

April 2, 2020
Approval: 4/9/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/53-3

2:30 p.m., June 21, 2019

3. Denmark—2019 Article IV Consultation

Documents: SM/19/140 and Correction 1; and Supplement 1; SM/19/144; and Correction 1

Staff: Segoviano Basurto, EUR; Gonzalez Miranda, SPR

Length: 37 minutes

Executive Board Attendance

D. Lipton, Acting Chair

Executive Directors Alternate Executive Directors

	A. Nainda (AE), Temporary
	H. Razafindramanana (AF)
G. Lopetegui (AG)	N. Heo (AP)
	P. Fachada (BR)
	K. Lok (CC), Temporary
	J. Montero (CE), Temporary
	P. Mooney (CO), Temporary
	S. Benk (EC)
	A. Castets (FF)
S. Meyer (GR)	M. Siriwardana (IN)
D. Fanizza (IT)	Y. Saito (JA)
	M. Daïri (MD)
	M. Merhi (MI), Temporary
	T. Manchev (NE), Temporary
T. Ostros (NO)	L. Palei (RU)
	W. Al Hafedh (SA), Temporary
A. Mahasandana (ST)	P. Trabinski (SZ)
	D. Ronicle (UK)
	D. Crane (US), Temporary

G. Tsibouris, Acting Secretary
 J. Morco, Summing Up Officer
 D. Alcantara, Board Operations Officer
 L. Nagy-Baker, Verbatim Reporting Officer

Also Present

European Central Bank: K. Nikolaou, R. Rueffer. European Department: J. Bricco, E. Detragiache, R. Huidrom, M. Segoviano Basurto, P. Wingender. Legal Department: J. Purcell, G. Rosenberg. Monetary and Capital Markets Department: S. Elekdag, I. Ergen. Research Department: J. Bluedorn. Strategy, Policy, and Review Department: M. Gonzalez Miranda.

Alternate Executive Director: J. Sigurgeirsson (NO). Senior Advisors to Executive Directors: M.Gilliot (FF), K. Karjanlahti (NO), W. Kuhles (GR), J. Shin (AP). Advisors to Executive Directors: D. Andreicut (UK), P. Di Lorenzo (IT), D. Fadhel (MI), H. Mori (JA), L. Nankunda (AF), B. Parkanyi (NE), F. Rivadeneira (BR), P. Snisorenko (RU), A. Srisongkram (ST), A. Urbanowska (SZ), N. Vaikla (NO), S. Alavi (MD).

3. DENMARK—2019 ARTICLE IV CONSULTATION

Mr. Ostros and Mr. Gade submitted the following statement:

On June 5, general elections took place in Denmark, resulting in a new parliamentary majority. Government formation negotiations are ongoing, and a new government's policy views are forthcoming. On behalf of the outgoing caretaker government and other Danish authorities, we would like to thank staff for candid and constructive policy discussions during the Article IV mission held in May. The authorities appreciate staff's high-quality report and analytical work on relevant issues.

Outlook and risks

The Danish economy has been growing robustly for the past four years, where growth in GDP has averaged more than two percent per year. Employment has increased continuously since 2013 and has reached a high level. There is a solid foundation for the expansion to continue in 2019 and 2020, where domestic demand is expected to be the main growth driver.

Risks to the outlook are mainly to the downside. There is uncertainty surrounding the strength of the global economy, which is exacerbated by the ongoing trade conflict between the United States and China. At the same time, the future relations between the United Kingdom and the EU after Brexit are still unclear. A no-deal Brexit would affect the Danish economy more strongly than most other European countries.

The Danish economy is operating above normal capacity utilization. Monetary policy in the euro area remains extraordinarily expansionary and is expected to remain so for some time. This underscores the important role of other policies in supporting economic stability.

Public Finances

For more than two decades, Danish fiscal policy has been conducted within a forward-looking medium-term fiscal framework. The associated plans contain operational targets for the medium-term structural fiscal balance and play an important role in ensuring long-term fiscal sustainability. The most recent update of the 2025-plan aims at structural fiscal balance in 2025.

For 2018 the structural fiscal balance is estimated to have been in balance at 0.0 percent of GDP. The structural fiscal balance includes an

estimated structural contribution from the non-permanent North Sea revenues of 0.3 percent of GDP in 2018.

The Budget Law was introduced in 2012 and took effect from the fiscal year of 2014. A key feature is expenditure ceilings, which set legally binding limits for expenditures in central government, municipalities, and regions respectively. The expenditure ceilings have, to date, put an end to the recurrent expenditure slippages, which were the Achilles heel of Danish fiscal outcomes for much of the 1990s and 2000s. The Budget Law also implements the European Fiscal Compact in Danish law, including a structural deficit limit of 0.5 percent of GDP, but also allowing for some flexibility in exceptional circumstances such as, e.g., a severe economic downturn.

The Budget Law will be evaluated in the parliamentary session that starts after the summer on the basis of, inter alia, comprehensive analyses of the experience with the Budget Law so far.

Structural policies

Wide-ranging reforms - of retirement and early retirement rules, the labor market, and taxes - have contributed significantly to the growing labor supply in recent years and will continue to do so in the coming years. This has mitigated the build-up of capacity pressures in the economy.

Whereas the isolated impact of fiscal policy initiatives from 2014 to 2018 has been broadly neutral for demand, the strengthening of the supply-side through reforms has helped to accommodate the growing demand and dampen the gradual build-up of capacity pressures.

Overall, the combined impact of fiscal and structural policies from 2014 to 2018 is estimated to have dampened capacity pressures to the tune of 0.8 percent of GDP – helping to ensure that the estimated output gap is only moderately positive at around 1 percent currently.

Financial sector issues

The outgoing government and a broad majority in the Danish Parliament has been committed to strengthen the fight against money laundering and terror financing. The AML/CFT framework must be effective and the sanctions severe.

On March 27, 2019, a broad majority of the parties in the Danish Parliament agreed on a new political agreement, which contains 16 initiatives to strengthening the AML/CFT regulation and expanding the Danish Financial Supervisory Authority's (FSA) sanctioning powers.

With the March agreement, the FSA will have additional tools for control and intervention, among other things be able to levy administrative fine notices for non-compliance with the AML/CFT obligations. In addition, the FSA has had its budgetary resources increased significantly. The agreement's thrust is to make sure that there are tougher consequences when bank management fails its responsibility, and to ensure that the authorities have the resources and means to achieve an AML/CFT supervision in the European elite.

This agreement further builds on a political agreement from September 2018, in which a broad majority of parties in the Parliament agreed that Denmark, within the framework of the Danish EU opt-outs, will actively participate in the upcoming and ongoing international work (at EU level and at Nordic/Baltic level) to strengthen and increase cross-border cooperation in the fight against money laundering and terror financing.

As regards considerations on Danish participation in the Banking Union, a designated government committee was established in July 2017. The committee is expected to conclude its work with a final report to the Government in fall 2019.

Monetary policy

The authorities welcome staff's assessment that Danmarks National Bank should remain ready to defend the peg. Maintaining the peg to the euro is the exclusive policy objective and hence, monetary policy rates are adjusted solely to keep the krone stable against the euro. Other considerations - such as cyclical developments in Denmark - are not taken into account when setting monetary policy rates.

External Sector Assessment

The authorities agree that the current account surplus is high, although the surplus declined notably in 2018. A current account surplus is not a policy objective per se, but the result of individual decisions by households and corporations. The surplus partially reflects a high private sector savings surplus in Denmark through the build-up of labor market pensions. For many

years, Denmark has had a focus on preparing for future demographic changes due to an aging population. To some extent, the surplus may also reflect deleveraging among households with high levels of debt. Finally, public finances are designed to be sustainable in the long run.

Mr. Fanizza submitted the following statement:

We thank staff for their informative report and Selected Issues paper in the context of Denmark's Article IV consultation and Mr. Ostros and Mr. Gade for their informative buff statement.

Denmark's strong economic performance is encouraging. Denmark's favorable business climate, low level of income inequality, strong labor market, and broadly balanced fiscal position demonstrate its economic strength. Nonetheless, we take note that risks around the outlook are tilted to the downside. We consider that the high household debt still constitutes the main domestic vulnerability. At the same time, we are encouraged by the slowing real-estate price dynamics and the increased use of fixed-rate and longer-dated mortgages with amortization. Meanwhile, we note that the economic environment is favorable to reduce the debt bias through further policy initiatives. Nevertheless, the necessary continued deleveraging of households will certainly take time and further policy efforts. Therefore, we share staff's call for enhancing the macroprudential toolkit and deploying it when needed. Recent efforts by the Danish authorities to strengthen AML supervision and enforcement are welcome developments. We also agree that there is a need to support broad-based innovation, enhance the institutional framework for competition and improve the capital market to facilitate access to equity finance for SMEs.

Macroeconomic developments

The recent strong growth is set to continue. The economy will likely gather momentum over the rest of the year, following the soft first quarter results in 2019. Healthy labor market and wage gains should keep supporting consumption and investments, while exports are expected to strengthen too. Moreover, the peg to the Euro will keep inflation quite low, only slightly increasing over the forecast horizon mainly through the support of rising wages. The combination of a moderately stronger than warranted external position and of a high household debt points to the need of policies that mitigate savings imbalances while increasing domestic productive investment.

Fiscal policies

While we note the differences in output gap estimates, we believe that the broadly neutral fiscal stance is adequate. We concur with staff and the authorities that in case of shocks to aggregate demand automatic stabilizers should constitute the first line of defense, especially considering their efficacy; we also agree that a temporary loosening should be considered in the event of a severe downturn, while remaining anchored to the medium-term objective. Furthermore, we share staff's recommendation to lower the participation tax rate of low-income earners and to lift spending to upgrade the infrastructure. Further and broader reductions in the mortgage interest deduction from the personal income tax should also be considered, because these tax expenditures may have led to a mortgage-debt bias and contributed to households' high indebtedness.

Financial market policies

The Danish banking system remains profitable, liquid, and solvent, and we welcome the effort to strengthen anti-money laundering supervision and enforcement as a top priority. We welcome the full implementation of the Bank Recovery and Resolution Directive framework, including setting the bank-specific minimum requirements for own funds and eligible liabilities (MRELs). In view of the close interlinkages across the Nordic financial system, we take positive note of the crisis management simulation exercise of the Nordic-Baltic region and of the recommendation by the Systemic Risk Board to gradually raise the countercyclical capital buffer to 1½ percent by June 2020. We also agree with staff that further refining the frameworks for assessing systemic risks may be necessary. In the aftermath of the recent money laundering case, Denmark has already strengthened both its anti-money laundering framework and its financial supervisory authority (FSA). A political agreement to further strengthen the FSA was concluded in March 2019, which includes granting the FSA powers to issue fine notices, as recommended by staff. However, we encourage the authorities to press ahead with the adoption, implementation, and enforcement of many of the agreed changes to the anti-money laundering law and the FSA that are still pending.

High household indebtedness amid elevated house valuations is a key source of concern and macro financial vulnerability. The combination of elevated housing prices in urban areas, high household debt, and debt servicing costs, together with the still large stock of interest-only and variable-interest mortgages call for additional measures to strengthen resilience. Therefore, like staff, we welcome both recent macroprudential

policies targeting households and financial intermediaries, and the reform of the property taxation. At the same time, the mortgage debt bias in Denmark could be reduced further and the macroprudential toolkit could usefully be enhanced to include additional borrower-based measures. The authorities should also consider the use of macroprudential stress tests to assess vulnerabilities due to the complex interconnections among Mortgage Credit Institutions, pension funds and the household sector.

We take note of staff's analysis of Denmark's Banking Union opt-in decision. It provides a useful backdrop to the ongoing work of the designated government committee which was established in July 2017 and which is expected to conclude its work with a final report in fall 2019.

Structural policies

Further measures are needed to boost potential growth and increase productivity in the Danish economy. While the overall level of research and development in Denmark is high, it is concentrated in a relatively low number of companies. Moreover, we commend the authorities for introducing pro-business policies, including those fostering the greater digitalization of SMEs. Nevertheless, there is a need to broaden the innovation base to include more companies. We would also recommend more public investment in sustainable transport infrastructure to reduce congestion around bigger cities. We also agree with staff that increasing the labor supply should be a priority to sustain the Danish economic and welfare system. To this end, increasing participation rates in vocational education and training for upskilling the workforce appears to be necessary. We acknowledge the efforts made to better integrate migrant workers in the Danish labor market but would also share staff's view that more could be done in this regard. Moreover, improving flexibility in access to childcare facilities could contribute to reducing the gender gap in management positions. While much progress has been made in terms of achieving longer participation rates on the labor market and promoting incentives to work, challenges remain, and we see merit in continuing reforms that could have a favorable impact on labor supply.

Mr. Lopetegui and Mr. Rojas Ulo submitted the following statement:

We thank staff for the reports and Mr. Ostros and Mr. Gade for their helpful buff statement.

Denmark's economy continues performing well. Since 2014 the country has maintained a steady upswing and broad-based economic growth,

albeit at a slower pace than peers, led by solid domestic demand and supported by sound economic and social policies and strong institutions. Economic growth is projected to increase from 1.4 percent in 2018 to 1.7 percent in 2019, and 1.9 percent in 2020 and decline to close to 1.5 percent over the medium term. The economy is exposed to external risks, including from the negative effects of trade tensions and a disorderly Brexit. Domestically, the main vulnerability appears to be the high household leverage amid elevated property valuations. We broadly concur with staff's recommendation on the implementation of structural reforms focused on enhancing resilience and boosting potential growth.

The fiscal position is very strong, with balanced budgets in structural terms and low debt levels; this gives Denmark ample room for maneuver to face negative shocks. The structural balance deficit is expected to remain practically unchanged this year compared to 2018 and is projected to remain close to zero over the medium term, conserving the neutral stance of the fiscal policy. We concur that automatic stabilizers should operate fully to accommodate shocks in domestic demand. In case substantial downside risks materialize, ample buffers give space to implement countercyclical fiscal policy. Staff suggests sensible measures to continue improving the efficiency of revenue collection and expenditure.

