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DENMARK

December 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2014 Article IV consultation with Denmark, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 5, 2014, following discussions that ended on September 26, 2014, 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 November 13, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its December 5, 2014 consideration of the staff report that concluded the Article IV consultation with Denmark.
- A **Statement by the Executive Director** for Denmark.

The following document has been or will be separately released.

Selected Issues Paper

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

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International Monetary Fund
Washington, D.C.

DENMARK

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

November 13, 2014

KEY ISSUES

Context: The economy is recovering slowly, driven mostly by private consumption and non-oil-and gas exports. Employment is increasing and unemployment has been trending downward slightly over the past year.

Macroeconomic policy: The exchange rate peg to the euro has served Denmark well. Fiscal policy turned slightly supportive in 2014 after a substantial consolidation in 2013. The government's fiscal stance for 2015 and the medium term imply a slightly negative fiscal impulse and are broadly appropriate in light of the expected gradual recovery.

Financial Sector Policy: Stress tests conducted as part of the IMF Financial Sector Assessment Program (FSAP) found that financial stability risks are contained. Important policy actions have helped to safeguard financial stability but the large size and high domestic interconnectedness of the financial system require even greater resilience and further measures are needed to reduce risks.

Household Debt and House Prices: Some features of tax, rental market, and financial sector policy should be reconsidered in order to limit house price volatility and to prevent excessive debt accumulation in the future. Specifically, the proposed new supervisory guidelines for mortgage credit institutions should be complemented by reduced tax preferences for housing and less rigid rental market regulations.

Productivity and labor market reforms: The government has included reforms in Growth Plan 2014 as a first response to the recommendations of the Productivity Commission. A continued consideration of reforms, including all of the remaining recommendations by the Commission, would be welcome. Increasing labor market participation is a high priority given the fiscal burden of an aging population and the recent actions by the government to address labor market challenges are welcome.

Approved By
Mahmood Pradhan and Peter Allum

Discussions took place in Copenhagen during September 16-26, 2014. The staff team comprised of Mr. Dorsey (head), Mr. Chen, and Mmes. Mircheva and Shirono (all EUR). Mrs. Marcussen (OED) joined the discussions and Mr. Morsink (MCM) joined the latter part of the mission for follow-up on the FSAP. Mr. Dowling and Mmes. Colon, Ho and Mordonu (all EUR) provided analysis and support from headquarters.

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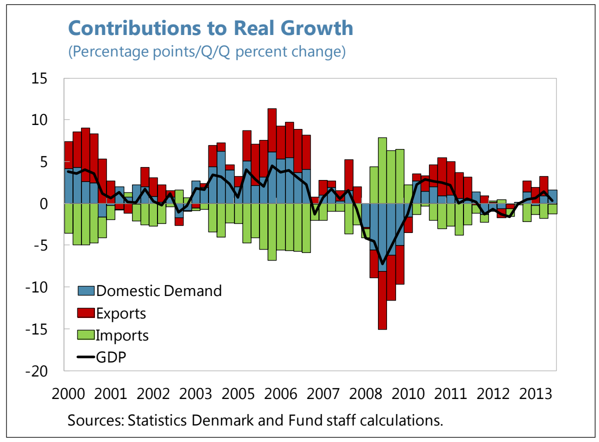
ANNEX

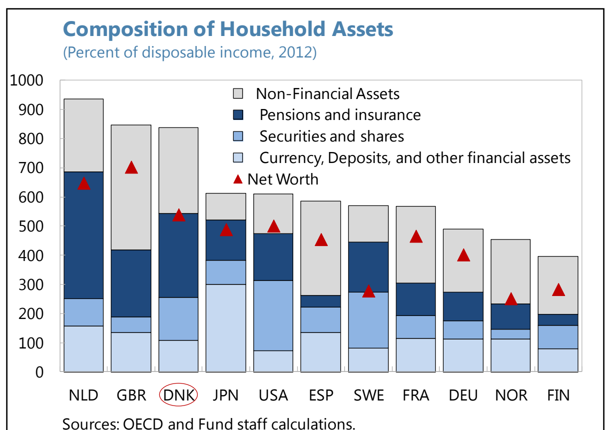
CONTEXT: DENMARK ON A SLOW RECOVERY TRACK

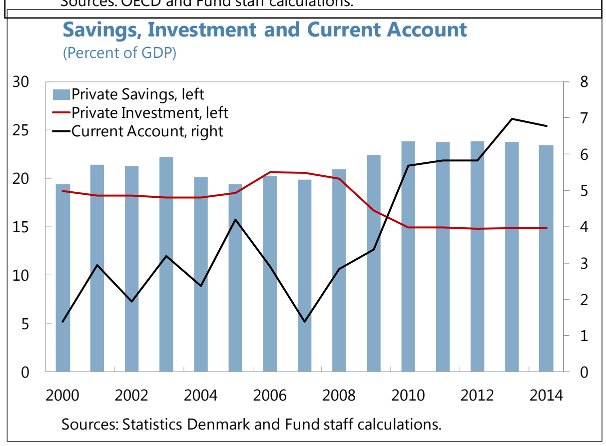
1. **The Danish economy is recovering, albeit slowly**. The economy contracted slightly (by 0.1 percent) in 2013, but it looks likely to accelerate modestly in 2014. Growth is supported by private domestic demand, but held back by a trend decline in North Sea oil and gas production (Box 1) as well as a decline in net exports to euro-area partners (particularly in the first half of 2014). Unemployment continued its slow decline.



2. **Inflation and interest rates remain low**. Domestic inflation is about 1.5 percent (yoy) through 2014 H1 even though lower or negative inflation from imports holds down the broader indices. Wage growth has moderated but remains positive. Real interest rates continue to stay at or below zero for most short-term rates, and treasury bill rates remain negative in nominal terms out to a two-year maturity, as is the case in Germany.

3. **Household indebtedness remains high**. House prices have been gradually picking up since 2012, although slowly and with substantial geographic variation. Driven mostly by mortgage debt, Danish households have the highest debt relative to disposable income in the OECD, at roughly 300 percent in 2013. Even though households have substantial assets and positive net worth, the assets are predominantly non-liquid holdings in the form of pension savings and housing assets. However, households have been rebuilding balance sheets and net wealth has been rising for the past year.



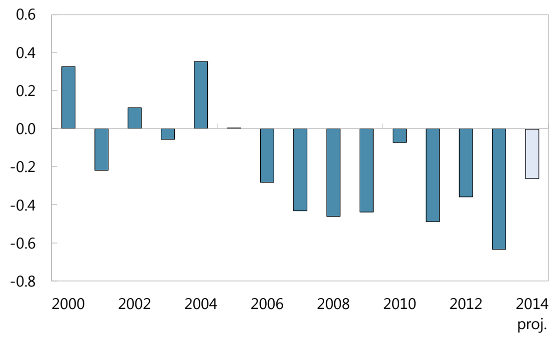


4. **Current account surpluses persist**. Following the crisis, high private sector savings have repaired balance sheets and built liquidity buffers. These private sector saving surpluses are reflected in current account surpluses, which persist at around 7 percent of

Box 1. Declining North Sea Oil and Gas

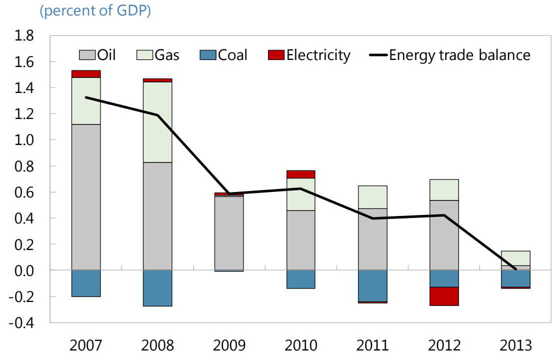
Denmark produces oil and gas from its part of the North Sea. However, 2013 oil production fell by more than half from its 2004 peak and production of natural gas has followed a similar trend. The contribution of mineral extraction to growth in gross value added (GVA) has been negative since 2006. In 2013 the impact was particularly large (-0.6 percentage point), but it is expected to taper off in 2014. Energy net exports have fallen from 1.5 percent of GDP in 2007 to 0.1 percent of GDP in 2013.

Contribution of Mining and Quarrying to GVA Growth
(percentage points)



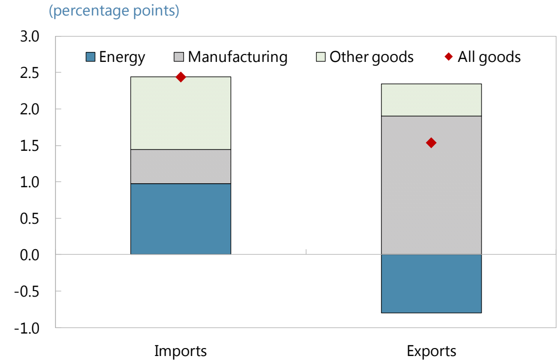
Sources: Statistics Denmark and Fund staff calculations.

Energy Trade Balance
(percent of GDP)



Sources: Statistics Denmark and Fund staff calculations.

Contribution to Trade Growth, 2013
(percentage points)

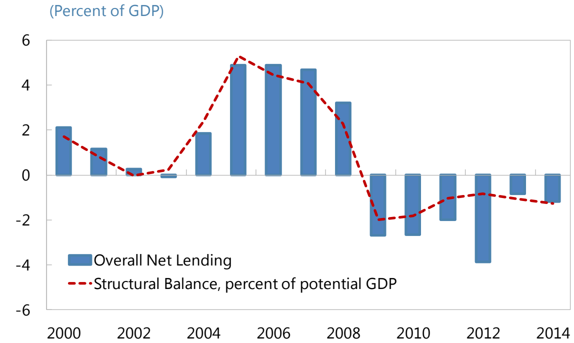


Sources: Statistics Denmark and Fund staff calculations.

GDP. Private sector investment dropped considerably after the crisis and has not yet recovered. This has been a drag on the recovery and investment is expected to recover only gradually.

5. **The exchange rate is broadly in line with fundamentals**. The External Balance Assessment (EBA) estimates indicate moderate undervaluation on balance (Box 2). Even though unit labor costs are elevated in Denmark and productivity growth is low compared to the historical average, the economy's external competitiveness has been maintained through improved terms of trade. This is also reflected in the current account surplus and the strong positive IIP position.

General Gov. Net Lending and Structural Balance
(Percent of GDP)



Sources: IMF World Economic Outlook, Statistics Denmark, and Fund staff calculations.

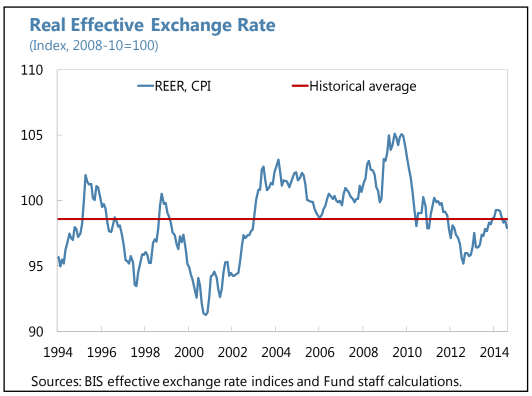
Box 2. External Sustainability Assessment and the Equilibrium Exchange Rate

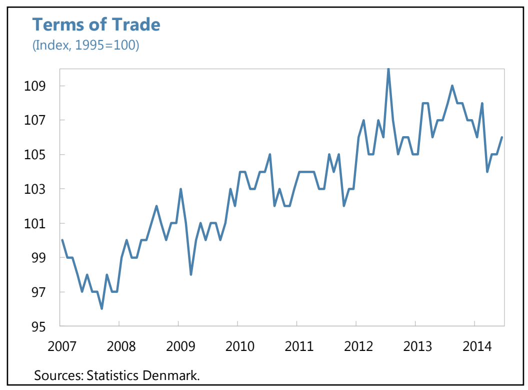
Denmark maintains a tight peg with the euro; however, since its 2009 trough the krone has appreciated in real effective terms by over 7 percent, partly driven by safe-haven flows reflecting Denmark's solid external positions. The IMF's External Balance Assessment (EBA) estimates are mixed: the REER approach supports the view that the krone is broadly in line with fundamentals and desirable policies, while the macroeconomic balance approach and external sustainability model suggest some undervaluation implied by the current account surplus. Exports of both goods and services have contributed to the strong current account position, reflecting Danish specialization in exports (e.g., design and pharmaceutical) that have benefited from rising prices.

External Balance Assessment (EBA) Methodologies, 2013 1/

Methodology	CA gap *(percent of GDP)*	REER gap *(percent)*
Macroeconomic balance (MB) approach	7.6	-17
Equilibrium real exchange rate (REER)approach	-	-3
External Sustainability Approach	6.9	-15

Sources: Fund staff calculations.
1/ CA gaps: minus indicates overvaluation, REER gaps: minus indicates undervaluation. EBA estiamtes are based on data available as of October 2014.





One factor not taken into account in EBA estimates is Denmark's substantial merchanting trade defined as goods trade that does not cross the border of the firm's resident country. Merchanting trade has shown empirically to be an important driver of the current account, because merchanting firms reinvest their earnings abroad to expand their international activates, raising national savings in the home country without increasing domestic investment.[1]

The net international investment position (excluding the central bank) reached about 40 percent of GDP in 2013, and net foreign exchange reserves are about one quarter of GDP.

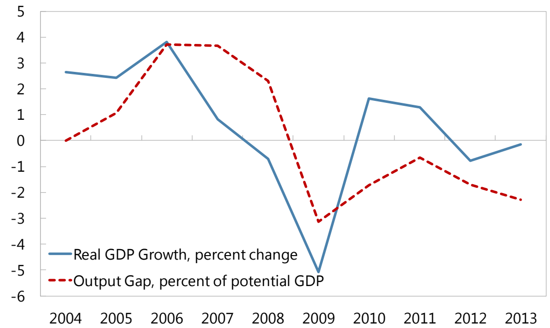
[1] Beusch, Elisabeth, Barbara Dobeli, Andreas M. Fischer, and Pinar Yesin, 2013, "Merchanting and Current Balances." Globalization and Monetary Policy Institute Working Paper 140, Federal Reserve Bank of Dallas.

