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Denmark: 2002 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Denmark

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Denmark, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 23, 2002,** with the officials of Denmark on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 12, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 8, 2002 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Denmark.

The document(s) listed below have been or will be separately released.

Selected Issues—The Danish Fiscal Framework—Looking Back and Ahead

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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DENMARK

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation with Denmark

Approved by Alessandro Leipold and Martin Fetherston

April 12, 2002

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I. Introduction

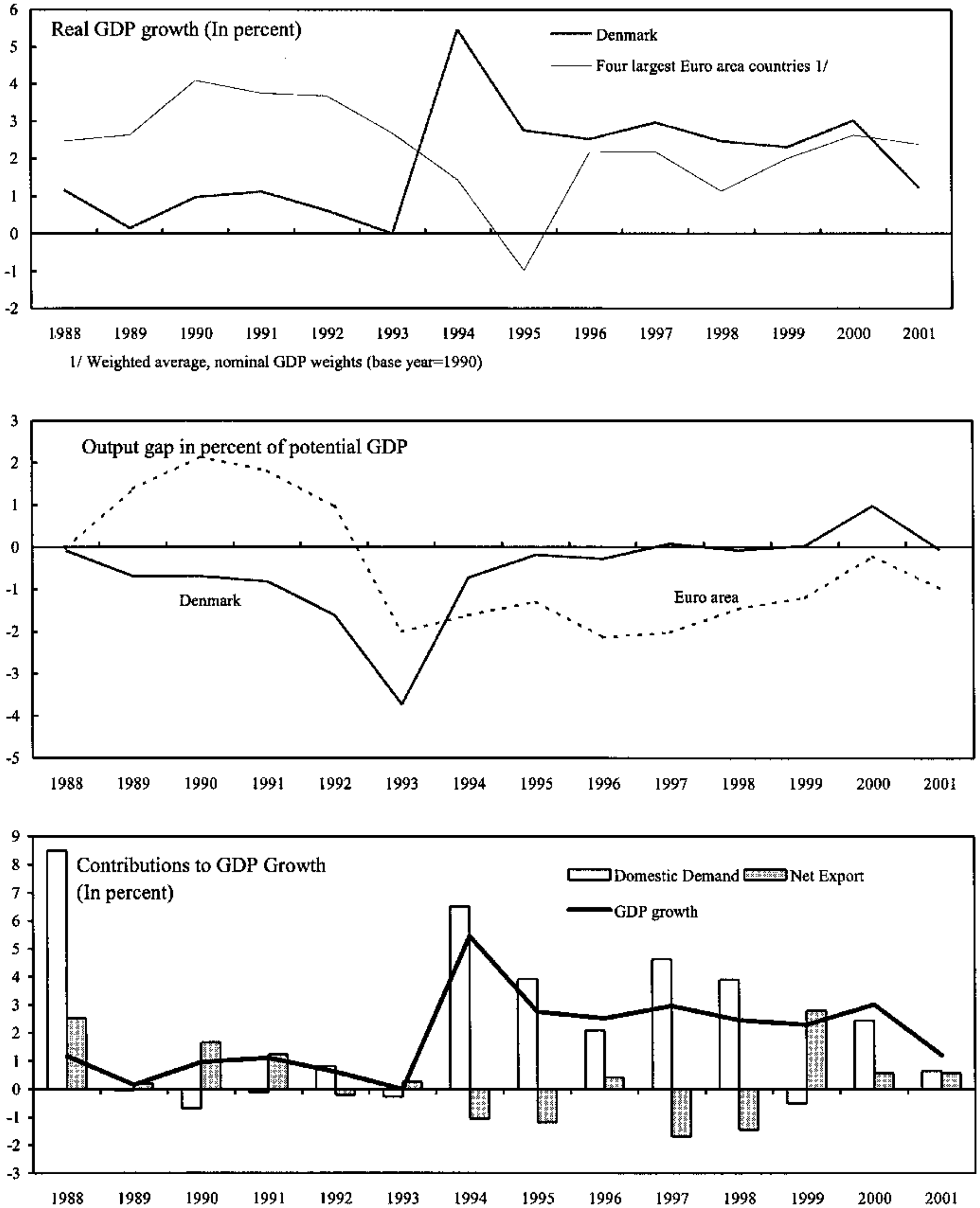
1. The 2002 Article IV consultation discussions were held in Copenhagen during January 14–23, 2002.[1] At the time, growth had slowed to below potential and concerns about overheating expressed at the conclusion of the last Article IV consultation on August 5, 1999 had receded. The mission discussed the policy priorities of the new center-right government that was elected in November 2001. The government has pledged to stick with the previous strategy of running fiscal surpluses and lowering debt levels to prepare for the coming demographic change—a policy the IMF Executive Board had supported. It has stated an interest in lowering the high tax and expenditure burden, but does not intend to make major changes to the comprehensive welfare system.

II. Background

2. **Denmark's economy took off in 1993 and grew by 2½ to 3 percent a year through 2000, providing an enabling environment for structural reforms.** Growth significantly exceeded that in the largest European economies (Figure 1). Labor market reforms reinforced growth, reducing the unemployment rate by 7 percentage points to a 25-year low of 5 percent (Figure 2). The favorable economic developments and reforms helped turn fiscal deficits into structural surpluses and the public debt ratio fell sharply (Figure 3). Following years of current account deficits, surpluses have, with only one exception, been registered each year since 1990 (Figure 4). Savings and investment ratios both rose steadily in the 1990s (Figure 5). By 1999, overheating concerns had however emerged.

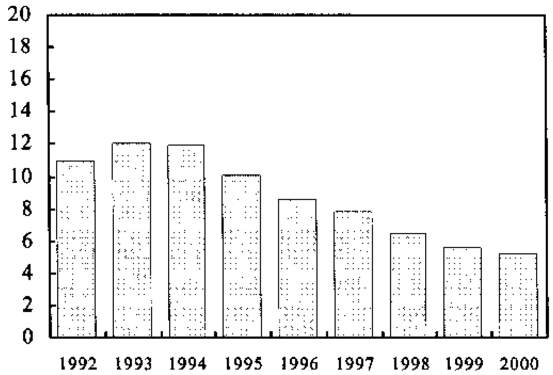
[1] The mission—comprising Messrs. Corker (Head) and Eskesen, Ms. Kodres, and Ms. Krajnyák—met with Mr. Pedersen, the Minister of Finance, Ms. Andersen, Governor of the National Bank, senior government officials, representatives of regulatory and supervisory agencies, municipal governments, the Economic Council, trade unions, the employers' confederation, and a major bank. Mr. Andersen (alternate Executive Director) participated in the discussions. Denmark has accepted the obligations of Article VIII, Sections 2, 3, and 4.

Figure 1. Denmark: Output and Demand Components, 1988-2001



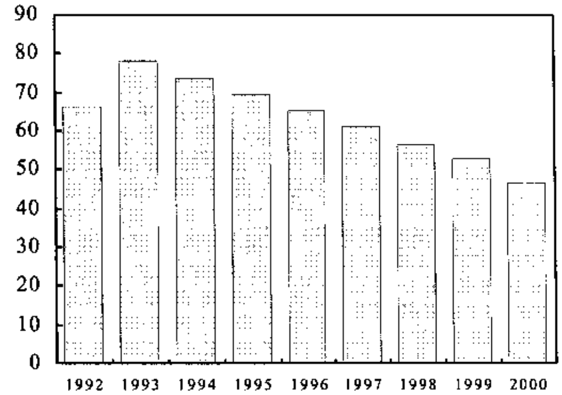
Source: IMF, World Economic Outlook.

Figure 2. Denmark: Unemployment Rate, 1992-2000 (In percent)



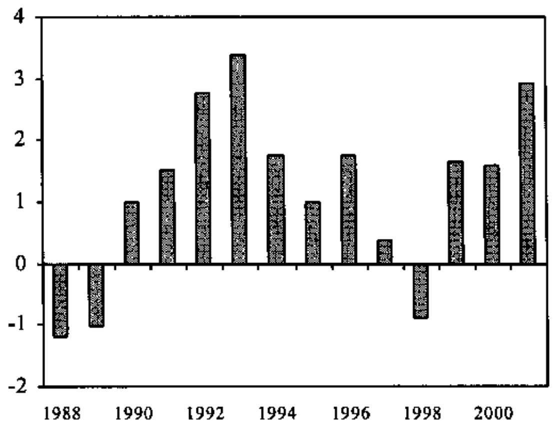
Sources: IMF, World Economic Outlook; and data provided by the authorities.

Figure 3. Denmark: Government Debt, 1992-2000 (In percent of GDP)



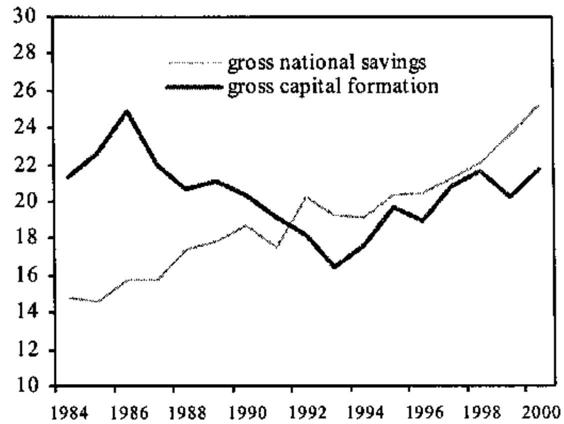
Sources: IMF, World Economic Outlook; and data provided by the authorities.

Figure 4. Denmark: Current Account Balance, 1988-2001 (In percent of GDP)



Source: IMF, World Economic Outlook.

Figure 5. Denmark: Savings and Investments, 1984-2001 (In percent of GDP)



Source: IMF, World Economic Outlook.

3. **More recently, a broad-based slowdown has been taking place.** Real GDP growth slowed from 3 percent in 2000 to just under 1 percent in 2001. Part of the slowdown reflected the unwinding of rapid growth in residential housing investment following weather-related damage in late 1999 (Table 1). Consumption growth remained weak, in part because car purchases—which tend to follow their own autonomous cycle in Denmark—continued to be depressed. At the same time, in the context of earlier interest rate increases and the global slowdown, machinery and equipment investment declined during most of 2001 and growth in exports dropped sharply. By end-2001, staff estimates that output slipped below potential.

Table 1. Contributions of Various Factors to GDP Growth, 1998–2001

	1998	1999	2000	2001
	(In percent)			
Real GDP growth	2.5	2.3	3.0	0.9
Domestic demand	3.9	-0.5	2.5	1.1
Final domestic demand	4.0	0.8	2.3	0.7
Consumption	1.9	0.6	0.0	0.7
Fixed investment	2.1	0.2	2.3	0.0
Inventories[1]	-0.1	-1.3	0.2	0.4
Net exports	-1.4	2.8	0.6	-0.1
Exports	1.6	4.0	4.6	1.4
Imports	-3.0	-1.2	-4.0	-1.5

Source: Danmarks Statistik.
[1]Change in inventories as percent of previous year's GDP.