The banking system is sound overall, and the authorities are appropriately focusing on ensuring the integrity of financial sector operations. The staff report shows that banks remain profitable, liquid, and solvent. In addition, there have been efforts to strengthen capital buffers. On the other hand, confidence in the financial sector was affected by the Danske bank money-laundering scandal, which revealed serious weaknesses in AML/CFT supervision. These matters should be fully addressed, aiming at ensuring best practices in monitoring, sanctioning, and collaboration with other jurisdictions. On the relaxation of credit standards in the corporate loan market, could staff elaborate more on the concerns and possible impact on credit quality?

The housing market is well developed and plays an essential role in the economy; further actions are needed to contain macro-financial vulnerabilities. Large household savings and pension contributions have facilitated the development of the world largest covered bond market. At the same time, household debt-to-income ratios are among the highest in OECD countries, making households (and private consumption) vulnerable to house price and interest rate shocks. We concur with staff's recommendation on the implementation of coordinated policy actions and macroprudential

instruments focused on income-based measures to reduce macro-financial vulnerabilities. Further efforts to expand the supply of housing could help contain property prices.

Policies to expand labor supply and productivity would spur potential growth. The staff report shows the labor market continues to improve due to the success of the past policies and, in recent years, unemployment has dropped below the structural rate. How is the structural rate of unemployment calculated? Productivity growth is assessed to be weak due to, among other factors, weak investment. We concur that the implementation of policies focused on increasing labor supply, such as tax and benefit reform, and improving skills, shrinking the gender gap, and integrating migrants, are sensible priorities. Structural reforms to boost investment, increase productivity, and innovation will also be beneficial.

With these comments, we wish Denmark and its people success in their future endeavors.

Mr. Doornbosch and Mr. Manchev submitted the following statement:

We thank staff for the focused set of papers and Messrs. Ostros and Gade for their insightful buff statement. Since we generally agree with the staff's assessment and associate ourselves with Mr. Fanizza's statement, the following comments on the cross-border financial sector supervision and macro-prudential policies are given for emphasis.

We welcome the recent strengthening of Denmark's financial regulatory framework and cross-border AML/CFT supervision. The political support to the Danish Supervisory Authority and cooperation among the regional supervisors will remain key to further reinforce the cross-border AML/CFT supervisory regime, given the high interconnectedness of the Nordic-Baltic financial system, the substantial level of the money-laundering threat, and the nature of the national supervisory obligations at the current juncture, even for EU banking union members. Staff's Selected Issues paper on the subject has also provided a focused analysis of the vulnerabilities, which helps to better understand Denmark's risk profile. Going forward, we encourage staff to remain focused on testing and cross-checking the enhancements to help strengthening the effectiveness of the international supervisory cooperation in the region.

We welcome the authorities' consistent implementation of prudential policies aimed at preserving financial stability. Deployment of the

counter-cyclical capital buffer should help Denmark to better withstand the risk build-up related to the housing market trends in a low-for-long interest rate environment. Given the broad agreement of staff and the authorities that economic expansion will continue in the medium-term, and the output gap to remain positive, we encourage the authorities to increase the banks' capital buffers through better calibration of the micro- and macroprudential policy mix in line with the staff recommendations. The prudential policies, however, should be supported by structural reforms, especially including measures to improve housing supply, reduce rent controls, and reconsider the overly favorable tax incentives.

Finally, we note that the considerable uncertainties in the staff's external sector assessment continue. Deeper analysis of the important country-specific factors of that provided in Annex IV of the report, including on the effects that each factor plays in the staff's assessment and policy recommendations, would be desirable. Staff's comments are welcome.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its reports and Messrs. Ostros and Gade for their informative buff statement. We broadly share staff's appraisal and associate ourselves with Mr. Fanizza's statement. We would like to offer the following comments for emphasis.

Strong institutions and sound economic policies are supporting a solid economic performance, driven by domestic demand and tightening labor markets. The external and fiscal accounts are healthy, while price and wage inflation remain moderate. Although house prices seem to be softening, they have surpassed the previous peak in some areas, while household debt is the highest among OECD countries as a share of disposable income. The authorities are aware of the risks stemming from the housing sector and have been very active in the implementation of macroprudential policies, as well as in promoting housing supply. Going forward, economic activity is expected to perform relatively well, driven by private demand and accommodative financial conditions, in a context of risks mainly to the downside. Policy buffers, however, are ample.

We note that staff projects a boost of 0.4 pp to potential output growth, up to 1.8 percent because of recent structural reforms. However, projected real GDP growth will be below potential and converge towards 1.5 percent over the medium term (by 2023/2024), which implies a very gradual closing of the output gap. Could staff comment whether this path is consistent with previous

cycles? Additionally, staff uses the OECD's structural unemployment rate, which remains flat at around 6 percent while the observed rate stays around 5 percent, suggestive of a positive output gap. Does staff envisage a fall in structural unemployment linked to those structural reforms?

We concur that the neutral fiscal stance seems appropriate for the Danish economy, as it will help cushion the impact from ongoing structural reforms, while at the same time preserving its ample buffers in case of adverse shocks. Both staff and authorities share the view that increasing labor supply is critical for the long-term sustainability of the Danish system. Staff suggests a wide-ranging set of structural measures to boost labor participation, with which we agree. However, we would also like to add another dimension to this challenge. As highlighted in the case of the US monetary policy, it is possible that continued policy accommodation could generate lasting positive supply-side effects through a better allocation of scarce labor resources and as labor force participation increases—by bringing discouraged workers back to the labor market—and booming demand encourages more investment into physical capital and R&D. Absent monetary policy as a stabilization tool, we wonder whether this reasoning could justify a more expansionary fiscal stance in Denmark's case. Staff's comments are welcome.

As highlighted in the past, high household leverage amid elevated housing valuations remains the main source of concern. The large share of variable-rate and deferred-amortization loans, along with favorable tax treatment, incentivize funding with large mortgages, which pose risks to economic and financial stability, particularly stemming from low-income households and those living in overvalued urban areas. We welcome the measures implemented in 2018 to limit interest-only and floating-rate mortgages to highly-indebted households. However, like staff, we see merit in shifting the focus to income-based measures to better address high leverage and encourage faster amortization. To further mitigate risks and reduce price fluctuations in the housing market, additional measures to facilitate housing supply, eliminate distortive tax incentives to debt-financed home ownership, and enhance rental market flexibility would be advisable. All these measures are more important in view of the limitations of monetary policy, which is constrained by the peg to the euro—which, otherwise, has served Denmark well to sustain low and stable inflation.

We welcome the authorities' strong commitment to fight against AML/CFT, as evidenced by the implementation of several initiatives to strengthen the AML/CFT regulation and expand the FSA's sanctioning powers. We encourage the authorities to build on these efforts and take

additional steps to enhance cross-border AML/CFT supervision, along the lines recommended by staff.

Mr. Fachada, Ms. Mohammed and Mr. Rivadeneira submitted the following statement:

We thank staff for the comprehensive reports and Messrs. Ostros and Gade for their statement. The Danish economy continues to experience moderate growth with subdued inflation and sustainable public debt. The financial conditions remain accommodative, while the fiscal stance continues to be neutral. Strengthening anti-money laundering supervision, addressing the vulnerabilities stemming from the housing market and boosting labor supply, productivity and investment seem to be important challenges that need to be addressed.

A neutral fiscal stance to allow the automatic stabilizers to operate remains appropriate to mitigate any demand shocks. We take note that although the outlook underscores steady growth, the report highlights a high degree of downside risks stemming from factors beyond the control of the authorities, in particular a sharper economic slowdown in Denmark's trading partners as well as a disorderly Brexit. This compounds the importance of policies to boost potential growth, whilst maintaining a neutral fiscal stance. We join with staff in welcoming the ongoing review of the budget law, which would ensure adequate flexibility with the structural deficit limit while maintaining the overarching objective of budget balance. That said, we recognize that the aging population and the associated increase in healthcare costs in the long-run warrant some fiscal prudence.

The financial sector remains sound, liquid and solvent despite slowing of credit growth and low interest margins. We take note that the banks have ample capital buffers but credit standards for corporate loans are weakening. Therefore, the authorities are encouraged to strengthen financial resilience and closely monitor the buildup of risks in the low-interest rate environment. The countercyclical capital buffer and a combination of micro and macroprudential tools should be employed if necessary. Reinforcing Denmark's regional and international cross-border cooperation is important to mitigate systemic risks in the financial system. The authorities are encouraged to build on their recent momentum to strengthen the AML/CFT framework and supervision.

Risk stemming from the housing market warrant continued vigilance. Given the vulnerabilities stemming from the relatively high household

leverage and the high house valuations, we encourage the authorities to progress with the implementation of the structural measures aimed to alleviate the housing market pressures, including enhancing the macroprudential toolbox, reducing favorable tax incentives and improving housing supply. Like staff, we believe that income-based macroprudential instruments may prove to be more effective than the current instruments that use loan-to-value ratios, which tend to become less binding in an environment with rising house prices.

Enhanced productivity and investment, as well as increased labor supply is important for long term macroeconomic sustainability. We tend to agree that broad-based innovation and enhanced institutional framework for competition would improve productivity and investment. Further, we commend the authorities for their efforts in improving the employment and labor force participation rate. Nonetheless, more needs to be done to better integrate migrants in the labor market and reduce the gender gap.

Mr. Saito and Ms. Mori submitted the following statement:

We thank staff for the comprehensive reports and Mr. Ostros and Mr. Gade for their informative statement. We welcome that Denmark's solid economic performance continues with high living standards along with low levels of inequality. The labor market is strong, inflation remains moderate, the fiscal stance is neutral and public debt remains sustainable. However, several challenges remain, including elevated household debt and money laundering cases. Therefore, we encourage the authorities to continue their policy actions to enhance macro-financial resilience and boost potential growth. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

We are pleased to see the assessment that Denmark's public finances are sound with substantial fiscal space in the medium term. We welcome that the Budget Law help put an end to the recurrent expenditure slippages and implements the European Fiscal Compact while allowing for some flexibility in exceptional circumstances. At the same time, the aging population is projected to increase healthcare costs substantially and we note the staff comment that long-run sustainability hinges on continued implementation of pension reform. In this context, could staff elaborate more on the authorities' pension reform plan.

Monetary Policy

We note that the exclusive objective of monetary policy is to maintain the peg and the fixed exchange rate policy has served Denmark well. We also note that the banking system remains profitable despite the negative interest rate environment and that staff refer to changes in the policy rate as deemed necessary. Against this background, we would like to hear staff's view about the impact of ECB's further interest rate cut, which might lead to further policy rate cut of Denmark, on the financial stability of Denmark.

Financial Sector

While the banking system remains profitable, liquid and solvent, the authorities need to remain vigilant to risks stemming from relaxing credit standards and money laundering related issues. We agree with staff that to strengthen financial resilience, a combination of micro- and macroprudential tools should be considered to increase capital buffers if risks continue to build up. Addressing the AML/CFT deficiency is vital as the ongoing money laundering case could affect the confidence in the financial sector and undermine financial stability. We welcome that Denmark has taken important steps to strengthen its AML/CFT supervision over the last two years and a broad majority in the Parliament agreed on a new political agreement on March 27 to strengthen AML/CFT regulation and expand sanctioning powers. In this regard, we would like to ask whether the 16 initiatives contained in the agreement covers elements of staff recommendations which are detailed in the SIP.

Housing Market

The housing market trend should be carefully monitored given the high household leverage and macro-financial linkages. We note that Danish households' debt-to-income ratios are the highest in advanced economies buoyed by several incentives. We recognize the actions taken by the authorities including policies targeting households and financial intermediaries in the forms of macroprudential policies and further encourage them to take additional income-based macroprudential measures if necessary.

Structural Reforms

It is commendable that the labor market continues to improve owing to the success of past policies. While we welcome that the participation rates have increased and the long-term unemployment rate has declined, challenges

such as the low average work hours, increasing youth inactivity, and skill shortages remain. We positively take note that raising labor supply further remains a priority for the authorities and the authorities continue budgetary support for vocational education and training programs.

Mr. Heo and Mr. Shin submitted the following statement:

We thank staff for their comprehensive reports on Denmark and Mr. Ostros and Mr. Gade for their frank and informative buff statement. Denmark's economy has shown solid growth over recent years, operating above potential, with favorable medium-term outlook, but risks remain in some areas such as the housing market and notably household debt. We generally agree with the staff assessment and have the following comments for emphasis and clarification.

While agreeing on the need for a neutral fiscal stance, we see some scope for rebalancing the public spending towards investment to raise potential growth. Given the elevated level of public sector revenue and expenditure (both exceeding 50 percent of GDP) and sufficient fiscal buffer, we share staff's view that focus should be placed on improving efficiency with reforms implemented in a fiscally neutral way. Noting that public investment remains quite low (just above 3 percent of GDP) compared to current spending, we suggest the authorities consider taking a more active role in public investment to improve future growth potential.

Still elevated housing prices and high household debt warrant close monitoring and additional measures. Being especially concerned over the large proportion of variable-rate and interest-only mortgages in the system that exposes the financial system to interest rate risk, we think Korea's macro-prudential measures might prove useful as a reference. Korean authorities have been incentivizing fixed rate loans and capped stressed DTI at 80 percent for banks. Banks are required to calculate the stressed DTI ratio of each borrower by adding the stressed interest rate – at least 100 basis points – to market rates should a borrower apply for a new floating rate mortgage loan. Banks are not allowed to grant a new mortgage loan if the stressed DTI breaches a ceiling. We hope these additional measures could lower the vulnerabilities in this area. We also note favorable tax treatment on home ownership with high MID and the exemption of capital gains tax. Could staff further elaborate on the overall tax scheme on real estates (transfer tax, property tax etc.) in Denmark and the authorities' policy direction on it?

Given the highly integrated Nordic/Baltic financial sector, we support staff's emphasis on cross-border AML/CFT supervision, as envisaged in the

informative Selected Issue Paper. Specifically, we would highlight that possible laundering of such scale could raise significant confidence risks in the Danish financial sector and regional financial market as well and encourage the authorities to move fast to reinforce the supervisory regime as suggested by staff. Could staff elaborate further on the current status of investigation on Danske Bank case?

