

Denmark—2006 Article IV Consultation, Preliminary Conclusions of the Mission

June 26, 2006

1. The Danish economy did very well in 2005 and early 2006, and is now faced with the risk of overheating. The main challenge in the period ahead will be to maintain the combination of a favorable economic development and macroeconomic stability. Although recent indicators point to a situation of modest inflation, current account and fiscal surpluses, and overall moderate wage increases, there are signs of cyclical pressures building up. Labor shortages have led to upward pressures on wages in certain sectors. Rapid credit growth has fueled strong increases in house prices and substantially boosted private consumption and imports, and inflation has been increasing from low levels to euro area averages.

2. Public expenditure restraint and continued wage moderation will be key to moderate demand pressures. The policy options available to the authorities are limited given the exchange arrangement (the peg to the euro), the current fiscal framework (an agreed tax freeze), and structural conditions that cannot be changed overnight. Continued fiscal restraint, an early implementation of policies to increase labor supply, as well as moderate wage increases will be required to ensure a continued, sustainable evolution of growth and avert overheating.

3. The recent agreement on welfare reform is an important step, but its short-term impact on labor supply will be limited. Denmark can be commended for forging a broad consensus on the need to prepare itself for the challenges of an aging population and globalization. Last week, an agreement was reached on a range of measures affecting retirement, education, social security, and expenditure on research and development. These measures will positively affect long-term sustainability of public finances, but result in additional expenditures in the short-term. In light of the current economic conditions, as well as the risk of inefficiencies, we recommend careful consideration and, where appropriate, temporization of these outlays.

Short-Term Outlook and Risks

4. We expect growth to continue at a strong but slightly lower pace in 2006, followed by a further moderation in 2007-08. Economic activity is likely to moderate in 2006 because of high capacity utilization and rising interest rates, while the effects of the 2004 tax cuts peter off. Growth is expected to gradually return to its potential (around 2 percent) in 2007-08, but this is conditional upon continued wage moderation and prudent fiscal policies. Inflation is projected to remain around 2 percent, supported by the exchange rate peg. Helped by continued high oil prices, the current account and government balances are expected to remain in surplus, albeit substantially less so than in 2005.

5. The short-term risks to this benign outlook are on the upside. A further reduction in the already low unemployment rate may give rise to tensions in the labor market. Upward wage pressures are already evident in the construction and financial sectors. In addition, the housing market has yet to show serious signs of a slowdown, although supply has recently increased.

6. At the same time, there are downside risks, in particular with regard to the housing market. A decline in house prices—or even a sudden halt to the recent strong increases—might have a sizeable negative impact on the economy. With household debt at internationally high levels, most of which covered by real estate collateral, any significant slowdown in the housing market would have a substantial effect on growth in domestic

demand, both directly through wealth effects on consumption, and indirectly through its impact on consumer confidence.

7. On the external side the Danish economy is sensitive to the exchange rate, the oil price, and its position in international sea trade. A further appreciation of the euro might negatively affect the trade balance. As a net exporter of oil, Denmark has benefited from the recent sharp increases in oil prices: in 2005, high oil prices significantly contributed to the budget surplus and the current account surplus. In addition, the economy—and in particular the export sector—is strongly affected by the performance of the shipping industry, which has benefited from the rapid growth in international trade, but similarly would be vulnerable to changing market conditions.

8. Continued wage moderation will be essential for Denmark's competitiveness. In smaller open economies with a fixed exchange rate, the wage level is one of the most important prices. Denmark scores highly on most indicators for external competitiveness. However, margins in international trade are small and significant wage increases would erode Denmark's external position. For a long time now, employers and unions have been able to agree on relatively modest wage increases with an eye on international trends and the impact of globalization. It will be essential that in the upcoming round of wage negotiations this consensus will be continued.

Fiscal Policy

9. Fiscal policy should continue to be guided by prudent medium-term objectives. The current framework—the Plan 2010 agreed to in 2001—aims at reaching a structural surplus over the medium-term of ½-1½ percent of GDP, while making room for a reduction in the (high) tax rates. Tax cuts were effected in 2002 as well as in 2004, when the burden of the high personal income tax was reduced by adjusting brackets and deductions. The medium-term framework has enabled an impressive decline in the debt-to-GDP ratio and related interest expenditures. When updating the plan, it will be important to maintain the current strong focus on the sustainability of public finances in the medium-term.

10. Containing expenditure growth will be essential in the current cyclical circumstances. So far, it has proven difficult to adhere to the agreed expenditure norms, with the actual public consumption growth exceeding the targets in 2004 and 2005. The expenditure pressures stem largely from local governments exceeding their spending limits. In line with the new welfare proposals, real public expenditure growth targets are to be revised upward. We are concerned that under the current cyclical circumstances additional expenditures risk adding to the already strong demand pressures. For the same reason, we welcome the Finance Minister's announcement that there will be no tax cuts in 2007.

11. The current tax freeze serves its purposes, but is too rigid. As part of the medium-term framework, the authorities have committed themselves to a tax freeze since 2002 to avoid any risk of the already high overall level of taxation becoming even higher, and also as an instrument to control expenditure, in particular at the local level. While these arguments are valid, it should be noted that the current system whereby not a single tax rate can be increased—even where it would enable other more harmful tax rates to come down—is overly rigid.

12. A revenue neutral trade-off between personal income and real estate taxation would support economic growth and financial stability. The current real estate taxation, based in part on fixed tax rates applied to below market, frozen real estate values, provides an unnecessary and potentially even damaging stimulus to the housing market. At the same time, high marginal personal income tax rates that kick in at relatively low levels,

unnecessarily constrain labor supply. Increasing real estate taxation and reducing personal income taxes correspondingly would augur well for economic activity and financial stability.

