August 1999

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Denmark: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Denmark on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Denmark, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Denmark; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

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DENMARK

Staff Report for the 1999 Article IV Consultation

Prepared by Staff Representatives for the 1999 Consultation with Denmark

Approved by Michael C. Deppler and Carlos Muñiz

July 15, 1999

- The discussions were held in Copenhagen during May 28–June 7, 1999.
- The Danish representatives included Ms. Jelved, Minister of Economic Affairs, Ms. Andersen, Governor of the National Bank, other senior officials, and representatives of the Economic Council, the trade unions, the employers' confederation, the confederation of industries, and the banking community.
- The staff team comprised Messrs. Vittas (head) and Gagales, Ms. Kodres and Ms. Krajnyák (all EU1). Mr. Hansen, Executive Director for Denmark, participated in the discussions.
- Denmark has accepted the obligations of Article VIII, Sections 2, 3 and 4. The exchange system is free of restrictions on the making of payments and transfers for current international transactions, except for a few restrictions notified under Decision 144 (Appendix II).
- Denmark has subscribed to the Special Data Dissemination Standard (Appendix III).
- A minority coalition government, led by the Social Democrats, has been in power since early 1993. The next elections are due in March 2002.
- Denmark is on the 24-month consultation cycle. An interim staff visit took place in February 1998.

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EXECUTIVE SUMMARY

Background

- The Danish economy continued to perform well in 1997–98. Real GDP growth, at about 3 percent, remained above potential and unemployment fell to 6 percent, less than half its level only five years earlier. Inflation was also subdued, at just below 2 percent. However, capacity constraints became more evident and the external current account switched into a deficit of 1.4 percent of GDP (the first since 1989). Also, wage inflation, at 4½ percent, remained higher than in the main trading partner countries.

- Economic policies aimed to slow the growth of domestic demand, while sustaining a rapid pace of structural reform. Assisted by the large fiscal dividends deriving from a buoyant economy and declining structural unemployment, the general government budget balance strengthened to show a surplus of 1 percent of GDP in 1998. Meanwhile, the krone weathered well episodes of turbulence, although at the cost of temporary increases in short-term interest rates and a widening of risk premia relative to euro area currencies.

- Real GDP growth is projected to slow to 1.3 percent in 1999, as a result of a new package of restrictive measures that began to be implemented at the beginning of the year. Inflation is forecast to edge up (to 2½ percent) owing mainly to increased environmental taxes, while the external current account deficit is expected to narrow, in response mainly to the sharp slowdown of domestic demand.

Policy Issues and Staff Assessment

- The recent policy package should prove adequate to ensure the elimination of excess pressures on resources, notwithstanding the subsequent unanticipated easing of monetary conditions. It should also help alleviate, over the medium term, supply-side constraints to non-inflationary growth and strengthen the external position. However, it is important to avoid slippages in policy implementation, such as have occurred repeatedly in the last few years, and to keep open the option of additional fiscal tightening in the budget for 2000, should excess demand persist. At the same time, it would be appropriate to allow full play to the automatic stabilizers, if growth slows more sharply than currently foreseen.

- Public expenditure overruns have not prevented a sharp improvement in the financial posistion of the general government. However, they have had the undesirable effect of crowding out private employment and exports. With this effect likely to increase under the current tight labor market conditions, the need to improve expenditure discipline and to seek ways to moderate the underlying strong growth in the demand for public services has become more pressing.

- The authorities' commitment to exchange rate stability has fostered fiscal and wage discipline and contributed over the longer run to Denmark's comparatively strong economic performance. While this commitment does not in itself prevent episodes of pressure on the krone, such episodes are likely to be short-lived, provided that the underlying fundamentals remain strong.

- Denmark has been remarkably successful in improving the performance of the labor market. The recent tax and labor market reforms should yield further significant benefits in coming years. Nevertheless, further measures will be needed to meet the official medium-term goals for raising employment and participation rates, which is essential to address longer-term challenges to the public finances without major cuts in entitlements or increases in the tax burden.

- Progress in improving the functioning of product markets has been far less impressive. However, the new Competition Act should breathe new life into competition policy, especially if steps are taken to strengthen enforcement of its provisions.

I. Introduction

1. The Danish economy performed well in the four years up to the last Article IV consultation in early 1997: real GDP growth, at an average annual rate of 3.2 percent, was well above potential and the EU average; the unemployment rate fell dramatically; inflation was subdued; and the external current account remained in surplus. Although the expansion was jump-started by a modest amount of fiscal stimulus in 1993–94 (which was meant to be withdrawn in the subsequent four years), it derived most of its strength from a pronounced relaxation of monetary and financial conditions. This reflected mainly the decline in global long-term interest rates and a narrowing of spreads relative to Germany; it contributed to a massive refinancing of outstanding mortgages and a surge in housing prices, consumer spending and residential investment. Nevertheless, the recovery was broadly based as exports and business investment also registered large gains (Figures 1 and 2). The period was also characterized by the implementation of far-reaching reforms in the labor market that helped to keep inflationary pressures in check, notwithstanding the drop in unemployment to levels well below those previously considered to be compatible with low wage and price inflation.

Figure 1. Output and Domestic Demand
(In billions of krone, 1990 prices)

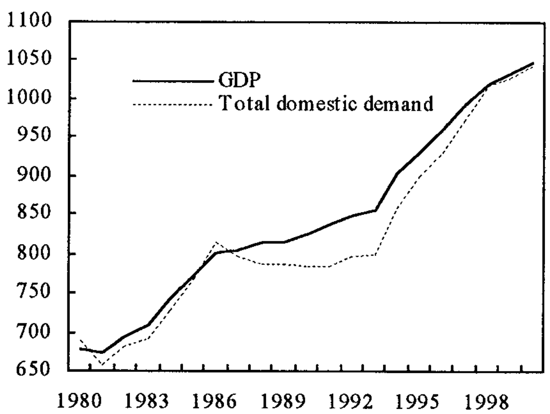
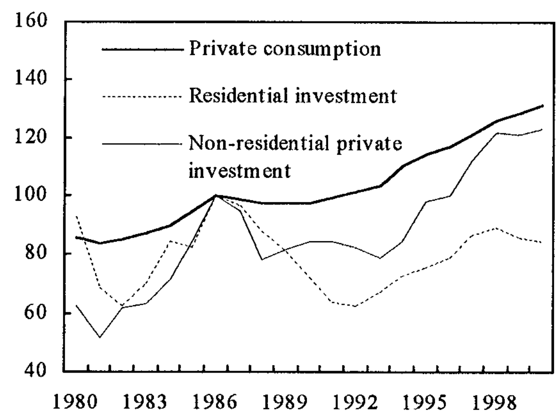


Figure 2. Components of Domestic Demand
(At constant prices, 1986=100)



2. In concluding the last Article IV consultation, on February 24, 1997, Executive Directors commended the authorities for their commitment to macroeconomic stability and structural reform which had contributed to Denmark's impressive overall economic performance. While noting that there was considerable uncertainty about the amount of slack in the economy, Directors felt that the budget for 1997 embodied a sufficient degree of restraint to ward off the risk of overheating. They also expressed support for the authorities' policy of maintaining a stable exchange rate of the krone against the core ERM currencies. Directors emphasized that achievement of the strong employment growth envisaged for the medium term would require additional reforms to strengthen incentives to work.

3. Economic growth in the subsequent two-year period remained strong, but the composition of demand became progressively less well-balanced, capacity constraints emerged, and the current account of the balance of payments moved into deficit. The increase in real GDP, at an average of about 3 percent in 1997–1998, remained above potential (estimated at about 2.5 percent). As a result, resource utilization rose and by 1998 output was clearly above potential. Growth was more than fully accounted for by buoyant private final demand, which was bolstered by continued declines in real long-term interest rates, strong growth in employment and wage earnings, rising asset prices, the implementation of some large infrastructural projects, and (in late1998) a substantial accumulation of stocks (which may have been, at least in part, involuntary). By contrast, the foreign balance made an exceptionally large negative contribution to growth, as a sizable part of the rise in domestic demand spilled over into imports, while exports weakened progressively. Public spending on goods and services (which is highly labor-intensive) grew at a more moderate pace than other components of domestic demand; it was, nevertheless, much stronger than intended, contributing to the unsustainably rapid pace of expansion and the upward pressure on wages.

Table 1. Contribution of Demand Components to GDP Growth (1993–2000)

(In percent)

	1993–96	1997	1998	1999 1/	2000 1/
Domestic demand	3.7	4.4	4.7	1.0	1.4
Private demand	2.9	4.1	4.1	0.6	1.1
Private fixed investment	0.9	2.1`	1.5	-0.2	0.2
Private consumption	1.8	1.8	1.8	1.2	1.0
Public demand	0.8	0.3	0.5	0.5	0.3
Net exports	-0.5	-1.3	-1.7	0.2	0.1
Exports	1.6	2.1	0.0	0.6	0.9
Imports	-2.1	-3.4	-1.7	-0.3	-0.8
GDP growth	3.2	3.1	2.9	1.3	1.5
Output gap (as percent of potential GDP)	-1.2	0.8	1.2	0.2	-0.4

1/ Staff forecast.

4. Registered unemployment continued to decline rapidly, reaching about 6 percent of the labor force in 1998 (Figure 3).[1] This was the lowest rate of unemployment since the 1970s and about 1 percentage point below structural unemployment (which is estimated by the authorities to have declined from over 10 percent in the early 1990s to about 7 percent in

[1] On an internationally comparable basis, the unemployment rate is estimated to be about 5 percent, among the lowest in industrial countries.

1998). While in the early years of the recovery the sharp drop in unemployment had reflected, in part, a substantial withdrawal of workers from the labor force, induced by generous early retirement and subsidized leave schemes, its recent further decline is due entirely to sustained rapid growth in employment (Figure 4). This exceeded 2 percent in each of the last two years,