On the labor market front, fast growing youth NEET (Not in Employment, Education or Training) ratio remains a major concern. Given youth inactivity mostly driven by the high bar of entering the Danish labor market, we are of the view that further efforts for aligning educations and skill training into the future labor demands need to be made especially thorough VET (vocational education & training). We also support strengthening the incentive for labor market participation such as in-work benefits. Could staff specify the type of in-work benefit relevant in the context of Danish labor market? Besides, we are aware that the “job rotation” program of Denmark has been highly praised for getting people in employment and improving the skills of labor force. We wonder about staff’s view or assessment on this program’s contributions to Danish labor market policy objectives.

We would appreciate more detailed data on the labor market – e.g. time-series of labor participation ratio (male/female), employment rate, unemployment rate, forms of employment data (short-term vs. long-term, temporary vs. permanent, underemployment rate).

Mr. Meyer and Ms. Kuhles submitted the following statement:

We thank staff for the informative report and Mr. Ostros and Mr. Gade for their helpful buff statement. We concur with the thrust of staff’s appraisal. We associate ourselves with Mr. Fanizza’s statement and fully agree with its central chapeau sentence: “Denmark’s strong economic performance is encouraging. Denmark’s favorable business climate, low level of income inequality, strong labor market, and broadly balanced fiscal position demonstrate its economic strength. Nonetheless, we take note that risks around the outlook are tilted to the downside.” We would like to offer the following points for emphasis.

Denmark’s banks are sound and profitable. However, pockets of vulnerabilities remain. We take positive note of Denmark’s profitable, liquid, and solvent banking system. However, the negative developments in the context of the money laundering case of Danske Bank have affected confidence in the Danish financial sector and could potentially undermine

financial stability. In addition, some banks are relaxing credit standards for corporate loans. We therefore agree with staff that micro- and macroprudential tools should be used to effectively increase buffers and that cross-border AML/CFT supervision should be strengthened.

As regards macroprudential oversight, which lies within the government, we take note that there exists a risk that political considerations could adversely affect the efficacy of policy implementation. We therefore agree with staff that improvements in the institutional framework would be worth exploring.

We take note of staff's analysis on the relatively high share of household debt. As staff outlines, high household leverage combined with high house valuations could be a source of macro-financial vulnerability. This would leave the economy vulnerable to a real estate shock. Against this backdrop, while we take note that the high household liabilities are counterbalanced by large housing and pension assets, we encourage the authorities to step up their efforts in this matter along the lines of past IMF policy recommendations. In the context of elevated housing prices, we particularly concur with staff that supply-side measures are a welcome step towards improving the demand-supply mismatches.

We take positive note of Denmark's sustainable public debt and its broadly neutral fiscal stance. As staff's analysis shows, Denmark has substantial fiscal space over the medium term. At the same time, the availability of sufficient buffers is particularly important in the case of an aging and small open economy such as Denmark's. More generally, long-run sustainability and potential growth depends on continued reform efforts, both on the fiscal and the productivity fronts. We further concur with staff that, in line with the view of the authorities, in case of shocks to aggregate demand automatic stabilizers should constitute the first line of defense, especially considering their efficacy.

We welcome the government initiatives to incentivize labor participation, avoid inactivity traps, upgrade skills and improve migrant stagnation. In order to further strengthen incentives to work, we concur with staff that high marginal and participation tax rates could be reduced. In addition, as outlined by staff, productivity growth has been weak after the crisis. Furthermore, capital markets are dominated by few large firms, hampering access to finance for SMEs. Therefore, we agree with staff that promoting investment through innovation-stimulating policies would be

beneficial not only to productivity but also to improve funding options for SMEs.

While we agree that higher investment activity would also contribute to reducing the current-account surplus, which is described by staff as “moderately stronger than the level consistent with medium-term fundamentals”, we would like to point out that the External Balance Assessment “is subject to important uncertainties” and that the staff does not identify policies to explain the bulk of the estimated current account gap.

Finally, on a more technical note, with regard to the balance of payments, we wonder what could be the drivers behind the highly volatile portfolio and other investments. In addition, we are surprised by the relatively high net errors and omissions. Staff comments would be welcome.

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following joint statement:

We thank staff for their reports and Messrs. Ostros and Gade for their useful and timely buff statement. Denmark’s economy is in good health. Growth is expected to continue on a positive trajectory in 2019, with domestic demand as the main driver. However, risks are tilted to the downside – these include a possible slowdown in global economic activity and high household indebtedness. We agree with the thrust of staff’s assessment and offer the following brief points for emphasis.

We agree with staff that the fiscal stance should remain neutral, with strong automatic stabilizers operating in the event of shocks to aggregate demand. Efficiency reforms covering the revenue and expenditure side of the budget, as outlined by staff, would be positive although these measures should be implemented in a fiscally neutral way. We positively note the impact of the Budget Law to date as outlined in the buff and welcome the forthcoming comprehensive analysis of this instrument.

We positively note that the banking system remains profitable, liquid, and solvent. We welcome the ongoing building of capital buffers and the implementation of the Bank Recovery and Resolution Directive. We positively note Denmark’s participation in the crisis management simulation exercise of the Nordic-Baltic region and the associated recommendation by the Systemic Risk Board to increase the countercyclical capital buffer to 1.5 percent by June 2020. As regards AML/CFT, the incoming authorities

should build on the momentum established to date in strengthening the regime – particularly in the aftermath of the recent money laundering case.

We welcome the ongoing improvements in the labor market, which have led to increased participation rates, particularly amongst older workers. We agree with staff that a comprehensive tax and benefit reform could further increase the labor supply. The accreditation of foreign degrees to raise the likelihood of migrants being employed, as proposed by staff, would be beneficial both in terms of the integration of migrants and attracting foreign labor. We agree with staff that, in order to close the gender gap, flexibility in the provision of childcare services should be increased. Finally, we welcome the legislative package for digitalization introduced last year, which provides incentives for SMEs to adopt new technologies.

Ms. Mahasandana, Mr. Sun, Mr. Srisongkram and Ms. Lok submitted the following joint statement:

We thank staff for the report, and Mr. Ostros and Mr. Gade for the informative buff statement.

The Danish economy continues to exhibit solid growth performance underpinned by sound macroeconomic fundamentals. While the growth outlook is positive, there remain risks from the less favorable external environment, and from vulnerabilities in the financial system that the authorities should keep a watchful eye on. Meanwhile, the authorities should continue to pursue structural policies to strengthen the labor market and boost productivity to uplift long-term growth. We agree with the thrust of the staff's appraisal and offer the following comments.

With healthy public finances, Denmark is well-placed to withstand shocks and prepare for long-term challenges. The current neutral fiscal stance appears appropriate, while strong automatic stabilizers are in place to alleviate shocks to aggregate demand. Going forward, additional investment to further upgrade infrastructure and support R&D could help raise potential growth. To this end, we note that there is a planned increase in public investment to 3.5 percent of GDP, could staff provide more information on the nature/content of this investment? Over the long term, continued fiscal prudence would help meet the sizeable increase in healthcare costs associated with Denmark's ageing population.

We note staff's assessment that Denmark's external position is moderately stronger than warranted and welcome their continued

acknowledgement of uncertainty surrounding the gap assessment. Staff's explanation of the structural characteristics of Denmark's large current account, and country-specific factors that have not been accounted for in the results (e.g. large structural savings from pension contributions, and measurement issues relating to offshore trading data) is well noted. We wonder if staff could share their estimates of how much the CA gap would be adjusted after accounting for these country specific factors and whether this would alter the policy advice?

The Danish financial system is sound with healthy banks, but pockets of vulnerabilities warrants close monitoring particularly in the housing market. We welcome the authorities' preparedness to further strengthen bank's buffers if deteriorating credit standards for corporate loans lead to further buildup of risk. We also welcome the authorities' commitment to follow through on the initiatives underway to strengthen the AML/CFT framework. The measures above will be key to reinforcing confidence in the Danish financial system. Risks pertaining to the housing market appear to be declining somewhat with softening property prices and homeowners shifting towards loans that are less sensitive to interest rates. Nonetheless, we encourage the authorities to maintain a proactive stance, especially as household debt remains elevated and property prices are still high in urban areas. Staff's call for a coordinated approach to tackling housing market risks is appropriate given its multi-faceted nature. That said, fine-tuning the different policy levers, especially in the macroprudential and tax areas, will require careful consideration of effectiveness and broader economic impact, as well as the appropriate sequencing.

Building on the success of past policies, additional structural measures could help further increase labor supply and boost potential growth. While the Danish social welfare model has been impressive and served the country well, there appears to be room for tax and benefit reforms to better align incentives in the labor market. At the same time, we see merit in further closing gender gaps through greater flexibility in the provision of child services and incentives for adjusting parental leave. Going forward, we believe the authorities' well-rounded business-oriented growth policy focusing on digitalization and fostering investment, among others, will play a key role in supporting productivity growth. Based on staff's analysis in Annex III, with its strong labor market institutions, Denmark also seems well-positioned to further develop its knowledge sector without significantly worsening inequality. In what ways can the business-oriented growth policy support expansion of the knowledge sector?

Mr. Raghani, Mr. Diakite and Ms. Nankunda submitted the following statement:

We thank staff for the set of comprehensive reports and Mr. Ostros and Mr. Gade for their insightful buff statement.

The performance of the Danish economy continues to be strong, driven by domestic demand. The external position remains solid with a narrowing surplus of the current account due to an increase in investment. However, household debt is elevated, and house prices have reached high valuations. In addition, we note that labor productivity growth is weak. While Denmark's economic outlook is broadly favorable, the economy faces downside risks stemming from Brexit and global trade tensions. Against this backdrop, we encourage the authorities to continue to implement the policies needed to increase growth potential and address the vulnerabilities associated with rising house prices and household debt by further strengthening macro-financial resilience.

We broadly concur with the staff's policy recommendations and would like to provide the following comments for emphasis.

We commend the authorities for their prudent fiscal policy stance. In light of the current economic cycle, we take positive note of the authorities' intention to implement a broadly neutral fiscal policy, supported by the full operation of automatic stabilizers to mitigate shocks to aggregate demand. Their prudent policy should also preserve the fiscal space to address the pressures of higher public investment and the needs created notably by population ageing and the integration of migrants. We welcome the reforms to improve fiscal efficiency. In this regard, we encourage the authorities to reduce the marginal and participation tax rates to support the supply of labor. We also share the staff's call for upgrading the country's infrastructure. We support the review of the budget law with the aim of providing more flexibility when determining the limit on the structural deficit while preserving the medium-term fiscal objectives.

The fixed exchange rate regime continues to serve Denmark well. As highlighted by the authorities and staff, the fixed exchange rate has helped maintain low inflation, and we are encouraged by their determination to preserve their framework through the use of monetary policy and foreign exchange interventions to support the peg should pressures arise from currency markets.

In the financial sector, while we welcome the overall soundness of the banking system, we encourage the authorities to pursue their efforts to tackle remaining vulnerabilities. We appreciate the analysis indicating that the level of profitability, liquidity and solvency of the banking system is adequate. We also commend the authorities for their actions to strengthen the regulatory framework and promote the building of capital buffers. To reduce vulnerabilities, there is a need to closely monitor credit standards for loans to corporations. We call on the authorities to continue to strengthen cross-border AML/CFT supervision as highlighted in the Selected Issues Paper (SIP). The rapid price increases in the housing market and high household debt are also sources of concerns for the stability of the financial sector and are to be addressed through an adequate use of micro and macroprudential tools. Could staff indicate how household debt is divided between high-income and low-income groups and the implications for risks in the financial sector?

Regarding structural reforms, while good progress has been achieved in strengthening the labor market, further efforts are needed to boost potential growth. The important reforms undertaken by the authorities in recent years have resulted in increasing labor force participation rate and reducing unemployment rates. These efforts should be pursued to further increase labor force supply, notably through better integration of immigrants and reduction of gender disparities. We also encourage policies to boost potential growth and increase productivity, including strengthening competition, promoting access of small and medium-sized enterprises (SMEs) to finance, and fostering innovation and R&D.

With these remarks, we wish the Danish authorities success in their future endeavors.

Ms. Pollard and Ms. Svenstrup submitted the following statement:

We thank staff for their very well-written report, including the insightful annexes and timely Selected Issues Paper on AML/CFT work. We also appreciate Mr. Ostros and Mr. Gade's helpful buff Statement.

Thanks to sound policies and strong institutions, Denmark continues to enjoy solid, demand-driven economic growth; a strong labor market; and very high standards of living. buffers are sufficient to absorb potential external shocks from lower-than-expected European growth or Brexit. Against this backdrop, we encourage the authorities to continue to focus their efforts on containing macro-financial risks and boosting potential growth. We broadly

agree with staff's policy recommendations and offer a few comments for emphasis.

Denmark's fiscal position is strong, and fiscal space is substantial. We encourage the new authorities to continue to make prudent decisions on public spending and investment to continue this strong track record. We appreciated staff's discussion of specific fiscally-neutral (or expansionary, if needed) fiscal measures for consideration, including reductions to the marginal tax rate to boost labor supply. Could staff discuss over what period in-work benefits and lower marginal tax rates would be revenue neutral—i.e., is there potential for labor supply to be sticky in the short term given social preferences?

We welcome the decline in Denmark's current account surplus, driven in part by an increase in investment. In addition to boosting growth potential, we agree with staff that initiatives to raise investment would also help to further reduce the surplus. Turning to the report's analysis, we agree with staff's assessment that Denmark's external position is moderately stronger than fundamentals based on the EBA current account model. We note, however, that the REER model shows a different assessment. In cases such as this, we urge staff to be more explicit on why REER models are less relevant and subject to greater uncertainty to help ground the headline conclusions. Staff comments would be appreciated.

While the Danish banking system is well-capitalized and profitable, we agree that additional micro- and macro-prudential tools should be considered to support resilience of the sector if further risks materialize. In light of the Danske Bank case and in the context of a highly integrated Nordic-Baltic financial sector, we strongly urge the authorities to continue their efforts to enhance cross-border AML/CFT supervision in line with FATF recommendations. We welcome the authorities' high-level commitment to addressing gaps and implementing reforms in this area, as noted by Mr. Ostros and Mr. Gade.

