

INTERNATIONAL MONETARY FUND

Concluding Statement of the Interim Staff Visit to Denmark

October 14, 2011

The immediate outlook for growth is clouded

1. Denmark's recovery from the global recession has been hesitant, and, given deteriorating international conditions, the outlook going into 2012 is weak at best. In addition, relative to GDP, both private consumption and business investment remain well below historical norms.

In addressing this challenge, Denmark has several strengths

2. Public net debt is zero, and gross debt remains around 45 percent of GDP, some 10 percentage points of which funds a deposit with Danmarks Nationalbank. This strong fiscal position and the buffer of precautionary liquidity guard against disruptions in sovereign and/or bank debt markets.

3. The targeted fiscal response to the recent global economic crisis cushioned the effect of the downturn while advancing Denmark's structural reform agenda.

4. Furthermore, the aim to return gradually to fiscal balance over the medium run is appropriate. And, in accord with the peg to the euro, the monetary policy stance is stimulative.

5. The current account surplus exceeds 5 percent of GDP. The net international investment position is in small credit.

6. The narrow band peg to the Euro is in robust health. Even at the nadir of the global crisis, net outflows from Denmark were modest and brief. Price and wage setters take the peg as a fact of life, with inflation in line with the Euro Area and wage growth slightly below 2 percent.

But countervailing factors are considerable

7. Export demand appears set to slow into 2012. And with Euro Area strains mounting, this softening could be accompanied by further bursts of international banking turmoil.

8. While Danish bank claims on distressed Euro area sovereigns are negligible, their claims on the Euro Area as a whole is some 80 percent of GDP. These are marked-to-market. Half of funding for the banking system is wholesale, and money market and CDS spreads have widened in recent weeks.

9. Domestically, a house price bubble has been deflating since 2007, with prices broadly flat for the past 18 months. While associated credit losses remain low so far, the housing market trends appear to underpin the recent extraordinary leap—by some 8 percentage points of GDP—in household savings rates in the past three years.

10. Alongside, while household net wealth is strong, Denmark stands out with gross household debt at 300 percent of disposable income. Though this exceptionalism is not new, and partly reflects mandatory private pension schemes, household leverage on this scale constitutes a macroeconomic and financial stability vulnerability.

Thus, four critical policy challenges lie ahead for the new administration

- Cementing policy credentials
- Supporting the resilience and consolidation of the financial sector
- Buttressing the recovery given domestic and external risks
- Fostering long-term growth

The first task is to reaffirm Denmark's policy credentials

11. This will maximize scope, given the peg, for short run fiscal flexibility to adjust to the deteriorated growth outlook and to possible further growth shocks.

12. In this light, prompt enactment of the reforms to early retirement is strongly encouraged, as well as actions on the announced intentions regarding student grants, disability benefits and the flexi-jobs system. To safeguard the long-term gains of these reforms, actions to strengthen the control of government expenditure will be essential alongside.

13. These steps should be supported by a cautious settlement in the forthcoming 2012 round of wage negotiations. Overall nominal wage increases below those of Denmark's main trading partners will underpin confidence in Denmark in an uncertain global environment and may begin to reverse the erosion of competitiveness over the past decade.

Reinforcement of the financial sector is also required

14. Much progress has been made in the past two years to strengthen the banking sector, notably with the various “bank packages”. These include activation of the new resolution procedures applying haircuts to senior bank debt, and signal intent to reduce the implicit government guarantee on banks. This will facilitate needed bank consolidation.

15. But stress in the system has recently increased markedly, in part reflecting European developments, and this requires a continued robust policy response.

16. In this context, the Basle III and the EU's Fourth Capital Requirements Directive targets on bank capital should be regarded as floors. With the EU itself recently setting more ambitious targets, the large size of the financial system in Denmark warrants even faster and further progress than required by these minima. This could reduce the macroeconomic and fiscal risks associated with the financial sector, thereby lowering funding costs and stimulating economic activity.

17. Furthermore, the proposed establishment of a committee of enquiry into the prudential arrangements for large banks is welcome. In the interim, however, given increased stress in the international financial system, the capital requirements for large banks should continue to be actively reviewed taking into account their systemic importance. In this context, these banks could be required to retain earnings to further strengthen capital.

18. The effort to strengthen banking liquidity should continue alongside, including the further expansion of relevant reporting requirements on foreign currency liquidity positions—anticipating eventual quantitative regulations on these. This will help to reduce reliance on official liquidity backstops.

19. These prudential arrangements are underwritten by the domestic and international supervisory structures. In this context, we look forward to recommendations to be made shortly by a government committee on supervisory architecture. Alongside, development of the general principles in the Nordic-Baltic MOU on resolution of cross-border banks into more specific agreement is encouraged.

20. In view of the increased challenges in the international banking system to which Denmark is exposed, an early review of the adequacy of funding of the Danish Financial Supervisory Authority to ensure that it remains fully effective in executing its mandate is encouraged.

These fiscal and financial sector steps allow policy support for activity in 2012

21. With public finances and the financial sector on a sound medium-term footing, the relatively large fiscal stabilizers can and should be given full rein to address the weakness in growth in the near term.

22. In addition, we see a case now to scale back the earlier-envisaged structural consolidation for 2012, in light of the deterioration in the growth outlook. Even though the fiscal multipliers are relatively low given Denmark's openness and household's high propensity to save, this is not the time to pursue immediate structural consolidation. Accordingly, rather than the earlier anticipated modest structural fiscal consolidation, an unchanged structural fiscal balance for 2012 could be appropriate. The accommodation thereby created should primarily be used to fund non-recurring and labor-intensive investments, notably repair and maintenance of infrastructure and public buildings at the local government level.

23. Any retrenchment in the structural objectives for 2012 should be set in a medium-term path detailing how the 2013 Excessive Deficit Procedure and 2020 fiscal balance

objectives will still be met. All this will ensure that more than sufficient fiscal firepower will remain in the medium-term should growth prove even weaker than is now anticipated.

24. Alongside, the role of the tax system in the high household debt ratios should be reviewed. Action should balance both need to remove the underlying distortions with the need to avoid a disruptive adjustment to debt—with attendant effects on activity. Re-establishing the link between house prices and property taxes is one option.

A strong structural reform agenda will secure sustained growth

25. The immediate challenges underscore that Denmark needs to raise productivity growth. Structural reforms to secure this aim will underpin the growth of households' incomes and strengthen the tax base. Actions to lower the size of government and therefore the burden of taxation, to encourage a rebalancing of highly skilled workers from the public to the private sector, and to encourage greater competition between firms may play key roles in securing these long term goals.

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We would like to thank all of our counterparts for the exceptional warmth of the welcome that we were accorded during our short visit to Denmark.