

Denmark

GDP is already above potential, but growth is set to continue at 3% in 2006 and 2½ per cent in 2007, with all demand components growing solidly. However, with capacity constraints already visible and wage and price inflation set to pick up in due course, domestic firms are likely to lose market share.

Expansionary monetary conditions are currently adding stimulus to the already buoyant economy. Hence, fiscal policy should be tighter and it is urgent to increase labour supply both by strengthening work incentives and by making it easier for foreigners to enter sectors like construction.

The economy accelerated strongly in the summer of 2005, with GDP increasing by 3% for the year as a whole – much faster than estimated potential GDP growth of 1½ to 2%. The expansion has become broadly based with buoyant consumption and residential construction being re-enforced by growing business investments and exports, as order books have filled up rapidly since mid 2005. However, with strong domestic demand, imports have grown more briskly than exports. Housing investment expanded by 13% in 2005 on the back of exceptionally strong house prices increases. The output gap is estimated to have closed in late 2005, and labour shortages are appearing, notably in construction. So far, wage growth has been modest, and while consumer price inflation has increased from its 2004 trough, it has not gone much above 2%. In a recent survey, however, 44% of firms reported rising wage pressures *versus* only 2% reporting declining wage pressures.

The expansion is strong and broadly based

With continued slack in the euro area, monetary conditions received *via* the fixed exchange rate regime will add excessive stimulus. At 2½ per cent, short-term interest rates are currently well below estimates of a neutral rate. Over the projection period, short rates should be expected to rise gradually in line with the European Central Bank's policy rate, reaching 3¾ per cent at the end of 2007. Nevertheless, with an increasing positive output gap and growing wage and inflationary pressures, the difference between actual interest rates and those appropriate for domestic stabilisation is likely to remain.

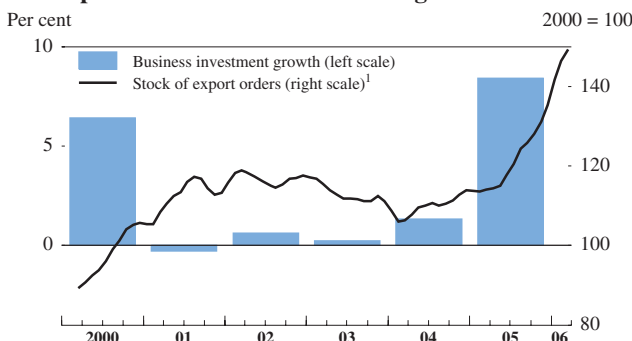
Monetary conditions are excessively stimulative

Capacity constraints are likely to limit the ability of domestic firms to meet growing demand in both home and export markets, as it has been the case in periods like the mid 1990s when the business cycle was desynchronised from that of the country's trad-

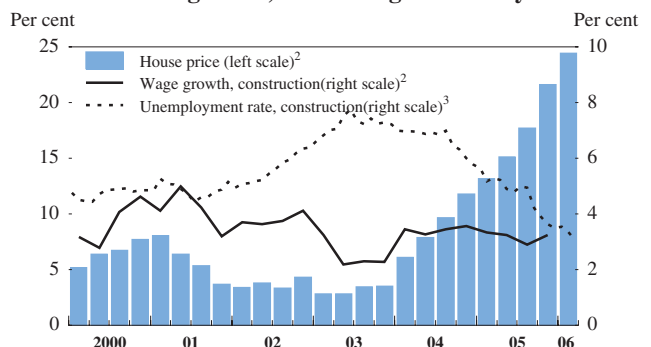
Capacity constraints lead to loss of market share

Denmark

Export and business investments gain momentum



Housing boom, but no wage reaction yet



1. Manufacturing, 3 months moving average, current prices.

2. Year-on-year percentage change.

3. Among persons with unemployment insurance. This tends to be higher than the Labour Force Survey concept used for the aggregate economy.

Source: Statistics Denmark.

StatLink: <http://dx.doi.org/10.1787/456308554210>

Denmark: Demand, output and prices

	2002	2003	2004	2005	2006	2007
	Current prices DKK billion	Percentage changes, volume (2000 prices)				
Private consumption	652.3	1.6	3.4	3.8	2.3	2.7
Government consumption	360.2	0.2	1.5	1.3	1.3	0.8
Gross fixed capital formation	270.8	2.0	4.5	9.0	8.7	5.8
Final domestic demand	1 283.3	1.3	3.1	4.2	3.4	2.9
Stockbuilding ¹	9.3	-0.6	0.2	-0.1	0.1	0.0
Total domestic demand	1 292.6	0.6	3.3	4.0	3.4	2.9
Exports of goods and services	648.9	-1.2	2.7	7.9	6.2	4.9
Imports of goods and services	568.7	-1.7	6.4	10.8	8.1	6.1
Net exports ¹	80.1	0.1	-1.3	-0.8	-0.5	-0.4
GDP at market prices	1 372.7	0.7	1.9	3.1	3.0	2.4
GDP deflator	—	1.9	2.2	2.6	2.0	2.9
<i>Memorandum items</i>						
Consumer price index	—	2.1	1.2	1.8	1.7	2.6
Private consumption deflator	—	2.0	1.7	2.0	2.0	2.6
Unemployment rate ²	—	5.3	5.5	4.8	4.2	3.9
Household saving ratio ³	—	3.3	3.0	-0.8	-1.0	-1.8
General government financial balance ⁴	—	-0.1	1.7	4.0	3.3	3.8
Current account balance ⁴	—	3.2	2.3	3.2	2.7	2.5

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see OECD Economic Outlook Sources and Methods, (<http://www.oecd.org/eco/sources-and-methods>).