We welcome the moderation of housing price growth due to a combination of macroprudential measures, increasing housing supply, and tax reform. At the same time, Denmark's household debt level remains high, although it is matched by high household assets and savings. Yet, given the unique features of the Danish mortgage market, the combination of these factors remains a source of macro-financial vulnerability. We urge the authorities to continue to monitor these risks closely. Further, in this context, tightening of macroprudential measures, along with the broader review of the macroprudential framework, may also be needed.

Finally, we agree that efforts to increase growth potential should be a priority, including by increasing labor supply and productivity. We welcome the authorities' efforts to expand job-oriented education and training programs, including for refugees. Efforts to enhance the business environment and access to finance will help boost productivity and foster private investment, helping to increase Denmark's long-term growth potential.

Mr. Geadah and Ms. Merhi submitted the following statement:

The Danish economy has continued to solidly grow, largely driven by domestic demand. Risks to the outlook are tilted to the downside, stemming from trade tensions and Brexit as well as macro-financial vulnerabilities from highly indebted households. As recommended by staff, it is suggested that economic policies continue to alleviate capacity constraints and lift potential growth while containing risks, and structural reforms focus on addressing labor supply constraints and raising potential growth. We focus our specific comments on a few issues:

The financial sector remains profitable, liquid and solvent. However, there has been some relaxation in credit standards for corporate loans amid a low interest rate environment. We welcome the strengthening of the financial regulatory framework and the building of additional capital buffers. We concur with staff that should risks continue to build-up, it would be recommended to use micro- and macro-prudential tools to address them.

Risks emanating from the housing market continue to warrant vigilance given strong macro-financial linkages. Debt to income ratios are amongst the highest in advanced economies even though households are switching to loans with interest rates fixed for longer periods and higher amortization. We agree with staff that macroprudential tools should be further tuned to diminish the build-up of systemic risks and prevent excessive accumulation of household debt. To that end, we welcome the recent restrictions on lending to highly indebted households with LTV greater than 60 percent. However, it might be worth evaluating stricter loan-to-income limits irrespective of LTV considerations. Moreover, and given that that tax relief offsets part of the debt service burden among high debt households, we see merit in staff's recommendation to make mortgage interest deductibility conditional on amortizing and/or fixed rate mortgages.

We welcome the significant measures taken by the authorities to strengthen the AML/CFT regulation and expand the Danish Financial

Supervisory Authority's (FSA) sanctioning powers, as well as its budgetary resources, as mentioned in the insightful buff of Mr. Ostros and Mr. Gade. However, staff notes that money laundering risks in the Danish financial sector remain significant and are almost certainly evolving. It would be useful to continue strengthening AML/CFT supervision by developing a comprehensive risk assessment model, increasing the depth of in-site inspections and levying fines in order to mitigate the reputational effects of the Danske Bank case, as elaborated in the SIP. It will also be important to strengthen cross border cooperation. Regarding Denmark's participation in the Banking Union, we look forward to the upcoming report which will inform the policy makers' decision.

With these comments, we wish the authorities the best with their economic policies.

Mr. Daïri and Mr. Alavi submitted the following statement:

We thank staff for their quality set of papers and Mr. Ostros and Mr. Gade for their insightful buff statement.

Reflecting strong fundamentals, a robust macro policy framework, and a sound social model, Denmark has recorded remarkable macroeconomic stability and a high level of shared prosperity. The country stands out with a high level of income, low inequality and poverty rate, top quality education, very favorable business environment, and a flexible labor market. The Danish authorities are to be commended for their achievements. In 2018, real GDP growth was above potential, inflation was moderate, the current account remained in surplus, and public debt remained sustainable. While the outlook is for continued robust growth with inflation set to gradually edge up towards the target, and there are large buffers, the economy remains vulnerable to a potential overheating of the housing market and to a weaker external environment, disorderly Brexit, and the escalating global trade tensions. We concur with the thrust of the staff appraisal and offer the following comments.

The authorities' neutral fiscal policy, under a forward-looking medium-term framework, has contributed to macroeconomic stability and steady growth. In 2018, the structural fiscal position was better than the deficit limit under the fiscal framework law, and public debt was sustainable and continued to decline. Nothing that the substantial fiscal space allows for a temporary relaxation of the budgetary stance, we concur with staff that the relaxation should be prudent and consistent with the authorities' medium-term objectives. We commend the authorities for achieving one of the lowest

income inequality levels in the world, and for skillfully striking a balance between equity and efficiency. Nevertheless, like staff, we see some scope for additional tax and benefits reforms to push closer to the equity-efficiency frontier.

The authorities' fixed exchange rate policy has provided a sound anchor for low and stable inflation, and their far-sighted financial sector policies have supported the stability and resilience of a profitable, liquid and solvent banking system. However, despite ample capital buffers and low NPLs, the banking sector is vulnerable to risks from an elevated housing debt amid high house valuations, spillovers from other Nordic countries, and deteriorating corporate loan standards. Against this background, we welcome the authorities' efforts to address vulnerabilities, including their recent strengthening of the financial regulatory and oversight framework. We support the authorities' comprehensive set of initiatives to reinforce the AML/CFT supervisory framework to address risks in this area, and encourage them to consider staff recommendations for full implementation of the risk-based approach and providing the Danish Financial Supervisory Authority with adequate resources and powers.

The authorities' sound structural policies have contributed to a robust labor market, with increased labor force participation and low unemployment. Remaining issues in the labor market, including low work hours, high labor tax rates, inactivity trap, and increasing skill shortages, along with gender gaps, warrant consideration of wide-ranging tax and benefits reforms. These reforms could be backed by policies to promote further digital and technical skills and increase employment in the knowledge-intensive sectors, as well as by better integration of migrants, youth, and women in the labor market. We welcome the efforts to boost productivity, including the initiatives on digitalization and adoption of cutting-edge technologies, cyber security and artificial intelligence, as well as steps to upgrade capital markets and streamline the framework for economic competition.

With this we wish the authorities continued success.

Mr. Trabinski and Mr. Skopiec submitted the following statement:

We thank staff for their informative reports and Mr. Ostros and Mr. Gade for their informative buff statement. We broadly concur with staff's assessment of the economic outlook and the balance of risks, and we would like to offer the following comments.

Denmark's growth prospects remain favourable. Solid growth is expected to continue, with private consumption and investments as main drivers. That said, risks are tilted to the downside, including a disorderly Brexit and a further escalation of trade tensions. At the same time, we concur with the authorities that the Danish economy has considerable buffers to react to external risks, including (i) a favourable composition of exports, (ii) substantial buffers accumulated by the private sector, and (iii) relatively balanced GDP growth over the recent years.

The neutral fiscal stance seems appropriate given that the economy is expected to run close to its potential. We welcome that the planned relaxation of the overall budget balance is consistent with a prudent use of the existing fiscal space. In this context, we also take good note of the effectiveness of the budget law, which sets legally binding limits for expenditures on all government levels. The staff report refers to an ongoing review of the budget law, and we learn from the buff statement that a parliamentary session on this topic will take place after the summer break. Could staff elaborate in more detail on process and the possible direction of this review?

Denmark's banking system remains sound, but some vulnerabilities remain. We take positive note that the Danish banking system is profitable, liquid and solvent. However, rising house prices and high household debt remain key sources of systemic risks for the financial system. Highly leveraged households are vulnerable to house price and interest rate shocks, as well as to a cyclical downturn. In addition, dynamic credit growth and a relaxation of credit standards in the corporate sector present challenges to macroprudential policy. Therefore, enhancing the existing macroprudential toolkit is important. Moreover, against the background of the recent events around Danske Bank, we encourage the authorities to further strengthen the AML/CFT framework.

Further labor market reforms are needed. As skills shortages in the knowledge-intensive sectors are increasing, there is a need to incentivize education that focuses on technical and digital skills. In addition, we agree that reducing the gender gap could help alleviate pressures in the Danish labour market. Finally, we commend the authorities for introducing business-oriented reforms and setting-up the Danish Growth Fund as a one-stop shop for SME financing. In this regard, could staff elaborate on the differences between the Danish Growth Fund and Danish Growth Capital Funds?

Mr. Mahlinza and Ms. Nainda submitted the following statement:

We thank staff for the informative set of papers and Mr. Ostros and Mr. Gade for their helpful buff Statement.

The Danish economy continues to post robust performance with growth currently above potential. Supported by strong institutions and sound economic and social policies, Denmark has maintained high levels of income and social inclusion, high employment growth, and low levels of inequality. Nevertheless, high household indebtedness amid high house valuations, uncertainty around Brexit and a sharper than expected slowdown in the economies of key trading partners, pose risks to the outlook. Against this background, we concur that the authorities should target higher potential growth and enhance macro-financial resilience.

Considering the economy is operating above potential, the neutral fiscal stance remains appropriate. We take note that Denmark has substantial fiscal space and agree with staff that automatic stabilizers should be allowed to operate fully to counter shocks to aggregate demand. This should also support the ongoing reforms in pensions, labor market and tax. With respect to the ongoing review of the budget law, staff seems optimistic that this offers an opportunity to ensure adequate flexibility in setting the structural deficit limit while the authorities do not expect the review to result in major changes. Could staff elaborate?

The financial sector remains sound however, additional policies are warranted to enhance the resilience of the financial system. In light of the survey results, which suggest that some banks are relaxing credit standards for corporate lending, we are concerned about the implication of this trend on bank balance sheets. Could staff explain the drivers of this development and the measures for addressing it? The strong interlinkages across the Nordic financial system is also a major source of vulnerability, which requires close monitoring. In this regard the Systemic Risk Council should stand ready to push ahead with further increases in the Countercyclical Capital buffer (CCyB) as well as deploy other micro-and macroprudential tools. In addition, we urge the authorities to further tighten cross-border AML/CFT supervision. The additional steps taken to empower the Danish Financial Supervisory Authority (DFSA) to revoke licenses in response to gross violation of rules are encouraging.

We take note of the steady progress in stabilizing house price growth; however, household leverage remains a key source of macro-financial

vulnerability. Current measures to strengthen macroprudential policies, including supply increases and the property tax reform assisted in softening house price growth, yet vulnerabilities remain. In this context, we agree with staff on the need to deploy further instruments such as the introduction of income-based measures which are more binding and would reinforce faster amortization. At the same time, we would urge the authorities to closely monitor risks from the high household debt.

Sustained labor market reforms should focus on enhancing incentives to work and addressing labor supply constraints. Raising labor supply and boosting domestic investment are imperative to increase capacity. As a country with one of the lowest average work hours among European peers, staff makes a compelling case in highlighting how Denmark's high taxes disincentivize labor supply and therefore weigh on government's ability to sustain high-levels of spending on social protection (Annex 1). We agree with staff's advice on the potential tradeoff between equity and efficiency that would be derived from a comprehensive tax and benefit reform to produce stronger outcomes in labor supply, productivity and growth. Additionally, better integrating migrants and improving their skills could effectively address labor shortages. Still on structural reforms, we missed a discussion on product market reforms. Could staff provide an update on reforms undertaken including progress on deregulation efforts.

Finally, following the recent general election that took place in Denmark, we wish the new parliamentary majority all the success with the ongoing government formation negotiations, and anticipate that the new government's policy will continue to maintain economic stability.

Mr. Benk and Mr. Reininger submitted the following statement:

We thank staff for their informative reports, and Mr. Ostros and Mr. Gade for their helpful buff statement.

Denmark's economy continues to show an outstanding performance in various dimensions, with relatively strong growth at already high per-capita-income levels, sustained employment growth since 2013, high labor participation rates, solid fiscal positions and an overall well-functioning and stable financial sector. We commend the authorities for their reforms in recent years to ensure sustainability of this success as well as for their quick and resolute response to address weaknesses that emerged in AML-related supervision and enforcement. In view of domestic risks resulting from high household debt, we encourage the authorities to continue taking risk-reducing

measures. More generally, the authorities would be well advised to maintain a proactive policy approach with respect to longer-term challenges, addressing labor supply and investment. We associate ourselves with the statement by Mr. Fanizza and would like to provide the following comments for emphasis.

Economic growth has been above two percent on average in the last four years, with domestic demand components as important pillars. Despite the strong domestic drivers, Denmark remains a highly open economy with significant reliance on exports, which also contributed substantially to growth in recent years. External risks stemming from trade tensions or disorderly Brexit are obviously even more serious and the authorities should stand ready to act if downside risks materialize.

We share the view that fiscal policy's neutral stance is fully appropriate under the baseline forecast. Automatic stabilizers should serve as a first line of defense in case of weakening of growth while temporary loosening may be warranted in case of severe downturns. We take positive note of the transitional fiscal arrangement with respect to the property tax and of the central government's more active role in the financing of social housing and consider the related fiscal risks as manageable. Moreover, we encourage the authorities to use the fiscal space for increasing public investment to upgrade infrastructure and for implementing tax changes related to financial sector and structural policy.

Concerning financial market policies, we commend the authorities for their measures to increase risk absorption capacity and to reduce the further build-up of risks by some tax changes and active macroprudential policy. While we wonder why the countercyclical capital buffer (CCyB) and not the systemic risk buffer (SRB) was activated, it is also not clear to us whether the CCyB will apply to mortgage credit institutions (MCIs) as well. Staff comments are welcome. We see merit in further reducing or eliminating mortgage interest deductibility but concede that targeted exemptions would have to be introduced as safeguards for already indebted low-income households. We support also staff's proposal of shifting the focus of mortgage lending-related macroprudential instruments from loan-to-value measures to debt-to-income measures. We highly welcome the set of measures adopted by the authorities to reinforce the AML/CFT-related supervision and enforcement, particularly also the underpinning by allotting additional budgetary resources for this purpose, and we look forward to the continued implementation of these measures. We thank staff for their helpful contribution in the form of a Selected Issues Paper and encourage the authorities to follow the priority next steps outlined in the staff report. In this

context, we would like to raise the question whether a dialogue with all relevant major central banks, including the Central Bank of Russia, is envisaged on the issue of illicit cross-border flows under the umbrella of stronger regional and institutional cooperation?