6. **The general government balance went from surpluses before the crisis to a deficit.** The deficit peaked at 3.9 percent of GDP in 2012, before being contained to 0.9 percent of GDP in 2013 to meet the requirements for exiting the Excessive Deficit Procedure (EDP) for a consolidation of the structural deficit by 1.5 percent from 2010 to 2013.

Figure 1. Denmark's Economy is on the Mend

Growth bottomed out but is still anemic….

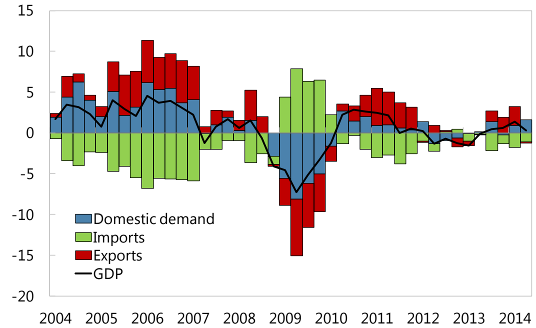
GDP Growth
(Percent)



Sources: IMF World Economic Outlook and Fund staff calculations.

….driven mostly by private domestic demand.

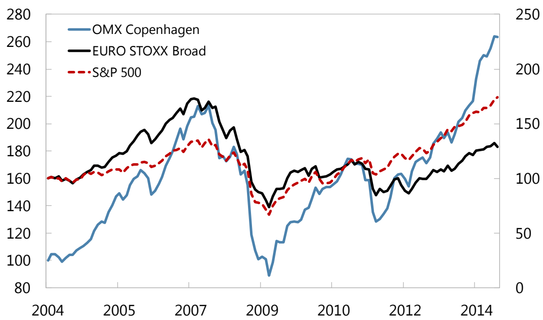
Contributions to Growth
(Percentage points; Q/Q percent change)



Sources: Statistics Denmark and Fund staff calculations.

Equity prices have been gradually picking up….

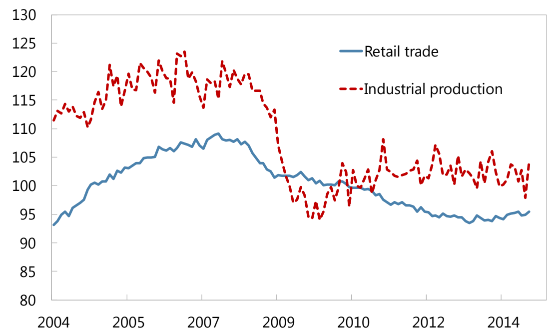
Equity Prices
(Index: 2004M1=100)



Sources: Danmarks Nationalbank, ECB, Financial Times, Standard and Poor's and Fund staff calculations.

….and retail sales are recovering slowly.

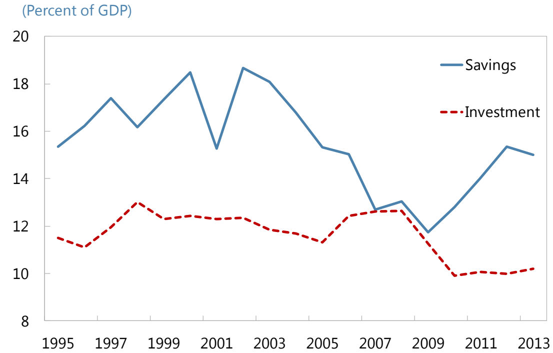
Retail Trade and Industrial Production
(Index: 1005=100, SA)



Sources: Statistics Denmark and Fund staff calculations.

Saving surpluses are still persistent…

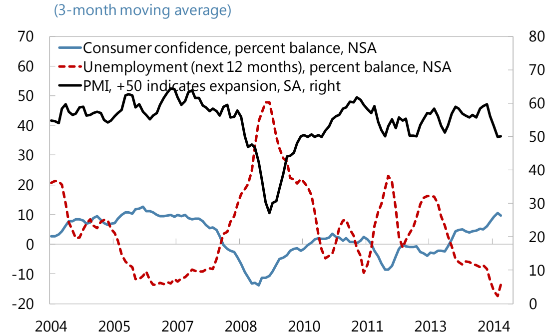
Nonfinancial Corporations Savings and Investment
(Percent of GDP)



Sources: Statistics Denmark and Fund staff calculations.

…. and consumer confidence is building up momentum while unemployment is declining.

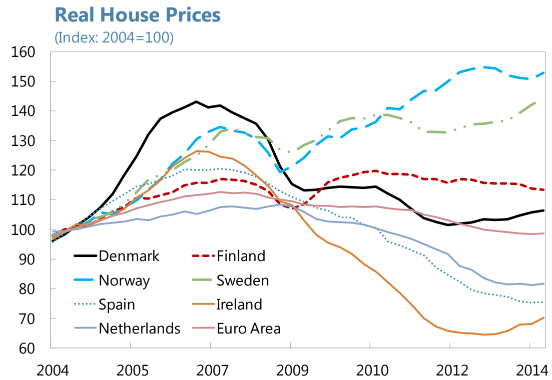
Consumer Survey
(3-month moving average)



Sources: Danish Purchasing and Logistics Forum, Statistics Denmark and Fund staff calculations.

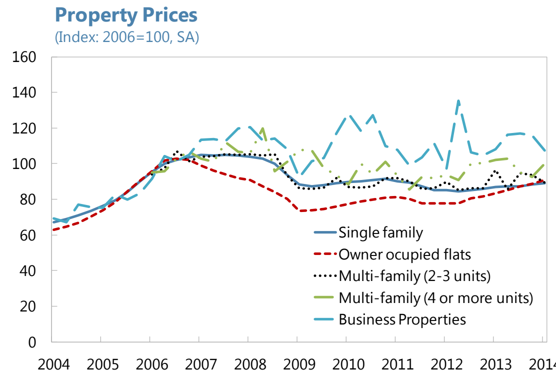
Figure 2. Household Balance Sheets and Consumption

Danish real house prices bottomed out and are recovering gradually…



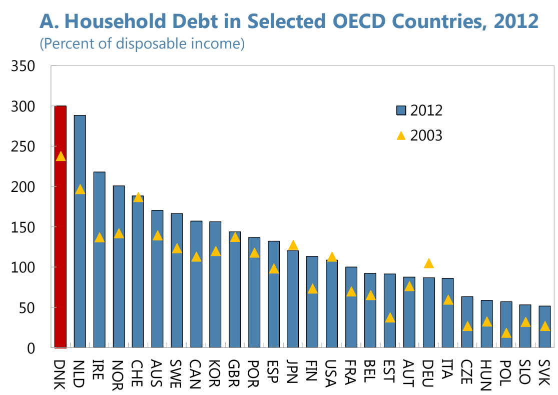
Sources: OECD and Fund staff calculations.

…but the pace of recovery varies across housing types as well as regions.



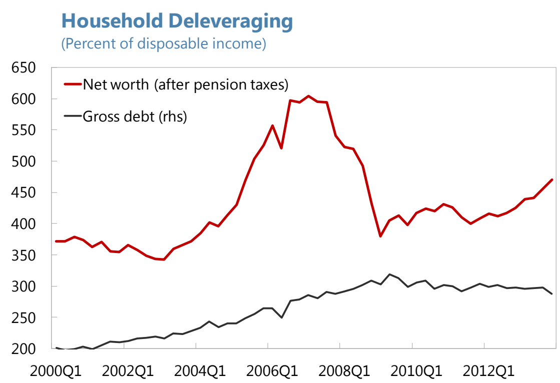
Sources: Statistics Denmark and Fund staff calculations.

Danish household debt continues to be the highest among OECD countries.



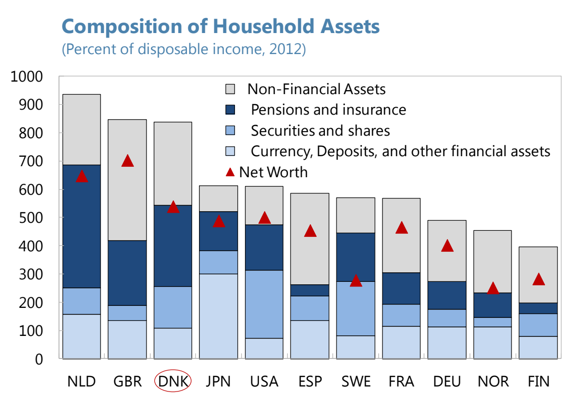
Sources: OECD and Fund staff calculations.

Net worth is positive and growing…



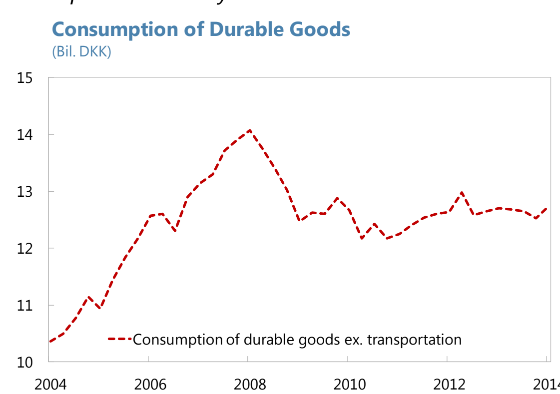
Sources: Danmarks Nationalbank and Fund staff calculations.

…but household assets are mostly illiquid.



Sources: OECD and Fund staff calculations.

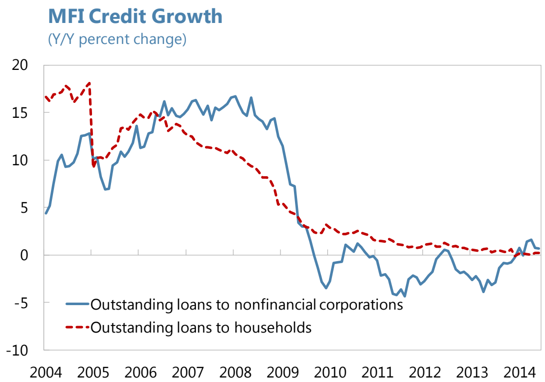
The need to rebuild balance sheets has suppressed private consumption in recent years.



Sources: Statistics Denmark and Fund staff calculations.

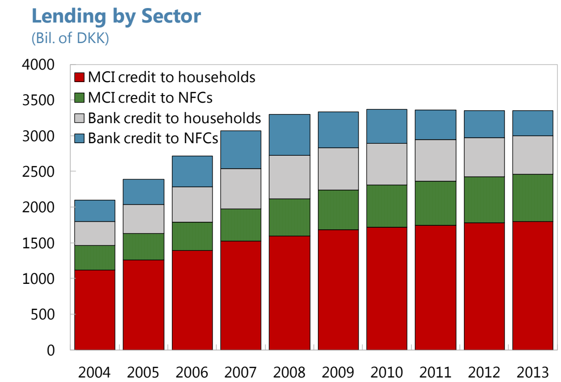
Figure 3. Credit Market Developments

Credit growth has stagnated….



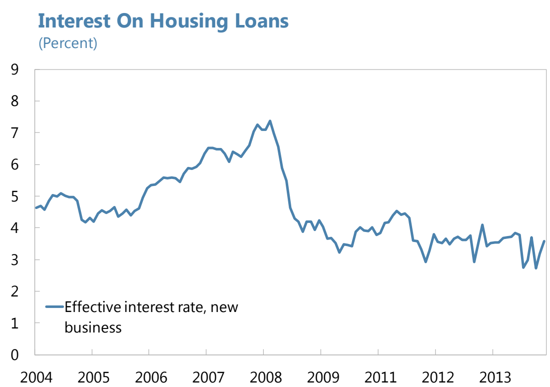
Sources: Statistics Denmark and Fund staff calculations.

… as credit to households and NFCs has steadied…



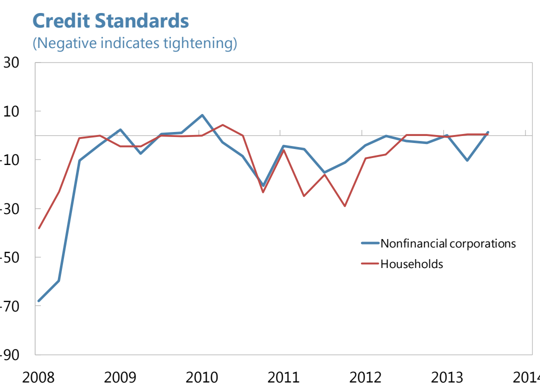
Sources: Statistics Denmark and Fund staff calculations.

… even though mortgage rates have been historically low …



Sources: ECB and Fund staff calculations.

… and credit standards are stable for corporations as well as households.

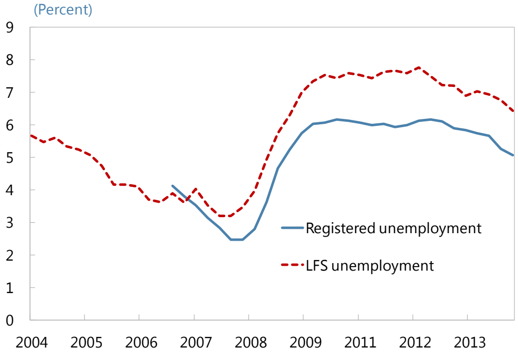


Sources: Statistics Denmark and Fund staff calculations.

Figure 4. Labor Market Developments

Unemployment has declined, albeit slightly….

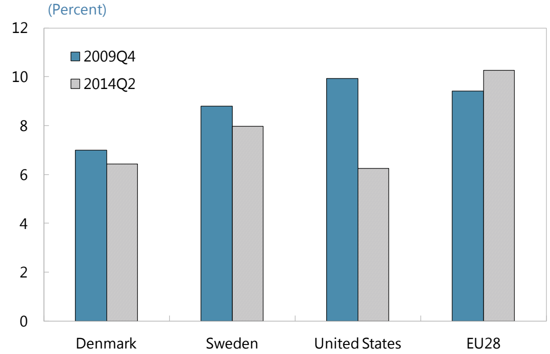
Unemployment Rate
(Percent)



Sources: Eurostat, Statistics Denmark and Fund staff calculations.

… which is also the trend among peers.