Figure 3. Employment, Participation, and Unemployment Rates

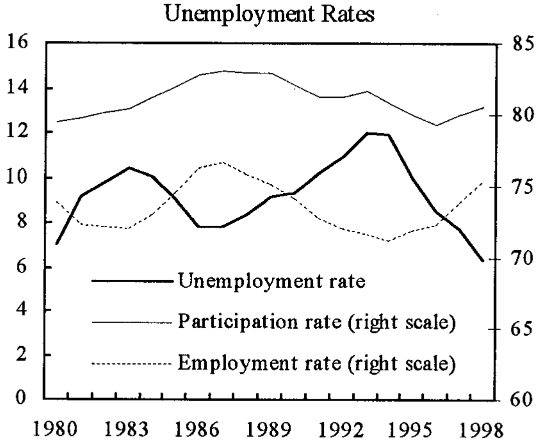
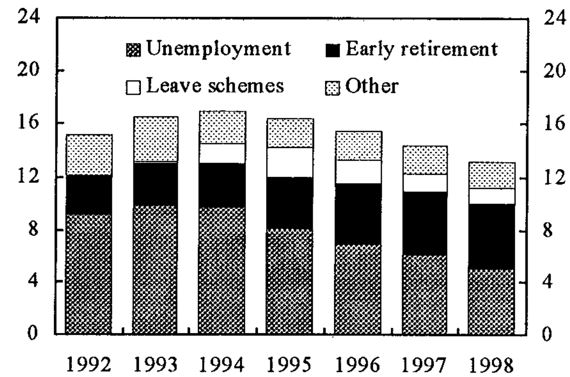
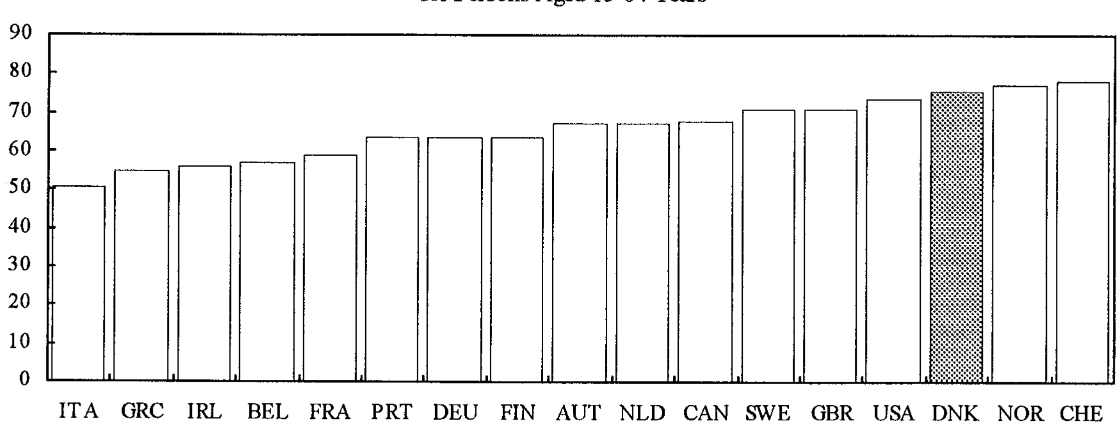


Figure 4. Unemployment and Labor Market Measures
(In percent of working age population)



bringing the cumulative increase since 1993 to 7.5 percent and raising the employment ratio to 75 percent, an exceptionally high ratio by the standards of most other EU countries and high even by comparison with the United States (Figure 5). By contrast, the number of people

Figure 5. Employment/Population Ratios for Persons Aged 15-64 Years



on leave schemes fell markedly, as steps were taken to tighten the eligibility requirements and compensation provisions of various such schemes. Although this contributed to renewed growth in the labor force, labor shortages emerged and the rate of increase in average hourly wage earnings accelerated, to about 4½ percent in 1998. Moreover, for the first time in many years, Denmark experienced a prolonged strike in 1998, providing further evidence of the tightness of the labor market.[2]

5. The rate of increase in the CPI remained subdued in 1997-98, at just below 2 percent, assisted by falling commodity prices and (during 1998) a modest nominal effective appreciation of the krone (Figure 6). However, **core** inflation, which is a better measure of underlying inflationary pressures as it excludes *inter alia* the effects of changes in import prices and indirect taxes, was somewhat higher and the differential against the EU average, measured on the basis of the EU harmonized CPI indices, widened. Also, housing prices continued to rise more rapidly than consumer prices, although in real terms they barely moved above their previous peak in the mid-1980s (Figure 7).

Figure 6. Inflation (Percent change in CPI)

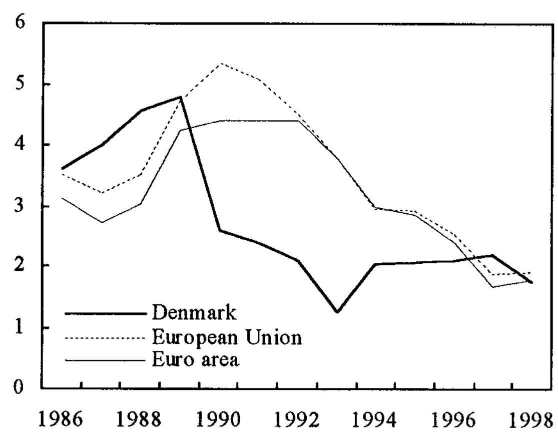
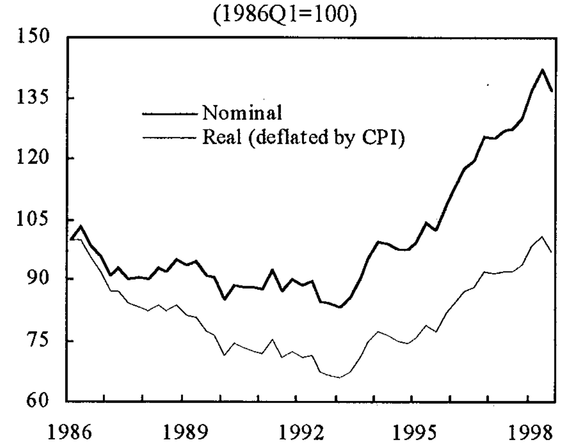


Figure 7. Prices of Single Family House (1986Q1=100)



6. The external current account continued to deteriorate, switching into a deficit of 1.4 percent of GDP in 1998, the first deficit since 1989 (Figure 8). The deterioration reflected the overly robust growth of domestic demand, but also the weakness of foreign demand and supply disruptions caused by the strike. Market share losses were quite large in 1997–98, owing mainly to the emergence of capacity constraints at home, although some erosion of the international competitive position of the tradables sector also contributed (Figures 9 and 10).

[2] The strike, which was ended only after legislative intervention, affected about a fourth of the labor force and is estimated to have reduced GDP in 1998 by about ½ of 1 percent.

Figure 8. Balance of Payments

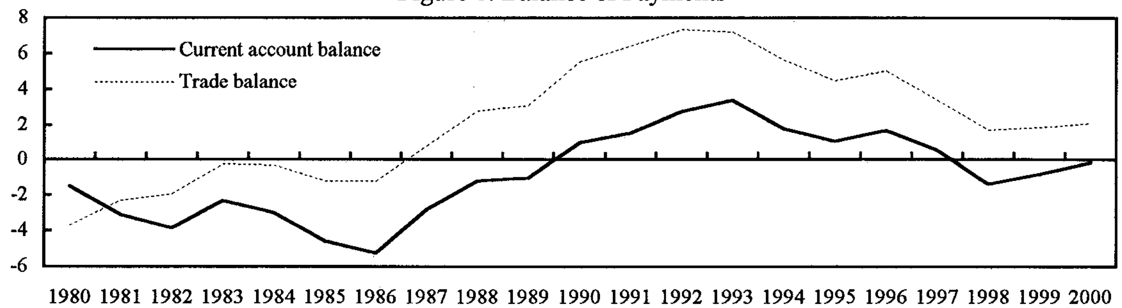


Figure 9. Trade Performance (1985=100)

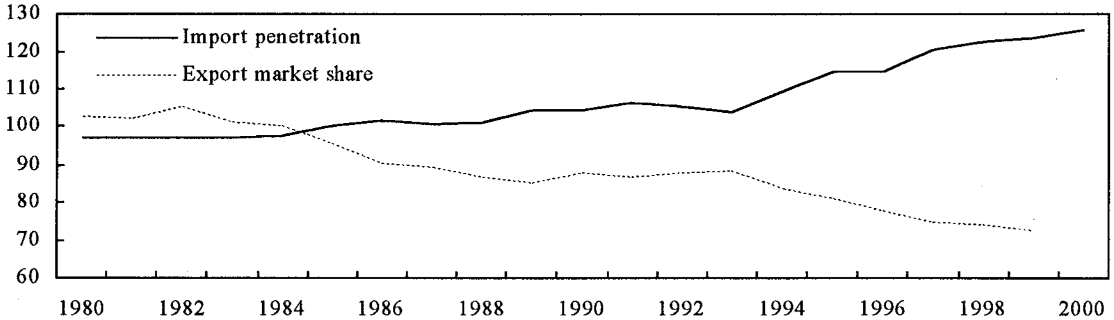
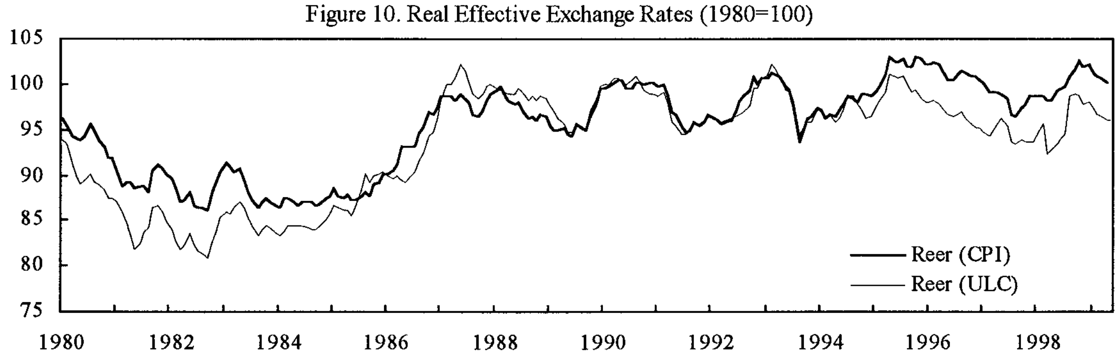


Figure 10. Real Effective Exchange Rates (1980=100)



In addition, in contrast to most other industrial countries, Denmark experienced a net worsening of the terms of trade in 1997–98.[3] From a savings-investment perspective, the

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[3]From a terms of trade perspective, Denmark did not benefit from the decline in energy prices as it is a small net exporter of energy products. In addition, prices for exports of pork (which account for 7 percent of merchandise exports) fell significantly in 1998, partly offsetting the decline in the prices of commodity imports.

weakening of the external current account reflected a deterioration in the net financial position of the private sector—which swung from a small surplus in 1996 to a deficit of 2.6 percent of GDP in 1998—owing both to the continued buoyancy of investment and to a decline in household saving induced by low real after-tax interest rates and wealth effects from the rise in house prices. By contrast, the financial position of the government sector continued to strengthen (see below).

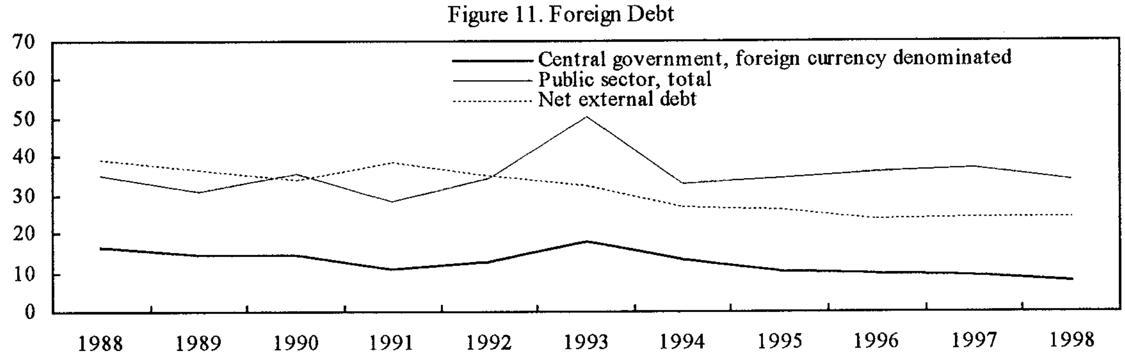
Table 2. External Current Account

	1994-96	1997	1998	1999 1/	2000 1/
Volume of exports (goods and services, percentage change)	5.4	5.5	0.1	1.5	2.4
Volume of imports (goods and services, percentage change)	8.9	9.8	4.7	0.9	2.1
Terms of trade (percentage change)	0.9	-1.2	0.4	-0.1	0.4
Current account balance (percent of GDP)	1.5	0.5	-1.4	-1.1	-0.7

1/ Staff forecasts.