13. The ongoing streamlining of local governments is welcome, but the costs need to be tightly monitored. This reform aims at improving the quality of service through a more efficient use of resources by merging existing local governments into larger entities, and by more clearly assigning responsibilities among different levels of government. The reform could also help the central government keep a tighter control over local expenditures in the medium-term, which constitute a large share of total spending. However, in the short-run this operation will involve upward pressures on expenditures and the authorities will need to focus on controlling these costs.

Monetary and Exchange Rate Policy

14. The fixed exchange rate system continues to serve Denmark well, and we support the arrangement. The peg to the euro, which helps anchoring inflationary expectations, represents a primary element in the authorities' stability-oriented policies. The margins around the central rate are small, as are interest rate differentials with the Euro area, which reflect market confidence in the peg. A key role of the peg lies in the discipline it has imposed on macroeconomic and structural policies, thereby contributing to the strong fiscal performance in Denmark. It will be very important that this disciplinary impact remains intact.

15. The tightening of monetary policy by the European Central Bank (ECB) is appropriate for Denmark. The Danish National Bank (DNB) closely followed the interest rate increases by the ECB in December 2005 and March and June 2006. It can be expected to follow the ECB again in possible future rate increases, which would be suitable in light of cyclical circumstances in Denmark. The pass-through of changes in interest rates has become quicker with the enhanced availability of adjustable rate products, in particular in housing finance.

Welfare reforms

16. The welfare agreement reached on June 20 marks an important step towards preparing Denmark for the implications of an aging population. In particular, the broad agreement with regard to gradually increasing the retirement and early retirement ages to 67 and 62 years respectively, while applying an indexation mechanism linked to life expectancy over the longer term, is a significant achievement and will help Denmark in maintaining sustainable public finances in the medium to long term.

17. Measures included in the welfare agreement aimed at increasing labor supply in the short to medium run could have been stronger. This involves measures to shorten the educational track, which is unusually long in Denmark, reduce the extended length of unemployment benefits for older workers, increase participation of immigrants in the workforce, and lift or reduce existing restrictions on foreign workers. Although these steps aimed at increasing labor supply in the short term will be helpful, they will not be sufficient to take away bottlenecks. In addition, the adoption of a number of recommendations of the Welfare Commission with regard to taxation and the introduction of user fees in the health sector would have been welcome.

18. Initiatives to enhance competitiveness appear well-placed, but only if carefully implemented. The Globalization Council recently issued its report, which reflects a commendable open and positive approach toward globalization. It includes a large number of recommendations to strengthen Denmark's competitiveness, mostly through increased spending on education, research and development (R&D), and by improving the business

climate. The welfare agreement builds on these recommendations. However, when unfocused and rushed, additional public spending on R&D could be inefficient and would be unhelpful from a cyclical perspective, and therefore expenditures should be linked to clear targets and phased in carefully. In addition, there will be an important role for the private sector in contributing to the efforts.

19. The authorities are advised to use the opportunity of the strong economy to forcefully move ahead with remaining reforms in product and service markets.

Product market reforms proceeded during the past two years, with further liberalization of the energy market and partial privatization of the public postal services. Consumers are now free to choose gas and electricity suppliers, and prices are more market-based. Competition in the public service sector has been enhanced by allowing the entry of private companies in certain sectors.

20. The Danish flexicurity model deserves praise but comes with a price. The model has attracted international attention for its ability to combine a flexible labor market, generous unemployment benefits, and active labor market policies. Labor market flexibility and active labor market policies have contributed to the significant reduction in unemployment, but high spending on the unemployed has been financed inter alia through a high tax wedge on labor income. High costs and certain moral hazard problems may impede the effective implementation of the flexicurity model, although the proposed adjustments will help reduce these aspects.

Financial Sector Issues

21. Overall, the Danish financial system is judged to be resilient and well supervised.

This is based on the comprehensive assessment of the financial sector undertaken in conjunction with this year's Article IV consultation. Financial institutions are experiencing record profits and their balance sheets remain healthy, reflecting the advanced cyclical phase of the economy and strong demand for credit. Sustaining the strong financial performance and stability will need to be supported by appropriate macroeconomic policies and continued supervisory vigilance, including ongoing monitoring and assessing of economic developments and associated risks. Any easing of capital requirements allowing for further expansion of credit should be done gradually, and supervisors should make greater use of their regulatory authority to require additional capital as appropriate in individual cases.

22. Close monitoring of the housing market will be required. The increase in house prices during 2005 by more than 20 percent was one of the highest worldwide, and went beyond what can be fully explained on the basis of income and interest rate developments. The favorable tax treatment as well as the introduction of new financial instruments, such as interest-only loans, has contributed to the rapidly rising house prices. The current situation warrants close monitoring and strict application of the supervisory regulations, as also reflected in the letter of the Danish Financial Supervisory Authority (DFSA) to the credit institutions in February. In addition, it will be important to ensure continued public awareness of the risks involved in over-borrowing.

23. The financial sector assessment for Denmark also finds a high level of compliance with international financial supervisory standards. However, these establish a floor on supervisory and regulatory requirements and do not preclude going beyond prescribed practices. Thus, considering the challenges ahead, some further strengthening would be desirable, especially with respect to the autonomy and resources of the DFSA, oversight of governance and internal controls in financial institutions, and cross-border supervision. The autonomy and accountability of the DFSA could be entrenched by providing the agency a statutory basis and granting it greater budgetary autonomy. The

authorities and the financial institutions appeared well aware of the need for contingency planning for threats to business continuity.

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