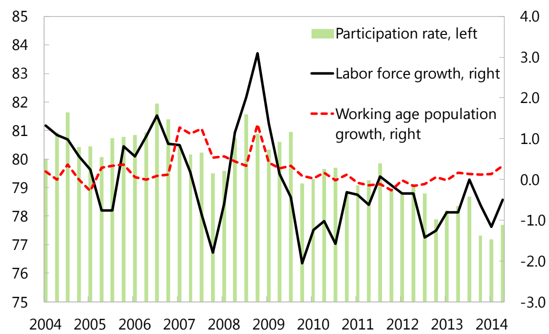
Cross-Country Change in Unemployment Rate
(Percent)



Sources: Eurostat and Fund staff calculations.

However, labor force participation is still not picking up.

Labor Force and Participation
(Percent of working-age population, left; Y/Y percent change, right)



Sources: Haver Analytics, Statistics Denmark and Fund staff calculations.

OUTLOOK AND RISKS: THE ECONOMY IS REBOUNDING BUT RISKS REMAIN

7. **Prospects for sustained recovery are good as some previous headwinds abate.** Activity is picking up in Denmark, driven mainly by private consumption and non-oil exports. Private consumption is supported by improved consumer confidence (Figure 1) and a gradual restoration of household balance sheets. Household net worth relative to disposable income has recovered much of its post-crisis decline with house prices rising since 2012, several years of elevated savings rates, and strong returns on financial assets (Figure 2 and Selected Issues, Chapter 1). Growth is projected at 0.7 and 1.4 percent in 2014 and 2015, respectively, rising slightly above 2 percent in the medium-term. Inflation is projected to increase even though external disinflationary pressures persist. Unemployment is expected to continue its slow decline and the output gap will close gradually after 2018.

8. **Some factors that had held back growth are receding**. The substantial fiscal consolidation in 2013 has concluded and the process of rebuilding fiscal buffers will require much more modest consolidation over the medium term. Household balance sheets are in a better position as savings have rebuilt net wealth and house prices are rebounding. Growth has also picked up in the major non-euro-area export markets (Norway, Sweden, the U.K., and the U.S.) and is expected to continue.

9. **However, downside risks remain**.

- ***Lower growth in advanced economies*** **and emerging markets** could slow the recovery by depressing Denmark's geographically-dispersed exports of goods and services.

- ***Surges in global financial markets volatility*** (from a disorderly UMP exit or other causes) that lead to a spike in market interest rates could depress consumption as households' cash flow is diverted to higher debt service on adjustable rate mortgages.

- ***A protracted period of low euro area interest rates*** as the Danish economy recovers could create overheating pressures and overvalued asset prices.

- ***A drop in confidence in Danish covered bonds*** could depress consumption through higher debt service on adjustable rate mortgages. While this is a very low probability event, the importance of the mortgage covered bond market in Denmark's financial system and the relatively direct pass-through of shocks to mortgage covered bond interest rates to

<table>
<tr><th colspan="3">Denmark: Risk Assessment Matrix[1] Potential Deviations from Baseline</th></tr>
<tr><th colspan="2">Source of Risks and Relative Likelihood
(High, medium, or low)</th><th>Expected Impact if Risk is Realized
(High, medium, or low)</th></tr>
<tr><td colspan="2">High

Protracted period of slower growth in advanced and emerging economies:

• Advanced economies: Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis, leading to secular stagnation.

• Emerging markets: Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth.</td><td>Medium

• Given Denmark's geographically dispersed exports, slower growth in advanced economies and emerging markets to a significant extent would weaken exports and lower domestic demand.</td></tr>
<tr><td>Policy response</td><td colspan="2">To the extent that the recovery allows, start building fiscal space. When this risk materializes, allow automatic stabilizers to operate and focus on structural reforms to improve the growth potential.</td></tr>
<tr><td colspan="2">Medium/ High

Side-effects from global financial conditions:

• Financial imbalances from protracted period of low interest rates continue to build: excess leverage, especially for corporates; asset price bubbles; delays in fiscal and structural reforms.

• An abrupt surge in global financial market volatility, as investors reassess underlying risk.</td><td>Medium

• If low interest rates persist while the Danish economy continues to recover, vulnerabilities could build up. This could create overheating pressures in asset markets, particularly on the housing market.

• Surges in global financial market volatility would affect Denmark if it results in an interest rate hike. This could lead to considerable burden on households as the majority of mortgages have variable interest rates. As households' cash flow is diverted to higher debt service on adjustable rate mortgages, consumption dampened which would in turn slow or reverse the recovery.</td></tr>
<tr><td>Policy response</td><td colspan="2">Maintain a gradual pace of fiscal consolidation. Reduce vulnerabilities of the financial sector by fully implementing the macroprudential toolkit and move ahead with financial sector reforms. In addition, reduce vulnerabilities in the household sector by building household buffers.</td></tr>
<tr><td colspan="2">Low
A drop in confidence in Danish covered bonds</td><td>High

• If materialized, this risk could lead to a reassessment of household credit quality (possibly due to the rise in impaired loans) which could increase concerns about the soundness as well as safety of mortgage credit institutions and hence about covered bonds which could depress consumption through higher interest rates and put downward pressures on house prices.</td></tr>
<tr><td>Policy response</td><td colspan="2">Use regulatory policies to encourage longer bond maturities, ensure that eventual interest-rate increases are better reflected in loan pricing and approvals, and increase buffers in loans with interest-only periods, e.g., by reducing the loan-to-value (LTV) ceiling.</td></tr>
<tr><td colspan="3">[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.</td></tr>
</table>

household debt service would have a much larger impact than a similarly-proportioned shock to covered bond markets in other countries.[1]

- The Nordic-Baltic financial system is tightly integrated and problems elsewhere in the region would spill over into Denmark, most directly from the overseas operations of the dominant Danish-headquartered banking group (Danske Bank) or through the Danish subsidiary of the Swedish-headquartered Nordea Bank (the second largest bank in Denmark). Outward spillovers in the financial system would most likely propagate through the same two banking groups.[2]

Authorities' views

10. **The authorities generally agreed with the outlook and the risk assessment**. However, there was a range of views on the speed at which the output gap is likely to close on both sides of staff estimates. They concurred with staff that global shocks would affect Denmark mostly through trade and interest rates, although the latter effect would possibly be beneficial due to safe-haven inflows. They also agreed that housing prices and related household debt levels present complex risks. However, the authorities stressed that they consider those risks contained at present but will continue monitoring developments closely. Furthermore, the authorities consider that current low inflation is not a sign of deflationary pressures in the Danish economy. While prices of imports and import-competing goods are falling, domestic prices and wages are showing modest growth.

POLICY DISCUSSIONS: MAINTAINING A STEADY RECOVERY

The nascent recovery provides an opportunity to start rebuilding fiscal buffers as conditions permit. Also, while substantial progress has been made in strengthening the financial system, reforms should continue in order to strengthen it, given its large size as well as the high domestic and regional interconnectedness. Related to this, household debt and large household balance sheets create vulnerabilities for the real economy; reducing distortions in the housing market that promote excessive leverage and volatility would be helpful. Furthermore, there is scope for continued structural reforms to promote productivity as well as to increase labor force participation rates.

A. Macroeconomic Policy

11. **Monetary policy is based on maintaining the very tight peg to the euro in the context of a fully open capital account.** This was tested during the crisis and it served the authorities well. International reserves fell sharply at the peak of the crisis, dropping by 17 percent in October 2008

[1] Additional information on the covered bond market in Denmark can be found in the Financial System Stability Assessment associated with this consultation.

[2] Additional information on the financial interconnectedness between Denmark and the rest of the Nordic-Baltic region is included in the Financial System Stability Assessment.

alone. However, exchange rate pressures quickly reversed and safe-haven inflows led to a large accumulation of foreign exchange that has raised international reserves to more than double the pre-crisis levels. To counter safe-haven inflows, the Danmarks Nationalbank cut policy interest rates and put one deposit rate at a negative level from July 2012 through early 2014. After exiting this period of negative rates, the Nationalbank once again set one of the policy rates at a negative value in September 2014 following the ECB decision to implement its own negative policy rate (Box 3).

12. **The measured fiscal impulse is expected to be slightly contractionary in 2015, but assessment of the broader fiscal stance is complicated by one-off measures and uncertainty around the estimated potential growth**. The general government headline balance stood at -0.8 percent of GDP in 2013, and is expected to widen to -1.2 and -2.5 percent in 2014 and 2015 respectively, with the widening accounted for by expiring one-off measures from 2013 and 2014. Without the one-off measures, the headline balance would remain largely unchanged at around 3 percent in all three years. Nevertheless, the structural deficit is projected to widen slightly in 2014 before starting a gradual decline in 2015, suggesting that the fiscal impulse for 2015 is slightly contractionary. In the medium to long term, the government plans a gradual tightening of the structural balance. Both revenue and expenditure decline as a share of GDP between 2014 and 2019, with the slightly larger expenditure decline producing the consolidation (Tables 1, 2, and 3). The decline in revenue share is driven by a projected decline in tax revenue from pensions and, to a lesser extent, a reduction in corporate income tax rates. The reduction in expenditures is driven primarily by expenditure ceilings on public consumption and declining social benefits as the economy recovers and reforms begin to reduce the number of beneficiaries (Annex I). Alternative approaches to estimation of potential output and structural deficits produce estimates that vary widely although the implied fiscal impulse is largely the same across the different approaches (Selected Issues, Chapter 2).[3]

13. **The 2015 fiscal stance seems appropriate after the policies announced in October**. The August 2014 budget plans left too little room against the 3.0 percent of GDP deficit target, and looked likely to exceed the ceiling once subsequent GDP data were taken into account. Therefore, the government announced additional, one-off pension tax measures in October 2014 which should result in a somewhat tighter headline fiscal position in 2015 that builds in a buffer with respect to the limit in the event of negative developments in the economy.[4] A focus of the government's budgetary adjustment has been to meet the deficit targets while minimizing the negative effects on the

[3] For example, the Ministry of Finance uses an approach to calculate the cycle that, inter alia, excludes resource revenue (see Box 1) and other elements of output that would be captured by standard methods of estimating potential output (including those used in the Fund), but would not seem related to the domestic business cycle.

[4] The government is extending a 2013-14 window to convert certain pension assets into from taxable to tax-free status upon withdrawal into 2015 as well as allowing the withdrawal of some pension assets paid in during the 1970s. A discounted rate of taxation applies to incentivize the conversion or withdrawal and generate current tax revenues. Because the former measure represents a transfer between categories of illiquid pension assets it is likely to have little effect on demand. The latter measure frees up previously sequestered assets for households to use, it would likely have an expansionary impact in spite of raising tax revenue that is not captured in standard estimates of the structural balance.

economy though the composition of the adjustment measures. Staff estimates of fiscal multipliers using IMF's Global Integrated Monetary and Fiscal (GIMF) model provide further estimations broadly support this view (Selected Issues, Chapter 3).

Authorities' views

14. **The authorities largely agreed on the assessment of the policy stance, although with some differences among institutions**. On monetary policy, the authorities view their experience with negative interest rates positively. While international reserves are higher than before the crisis, the experience of the last several years suggests a higher threshold for reserve adequacy than the actual pre-crisis level of reserves. They did not see deflation as an immediate concern, and noted that monetary policy would continue to be based on the exchange rate peg rather than inflation. The authorities also stressed their commitment to adhere to the guidelines of the Stability and Growth Pact, noting the importance of maintaining Denmark's credibility. However, they noted that further tightening should be considered carefully in light of the fragile recovery. While fiscal policy is broadly appropriate, in 2015 it would be consistent with the closing output gap to have a margin to the limits for budget deficits. They noted that there will be a need to gradually normalize the current supportive fiscal stance over the coming years as the economic recovery gains momentum. The fiscal authorities did not see a need for a tightening of the planned fiscal stance in 2015.

B. Financial Sector Policy

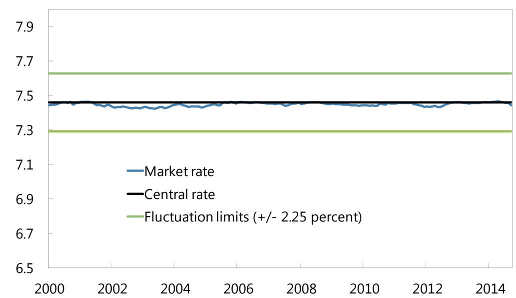
15. **The large size of the financial sector and the constraints on the exchange rate peg, make financial sector structural policy particularly important.** The financial sector is large with assets over 650 percent of GDP. Financial sector stability issues also need to be addressed by macroprudential and other structural policies, given that the constraints of an exchange rate peg and fully-open capital account that largely determine monetary policy.

16. **The recent FSAP mission concluded that financial stability risks in Denmark are contained.** The authorities have taken steps to enhance financial system resilience since the global financial crisis, including: (i) a new bank resolution framework that entails bail-in of creditors which was used to resolve small and medium-sized banks; (ii) a new institutional framework for macro-prudential policy; (iii) implementation of regulations on domestic systemically important financial institutions; and (iv) recent legislation requiring maturity extension of covered bonds in stress situations with the aim of reducing refinancing risk in the

Box 3. Negative Interest Rates

The objective of Denmark's monetary policy is to ensure price stability through a peg to the euro. Interest rate policy is thus guided solely by the need to maintain the peg. Formally, the Danish krone is kept within a band of 2.25 percent in each direction, but the actual band is much smaller in practice.

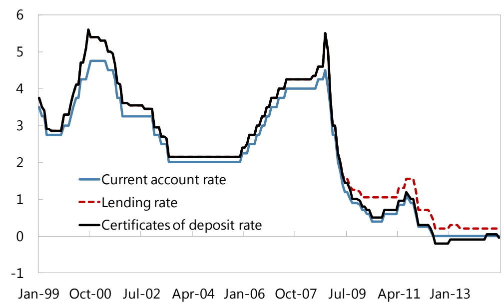
Danish Krone Per Euro



Sources: Statistics Denmark and Fund staff calculations.

The Danmarks Nationalbank's reaction function is well-known to market participants. The bank's first response to pressure on the rate in either direction is to intervene in the foreign exchange market. If intervention is not sufficient to stabilize the rate, policy interest rates will be adjusted. Given the peg, Danmarks Nationalbank policy rates are usually close to ECB rates although generally not identical.