As for structural policy, we support the staff proposals for fostering labor supply. We place high premium on measures intended to increase work incentives, akin to earned-income-tax-credit (EITC) measures. In this vein, we encourage the authorities to consider raising benefits for low-income workers, comprising both those coming out of inactivity and those pertaining to the working-poor segment. Concerning the proposal to reduce marginal tax rates, the question arises whether first and foremost the lowest taxation threshold could be lifted and the tax rate in the lowest income bracket should be reduced. Staff comments are welcome. Concerning structural reforms to foster investment, we see merit in relaxing the cap on the use of carry-forward losses for startups, and we encourage the authorities to conduct a feasibility study on the introduction of an incremental allowance for corporate equity (ACE).

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their insightful set of documents and Mr. Ostros and Mr. Gade for their informative buff statement. We associate ourselves with Mr. Fanizza' s statement and we wish to make some additional comments for emphasis.

Outlook

We commend the strong performances of the Danish economy and the set of sound economic policies in place since the great financial crisis. Denmark has been enjoying since then a stable and solid growth fueled by buoyant domestic demand, low unemployment and wage growth in line with productivity growth. The introduction in February 2018 of a targeted earned income tax credit to low-income households has also supported private consumption. As underscored in the report, generous transfers to these households and extensive active labor market policies have also translated into low levels of income inequality and the lowest poverty rate among all OECD countries. The decrease in savings has contributed to the decline in the current account surplus since 2017 while remaining large and stronger than implied by medium-term fundamentals according to staff's assessment.

Fiscal policy

The current fiscal stance is adequate. While Denmark posts a fiscal surplus, the structural balance is bound to remain well above the medium-term objective and public debt is set to continue to fall reflecting stable growth, low interest rates and positive primary balance. Drawing on the existing substantial fiscal space to continue supporting growth-enhancing reforms seems consistent. We agree that improving the efficiency of both revenues and expenditures including the reform of taxation in startups and high-technology firms (introduction of an incremental allowance for corporate equity), the reduction of the Mortgage Interest Deductibility (MID) or the increase in public investment to boost investment and productivity. Long term risks linked to ageing population and the related costs should also be contemplated through structural policies rather than only referring to fiscal prudence. Finally, we concur with staff that additional temporary fiscal stimulus should be considered in case of severe downturn.

Financial sector and macro-financial policies

As underscored in the report, Denmark's high household leverage and macro-financial linkages related to the housing market and the financial system are one of the country's main risks to financial stability. While the housing sector has been benefiting from high house prices, a favorable tax treatment and easy access to low-cost borrowing, the build-up of large households' liabilities has been counterbalanced by significant assets. The tight macro-financial linkages between the household sector and non-banking financial entities such as insurance companies, pension funds and foreign investors who are the largest holders of covered bonds issued by Mortgage Credit Institutions to fund household mortgages could prove to be highly detrimental to the household's financial and non-financial assets and wealth in case of reversal in the real estate sector. Consequently, we strongly encourage the supervisory authorities to closely keep monitoring the sector and to stand ready to use micro and macroprudential tools along with additional measures to review tax-related policies (on owner-occupied housing, MID), stimulate housing supply and improve demand-supply mismatches, in particular in urban areas. In this respect, we salute the activation of the Counter Cyclical Capital buffer and its implementation at end-September 2019 to 1 percent.

Cross-border AML/CFT supervision should be strengthened. We appreciate Mr. Ostros and Mr. Gade's complementary and useful information in this respect and commend the authorities for having agreed in March 2019 on new set of initiatives, including additional tools for control, intervention

and sanction to the Financial Supervisory Authority (FSA) that seems encouraging.

Structural reforms

As mentioned earlier, structural reforms are key to enhance Denmark's potential growth and productivity. Increasing the older workers' employment rate, improving migrant integration and upgrade skills have been significant steps in the right direction. Still, we believe that labor participation of some population groups such as refugees, young and unskilled workers, or disabled persons should be also incentivized. Steps taken to increase productivity growth and foster investment have been welcomed and we encourage the authorities to continue to increase access to finance entrepreneurs, innovation and R&D, in particular to SMEs. Lastly, we would appreciate that risks related to climate change be covered in the following Article IV consultations.

Mr. Palei and Mr. Snisorenko submitted the following statement:

We thank staff for the comprehensive report and Mr. Ostros and Mr. Gade for their informative buff statement. The Danish economy continues to show solid growth performance with low inflation, while income inequality is low. At the same time, with the economy operating above potential, pressures in the labor market are gradually building up. Elevated household debt together with the risk of an overheated housing market pose a threat to macroeconomic stability. We encourage the authorities to build on their strong track record of sound policies and reforms to further enhance macro-financial resilience and boost potential growth. We agree with the thrust of the staff appraisal and would like to offer the following points for emphasis.

Despite the decrease from 8 percent of GDP in 2017 to 5.8 percent of GDP in 2018 Denmark's current account surplus remains high. Subdued investment seems to be the main contributor to persistent surplus. "Merchanting" trade also comprises a large share of the current account surplus in Denmark. The earnings of merchanting firms are usually reinvested abroad at the expense of the domestic investment¹. Does this effect feature in the calculation of the current account norm by staff and what would be the policy advice for promoting investment under these circumstances?

¹ Merchanting and Current Account Balances. Beusch and others. Working Paper No. 140. Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, 2013.

With the economy operating above potential, the fiscal stance should remain neutral. While fiscal space could be used to support growth-enhancing reforms, cyclical position of the economy calls for caution in this area. Monetary policy seems to be successful and credible in maintaining the peg to the euro.

While the financial sector is healthy, we share the staff's concerns regarding the risks stemming from the housing market and high household leverage. Despite recent softening in housing prices and a shift towards fixed rate mortgages, further measures to address remaining vulnerabilities may be warranted.

We welcome the Danish authorities' recent efforts to strengthen AML/CFT supervision and enforcement. High risks emanating from the weaknesses in the implementation of the AML/CFT rules call for strengthening governance frameworks and widening regional cooperation. In this regard, we welcome the recommendations in the Selected Issues paper on reinforcing Denmark's cross-border AML/CFT banking supervision. Could staff elaborate on the consistency of these recommendations and the political agreement mentioned by Mr. Ostros and Mr. Gade in their buff statement?

The Danish social welfare model successfully combines high income and low inequality levels. At the same time, we noted from the insightful Annex I that some deficiencies exist. For example, a lack of in-work benefits in Denmark leads to a situation when disposable income levels in and out of work are virtually identical, particularly at the low-end of the distribution. These shortcomings negatively affect the incentives to work. We agree with staff that the equity-efficiency tradeoff could be further improved leading to an increase in labor supply.

Mr. Mouminah, Mr. Alkhareif and Mr. AlHafedh submitted the following statement:

We thank staff for the well-written reports and Mr. Ostros and Mr. Gade for their informative buff statement. We broadly share staff's conclusions and policy recommendations and would limit our remarks to a few issues.

We agree that policies should aim at higher potential growth and enhance macro-financial resilience to reinforce the current solid economic performance. In particular, policy actions are required to address vulnerabilities due to high household debt, including by enhancing the macroprudential toolbox. At the same time, supportive capacity-enhancing

policies tailored to boost labor supply, productivity and investment will be helpful in putting the growth on a more sustainable path.

With the economy operating above potential, a neutral fiscal stance would facilitate the ongoing reforms. In this context, we agree with staff that automatic stabilizers should operate fully in case of shocks to aggregate demand. Furthermore, we share staff's recommendation to reduce participation tax rates and to increase spending to upgrade the infrastructure and R&D. Here, we welcome the ongoing review of the budget law, which offers an opportunity to ensure adequate flexibility in setting the structural deficit limit, while maintaining the medium-term objective of budget balance.

The fixed exchange rate policy has served Denmark well, as it provides a framework for low and stable inflation. We also take positive note that banking system remains profitable, liquid and solvent. At the same time, we encourage the authorities to continue their efforts to strengthen financial resilience and AML/CFT supervision.

Finally, boosting productivity, addressing the debt bias and improving access to equity finance for SMEs are some of the priorities to promote investment. In this context, we take positive note of the authorities' efforts to improve employment in knowledge-intensive services sector, better integrate migrants, and attract skilled foreign labor.

With these remarks, we wish the authorities further success.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for the well-written reports and Mr. Ostros and Mr. Gade for their informative buff statement.

The solid performance of the Denmark's economy continues. Growth remains above potential, driven by domestic demand. Inflation remains moderate and fiscal position is balanced. The surplus in the current account has declined, mainly reflecting higher investment. The financial system remains sound and resilient, despite the low interest rates environment. With high employment rates, Denmark continues to experience low levels of income inequality. Moving forward, the outlook is positive but with downside risks. The country faces several challenges, including the housing market vulnerability, growing labor shortages and capacity pressures, and heightened external risks. We broadly concur with the thrust of the staff report and wish to make following remarks for emphasis.

Staff assesses that Denmark has a significant fiscal space in the medium-term. We concur with staff on the need for continuing the neutral fiscal stance and let the automatic stabilizers to operate in case of shocks to aggregate demand. A fiscally neutral changes, especially in favor of productive investments, will serve to enhance growth potential. In order to ensure long-run sustainability, continued efficiency-improving reforms are important in revenues and expenditures, while giving specific attention to pension reforms and healthcare expenditures, which are expected to increase by around 10 percent of GDP in the long run (footnote 9), given the ageing population.

The fixed exchange rate policy has served Denmark well. We align ourselves with staff's recommendation that Danmarks Nationalbank (DN) should remain ready to defend the peg. In this regard, we are reassured by the authorities' indication in the buff statement that monetary policy rates are adjusted to keep the krone stable against the euro.

The Danish banking system remains profitable, liquid, and solvent, but pockets of vulnerability remain. Staff assesses that the ongoing money laundering case involving Denmark's largest bank could further impact confidence in the financial sector and undermine financial stability. We also note that the higher expenditures for AML controls and augmented cost of funding due to increased risk perception have already impacted Danske bank's profitability. Could staff comment on these developments in the context of ongoing case? We also encourage the authorities to implement priority next steps highlighted by staff to strengthen cross-border AML/CFT supervision.

High household leverage amid high house valuations remains as a key source of macro-financial vulnerability. The high indebtedness, particularly in urban areas, is a major concern. While commending the authorities for the recently implemented macroprudential policies in this regard, we stress the need for continued measures to reduce further build-up of housing debt and safeguard the macro-financial stability. Continued vigilance on the housing sector and addressing supply-side of the housing market are also important in this context. We support the staff's call for coordinated policies to address remaining vulnerabilities given the importance of this issue.

Increasing labor supply and improving productivity are vital in sustaining long-term growth. The significant measures taken to integrate migrants into the labor force are commendable. We noted that there is scope to increase employment in knowledge-intensive sectors (KIS) and labor

market institutions should adapt to cope with transformation towards this direction. The encouragement of investment in knowledge-based fields will help meet future labor demands and facilitate youth employment. Could staff elaborate more on the targeted in-work benefits to low income workers in alleviating inactivity traps? The recent measures towards digitalization and incentives in adopting new technologies will help further improve productivity, which should provide with increased support to broad-based innovation and improving institutional framework to competition. Meanwhile, upgrading capital markets is also important to improve access to equity finance for SMEs.

With these remarks, we wish the Danish authorities all success in their future endeavors.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their report and Mr. Ostros and Mr. Gade for their buff statement. We associate ourselves with the statement by Mr. Fanizza.

Underpinned by sound macroeconomic policies and a favorable business climate, Denmark's strong economic performance is expected to continue over the forecast horizon. Private consumption and business investment are the main elements behind the expected regaining of momentum during 2019 after a soft Q1 2019 outturn. A healthy labor market and wage gains should keep consumer spending strong, while exports are expected to strengthen compared to the performance in 2018. Overall, HICP inflation is set to remain modest, only slightly increasing over the forecast horizon mainly supported by rising wages and dynamic growth.

However, risks remain skewed to the downside mainly driven by external uncertainties (e.g. Brexit and trade tensions). A marked slowdown in global economic activity would weigh on external demand and dampen business confidence, which would hurt growth in the export-oriented sectors as well as investment prospects more generally. High household indebtedness could also weight on economic activity in particular if the risks related to external uncertainties materialize.

Denmark has maintained sound fiscal positions and is expected to remain in compliance with the rules of the Stability and Growth Pact (SGP). In view of the strong growth performance of the economy, we share Staff's

view that fiscal policy should not stimulate aggregate demand further. In fact, more counter-cyclical fiscal policies may have the benefit of reducing risks of overheating. Furthermore, while we agree with Staff that reforms covering the revenue and expenditure side of the budget could improve efficiency, we consider they should be implemented in a fiscally neutral way given the state of the business cycle. A reduction of the mortgage interest deduction in personal income tax could also be considered, as such tax expenditures might set wrong incentives and could lead to higher risks related to household indebtedness. We also agree with Staff's recommendation to reduce the labor tax wedge, as high tax burdens on low income earners can be particularly harmful for long-term growth. We note Staff's view that an incremental Allowance for Corporate Equity (ACE) can be an effective instrument to address the corporate debt bias but would caution that assessing the revenue costs of such reforms over time is challenging.

Given that productivity growth in Denmark has been weak for some time, particularly after the Great Recession, we share Staff's view on the need to boost productivity to enhance potential output. Although weak productivity growth is a feature shared with other advanced economies, in Denmark further deregulation of retail, the taxi and utility sectors could boost competition and encourage productivity-enhancing investment. We also agree that there is a need to support broad-based innovation, enhance the institutional framework for competition and improve the capital market to facilitate access to equity finance for SMEs. In addition, and as mentioned by Staff in Annex IV, this could also contribute to reduce the large Danish current account surplus.

We agree with Staff that high household indebtedness amid elevated house valuations is a key source of concern and macro-financial vulnerability. Against this background, we concur with Staff's policy recommendations on the need of coordinated policy action including enhancing the macroprudential toolbox, reducing overly favorable tax incentives and improving housing supply.