7. Private capital flows exhibited considerable volatility, especially during periods of turbulence in international financial markets in 1998. The key features were a continued large acquisition of foreign securities by residents (equivalent to 4½ percent of GDP in 1998); a substantial decline in inward portfolio investment (coupled with a switch in its composition from government bonds to mortgage bonds induced by relative yield considerations); and a large increase in net FDI inflows in 1998; which reflected the privatization of Tele Danmark. The privatization proceeds were used to retire public foreign currency-denominated debt, which fell to 8 percent of GDP at the end of 1998 (compared with 18 percent of GDP at the end of 1993) (Figure 11). After rising sharply in 1997, gross official reserves were on a declining trend during the first nine months of 1998 but then recovered strongly, reaching a new peak in mid-1999, equivalent to roughly 4½ months of imports of nonfactor goods and services.

Figure 11. Foreign Debt



8. With monetary policy constrained by the exchange rate regime (see below), fiscal policy in 1997–98 continued to aim at moderating the growth of demand. As in previous years, the withdrawal of fiscal stimulus fell short of announced intentions. Nevertheless, the general government financial balance continued to improve, moving to a surplus in 1998, a year ahead of schedule (Figure 12). The structural fiscal balance also strengthened significantly, reflecting in part reductions in interest payments, but mainly the large fiscal dividends from the progressive decline in structural unemployment. In relation to GDP, transfer payments to households continued to fall, lowering the overall public expenditure ratio to below 56 percent, compared with 61 percent in 1994 (Table 3). The gross public debt also fell to 56 percent of GDP at end-1998, from 78 percent of GDP four years earlier. However, the tax ratio has hardly changed in recent years (Figure 13).

Figure 12. General Government Financial Balance

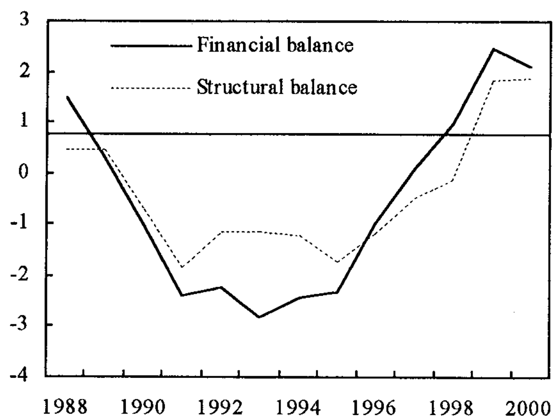


Figure 13. General Government Gross Debt

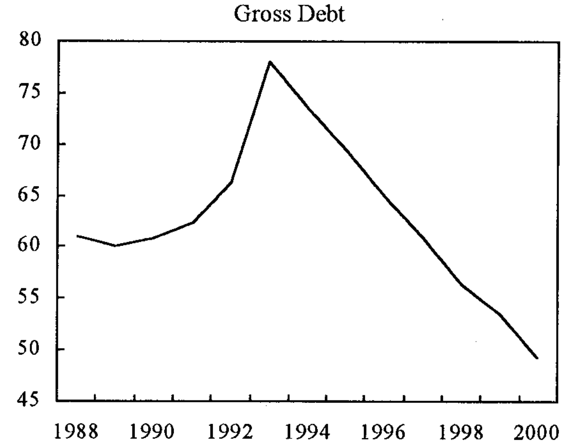


Table 3: General Government Finances

(In percent of GDP)

	1994	1995	1996	1997	1998	1999
Expenditure	60.9	59.6	58.8	57.1	55.6	54.7
Tax revenue	49.0	49.2	49.6	49.2	49.1	50.2
Total revenue	58.5	57.3	57.8	57.3	56.5	57.1
Budget balance 1/	-2.4	-2.3	-1.0	0.1	1.0	2.5
Structural balance 2/	-1.2	-1.7	-1.2	-0.5	-0.1	1.8
Primary structural balance 2/	2.0	1.3	1.7	2.3	2.3	4.1
Fiscal impact 3/	0.5	-0.2	0.7	0.0	-0.5	-0.4

1/ Staff forecasts for 1999 and 2000.

2/ Staff estimates.

3/ Danish Ministry of Finance estimates. They measure the impact of discretionary changes in tax and expenditure policies on GDP, taking into account estimated first-year multiplier effects.

9. Monetary policy retained its focus on maintaining exchange rate stability (against the core ERM currencies until end-1998 and against the euro since then). With nominal and real long-term interest rates in core Europe declining, and spreads vis-à-vis Germany tending to narrow, Danish bond yields were on a declining trend during 1997 and 1998, providing further impetus to demand and contributing to the fairly rapid growth in bank lending to the private sector. However, short-term rates were on a flat trend for most of this period and rose significantly in May, and again in August and September 1998, when the krone came under downward pressure in the context of unsettled international currency markets (Figure 14). This compelled the National Bank to undertake substantial (nonsterilized) interventions in the foreign exchange market and to raise its interest rates. In the process, spreads relative to other ERM countries widened considerably (Figure 15). Although stable market conditions were restored quickly after each of these episodes, allowing the increases in official rates to be gradually reversed, short-term spreads are still above their pre-May 1998 levels. Meanwhile, the krone appreciated modestly in nominal effective terms, leading to some firming of monetary and financial conditions during the course of 1998 (Figures 16 and 17). Nevertheless, these conditions remained more accommodative than might be warranted by the comparatively advanced stage of the business cycle in Denmark and eased further in the first half of 1999, broadly in line with the evolution of interest and exchange rates in the Euro area.

Figure 14. Interest Rates

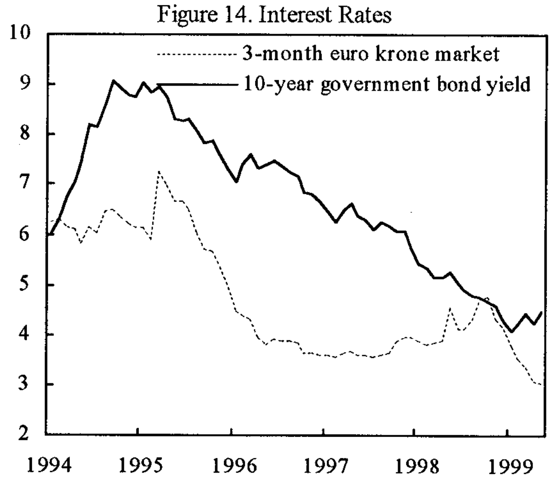


Figure 15. Differentials with Germany

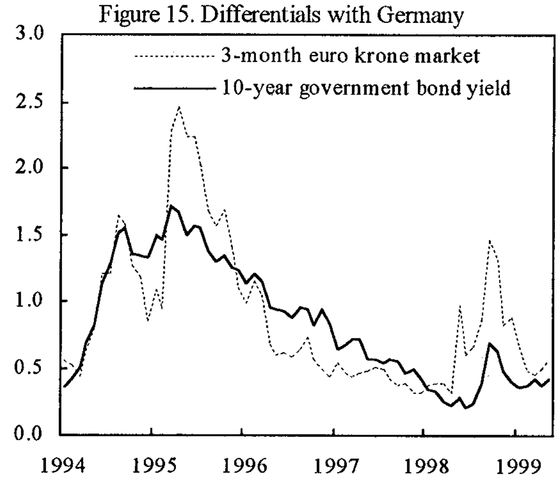


Figure 16. Nominal Effective Exchange Rate (1990=100)

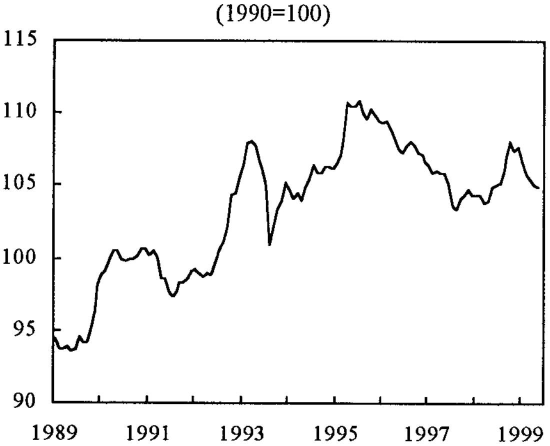
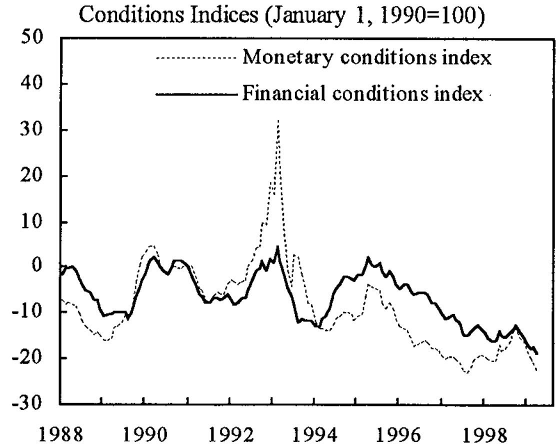


Figure 17. Monetary and Financial Conditions Indices (January 1, 1990=100)



10. Budgetary plans for 1999 aim to impart a modest restrictive impact on aggregate demand. This is estimated by the authorities to be equivalent to about 0.5 percent of GDP. However, the projected improvement in the primary structural surplus indicates that the effect could be larger.[4] The budget incorporates the first installment of a package of measures (announced in June 1998) intended to restrain consumer and housing demand and to strengthen incentives to work and to save (Box 1). The main feature of the so-called Whitsun package, which is to be implemented gradually over the four years to 2002, is a major reform of the personal income tax system (the third since 1986); it entails large cuts in the tax value of interest deductions, a cut in the effective marginal tax rates applying to low wage earners, and various other measures to broaden the tax base and reduce distortions in the tax treatment of capital income. In addition, the package includes significant increases in environmental taxes, a lowering of the corporation tax rate and some adjustments in property taxation. Finally, a 1 percentage point increase in mandatory contributions to the supplementary pension Fund, which had been introduced as a temporary measure in 1998, was made permanent. The general government surplus is projected by the staff to widen to 2.5 percent of GDP in 1999. The improvement will reflect, apart from the impact of the measures outlined above, a further reduction in transfer payments relative to GDP, and subdued growth in other outlays, which should help contain the nominal growth in overall public spending to 2.5 percent.

11. Economic growth is projected by the authorities to slow markedly in 1999 and 2000, to 1.3 percent. The forecast is predicated on the assumption that the recent policy package will lead to a sharp slowdown in the growth of domestic demand. It also takes into account the weakening of foreign demand (which had accounted for a perceptible deceleration in the pace of growth already during the second half of 1998). Inflation is expected to edge up slightly, reflecting increases in environmental taxes that come into effect at the beginning of 1999. Given the economic slowdown, which is projected to lead to a slight increase in the rate of unemployment in late 1999, and recent settlements indicating some abatement in wage claims, wage inflation is projected to moderate gradually. It is likely, however, to remain somewhat higher than in competitor countries, contributing to a further erosion of competitiveness. Nevertheless, the external current account deficit is expected to fall to below 1 percent of GDP, owing mainly to the projected sharp deceleration of import growth and a

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[4] The projected increase in the primary structural surplus from 1998 to 1999 (1.8 percent of GDP) is much larger than the official estimate of the restrictive impact of the budget on aggregate demand. Part of the difference is accounted for by the decision to convert the temporary 1 percent contribution to the supplementary pension fund, which was an off-budget item, into a permanent source of revenue. This change is unlikely to have any impact on demand in 1999. In addition, the reduction in transfer payments and increase in revenues associated with ongoing progress in lowering structural unemployment and raising participation rates is not viewed in the official calculations as a discretionary policy change that restrains demand, although it does, of course, contribute to strengthening the structural budgetary position.

small gain in the terms of trade. Staff forecasts are broadly similar, although they envisage a somewhat higher growth rate in 2000 (1.5 percent) on account of a more favorable assessment of external demand.