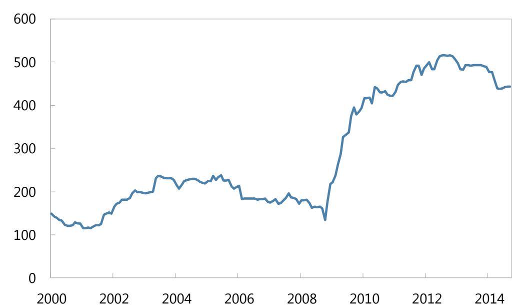
Monetary Policy Interest Rates
(Percent)



Sources: Statistics Denmark and Fund staff calculations.

The move to a negative policy rate in July 2012 was in line with this reaction function. The krone started to strengthen from mid-2011 as market participants increasingly saw it as a safe haven currency in light of euro zone break-up fears. Following extensive intervention that resulted in a substantial buildup of reserves and reductions in policy rates, the bank cut one of its deposit rates to -0.2 percent in July 2012. In January 2013, the bank raised this rate to -0.1 percent before moving it back into positive territory (0.05 percent) in April 2014. However, the exit from negative rates was temporary; the deposit rate was lowered to -0.05 percent following the ECB's move to negative policy rates in September 2014.

Foreign Exchange Reserve
(Billion Danish krone)



Sources: Statistics Denmark and Fund staff calculations.

The impact of negative interest rates has been limited in the case of Denmark. The negative rate had the desired effect on money-market and exchange rates, but the assessment of the impact is complicated by the near-simultaneous announcement of the Outright Monetary Transactions and the "whatever it takes" statement of the ECB President. The financial burden on banks has been very small (e.g., the shift of the relevant rate from zero to -0.2 percent had a cost to banks of only 0.02 percent of GDP in a banking system with assets of roughly 400 percent of GDP. More information and assessment can be found in the Staff Report and Selected Issues Paper (IMF Country papers 13/22 and 13/23) and the Danmarks Nationalbank's Monetary Review: 2012, Q3.

mortgage finance system. The impact of all of these measures will have to be assessed over the coming years given that all are quite new.

17. **More recently, the authorities have proposed supervisory guidelines for mortgage credit institutions to prevent a recurrence of the loose credit standards in the boom.** The "supervisory diamond" for mortgage credit institutions proposes to address risks by monitoring five risk indicators: (i) growth in lending; (ii) borrower's interest-rate risk; (iii) deferred amortization loans with high loan-to-value (LTV) ratios; (iv) high-LTV loans with short-term funding; and (v) large exposures. Two additional proposals require that (i) home buyers will have to make a down payment of at least 5 percent when purchasing a home including first mortgage (capped at 80 percent of home value) and other borrowing collateralized by the real estate; and (ii) commercial properties must be able to generate a positive cash flow before they can be financed. The proposed supervisory diamond for mortgage credit institutions is planned to be finalized by January 2015 and phased-in by 2018 or 2020, for the various indicators. The parameters are largely calibrated to reflect the current practice to contain the impact on the economy of any future incipient loosening of lending standards.

18. **Important policy actions have helped to safeguard financial stability but the large size and high domestic interconnectedness of the financial system require even greater resilience**. Staff recommended further measures to reduce risks:

- *Mortgage banks and covered bonds market*. To mitigate risks introduced by recent product innovation, use regulatory policies to encourage longer bond maturities, ensure that interest-rate risk is better reflected in loan pricing and approvals, and increase buffers in loans with interest-only periods, for example, by reducing the loan-to-value ceiling. The proposal for a supervisory diamond for mortgage credit institutions goes in the right direction.

- *Macroprudential policy*. Explore new instruments capable of addressing time-varying systemic risk, such as limits on LTV and debt service to income ratios. Review the experience with institutional arrangements, especially the appointment of the government as the designated macro-prudential authority. The proposed requirement that home buyers make a down payment of at least 5 percent is welcome.

- *Prudential supervision*. Reduce the length of examination cycles for banks and insurance companies through the use of additional resources, and ensure the operational independence of the Danish Financial Supervisory Authority (DFSA).

- *Crisis management and bank resolution*. Continue to implement early resolution triggers and strengthen funding arrangements as well as the resolution toolkit, prepare resolution plans and resolvability assessments, and enhance the deposit guarantee scheme. Formalize the framework for emergency liquidity support.

Authorities' views

19. **The authorities broadly agreed with staff's conclusions**. The DFSA is developing guidance (a supervisory diamond) to address the enhansed risks in the mortgage finance system. On macroprudential policy, the authorities pointed to recent initiatives on a down payment of five percent in relation to housing finance and a requirement of positive cash flow in relation to financing commercial properties. The purpose of these proposals is to prevent a weakening of lending standards. The forthcoming transposition of the EU Banking Recovery and Resolution Directive into national law would largely address staff's recommendations on the bank resolution framework. Staff's recommendations on prudential supervision would be brought to the DFSA Board in the near future. Furthermore, the authorities welcomed the final LCR requirements recently approved by the European Commission. On the Banking Union, no decision has been taken on Danish participation as a non-euro Member State.

C. House Prices and Household Debt

20. **High household debt is an underlying vulnerability and house price volatility has consequences for the real economy**. While household debt has not posed a direct risk to financial stability so far, it leaves households more exposed to income, interest, and asset price shocks with implications for both the real economy and the financial sectors. In the face of shocks, high household debt and the low level of liquid financial assets are likely to induce households to cut consumption, which will undermine macro stability, with adverse consequences for retail trade and construction, and the lenders to those sectors (Box 4).

21. **Staff recommended a multi-pronged approach to containing risks and limiting the build-up of further household debt.** Various features of tax, rental market, and financial sector policy need to be reconsidered in order to limit house price volatility and to prevent excessive debt accumulation in the future. The freeze on real estate valuations for tax purposes at 2002 levels leads to a pro-cyclical impulse. This valuation freeze creates a bias in the tax system towards owner-occupied dwellings relative to other investment. A bias will also arise as interest rates normalize. Tight rent control also contributes to increased price volatility in owner-occupied dwellings, and may push households with limited financial buffers into premature home ownership. Finally, deferred amortization loans limit the build-up of home equity and increase the exposure of households to shocks. The latter is also the case for adjustable rate loans. The proposals for a mortgage credit institution supervisory diamond and 5 percent down payment requirement should be complemented by reduced tax preferences for housing and less rigid rental market regulations.

Authorities' views

22. **The authorities noted that structural factors such as the highly developed mortgage financing system and high pension assets are behind the high levels of household debt.** A series of studies conducted by Danmarks Nationalbank using household level micro data have shown that debt is more concentrated in families with high income. Stress tests have also shown that most households are resilient to interest rate shocks and the number of families in arrears remains

relatively low even in stress scenarios. While the authorities viewed that the direct impact from household debt on financial stability is limited, they acknowledged that the size of household balance sheet could imply some risks to macro stability with a possible indirect effect on the financial system in the case of severe adverse shocks to the Danish economy. They emphasized the importance of a stable housing market in this respect. The authorities noted that the gradual reduction of the mortgage interest rate deduction goes in the direction of reducing the procyclicality of the housing market. Danmarks Nationalbank acknowledged that the tax freeze on real estate leads to procyclical effects, and noted that, to curb fluctuations in house prices, housing taxes should be changed so they automatically reflect property and land values.

D. Productivity and Labor Market reform

23. **Productivity in Denmark has grown only modestly in the past decade**. Productivity growth is lagging behind the Danish historical average as well as that of peer countries. This contributed to rising unit labor costs and lowered competitiveness. The government appointed a Productivity Commission in 2012 which released its final report in early 2014. The Commission made more than one hundred specific recommendations in three main areas: (i) strengthening competition, (ii) improving the quality of education, and (iii) enhancing the efficiency of the public sector. Many of the recommendations seem appropriate (e.g., increase taxation of property and lower marginal tax rates on earned income for high earners and corporate taxes) and some are in line with past Fund advice (relax restrictions on large retail stores and remove ownership restrictions on businesses such as pharmacies). However, others are outside the Fund's core areas (e.g., reform of higher education) or are stated in very general terms (evaluating the stock of regulations to see which are still relevant).

24. **The authorities plan to adopt some of the recommendations of the Commission**. Many of the recommendations of the Commission are in areas where the government has been making gradual reforms over time. For example, the government had already implemented a tax reform plan that will reduce the rate of corporate income tax from 25 percent in 2013 to 22 percent in 2016. Further reforms were included in the Growth Plan 2014 as a first response to the recommendations.[5] However, some of the suggested reforms have been rejected such as relaxing the restrictions on large retail establishments.

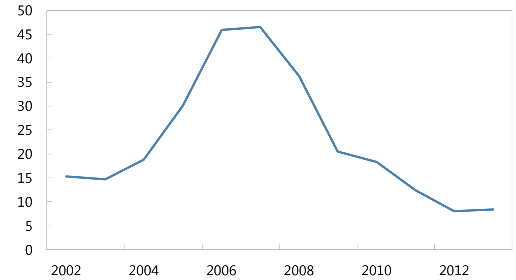
25. **Labor market challenges persist but a number of actions have been put in place to address them**. The government reformed the early retirement scheme in 2011, increased the statutory retirement rate from 65 to 67 over the period 2019-22, and indexed the retirement age to life expectancy from 2025. The maximum period of unemployment insurance benefits has also been shortened from 4 to 2 years. Most recently, the eligibility criteria for disability pensions as well as

[5] For additional details, see Denmark Selected Issues Paper Chapter 4.

Box 4. House Prices and Household Debt

Danish house prices bottomed out and have recently started to pick up gradually. From the 2007 peak to the 2012 bottom, real house price dropped by about 30 percent. Real house prices started to rise in 2013 and grew 2.6 percent (y/y) in the second quarter of 2014 even though the pace of house price recovery varies across regions and types of housing (e.g., a stronger recovery in the prices of owner occupied flats in the Copenhagen area). Staff estimates based on three different metrics (price-to-income ratio, price-to-rent ratio, and model based) suggest that house prices are currently close to fundamentals.

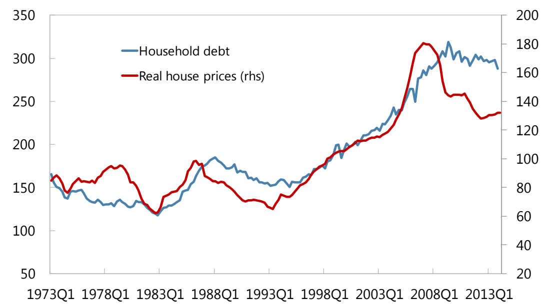
Average Estimates of House Price Valuation Gaps
(Percent)



Sources: OECD and Fund staff calculations.
*Based on the methodologies as in the 2013 Nordic Regional Report.

Danish household debt continues to be the highest among the OECD countries, in large part to finance housing wealth. Household debt has been always relatively high in Denmark, but it grew rapidly during the housing boom, facilitated by the introduction of deferred amortization loans in 2003, reaching about 300 percent of disposable income. On the other side of the balance sheet, household assets are also large with positive net worth. However, these assets consist mostly of illiquid mandatory pension accounts and housing, leaving households with limited liquid buffers and making them more vulnerable to interest rate shocks. The need to rebuild balance sheets has depressed private consumption, weighing on the recovery in recent years.

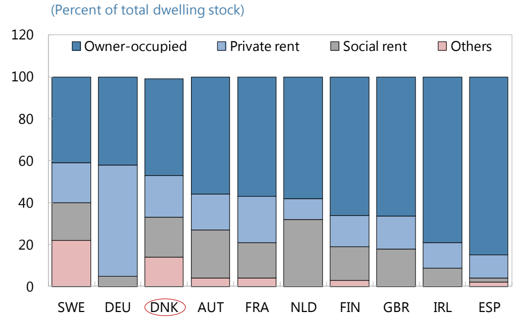
Danish Household Debt and Real House Prices
(Percent of disposable income, index with historical average=100)



Sources: Danmarks Nationalbank, OECD and Fund staff calculations.

Factors other than mortgage borrowing during the housing boom have permitted high levels of Danish household debt. The large pension assets imply high replacement rates for retirement income, and tax preferences for owner-occupied housing make borrowing to invest in housing attractive. While the rental market is relatively large compared with other OECD countries, it is heavily regulated with a large portion of rental units being subject to rent controls and long waiting lists, likely inducing young households to purchase a home earlier than they would have otherwise.

Status of Tenure, 2008
(Percent of total dwelling stock)

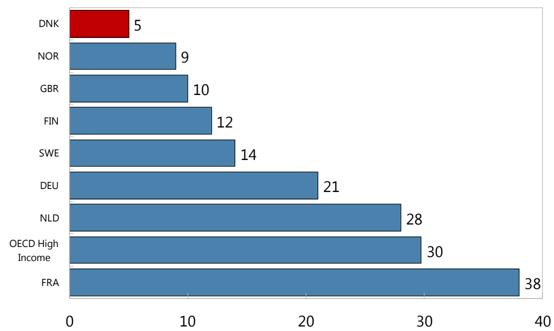


Sources: CECODHAS Housing Europe Review, 2012 and Fund staff calculations.
For Ireland, the data are as of 2004.

Figure 5. Competitiveness

Denmark scores relatively high compared to peers in terms of its business environment….

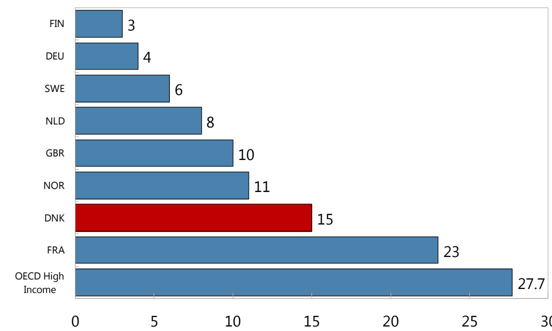
Denmark: Ease of Doing Business Overall Rank
(Rank: 1 is highest, 189 is lowest)



Sources: World Bank Doing Business 2014 and Fund staff calculations.

… as well as competitiveness.