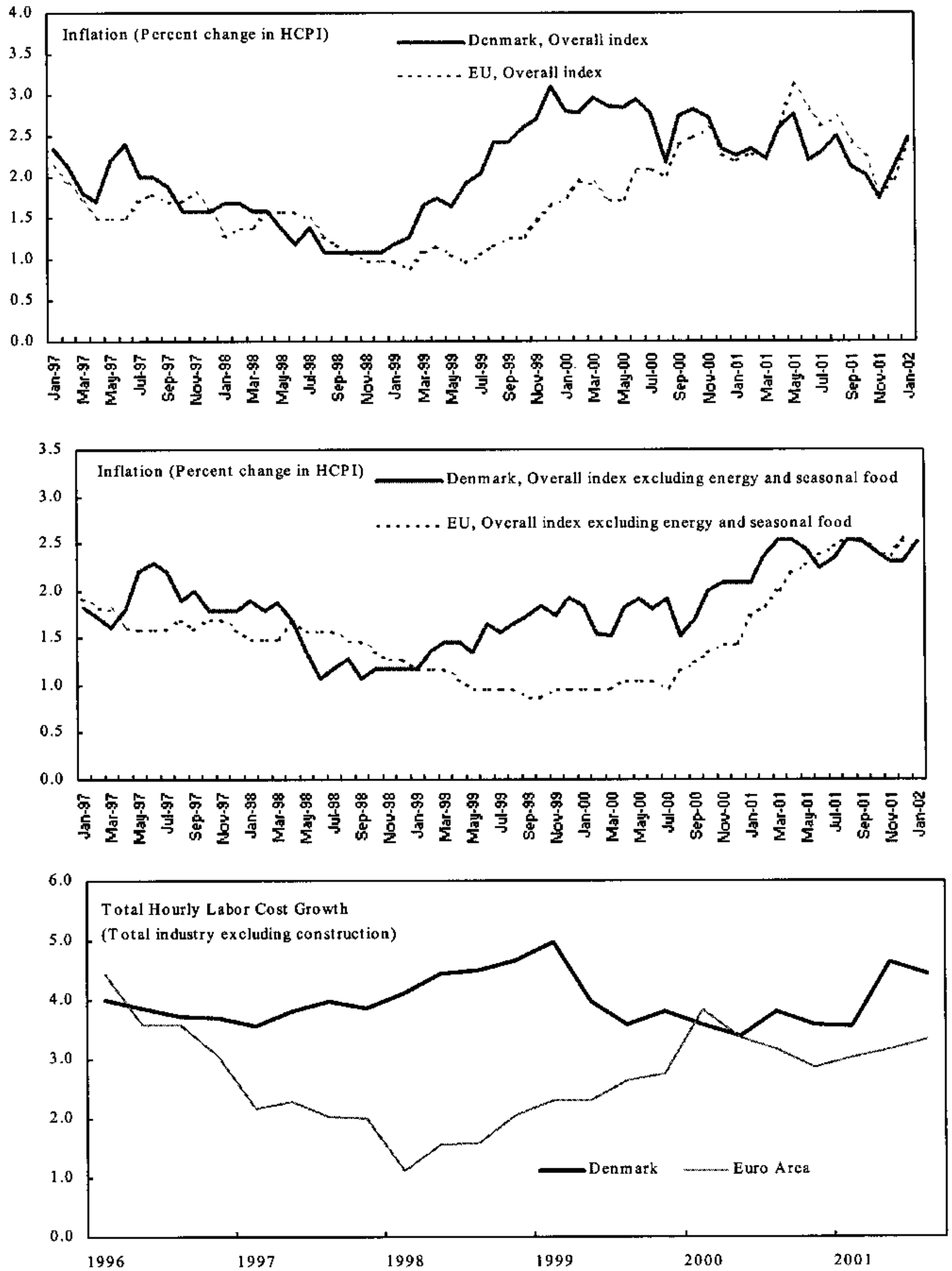
4. **Although price inflation remains low, unit labor cost growth has been above the euro area average.** In 2001, consumer price inflation (EU-harmonized) fell back to about 2 percent from 2¾ percent in 2000 as one-time hikes in "green" taxes and rising energy prices dropped out of the calculations (Figure 6). Nonetheless, with little slack in the labor force—unemployment has stayed close to its 25-year low—hourly labor cost increases remained higher than in the euro area, in part because of additional paid holidays. Labor productivity growth has been around the euro area average.

5. **Asset price developments were mixed.** The Danish stock market peaked in 2000, although its subsequent fall has been less dramatic than in the major international markets (Figure 7). By contrast, house prices continued to increase in 2001, albeit at a slower rate than in previous years (Figure 8). Since 1993, real house prices have risen by 70 percent, but in level terms they are only slightly above the peak seen in the mid-1980s and below the peak in the late 1970s.

6. **Monetary conditions have loosened as Danish interest rates have followed euro area rates down since February 2001 (Figure 9).** The interest rate cuts put real short- and long-term rates about 1 percentage point below their historical averages (Figure 10). The Nationalbank has kept the krone within a tight band around the central rate against the euro.[2]

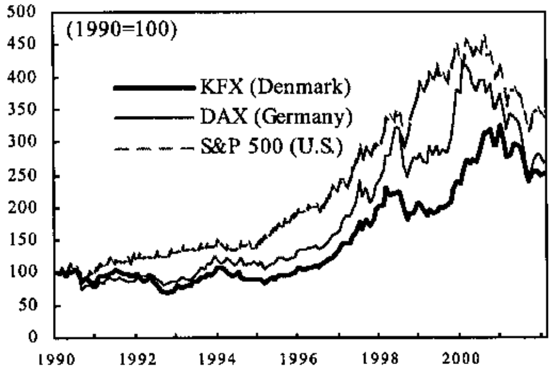
[2] Denmark rejected participation in EMU in a referendum in September 2000, thus continuing its participation in ERMII. Rejection had no lasting impact on financial and exchange markets as a modest widening of interest rate differentials in the run-up to the referendum proved temporary.

Figure 6. Denmark: Inflation and Wages, 1996-2001



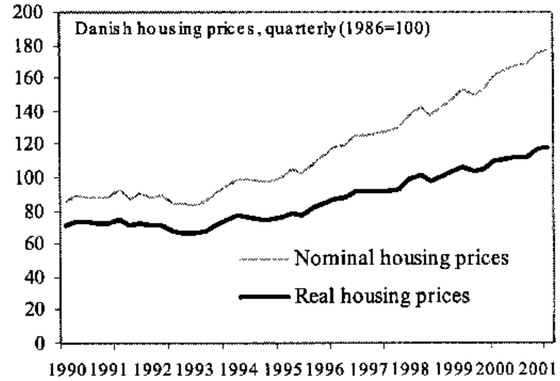
Sources: Eurostat; and Danish authorities.

Figure 7. Denmark: Stock Market, 1990-2001



Source: Bloomberg.

Figure 8. Denmark: Housing Prices, 1990-2001



Sources: Bloomberg; and Danmarks Statistik.

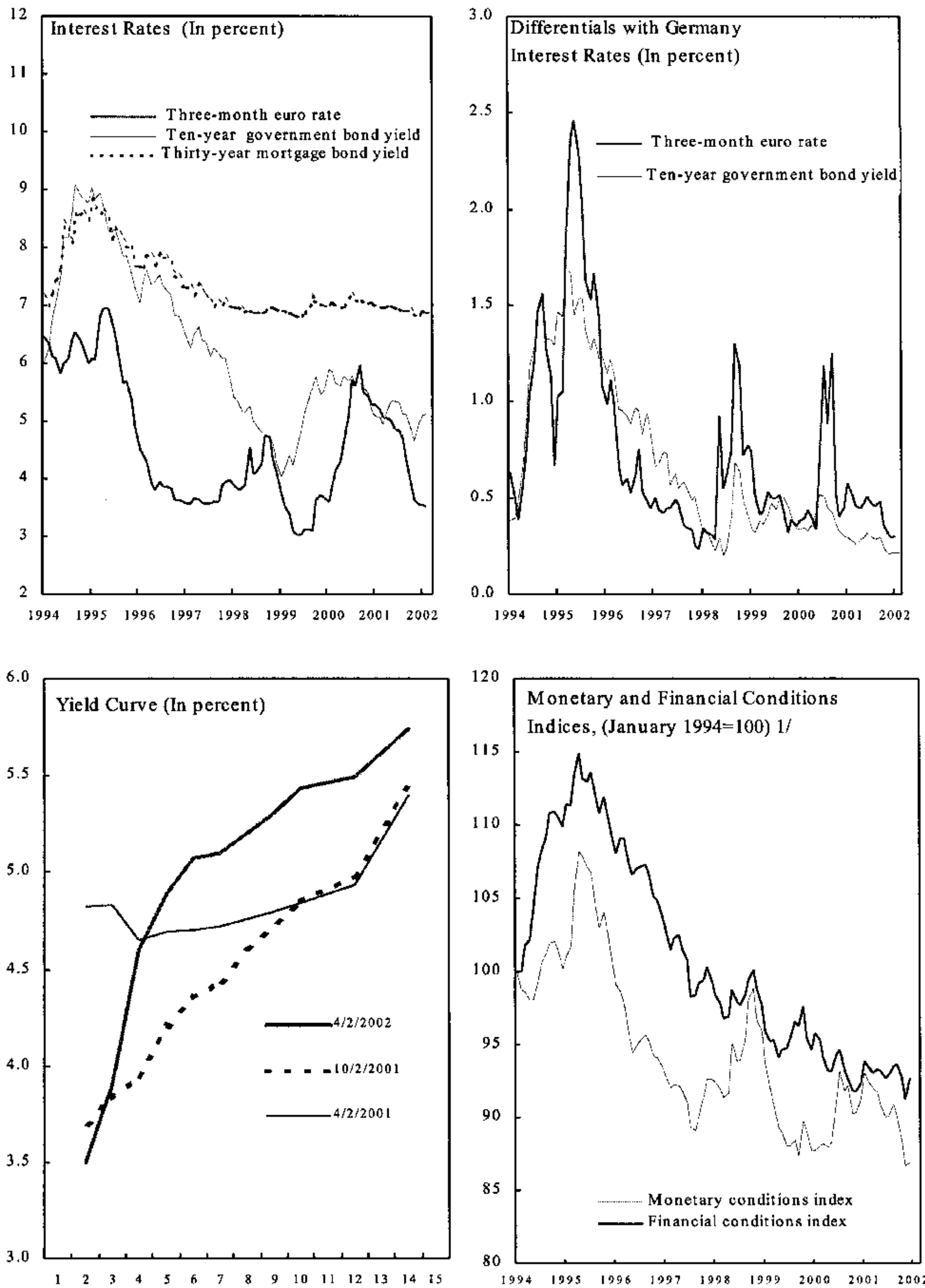
Strong capital inflows, in part from the rebalancing of pension funds' and insurance companies' portfolios away from slumping foreign equities, have contributed to a further narrowing of already-low spreads with German fixed-income securities.

7. **Denmark has run structural budget surpluses since 1997 (Figure 11).** The shift to surpluses can be attributed mainly to a large reduction in expenditure on transfers since 1993 as unemployment has fallen, and to declining interest payments. Meanwhile, the revenue-to-GDP ratio has continued to hover around a high level. A 1998 tax reform package phased in modest cuts in marginal income tax rates financed by higher "green taxes." However, the impact on the overall income tax burden was offset by increased local income tax rates to finance higher public service costs.

8. **The 2002 budget implies a broadly neutral fiscal stance.** The authorities project the actual surplus to be around 1.9 percent of GDP (Table 2). The budget incorporates a "freeze" on both tax rates and taxes that are expressed in nominal terms (notably excises and property taxes). Real public consumption growth is expected to remain above 1 percent, the target in the medium-term fiscal strategy, partly because of health care spending. Staff also assumes that spending at the local level will exceed plans. Nonetheless, staff expects the surplus to remain within the medium-term target range of 1½–2½ percent of GDP.[3]

[3] In the fiscal data for 2002 and beyond, the authorities plan to adjust revenues downward by 0.5 percentage points of GDP to reflect the removal of a funded pension plan from the public accounts. This technical change implies that the medium-term goal for fiscal surpluses would be 0.5 percentage points less than previously, making the formal target range 1½–2½ percent of GDP. For comparability, staff estimates in Table 2 adjust the fiscal accounts back to 2000. The fiscal balance continues to include another ½ percent of GDP of funded pension liabilities, making the implicit target range a surplus of 1–2 percent of GDP.

Figure 9. Denmark: Interest Rates and Monetary Conditions, 1994-2002



Sources: IMF staff calculations; and data provided by the authorities.

1/ A weighted average of deviations of interest rates (3-month for monetary conditions, and 10-year for financial conditions) and the nominal effective exchange rates from their January 1994 levels.