We note Staff's assessment that the banking system remains profitable, liquid, and solvent. Staff consider that, while profitability has decreased, it remains solid despite slow credit growth, low interest margins, and the introduction of IFRS 9. Staff observe that this is due to a rise in net fee income and income from administration margins. However, as Staff note, pockets of vulnerabilities remain, including some signs of a relaxation in credit standards for corporate loans, ongoing money laundering issues and interconnections with the wider-Nordic financial system. We welcome the

efforts of the national authorities to strengthen anti-money laundering supervision and enforcement as a top priority.

We take note of staff's analysis of Denmark's Banking Union opt-in decision. It provides a useful backdrop to the ongoing work of the designated government committee which was established in July 2017 and which is expected to conclude its work with a final report in fall 2019.

Mr. Fanizza made the following statement:

Denmark can boast a great business climate, low income inequality, a solid labor market, and a strong fiscal position. It all sums up to an impressive economic performance. However, risks have tilted to the downside. High household debt, combined with a moderately stronger-than-warranted external position, points to the need for policies to mitigate saving imbalances and increase domestic productive investment. High housing prices and household debt in urban areas call for efforts to strengthen resilience and reduce bias in federal mortgage debt, although we believe the increasing use of fixed rates and longer length mortgages constitutes favorable developments. We welcome both the reform of property taxation and the recent macroprudential policies targeting households and financial intermediaries. Because deleveraging households will take time, the authorities should broaden their macroprudential toolkit to include the additional borrower-based measures. The authorities should also consider using macroprudential stress tests to assess vulnerability from the interconnections among mortgage credit institutions, pension funds, and the household sector.

On the fiscal side, a broadly neutral stance remains appropriate. We agree with the staff and the authorities that in case of a slowdown in aggregate demand, automatic stabilizers should be left free to operate. But in the event of a severe downturn, the authorities should consider a temporary loosening. Furthermore, we share recommendations on lowering the participation tax rate for low-income earners and lifting spending to upgrade infrastructure. We welcome the authorities' efforts to strengthen anti-money laundering (AML) supervision and enforcement. We encourage the authorities to press ahead with adopting and enforcing the agreed changes to the AML law in the financial sector authority that are still pending.

We take favorable note of the crisis management simulation exercise for the Nordic-Baltic region and of the recommendation of the Systemic Risk Board to gradually raise the countercyclical capital buffer to 1.5 percent by June 2020. Boosting potential growth and increasing productivity is needed to

sustain the so far favorable economic performance. We commend the authorities for introducing pro-business policies, in particular those to digitalize small- and medium-sized enterprises (SMEs). Nevertheless, we see a need to broaden the innovation base to include more companies. With these remarks, we would like to wish the Danish authorities all success in their endeavors.

Ms. Mahasandana made the following statement:

Denmark's solid growth performance is a testament to the country's strong macroeconomic fundamentals and sound macro policy management, and we are pleased to see this reflected among the people. As the staff mentioned in the report, that the Danish are among the happiest people in the world.

First, addressing the risks related to the housing market and high household debt is a key priority. This is especially the case given the close interlinkage in Denmark's context, which presents an important source of macro and financial vulnerabilities. Like other Directors, we agree that the coordinated approach utilizing a combination of tools to address imbalances in real estate and household debt would be appropriate. We also note that the authorities have agreed that additional measures would require careful assessment. If staff could shed some light on the authorities' view on this, it would be helpful.

My second point is on the external balance assessment (EBA). We thought staff did a very good job in acknowledging the uncertainty of this assessment and explaining Denmark-specific factor not captured in the model. As pointed out in a few other gray statements, we also believe the staff could be more explicit in explaining the discrepancy in the current account and real effective exchange rate (REER) gap result and residuals and how country-specific factors such as data limitation issues would affect the gap assessment.

We believe that Denmark's case was a good example of exercising judgment in accounting for country-specific factors when interpreting model results, and also reflects the broader need to further refine this analytical tool going forward.

Mr. Trabinski made the following statement:

We thank the staff for their informative reports and Mr. Ostros and Mr. Gade for their informative buff statement. The Danish economy is performing well, being supported by strong domestic demand, moderate inflation, and balanced fiscal position. The financial sector is resilient and the employment rate high. What remains a challenge for the medium term is growing labor shortage and housing market vulnerabilities amid increased external risks. We issued a gray statement where we emphasized the most important points, so let me focus on the three additional issues.

First, we note that in the staff's view, the high household debt is counterbalanced by large household assets. Are the household's assets accumulated broadly by the same households which are heavily indebted, or is it otherwise?

Second, it seems that lack of standby access to a liquidity facility in euros from the European Central Bank (ECB) could be perceived as one of the deficiencies of the banking union. How does this argument factor in the discussion on pros and cons of Denmark's participation in the banking union?

Finally, we take positive note of the authorities' program aimed at integrating refugees into the labor market, including basic integration education program. However, we are wondering to what extent refugees are helpful in addressing skill shortages. Also, we would appreciate some more information on the sectors that are now in highest labor demand.

With this, let me wish the Danish authorities all the best and success in their future endeavors.

Mr. Meyer made the following statement:

We mostly share the staff's analysis and policy recommendations, and we associate ourselves with Mr. Fanizza's gray statement, and I thank him for the precise reading of his oral remarks, which he did also on behalf of European colleagues.

First, I commend the Danish authorities for the strong performance of their economy with low levels of unemployment, income equality being at a very low level, and a broadly balanced fiscal space. However, as always, policy challenges remain, and we mentioned two. First, as regards the housing market, high private household leverage in combination with elevated house

valuations constitute an important source of macrofinancial vulnerability. We therefore encourage the Danish authorities to step up their efforts to address these vulnerabilities along the lines of current and past Fund policy recommendations.

Second, with regard to the financial sector more generally, pockets of vulnerabilities remain, including signs of relaxation of credit standards for corporate loans and ongoing money-laundering issues. This calls for micro and macroprudential measures to increase buffers and the further strengthening of cross-border Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) supervision, including the implementation and enforcement of the many already agreed enhancements.

On fiscal policy, we commend the Danish authorities for their sound public finances. Factors like aging population call for continued fiscal prudence. However, we fully agree that fiscal space is there and should be used to upgrade infrastructure, as indicated by the staff.

In this context, like the staff and the Danish authorities, we would like to highlight the importance of Denmark's strong automatic stabilizers, which should constitute the first line of defense in case of shocks to aggregate demand. I would like to make a general comment in this regard. I observed that staff reports are more often looking explicitly at automatic stabilizers, and I just want to highlight that this chair appreciates that fact.

Finally, let me finish with a comment on Denmark's external position, which the staff assesses as moderately stronger than levels consistent with medium-term fundamentals. We would like to point out that the staff itself acknowledges that this assessment "remains subject to important uncertainties as it does not account for Denmark-specific factors."

As Mr. Ostros and Mr. Gade have highlighted in their gray statement, the current account surplus is the result of individual decisions by households and corporations and partially reflects pension-related private sector savings and deleveraging of highly indebted households, which are desirable per se. Here we agree with Mr. Doornbosch and Mr. Manchev that a deeper analysis of these important country-specific factors would be desirable going forward. With this, I wish all the best to the authorities.

Mr. Montero made the following statement:

I associate myself with Mr. Fanizza's statement. We have issued a gray statement, so let me focus on a specific issue that we raised in the gray statement and on which we got a very good response from the staff.

We believe that this is a general issue that deserves more attention. I am referring to this concept of a high-pressure economy. We believe that it is a good time to consider the possibility of hysteresis seriously in view of the problems that we have been having pointing to—a slack in the economy and the frequent downward revisions to GDP and potential growth since the global financial crisis.

Moreover, there is increasing empirical evidence that cyclical events have permanent effects on GDP, and these results are natural in many models of endogenous growth in which driving forces are affected by cyclical shocks. Incorporating this possibility of hysteresis into policymaking can change how we think about the role of monetary and fiscal policy in important ways, and the implications go beyond the potential damage that can be caused by misguided policies during large crisis, and the typical example that comes to mind was this idea of tightening in fiscal policy after the global financial crisis. Marginally, we have to consider the possibility that at times cyclical fluctuations can have much larger benefits than previously thought because of their effects on long-term outcomes, and this morning we have a partial discussion on this.

The benefits and costs of expansionary policy, faster recoveries, and longer-lasting economic booms on GDP might have to be factored in when designing optimal stabilization policies. We call on the staff to think about this topic going forward.

Mr. Palei made the following statement:

Recently we discussed the reasons for the imposition of the floor on education spending, and then after the Board meeting, I went to the databases and found out that Denmark is one out of only three countries in the OECD database that have a ceiling above 6 percent. But some of the neighboring countries like Finland and Iceland also have very high educational spending. As I understand it, the economy is functioning at potential, and the staff are reluctant to advise on additional fiscal easing, but we also note that the authorities plan to increase public investment. Usually when we discuss public investment at the height of the business cycle, it is considered that it may

crowd out the private sector investment, and in this case, we do not see that the staff are concerned about it. Maybe the staff could say a few words about the possibility of crowding out or crowding in of private sector investment.

One more issue I have to react to is the question asked by Mr. Benk and Mr. Reininger about the AML/CFT issues. Somehow they singled out the Central Bank of Russia and asked about cooperation in this area with Russia. I have to say that the Central Bank of Russia was very attentive to these issues about 15 years ago, and there were formal decisions, and the bank was outspoken about these issues. It actually called on the Fund to pay more attention to these issues in the region represented by Mr. Ostros. My authorities would be very willing to cooperate with anybody who is interested in dealing with illicit financial flows, and I note that the Danish authorities and other authorities in the region are now showing major efforts in this area, and I hope that they will be very successful.

The representative from the European Department (Mr. Segoviano), in response to questions and comments from Executive Directors, made the following statement:²

I thank Directors for their insightful comments. I will start by addressing the questions related to macrofinancial vulnerabilities. The key macrofinancial vulnerability is the high level of indebtedness amid high house prices. The authorities are watching this. They are looking at developments in the housing sector. House prices are softening. At the same time, the quantity of risky loans, meaning low amortized loans and variable rate loans, are decreasing. We have emphasized the need to keep watching this, and as it was pointed out, we made specific recommendations of additional tools that they could prepare to deploy. However, for the time being, given that house prices have started softening, and they see this positive development in the proportion of risky loans, they are watching.

Regarding the EBA discrepancy, yes, we always take a holistic approach to try to make the assessment. We do not rely on one single model, and it is clear that no single model appropriately describes all of the features of a country. In this case, we have pointed out that there seem to be two factors that might not be captured adequately, which are related to savings and mainly to a transition to a fully funded system and to investment, especially because of the large proportion of merchanting trading in Denmark. We keep working with our colleagues from the Research Department (RES) to improve

² Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

the model. Therefore, we also looked at the additional models, and we were clear about the uncertainties that we have in this regard.

There was a question related to whether these uncertainties would change our policy advice. We would not change our policy advice because we consider it very important for Denmark to keep on increasing investment given the impact on potential output. Irrespective of this, the policy advice would remain similar.

There were other questions related to who has debt in terms of the households. We look at the distribution of net debt among households. We see that the most indebted households are the wealthier households. However, within the low-income households, there are groups that are highly indebted. For low-income households, the median net debt would be around zero. But there is a distribution that would indicate that some of them would have very high level of indebtedness. We referred to this in the report as the potential vulnerable households. Our view is that while net assets keep being positive in Denmark when we look at assets and liabilities, some specific groups might be affected significantly in the event of a shock that would affect the assets and liabilities asymmetrically.

There was another question related to the intervention programs and whether they would help alleviate the skills shortage. Denmark has different programs. Some of them are targeted to highly skilled foreigners, and these seem to be working well. They also have the basic integration education (IGU) program for low skilled migrants, and we were pleased to see that this program has been quite successful in terms of integrating especially male migrants. However, there is a gap with females, and this is an area where more needs to be done in order to close the gender gap, especially in this area.

Regarding the spending and public investment, we did answer that question; and we looked at the numbers, and the increase in public investment that is perceived to be in the baseline will be focused mainly on green energy resources, new transport infrastructure, health care, and defense. Therefore, we see that this could have a positive impact on aggregate supply.

Mr. Castets made the following statement:

I wanted to listen to the staff's answer on the external sector balance before reacting to what was written in the report, and we reacted to that in our gray statement. On the question of the impact of the pension system, when we look in detail at the breakdown of what explains the increase of the current

account surplus in Denmark, it seems that the bulk of the increase is due to the behavior of non-financial firms, rather than from households. I ask the staff to comment on that. In our current model, we already have two factors to take into consideration, demographic shift or demographic changes, so I guess the aim when we modified those factors at the previous discussion on the EBA model, was to try to better capture the possible impact of aging population. Then we will have to have a gradual approach to take into consideration each feature of the pension system of each country, which probably would be technically demanding.

The representative from the European Department (Mr. Segoviano), in response to further questions and comments from Executive Directors, made the following additional statement:

Yes, we tried to look at this. There are different factors that might be playing, but this is a complex issue. There might be some measurement errors related to the fact that some individuals that are professionals could register themselves as corporates. That is something that can happen in Denmark and in many other countries. The other possibility is related to the fact that this could also be due to deleveraging after the crisis. We saw that savings in non-financial corporates remained high, possibly due to a fact of deleveraging. However, as we pointed out, investment has increased substantially in the last year, and we forecast it to increase more in the near future as domestic demand would be aggregate-driven demand.

Mr. Ostros made the following concluding statement:

On behalf of the Danish authorities, I thank Directors for their statements and their constructive input and concerns, which I will convey to the authorities. General elections took place in Denmark on June 5. The outcome was a change in the parliamentary majority, and government formation negotiations are currently ongoing. Let me respond to some of the issues that were raised in gray statements and today. My comments revolve mainly around fiscal policy, household indebtedness, and AML/CFT. I will also say something about the EBA.

First, on fiscal policy, I took note that many statements saw the neutral fiscal stance as appropriate. It is important to remember that there are large automatic stabilizers in the Danish economy due to a high degree of public redistribution. Hence, while the fiscal framework ensures a prudent fiscal policy and is designed to be sustainable in the long run, public finances themselves play a natural countercyclical role via the automatic stabilizers.