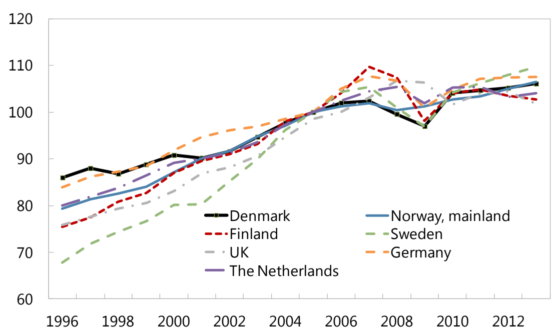
Denmark: Global Competitveness Index
(Rank: 1 is highest, 148 is lowest)



Sources: World Economic Forum 2014 and Fund staff calculations.

However, productivity has stalled….

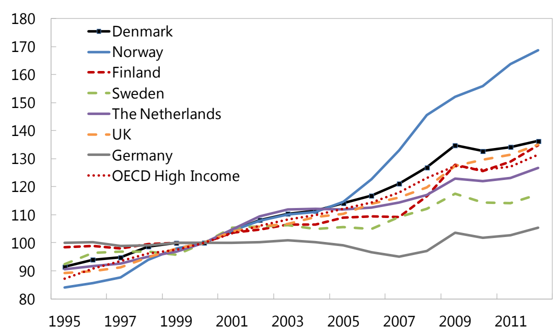
Gross Value Added Per Hour Worked
(Index 2005=100)



Sources: OECD and Fund staff calculations

… while unit labor costs have been rising.

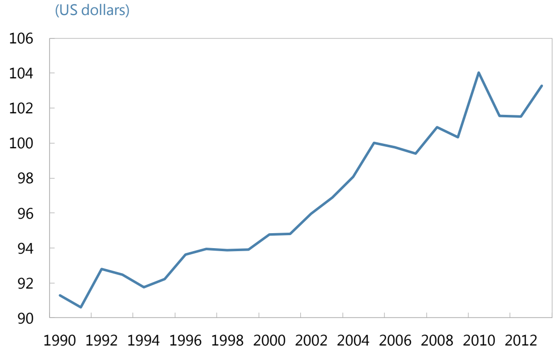
Unit Labor Costs
(Index: 2000=100)



Sources: OECD and Fund staff calculations.

Nevertheless, the terms of trade have been favorable…

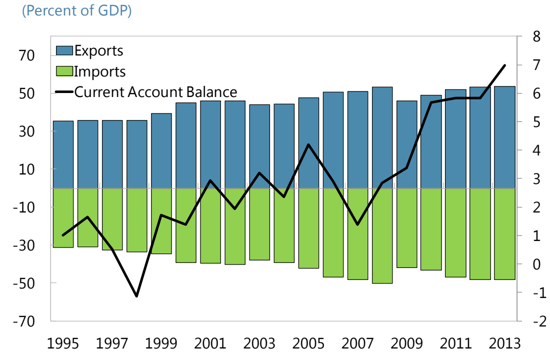
Denmark Terms of Trade, 1990-2013
(US dollars)



Sources: IMF World Economic Outlook and Fund staff calculations.

… and non-price competitiveness is also reflected in the persistent trade and current account surpluses.

Current Account and Trade in Goods and Services
(Percent of GDP)



Sources: IMF World Economic Outlook and Fund staff calculations.

social assistance have been tightened and the period for sickness benefits shortened. In addition to sharing the common theme of restricting eligibility or the length of benefits, these reforms also focus on using the resources saved to provide greater support services for beneficiaries (Annex I).

Authorities' views

26. **The authorities agreed on the need to improve productivity**. They stressed that many of the recommendations by the Productivity Commission are in areas where the government has been making progress over the years. In addition, the Growth Plan 2014 is an initial response of the government to the recommendations of the Productivity Commission and includes a number of specific reforms targeted at boosting productivity. They also pointed to the encouraging evidence that recent reforms to unemployment, sickness, and disability benefits were having the desired effects in terms of increased labor force participation.

STAFF APPRAISAL

27. **The very tight peg to the euro has served Denmark well**. It has anchored inflation and interest rates and facilitated trade with the neighboring euro-area countries.

28. **The government's fiscal policy for 2015 and the medium term is broadly appropriate and should meet the headline deficit targets**. On current budget plans, the headline deficit should meet the target, although it is difficult to assess the structural balance. In any event, Denmark's low net and gross debt levels and strong track record support the positive market perception of its fiscal strength.

29. **Stress tests conducted as part of the FSAP update found that financial stability risks are contained but further measures to reduce risks would be helpful**. The authorities have taken steps to enhance financial system resilience since the global financial crisis. However, additional measures in the areas of: (i) mortgage banks and the covered bond market; (ii) macroprudential policy; (iii) prudential supervision; and (iv) crisis management and bank resolution would reduce risks further. Specifically, developing the loan-to-value and debt service-to-income ratios as macroprudential tools, lengthening covered bond maturities, reducing the length of examination cycles, and strengthening the toolkit and funding arrangements for bank resolution would all be welcome.

30. **High household debt is an underlying vulnerability and house price volatility has consequences for the real economy**. Some features of tax, rental market, and financial sector policy should be reconsidered in order to limit house price volatility and to prevent excessive debt accumulation in the future. The proposals for a mortgage credit institution supervisory diamond and 5 percent down payment requirement should be complemented by reduced tax preferences for housing and less rigid rental market regulations.

31. **Productivity in Denmark has grown only modestly in the past decade**. The Productivity Commission has released its recommendations, many of which are in areas where the government

has been making gradual reforms over time. Further reforms were included in the Growth Plan 2014 as a first response to the recommendations but all of the remaining recommendations by the Commission deserve further consideration.

32. **Labor market challenges persist but recent actions to address them are welcome**. Increasing labor market participation is a high priority given the fiscal burden of an aging population. Building on previous measures to increase the retirement age, reforms to disability, sickness, and unemployment benefits as well as other active labor market policies and social assistance have been put in place. These share the common theme of restricting eligibility or the length of benefits and using the resources saved to provide greater support services for beneficiaries.

33. **It is recommended that the next Article IV consultation with Denmark be held on the standard 12-month cycle**.

Table 1. Denmark: Selected Economic and Social Indicators, 2010–19

	2010	2011	2012	2013	2014 proj.	2015 proj.	2016 proj.	2017 proj.	2018 proj.	2019 proj.
Supply and Demand (change in percent)										
Real GDP	1.6	1.3	-0.8	-0.1	0.7	1.4	2.0	2.1	2.2	2.2
Net Exports 1/	0.5	0.6	-0.4	-0.4	0.0	0.4	0.4	0.5	0.5	0.5
Final domestic demand	-0.1	0.1	0.2	0.2	0.6	1.4	1.7	1.7	1.9	1.9
Private Consumption	0.8	0.3	0.2	0.1	0.6	1.5	1.8	1.9	2.2	2.2
Gross fixed investment	-4.0	2.1	0.4	0.6	0.6	1.4	2.2	2.2	2.2	2.2
Gross national saving (percent of GDP)	24.1	25.1	24.6	25.8	25.2	24.9	24.8	24.7	24.8	24.9
Gross domestic investment (percent of GDP)	18.4	18.4	18.2	18.1	18.1	18.1	18.1	18.1	18.1	18.1
Potential output	0.2	0.2	0.3	0.5	0.5	0.9	1.3	1.6	1.8	2.1
Output gap (in percent of potential output)	-1.7	-0.7	-1.7	-2.3	-2.1	-1.6	-1.0	-0.5	-0.1	0.1
Labor Market (change in percent) 2/										
Labor force	-0.8	0.1	-0.5	-0.7	0.1	0.3	0.3	0.3	0.3	0.3
Employment	-2.4	0.0	-0.5	-0.1	0.2	0.7	0.8	0.9	0.5	0.5
Harmonized Unemployment rate (in percent)	7.5	7.6	7.5	7.0	6.9	6.6	6.2	5.7	5.5	5.3
Prices and Costs (change in percent)										
GDP deflator	3.2	0.6	2.5	1.6	0.2	1.6	1.9	2.0	2.1	2.1
CPI (year average)	2.3	2.8	2.4	0.8	0.6	1.6	1.8	2.0	2.0	2.0
Public finance (percent of GDP)										
Central government balance	-2.5	-2.1	-3.8	-0.9	-1.2	-2.5	-2.3	-1.7	-1.2	-0.9
General government revenues	53.6	54.2	54.1	55.0	54.2	52.3	51.9	51.8	51.8	51.7
General government expenditure	56.3	56.2	58.0	55.9	55.4	54.8	54.2	53.4	53.0	52.7
General government balance	-2.7	-2.0	-3.9	-0.8	-1.2	-2.5	-2.3	-1.7	-1.2	-0.9
General government structural balance (percent of potential GDP)	-1.8	-1.0	-0.8	-1.1	-1.3	-1.1	-0.9	-0.6	-0.4	-0.2
General government primary balance 3/	-2.0	-1.5	-3.3	-0.6	-0.6	-2.0	-1.8	-1.3	-0.8	-0.5
General government gross debt	42.9	46.4	45.6	45.0	45.8	46.9	47.5	47.3	46.5	45.5
Money and Interest rates (percent)										
Domestic credit growth (end of year)	1.3	-1.5	-0.1	0.6	...	...	...	...	...	
M3 growth (end of year)	7.9	-5.9	2.0	-1.7	...	...	...	...	...	
Short-term interest rate (3 month)	1.2	1.4	0.6	0.3	...	...	...	...	...	
Government bond yield (10 year)	2.9	2.7	1.4	1.8	...	...	...	...	...	
Balance of payments (in percent of GDP)										
Exports of goods & services	48.9	52.1	53.3	53.7	54.2	53.7	53.4	53.2	53.1	52.7
Imports of goods & services	43.2	46.8	48.2	48.2	48.8	48.1	47.6	47.2	46.8	46.2
Trade balance, goods and services	5.6	5.3	5.1	5.5	5.4	5.6	5.8	6.0	6.2	6.5
Current account	5.7	5.8	5.8	7.0	6.8	6.9	6.8	6.6	6.7	6.8
Exchange rate										
Average DKK per US$ rate	5.6	5.4	5.8	5.6	...	...	...	...	...	
Nominal effective rate (2010=100, ULC based)	100.0	99.2	96.9	98.7	...	...	...	...	...	
Real effective rate (2010=100, ULC based)	100.0	96.6	96.1	99.1	...	...	...	...	...	

Social indicators (Reference year)
GDP per capita, USD (2013): $59,129; At-risk-of-poverty rate (2012): 19.0 percent.

Sources: Danmarks Nationalbank, Eurostat, IMF *World Economic Outlook,* Statistics Denmark, World Bank WDI, and Fund staff calculations.

1/ Contribution to GDP growth.
2/ Eurostat definition.
3/ Overall balance net of interest.

Table 2. Denmark: Public Finances, 2010–19
(in percent of GDP)

	2010	2011	2012	2013	2014 proj.	2015 proj.	2016 proj.	2017 proj.	2018 proj.	2019 proj.
General Government										
Total Revenues	53.6	54.2	54.1	55.0	54.2	52.3	51.9	51.8	51.8	51.7
Personal Income Taxes	23.1	23.1	23.3	25.8	24.8	23.1	23.1	23.1	23.1	23.1
Pension Return Taxes	2.0	2.1	2.3	1.0	1.3	1.3	0.9	0.9	0.9	0.9
Company Taxes	2.7	2.7	3.0	3.3	3.2	3.0	3.0	2.9	2.9	2.9
Taxes on Goods and Services	14.6	14.7	14.6	14.5	13.0	13.0	13.0	13.0	13.0	13.0
Social Contributions	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Interest and Dividends	1.6	1.6	1.5	1.5	1.0	1.0	1.0	1.0	1.0	1.0
Other revenues	7.9	8.3	7.6	7.2	9.2	9.1	9.1	9.1	9.1	9.1
Total Expenditures	56.3	56.2	58.0	55.9	55.4	54.8	54.2	53.4	53.0	52.7
Public Consumption	28.3	27.6	27.7	27.5	27.8	28.0	27.9	27.7	27.6	27.4
Public Subsidies	2.5	2.5	2.5	2.6	2.6	2.5	2.5	2.5	2.3	2.3
Interest Expenditures	2.1	2.1	2.0	1.8	1.6	1.5	1.5	1.4	1.4	1.4
Social Expenditures	18.4	18.5	18.8	18.8	18.0	17.5	17.2	16.7	16.7	16.7
Other Expenditures	5.1	5.5	7.0	5.3	5.4	5.3	5.1	5.1	5.0	4.9
Balance	**-2.7**	**-2.0**	**-3.9**	**-0.8**	**-1.2**	**-2.5**	**-2.3**	**-1.7**	**-1.2**	**-0.9**
Primary Balance 1/	-2.0	-1.5	-3.3	-0.6	-0.6	-2.0	-1.8	-1.3	-0.8	-0.5
Structural Balance 2/	-1.8	-1.0	-0.8	-1.1	-1.3	-1.1	-0.9	-0.6	-0.4	-0.2
One-off Measures 2/	0.4	0.3	-0.9	1.3	1.1	-0.6	0.8	0.6	0.6	0.6
Cyclically Adjusted Balance 2/	-1.2	-1.0	-1.2	-1.0	-0.9	-0.7	-0.4	-0.1	0.0	0.1
Gross Debt	42.9	46.4	45.6	45.0	45.8	46.9	47.5	47.3	46.5	45.5
Memorandum Item										
Gross Domestic Product	1799	1833	1863	1891	1908	1966	2043	2128	2221	2317

Sources: Statistics Denmark and Fund staff calculations.
1/ Overall balance net of interest.
2/ In percent of potential GDP.