Table 2. Staff and Authorities' Fiscal Forecasts: 2001 and 2002

(In percent of GDP)

	2000	2001	2002 Staff	2002 Authorities
Revenues[1]	55.2	55.5	54.9	54.5
Expenditure	53.2	53.3	52.9	52.6
Balance	2.0	2.2	2.0	1.9
Structural balance[2]	1.3	2.5	2.5	--
Primary structural balance[2]	3.1	4.1	3.8	--
Fiscal impulse[3]	1.9	-1.0	0.3	0.2
Output gap (in percent of potential of GDP)	1.0	-0.1	-0.7	0.3

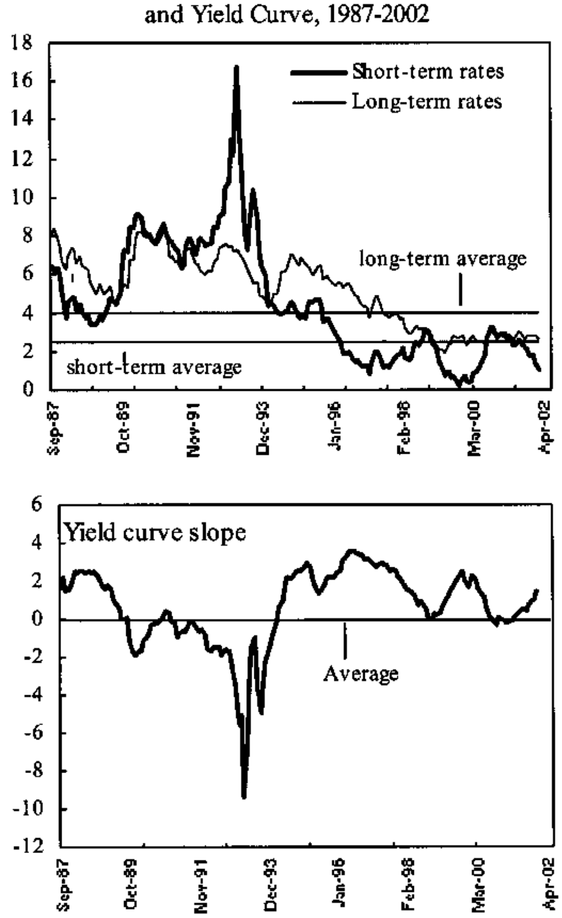
Sources: Danish Ministry of Finance; and IMF staff estimates.

[1] Revenues are reduced by 0.5 percent of GDP for transfer of pensions to private sector for comparability across years.

[2] Staff estimates of structural revenues adjust for the economic cycle and volatility in the pension yield tax.

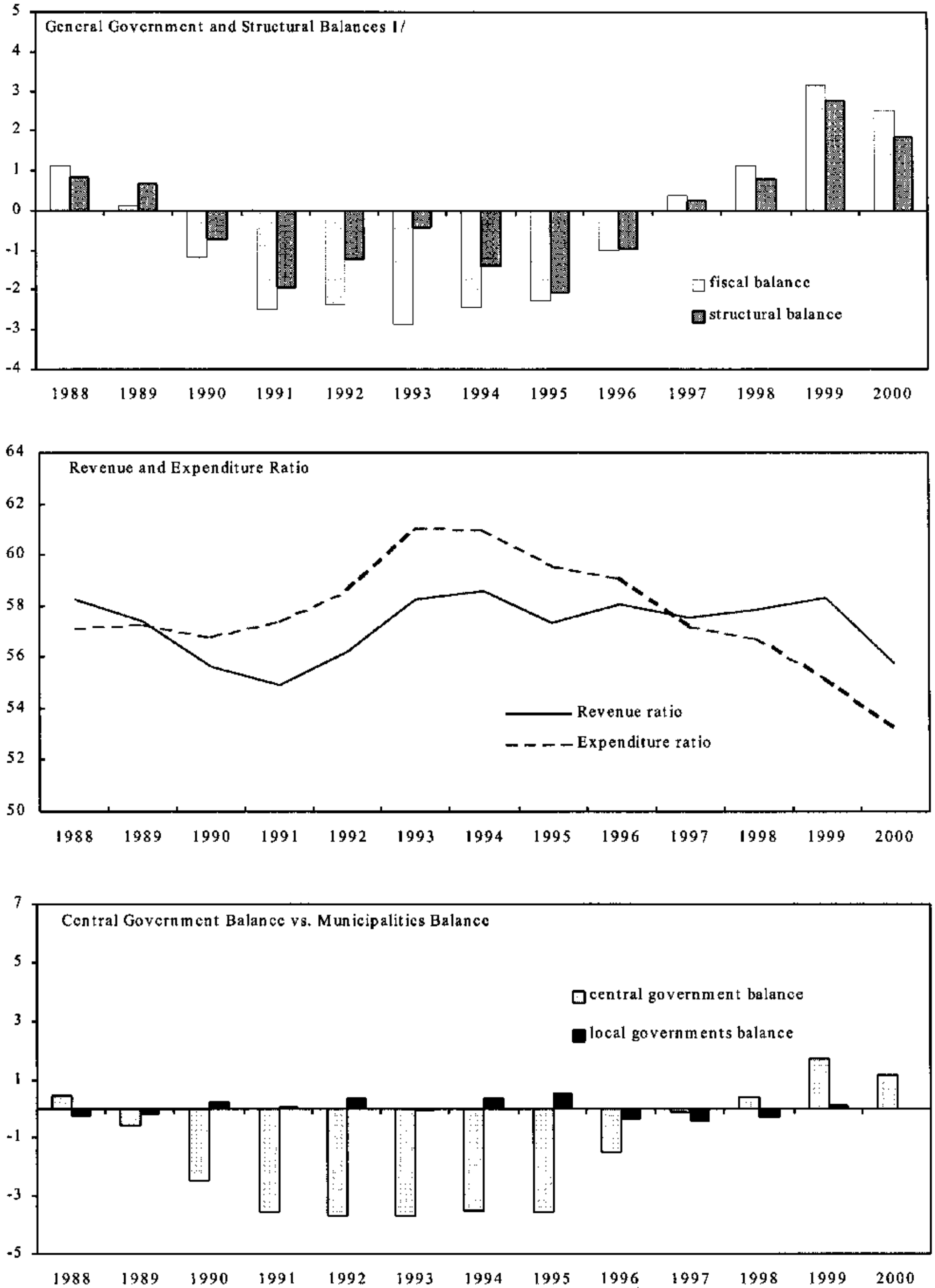
[3] Staff estimates based on the change in the primary structural balance.

Figure 10. Denmark: Real Interest Rates and Yield Curve, 1987-2002



Sources: WEFA database; Bloomberg; and staff calculations.

Figure 11. Denmark: General Government, 1988-2000
(In percent of GDP)



Source: IMF, World Economic Outlook.
1/ Structural surpluses for 1999 and 2000 are adjusted for the pension yield tax.

III. Report on Policy Discussions

9. **Discussions focused on both near-term issues—whether Denmark could manage a soft landing despite the global slowdown—and the longer-term goal of safeguarding the welfare state while accommodating the fiscal costs of an ageing population.** Denmark's recent growth record has been relatively good by continental European standards and, given earlier concerns about possible overheating, some slowdown has not been unwelcome. Concerns about a possible hard landing—present at the time of the mission, when global growth prospects were highly uncertain and risks of prolonged weakness in external demand remained significant—have now receded and the risks to the outlook have become better balanced. On longer-term issues, the authorities have made impressive progress in strengthening the fiscal position in preparation for the coming demographic change. The discussion focused on the sustainability of fiscal surpluses: whether the will existed and the mechanisms were in place to maintain sufficient expenditure discipline and whether supporting measures to alleviate labor supply constraints were adequate. A more fundamental question was whether public spending targets were sufficiently tight given that the process of globalization could be expected to eat away at the tax base that finances Denmark's comprehensive provision of public services.

A. The Short-Term Economic Outlook and the Policy Stance

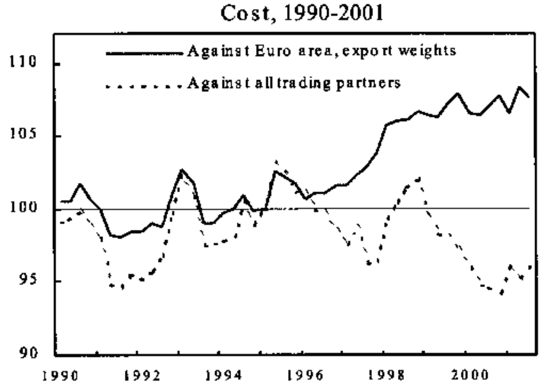
10. **The authorities felt that the slowdown in growth had been fairly gentle given the weakening environment.** They pointed out that the apparent sharp drop in growth between 2000 and 2001 was misleading because growth in 2000 had been distorted upward (and 2001 growth correspondingly distorted downward) by one-off construction spending. They viewed the drop in exports as somewhat muted relative to some of their European neighbors, reflecting the flexibility of Denmark's small- and medium-sized enterprises to respond to changing market conditions and, to a lesser extent, a compositional shift toward less cyclically-sensitive niche markets. Output growth had slowed, but this was in line with policy objectives over the last several years aimed at easing earlier concerns of overheating.

11. **The staff agreed that the economy was on course for a soft landing, but noted that the short-term outlook still contained uncertainties.** Toward the end of 2001 the economy appeared to be stagnating. With global conditions expected to remain relatively weak, the Danish economy was projected to grow by only about 1¼ percent in 2002, significantly below potential—although monetary conditions should support a firming of growth during the year. The authorities' growth forecast for 2002 is similar to the staff's. Some questions remained about the property market, where a price correction could dampen domestic demand. However, the extent of possible overvaluation was not large by historical standards and other indicators (loan-to-value ratios and household interest burden) did not appear worrisome.

12. **Both staff and the authorities expected price inflation to remain subdued in 2002, assuming that wage pressures subside.** Given that Denmark's relatively flexible labor markets allow wage contracts to reflect local productivity performance, the authorities

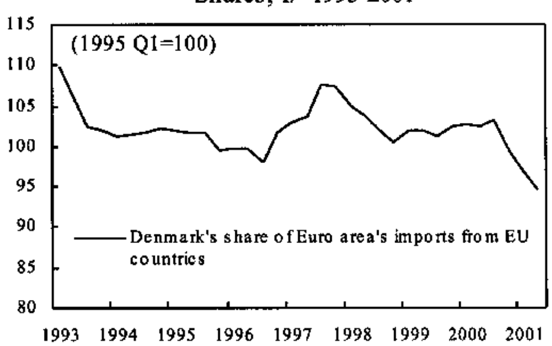
were confident that wage growth would adjust down in the coming negotiations. They were not overly concerned about recent losses in competitiveness against euro area partners, noting that overall competitiveness remained strong as reflected in a current account surplus that was expected to persist in the medium-term (Table 3). The staff observed that the overall competitiveness position reflected the weakness of the euro against major currencies; within the euro area, losses of bilateral competitiveness had shown up in a decline of market share in the last few years (Figures 12 and 13). The risk that a snap-back of the euro could reverse recent corresponding market share gains in the United States and United Kingdom, and intensify competition for sales within the euro area, reinforced the need for continued efforts to alleviate labor supply constraints in order to facilitate wage moderation.

Figure 12. Denmark: Relative Unit Labor Cost, 1990-2001



Sources: IMF, Direction of Trade Statistics; and IMF staff calculations.

Figure 13. Denmark: Export Market Shares, 1/ 1993-2001



Sources: IMF, Direction of Trade Statistics; and IMF staff calculations.

1/ Four-quarter moving average.

13. **Monetary conditions were judged to be somewhat on the easy side.** Given the cooling of the economy, the authorities were less concerned than they had been in 1999–2000 that Danish monetary conditions—determined essentially by the ECB—were too easy. Nonetheless, with the economy still close to capacity—unemployment at a 25-year low, and wage growth remaining strong—the degree of easing in 2001 had gone far enough from Denmark's perspective. Staff agreed. It also observed that the current monetary arrangements, whereby the krone is tied closely to the euro, are continuing to work well.

14. **In this context, the broadly neutral stance of the 2002 budget was judged to be appropriate and staff urged the authorities to avoid slippage in its implementation.** The authorities explained that the new government's tax freeze and election expenditure promises had been accommodated through expenditure savings in central government administration, subsidies, and foreign aid. The staff nonetheless observed that fiscal policy had a slightly expansionary bias noting that changes in the composition of spending away from foreign aid toward public consumption would add to the very small measured impulse. Given that monetary policy was providing sufficient support to demand, it would be important to avoid spending overruns, as had occurred in recent years.