Box 1. The Whitsun Package of Fiscal Measures

Adopted in June 1998 in the wake of buoyant domestic demand and a widening external current account deficit, the package comprises tax measures aimed at stimulating private savings, strengthening work incentives, and cooling off the housing market. These measures are scheduled to be phased in over a period of four years (1999–2002) and will result in a significant drop in the marginal effective tax rates on labor incomes as well as a steep reduction in the tax value of interest deductions.

Personal taxes

- The tax value of deductible interest payments is lowered gradually from 46.4 percent in 1998 to 32.6 percent in 2002.
- The base tax rate is lowered gradually from 8 percent in 1998 to 5.5 percent in 2002.
- The deductibility of transport expenses is raised for taxpayers in low-income brackets.
- The tax rates for company cars are raised.

Property taxes

- The tax on imputed rent of owner-occupied homes is replaced by a local government tax of 1 percent of the property value, but 3 percent of the amount exceeding DKr 2,150,000.

Pensions

- The 1 percent extra contribution to the Labor Market Supplementary Pension Fund (ATP), which was introduced in 1998 as a temporary measure, becomes permanent.

Other measures

- The real-interest tax is converted to a tax rate of 26 percent on returns.
- A tax on equity returns of 5 percent is introduced.
- A number of energy taxes are raised.
- VAT credit periods are amended and depreciation rules adjusted.

12. The risks to the forecast are evenly balanced. On the upside, there is a risk that the effect of the policy package will be offset, to a greater extent than has been allowed in the forecast, by the subsequent easing of monetary conditions. There is also a risk that public consumption will continue to exceed budgetary allocations. On the other hand, the weakening of consumer confidence in the wake of the introduction of the Whitsun package (Figure 18) and the apparently involuntary character of the inventory buildup in late 1998 could signal a more pronounced slowdown in domestic demand than currently foreseen. The risk of a hard landing would also increase if there is any renewed deterioration in the growth prospects of Denmark's European trading partners.

13. The authorities' Convergence Plan, which was submitted to the EU Commission in November 1998, envisages that economic growth in the period through 2005 will average about 2 percent per year (Figure 19). This is about 1 percentage point below the average of

Figure 18. Consumer Confidence

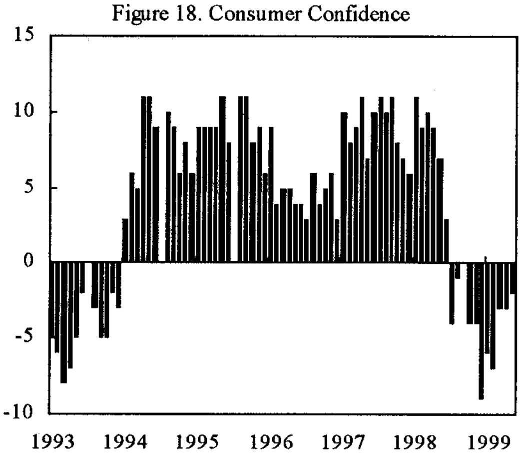
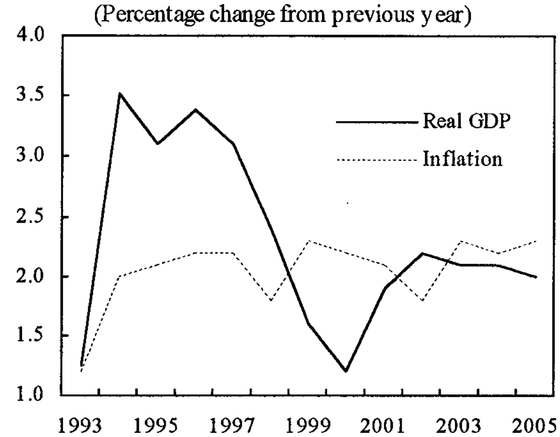
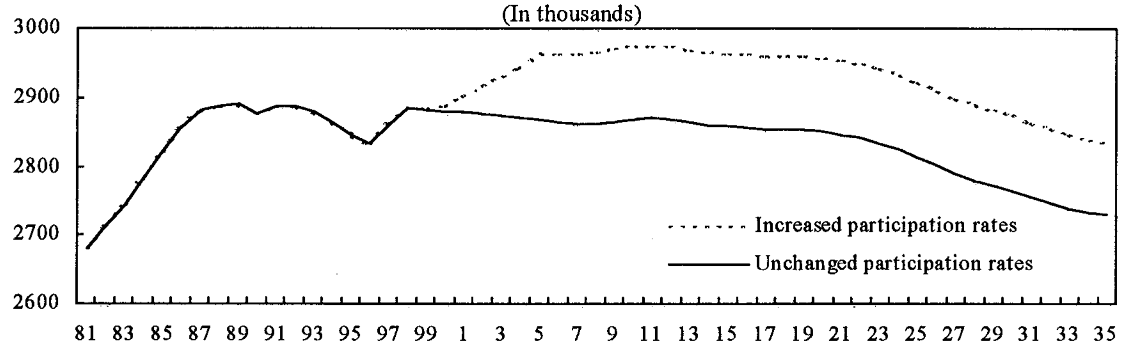


Figure 19. Growth and Inflation
(Percentage change from previous year)



the past five years, reflecting the expected sharp slowdown in the growth of the labor force, on account of demographics, the judgment that economic slack has been fully absorbed, and the rather limited scope that is still available for further lowering structural unemployment (Figure 20). Although the authorities expect the ongoing reforms of the tax system and the labor market to contribute to a significant increase in the labor force participation rate, they accept that the labor supply constraint to growth will be tighter that in the recent past, implying a heightened need for policies that ensure adequate restraint in the growth of demand.

Figure 20. Labor Force Projections
(In thousands)



II. Report on the Discussions

14. The discussions focused on four sets of issues: (a) the effectiveness of the Whitsun package in eliminating excess demand and alleviating medium-term constraints to growth; (b) the medium- and longer-term challenges confronting fiscal policy; (c) the challenges confronting monetary policy under the ERM2 arrangement; and (d) the progress being made in increasing the flexibility of labor and product markets.

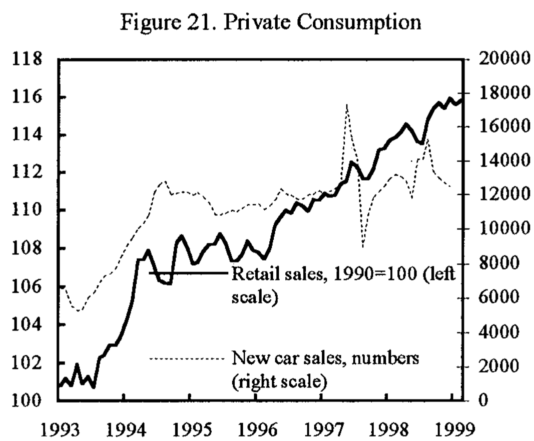
A. Effectiveness of the Whitsun Package

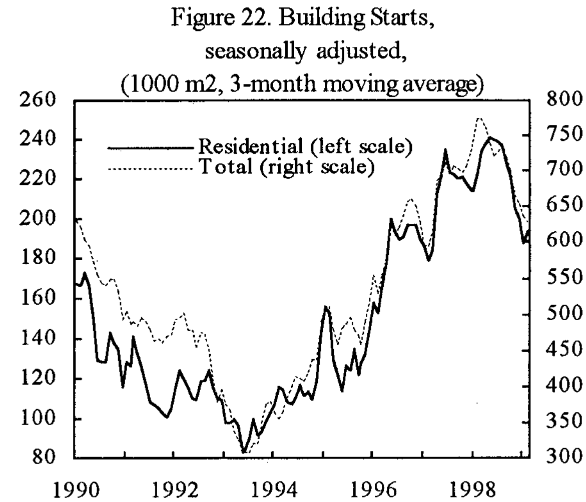
15. The authorities noted that the Whitsun package was introduced in mid-1998, at a time when pressure on productive capacity was clearly excessive and when there was concern that, under the impetus of declining bond yields and strong increases in real wage earnings, domestic demand would continue to grow at an unsustainable pace. It had been expected that the package would have a quick effect in discouraging residential investment and dampening house price inflation and consumer spending. In the event, this expectation had not materialized, partly because monetary conditions had continued to ease. Nonetheless, officials remained confident that the Whitsun package would meet its short-term objective of restraining demand and ensuring a soft landing. They noted that in the early months of 1999 new car registrations and retail sales had fallen, housing starts had dropped, and the rise in house prices had slowed (Figures 21 and 22).

16. The staff acknowledged that it was reasonable to expect domestic demand to decelerate sufficiently to eliminate concerns about overheating. Indeed, in light of the recent rather abrupt weakening of business and consumer confidence, it was even possible that the tightening of policy might prove excessive.[5] In general, the uncertainties still clouding short-term macroeconomic prospects suggested some need for flexibility in the conduct of fiscal

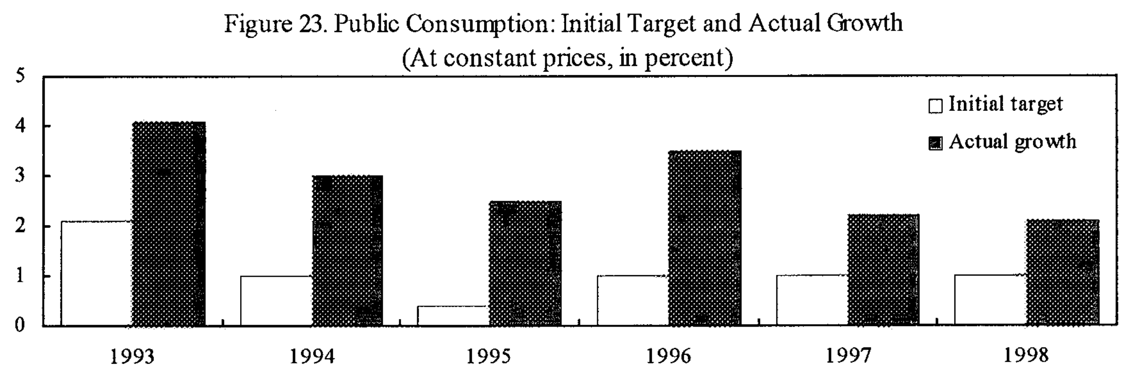
[5] The authorities did not consider that there was any significant risk of overkill. They noted that the unemployment rate had continued to fall, albeit slowly, in recent months and that

(continued…)





policy, including a readiness to reconsider the intention to introduce a neutral budget in 2000. In this context, the staff expressed concern about the observed tendency toward public consumption overruns, which could undermine short-term demand management objectives and jeopardize the medium-term goal of easing the labor constraint on economic growth (Figure 23). It inquired whether any steps had been taken or were under consideration to avoid such overruns in the future.

