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Commission's assessment of the 2005 update of the convergence programme of Denmark

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Denmark was submitted in October 1998. In accordance with the Regulation, the Council delivered an opinion on it on 1 December 1998 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good

1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website:

times should be achieved, while “major structural reforms” with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services’ autumn 2005 forecast, the code of conduct², the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the convergence programme of Denmark and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

Assessment

The 2005 update of the Danish convergence programme, covering the period up to 2010, was submitted to the Commission on 30 November 2005. The programme is based on the Budget Bill for 2006 adopted by Parliament on 14 December. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. The programme has gaps in the compulsory and optional data prescribed by the new code of conduct (especially projected world and EU GDP growth for certain years are missing). The Danish programme does not explicitly define the medium-term objective as required by the code of conduct.

Over the last decade, GDP growth has averaged some 2 per cent, while inflation has broadly followed euro area inflation. Employment growth has picked up in recent years and unemployment is close to its lowest level in the last decade. Real GDP growth rates of 2.4% are foreseen for 2005 and 2006, as domestic demand, in particular private consumption, is projected to continue to grow vigorously. For 2007-2008, GDP growth is set markedly lower, as a technical assumption, followed by growth of around 2% annually in the remainder of the programme period. The macroeconomic scenario underlying the update is broadly in line with the Commission services’ evaluation in the autumn 2005 forecast in the period until 2006 and reflects on the whole cautious assumptions. In particular for the years 2007 and 2008, the growth outlook is on the cautious side, with growth assumptions below the Commission services’ estimates of potential growth. The update expects inflationary pressures to remain relatively subdued, which appears realistic.

Since the inception of the ERM II mechanism on 1 January 1999, there have been no tensions affecting the exchange rate of the krone. Deviations of the exchange rate from the central parity have been much smaller than the official band width and the short-term interest rate differential to the euro area has continued to be small. This reflects the confidence in the fixed exchange rate regime. The macroeconomic policy framework continues to ensure low long-term bond yields. The yield differential between long-term government bonds in Denmark and the euro area has declined to almost zero basis points, at times it has been slightly negative.

On 17 February 2005, in its opinion the Council endorsed the budgetary strategy presented in the 2004 update of the convergence programme of Denmark. Regarding the

2 Opinion of the Economic and Financial Committee on the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 11 October 2005.

2005 budgetary implementation, the 2004 update targeted a 2.2% of GDP general government surplus for 2005 while the current update forecast a 3.6% surplus for a similar GDP growth outlook. Overall, revenues have come in better than expected, including revenues from the pension fund yield tax as well as from oil and gas exploitation, but also expenditures have developed in a contained way.

The medium-term budgetary strategy aims at maintaining high primary surpluses throughout the programme period so as to ensure a rapid decline in the debt ratio. The strategy is based on expenditure restraint, with the objective of keeping the annual growth of real public consumption at 0.5%, maintenance of the tax freeze and of a balance budget requirement for local governments. This update foresees the general government surplus narrowing from a peak of 3.6% of GDP in 2005 (driven by exceptional factors, including revenues from the pension fund yield tax and oil and gas-related activities) to just over 3% in both 2006 and 2007 and declining slightly thereafter to reach 2.9% of GDP at the end of the programme period. The time profile of the primary surplus is similar, with a reduction by 2 percentage points of GDP over the programme period (1 percentage point if the exceptionally high surplus of 2005 is left out of the comparison). Both expenditure and revenue ratios are on a gradually declining trend over the projection period. This reflects a fall in tax revenues (partly due to the tax freeze), expenditure restraint based on limiting real public consumption growth to 0.5% annually and a decline in the interest burden. Compared with the previous programme, the new update over-achieves the planned path of the general government balance against a broadly unchanged macroeconomic scenario. Denmark uses the transition period for the implementation of the Eurostat decision of 2 March 2004 on the classification of funded second-pillar pension schemes; the estimated impact of implementing the decision is to reduce the general government balance by around 1% of GDP annually.

Commission services' calculations on the basis of the programme according to the commonly agreed methodology show that the structural surplus (i.e. the cyclically-adjusted surplus net of one-off and temporary measures) eases from its peak of 3½% of GDP in 2005 to around 2¾% of GDP in 2006 before rising to 3¼% of GDP thereafter. The decline in the structural position between 2005 and 2006, when the output gap improves from slightly negative in 2005 to marginally positive in 2006, largely reflects the exceptionally high revenues in 2005 followed by an expected normalisation of these revenues in 2006.

The programme targets a structural balance (taking into account the use of the transition period of the Eurostat decision mentioned above) of between 1½% and 2½% of GDP over the programme period. For the purpose of this assessment, this is taken to be the programme's MTO.

As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of about 1/2% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is significantly more demanding than implied by the debt ratio and average potential output growth in the long term. The programme explains that the MTO is set at a more demanding level than required by the Pact to set a sound basis for long-term fiscal sustainability through a rapid debt reduction.

On balance, the risks to the budgetary projections in the update appear to be on the positive side, mainly as GDP growth may be higher than expected, mainly due to the technically-assumed low GDP growth in 2007 and 2008. Hence, GDP growth and the budgetary outcome in these years could be better than projected in the programme. A negative risk is the compliance with the target of limiting the growth of real public consumption, against the background of a mixed track record.