Table 3. Denmark: Balance of Payments on the Current Account

(In billions of krone)

	2000	2001	2002	2003	2004	2005	2006	2007
Current account balance	20.6	39.1	34.4	46.3	45.8	44.6	42.3	39.4
(In percent of GDP)	*1.6*	*2.9*	*2.5*	*3.2*	*3.0*	*2.8*	*2.6*	*2.3*
Goods and services balance	69.0	76.7	68.4	67.1	64.4	60.9	56.5	51.6
Trade balance	52.4	53.9	48.4	47.7	46.0	43.7	40.9	37.7
Exports	403.0	416.9	430.8	458.9	487.8	516.0	544.5	569.4
Imports	350.7	362.9	382.4	411.3	441.8	472.3	503.6	531.7
Services balance	16.6	22.8	20.0	19.5	18.4	17.1	15.6	13.8
Receipts	168.1	197.4	204.0	217.3	231.0	244.3	257.8	269.6
Expenditures	151.5	174.6	184.0	197.9	212.6	227.2	242.3	255.8
Net factor income	-24.1	-20.8	-13.2	-9.2	-6.4	-3.7	-1.0	1.5
Transfers balance	-25.2	-25.5	-20.9	-11.6	-12.1	-12.6	-13.1	-13.7
Capital account	-0.1	2.0	2.3	2.8	1.8	2.2	2.3	2.3
Financial account	-45.3	-41.1	-36.7	-49.1	-47.6	-46.8	-44.6	-41.7
Net foreign direct investment	63.8	3.8	4.7	5.2	5.8	6.9	7.3	7.5
Net portfolio investment	-162.4	-5.9	-4.8	-6.7	-8.2	-14.0	-22.0	-17.6
Net other investment	51.0	-34.5	-29.5	-41.7	-37.2	-33.1	-22.5	-22.5
Change in reserves	45.8	-4.4	-7.1	-6.0	-8.0	-6.6	-7.5	-9.1
Errors and omissions	-20.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: International Financial Statistics; and Fund staff estimates, 2001-2007.

The authorities recognized the tendency toward cost overruns and had asked local governments—where much of the slippage had arisen—to find offsetting savings. The automatic stabilizers would be allowed to operate freely in the event that growth differed from that projected for 2002.

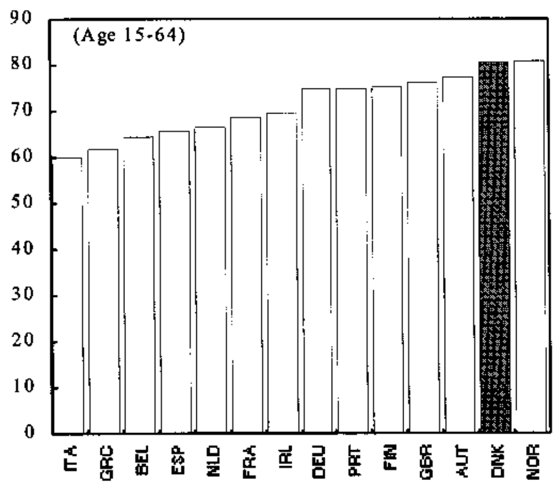
B. The Medium-Term Strategy

15. **The medium-term policy goals are well chosen but questions remain as to whether the measures to achieve them will be sufficient.** The new government has pledged its support for continuing the existing medium-term strategy. In particular, the goal is to maintain surpluses of 1½–2½ percent of GDP through 2010. To accomplish this, the authorities estimate potential output growth needs to be sustained between 1¾ to 2 percent and the labor market participation rate—which is already high by international standards—needs to increase by about 0.2 percent a year. Maintaining surpluses also relies on lowering the real public consumption growth target to 0.5 percent a year in 2006–2010 from its current target of 1 percent. Along with the expected success of current structural reforms, this would accommodate a decline in the tax burden by about 2 percentage points of GDP over the next decade. In reviewing the strategy, the discussions focused on three key questions: Are efforts to address labor market and other constraints to potential growth likely to be sufficient? Do plans to lower the tax burden go far enough? And how can expenditure restraint be achieved in the context of Denmark's decentralized public service distribution system?

Labor supply and structural reforms

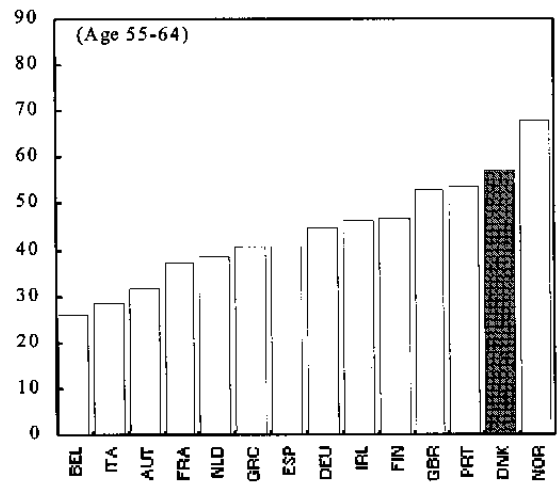
16. **The authorities' labor policies target increasing employment in a few areas where there are still pockets of relatively low labor market participation, such as older workers and immigrants (Figures 14 and 15).** Policies specifically focus on strengthening disincentives for early retirement through the redesign of early retirement schemes and on addressing welfare traps for immigrants, including by cutting their benefits for the first seven years after entering Denmark. The authorities also aim to lower the NAIRU from its current level of about 5½ percent to 4½ percent mainly through improvements in the coordination of active labor market policies with other schemes and in public placement services.

Figure 14. Denmark: Participation Rate in 2000



Sources: OECD, Analytical database.

Figure 15. Denmark: Participation Rate in 2000



Sources: OECD, Analytical database.

17. **The staff questioned whether current policy initiatives would prove sufficient to achieve the targeted growth in labor supply.** Previous changes to early retirement schemes appeared to have contributed to lengthening working life and increased participation of older workers.[4] Independent studies estimate, however, that the additional number of older workers encouraged to stay on the job will likely fall short of the authorities' expectations. The staff thus suggested that added financial disincentives for early retirement would be needed, such as raising pension benefits for those working longer and paying lower pensions to those opting for early retirements. Furthermore, measures aimed at eliminating welfare traps for immigrants by cutting benefits might not be effective in raising employment given the relatively low skill and productivity of many immigrants combined with the high minimum wage levels agreed among the social partners. In any case, welfare traps were not solely an issue for immigrants and a general review of the duration and generosity of benefits was called for. This would be consistent with the objective of reducing the NAIRU further. The authorities noted that both early retirement and immigrant participation were highly sensitive and challenging issues. As the elimination of the pre-early retirement scheme had been politically contentious, new initiatives were on hold. As regards immigrant participation, they pointed out that their policy proposals contained a number of measures to strengthen training

[4] The now-eliminated pre-early retirement scheme allowed long-term unemployed 50-59 year olds who were members of an insurance fund to leave the labor market. Early retirement allows 60–66 year olds who have been members of an insurance fund for at least 25 of the last 30 years to partially or fully withdraw from the labor market.

and integration. They were also asking the social partners to relax minimum wage requirements for immigrants and conditions for their participation in apprenticeships.

18. **The authorities emphasized their determination to continue structural reforms in product markets.** Denmark has taken steps to enhance competition policy, including by tightening merger control, and further changes are being reviewed, such as a proposal to increase financial penalties for anti-competitive behavior (deemed to be too low compared to other European countries). The authorities identified competition problems in a number of industries but noted that, with the full effect of recent policy changes, these should diminish.[5] Further deregulation in a number of sectors (natural gas, electricity, railway and postal sectors) was also expected to enhance competition. Staff supported the planned privatization and deregulation in these sectors, noting that they should lead to cost savings and higher efficiency, but cautioned that a strong regulatory framework was needed prior to privatization of network industries to avoid the pitfalls observed in other countries. It noted that, in the utility sector, the opening of the natural gas market has trailed that of European partners. Moreover, some aspects of environmental policies had been poorly designed, leading to inefficient subsidies for some types of energy production. The authorities recognized these issues and were attempting to correct them.

Tax burden sustainability

19. **Staff welcomed the new emphasis on reducing the tax burden, which at about 48 percent of GDP is one of the highest in the EU, but questioned whether current plans went far enough.** The sustainability of Denmark's high taxes may become questionable, especially as other EU countries plan to lower their tax burdens over time; on current plans, the tax burden would only fall to 46 percent of GDP in 2010 (Box 1). While empirical evidence of clearly deleterious effects of high taxes on Denmark's growth performance is not conclusive, globalization is likely to enhance factor mobility and raise the likelihood of tax base erosion. The freeze on taxes was thus a welcome first step, but staff felt that its extension to categories (excises and property taxes) where tax revenues normally increase with inflation would need to be reviewed. The resulting revenue losses over time would whittle away the opportunities for other more needed tax cuts.[6] The authorities were aware that the freeze was not necessarily the most efficient way to bring down the tax burden, but emphasized that it was helping to draw attention to high taxes and to instill spending discipline. The tax freeze was in any case a political commitment for the new government's term of office.

[5] The Competition Authority's analysis shows competition in Denmark to be in the bottom half of OECD countries.

[6] The authorities estimate the revenue loss as 0.3 percent of GDP (2000-level) until 2005 using up about one-third of the margin for tax reductions that had been built into the previous medium-term strategy.

Box 1. Do High Taxes Matter for Denmark's Growth Potential? [1]

Denmark's tax burden is the second highest among EU countries. The average marginal effective tax rate on labor income is, at close to 55 percent, particularly high. However, **while high taxes can create distortions and reduce economic efficiency, empirical studies are not clear on how much this has affected Denmark's growth performance:**

- High labor income taxes, combined with a generous benefit system, potentially make for a bias toward leisure. This manifests itself in welfare traps at the low end of the wage scale and shrinking hours at the higher end. But while studies detect welfare traps, they find that labor supply elasticities are quite low in Denmark—hence the impact on working hours is possibly relatively small.
- Healthy levels of aggregate and household savings do not provide *prima facie* evidence of distortions of the consumption-savings choice. Denmark's complicated and non-neutral taxation of capital income may, however, lead to distortions in the *structure* of savings. This is confirmed in one study showing that household financial savings are very sensitive to tax changes.

Nonetheless, maintaining a high tax level is likely to become more challenging in the future:

- Increased economic integration and factor mobility may erode the tax base.
    - Empirical evidence indicates that foreign direct investment flows are both strongly influenced by taxation and influence the corporate tax base.
    - Migration may erode the labor income tax base if workers with higher income move to countries with a lower tax burden. So far, while the trend is clear, the number of high income-earning emigrants from Denmark is not large.
- Similar forces could lead to competition to cut tax rates, although empirical evidence of a race to the bottom is as yet not overwhelming.
- Demographic developments that will shrink the labor income tax base will likely necessitate a shift toward alternative tax bases. As VAT rates are already high, and taxing mobile bases is inefficient and/or distortionary, finding substitutes is likely to be difficult.
- "Fiscal termites"—a phrase coined by Tanzi—may eat into the foundations of the tax system. Globalization and technological changes, including e-commerce, will continue to make tax evasion easier.
- Distortions may become stronger over time. Some economists have argued, for example, that over the long run, social norms may drift in countries with large welfare states. This would manifest itself in tax evasion, an increasing misuse of welfare services, and an expanding shadow economy.

[1] Further discussion and references to specific studies can be found in the accompanying paper on Selected Issues and in the Selected Issues Paper on Sweden, SM/01/269.

20. **Lowering high labor income tax rates is the first priority (Figure 16).** Currently, for example, over 40 percent of full-time single workers pay the highest marginal tax rate of 63 percent. Although evidence regarding the effect on labor supply is mixed, studies have noted that a reduction of the number of individuals covered by the highest tax bracket would not greatly reduce tax revenues while potentially encouraging labor supply. Tentative signs of a Danish "brain drain" and pressure for lower working hours were cited as evidence of the effects of high taxes. Staff noted that there was little scope to shift from direct to indirect taxes as Denmark had one of the highest VAT rates in the world and "green" taxes already amounted to about 10 percent of total tax revenues. The authorities had placed income tax cuts high on their agenda even though they did not see current tax levels as an immediate problem for labor supply.