Table 3. Denmark: GFSM 2001 Statement of General Government Operations, 2010–19
(Bil. Danish Kroner)

	2010	2011	2012	2013	2014 proj.	2015 proj.	2016 proj.	2017 proj.	2018 proj.	2019 proj.
General Government										
Total Revenues	964.8	993.9	1008.9	1040.3	1034.7	1027.5	1059.4	1101.4	1149.4	1199.2
Personal Income Taxes	415.2	422.5	434.3	487.7	473.2	454.1	471.9	491.6	513.0	535.2
Pension Return Taxes	36.5	38.1	43.6	19.5	24.8	25.6	18.4	19.2	20.0	20.9
Company Taxes	49.1	49.9	55.6	62.2	61.1	59.0	61.3	61.7	64.4	67.2
Taxes on Goods and Services	261.9	268.7	271.9	273.5	248.1	255.5	265.6	276.7	288.7	301.2
Social Contributions	31.4	33.4	34.4	33.5	33.8	34.8	36.2	37.7	39.3	41.0
Interest and Dividends	27.9	28.9	28.3	28.0	19.1	19.7	20.4	21.3	22.2	23.2
Other revenues	142.7	152.4	140.8	136.0	174.6	178.9	185.7	193.3	201.8	210.5
Total Expenditures	1012.6	1030.5	1080.8	1056.1	1057.0	1076.4	1106.9	1137.3	1176.1	1220.5
Expense	680.8	690.5	731.1	701.3	713.5	732.4	755.5	781.9	805.2	833.6
Public Consumption	508.3	505.8	517.0	519.2	530.3	549.6	569.6	590.4	612.0	634.3
Public Subsidies	44.4	45.8	47.3	48.6	49.6	49.1	51.1	53.2	51.1	53.3
Interest Expenditures	36.9	38.6	36.5	34.0	30.5	29.5	30.6	29.8	31.1	32.4
Social Benefits	331.8	340.0	349.7	354.8	343.5	344.0	351.4	355.4	370.9	386.9
Other Expenditures	-240.8	-239.7	-219.3	-255.3	-240.4	-239.8	-247.2	-246.9	-259.8	-273.4
Net Acquisition of Nonfinancial Assets	331.8	340.0	349.7	354.8	343.5	344.0	351.4	355.4	370.9	386.9
Gross operating balance	284.0	303.3	277.7	339.0	321.1	295.1	304.0	319.5	344.2	365.5
Net lending/borrowing	-47.9	-36.6	-71.9	-15.8	-22.4	-48.9	-47.4	-35.9	-26.7	-21.4
Net financial transactions	-47.8	-30.0	-1074.0	1008.9	..	..	..	..	..	..
Net acquisition of financial assets	44.7	46.4	17.1	1027.0	..	..	..	..	..	..
Currency and deposits	-15.9	62.2	0.0	270.1	..	..	..	..	..	..
Securities other than shares	15.7	1.3	6.8	131.5	..	..	..	..	..	..
Loans	-0.8	5.4	0.3	167.2	..	..	..	..	..	..
Shares and other equity	2.6	2.3	2.0	283.9	..	..	..	..	..	..
Other financial assets	43.1	-24.9	8.0	174.4	..	..	..	..	..	..
Net incurrence of liabilities	92.6	60.3	1074.0	0.0	..	..	..	..	..	..
Currency and deposits	0.3	0.0	14.9	0.0	..	..	..	..	..	..
Securities other than shares	76.8	60.3	806.6	0.0	..	..	..	..	..	..
Loans	5.4	0.4	128.6	0.0	..	..	..	..	..	..
Other liabilities	10.0	-0.4	123.9	0.0	..	..	..	..	..	..
Discrepancies 1/	*0.0*	*16.1*	*17.1*	*18.1*	..	..	..	..	..	..

Sources: Statistics Denmark and Fund staff calculations.
1/ Discrepancy due to time difference in nonfinancial and financial data.
2/ Overall balance net of interest.
3/ In percent of potential GDP.

Table 4. Denmark: Balance of Payments, 2010–19

	2010	2011	2012	2013	2014 proj.	2015 proj.	2016 proj.	2017 proj.	2018 proj.	2019 proj.
					(Bil. Danish Kroner)					
Current Account	102.3	106.7	108.6	131.9	129.1	134.7	138.0	141.4	149.4	158.3
Balance on Goods	51.3	54.5	49.2	46.3	44.6	51.1	58.1	66.0	74.4	83.0
Merchandise exports f.o.b.	534.5	597.2	610.8	616.4	627.5	642.1	667.2	695.5	726.4	756.0
Merchandise imports f.o.b.	483.1	542.8	561.6	570.1	582.9	591.0	609.1	629.5	652.0	673.0
Balance on Services	50.1	42.2	45.3	58.2	58.0	58.4	59.8	62.0	64.4	66.5
Exports of services, total	344.3	357.0	382.3	399.3	406.5	412.8	424.0	437.3	451.9	465.3
Imports of services, total	294.2	314.8	337.0	341.2	348.5	354.4	364.2	375.3	387.5	398.8
Balance on Income	0.9	10.1	14.1	26.3	26.5	25.2	20.0	13.4	10.7	8.8
Capital and Financial Account	-5.4	104.9	111.7	133.2	130.2	135.8	139.1	142.6	150.7	159.6
Capital transfer, net	0.5	5.9	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6
Financial Account	-5.9	99.0	111.2	132.7	129.6	135.3	138.5	142.0	150.0	159.0
Direct investment, net	64.7	-4.1	30.2	51.9	52.4	53.9	56.1	58.4	60.9	63.6
Abroad	-1.5	68.7	46.1	60.9	61.4	63.3	65.8	68.5	71.5	74.6
In Denmark	-66.2	72.8	16.0	9.0	9.1	9.3	9.7	10.1	10.5	11.0
Portfolio investment, net	7.8	-4.8	92.7	-54.2	-54.7	-56.4	-58.6	-61.0	-63.7	-66.5
Assets	97.4	-5.3	151.4	32.8	33.1	34.1	35.4	36.9	38.5	40.2
Liabilities	89.7	-0.5	58.7	87.1	87.8	90.5	94.0	98.0	102.2	106.7
Financial derivatives, net	-27.3	-5.3	-41.1	-34.2	-34.5	-35.5	-36.9	-38.5	-40.2	-41.9
Other investment, net	-75.1	56.6	18.6	173.2	166.5	173.2	178.0	183.1	192.9	203.8
Reserve assets	24.1	56.7	10.7	-3.9	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	107.7	1.8	-3.1	-1.4	0.0	0.0	0.0	0.0	0.0	0.0
					(in percent of GDP)					
Current Account	5.7	5.8	5.8	7.0	6.8	6.9	6.8	6.6	6.7	6.8
Balance on Goods	2.9	3.0	2.6	2.4	2.3	2.6	2.8	3.1	3.3	3.6
Merchandise exports f.o.b.	29.7	32.6	32.8	32.6	32.9	32.7	32.7	32.7	32.7	32.6
Merchandise imports f.o.b.	26.9	29.6	30.1	30.1	30.5	30.1	29.8	29.6	29.4	29.0
Balance on Services	2.8	2.3	2.4	3.1	3.0	3.0	2.9	2.9	2.9	2.9
Exports of services, total	19.1	19.5	20.5	21.1	21.3	21.0	20.8	20.5	20.3	20.1
Imports of services, total	16.4	17.2	18.1	18.0	18.3	18.0	17.8	17.6	17.5	17.2
Balance on Income	0.0	0.6	0.8	1.4	1.4	1.3	1.0	0.6	0.5	0.4
Capital and Financial Account	-0.3	5.7	6.0	7.0	6.8	6.9	6.8	6.7	6.8	6.9
Capital transfer, net	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-0.3	5.4	6.0	7.0	6.8	6.9	6.8	6.7	6.8	6.9
Direct investment, net	3.6	-0.2	1.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Abroad	-0.1	3.7	2.5	3.2	3.2	3.2	3.2	3.2	3.2	3.2
In Denmark	-3.7	4.0	0.9	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Portfolio investment, net	0.4	-0.3	5.0	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Assets	5.4	-0.3	8.1	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Liabilities	5.0	0.0	3.1	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Financial derivatives, net	-1.5	-0.3	-2.2	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
Other investment, net	-4.2	3.1	1.0	9.2	8.7	8.8	8.7	8.6	8.7	8.8
Reserve assets	1.3	3.1	0.6	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	6.0	0.1	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Net oil and oil-related exports	0.6	0.4	0.4	0.0	...	...	...	...	...	...
Net sea transportation receipts	3.3	2.8	3.0	3.1	...	...	...	...	...	...
Current Account net of items above	1.7	2.6	2.4	3.8	...	...	...	...	...	...
Gross External Debt	186.5	179.2	178.1	173.6	...	...	...	...	...	...
Gross Domestic Product	1,799	1,833	1,863	1,891	1,908	1,966	2,043	2,128	2,221	2,317

Sources: National Bank of Denmark, Statistics Denmark, and Fund staff calculations.

Table 5. Denmark: Net International Investment Position, 2005–13

(percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
ASSETS	198.0	201.0	215.9	208.8	236.9	256.7	259.3	275.3	281.6
Direct investment	51.7	49.8	53.9	57.3	64.5	69.4	72.5	75.7	77.1
Equity & investment fund shares	35.7	34.4	37.4	36.2	42.6	46.3	46.2	51.9	54.8
Debt instruments	16.0	15.4	16.5	21.1	21.9	23.0	26.3	23.8	22.3
Portfolio investment	78.4	84.7	87.9	68.7	89.8	101.3	97.6	111.6	114.8
Equity & investment fund shares	35.2	44.4	45.8	25.1	35.8	42.5	40.5	49.4	58.1
Debt securities	43.2	40.3	42.2	43.6	54.0	58.8	57.1	62.3	56.7
Fin. deriv. (other than reserves)	5.4	2.8	0.0	4.6	1.2	2.1	6.5	5.7	3.8
Other investment	49.0	53.1	64.0	65.8	58.1	60.0	56.0	55.0	60.5
Reserve assets	13.6	10.5	10.0	12.5	23.2	23.9	26.7	27.4	25.3
LIABILITIES	194.3	201.3	221.6	213.9	233.4	243.7	232.0	239.0	243.2
Direct investment	46.3	44.7	47.1	44.7	46.6	43.8	43.9	44.3	43.3
Equity & investment fund shares	31.8	28.6	31.2	28.4	29.0	27.5	27.4	27.5	27.7
Debt instruments	14.5	16.0	15.9	16.3	17.7	16.2	16.5	16.7	15.6
Portfolio investment	83.8	84.5	88.9	80.1	99.7	109.0	104.8	113.8	120.6
Equity & investment fund shares	19.6	21.2	24.3	13.4	20.3	28.9	24.6	32.6	41.2
Debt securities	64.2	63.3	64.6	66.7	79.4	80.0	80.1	81.2	79.3
Other investment	64.2	72.2	85.6	89.1	87.0	91.0	83.3	80.9	79.3
NET INVESTMENT POSITION	3.7	-0.3	-5.7	-5.0	3.5	13.0	27.4	36.3	38.3
Direct Investment	5.4	5.2	6.8	12.6	17.9	25.6	28.6	31.4	33.8
Portfolio Investment	-5.4	0.3	-0.9	-11.4	-9.9	-7.7	-7.2	-2.2	-5.8
Other Investment	-15.3	-19.0	-21.6	-23.3	-28.9	-30.9	-27.3	-25.9	-18.9

Sources: International Financial Statistics and Fund staff calculations.

Table 6. Financial Soundness Indicators, 2006–13

(In percent)

	2006	2007	2008	2009	2010	2011	2012	2013
Deposit-taking institutions: Total								
Regulatory capital to risk-weighted assets	13.8	12.3	14.1	17.9	17.9	20.1	22.1	22.3
Regulatory Tier I capital to risk-weighted assets	10.9	9.2	10.7	14.6	15.1	17.2	19.2	19.5
Core / Common Equity Tier 1 capital to risk-weighted assets	..	8.7	10	11.8	12.2	14.4	16.3	16.7
Nonperforming loans net of provisions to capital	4.5	5	18	20.6	22.9	22	22.9	22.4
Bank provisions to Nonperforming loans	51.7	45.6	42.1	53.7	55.2	50.2	50.8	51
Nonperforming loans to total gross loans	1.5	1.2	3.8	7	7.9	7.9	8.3	8.7
Sectoral distribution of loans to total loans, *of which*								
Nonfinancial corporation	71.2	69.5	72.8	69.4	41.8	43.5	39.1	37
Households (including individual firms)	26.7	28	24.9	28.3	31.1	32.5	33.1	32
ROA (aggregated data on a parent-company basis) 2/	1.2	0.9	-0.1	-0.4	0.1	0.1	0.2	0.4
ROA (main groups on a consolidated basis) 3/	0.9	0.7	0	-0.1	0.1	0.1	0.2	0.4
ROE (aggregated data on a parent-company basis) 2/	19.7	16.2	-2.9	-6.4	1.7	1.3	2.7	5.7
ROE (main groups on a consolidated basis) 3/	20.3	17.5	0.5	-2.7	2.2	2.1	3.4	6.9
Interest margin to gross income	71.8	78.1	87.4	78.5	70.1	73.4	67	64.2
Noninterest expenses to gross income	25.8	23.4	25.9	36	42.7	43.8	44.9	47.2
Liquid assets to total assets	24.5	21.3	19.9	28.4	27.8	23.6	27	30.9
Liquid assets to short-term liabilities	34.8	31.6	30.3	44.3	45.6	37.3	45.4	49.8
Foreign currency position	..	9.6	6.4	3.3	3.4	2.8	1.4	1.2

1/ These may be grouped in different peer groups based on control, business lines, or group structure.
2/ All credit institutions' aggregated data on a parent-company basis.
3/ Consolidated data for the five main banking groups (IFRS).