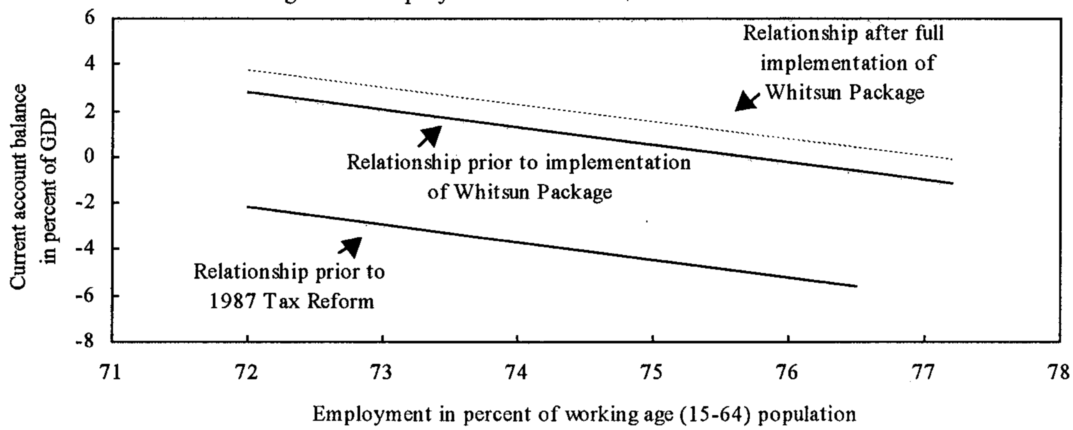


business and consumer surveys were not reliable leading indicators of demand. In any case, the fiscal stabilizers are powerful in Denmark and would help moderate any precipitous fall in private demand.

17. Officials noted, in response, that the overruns were accounted for mainly by the local authorities, which are responsible for the administration of about two thirds of public consumption outlays and employ about a fourth of the Danish labor force. Although the local authorities enjoy a relatively high degree of autonomy, they accept the need to coordinate their expenditure and tax policies with the central government which is responsible for setting overall fiscal policy. Such coordination is sought through negotiated agreements which include recommendations on the level of local expenditures and local taxation. The latest such agreement covers the four-year period to 2002 (rather than just the year ahead as was the case previously). It aims to contain the real annual rate of growth of local authority spending to 1 percent, which is less than half the actual rate of increase over the past few years, and to avoid any rise in local tax rates. Indeed, the agreement provides some incentives to induce local authorities to lower tax rates. It also incorporates improved monitoring mechanisms and an understanding that overspending in any particular year will be offset in the subsequent year. However, it has no provision for sanctions in the event of persistent overruns. Moreover, there is a risk that the expenditure targets might not prove adequate to cover prospective increases in the demand for local authority services (see Section B below). Accordingly, officials recognized that it was still unclear whether the new agreement would ensure sufficient fiscal discipline. They concurred with the staff that additional steps would need to be explored to streamline public spending and tighten control mechanisms.

18. The authorities stressed that a key medium-term objective of the tax reform measures embodied in the Whitsun package was to improve the net financial position of the private sector and thereby to strengthen the external position. Their analysis suggested that the recent weakening of the current account could be ascribed primarily to the relative strength of domestic demand, which had contributed to the sizable losses in market shares that Danish producers had experienced. However, the persistence of distortions in the tax system that encouraged households to borrow rather than to save had been a significant underlying factor. By comparison, the impact of the recent modest erosion of wage competitiveness was small. The Whitsun package, which entailed *inter alia* a significant increase in real after-tax interest rates, would ameliorate the net financial position of the private sector by both strengthening the incentive to save and discouraging excessive investment in real estate. Moreover, with the support of labor market reforms, the package would enhance incentives to work and thus ease wage pressures. On the basis of fairly robust econometric relationships, it was expected that over the medium term the structural measures of the package would improve the trade-off between employment and the balance of payments by the equivalent of about 1 percent of GDP (Figure 24).

Figure 24. Employment Ratio and Current Balance



19. The staff recognized that the tax and labor market reforms should raise net private savings and contribute to a moderation of wage inflation, thereby buttressing the external position. It noted, however, that these effects were likely to emerge only slowly. In the meantime, and given the decentralized wage bargaining arrangements, demand restraint would need to play a key role in containing wage pressures, arresting the erosion of wage competitiveness, and ensuring renewed progress toward the official objective of lowering (and eventually eliminating) net external debt.

B. Medium- and Longer-Term Challenges Confronting Fiscal Policy

20. The authorities observed that Denmark had already fulfilled the medium-term target of the Stability and Growth Pact, which requires EU member states (including those not participating in EMU) to achieve a fiscal position close to balance or in surplus no later than in the year 2001. Indeed, sensitivity analysis suggested that the structural budgetary position was strong enough to allow the Danish economy to sustain negative shocks in the future without running the risk of breaching the excessive deficit provision (a budget deficit in excess of 3 percent) of the Pact.[6] However, merely satisfying the criteria of the Pact was not considered by the authorities to be a sufficiently ambitious target. Their own objective, as stated in the 1998 Convergence Plan, was to ensure a solid budget surplus, averaging about 3 percent of

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[6] Staff calculations, based on historical experience regarding the amplitude of cyclical fluctuations in economic activity, indicate that a general government financial surplus of about ½ percent of GDP would be needed to allow Denmark to respect the excessive deficit provisions of the Pact even in the event of a protracted cyclical downturn. The calculations take into account the fact that the sensitivity of the budget to cyclical conditions is one of the highest among EU countries.

GDP over the period to 2005 (Figure 25). This would allow the public debt to be reduced to below 40 percent of GDP by 2005. The objective was to be pursued mainly through continued structural reforms that would lower the number of benefit recipients from 1997 to 2005 by about 150,000, raise employment by 170,000, and reduce the unemployment rate to 5 percent. Together with prospective declines in interest payments on the public debt, these targets would make it possible to lower the public expenditure to GDP ratio by about 7 percentage points while also leaving some room to lower the tax ratio by about 2 percentage points (Figure 26).

Figure 25. General Government Balance and Current Account (In percent of GDP)

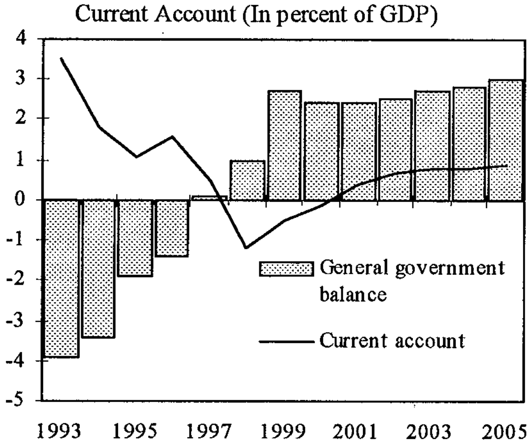
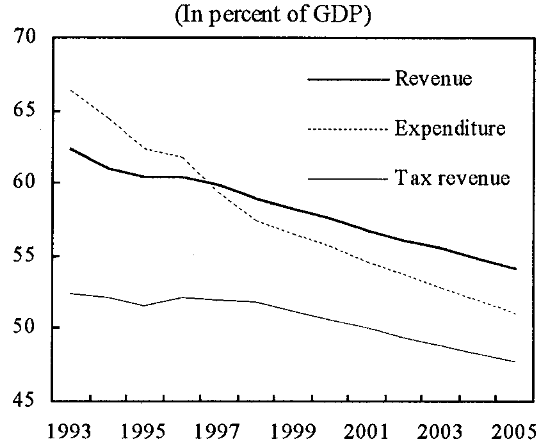


Figure 26. General Government (In percent of GDP)



21. The staff acknowledged that Denmark had reached an enviable fiscal position and commended the authorities for setting even more ambitious targets for the period ahead. It cautioned, however, that meeting the targets for the reduction in the number of benefit recipients and growth in employment could prove difficult without additional measures to discourage early retirement and strengthen work incentives. The staff also wondered whether it might not be preferable to use some of the prospective fiscal surpluses in the period ahead to effect larger reductions in the overall tax burden, which was comparatively high in Denmark. Officials responded that, because of demographic and other pressures on the public finances, the fiscal surpluses were not expected to persist over the longer term. In view of this, and the priority attached to maintaining the level of benefits broadly unchanged, the authorities did not consider it appropriate to use the fiscal surpluses to finance large permanent reductions in the tax burden.

22. The authorities added that the fiscal room for maneuver in coming years will be constrained by the need to address two longer-term challenges to the public finances. The first of these challenges stems from the aging of the population. The ratio of persons aged 60 years or more, relative to those aged 15–59, is projected to rise from about 30 percent in 1998 to

50 percent in 2035. In the absence of policy changes, public expenditure on pensions and health care, relative to GDP, would increase by about 6 percentage points.[7] The strategy that the authorities had developed in order to finance this additional spending entails two central elements: an increase in the labor force participation ratio by about 2½ percentage points; and the gradual elimination of the public debt. The first element of the strategy would generate additional revenue and offset much of the prospective increase in transfer payments while the reduction in debt service payments associated with a lowering of the debt would cover the balance.

23. The second longer-term challenge to the public finances reflected the high income elasticity of the demand for various services currently provided by the public sector to households, either free of charge or at user fees that cover only a small fraction of their cost. As a result, expenditure on these services, which include education, health care and child care, was expected to rise more rapidly than GDP. This trend would be exacerbated by the prospective growth in the proportion of the population entitled to such services as well as by the need to improve the quality of the services being provided. Since the supply of these services is labor-intensive, public employment would need to rise markedly to meet the growth in demand. Other things equal, this in turn would put strong upward pressure on the tax burden, with potentially adverse effects on work incentives and overall economic performance.[8] Officials noted that although a precise strategy for addressing this challenge had not yet been worked out, efforts had been made to heighten the public's awareness of the fiscal and economic implications of current arrangements and of the need to seek rational solutions. They agreed with the staff that the eventual solutions would need to include greater reliance on user fees, in order to discourage wasteful demand, as well as intensified efforts to raise productivity in the provision of these services. In addition, the scope for increasing the role of the private sector in supplying these services, would be explored.

C. Monetary and Financial Sector Issues Under ERM2

24. Denmark is one of four European Union member countries that did not join EMU at its start, even though it was among the first to fulfill all the convergence criteria. The authorities pointed out that the decision not to join the single currency was dictated by the

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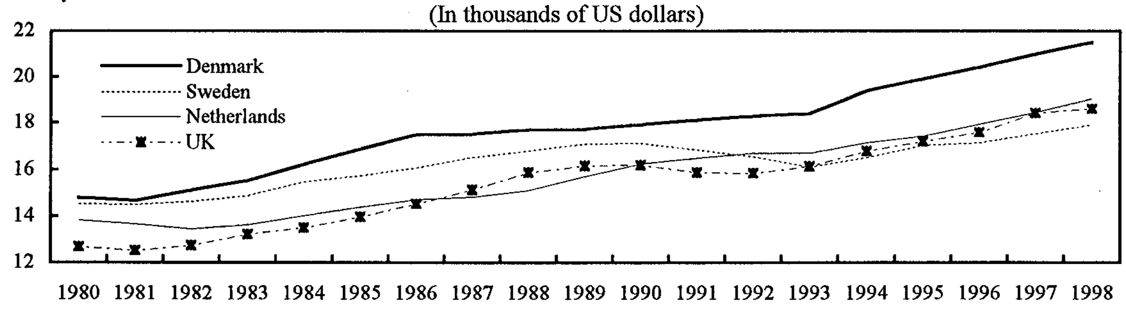
[7] The net impact on the fiscal position would be less severe, however, as income transfers (and other unearned income, including pensions not financed by the state) are subject to tax.