Expenditure restraint

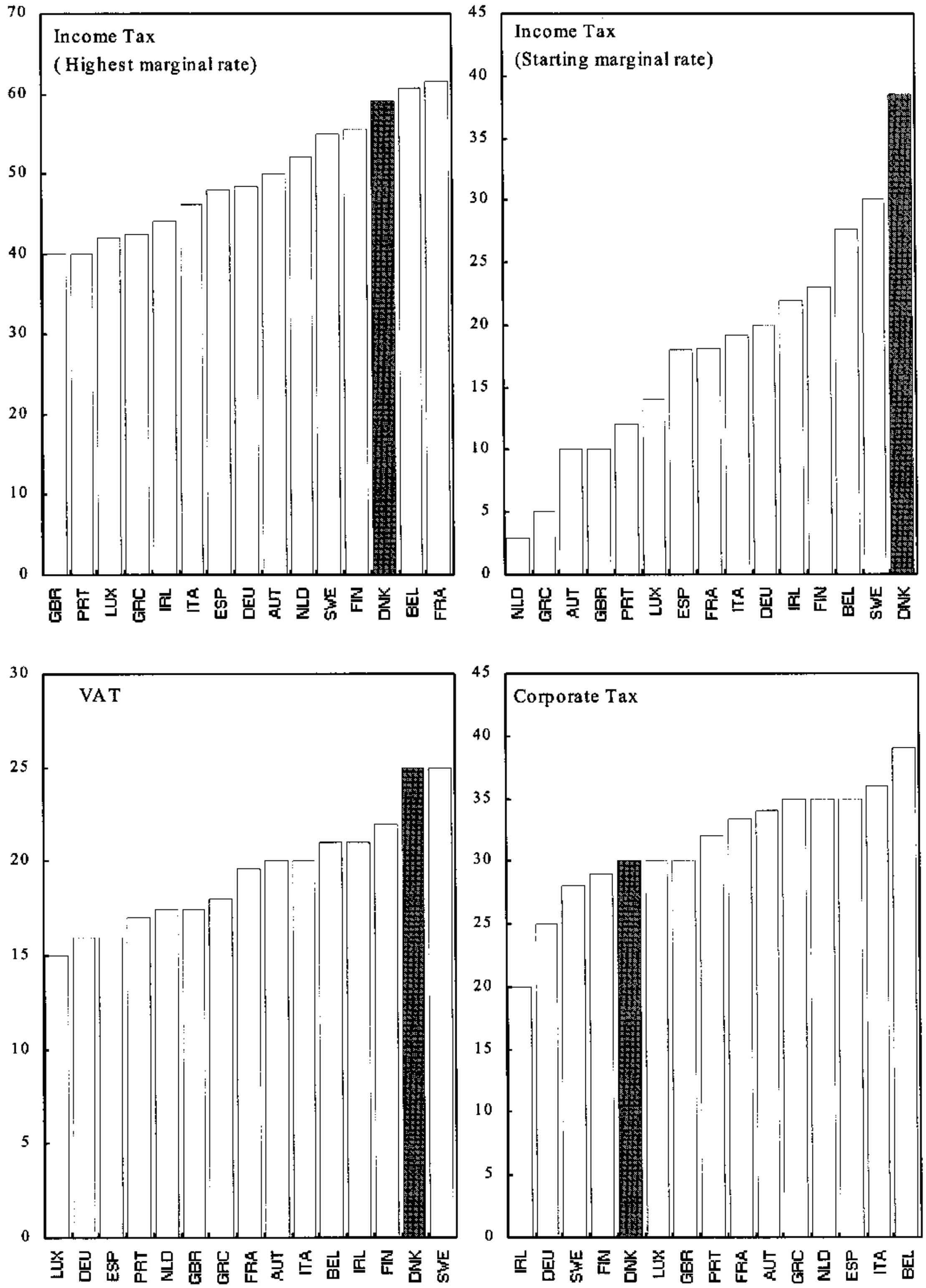
21. **The Achilles' heel of Danish fiscal policy has long been expenditure restraint.** Staff acknowledged that the reduction in the expenditure burden has been impressive—a drop of 8 percentage points from 61 percent of GDP in 1994 to 53 percent of GDP in 2001—but noted that much of the reduction reflected the one-time effects of a fall in unemployment, and interest savings. By contrast, the public consumption growth target had been breached in most of the last several years. Staff simulations showed that even small slippages from the real public consumption growth targets in the future could lead to an early elimination of the fiscal surplus and steeply rising debt levels in the longer run (Box 2).[7] The authorities explained that expenditure overruns mainly occurred at local levels, particularly in health care where spending was not high by international standards.

22. **The staff stressed the need for better expenditure control at the local government level.** Some 70 percent of government consumption occurs at the local level and municipalities and counties are responsible for administering many of the social services and benefits covered by the public sector. The authorities acknowledged that annual agreements between the central and local governments regarding the local governments' budgets had not been adhered to. Nonetheless, previous attempts to strengthen incentives to restrain spending or impose penalties on over-spending of localities had been unsuccessful. They saw some hope that the tax freeze would gain acceptance at local levels and thus exert a degree of spending discipline.[8] Staff was less convinced that voluntary mechanisms would be sufficient and urged the authorities to look again into where perverse incentives for local government to

[7] See accompanying Selected Issues Paper.

[8] Localities and municipal governments are not allowed to run deficits. Increased spending is accompanied either by more transfers from the central government or increased local taxes.

Figure 16. Tax Rates in Selected Countries in 2000



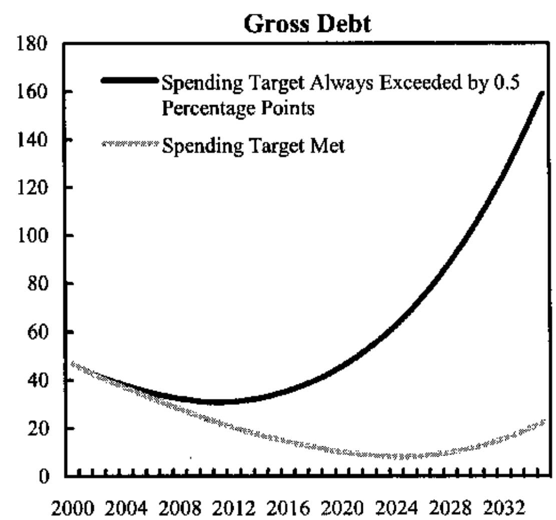
Sources: International Bureau of Fiscal Documentation, European Tax Handbook 2000; Price Waterhouse Coopers Corporate Taxes 1999-2000 and Individual Taxes 1999-2000; German Ministry of Finance; and EU Excise Duty Tables (July 2001).

spend could be eliminated and where rewards and penalties could play a useful role.[9] For their part, the local and municipal governments felt that the burden of supplying public services to satisfy the increasing demands of their constituents, especially for health care, elderly care, and education, left them few choices. The staff encouraged the authorities to explore methods to help make public service provision more efficient, such as improving public management incentives, outsourcing services where appropriate, and examining likely areas to impose user fees. The new government has placed these items on its agenda.

Box 2. Age-Related Spending Increases and Public Finance Sustainability

Staff estimate that the GDP shares of health care, long-term care, and old age pensions will increase by 0.7, 2.3, and 2.9 percentage points, respectively, from 2000 to 2035—altogether nearly 6 percentage points. Assuming tax-raising possibilities will be limited in the future, restraint on other spending will be necessary to avoid the reappearance of large fiscal deficits.

The current fiscal strategy is well designed to take care of expected demographic pressures. Assuming the authorities' reform agenda successfully raises labor supply and real public consumption growth is kept to the target, staff projections show that the public debt ratio would fall to a very low level before rising moderately in the years when demographic strains would be greatest. This suggests that the authorities have some room to accommodate deviations from assumptions or policy slippage. However, staff sensitivity analysis (described in the accompanying background paper) suggests that the room is quite limited. In particular, if the tax base were to come under significant pressure, any room would be quickly exhausted. And if the spending targets were exceeded by only 0.5 percentage points a year, budget surpluses would vanish rapidly and the debt-to-GDP ratio would be on an unsustainable path (see figure).



[9] Recent evidence is suggestive. When the central government agreed to pay local government only 35 percent of the disability payment instead of 50 percent, the number of new recipients into this scheme declined dramatically.

C. Financial Sector

23. **Several years of solid economic growth have enabled Danish banks to build up capital and reduce bad loans, suggesting potential losses associated with the slowing economy can be comfortably accommodated.** The supervisory authorities noted that bank capitalization ratios were high, provisions were coming off historic lows, and profitability had been good (Table 4).[10] They expected some deterioration in credit quality as the previously high credit growth and the slowing economy combine to increase non-performing loans. While some types of real estate lending remained on banks' balance sheets, risks of housing price declines were mostly borne by mortgage bondholders. Moreover, household mortgage defaults and forced sales were at historical lows. Outside the banking sector, insurance companies and pension funds had been hit by declines in the stock market that had eaten into their reserves. The situation was exacerbated by their earlier guarantees to pay fixed nominal interest rates on some policies, forcing them to take on higher risks in equity markets to make up for lower fixed-income returns. Supervisors were cognizant of these risks and had been proactively forcing firms with low reserves to recapitalize. They believed the risks, however, were contained to just a few of the 90 pension and insurance companies and that adequate separation of legal entities existed to forestall systemic links to the banking system.

24. **Increasing conglomeration and cross-border mergers in the financial service industry are providing regulators and supervisors with new challenges.** Two mergers among the largest financial institutions in Denmark have led to very high concentration ratios in the banking sector—70 percent of total loans are held by the top 2 banks. Despite these levels, the authorities thought that competition in the retail market was still robust, aided by adequate consumer information and the advent of e-banking. Competition analysis also needed to account for the different markets in which banks operate. For instance, a recent Nordic cross-border merger implied that the resulting large bank competed in both the international and the domestic arena. The Financial Supervisory Authority (FSA) had signed a complex four-country Memorandum of Understanding (MOU) to assure appropriate supervision over the cross-border entity, but felt such MOUs, if needed for every such institution, would soon become burdensome to negotiate. Increased conglomeration had prompted the FSA to amalgamate the several supervisory acts into one law to remove any loopholes that may exist. In this way, the FSA has taken preemptory actions to minimize problems that can arise, for example, from disparate capital requirements, and provide consistent consolidated supervision. The authorities expressed their interest in undertaking a Financial Sector Assessment Program (FSAP).

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[10] The average solvency ratio for Danish banks is about 15 percent, well above the Basel 8 percent minimum. The average Tier I capital ratio is just above 9 percent.