Authorities' Response to Past IMF Policy Recommendations

Fund Policy Advice from 2012 Consultation	Authorities' Actions
Fiscal Policy: The Executive Board supported Denmark's medium term fiscal consolidation plans and agreed that, if growth falls significantly below current projections, the authorities should allow automatic stabilizers to operate fully and consider additional support to the economy within the space permitted by EU commitments. The Board underscored the importance of meeting the 2013 targets under the EU Excessive Deficit Procedure and exiting from it in early 2014 for maintaining market confidence.	The deficit peaked at 3.9 percent of GDP in 2012 but was contained to 0.9 percent of GDP in 2013. Consequently, Denmark met the requirements for exiting the Excessive Deficit Procedure (EDP) also with a consolidation of the structural deficit by 1.5 percent from 2010 to 2013.
Financial Sector: The Board welcomed the authorities' initiatives on macro-prudential and crisis resolution policies, including the creation of the interagency Systemic Risk Council. The Board stressed that there is scope for additional strengthening of the financial sector through more robust capital and liquidity buffers, risk-based deposit insurance premia, limits on deferred amortization mortgage loans, and a reversal of the decoupling of taxes from real estate values to limit excess volatility in housing markets.	The authorities are strengthening capital and liquidity buffers with the implementation of the Basel III/CRDIV requirements. More recently, the authorities have proposed supervisory guidelines for mortgage credit institutions to prevent a recurrence of the loose credit standards in the boom, including a limit on deferred amortization loans with high loan-to-value ratios..
Competitiveness and Productivity Growth: Directors agreed that additional reforms to raise potential growth would include further measures to boost competition and limit tax disincentives to work and to the accumulation of human capital. In this context, Directors looked forward to the findings of the Productivity Commission on productivity enhancements, including in the public sector	The Productivity Commission released its final report in early 2014 with more than one hundred specific recommendations. Many of the recommendations of the Commission are in areas where the government has been making gradual reforms over time. Further reforms were included in the Growth Plan 2014 as a first response to the recommendations

Annex I. Recent Labor Market Reforms

Unemployment benefits: In July 2010, a reform of the benefit scheme reduced the maximum unemployment benefit period from four years within the last six years to two years within the last three years (however, a lower benefit for a subsequent two years is possible). In addition, effective July 2012, entry criteria were tightened from 26 weeks of employment to re-qualify for unemployment benefits to 52 weeks.

Disability pension: In January 2013, the criteria for receiving a disability pension were tightened but options and support for rehabilitation were added. In particular, disability pension is discontinued for persons under the age of 40 (with very few exceptions), and access to disability pension in general requires prior participation in at least one rehabilitation program. Instead of a disability pension, persons with substantially reduced work capacity will be offered individually-tailored rehabilitation and support measures for up to 5 years. In addition, the new *flex-job* scheme (the special employment program for persons with disabilities) allows for part-time work at the normal wage (paid by the employer) plus unemployment benefit-level pay for the rest of the working week. The reform has so far been successful in cutting new entries to disability pensions in half.

Social assistance: A reform of social assistance was implemented in January 2014 that establishes a requirement for education for people below the age of 30 who do not have training or education but have sufficient basic skills. Social assistance for this group is also lowered to the same level as education support. Those who have received training/education will be required to get a job. More vulnerable groups (e.g., people with a range of challenges, single parents) will receive additional assistance in the form of mentoring and a coordinating caseworker. Since being implemented, the reform has helped reduce the number of young social assistance recipients below 30, with about half of the reduction resulting from entering into education and about half from employment.

Sickness benefits: In July 2014, a reform of the sickness benefit scheme reduced the maximum sickness benefit period from 12 to 5 months (with various exemptions), but provides for additional support including potential access to a rehabilitation scheme (for up to several years), at a lower level of assistance than the sickness benefits.

Active labor market policy (ALMP): A reform of ALMP is expected in early 2015, with emphasis on new, individual and job-focused effort for the unemployed, targeted training and education with enhanced focus on the demand of companies, and improved cooperation between job centers and companies. In addition, a new funding system, expected to be in place early 2016, aims to give the municipalities greater incentives to help the unemployed find jobs. In particular, municipalities pay for unemployment benefits, with state co-financing decreasing with longer unemployment duration.

International recruitment: A reform of international recruitment, which takes effect early 2015, is expected to facilitate Danish enterprises' access to highly qualified labor. The key initiatives include a scheme that allows foreign employees in certified enterprises to start work before formal approval of residence and work permits, and easier access for foreign graduates with a Danish MA or PhD.

INTERNATIONAL MONETARY FUND

DENMARK

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 13, 2014

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

AS OF SEPTEMBER 30, 2014

Membership Status: Joined: March 30, 1946; Article VIII

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	1,891.40	100.00
Fund holdings of currency (Exchange Rate)	1,463.69	77.39
Reserve Tranche Position	427.72	22.61
Lending to the Fund		
New Arrangements to Borrow	428.06	

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SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	1,531.47	100.00
Holdings	1,422.89	92.91

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund[1]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal	...	...	...	...	...
Charges/Interest	0.01	0.05	0.05	0.05	0.05
Total	0.01	0.05	0.05	0.05	0.05

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Arrangements: Denmark participates in the European Exchange Rate mechanism II (ERMII) with a central rate at DKr 746.038 per €100. The standard width of the fluctuation band in ERM II is +/-15 percent. However, due to its high degree of convergence, Denmark has entered into an agreement with the European Central Bank (ECB) and the euro area member states on a narrower fluctuation band of +/- 2.25 percent. This means that the krone can only fluctuate between DKr 762.824 per 100 euro and DKr 729.252 per €100.

Denmark has accepted the obligations of Article VIII, Sections 2(a), 3 and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, apart from those imposed solely for the preservation of national or international security, as notified to the Fund by the National Bank of Denmark in accordance with Executive Board Decision No. 144-(52/51).

Article IV Consultation: The last Article IV consultation was concluded by the Executive Board on January 16, 2013. The staff report (IMF Country Report No. 13/22) was published with Public Information Notice (PIN) No. 13/08 (January 24, 2013)..

Outreach: The team met with representatives of the private sector, labor and financial institutions.

Press conference: The mission held a press conference after the concluding meeting on September 26, 2014

Publication: The staff report will be published.

Technical Assistance: None.

Resident Representative: None.

STATISTICAL ISSUES

Data provision is adequate for surveillance. The country has a full range of statistical publications, many of which are on the Internet. The quality and timeliness of the economic database are generally very good. The country subscribes to the Fund's Special Data Dissemination Standard. Metadata are posted on the Dissemination Standards Bulletin Board.

National Accounts: Denmark adopted the *European System of Accounts 2010 (ESA 2010)* in September 2014. The transition from the *ESA 1995 (ESA95)* requires a revision of national accounts data. New data sources are also incorporated in the new estimates which were published in mid-September 2014. Historical data are revised going back to 1966.

Government Finance Statistics: Starting from September 2014, government finance statistics data is based on the *ESA 2010* methodology which includes revisions of the general government deficit and debt levels from 1995 onwards. Revised data series was published in October 2014.

External Statistics: Starting in 2014, external sector statistics are compiled according to the *Balance of Payments and International Investment Position Manual, sixth edition (BPM6)* and in accordance with legal requirements of the ECB and Eurostat.

Monetary and Financial Statistics: Monetary data reported for International Financial Statistics are based on the European Central Bank's (ECB) framework for collecting, compiling, and reporting monetary data.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(AS OF OCTOBER 10, 2014)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	10/14	10/14	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	7/14	10/14	M	M	M
Reserve/Base Money	7/14	10/14	M	M	M
Broad Money	7/14	10/14	M	M	M
Central Bank Balance Sheet	7/14	10/14	M	M	M
Consolidated Balance Sheet of the Banking System	7/14	10/14	M	M	M
Interest Rates[2]	8/14	10/14	D	D	D
Consumer Price Index	9/14	10/14	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	2013	2014	A	A	A
Revenue, Expenditure, Balance, and Composition of Financing[3]—Central Government	2013	2014	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2013	2014	A	A	A
External Current Account Balance[8]	6/14	10/14	M	M	M
Exports and Imports of Goods and Services	6/14	10/14	M	M	M
GDP/GNP	Q2 2014	10/14	Q	Q	Q
Gross External Debt	12/13	10/14	Q	Q	Q
International Investment Position[6,8]	12/13	10/14			

1/ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currenc including those linked to a foreign currency but settled by other means.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7/ Daily (D), weekly (W), monthly (M), quarterly (Q), annual (A), irregular (I); and not available (NA).
8/Starting with data for 2014, external sector statistics are compiled according to the the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*) and in accordance with legal requirements of the ECB and Eurostat.

Press Release No. 14/558
FOR IMMEDIATE RELEASE
December 9, 2014

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

IMF Executive Board Concludes Article IV Consultation with Denmark

On December 5, 2014 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Denmark.[1]

The Danish economy is recovering slowly and unevenly. The economy contracted slightly (by 0.1 percent) in 2013, but it looks likely to accelerate modestly in 2014. Growth is held down by a trend decline in North Sea oil and gas production as well as exports to euro-area partners. At the same time, private domestic demand and non-oil exports are supporting growth. Employment has increased and unemployment has been trending downward slightly over the past year. Inflation and interest rates remain low. Domestic inflation is about 1.5 percent although lower inflation in imports holds down the broader indices. Wage growth is also moderate. Deposit and lending rates remain very low, while government bond rates are negative out to two year maturities.

Fiscal policy turned slightly supportive in 2014 after a substantial consolidation in 2013. While the 2013 consolidation was sufficient to exit from the Excessive Deficit Procedure, the headline deficit is expected to expand in 2014 and is projected to widen further in 2015.

Financial system profitability is still low, in line with weak credit growth, but capitalization has improved. For commercial banks as a whole, already-high capital ratios have risen further and liquid assets as a share of total assets have also increased. At mortgage credit institutions, capital ratios are also high. However, weaknesses in some non-systemic banks warrant close monitoring and may require intervention.

The recovery is likely to continue but remain fragile. Annual growth is estimated at 0.7 percent in 2014, projected to increase to 1.4 percent in 2015, and trend to slightly above 2 percent thereafter. Domestic demand and exports to non euro-area countries should support the recovery. As the recovery continues at a modest pace, the output gap is expected to largely close by 2018.

[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.

However, risks remain on the downside. Surges in global financial markets volatility (disorderly exit from unconventional monetary policy or other causes) that lead to a spike in market interest rates could depress consumption as households' cash flow is diverted to higher debt service on adjustable rate mortgages. A protracted period of low euro area interest rates as the Danish economy recovers could create overheating pressures and overvalued asset prices. A drop in confidence in Danish covered bonds could depress consumption through higher debt service on adjustable rate mortgages. Last but not least, the Nordic-Baltic financial system is tightly integrated and problems elsewhere in the region would spill over into Denmark and outward spillovers from Denmark would most likely propagate through the financial system channel.

Executive Board Assessment[2]

The Executive Directors welcomed the rebound in economic activity, the steady decline in unemployment, and the improved housing market. Directors agreed that growth prospects are favorable, underpinned by the strong track record of prudent macroeconomic policies and financial system stability, while the exchange rate peg continues to serve the economy well. Meanwhile, vulnerabilities remain from the elevated household debt and weak growth in Denmark's main trading partners.

Directors commended the authorities for their substantial fiscal consolidation efforts in recent years, which have kept the debt-to-GDP ratio at low levels and strengthened public finances. They agreed that the fiscal stance for 2015 is broadly appropriate, consistent with the medium-term goal of achieving a structural budgetary balance. Directors supported the authorities' intention to start rebuilding fiscal buffers, taking due account of cyclical developments.

Directors noted that, while financial stability risks are generally contained, further efforts are needed to enhance the resilience of the financial system, in view of its large size and risks in mortgage finance. Priorities include developing macroprudential tools; strengthening prudential supervision and regulatory requirements for mortgage banks; and improving crisis management and bank resolution. Directors looked forward to continued close regional cooperation and full implementation of the recommendations of the updated Financial System Stability Assessment.

Directors emphasized the need to prevent excessive accumulation of household debt. They agreed that the new supervisory guidelines for mortgage credit institutions, the down payment requirement, and the gradual reduction in mortgage interest deductibility would go a long way in

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[2] At the conclusion of the discussion, the Managing Director, as a Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

reducing risks and house price volatility. Directors noted that these initiatives could be complemented by measures to rebalance tax incentives and deregulate the rental market. Directors encouraged the authorities to pursue additional reforms to enhance productivity growth and competitiveness. In this regard, they considered that many recommendations from the recent Productivity Commission warrant further consideration. Directors also called for continued efforts to increase labor market participation and improve the functioning of the labor market more broadly.

Denmark: Selected Economic and Social Indicators, 2010–19

	2010	2011	2012	2013	2014 proj.	2015 proj.	2016 proj.	2017 proj.	2018 proj.	2019 proj.
Supply and Demand (change in percent)										
Real GDP	1.6	1.3	-0.8	-0.1	0.7	1.4	2.0	2.1	2.2	2.2
Net Exports 1/	0.5	0.6	-0.4	-0.4	0.0	0.4	0.4	0.5	0.5	0.5
Final domestic demand	-0.1	0.1	0.2	0.2	0.6	1.4	1.7	1.7	1.9	1.9
Private Consumption	0.8	0.3	0.2	0.1	0.6	1.5	1.8	1.9	2.2	2.2
Gross fixed investment	-4.0	2.1	0.4	0.6	0.6	1.4	2.2	2.2	2.2	2.2
Gross national saving (percent of GDP)	24.1	25.1	24.6	25.8	25.2	24.9	24.8	24.7	24.8	24.9
Gross domestic investment (percent of GDP)	18.4	18.4	18.2	18.1	18.1	18.1	18.1	18.1	18.1	18.1
Potential output	0.2	0.2	0.3	0.5	0.5	0.9	1.3	1.6	1.8	2.1
Output gap (in percent of potential output)	-1.7	-0.7	-1.7	-2.3	-2.1	-1.6	-1.0	-0.5	-0.1	0.1
Labor Market (change in percent) 2/										
Labor force	-0.8	0.1	-0.5	-0.7	0.1	0.3	0.3	0.3	0.3	0.3
Employment	-2.4	0.0	-0.5	-0.1	0.2	0.7	0.8	0.9	0.5	0.5
Harmonized Unemployment rate (in percent)	7.5	7.6	7.5	7.0	6.9	6.6	6.2	5.7	5.5	5.3
Prices and Costs (change in percent)										
GDP deflator	3.2	0.6	2.5	1.6	0.2	1.6	1.9	2.0	2.1	2.1
CPI (year average)	2.3	2.8	2.4	0.8	0.6	1.6	1.8	2.0	2.0	2.0
Public finance (percent of GDP)										
Central government balance	-2.5	-2.1	-3.8	-0.9	-1.2	-2.5	-2.3	-1.7	-1.2	-0.9
General government revenues	53.6	54.2	54.1	55.0	54.2	52.3	51.9	51.8	51.8	51.7
General government expenditure	56.3	56.2	58.0	55.9	55.4	54.8	54.2	53.4	53.0	52.7
General government balance	-2.7	-2.0	-3.9	-0.8	-1.2	-2.5	-2.3	-1.7	-1.2	-0.9
General government structural balance (percent of potential GDP)	-1.8	-1.0	-0.8	-1.1	-1.3	-1.1	-0.9	-0.6	-0.4	-0.2
General government primary balance 3/	-2.0	-1.5	-3.3	-0.6	-0.6	-2.0	-1.8	-1.3	-0.8	-0.5
General government gross debt	42.9	46.4	45.6	45.0	45.8	46.9	47.5	47.3	46.5	45.5
Money and Interest rates (percent)										
Domestic credit growth (end of year)	1.3	-1.5	-0.1	0.6	…	…	…	…	…	
M3 growth (end of year)	7.9	-5.9	2.0	-1.7	…	…	…	…	…	
Short-term interest rate (3 month)	1.2	1.4	0.6	0.3	…	…	…	…	…	
Government bond yield (10 year)	2.9	2.7	1.4	1.8	…	…	…	…	…	
Balance of payments (in percent of GDP)										
Exports of goods & services	48.9	52.1	53.3	53.7	54.2	53.7	53.4	53.2	53.1	52.7
Imports of goods & services	43.2	46.8	48.2	48.2	48.8	48.1	47.6	47.2	46.8	46.2
Trade balance, goods and services	5.6	5.3	5.1	5.5	5.4	5.6	5.8	6.0	6.2	6.5
Current account	5.7	5.8	5.8	7.0	6.8	6.9	6.8	6.6	6.7	6.8
Exchange rate										
Average DKK per US$ rate	5.6	5.4	5.8	5.6	…	…	…	…	…	
Nominal effective rate (2010=100, ULC based)	100.0	99.2	96.9	98.7	…	…	…	…	…	
Real effective rate (2010=100, ULC based)	100.0	96.6	96.1	99.1	…	…	…	…	…	

Social indicators (Reference year)

GDP per capita, USD (2013): $59,129; At-risk-of-poverty rate (2012): 19.0 percent.

Sources: Danmarks Nationalbank, Eurostat, IMF *World Economic Outlook,* Statistics Denmark, World Bank WDI, and Fund staff calculations.

1/ Contribution to GDP growth.

2/ Eurostat definition.

3/ Overall balance net of interest.

Statement by Audun Groenn, Executive Director for Denmark and Anne Marcussen, Advisor to Executive Director for Denmark
December 5, 2014

On behalf of our Danish authorities, we would like to thank staff for candid and constructive policy discussions in Copenhagen during the Article IV and FSAP missions. Our authorities appreciate the high quality papers addressing topical issues for the Danish economy. They broadly concur with staff's analysis and assessment and will carefully consider the recommendations.

Economic outlook

The recovery of the Danish economy is progressing, although at a moderate pace, and growth has been somewhat slower than previously expected. The improvement is most evident in private sector employment, which has increased by 1.5 percent since mid-2013. This reflects the fact that production in the private sector has risen by more than is shown by GDP. In the first three quarters of 2014, GDP has been 0.7 percent higher than in the same period the previous year, whereas growth in the gross value added in the private sector, excluding mining and quarrying, has been 1.1 percent.

The subdued growth in the Danish economy in recent years must be seen in connection with weaker-than-expected growth in the euro area. Furthermore, growth in consumer spending has been subdued, despite an increase in consumer confidence. However, the sluggishness of private consumption also reflects unusually low expenditures on energy consumption in 2014. Normalization thereof may lead to a higher contribution from consumption in 2015. Going forward, consumption is expected to grow in line with income.

According to the outlook, growth in the Danish economy will continue and pick up in the coming years. It is expected that exports, including to the euro area, can be an important driver for the Danish economy, and going forward domestic demand will contribute more to growth. Growth is expected to mainly take place in the private sector. Along with the outlook for gradually strengthening growth, the decline in layoffs and the increasing number of available jobs provide a basis for employment growth to continue.

The preconditions for a pick-up in growth are present. The adjustment of the Danish economy has come very far after overheating in the 2000s and the global downturn in 2008-09. Competitiveness has been strengthened considerably in recent years, progress in the housing market is becoming more broad-based, and households have consolidated their finances. This provides a stronger basis for growth for the Danish economy to continue and accelerate in the coming years. Furthermore, the Government has implemented a series of reforms and growth initiatives that will support opportunities for

growth. Growth is also supported by the low interest rates that reflect a very accommodative monetary policy while fiscal policy remains supportive.
Concerning risks to the outlook, the Danish economy is closely connected to the international economy, and especially that of the euro area. Should the international economy grow by less than expected, it will dampen growth in the Danish economy. In addition to the direct impact, through lower demand for exports, it may also impact the economy through adverse effects on consumer and business confidence.

Fiscal policy

On fiscal policy, the Danish authorities note staff's view that the 2015 fiscal stance seems appropriate following the additional policy measures announced in October. These measures do not affect the structural balance or the fiscal impulse, but are aimed at creating a safety margin relative to the 3 percent deficit limit in the EU's Stability and Growth Pact. This is achieved through an intertemporal shifting of revenues related to the large amount of tax-liable pension savings in Denmark.

Staff characterizes the fiscal impulse in 2015 as slightly contractionary. Subsequent data suggest however, that spending will come in lower than expected in 2014, which implies that planned spending in 2015 will now be compared to a lower base. Factoring in also some reprioritization in the 2015 budget accord, the fiscal stance for 2015 may now be better characterized as roughly neutral.

Fiscal policy should not just be viewed in year-to-year changes but also in terms of levels. In level terms, the fiscal stance for 2015 is supportive, i.e. the structural balance is below its sustainable medium-term level. In addition, automatic stabilizers are high in Denmark, and the deficit is close to 3 percent excluding one-off measures. Hence, in level terms, fiscal policy is still providing support to the economy.

Going forward, there will be a need to start rebuilding fiscal buffers over the medium term. The pace should be timed in relation to cyclical developments. Fiscal policy in Denmark has long been planned within a medium-term framework and with a view to addressing longer-term challenges from population ageing and declining oil and gas revenues. With the major reforms of pensions and other spending, fiscal policy is now assessed by the government, as well as by independent institutions, to be sustainable over the long term.

Since the onset of the global financial crisis, Danish economic policy has responded with reforms of pensions, taxes, unemployment and cash benefits, disability benefits and more. In sum, the reforms since 2009 are estimated to raise potential output in the medium term by up to 5 percent by 2020. This reform drive has been complemented with measures to improve expenditure control, which had long been the Achilles Heel of fiscal policy before the adoption of the "Budget Law." Since 2011, there has no longer been any expenditure slippage. Expenditure control is now backed by rolling 4-year expenditure ceilings which cover the bulk of government spending (except public investment, interest payments and unemployment-related expenditure).

In the medium term, the structural deficit will gradually be reduced towards the medium-term structural balance target in 2020. Staff rightly notes that there are differing estimates of the current level of potential output, and hence of the structural balance. The government is strongly committed to achieve the aim of structural balance in 2020, which on current assessments is consistent with long-term sustainable policies.

Monetary and exchange rate policy

The Danish authorities welcome the assessment that the fixed exchange rate policy continues to serve Denmark well. This has also been the case in periods when the interest rate on certificates of deposits has been negative, which did not impose significant burdens on the financial sector or on non-financial firms and households.

The peg to the euro helps anchor inflation expectations and it is a cornerstone of the stability-oriented economic policy. In this respect, it is important to note that inflation has been close to the rate of inflation in the euro area for many years. At the same time, external competitiveness has improved, the current account surplus is relatively high and unemployment is relatively low, despite a sharp fall in domestic and external demand. As pointed out by IMF staff, the peg also helps facilitate trade with neighboring euro area countries. These benefits clearly outweigh the theoretical drawback that interest rates do not correspond fully to cyclical conditions in Denmark.

House prices and household debt

The Danish authorities share the view that household indebtedness does not pose a direct threat to financial stability. Debt is concentrated among households with high incomes and stress tests have shown that most households are resilient to interest rate shocks and that the number of families in arrears remains relatively low even in stress scenarios. However, the authorities acknowledge that the size of household balance sheets may imply some risks to macroeconomic stability if interest rates should rise markedly, with potential spillovers to the financial sector.

The mortgage credit system is the primary source of financing for house purchases in Denmark. As pointed out by IMF staff, the system is highly developed and the average price of mortgage loans is among the lowest in Europe. Moreover, the system has proven resilient even in periods with substantial financial stress. In conjunction with the widespread use of occupational pension schemes, this is a key factor behind the high levels of household debt. The well-functioning mortgage system and the widespread use of occupational pension schemes in themselves provide substantial benefits for Danish households.

The authorities acknowledge that flexible rate mortgages and mortgages with deferred amortization have introduced additional risks into the system, but it is also important to note (as pointed out by IMF staff) that variable rate mortgages have played an important counter-cyclical role during and after the financial crisis. The additional risks are, to a large extent, being addressed by the new supervisory framework ("supervisory diamond") for mortgage banks and by the additional measures discussed in the section on financial sector policies. Innovations in the mortgage market have given households additional flexibility to manage their finances. This should be taken duly into account when considering further initiatives addressing risks in the mortgage market.

While some further steps could be taken in order to reduce risks in the mortgage market by e.g. reducing LTV ratios for deferred-amortization mortgages, the authorities do not see a case for introducing legislation directly targeted at achieving a general reduction in mortgage debt. If credit to households were to expand rapidly relative to income in a future upturn, that would call for increased attention. The authorities are currently looking into options for improving data collection with a view to, inter alia, better identify and monitor systemic risks. Large household balance sheets reinforce the need for policies aimed at ensuring macroeconomic stability. A stable housing market is key in this respect. The gradual reduction in mortgage interest deductibility goes some way in the direction of reducing the pro-cyclicality of the housing market.

The authorities acknowledge that the structure of the rental market may affect the demand for housing and mortgage debt. However, distortions in the rental market should be seen in a broader context, as the rental market performs a social role in providing affordable housing for low-income families. Any changes to the regulations of the rental market should also be seen in conjunction with the treatment of owner-occupied housing.

Productivity and labor market reforms

The Danish authorities welcome the assessment on productivity and labor market reforms, as well as the acknowledgement of recent actions addressing labor market challenges. The Danish Government's persistent reform efforts have improved the growth potential of the Danish economy. The Government has a target to increase structural GDP by DKK 20 billion by 2020 through improved conditions for private companies and another DKK 20 billion through increased employment and increased educational attainment in the working age population.

The 2013 and 2014 growth packages will contribute to raising GDP by DKK 11.5 billion by 2020 through improved conditions for private companies. The agreements contain a great number of specific initiatives to make it easier and less expensive for companies to operate by e.g. reducing administrative burdens, enhancing the efficiency of the utility sectors, removing ownership barriers in order to enhance competition, reducing the corporate tax, and a number of targeted taxes, including cuts in energy taxes. At the same time, a number of labor market reforms have been adopted, which will contribute to boosting employment through increased labor supply and, consequently, increase GDP by another DKK 19.5 billion by 2020. In other words, important steps have been taken towards the fulfillment of the 2020 growth targets presented in Growth Plan DK.

Staff recommends a continued consideration of reforms to improve productivity, including all of the remaining recommendations by the Productivity Commission. Productivity growth is the primary driver for sustained growth in the economy. Denmark faces the challenge that real GDP growth has been low since 1995 due to relatively low productivity growth. However, Denmark has remained among the wealthiest countries in the world through that period as a result of gains in terms of trade and increased foreign income. Further reforms and initiatives will be needed in order to achieve the remaining DKK 8.5 billion through improved conditions for private companies. The work towards achieving the Government's growth target will continue.

The Danish Government has decided to strengthen impact assessments of new legislation and reduce the burdens of government regulation by another DKK 2 billion by 2020, and has established a committee to review the rules for the taxation of businesses at the company and owner level and a committee to review energy subsidies and taxes.

It is worth noting that wage competitiveness has improved significantly since 2008. The recovery of wage competitiveness has improved the conditions for manufacturing jobs in the future. The trend in advanced production and automation provides a further potential for manufacturing in Denmark, because factors other than wages will become increasingly significant.

Financial sector policies

The Danish authorities welcome the assessment of the regulation and supervision of the Danish banking and insurance sectors, and generally share the views expressed in the assessment reports as well as the grading of most of the Basel Core Principles and Insurance Core Principles. Observations and recommendations in the assessment reports will be used to further improve work on regulation and supervision in Denmark.

The authorities also welcome the work on stress testing the large financial companies in Denmark. On the banking side, the recent European stress test and asset quality review

confirms the robustness of the largest Danish banks that together account for the main part of the banking sector. On the insurance side, the authorities have commented that the assumptions in the stress tests are restrictive, which have large negative effects on solvency positions in the scenarios. This is also reflected by the IMF in the reports. The Danish FSA has concluded a robustness analysis in the beginning of November. The analysis shows that the sector in general is financially prepared for the transition to Solvency II under the current market conditions.
The Danish authorities appreciate the analysis of the challenges arising from the growth in adjustable rate mortgage loans and mortgages with a temporary interest only feature. On 2 December 2014 the Danish FSA published the final version of the supervisory diamond for mortgage-credit institutions. The supervisory diamond contains five indicators with corresponding limits on the risk of the institutions. Amongst the indicators are the proportion of loans without amortisation (interest-only) and the proportion of loans with frequent refinancing. The supervisory diamond will take effect in two steps in 2018 and 2020, and will constitute a significant step in creating a more robust mortgage system safeguarding financial stability.

On macroprudential policies, the authorities agree with staff that the arrangements on the Systemic Risk Council's (SRC) transparency and accountability are sound. A review of the SRC is planned for 2016. The authorities take note of staff's recommendation to review the institutional arrangements more broadly, including the appointment of the government as the designated authority. Staff recommends a further development of the macroprudential policy framework, for instance to develop LTV limits. In September, the Danish FSA and Minister of Business and Growth put forward an initiative requiring a down payment of five percent when financing house purchases. Staff also recommends developing limits on the DSTI ratio. The government has no plans to introduce such a measure. The legal basis for imposing sectoral capital requirements is already in place through the implementation of the European Capital Requirements Directive and regulation.

On crisis management and bank resolution, the authorities also generally welcome staff's recommendations which largely correspond to the authorities' priorities. The authorities' main focus in this regard is the full implementation of the BRRD in national law which is expected to be completed in the first half of 2015.