Taking account of the balance of risks to the budgetary targets, the budgetary strategy outlined in the programme seems sufficient to ensure that the MTO identified therein is maintained by a large margin throughout the programme period. It is also sufficient to provide a safety margin against breaching the 3% of GDP deficit reference value with normal macroeconomic fluctuations in each year. As regards the requirement for countries that have already reached their MTO to avoid pro-cyclical fiscal policies in good times, the structural balance deteriorates by 0.3 percentage point of GDP between 2005 and 2010, with a fall of 0.8 percentage point between 2005 and 2006 when the output gap turns from slightly negative to marginally positive. Taking into account the exceptional revenues recorded in 2005, the budget package for 2006 and the uncertainties attached to the calculation of the output gaps, Denmark's fiscal policy probably cannot be characterised as pro-cyclical.

The reclassification of the second-pillar funded pension schemes from spring 2007 (when the transition period for implementing the March 2004 Eurostat decision on the matter expires) would not materially alter this assessment. Overall, the budgetary position is sound and the budgetary strategy provides a good example of fiscal policies run in compliance with the pact.

At 36% of GDP in 2005, gross debt is already well under the 60% of GDP Treaty reference level. According to the update, the debt ratio is projected to fall further over the programme horizon, to stand at 21½ % of GDP in 2010. Mainly due to larger primary balances, this is a more rapid debt reduction than foreseen in the previous update.

With regard to the sustainability of public finances, Denmark appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The level of gross debt is currently comfortably below the 60% reference value and is projected to remain below the reference value throughout the projection period. The strategy of putting sustainability concerns at the heart of fiscal policy-making, including containing pension expenditure and involving accumulation of assets, contributes positively to the long-term outlook for public finances. The currently very favourable budgetary position contributes to limit the projected budgetary impact of ageing populations and the medium-term budgetary plans are consistent with low risks to public finance sustainability.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines, included in the integrated guidelines, for the period 2005-2008. In particular, Denmark respects its MTO. However, new measures have not been specified to achieve the assumed increase in employment of close to 2% of the labour force by 2010.

The National Reform Programme of Denmark, submitted on 26 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) improving labour supply to ensure the long-term sustainability of public finances and (ii) improving the efficiency of the public sector. The budgetary implications of the actions outlined in the National

Reform Programme are reflected in the budgetary projections of the convergence programme. The measures in the area of public finances envisaged in the convergence programme are in line with the actions foreseen in the National Reform Programme.

Comparison of key macroeconomic and budgetary projections¹

		2004	2005	2006	2007	2008	2010
Real GDP (% change)	CP Nov 2005	2.0	2.4	2.4	1.1	1.6	2.1
	COM Nov 2005	2.1	2.7	2.3	2.1	n.a.	n.a.
	CP Nov 2004	2.2	2.5	1.3	1.9	1.8	1.8
HICP inflation (%)	CP Nov 2005	0.9	1.6	2.0	1.3	1.9	1.8
	COM Nov 2005	0.9	1.7	2.0	1.9	n.a.	n.a.
	CP Nov 2004	1.2	1.7	1.6	1.7	n.a.	1.6
Output gap (% of potential GDP)	CP Nov 2005²	-0.8	-0.3	0.1	-0.7	-0.9	-0.6
	COM Nov 2005 ⁶	-1.3	-0.6	-0.4	-0.4	n.a.	n.a.
	CP Nov 2004 ²	-0.6	-0.1	-0.5	-0.4	n.a.	-0.4
General government balance (% of GDP)	CP Nov 2005	2.3	3.6	3.1	3.2	2.7	2.9
	COM Nov 2005	2.9	3.7	3.0	2.7	n.a.	n.a.
	CP Nov 2004	1.4	2.2	1.8	1.9	2.2	2.2
Primary balance (% of GDP)	CP Nov 2005	4.7	5.6	4.7	4.1	3.5	3.7
	COM Nov 2005	5.3	5.8	4.9	4.4	n.a.	n.a.
	CP Nov 2004	4.5	4.8	4.5	4.6	n.a.	4.4
Cyclically-adjusted balance (% of GDP)	CP Nov 2005²	2.8	3.8	3.0	3.6	3.3	3.3
	COM Nov 2005	3.8	4.1	3.3	3.0	n.a.	n.a.
	CP Nov 2004 ²	1.7	2.0	2.0	2.0	n.a.	2.3
Structural balance ³ (% of GDP)	CP Nov 2005⁴	2.6	3.6	2.7	3.3	3.3	3.3
	COM Nov 2005 ⁵	3.6	3.9	3.0	2.7	n.a.	n.a.
	CP Nov 2004	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	CP Nov 2005	42.3	35.6	31.7	28.9	26.5	21.5
	COM Nov 2005	43.2	36.0	33.0	31.5	n.a.	n.a.
	CP Nov 2004	42.3	39.4	37.4	35.3	33.1	28.8

Notes:

¹The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact, the general government balance would be 1.3% of GDP in 2004, 2.7% in 2005, 2.1% in 2006, 2.2% in 2007, 1.7% in 2008 and 1.9% in 2009, while government gross debt would be 43.5% of GDP in 2004, 36.8% in 2005, 32.9% in 2006, 30.1% in 2007, 27.7% in 2008 and 22.7% in 2010.

²Commission services calculations on the basis of the information in the programme.

³Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

⁴One-off and other temporary measures taken from the programme (0.2% of GDP in 2004 and 2005 and 0.3% in 2006 and 2007; all deficit-reducing).

⁵One-off and other temporary measures taken from the Commission services' autumn 2005 forecast (0.2% of GDP in 2004 and 2005 and 0.3% in 2006 and 2007; all deficit-reducing).

⁶Based on estimated potential growth of 1.9%, 2.1%, 2.1% and 2.1% respectively in the period 2004-2007.

Source:

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations