions are employed for the years following 2010, cf. *Convergence Programme for Denmark, November 2003*.