[8] In the worst-case scenario the required increase in the tax burden during the 30 years to 2035 was estimated to be as high as 5 percentage points of GDP. The scope for further broadening tax bases was thought to be limited and international competition made it unwise to contemplate any increases in corporation taxes, indirect taxation, or taxes on capital income. Thus, any increase in the tax burden would have to take the form mainly of increases in marginal tax rates on labor incomes.

opt-out clauses that Denmark had negotiated with its EU partners in the 1992 Edinburgh meeting of the European Council, prior to the ratification of the Maastricht Treaty in a Referendum in 1993. It followed that this decision could be reversed only as a result of a new Referendum. Opinion polls suggested that a majority of the Danish voters were now in favor of EMU membership and the Prime Minister had stated that it would be best for Denmark, for employment and Danish welfare, if Denmark at some point in time joined the euro. The government has not fixed any date for a referendum.

25. In the meantime, the authorities remain strongly committed to the policy of exchange rate stability. The policy was well understood and had acted as a restraint on wage formation and fiscal policy. It also had provided a stable environment for business decisions, contributing to the comparatively strong performance of the Danish economy over the years (Figure 27). All in all, the authorities were convinced that the fixed exchange rate regime had served Denmark very well since its adoption in 1982. Accordingly, they had been keen to enter into a new cooperative agreement with their EU partners, under which the krone participated in ERM2 with relatively narrow fluctuation margins (2¼ percent). In practice, they intended to keep variations in the rate of the krone relative to the euro well within this narrow band, implying that access to the financing facilities of the cooperative arrangement would play only the role of a safety net. The authorities accepted that the ERM2 arrangement was less advantageous than membership of EMU since it did not allow Danish enterprises, consumers and the State to enjoy fully the benefits of monetary union (such as, for example, those associated with increased competition and price transparency, easy access to large liquid capital markets, or the narrowing of risk premia on interest rates). They believed, however, that the economic costs of opting out, in the form of higher spreads on Danish interest rates, were not large under normal circumstances. Officials agreed with the staff that such costs could increase significantly in periods of uncertainty, as had been demonstrated by the few episodes of currency turmoil during 1998. Nevertheless, they were confident that the steps that had been taken recently to safeguard the progress that Denmark had made in achieving nominal and real convergence with the Euro area and reaffirm the government's commitment to sound policies would reduce the vulnerability of the krone to such episodes in the future.

Figure 27. Per Capita GDP (PPP-based)
(In thousands of US dollars)



26. The authorities concurred with the mission that the monetary stance associated with the maintenance of the fixed exchange rate regime was not at present fully appropriate from a domestic cyclical perspective. This was not in itself worrisome as changes in short-term interest rates had a rather small effect on economic activity. It did, however, serve to emphasize the need for fiscal policy to play an active role in demand management. Officials also pointed out that the desynchronization of the business cycle between Denmark and some of its main trading partners in recent years reflected the asymmetric effect of some large shocks (such as that of German unification) but also differences in the timing of major structural reforms. In this context, Denmark appeared to have made more progress than other countries in implementing reforms that had enhanced flexibility and the economy's ability to cope with shocks. This, they felt, would remain a source of strength in the future.

27. The authorities noted that Danish banks had not been significantly affected by the international currency turmoil as their exposure to the countries most affected by it is extremely limited. Danish banks are in general well capitalized, reflecting in part the rather favorable tax treatment of provisions which has encouraged them to maintain a high level of loan loss reserves.[9] Bank profitability has also improved in recent years. It was recognized that the incidence of bad loans would increase, if economic growth slows as expected, and that bank earnings would continue to come under pressure as a result of greater competition and the globalization of financial activities, which had led to a narrowing of interest rate margins and added to the need for banks to invest in costly new technology. These developments had induced the banks to rely to a growing extent on nontraditional lines of business, such as fee-based services and earnings from capital market activities, which were potentially more risky. Although no significant difficulties were foreseen, the Danish Financial Supervisory Authority (FSA) was monitoring developments closely and would continue to encourage the banks to follow prudent lending policies and improve their risk management systems.

28. Officials added that the FSA, which is responsible for the supervision of all financial intermediaries, was also well placed to deal with issues arising from the emergence of financial conglomerates and the growing tendency for cross-border alliances. In this context, they noted that Danish financial intermediaries appeared to be interested mainly in securing a niche in an integrated Nordic financial market, rather than in establishing links with EMU-based institutions. The FSA was cooperating closely with the supervisory authorities of other Nordic countries to enhance its ability to deal with any problem cases. It had also undertaken a self-assessment exercise and had found that it was in compliance with the Core Principles of the Basle Committee on Banking Supervision.

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[9] Although there is no rigid definition of nonperforming loans, banks tend to be conservative in making provisions for potential credit losses and the Financial Supervisory Authority has the power to require additional provisions (or reductions), as appropriate.

D. Labor and Product Markets

29. The authorities pointed out that their labor market strategy was driven by the twin objectives of enhancing labor market flexibility and maintaining a relatively equitable income distribution. The strategy combined low hiring and firing costs with a relatively generous benefit system and with progressive reforms that improved employability and strengthened the incentive to work (Box 2). It had succeeded in bringing about substantial structural improvements in the labor market, as reflected not only in the marked decline in the overall and youth unemployment rates, but also in the decreasing dispersion of unemployment rates across skill categories and the shrinking size of marginalized groups. Officials added that attention now focused on alleviating labor supply constraints over the medium term through measures to raise labor force participation rates. This objective was being promoted in part through the recent tax reform, which significantly reduced marginal tax rates on labor incomes, especially at the low end of the income distribution. It was also supported by reforms to the pension system in late 1998, which aimed at discouraging early retirement, and the gradual phasing out of the transitional allowance scheme (a "pre-early retirement scheme" for the 50–59 cohort) which would add 30,000 persons to the labor supply over the medium run. In addition, it was intended to create by 2005, 30–40,000 "flex jobs" for people with diminished working abilities.

30. The staff agreed that Denmark's labor market performance has been impressive. It welcomed the latest reforms but expressed some skepticism as to whether the official targets for raising labor supply over the next several years could be reached without additional measures . Officials identified two areas where the scope for further reforms remained substantial: training and education (where a reform of the adult education system is to be discussed by Parliament in October 1999); and social assistance (where a further shift towards a "workfare" model is envisaged). If warranted, the benefit system could be further rationalized and the desirability of taking steps to encourage speedier entry of young adults into the labor force could be explored.

31. The authorities recognized that only limited progress had been made so far in strengthening competition in product markets. However, they noted that the 1998 Competition Act, which prohibits anti-competitive practices unless they are specifically allowed by other statutes, had improved the competition framework and would provide new impetus to their effort to increase the flexibility of markets. The new law has helped reduce cartelization in the dairy industry by dismantling exclusive relations between retailers and producers. However, issues concerning cartelization, merger control, and tender procedures, notably in areas (such as the utilities) not covered by the new law, remained to be resolved and the effectiveness of the Competition Authority was constrained by its limited power to initiate investigations and impose penalties. Regarding the utilities, the authorities noted that with the sale of the state stake in Tele Danmark in 1998, the liberalization of telecommunications, which had started in 1996, had been completed; in the electricity sector, production and trade had already been liberalized but the complicated structure of local utilities hampered the liberalization of the distribution network; and in the retail sector, legislation was being prepared for further liberalizing shopping hours.

Box 2. Labor Market Reforms

Denmark has introduced major reforms of labor market policies since 1994. The most important measures are listed in Appendix IV.

The initial results were mediocre, as undue emphasis was placed on leave and job rotation schemes that contributed to lowering participation rates. However, the emphasis later shifted to strengthening work incentives and enhancing employability. Although benefits remained generous, their attractiveness was reduced and the reforms have been remarkably successful in decreasing structural unemployment (particularly youth and long-term unemployment), thereby also contributing to high growth rates and the strengthening of the public finances.

Notwithstanding this success, the authorities introduced in 1998 further measures to improve the functioning of the labor market. Recent measures include the following:

- Unemployed individuals are now obliged to accept job offers outside their occupational area after three months of receiving unemployment benefits.

- The mandatory "activation" of the unemployed after six months of unemployment was extended to all persons under 25; for other age groups, the time limit for activation was reduced from two to one year; and the exemption from activation was abolished for the 50-55 age group. For those under 25, failure to activate (i.e., to accept a job or a placement in a training/retraining scheme) entails complete loss of benefits.

- The minimum age for extended unemployment benefits was raised from 50 to 55 years.

- The maximum unemployment benefit period was reduced from 5 to 4 years.

- Training for the unemployed is to become more targeted and participation in educational leave schemes is projected to decline from its peak of 82,000 in 1995 to 30,000 by 2000.

Additional recent policy changes expected to influence the labor market via their effects on labor supply include the income tax reform, which will lower gradually the marginal tax rates on labor incomes; and the 1998 pension reform, which:

- merged the full- and part-time early retirement schemes, thereby creating a more flexible, unified, and transparent system;

- introduced tax and benefit incentives to prolong full-time working life until 62 years of age; and

- enhanced income incentives for early retirees who want to work.

E. Other Issues

32. Official development assistance reached 1 percent of GDP in 1998 and was the highest among DAC members. It was provided in the form of grants and was equally divided between bilateral and multilateral aid. Bilateral aid was concentrated in 20 countries, 18 of which were among the least developed countries, and focused primarily on poverty reduction. In addition to ODA, in 1998 Denmark contributed an amount equivalent to 0.25 percent of GDP to the Environment, Peace and Stability Fund.

33. The authorities did not expect any significant systemic problems in connection with Y2K. Financial institutions and the payments system were already compliant and government agencies and utilities were at an advanced stage of addressing the problem. Regarding the private sector, auditing firms had been asked to review Y2K planning as part of their annual auditing of enterprises, but smaller enterprises had been slower in taking action. The authorities were preparing contingency plans and emergency procedures to tackle any problems that might arise.

34. Denmark subscribes to the Special Data Dissemination Standard (SDDS) and its statistics are generally adequate for surveillance purposes (Appendix III).

III. Staff Appraisal

35. Developments in the Danish economy since the last consultation testify to the success of the authorities' strategy of financial discipline and structural reform. Output, employment, and business investment have all expanded at a brisk pace and unemployment has fallen to less than half its level five years ago. Despite the rapid absorption of economic slack, inflationary pressures have been subdued. Meanwhile, the public finances have continued to strengthen, moving into a sizable surplus ahead of schedule.

36. The recovery, however, has not been entirely free of strains and imbalances. Labor shortages have been experienced in some sectors; increases in wage earnings have been higher than on average in the main trading partners; and low and declining interest rates, notably in real after-tax terms, have sustained rapid increases in house prices and a surge in consumer spending. Thus, the household saving rate has fallen to a rather low level, contributing (in combination with high business investment and subdued foreign demand) to a significant weakening of the external current account position.

37. Although the imbalances that emerged were modest in size, they elicited a forceful and timely policy response. Commendably, this included not only the necessary element of demand restraint, but also a new set of ambitious structural reforms designed to gradually strengthen the incentives to save and to work and thus to ease constraints to balanced, noninflationary growth over the medium term.