Table 4: Denmark: Indicators of External and Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002 1/	Obs. Date 2/
External indicators						
Exports (annual percentage change, in U.S. dollars)	-3.23	7.05	6.46	5.22	3.35	
Imports (annual percentage change, in U.S. dollars)	3.69	-0.68	5.98	4.73	5.37	
Terms of trade (annual percentage change)	0.0	0.5	0.8	1.5	-2.0	
Current account balance	-0.9	1.7	1.6	2.9	2.5	
Capital and financial account balance	-1.2	5.8	-4.3	-0.3	--	Dec '01
Of which: Inward portfolio investment (net,debt securities)	0.2	1.2	-1.6	-1.3	-0.7	Jan '02
Inward portfolio investment (net,equity)	-1.2	0.0	1.5	0.6	0.0	Jan '02
Inward foreign direct investment	4.0	9.1	20.1	4.2	0.1	Jan '02
Other investment liabilities (net, inward =positive)	2.5	7.1	4.2	0.5	2.9	Jan '02
Official Reserves (in billions of U.S. dollars, end-of-period)	15.1	23.7	15.1	17.5	20.6	Jan '02
M3 to reserves ratio	5.2	3.2	4.1	3.7	--	Dec '01
Central bank foreign liabilities (in billions of U.S. dollars)	0.2	0.3	0.4	0.4	0.2	Feb '02
Foreign assets of the financial sector (in billions of U.S. dollars) 3/	74.6	82.6	78.0	66.8	71.7	Feb '02
Foreign liabilities of the financial sector (in billions of U.S. dollars)	59.3	73.3	82.1	82.6	92.6	Feb '02
Official reserves in months of imports	3.1	4.9	2.9	3.3	--	Nov '01
Total net external debt	26.48	14.42	16.90	--	--	Dec '00
Of which: General government debt	29.08	23.15	17.05	--	--	Dec '00
External debt to exports ratio	0.72	0.38	0.38	--	--	Dec '00
Exchange rate against U.S. dollar (period average)	6.70	6.97	8.11	8.35	8.57	Feb 28, '02
Financial markets indicators						
Public sector debt (Maastricht definition)	56.2	52.7	46.8	43.9	42.9	Jan '02
3-month CIBOR yield (e.o.p)	4.1	3.7	5.3	3.5	3.7	April 2, '02
3-month CIBOR yield (real)	3.0	1.7	3.3	1.2	1.1	April 2, '02
Change in stock market index (percent, end of period) 4/	4.2	16.6	22.4	-13.5	2.6	April 2, '02
Spread of 3-month CIBOR with the FIBOR/EURIBOR (basis points, e.o.p.)	77	22	35	23	24	April 2, '02
Spread of 10-year govt. bond with the 10-yr Bund (basis points, e.o.p.)	40	34	30	22	23	April 2, '02
Financial sector risk indicators						
Share of foreign denominated liabilities in total liabilities (percent)	26.0	31.1	38.1	38.0	41.9	Feb '02
Share of mortgage credit institute lending in total lending (percent) 5/	58.2	55.3	53.7	54.5	--	Feb '02
(percent growth in lending)	9.1	8.5	4.2	8.8	1.0	Feb '02
Share of owner-occupied homes in mort. credit inst. lending (percent)	55.7	56.7	57.4	58.5	58.5	Feb '02
(percent growth on owner-occupied lending)	12.1	10.5	5.5	10.9	1.0	Feb '02
Share of adjustable rate mortgages in total mortgage lending 6/		5.7	9.1	20.1	22.4	Feb '02
Percent of total loan loss reserves in loans and guarantees (stock)	3.2	2.8	2.7	--	--	2000
Percent of specific loan loss provisions in loans and guarantees (flow)	0.3	0.3	0.3	--	--	2000
Core capital ratio (Tier 1)	9.3	9.0	9.9	--	--	2000

Sources: Danmarks Nationalbank; IMF, International Financial Statistics; IMF, World Economic Outlook.

1/ Fund staff estimates and projections, unless otherwise indicated.
2/ Date of last available observation.
3/ Financial institutions are banks (excludes mortgage institutes).
4/ KFX stock market index.
5/ Share of mortgage credit institutes lending in total bank and mortgage institute lending.
6/ Data collected from 1999 only.

D. Statistical and Other Issues

25. Denmark subscribes to the SDDS and its **economic data** coverage is comprehensive. Balance of payments data, which come from two sources, show increasing discrepancies. The authorities are developing methods for reconciling the data.

26. The 2002 government budget reduces **ODA** slightly but Denmark will continue its top ranking among OECD countries with ODA equivalent to 1.0 percent of GNP. The authorities argued their commitment to development aid was undiminished.

27. Denmark has adopted the OECD's **anti-bribery convention** and has satisfied the 40 Financial Action Task Force (FATF) recommendations (including all 28 of the recommendations requiring specific action) in the area of **money laundering**. New legislation that strengthens the original law and adds elements to combat terrorist financing has been introduced to Parliament and is expected to pass quickly.

IV. Staff Appraisal

28. **Denmark has weathered the global slowdown well with economic developments consistent with a successful soft landing.** Sound economic policies and relatively flexible labor markets have contributed to the economy's resilience. Although economic growth is likely to remain sluggish in the first half of 2002, the expected recovery in the global economy and supportive monetary conditions should boost growth in the second half of the year.

29. **The policy stance appears appropriately tailored to the risks to the outlook.** Monetary conditions are putting a protective floor under the economy in case downside risks begin to materialize. The remaining vestiges of previous overheating—relatively strong wage growth and high capacity utilization in some industries—militate against an active fiscal policy response to such risks. It will be important, therefore, to avoid spending overruns while allowing for the operation of automatic stabilizers.

30. **Overall competitiveness appears healthy, providing few tensions for the exchange rate peg.** Some wage moderation is likely to be needed in the period ahead to stem recent losses of market share in continental Europe especially as a possible snap-back in the euro could intensify competition for external markets. Ongoing efforts to improve the flexibility of labor markets and increase labor supply would facilitate wage adjustment.

31. **Policymakers' focus on providing a stable macroeconomic framework that prepares the fiscal accounts for the consequences of population ageing is well-placed.** So far, Denmark's preparations for the forthcoming challenges to fiscal policy have been exemplary. The medium-term strategy of running fiscal surpluses should continue.

32. **To maintain surpluses in the targeted range, however, the mixed record of expenditure discipline will need to be improved.** The government's tax freeze will help to focus attention on the redistribution of public expenditures, but does not provide a full solution to problems of poor expenditure control, particularly at lower levels of government. In this regard, attempts to penalize over-spending should be renewed and a limit to local tax increases could be explored. As well, intentions to improve public management, outsource services where appropriate, and impose user fees are encouraged.

33. **Potential threats to the sustainability of the tax base reinforce the need for expenditure control.** In this regard, the public expenditure target may not be sufficiently ambitious to provide enough room for tax cuts in the medium term. The authorities should therefore give consideration to bringing forward the planned reduction to 0.5 percent of the targeted growth rate for real public consumption. As meaningful medium-term spending restraint will require a careful examination of all programs, thought should also be given to broadening the expenditure target to cover social transfers, which are high by international standards.

34. **The most pressing area for tax reform is labor income taxes where rates are among the highest in the world, potentially dampening labor supply incentives.** While the tax freeze is a useful start in rolling back the overall tax burden, it could be better targeted. Income tax rates will need to be reduced and tax thresholds raised to provide an environment more conducive to improving labor supply.

35. **Policies to alleviate labor supply constraints should be strengthened.** Denmark has accomplished much over the last several years, instituting reforms that have lowered structural unemployment substantially. The leakage of workers out of the labor force through early retirement and disability is being stemmed, but to encourage older workers to stay longer in the labor force, additional financial disincentives for early retirement should be considered. And welfare traps and problems of high minimum wages dampen labor supply not only of immigrants, and should be addressed more broadly through reform of the benefit and tax system.

36. **Recent steps to strengthen competition policies are welcome and should be accompanied by further efforts to open up network sectors.** The Competition Act, considered a sound basis, is being strengthened by, for instance, increasing financial penalties for anti-competitive behavior. The authorities are encouraged to speed up the opening of natural gas markets, which is lagging EU peers, and to ensure that their commendable environmental protection does not obstruct competition in the energy markets.

37. **In the financial sector, high capitalization ratios suggest banks are well-positioned to weather the economic slowdown.** Although some insurance and pension funds were put under pressure last year when stock markets fell, the problems appear limited in scope. However, the movement into potentially more risky and complex securities by these institutions will require improved risk management systems. The planned unification of the financial supervisory acts and the establishment of a cross-border MOU are laudable and

should help to enhance consolidated supervision. The authorities are urged to move ahead expeditiously with their proposed new anti-money laundering law.

38. **Denmark has an outstanding record of providing ODA.** It is accordingly hoped that the authorities will not scale back the aid budget further.

39. Denmark provides comprehensive data that are generally adequate for surveillance purposes. It is proposed that the next Article IV consultation take place on the 24-month cycle.

Denmark: Basic Data

Total area 43,094 square kilometers
Total population (2000) 5.3 million

	2001 In billions of krone	2001 In percent of GDP	1997	1998	1999	2000	2001 1/	2002 1/
	(At current prices)		(Percentage change at 1990 prices)					
Demand and supply								
Private consumption	630	46.9	2.9	2.3	0.2	-0.3	0.6	1.1
Public consumption	343	25.5	0.8	3.1	1.8	0.6	1.4	1.4
Gross fixed investment	284	21.1	10.9	10.1	1.0	10.7	0.0	1.7
Residential buildings	53	3.9	7.1	4.2	2.5	11.0	-13.1	0.5
Inventory accumulation 2/	0	0.0	0.9	-0.1	-1.3	0.2	0.4	-0.1
Total domestic demand	0	0.0	4.9	4.0	-0.5	2.6	1.1	1.2
Exports of goods and nonfactor services	609	45.3	4.1	4.3	10.8	11.5	3.1	3.7
Imports of goods and nonfactor services	523	38.9	10.0	8.9	3.3	11.2	3.8	3.6
Foreign balance 2/	86	6.4	-1.7	-1.4	2.8	0.6	-0.1	0.2
GDP	1,343	100	3.0	2.5	2.3	3.0	0.9	1.3
Output gap (in percent of potential GDP)			0.1	-0.1	0.0	1.0	-0.1	-0.7
			(In percent of GDP)					
Saving								
Private			18.9	18.0	17.2	18.5	21.0	22.0
Public			2.3	2.8	4.6	4.7	3.0	3.0
			(Percentage change)					
Employment and unemployment								
Labor force			0.3	0.3	0.3	0.5	0.3	0.2
Employment			1.4	1.7	1.3	0.8	0.5	-0.1
Unemployed 3/			7.8	6.5	5.6	5.2	5.0	5.2
			(Percentage change)					
Prices and incomes								
GDP deflator			2.2	1.0	2.7	3.7	2.7	2.2
Consumer price index			2.2	1.8	2.5	2.9	2.1	2.3
Hourly wages (Private sector)			3.7	3.9	4.2	4.0	4.3	4.4
Unit labor costs (manufacturing)			-3.9	4.6	2.6	-3.0	0.4	3.2

1/ Staff projections.
2/ Change as percent of previous year's GDP.
3/ In percent of labor force.

Denmark: Basic Data (concluded)

	2001 In billions of krone	1997	1998	1999	2000	2001 1/	2002 1/
			(In percent of GDP; unless otherwise noted)				
Public finances							
General government							
Expenditure	715	57.2	56.7	55.2	53.2	53.3	52.9
Revenue 2/	739	57.7	57.9	58.3	55.7	56.0	54.9
Financial balance 2/	23	0.5	1.1	3.1	2.5	2.7	2.0
General government debt	592	61.2	56.2	52.7	46.8	44.1	41.0
			(In billions of DKr., unless otherwise noted)				
Balance of payments							
Merchandise trade balance (f.o.b.)		38.1	23.0	42.4	52.4	53.9	48.4
Non-factor services balance		8.9	-3.1	11.4	16.6	22.8	20.0
Net factor income		-24.0	-28.7	-17.0	-24.1	-20.8	-13.2
Net transfers		-8.8	-9.9	-20.4	-25.2	-25.5	-20.9
Current account		4.4	-10.2	20.2	20.6	39.1	34.4
(In percent of GDP)		0.4	-0.9	1.7	1.6	2.9	2.5
Financial account		56.1	-10.0	42.3	-45.3	...	...
Foreign direct investment		-10.3	16.5	-10.4	63.8	...	...
Portfolio investment		32.7	-68.1	-18.9	-162.4	...	...
Other		33.8	41.6	69.6	51.0	...	...
Derivatives		....	....	2.0	2.3	...	...
Net increase (+) of foreign exchange reserves less gold (percent)		35.2	-20.2	46.0	-32.2	13.3	...
Foreign exchange reserves (US$, e. o. p.)		18.2	13.8	21.1	14.5	16.1	...
			(Percentage changes, end of period)				
Monetary data							
Broad money (national definition)		5.2	2.9	4.1	2.0	...	...
Domestic credit 3/		8.7	13.1	-1.9	6.1	3.6	...
			(Period averages in percent)				
Interest rates 4/							
Three-month euro rate		3.7	4.2	3.3	4.9	4.6	3.7
differential with Germany		0.4	0.7	0.4	0.6	0.4	0.2
Yield on ten-year government bonds		6.3	4.9	4.9	5.7	5.1	5.5
differential with Germany		0.6	0.4	0.4	0.4	0.3	0.2
			(Levels)				
Exchange rates 4/							
DKr per US$ (end of period)		6.8	6.4	7.4	8.0	8.4	8.5
DKr per US$ (annual average)		6.6	6.7	7.0	8.1	8.3	8.5
Euro per US$		0.88	0.90	0.94	1.08	1.12	1.14
Nominal effective rate (1990=100) 5/		104.9	105.6	104.4	100.6	102.1	101.9
Real effective rate (1990=100) 6/		98.3	100.1	99.4	95.2	96.6	97.7

1/ Staff projections, unless otherwise stated.
2/ Fiscal revenues and financial balance for 2002 reduced by 0.5 percent of GDP for transfer of pensions to private sector.
3/ Lending growth for banks and mortgage institutions.
4/ Data for 2002 refer to April 2, 2002.
5/ Data for 2002 refer to February 2002.
6/ Based on consumer price index; data for 2002 refer to January 2002.