Given the overall economic policy setup in Denmark, it is important that the functioning of public finances is geared toward supporting economic stability.

Second, a concern among Directors is the level of household debt, and I will convey that to the authorities along with the constructive reference to the Korean macroprudential measures by Mr. Heo and Mr. Shin. It is important to note that while the level of debt among households remains high, households have been consolidating over the last decade, and they have substantial net wealth. The authorities have been vigilant in terms of guidance to the financial sector, macroprudential measures, including income-based measures, and appropriate tax reform. The financial sector is also taking its own initiatives to strengthen households' incentives to move into longer-dated and fixed-rate mortgages, and the system today is much better capitalized. All these measures are having the intended effect. However, pockets of vulnerabilities remain, as also outlined in the staff report, and the authorities continue to monitor these developments and will take additional measures if needed, taking into consideration the constructive Fund analysis and advice.

The authorities agree that the current account surplus is high. However, looking at the cyclical developments, the net surplus declined notably in 2018 due to higher investments. Looking at the surplus more structurally, the surplus partially reflects a higher private sector saving surplus in Denmark through the buildup of labor market pensions. For many years, Denmark has had a focus on preparing for future demographic changes due to an aging population, and public finances are designed to be sustainable in the long run. To some extent, the surplus may also reflect deleveraging among households with high levels of debt.

Finally, merchanting and processing activity abroad by Danish companies make the current account more difficult to interpret.

On AML/CFT, I would like to reassure Directors that the Danish authorities are strongly committed to strengthen the fight against money-laundering and terror financing. This has so far resulted in several political agreements with broad-based support in parliament, increasing the resources, and strengthening the means of surveillance and enforcement powers of the Financial Supervisory Authority and the police. The staff approached the issue in a constructive and diligent way. The selected issues paper provided many operational recommendations, most of which are in the process of being either adopted, developed, or implemented. It is a top priority.

Finally, let me conclude by sincerely thanking Mr. Segoviano and the team for their work on Denmark. The team has produced a very rich report in a cross-departmental effort. Fund analysis and inputs are greatly appreciated by the authorities, and they look forward to continued engagement with Fund staff in the upcoming Financial Sector Assessment Program later this year.

The Acting Chair (Mr. Lipton) noted that Denmark is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for sound economic and social policies that have delivered robust economic performance and high levels of social inclusion. They note that while the outlook is for continued growth, risks are tilted to the downside. In this context, they stressed the importance of policies to raise potential growth and enhance macro-financial resilience.

Given the substantial fiscal space in the medium term, Directors agreed that the fiscal stance should remain neutral, while letting automatic stabilizers operate fully in case of shocks to aggregate demand. Additional temporary loosening could also be considered in the event of a severe downturn, while remaining anchored to the medium-term objective. Directors encouraged the authorities to pursue further efficiency-improving reforms covering both revenues and expenditures, noting this could be implemented in a fiscally-neutral way or designed to provide stimulus if loosening is warranted.

Directors agreed that the fixed exchange rate policy has served Denmark well. They stressed that monetary policy should remain focused on maintaining the exchange rate peg.

Directors welcomed the overall soundness of the banking sector but noted that there are pockets of vulnerabilities. To strengthen financial resilience, Directors recommended a combination of micro- and macroprudential tools to increase buffers, in addition to the counter cyclical capital buffer, if risks continue to build up.

Directors commended the authorities for their recent efforts to strengthen cross-border AML/CFT supervision. They encouraged the authorities to continue to build on these efforts by adopting a comprehensive institutional risk assessment model, increasing the depth of AML/CFT

inspections, and further expanding supervisors' sanctioning powers. They also saw scope to strengthen regional and international cooperation.

Directors considered that high household leverage amid elevated house valuations requires coordinated policy action. To reduce vulnerabilities, they suggested enhancing the macroprudential toolbox, including by increasing focus on income-based macroprudential instruments. They encouraged the authorities to further reduce mortgage interest deductibility and consider new policies to promote housing supply.

Directors commended the strong labor market. They noted that increasing benefits to low-income workers would help alleviate inactivity traps, while reducing marginal tax rates for average income earners could increase hours worked. Directors also saw merit in further measures to incentivize the upgrading of technical and digital skills, close gender gaps, integrate migrants, and attract skilled foreign labor.

Directors noted that productivity growth remains weak. They encouraged the authorities to support broad-based innovation, improve the institutional framework for competition, and foster the environment for high-productivity sectors to expand. They also noted that addressing the debt bias and improving access to equity finance for SMEs would promote investment and help reduce the current account surplus.

It is expected that the next Article IV consultation with Denmark will be held on the standard 12-month cycle.

APPROVAL: April 9, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and risks

1. *We note that staff projects a boost of 0.4 pp to potential output growth, up to 1.8 percent because of recent structural reforms. However, projected real GDP growth will be below potential and converge towards 1.5 percent over the medium term (by 2023/2024), which implies a very gradual closing of the output gap. Could staff comment whether this path is consistent with previous cycles?*
- Gradual real GDP growth is anticipated due to subdued inflation forecast in the Euro area, which is expected to keep monetary and financial conditions accommodative in Denmark over the medium term. This will support robust private consumption and investment growth. In addition, the overall government balance will also decline marginally, which will also support domestic demand over the period. Regarding potential output, the ongoing reforms will help potential growth reach its long run average by 2024. Therefore, the combination of the projected real and potential GDP growth paths will result in a very gradual closing of the output gap. The current economic expansion is projected to last at least 9 years (started in 2015), which is not atypical for Denmark. The economy experienced a similarly long boom from broadly 1995 to 2003. In addition, the recovery from the GFC was particularly slow, with a negative output gap that lasted from 2009 to 2015. This prolonged period of slack therefore leaves plenty of room for investment to continue.

Fiscal policy

2. *Absent monetary policy as a stabilization tool, we wonder whether this reasoning could justify a more expansionary fiscal stance in Denmark's case. Staff's comments are welcome.*
- Our recommendation regarding fiscal policy rests on several considerations:
 - A neutral fiscal stance would support the authorities' ongoing structural reforms.
 - It would help protect buffers in the short term in case adverse shocks were to materialize. This is especially relevant for Denmark as a small open economy.
 - The ageing population is projected to increase healthcare costs quite substantially also calling for fiscal prudence.
 - The significant decline in the current account surplus and projected increases in investment and consumption undermine the case for fiscal loosening based on external balance considerations.

- In addition, the output gap has been positive for 3 years in a row and continues to grow, while unemployment has dropped below the structural rate and household leverage remains at very high levels. There is therefore a risk that further fiscal stimulus could lead to overheating of the economy, with adverse consequences for Denmark's financial stability and competitiveness. This was the case in the period preceding the GFC, when capacity constraints suddenly increased and a housing bubble burst at the tail end of the boom.
 - For a small open economy like Denmark with increasing capacity constraints, potential supply-side effects from continued policy accommodation seem uncertain and hard to measure.
 - Instead, we would like to point out that the baseline projection incorporates an increase in public investment, which should have beneficial supply-side effects. Moreover, the pension and labor market reforms already underway and staff recommendations would further increase labor force participation. We also think our targeted recommendations on supporting broad-based innovation, improving the institutional framework for competition and access to finance to SMEs, among others, is a more prudent and effective way to stimulate investment and innovation than relying on broad and potentially excessive fiscal stimulus.
3. ***To this end, we note that there is a planned increase in public investment to 3.5 percent of GDP, could staff provide more information on the nature/content of this investment?***
- The increase in public investment over the medium term comprises a number of new investment projects that resulted from recent political agreements. In June 2018, it was agreed to boost investments in green energy sources such as windmill parks at sea, solar power cells, wind on land, and biogas. The investments are intended to help Denmark reach approximately a 55 percent renewable energy share in 2030. The March 2019 *Agreement on a Coherent Denmark* included a total of DKK 112.7 bn in new transport infrastructure sector planned over the period 2021-2030. The *Agreement on Stronger Health Care* also contains an increase of public investments, as does a 2018 agreement on higher defense spending for 2018-2023. With these adjustments, the level of public investments is projected to reach 3.4-3.6 percent of GDP in 2019-25. This is a higher share compared to the years before the financial crisis.
4. ***Could staff discuss over what period in-work benefits and lower marginal tax rates would be revenue neutral—i.e., is there potential for labor supply to be sticky in the short term given social preferences?***

- We consider that social preferences would indeed have a role on changes to labor supply. Therefore, additional policies to complement the proposed tax-benefit reform might be needed to support higher labor supply. For example, increasing the flexibility in the provision of childcare services.
- From a modeling perspective, we used a comparative static model, which does not have an explicit dynamic profile. However, the implementation of the model used to support our recommendation used Denmark-calibrated labor supply and taxable income elasticities focused on the short-term (one year to three years) responses to tax changes. This is consistent with other studies focused on Denmark³ and the micro-econometric literature on labor supply and taxable income elasticities. We therefore expect that the proposed reform, which used Denmark-specific elasticity estimates would be broadly revenue-neutral in the short-run.
- However, if welfare benefits are only adjusted slowly through lower indexation (so as to maintain benefits constant in nominal terms), then the reform would not be revenue neutral in the short term. Our back-of-the-envelope calculations indicate it would take 10 years for welfare benefits to reach the proposed optimal level in real terms by indexing the benefits to CPI changes instead of nominal wage growth.

5. *Could staff specify the type of in-work benefit relevant in the context of Danish labor market?*

- The proposed in-work benefit could build off the existing tax allowance for earned income (*Beskæftigelsesfradrag*), which allows taxpayers to deduct 9.50 percent (in 2018) of earned income subject to a maximum of DKK 33,300 in order to calculate taxable income. The reform would instead introduce a refundable scheme—taxpayers would be entitled to a tax refund in case of negative tax liabilities—and would feature a tax credit as opposed to a tax deduction. Crucially, the size of the transfer should be increased significantly so that there would be a net benefit for low income workers to enter employment. This is not the case at the moment, as the current tax and benefit system entails a small penalty from taking up employment for low income workers as shown in Text Table 1, mainly as a result of lower housing benefits and parents having to pay part of the cost for childcare. The Earned Income Credit in the U.S. provides a helpful blueprint for such a benefit in Denmark.

6. *Could staff elaborate more on the targeted in-work benefits to low income workers in alleviating inactivity traps?*

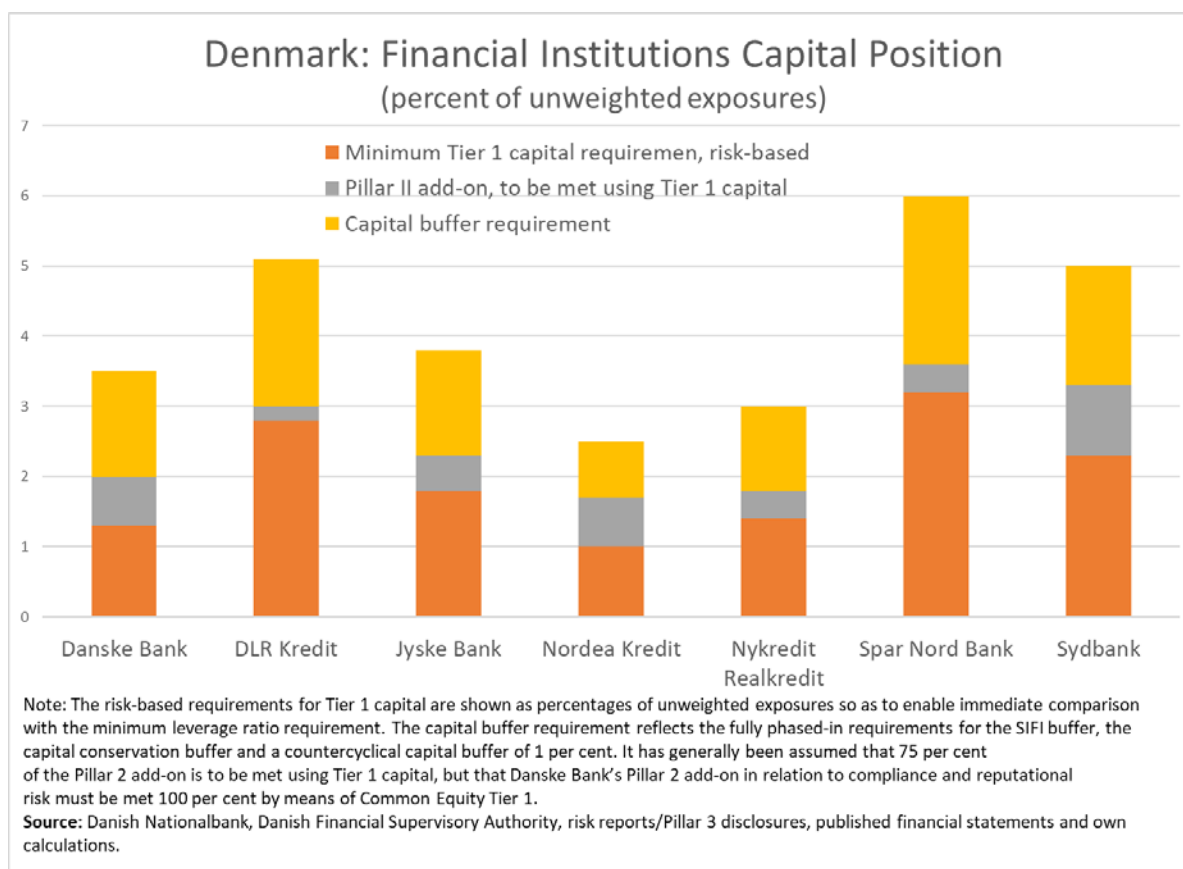
³ Kleven and Schultz (2014). "Estimating Taxable Income Responses Using Danish Tax Reforms,"; also see Saez, Slemrod, and Giertz (2012). "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review".