38. The staff shares the authorities' judgment that the measures taken should prove adequate to ensure the speedy elimination of excess pressures on resources. This, in turn,

would facilitate a smooth transition from the exceptionally high rates of economic growth of recent years to the more modest rates of expansion that appear sustainable in the years ahead, given the leveling out of the working age population and the rather limited scope to lower structural unemployment and raise participation rates. There are, however, some upside risks in the short-term outlook associated both with the stimulus to demand provided by the recent relaxation of monetary conditions, and the ever-present threat of public spending overruns. In view of these risks, it is important to intensify efforts at avoiding slippages in policy implementation and to keep open the possibility of introducing further measures to restrain demand in next year's budget, if pressures on resources remain excessive. By the same token, however, there is also a risk that the slowdown in economic growth will prove more pronounced than currently foreseen. Were this risk to materialize, it would be appropriate to allow the automatic fiscal stabilizers to operate in full.

39. In recent years, public spending on goods and services has been considerably higher than budgeted. Although expenditure overruns did not prevent a marked improvement in the public finances, they have had undesirable side effects. In particular, they have increased the absorption by the public sector of scarce labor resources and have undermined plans for lowering the tax burden on labor incomes, thereby adding to the upward pressure on wages and crowding out private employment and exports. Such crowding-out effects may well have become more important under the current tight labor market conditions. Against this background, recent initiatives to strengthen expenditure discipline at the local authority level are welcome. However, their effectiveness could be enhanced if steps are taken to ensure that the assignment of tasks and responsibilities to local authorities does not overstretch their capacity to finance the resulting outlays without raising taxes or other sources of revenue. More generally, it remains desirable to seek ways to exploit the potential for economies of scale in public spending and to strengthen expenditure control mechanisms at all levels of government. From a longer-term perspective, means would also need to be identified for moderating the likely rapid growth in the demand for personal services currently provided by the public sector, as well as reducing the extent to which they are financed by the taxpayer.

40. The authorities' objective of sustaining a sizable surplus in the general government accounts for several years ahead is laudable as it would enable Denmark to comply with the requirements of the Stability and Growth Pact without undue difficulty and provide some margin for discretionary fiscal stimulus. Moreover, by allowing a rapid repayment of public debt and a lowering of the associated debt service burden, it would create room to accommodate the prospective increase in pension outlays stemming from the aging of the population, without reducing markedly the level of benefits. It is important to keep in mind, however, that realization of the authorities' objective will depend crucially not only on greater success than in the past in adhering to short-term public spending ceilings but also on the attainment of challenging goals for raising employment and participation rates. This reinforces the short-term argument for prudence in the management of the public finances and underscores the need for sustained efforts at further enhancing the flexibility of the labor market.

41. The authorities' long-standing commitment to exchange rate stability, which is continuing with the krone's participation in ERM2, has fostered greater discipline in financial policies and wage behavior and contributed to Denmark's comparatively good economic performance over the past fifteen years. The commitment in itself does not prevent occasional pressures on the krone, as was illustrated during episodes of turmoil in the foreign exchange markets in the course of 1998. However, provided the underlying fundamentals of the economy remain sound, the monetary authorities' demonstrated willingness to adjust policy settings as needed to stabilize market expectations, coupled with their access to sizable foreign exchange reserves, should be sufficient to ensure that the krone maintains a comfortable position within its band and that any episodes of tension are short-lived. An obvious implication of the policy of exchange rate stability is that interest rates can hardly be used for domestic demand management purposes. Indeed, at present, monetary conditions are somewhat easier than might be warranted from a domestic cyclical perspective. This situation, which looks likely to continue in the months ahead, adds to the need for fiscal policy to err on the side of caution in managing demand.

42. Denmark has been remarkably successful in recent years in improving the functioning of the labor market. This has been evident *inter alia* in the virtual elimination of youth unemployment and the significant reduction in unemployment among other groups. Success has resulted from the continuation of flexible hiring and firing policies, coupled with the steady shift away from schemes that encouraged premature withdrawal from the labor force to policies that strengthen the opportunity and the incentive to work. Notwithstanding the impressive progress that has been made and the additional benefits that should flow from the gradual implementation of the recent tax and labor market reforms, continued effort is likely to be needed to alleviate the labor supply constraint to growth over the medium term. In this regard, it would seem worthwhile to explore the scope for further measures to raise the labor force participation rate among the older age cohorts and encourage speedier entry of young adults into the labor market.

43. Progress in improving the functioning of product markets has been far less impressive. However, the new Competition Act should breathe new life into competition policy, especially if steps are taken to increase the range of instruments that are available to the competent authorities for enforcing its provisions. In addition, it is desirable to intensify efforts at strengthening competition and/or the regulatory environment in markets that are still regulated, including in energy distribution.

44. The banking sector has weathered the strains in the global financial system well. Indeed, under the recent favorable business cycle conditions, bank profitability has continued to improve. However, the incidence of problem loans would likely increase if economic growth slows as expected. Moreover, pressures on bank earnings could intensify as a result of growing competition and the increased risks associated with financial market activities. In this environment, it is important for supervisors to remain vigilant and for the banks and other financial intermediaries to continue their efforts at cost containment and at strengthening their risk management systems.

45. Denmark has established an excellent record in extending assistance to developing countries and provides a role model to other countries by focusing its assistance on the poorest countries. The authorities' continued efforts to improve the quality and timeliness of Danish economic and financial statistics are welcome.

46. It is recommended that Denmark remain on the 24-month consultation cycle.

Statement by the IMF Staff Representative
August 5, 1999

This statement provides information that has become available since the staff report for the 1999 Article IV consultation with Denmark (SM/99/179) was issued on July 15, 1999. This information does not alter the thrust of the staff appraisal.

1. According to recently released data, real GDP growth slowed to 1 percent in the year to the first quarter of 1999. This is slightly lower than the 1.3 percent growth rate expected by the authorities and the staff for the year as a whole. However, part of the growth slowdown in the first quarter of 1999 reflected a reversal of the high level of stockbuilding in 1998, which is not expected to continue. Consumer confidence improved in May but remained negative.

2. Monthly data indicate a steady improvement of the external current account. The April 1999 data (released July 27) show a narrowing of the cumulative 12-month deficit to DKr 5 billion. (The deficit in 1998 was DKr 14.7 billion.)

3. Price increases continue to exceed slightly inflation in the euro area. Headline inflation edged up to 2.4 percent in June (1.9 percent on an EU-harmonized basis), while core inflation remained stable at 3 percent. Housing prices continued to increase in real terms in the second quarter of 1999.

4. Evidence of a tight labor market persists. Wage increases remained higher than in trading partners, at 4.7 percent in the year to the first quarter of 1999, and unemployment declined to 5.7 percent in June.

5. The krone weakened slightly vis-à-vis the euro during July, but remained above its central rate and in nominal effective terms it strengthened, reversing part of its depreciation earlier in the year. Meanwhile, long-term interest rates have risen markedly since February, contributing to a welcome firming of financial conditions. Gross official foreign exchange reserves reached a new record high of DKr 160 billion at the end of June 1999, but declined by DKr 3 billion in July.

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IMF Concludes Article IV Consultation with Denmark

On August 5, 1999, the Executive Board concluded the Article IV consultation with Denmark.[1]

Background

The Danish economy continued to perform well in 1997–98. Real GDP growth of about 3 percent remained above potential and unemployment fell to 6 percent, less than half its level only five years earlier. Consumer price inflation remained subdued at slightly below 2 percent. However, capacity constraints became more evident and the external current account balance showed a deficit, for the first time since 1989, of 1.4 percent of GDP. Also, at 4½ percent, wage inflation remained higher than in the main trading partner countries.

Economic policies aimed at slowing growth in domestic demand, while sustaining a rapid pace in implementing structural reforms. Thanks to the large fiscal dividends deriving from a buoyant economy and declining structural unemployment, the general government budget balance strengthened to show a surplus of 1 percent of GDP in 1998. Meanwhile, the Danish krone resisted episodes of turbulence, although that was only possible at the cost of temporary increases in short-term interest rates and a widening of risk premia relative to euro area currencies.

Real GDP growth is projected to slow to 1.3 percent in 1999 as a result of new measures started in mid-1998 that are partly designed to dampen consumer spending and housing demand. Inflation is forecast to edge up to 2½ percent mainly because of higher environmental taxes, while the external current account deficit is expected to narrow due to the sharp slowdown of domestic demand.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

Executive Board Assessment

Executive Directors commended the authorities for their sustained implementation of a strategy of fiscal discipline and structural reform, which had contributed to a prolonged economic expansion. There had been large increases in employment and business investment, and unemployment had fallen by more than half in five years. Meanwhile, inflation had remained subdued and the public finances had strengthened.

Directors observed that indicators regarding short-term prospects are mixed. On one side, the past two years had seen an acceleration of wage inflation, a surge in consumer spending and housing prices, and a weakening of the external current account. Some Directors considered that these developments suggested that particular caution was needed to preserve Denmark's external competitiveness. Other indicators, however, suggested that the inflationary pressures may already be subsiding. On balance, Directors welcomed the measures taken by the authorities to restrain demand. They considered that, partly in view of the discipline imposed by the exchange rate arrangement, the authorities should stand ready to tighten fiscal policy further, should evidence of overheating persist. At the same time, they agreed that there was scope for the automatic fiscal stabilizers to operate if activity turned out to be markedly weaker than currently foreseen.

Directors broadly welcomed the authorities' objective to sustain large structural budgetary surpluses in coming years and supported their intention to use these surpluses for a substantial reduction in debt, rather than to lower the tax burden. Lower debt, in turn, would allow the effects of longer-term demographic pressures to be accommodated without compromising the strength of public finances. Directors emphasized, however, that realization of the projected fiscal surpluses would depend crucially on expenditure restraint and on continuing structural reforms. In this context, they stressed the need to strengthen expenditure discipline, especially at the local authority level. They urged the authorities to fully exploit the potential economies of scale in the provision of public services, and to explore the scope for user fees and private service provision. Directors emphasized that the growth in demand for publicly-provided services needs to be curbed over time if goals for the fiscal balance are to be achieved without increasing Denmark's already high tax rates.

Directors welcomed Denmark's impressive progress in improving the functioning of the labor market, which had made a vital contribution to fiscal consolidation. While noting recent tax and other structural reform initiatives, Directors nevertheless considered that additional reforms to enhance incentives and flexibility in the labor market will be needed to achieve the authorities' targets for employment and participation rates on which, in turn, the achievement of fiscal goals partly depends. In this context, Directors suggested that attention should focus on further reducing incentives for early retirement and on encouraging earlier entry of young adults into the labor market. Some Directors considered that the generosity of unemployment benefits should also be reviewed.

Directors supported the authorities' long-standing commitment to exchange rate stability, which is continuing with the krone's participation in ERM2. This commitment had enhanced fiscal discipline and contributed to wage restraint. Directors noted, however, that the exchange rate arrangement at times implied the maintenance of monetary conditions that are not well attuned to Denmark's cyclical conditions. This added to the need for fiscal policy to play a major role in stabilizing demand and ensuring that external competitiveness remained adequate.

Noting that the liberalization of product markets should not fall behind that in the labor market, Directors urged the authorities to build further on their achievements in deregulating markets and easing barriers to entry in sectors where public entities have traditionally enjoyed a protected status.