Denmark: Fund Relations
(As of February 28, 2002)

I. **Membership Status**: Joined March 30, 1946. Denmark has accepted the obligations of Article VIII.

		SDR Million	Percent Quota
II.	**General Resources Account**:	SDR Million	Percent Quota
	Quota	1,642.80	100.00
	Fund holdings of currency	1,056.08	64.29
	Reserve Tranche position	586.72	35.71

III.	**SDR Department**:	SDR Million	Percent Allocation
	Net cumulative allocation	178.86	100.00
	Holdings	159.19	89.00

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None.

VII. **Exchange Rate Arrangements**:

- Denmark participates in the exchange rate mechanism II (ERMII). It maintains 2¼ percent fluctuation margins vis-à-vis the euro with a central rate at DKr 746.038 per €100.

- Denmark maintains exchange restrictions against Iraq (U.N. Security Council Resolution No. 661) and against Libya (U.N. Security Council Resolution No. 833). These have been notified to the Fund in accorance with Decision No. 144.

VIII. **Article IV Consultation**: Denmark is on the 24-month consultation cycle. The staff report for the last Article IV consultation (SM/99/197) was discussed at EBM/99/89 (August 5, 1999).

IX. **Technical Assistance**: None.

X. **Resident Representative**: None.

Denmark: Statistical Appendix

Denmark has a full range of statistical publications, many of which are on the Internet. The quality and timeliness of the economic database are very good and generally adequate for surveillance purposes.

The gap between exports based on trade data (collected by Danmarks Statistiks) and exports based on balance of payments statistics (collected by the Nationalbank Danmark) has widened in recent years. The discrepancy reflects different sources of information and methodologies used by the two organizations. Ongoing discussions between the two organizations, however, have not yet led to a satisfying reconciliation of the two data series.

The authorities have introduced new data on monetary financial institutions that conform to the ESA95 and expand the set of financial institutions covered in the Nationalbank's statistical bulletin. This permits an examination of some categories of financial institutions not covered before (e.g. money market funds, small banks, and cooperative banks) allowing a more thorough look at the financial sector. Some of the financial account data come from this enhanced source. Data for monetary authorities are reported to STA on a timely and regular basis. Work on the resumption of regular reporting to STA of revised data for deposit money banks is underway.

Denmark subscribes to the Fund's Special Data Dissemination Standards (SDDS). Metadata are posted on the Data Standards Bulletin Board.

Denmark: Core Statistical Indicators
as of April 3, 2002

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	4/2/02	2/28/02	2/28/02	2/02	12/01	4/2/02	2/02	1/02	1/02	2000	2001 Q4	12/00
Date Received	4/3/02	3/4/02	3/4/02	3/21/02	3/02	4/3/02	3/12/02	3/16/02	3/16/02	11/01	2/27/02	3/02
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Semi-Annual	Quarterly	Annually
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Quarterly	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Annually
Source of Update	TRE database; RES database	Nationalbank website	Nationalbank website	National-bank website	National-bank website	TRE data-base; RES data-base	Electronic update	Electronic update	Electronic update	Danmarks Statistics	Electronic update	Electronic update
Mode of Reporting	Electronic	Publication	Publication	Publication	Publication	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Quarterly	Daily	Monthly	Monthly	Monthly	Semi-annually	Quarterly	Annually

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/55
May 21, 2002

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Denmark

On May 8, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Denmark.[1]

Background

Since 1993, Denmark has enjoyed relatively robust economic growth. Helped by cautious fiscal policies and reforms in labor markets, fiscal deficits have been turned into structural surpluses and the public debt ratio has been nearly halved. The unemployment rate has declined to a 25-year low of 5 percent. The external current account has been registering comfortable surpluses.

Growth slowed significantly during 2001 as domestic demand weakened and exports were hit by the global economic slowdown. Unemployment remained low and wage growth was somewhat faster than in euro area partner countries. However, price inflation was subdued. Monetary conditions were eased during 2001 as Danish interest rates generally followed those of the European Central Bank (ECB) downward. The 2002 budget implies a broadly neutral fiscal stance with the surplus projected to remain within the medium-term target of 1.5–2.5 percent of GDP. IMF staff project that real GDP growth in 2002 will be about 1.3 percent as recovery in Denmark's trading partners and supportive monetary conditions are expected to foster a pickup in growth during the second half of the year.

[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. This PIN summarizes the views of the Executive Board as expressed during the May 8, 2002 Executive Board discussion based on the staff report.

The new government intends to continue the medium-term strategy of running fiscal surpluses in order to prepare for the fiscal costs of an ageing population. To meet the fiscal target and provide some room for reducing Denmark's high tax burden, real public consumption is targeted to grow by 1 percent a year until 2006, at which point the target rate is set to fall to 0.5 percent until 2010. In addition, the government has declared a freeze on all taxes. The strategy also recognizes the need to address constraints on labor supply. Policy measures aim at increasing the participation in the labor market of older workers and immigrants.

Executive Board Assessment

Executive Directors commended the authorities for their sustained strategy of fiscal discipline and structural reforms. Unemployment is at a 25-year low, inflation is subdued, and Denmark's strong economic fundamentals have permitted the economy to weather the global slowdown reasonably well. Although growth slowed in 2001, conditions are in place for a pickup in the course of 2002.

Directors viewed the macroeconomic policy stance as appropriate at this juncture. Accommodative monetary conditions, consistent with Denmark's fixed exchange rate policy vis-à-vis the euro, are putting a protective floor under the economy in case downside risks to growth were to materialize. At the same time, strong wage growth and high capacity utilization in some industries argue against an active fiscal policy response to such risks, and it will be important to avoid public spending overruns while allowing for the operation of automatic stabilizers.

Directors judged overall competitiveness to be healthy, although the increase in unit labor costs relative to the euro area indicates that some wage moderation is needed to stem losses in market shares in continental Europe. They noted that efforts to improve the flexibility of labor markets and increase labor supply would be helpful in this regard.

Directors welcomed Denmark's progress in implementing a strong medium-term strategy to deal with the fiscal costs of an ageing population. While the goal of continuing to run fiscal surpluses is commendable, possible future pressures on the high level of taxation and the desire to maintain a comprehensive welfare system pose significant challenges for the medium term. Against this background, Directors agreed that improving public expenditure discipline, particularly at the lower levels of the government, should be a priority. They considered that a more formally binding fiscal framework would usefully support higher spending discipline, and they welcomed, in this regard, the recent agreement with the Association of Municipalities as a first step in the right direction. Directors also encouraged the authorities to pursue intentions to strengthen public management and outsource services where appropriate. While recognizing the high degree of social cohesion, a number of Directors recommended that the long-term viability of the present welfare system should be kept under close review by the Danish authorities.

Most Directors considered that high taxes might hamper efforts to increase labor supply. While welcoming the recent across-the-board tax freeze, they encouraged the authorities to aim for a more ambitious tax reform, that would focus on reducing high income tax rates and raising tax thresholds.

Directors commended Denmark's labor market reforms over the last several years, which have contributed to substantially lowering the structural unemployment rate. In view of labor supply constraints, additional reforms will, nevertheless, be needed. While Denmark's overall labor market participation rate is high by international standards, Directors saw scope to raise the participation of some groups, such as older workers and immigrants, and they welcomed, in this regard, the authorities' aim to increase the effectiveness of active labor market policies. They furthermore pointed out that problems of welfare traps and high minimum wages extend beyond these groups, and should be addressed more broadly through reform of the tax and benefit system.

Directors welcomed steps to strengthen competition policy. They encouraged the authorities to speed up the opening of the natural gas market and looked forward to the planned privatization and deregulation of network industries, supported by strong regulatory frameworks.

Directors considered that Denmark's financial sector appears sound, as evidenced by the high capitalization ratios of banks, although it was noted that the rapid increase in mortgages with adjustable interest rates should be monitored. The problems faced by some insurance companies and pension funds last year, in an environment of low interest rates and stock market returns, was also highlighted as an area requiring improved risk management. Directors commended the supervisory authorities for their attempts to improve consolidated financial sector supervision, most recently by unifying disparate financial supervisory acts and establishing cross-border memoranda of understanding. They also commended the authorities' firm stance on combating money laundering and the financing of terrorism, and looked forward to the early enactment of additional legislation in this area. Directors welcomed the authorities' interest in undertaking a Financial Sector Assessment Program.

Directors expressed their strong appreciation for Denmark's outstanding record on official development assistance, which sets an example for other industrial 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. The Staff Report for the 2002 Article IV Consultation with Denmark is also available.

Denmark: Selected Economic Indicators

	1998	1999	2000	2001 1/	2002 1/
Output and demand (change in percent)					
Real GDP	2.5	2.3	3.0	0.9	1.3
Net exports 2/	-1.4	2.8	0.6	-0.1	0.0
Total domestic demand	4.2	0.8	2.4	0.7	1.3
Private consumption	2.3	0.2	-0.3	0.6	1.1
Gross fixed investment	10.1	1.0	10.7	0.0	1.7
Savings and investment					
Gross national savings (percent of GDP)	20.8	21.8	23.3	24.1	25.0
Gross national investment (percent of GDP)	21.7	20.2	21.7	21.2	21.8
Labor market					
Employment	1.7	1.3	0.8	0.5	-0.1
Unemployment rate (in percent)	6.5	5.6	5.2	5.0	5.2
Unit labor cost (manufacturing)	4.6	2.6	-3.0	0.4	3.2
Inflation					
GDP deflator	1.0	2.7	3.7	2.7	2.2
CPI (year average)	1.8	2.5	2.9	2.1	2.3
Public finance (percent of GDP)					
General government revenues 3/	57.9	58.3	55.7	56.0	54.9
General government expenditure	56.7	55.2	53.2	53.3	52.9
General government balance	1.1	3.1	2.5	2.7	2.0
Structural government balance	0.8	2.8	1.8	3.0	2.5
General government debt	56.2	52.7	46.8	44.1	41.0
Money and credit (end of year, percent change)					
Domestic credit 4/	13.1	-1.9	6.1	3.6	...
M3	2.9	4.1	2.0	...	...
Interest rates (percent)					
Money market rate 5/	4.2	3.3	4.9	4.6	3.7
Government bond yield 5/	4.9	4.9	5.7	5.1	5.5
Balance of payments (In billions of DKr., unless otherwise noted)					
Exports	316	342	403	417	431
Imports	-293	-300	-351	-363	-382
Current account (percent of GDP)	-0.9	1.7	1.6	2.9	2.5
Exchange rate					
Exchange rate regime	Participant in ERM2				
Present rate (April 3, 2002)	Danish Kroner 8.4434 per US$1				
Nominal effective exchange rate (1990=100) 6/	105.6	104.4	100.6	102.1	101.9
Real effective exchange rate (1990=100) 6/ 7/	99.3	98.9	95.5	96.4	96.3

Sources: IMF, International Financial Statistics; IMF, World Economic Outlook; and IMF staff projections.
1/ Staff projections.
2/ Contribution to GDP growth.
3/ Revenues for 2002 reduced by 0.5 percent of GDP for transfer of pensions to private sector.
4/ Lending growth for banks and mortgage institutions
5/ Data for 2002 refer to April 2, 2002.
6/ For 2002, data refer to February 2002.
7/ Based on relative normalized unit labor cost in manufacturing.