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

2. Based on the Labour Force Survey, being ½-1 percentage point below the claimant-count unemployment rate.

3. As a percentage of disposable income, net of household consumption of fixed capital.

4. As a percentage of GDP.

Source: OECD Economic Outlook 79 database.

StatLink: <http://dx.doi.org/10.1787/356118422342>

ing partners. With an output gap moving from -2% of GDP in 2004 to a projected +1½ per cent of GDP in 2007, while growth abroad is around potential, negative net exports are likely to continue even though external demand is strong. The aggregate effect of the trade boycott following newspaper cartoons of the prophet Muhammad, is likely to be negligible, as only 2% of Danish exports go to the Middle East.

GDP growth remains well above potential

GDP is projected to continue growing at 3% in 2006 before slowing to around 2½ per cent in 2007. Consequently, private sector employment is set to expand and unemployment to fall further below its structural level. Wage and price inflation is expected to pick up, although with a lag. Imports should be growing somewhat faster than exports, and the trade balance should deteriorate. If oil prices remain at their current high level, revenues from corporate taxation of North Sea oil exploration will continue to boost the fiscal balance with the surplus remaining not far below the 2005 record of 4% of GDP. The effect of fiscal policy on economic activity is estimated to be broadly neutral, although tightening would be warranted.

House prices could pose risks

Gradually rising short- and long-term interest rates will help dampen the housing boom. A soft landing is still the central scenario, but if house prices continue going up at the exceptional pace seen lately, then a subsequent downward correction cannot be excluded. However, continued growth in employment and earnings should cushion household spending even if wealth effects from house price increases dissipate or reverse modestly. Large-scale mortgage equity withdrawals during 2005 are waiting to be spent. Meanwhile, even if falling a bit, house prices are so much above construction costs that residential investment should remain attractive.

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TABLE OF CONTENTS

Editorial: Still buoyant overall, but vulnerable.....	vii
I. General assessment of the macroeconomic situation.....	1
Overview	1
The expansion is strengthening	2
But tensions keep building.....	7
A still benign outlook	17
Challenges for macroeconomic policy	23
Appendix I.1: Revised OECD supply-side estimates: a capital services approach.....	36
Appendix I.2: The medium-term reference scenario	45
II. Developments in individual OECD countries and selected non-member economies...	51
United States	51
Japan	55
Euro area.....	59
Germany	63
France	67
Italy	71
United Kingdom	75
Canada	79
Australia	83
Austria	85
Belgium	87
Czech Republic	89
Denmark.....	91
Finland.....	93
Greece	95
Hungary.....	97
Iceland	99
Ireland	101
Korea	103
Luxembourg.....	105
Mexico	107
Netherlands	109
New Zealand.....	111
Norway.....	113
Poland	115
Portugal.....	117
Slovak Republic	119
Spain	121
Sweden.....	123
Switzerland.....	125
Turkey	127
Brazil.....	129
China.....	133
India	137
Russian Federation.....	140
III. Future budget pressures arising from spending on health and long-term care.....	145
Appendix: Cost containment policies in OECD countries: An overview.....	154
Special chapters in recent issues of OECD Economic Outlook.....	157
Statistical Annex.....	159
Country classification	160
Weighting scheme for aggregate measures.....	160
Irrevocable euro conversion rates.....	160
National accounts reporting systems and base-years.....	161
Annex Tables.....	163
Boxes	
I.1. How weak has business investment been in this cycle?	4
I.2. Why are bond yields so low?.....	14
I.3. Are house prices nearing a peak?.....	18
I.4. Policy and other assumptions underlying the projections.....	23
I.5. How does globalisation affect inflation?	26
I.6. How has fiscal policy contributed to stabilising cyclical fluctuations?.....	32
I.7. Assumptions underlying the medium-term reference scenario	49
III.1. Exogenous assumptions underlying the projections	147

Tables

I.1. The expansion should continue	1
I.2. Real wages lag productivity	3
I.3. Labour markets are recovering	6
I.4. Strong GDP growth in the first two quarters of 2006.....	21
I.5. Strong world trade growth and widening external imbalances	22
I.6. The upswing is broadening	24
I.7. Not enough fiscal consolidation	31
I.8. Trend growth decomposition with revised method	43
I.9. Medium-term reference scenario summary	46
I.10. Fiscal trends in the medium-term reference scenario	47
I.11. Growth in total economy potential output and its components	48
III.1. Summary projections of public health and long-term care spending	146
III.2. Decomposition of projected GDP per capita	148

Figures

I.1. The expansion has recently become less lopsided.....	3
I.2. Energy markets are hot	8
I.3. Imports of oil producers lag exports.....	9
I.4. Current account imbalances are growing and official reserves soaring	10
I.5. Financial conditions are still easy.....	16
I.6. Business confidence is improving	20
I.7. Most policy rates are moving up	25
I.8. The link between local demand pressure and inflation is weakening	25
I.9. Factors shaping core inflation.....	28
I.10. Headline and underlying inflation are converging	29
I.11. Fiscal targets keep moving	34
I.12. Total economy potential and output gaps.....	37
III.1. Total increase in health and long-term care spending by country, 2005-2050.....	147
III.2. Demography effects on health care spending.....	149
III.3. Demography effects on long-term care spending.....	150

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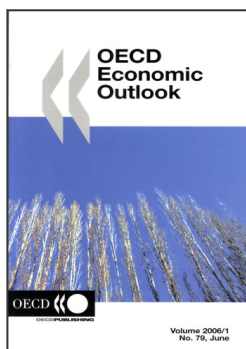
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Conventional signs

\$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mb/d	Million barrels per day	Trillion	Thousand billion
..	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
–	Irrelevant		



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