MISSION CONCLUDING STATEMENT

Denmark -- Concluding Statement of the 2008 IMF Mission

October 2, 2008

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1. **Strong initial conditions, sound policies, and solid institutions have put the Danish economy in a good position to meet the significant challenges that lie ahead.** The main policy priorities are: to contain spillovers from the global financial crisis, to manage the cyclical slowdown, and to strengthen fiscal sustainability.

2. **The global financial crisis puts a premium on making liquidity available to sound banks.** The direct effects of the crisis have been limited because Danish banks have small exposures to US subprime assets. Instead, the main channels of contagion have been an increase in risk aversion and a dry-up of liquidity, developments which have increased short-term interest rates and shut down parts of the interbank market. Some small and medium-size banks have been particularly hard hit and are finding it difficult to roll over their short-term borrowing. The temporary liquidity facilities recently established by Danmarks Nationalbank are thus welcome.

3. **The ongoing slowdown is a necessary adjustment that should be allowed to continue until wage and price pressures ease.** Despite the negative growth at the turn of the year, output is still above potential, unemployment is exceptionally low, and wages are rising too fast. Consequently, while the liquidity crisis is likely to sharpen the slowdown, it does not provide grounds for a loosening of fiscal policy.

4. **Upfront action is needed to ensure fiscal sustainability.** Denmark faces significant demographic changes that will increase the cost of its extensive welfare state. Given that the tax burden is already high, difficult choices must be made to realign taxation, social benefits, and labor market policies in order to achieve fiscal sustainability. Recent proposals by the labor market commission would go some way to squaring the circle.

Macroeconomic outlook and risks

5. **Assuming that the global liquidity crisis abates, we expect growth to slow during 2008-10 and then rise back to its potential rate once unemployment has reached a sustainable level.** Confidence has been shaken by higher interest rates and inflation, a turnaround in the property market, and the worsening global crisis. Consumption and investment growth will, therefore, remain sluggish, while exports will be constrained by high labor costs and weak export markets. In time, wage growth is expected to slow, allowing firms to rebuild profit margins and creating conditions for sustainable growth. On balance, we expect GDP growth of slightly less than one percent this year and slightly less than half a percent in 2009-10, with a pickup in 2011. The external current account balance is projected to strengthen slightly, owing to the contraction in domestic demand. Inflation, anchored by the peg to the euro, should decline as wage growth slows and global commodity price increases abate.

6. **The main risk to this benign central outlook is a significant worsening of the external environment.** A protracted global liquidity squeeze would compound the stresses in the banking sector, putting the brakes on bank credit and domestic demand. An associated global recession would also further slow Denmark's exports. The impact could be magnified by a sharp drop in housing prices, affecting construction as well as household consumption.

7. **Another source of risk is that the recent high wage growth may gain momentum.** After more than a year of slowing growth, the labor market is still remarkably tight: unemployment is very low and vacancy rates are high. The tight labor market, the generous 2008 public sector wage agreement, and rising food and fuel prices have pushed nominal wage growth to nearly 5 percent. Consequently, real wages have grown faster than productivity. If wage growth does not slow, firms' profitability will be undermined, leading to a possibly protracted period of high unemployment.

8. **Competitiveness currently appears adequate, but recent trends in wages and productivity cannot be sustained.** Our assessment, based on analyses of the external current account and of price developments, is that the real effective exchange rate is well aligned. However, Denmark's productivity growth is slower than that of its trading partners and real wage growth has been faster, eroding wage competitiveness. To date, the effect on price competitiveness has been mitigated by improvements in the terms-of-trade, owing partly to specialization in the export of high value-added goods. Even so, Denmark's share in export markets has eroded. Moreover, terms of trade improvements cannot be counted on to continue compensating for a trend increase in labor costs. Looking ahead, the alternatives are a sufficiently strong wage adjustment or weaker competitiveness leading to higher unemployment.

Banking sector

9. **While the banking sector entered the crisis from a position of strength, the global liquidity shortfall has exposed pockets of vulnerability.** Overall the sector is well capitalized, though buffers have been slimmed with the phasing-in of Basel II and IFRS. With the growth slowdown still in an early stage, loan portfolios, and mortgages in particular, are performing well, but the end of the property boom has caused a deterioration in asset quality in the real estate development and construction sectors. Some small and medium-sized banks are particularly vulnerable since they increased their lending rapidly during the boom, relying for the first time on significant amounts of wholesale deposits and money market funding, including from abroad. The liquidity crisis, combined with the cyclical slowdown, has put such banks under severe pressure and could reinforce the existing trend for mergers at a time when it may be more difficult to find partners.