Directors welcomed Denmark's excellent record in extending assistance to developing countries and its efforts to target this assistance on the poorest countries.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 1999 Article IV consultation with Denmark is also available on the IMF's website (http://www.imf.org).

Denmark: Selected Economic Indicators

	1996	1997	1998	1999 1/	2000 1/
Real economy (change in percent)					
Real GDP	2.8	3.1	2.7	1.3	1.5
Domestic demand	2.5	4.6	4.6	1.0	1.4
CPI (year average)	2.1	2.2	1.7	2.5	2.5
Unemployment rate (in percent)	8.6	7.7	6.3	6.0	6.2
Gross national savings (percent of GDP)	20.9	21.2	20.6	19.6	19.7
Gross domestic investment (percent of GDP)	19.2	20.7	21.9	20.7	20.4
Public finance (percent of GDP)					
Central government balance	-1.5	-0.3	2.2	0.6	1.7
General government balance	-1.0	0.1	1.0	2.5	2.1
General government debt	64.8	61.1	56.3	53.4	49.3
Money and credit (end of year, percent change)					
Domestic credit 2/	8.7	6.2	13.5	2.5	...
M3 2/	7.2	5.2	2.9	3.9	...
Interest rates (percent)					
Money market rate 3/	4.0	3.7	4.2	3.2	...
Government bond yield 3/	7.2	6.3	4.9	5.2	...
Balance of payments (percent of GDP)					
Trade balance	4.9	3.4	1.8	4.1	3.7
Current account	1.7	0.5	-1.3	-1.1	-0.7
Official reserves (US$ billion) 4/	14.1	19.1	15.3	...	...
Reserve cover (months of imports of GNFS)	2.9	4.1	3.1	...	...
Fund position 5/					
Holdings of currency (percent of quota)			56		
Holdings of SDRs (percent of allocation)			136.9		
Quota (millions of SDRs)			1,642.8		
Exchange rate					
Exchange rate regime			Participant in ERM2		
Present rate (August 2, 1999)			Danish kroner 6.975 per US$1		
Nominal effective exchange rate (1990=100) 6/	108.0	105.0	105.6	104.2	...
Real effective exchange rate (1990=100) 6/ 7/	96.7	94.4	94.4	95.4	...

Sources: IMF, International Financial Statistics; IMF, World Economic Outlook; and IMF staff projections.
1/ Staff projections.
2/ Data for 1999 refer to April 1999 compared with April 1998.
3/ For 1999, data refer to August 2, 1999.
4/ Excluding gold.
5/ As of June 30, 1999.
6/ For 1999, data refer to June 1999.
7/ Based on relative normalized unit labor cost in manufacturing.

Statement by Kai Aaen Hansen, Executive Director
for Denmark
August 5, 1999

My Danish authorities welcome the staff report which provides a good description of the Danish economy and gives a fair and balanced presentation of the consultation discussions in Copenhagen.

Overview

When the present government took office in 1993, the primary goals were to boost growth and to reduce unemployment significantly. These goals have been reached. GDP grew by more than 3 percent annually in the period 1994 to 1998, and unemployment has been halved from above 12 percent of the labor force in 1993 to less than 6 percent at present. Structural reforms of the labor market and the tax system have been essential factors behind this development.

Public finances have improved from a deficit in 1993 of almost 3 percent of GDP to an expected surplus of the same magnitude this year.

Despite the fast growth and low unemployment, wage and price increases have remained relatively modest.

The government has continued the exchange rate policy. From January 1 this year, the krone shall be kept stable vis-à-vis the euro. This strategy has gained credibility over the years, and the Danish interest rates have followed the European rates. Admittedly, a small spread exists between Danish interest rates and the euro rates.

In the short run, the main challenge for economic policy is to secure a soft landing after the strong recovery. The Danish economy is now running close to its present potential. A slowdown – especially in domestic demand – has been necessary to avoid overheating, causing inflation and a more abrupt end to the business cycle. Furthermore, the supply of labor should be increased to support growth in the medium term.

Economic policies

There have been no major new economic policy initiatives since the consultations took place, and the overall economic objectives are unchanged. The staff report gives an accurate description of the discussions on economic policies at the consultations. Furthermore, the report gives a balanced presentation of the major economic policy initiatives i.a. the Whitsun Package and other structural measures, especially regarding the labor market.

Concerning the *Whitsun Package*, the report accurately describes the main objectives behind the Package. The Whitsun Package is a structural initiative that is expected to be timed appropriately in relation to the business cycle, where the intention in the short run is to dampen the growth of domestic demand. This is primarily achieved by cutting the tax value of deductible interest payments gradually towards the year 2001. It is expected that this initiative in the short run will reduce demand for houses, and thereby restrain the development in house prices. This will – through a wealth effect – reduce the rate of growth in private consumption and thereby reduce domestic demand in the short run.

As noted in the staff report, the developments in house prices – since the Whitsun Package was announced – have been more buoyant than expected. However, there are a number of indications that the package is working. Thus, there has been a marked drop in housing starts, as well as in housing sales. This indicates that the growth in house prices will be dampened in the near future.

The staff suggests that there might be a risk of "overkill". However, it is the view of the Danish authorities that this risk is not significant. On the other hand, the developments in the housing market are, of course, monitored closely.

The structural effect of the Whitsun Package is believed to be – as recognized in the report – to raise private saving in the long run and also increase incentives to work for low wage earners.

Concerning *fiscal policy*, the Danish Government will present the central government budget proposal for the year 2000 later this month. The budget will continue the fiscal consolidation process. Furthermore, the budget – combined with the agreement between the central government and local authorities concerning the economy of the municipalities for year 2000 – should imply an overall neutral fiscal stance in 2000.

The staff has expressed concern about the tendency toward public consumption overruns. The Danish authorities recognize that in later years there has been an unfortunate tendency toward public consumption overruns. It is believed that the negotiated agreements with local authorities and improved monitoring mechanisms will reduce this problem.

In regard to *the medium term objectives of fiscal policy*, the Danish Government is committed to continuing the reduction of public debt. Public gross debt has been reduced from 78 percent of GDP in 1993 to 55 percent in 1998. The goal is to bring the gross public debt down to 40 percent of GDP by 2005. Fiscal consolidation is very important, first of all because the demographic development will intensify the pressure on public finances after 2005. The long-term strategy is to reduce public debt and thereby interest payments, to make room for increased expenditures relating to demographic changes without having to increase the tax burden.

At the consultations, the staff wondered whether part of the fiscal surplus could be used to lower the overall tax burden. As a significant reduction of the public debt is the main priority, it will not be possible to implement tax cuts until the public finances are showing a robust surplus on average over the business cycle. This leaves only a small room for tax reductions in the near future.

In general, the Danish authorities find the staff's analysis of *monetary policy* issues comprehensive and well balanced.

The *fixed exchange rate policy* has been a cornerstone in the Danish economic policy since the beginning of the 1980s. The strong commitment to maintaining exchange rate stability has effectively brought down inflation expectations and acted as a restraint on fiscal policy. After the introduction of the euro January 1, 1999, the Danish participation in ERM II constitutes the formal framework for the continuation of the fixed exchange rate policy.

With monetary policy directed solely at maintaining exchange rate stability, the monetary and financial stance of the economy can, from time to time, be somewhat more accommodative than warranted from a purely domestic cyclical perspective. In Denmark, however, movements in short-term interest rates have only a limited direct effect on domestic demand. Thus the relatively marked, and from a cyclical point of view, undesirable, easing of monetary and financial conditions which was observed during the last months of 1998 and in the beginning of 1999 was almost exclusively caused by movements in the effective exchange rate and long-term interest rates. At present, the easing of financial conditions has been partly reversed by the upswing in long-term interest rates since February 1999.

It is obvious that the Danish opt-out clause to EMU does not allow Denmark to reap the full benefits of the European internal market in terms of increased competition, lower transaction costs, greater price transparency, etc.

Furthermore, as a consequence of the opt-out, some risk premiums on interest rates are likely to prevail, especially during periods of exchange rate turmoil, where short-term interest rates will be raised in order to maintain exchange rate stability. As short-term interest changes have only a modest impact on economic activity, occasional and temporary currency unrest does not in itself constitute a major problem, provided the economic fundamentals remain sound.

It is acknowledged that the Danish opt-out and the participation in ERM II offer a limited scope for the narrowing of the long-term interest differential to Germany. It is important to emphasize, however, that the current differential is not the relevant measure of the cost of opting out. Long-term interest rate differentials also persist within the euro area, reflecting varying degrees of credit and liquidity risks.

Taken together, it is the assessment of the Danish authorities that the economic costs in terms of the interest rate differential of opting out of EMU are only modest under normal circumstances. The comparatively strong performance of the Danish economy since 1993 gives an indication of the fact that the monetary policy framework, now as a member of the ERM II, has served the Danish economy well, as emphasized in the present report from the staff.

With regard to *labor and product markets*, a number of reforms have been implemented in recent years. The strategy behind the Danish labor market reforms has been to enhance labor market flexibility by increased education and training. Furthermore, work incentives have been strengthened by lowering marginal income taxes – especially for low income workers – and stricter availability rules. The labor market reforms have reduced structural unemployment, and unemployment has been reduced significantly, with wage increases being relatively modest. The challenge now is to increase labor supply and improve incentives to stay longer in the labor force.

In the product markets, the Competition Act has been strengthened, publicly owned enterprises have been privatized, and a number of sectors, e.g., telecommunications, electricity and bus transport, have been liberalized to a substantial degree. However, the Danish Government acknowledges that there is scope for enhancing competition through further liberalizations.

Recent developments

Since the mission took place, a number of statistics have been published.

National account figures for the first quarter of 1999 and revised figures for 1995 to 1998 were published at the end of June.

GDP growth has been dampened in line with national and staff projections. GDP growth year-on-year fell to 1 percent in the first quarter of 1999, as destocking contributed negatively to GDP growth.

The negative stock building partly explains the low level of import of goods in the first quarter of 1999, hence the improvement of the trade balance is expected to be less pronounced during the rest of 1999.

Gross fixed investments increased more than anticipated, which was primarily due to large increases in machines and equipment. Despite the slowdown in production, employment rose further, and labor productivity is thus performing poorly.

The annual increases in wages have continued to edge up. The increase in the private sector hourly wage index was 4.7 percent in the first quarter of 1999.

The accelerating wages reflect that unemployment has fallen continuously, and is now below structural unemployment. The unemployment rate was 5.7 percent in June 1999.

However, a turning point in unemployment is expected to occur in 1999, as the decelerating production is projected to lower employment eventually.

Recent consumer price index figures are in line with projected price inflation, around 2 ½ percent in 1999 and 2000. Consumer price inflation in June was 2.4 percent, and is expected to increase during 1999, as raw materials prices feed through. Inflation is expected to abate slightly during 2000 due to less impact from excise duties and slowdown in demand.

Following the increase in the first quarter of 1999, house prices were expected to level off during the rest of 1999. However, some preliminary information points to a continued rise in house prices in the second quarter of 1999, but, in our assessment, this is mainly due to composition effects and seasonal effects.

Consumer confidence has improved further, but the level is as low as in the recession year 1993. New car registrations fell further in the second quarter, and the most recent retail sale figures also indicate a dampening of private consumption growth.

The recent increase in long-term interest rates will contribute to ease demand pressure in the housing market and in other parts of the domestic economy.

In conclusion, recent statistical information supports the view that the Danish economy is on its way to a soft landing.