Statement by Benny Andersen, Alternate Executive Director for Denmark
May 8, 2002

1. My Danish authorities welcome the staff report, which provides a fair and balanced description of the consultation discussions in Copenhagen and developments in the Danish economy. They find themselves in broad agreement with the staff's policy recommendations in areas where further improvements are necessary.

2. The new liberal-conservative government took office shortly after the general election in late November 2001. The government has stated that it will pursue a tight fiscal policy and continue the stability-oriented policy, which has been conducted since 1982, based on the fixed krone exchange rate vis-à-vis continental European currencies and since 1999 vis-à-vis the euro. The overall macroeconomic targets in the medium term are:

- Continued fiscal surpluses in the order of 2 percent of GDP on average, thereby lowering public debt levels in order to enhance the sustainability of public finances and further prepare for the impact of future demographic changes.
- A tax freeze to be followed by lower tax on earned income.
- Real annual growth in public consumption of up to 1 percent on average during 2002-2005.
- Outsourcing and improved efficiency in the public sector.
- Increased employment through higher participation rates and lower unemployment.
- Low and stable inflation of just below 2 percent a year.
- Favourable conditions for private savings, which, in conjunction with the surplus on general government finances, pave the way for gradual repayment of foreign debt.

3. The Danish economy has weathered the effects of the international slowdown well with a relatively small downward revision of the Danish growth forecasts. The estimated GDP growth of 0.9 percent in 2001 in fact overstates the apparent deceleration in the pace of economic activity, since growth had been unexpectedly strong in 2000 – in part due to hurricane repair works – leading to the re-emergence of wage pressures in the Danish economy with wage increases accelerating somewhat around late 2000. The slowdown in activity should act to weaken these pressures. Denmark meets all four EU convergence criteria by a broad margin, unemployment remains around its lowest level for 25 years, there is a strong and robust surplus on the current account, and public finances likewise show a strong and sustained surplus. With the prospect of an international recovery, the main challenge in the short-term is to forestall an intensification of pressures in the economy. In the medium term perspective, maintaining public surpluses and achieving an expansion of the labor force whilst ensuring adequate skill levels constitute important policy challenges.

Economic Policies

4. The new government presented the budget for 2002, which had been delayed due to the election, at the end of January. The fiscal impact and the surplus provided for in the budget correspond closely to the proposal put forward by the former government in the autumn 2001, but the new government rearranged expenditures and taxes reflecting new priorities, and among other things a number of planned tax increases was left out. With minor amendments, the budget was approved in parliament in the beginning of March. Furthermore, new policy initiatives are being developed in accordance with the new government's platform.

5. An important part of the new government's economic policy is a so-called "tax freeze", which broadly speaking means that both tax rates and taxes that are expressed as an amount in Danish kroner will not be increased. The tax freeze also applies to local government taxes as a whole. In its work program the government has announced that it will follow a tight expenditure policy, and the tax freeze implies an increased commitment to exercise expenditure control as it deliberately shifts attention to the prioritization of expenditures. Moreover, the budget for 2002 includes cuts across ministries in expenditures for subsidies and administrative functions, including advisory bodies. The staff report suggests that ensuring sufficient expenditure control and preventing expenditure overruns may prove difficult. The Danish authorities acknowledge that expenditure overruns have been a problem in the past, especially at the local government level. In late February, the government signed a letter of agreement with the Association of Municipalities ("Kommunernes Landsforening") regarding the tax freeze and targets for expenditure growth. If contrary to these objectives budgets for municipalities and counties turn out to display an actual increase in average tax rates, the government intends to neutralize the effect hereof.

6. As noted by the staff, the budget includes a reform of the compulsory pension scheme known as the Special Pensions Fund, whereby the scheme will be rearranged from a redistributive tax scheme into an individual scheme based on actuarially fair principles. The Special Pensions Fund is therefore no longer included in the public finances, and the present surpluses in the Fund of around ½ percent of GDP (as well as future payments from the Fund) are no longer included in the fiscal surplus. Obviously, this technical modification does not affect the long-term sustainability of public finances, but technically the budgetary surplus will be reduced by ½ percent of GDP to an estimated 1.9 percent of GDP in 2002 and the medium-term target range for public finance surpluses reduced to 1 ½ - 2 ½ percent of GDP instead of the previous target range of 2-3 percent of GDP.

7. The staff report seems to suggest that Denmark may not be able to maintain its, admittedly, high level of taxes in the medium term due to increased pressures that erode the tax base. The Danish authorities share this concern to some extent, but the challenge needs to be put into perspective. The government has stated its intention to lower the taxation on labor as of 2004 provided the necessary fiscal room for maneuver is available in terms of public debt reduction, fiscal sustainability, and the cyclical position of the economy. In this context, it is perhaps worth noting that the fiscal challenge resulting from ageing not only limits the

scope for tax reductions in Denmark, but also in other countries, of which many have made much less preparation for the consequences of population ageing. Moreover, as a technical matter, comparisons of taxation of labor across countries should take the level of employers' social contributions into account. Such contributions are low in Denmark compared to many other OECD countries. Whilst not disputing that taxation of labor – and the redistribution through taxes and public expenditures – is higher in Denmark than in most other OECD countries, this is less so when taking social contributions into account. As noted by the staff, for all practical purposes erosion of the tax base due to migration of high-income earners is not yet appearing as a significant problem. Furthermore, the effects of lower taxes should not be exaggerated. With reference to targeted tax reductions, it is the authorities' assessment that the labor supply response would only partly – and with a costly lag – compensate the immediate loss of revenue.

8. The Danish authorities fully share the staff's assessment of the monetary arrangements, which continue to work well without any apparent strains. The fixed exchange rate policy has been a cornerstone in the Danish economic policy during the past two decades. The objective of the policy is to keep the Danish krone stable against the euro, which is formally being pursued within the framework of the EU exchange rate mechanism, ERM II. Since 1997, the Danish krone rate has remained close to the central parity of the exchange rate mechanism and day-to-day fluctuations in the krone rate have been small. The fixed exchange rate policy constitutes a strong foundation for price stability in Denmark and the conditions for maintaining it are well understood by wage negotiators and fiscal authorities. The fixed exchange rate policy implies that monetary policy can only be directed at maintaining the fixed exchange rate vis-à-vis the euro. Normally, Denmark's official interest rates are adjusted in step with the ECB's adjustments of its interest rate with small independent steps being triggered by capital flows. Consequently, the implicit monetary policy stance can sometimes be more accommodative than warranted from a cyclical perspective. During these periods, other economic policies, in particular fiscal policy, must play a larger role as an instrument in stabilizing the economy. The experience with this policy is very good, thereby also sheltering the real economy from random exchange rate fluctuations and currency speculation.

9. With respect to labor markets, continued structural reforms have been essential factors in ensuring a further reduction of unemployment and further gains in employment. Among other things, benefit periods have been reduced and various schemes of early retirement have been reformed. The staff has expressed concerns whether current policy initiatives will prove sufficient to achieve the targeted growth in labor supply. The Danish authorities recognize that a major challenge now is to increase labor supply and provide incentives to stay longer in the labor force. In this respect, it is encouraging to see that reforms of early retirement schemes in the late 1990s have reduced inflow rates into these schemes markedly, and this will contribute significantly to the labor supply in the coming years. Looking ahead, active labor market policy is set to be more efficient, with greater focus on activation directly qualifying a person for a job and more people receiving private job training. The mediation of jobs will be made more efficient, and the successful special initiatives aimed at young

people will be extended to people aged 25-29. Furthermore, the government has put focus on improving the weak employment record of immigrants and refugees.

10. In the product markets – as noted by the staff – further deregulation and privatization is planned. The affected sectors include natural gas, electricity, railways, and postal services.

11. The Danish banks continued to present sound earnings with substantial profits for the seventh consecutive year, although losses and provisions have increased somewhat in view of the slowdown in the economy. The staff notes that Danish insurance companies and pension funds are vulnerable to falling stock prices or long-term yields. This is due to their guarantees to pay a minimum nominal interest rate for many years into the future. However, since mid-2001 a number of insurance companies and pension funds have used the option market to hedge against interest rates falling below an agreed threshold. In 2001 structural improvements in the taxation of capital income in pension institutions has made the taxation neutral in relation to changes in asset prices over the business cycle. Moreover, problems within Danish pension and insurance companies are not expected to result in systemic risks. In spite of the high concentration ratios in the banking sector, competition increasingly has to be seen in an international and especially a Nordic context. In Denmark, there are banks in almost every city and compared to other countries, the number of branches is relatively high. The total number of Danish banks is 190.

12. Denmark is implementing all UN Security Council resolutions on financing of terrorism through the relevant European Council Regulations. Furthermore, the government has presented a legislative package to Parliament containing a broad range of initiatives aimed at combating money laundering and the financing of terrorism. It is expected that the package will be adopted within the next month. The Danish Financial Intelligence Unit (FIU) is a mixed police/judicial unit organised within the office of the Public Prosecutor for Serious Economic Crime. The Danish FIU is in charge of the collection, registration, coordination, analysis, and dissemination of all information concerning money laundering and the financing of terrorism. The Danish FIU is authorised to share information with all foreign FIUs.

Recent developments

13. Presently the Danish economy is running close to its potential. This should be seen in the context of a rebalancing of demand through a slowdown in domestic demand following the so-called Whitsun package, which was decided in 1998 amidst fears of overheating and implemented over the period 1999 to 2002.

14. Since the mission took place, a number of statistics have been published. National account figures for the fourth quarter of 2001 and revised figures for 1999 to 2001 were published at the end of March. GDP growth slowed to 0.3 percent year-on-year as stock adjustment in the fourth quarter contributed negatively to GDP growth. However, non-residential private investments and public consumption growth was quite strong in the fourth quarter.

15. The latest figures for unemployment and consumer prices confirms the impression that pressures in the economy remain a source of some concern despite the lower pace in the economy. In March, the seasonally adjusted rate of unemployment was 5.1 percent and, unlike what has been the case in many other countries, there has hardly been any increase. Consumer prices increased more than expected in the first months of 2002. In March, consumer price inflation stood at 2½ percent – the euro area average – among other things reflecting international increases in food and vegetable prices. The annual increases in wages have moderated slightly, although wage increases remain above those of Denmark's main trading partners. The continuing wage pressures reflect that unemployment is below structural unemployment.

16. Consumer confidence has increased in recent months and is now above the 2001 level. Car sales, which during the last couple of years have fallen to their lowest level in 8 years, in March showed an increase of 8 percent, whilst retail sales increased 2.4 percent in real terms year-on-year in the first two months of 2002. The strong performance in the housing market has continued throughout 2001, supported by lower interest rates and increasing use of floating rate mortgages where interest rates are about 2 percentage points lower than for long-term fixed rate mortgages. Nonetheless, the latest figures support the impression of a gradual leveling off. The number of forced sales of owner-occupied houses has increased somewhat during the latest months, though they remain at historically low levels. Also, the increase in house prices fell to 4.6 percent year-on-year in the 1st quarter of 2002 compared to 7½ percent in the 1st half of 2001. Business confidence has improved markedly in the first months of 2002 – and presently the level of confidence corresponds to its average over the last 10 years.

17. On the currency market, the Danish krone rate has remained a little stronger than its central parity in ERM II. During the first four months of 2002, Danmarks Nationalbank's net purchase of foreign exchange amounted to DKK 25 billion. On 1 February, the Nationalbank lowered the lending rate by 0.05 percent, thereby narrowing the differential to the ECB's minimum bid rate to 0.30 percent.

18. In conclusion, recent statistical information supports the view that the slowdown during 2001 has helped to mitigate the price and wage pressures. The outlook for 2002 and 2003 appears reasonably balanced, but price and wage pressures remain a source of concern, particularly if the expected pickup in growth turns out to be stronger than expected.