10. **The authorities' preemptive approach to bank resolution has worked well so far.** A new contingency facility to support banks under stress was established by the Danish Bankers Association in 2007 and was welcomed by the Danish Financial Supervisory Authority (DFSA) and the Danmarks Nationalbank (DN). It was used for the first time in August 2008 to facilitate the purchase of Roskilde Bank, several branches of which have now been sold to private banks. The DN has also intervened a small bank that had liquidity and asset quality problems. In addition, a few small banks with liquidity problems have been purchased by larger institutions.

11. **The authorities' initiatives to enhance banking sector liquidity are welcome.** The DN has created several instruments and lending facilities that should help alleviate the liquidity shortage, particularly for small banks: a temporary secured lending facility based on "loan bills," a temporary credit facility offering banks credit on the basis of their excess capital adequacy, and an expanded collateral base for borrowing by banks. The dollar shortage has been addressed by an extraordinary auction of treasury bills-which are acceptable as collateral for borrowing from the US Federal Reserve-and the auction of funds obtained through swap lines with the US Federal Reserve.

12. **Current conditions underscore the importance of intensifying financial sector surveillance and supervision.** The anticipated slowdown and the pressure in the global financial markets call for intensified monitoring of risks to the financial system. The DFSA's recent initiatives to sharpen their focus on liquidity are welcome. Although financial stability work is well established in Denmark, there is scope for further strengthening. It is important to ensure that the DFSA has the resources to recruit and retain staff, especially in light of their expanded mandate under Basel II.

Stabilization policy

13. **The near-term macroeconomic outlook and high wage growth call for a neutral fiscal stance.** From the perspective of demand management, the goal should be to allow the economy to slow until output returns to capacity, labor market pressures ease, and wage growth decelerates to a sustainable rate. While the global financial crisis could add pace to the slowdown, the risk of a "hard landing" seems small: the severity of the downswing will be cushioned in the early phases by high employment and wage inertia and later by strong automatic stabilizers and, in time, more normal global credit conditions. The case for a fiscal easing at the present juncture is therefore weak. Indeed, fiscal sustainability considerations, discussed further below, argue for keeping the fiscal position as tight as possible. Consequently, the authorities should resist pressure to relax the fiscal stance in 2009, aiming instead for a fiscal effect of approximately zero.

14. **The fixed exchange rate policy continues to serve Denmark well, and we support this arrangement.** The peg to the euro anchors inflationary expectations and has helped discipline the macroeconomic and structural policy frameworks, contributing in particular to a strong fiscal policy. The peg implies that Denmark effectively imports the monetary posture of the euro area; this is likely to remain broadly appropriate while Denmark and the euro area face similar challenges in financial markets. The peg has not come under pressure during the months of the financial crisis, reflecting market confidence.

Fiscal sustainability and structural policies

15. **Denmark's achievements on the fiscal front during the past two decades have been remarkable, but they do not yet close the long-term fiscal gap.** The expenditure ratio has declined significantly, the general government surplus is among the highest in the EU, and the debt ratio has declined to a little over 20 percent. Nonetheless, the generous social welfare system, combined with the unfavorable demographic outlook, poses a significant challenge.

16. **Denmark was among the first in the OECD to articulate and implement a long-term framework for fiscal sustainability.** The strategy rests on two pillars-accumulating assets in good times (with favorable demographics and North Sea oil revenues) and implementing structural reforms for the longer haul. The first pillar, set out in the 2015 plan, targets fiscal surpluses during the next several years, with a view to increasing net government assets to about 10 percent of GDP. The second pillar consists of structural reforms intended to strengthen work incentives and increase the labor force. To date, these include reforms to increase the retirement age starting in 2019 and index it to longevity, to strengthen work incentives, and to reduce the tax wedge on wages.

17. **Further reforms of social benefits will be needed, as acknowledged by the 2015 plan.** The mission strongly endorses the recent proposals by the Labor Market Commission, which will substantially improve the prospects for long-term fiscal sustainability. Bringing forward the increase in the retirement age to 2009 and reducing the duration of unemployment benefits would reduce budget expenditures and raise revenues by boosting structural employment.

18. **Measures to increase revenue may also be needed in order to close the long-term fiscal gap.** In this regard, consideration could be given to the introduction of user fees, the indexation of the tax on residential property and reducing the deductibility of mortgage interest. After six years of a tax freeze, the work of the Tax Commission provides a window of opportunity to improve the structure of taxation and address fiscal sustainability by strengthening revenues. It is

thus unfortunate that the Commission's mandate requires a revenue-neutral package and excludes taxation on residential property, and we would urge the authorities to consider a more ambitious package.

19. **Denmark's continued generous provision of foreign aid is welcome.** Denmark is committed to maintaining development assistance at the internationally high level of 0.8 percent of gross national income.

IMF EXTERNAL RELATIONS DEPARTMENT

Public Affairs

E-mail: publicaffairs@imf.org (mailto:publicaffairs@imf.org)

Fax: 202-623-6220

Media Relations

E-mail: media@imf.org (mailto:media@imf.org)

Phone: 202-623-7100