- See response above.
7. *Concerning the proposal to reduce marginal tax rates, the question arises whether first and foremost the lowest taxation threshold could be lifted and the tax rate in the lowest income bracket should be reduced. Staff comments are welcome.*
(Mr. Benk and Mr. Reininger)
- As discussed in Annex I and shown in Text Table 1, the marginal *effective* tax rate—one minus the net financial return after taxes and benefits from one additional hour of work—in the lowest income bracket should be *increased* significantly under the reform for the first percentile. The reason for such a counterintuitive change is that an optimal tax and benefit system would introduce a large transfer to low-income individuals conditional on being employed (in-work tax credit). In order to maintain fiscal sustainability and contain fiscal costs, this large transfer would need to be phased-out rapidly so that only the poorest workers benefit. This leads to an increase in the marginal effective tax rate (METR) for low-income workers as the benefit is phased out. However, average tax rates would be much lower, as indicated by net income gains. The U.S. Earned Income Credit is an example of such a transfer. The analysis in Annex I shows that this has a large effect on labor force participation.
8. *With respect to the ongoing review of the budget law, staff seems optimistic that this offers an opportunity to ensure adequate flexibility in setting the structural deficit limit while the authorities do not expect the review to result in major changes. Could staff elaborate?*
- The Ministry of Finance is in the process of reviewing the experience with the Budget Law, which was introduced in 2012. In addition to a structural deficit limit, a key feature also introduced in the Budget Law were expenditure ceilings at the various levels of government. The review includes a number of ongoing comprehensive analyses on the experiences with expenditure control and expenditure ceilings. The Ministry of Finance is expected to put forward a proposal for revision in the next parliamentary session. During the mission, authorities showed openness for evaluating possible changes to the budget law if these were needed.
9. *Could staff elaborate more on the budget review process and its possible outcome in the context of the recent change in Government?*
- See response above.

Monetary policy and macro-financial policies

10. *On the relaxation of credit standards in the corporate loan market, could staff elaborate more on the concerns and possible impact on credit quality?*

- In the current low interest rate environment and with ample liquidity at hand, many banks have capacity to increase lending, which intensifies both competition for corporate customers and the pressure on credit standards. If credit standards are eased, this could result in losses when the economy reverses, and firms' earnings opportunities decline. The interest margin should reflect the risk on the loan in question, and the robustness of firms should be assessed across the entire business cycle to ensure that their foundation is solid when the economy reverses.
- Amid risk build-up related to the low interest rate environment, the Systemic Risk Council has recommended to activate and increase the counter cyclical capital buffer (CCyB) in past years which is set to increase to 1.5 percent by June 2020. Authorities keep monitoring developments and seem to be ready to deploy further measures if risks continue to build up.
- In addition to the CCyB, some financial institutions have to meet a capital conservation buffer, pillar II add-on, and the systemically important financial institutions (SIFI) the SIFI buffer.

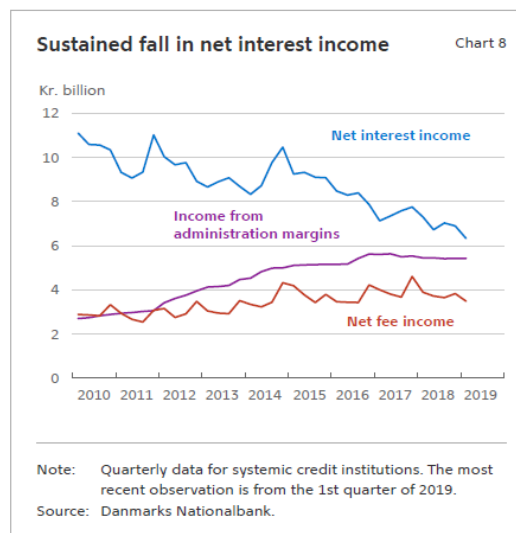


11. *In light of the survey results, which suggest that some banks are relaxing credit standards for corporate lending, we are concerned about the implication of this trend on bank balance sheets. Could staff explain the drivers of this development and the measures for addressing it?*

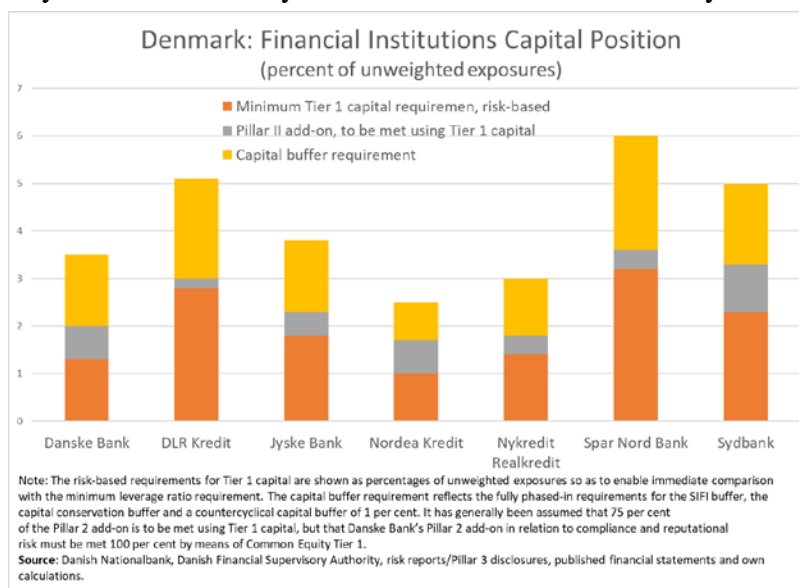
See response above

12. *We also note that the banking system remains profitable despite the negative interest rate environment and that staff refer to changes in the policy rate as deemed necessary. Against this background, we would like to hear staff's view about the impact of ECB's further interest rate cut, which might lead to further policy rate cut of Denmark, on the financial stability of Denmark.*

- While banks remain profitable, net interest income (NII) has been on a downward trend since the GFC. However, Danish banks were successful in compensating this decline in NII by increases in income from administration margins and fees. On the one hand, another decrease in interest rates would put further pressure on banks NII. If banks are able to compensate this decrease (as in the past) by higher administrative margins or fees, then profitability might not be impacted. However, if this is not the case, their profitability might decrease albeit from a high level. On the other hand, lower interest rates could result in higher credit expansion, potentially increasing profitability.
 - Moreover, authorities stress tests suggest that even under a severe recession scenario, which would lower banks profitability (e.g. via higher loan loss provisions) systemic banks would satisfy capital and leverage ratio requirements. The forthcoming FSAP (scheduled for next year) will however assess banks' vulnerability to lower (and higher) interest rates through sensitivity analysis and will be in a better position to give an assessment on the impact on financial stability.
13. *While we wonder why the countercyclical capital buffer (CCyB) and not the systemic risk buffer (SRB) was activated, it is also not clear to us whether the CCyB will apply to mortgage credit institutions (MCIs) as well. Staff comments are welcome.*



- We should clarify that the CCyB was activated in addition to the existing systemic risk buffer for SIFIs. But the CCyB has to be met by all financial institutions not only the SIFI's. This also applies to MCIs. Note however, that most MCI's are either owned by a bank or own a bank, so they met all regulatory capital requirements at the group level. For instance, Nykredit Realkredit is a MCI that owns a bank (Nykredit Bank), Danske Bank owns Realkredit Danmark which is an MCI, Nordea Kredit is considered an MCI (with a bank branch in Denmark), Jyske Bank owns BRFkredit which is an MCI, DLR Kredit is an MCI, Spar Nord Bank and Sydbank are considered as systemic banks.



14. *Could staff elaborate further on the current status of investigation on Danske Bank case?*

- Publicly available information suggests that there are several ongoing investigations related to the Danske Bank case, both at the national and supranational (European Union – EU) levels. Fund staff has not discussed this case with national or supranational investigators, and so cannot independently confirm the status of the investigations listed below.
- Press reports indicate that former Danske Bank Chief Executive Officer (CEO) Thomas Borgen was charged by Danish prosecutors in May 2019 in connection with this case. Danish prosecutors filed preliminary charges against Danske Bank itself, in November 2018.
- Press reports indicate that the Estonian authorities arrested 10 former employees of the local Danske Bank branch in December 2018; those cases appear to be ongoing.
- Press reports indicate that there are open investigations into this case in France, the United Kingdom, and the United States. Some of the funds potentially laundered via the Danske Bank branch in Estonia were transferred to or through those countries.

- In February 2019, the European Banking Authority (EBA) opened a formal investigation into a possible breach of Union law by the Danish and Estonian financial supervisory authorities (the DFSA and the EFSA), based on a referral from the European Commission (EC). That investigation was closed in April 2019, after the EBA’s Board of Supervisors (BoS) rejected a proposal to issue a breach of Union law recommendation.
 - The EC has publicly indicated that it will continue its own, separate investigation as part of “infringement proceedings” against Denmark and Estonia. Those proceedings are designed to determine whether either country failed to implement the relevant EU anti-money laundering (AML) regulations/directives in connection with the Danske Bank case.
- 15. *We welcome that Denmark has taken important steps to strengthen its AML/CFT supervision over the last two years and a broad majority in the Parliament agreed on a new political agreement on March 27 to strengthen AML/CFT regulation and expand sanctioning powers. In this regard, we would like to ask whether the 16 initiatives contained in the agreement covers elements of staff recommendations which are detailed in the SIP.***
- Several of the 16 initiatives in the March 2019 political agreement are indeed reflected in staff recommendations, as summarized in Table 2 of the Selected Issues Paper (SIP). The relevant initiatives and corresponding recommendations are provided in the chart below. Where a key initiative is outstanding (meaning that it has yet to be fully implemented), staff has tailored its recommendation(s) accordingly.
 - Note, however, that staff’s recommendations go well beyond the initiatives in the March 2019 political agreement, covering international and domestic cooperation (7 recommendations), the implementation of the risk-based approach to anti-money laundering and combating the financing of terrorism (AML/CFT) supervision (3 recommendations), and the Danish Financial Supervisory Authority’s (DFSA’s) resources, procedures, and powers (6 recommendations).

Initiative	Initiative Text	Recommendation	Recommendation Text
1	The Danish FSA will be given broad access to issuing administrative fine notices.	11	Fully and expeditiously implement, in law, the March 2019 political agreement to expand the DFSA’s powers, including the authority to issue administrative fine notices for non-compliance with AML/CFT
3	The Danish FSA will be given the option of appointing a qualified person who may, under mandate from the Danish FSA and for a shorter period		

	of time, monitor the daily operations of the banks where it is necessary to monitor a company with a risk of financial crime.		requirements. (SIP Table 2)
5	The Danish FSA will be given the option of issuing orders stating that a company cannot enter into new customer relationships, if serious infringements of key anti-money laundering rules have been identified in the company.		
6	The Danish FSA supports the financial sector in building common infrastructure that can strengthen KYC processes.	7	Issue findings on the feasibility and benefits of a private sector-led CDD utility, and its potential mobilization to support AML/CFT supervision. (SIP Table 2)
11	The Danish FSA's organization is changed with a view to ensuring stronger focus on preventing and combatting financial crime.	14	Complete the hiring and training of new inspectors to bring the DFSA's AML Division to full strength and develop a formal staff retention plan. (SIP Table 2)
12	The Danish FSA's and the Ministry of Justice's area will receive increased resources to strengthen efforts to combat financial crime.		
15	The cooperation and coordination between authorities and companies in the Anti-Money Laundering Forum is strengthened. (In relation to the framework for the cooperation, it is important that the authorities can exchange necessary information about i.a.	2	Ensure that the MLS is proactive in sharing with the DFSA analysis of STRs that may indicate a shift in banks' institutional risk profiles or changes in the approach or quality of their reporting. (SIP Table 2)
		3	Complete and adopt the planned update to the MLF MOU. (SIP Table 2)

	current crime trends and risks.)		
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- 16. *We welcome the recommendations in the Selected Issues paper on reinforcing Denmark’s cross-border AML/CFT banking supervision. Could staff elaborate on the consistency of these recommendations and the political agreement mentioned by Mr. Ostros and Mr. Gade in their buff statement?***

See response above

- 17. *We also note that the higher expenditures for AML controls and augmented cost of funding due to increased risk perception have already impacted Danske bank’s profitability. Could staff comment on these developments in the context of ongoing case?***

- It is not uncommon for banks publicly known to have been involved—or under investigation for their potential involvement—in money laundering cases to increase their expenditures for anti-money laundering controls, both to shore up any weaknesses in those controls and to reassure investors, correspondents, and customers. In parallel, such banks typically experience a decline in their share price (as investors anticipate or “price in” future legal expenses, elevated auditing costs, and possible fines from national and/or supranational regulators) along with a rise in their funding costs, owing to increased risk perceptions. Danske Bank has followed this general pattern.
- Staff assesses that larger-than-expected fines levied by any of the authorities currently conducting investigations into this case (i.e., fines in excess of those already “priced in” by the market) would be likely to impact Danske Bank—and in particular, its share price—negatively.
- On average, funding cost for Danske increased by about 33 basis points in 2018 (from about 11 at the beginning of the year to 44 at the end).



- Credit Default Spreads for Danske went up as well while the stock price declined. Profits and deposits declined by about 28 percent and 2 percent in 2018 respectively.

18. *We would like to raise the question whether a dialogue with all relevant major central banks, including the Central Bank of Russia, is envisaged on the issue of illicit cross-border flows under the umbrella of stronger regional and institutional cooperation?*

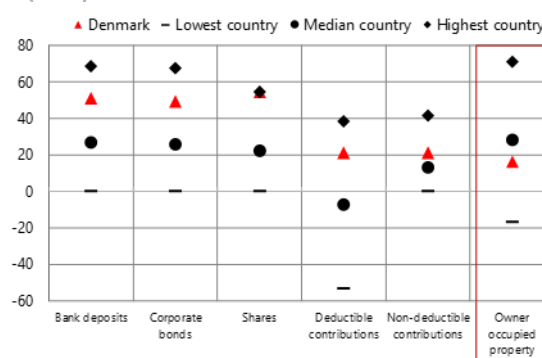
- Staff is not aware of a formal or regular dialogue among the central banks of the Nordic, Baltic, Eastern European, and Commonwealth of Independent States (CIS) countries with respect to illicit cross-border flows.
- The parties comprising the outgoing Danish government, along with most of the other parties in parliament, concluded a political agreement in September 2018 that includes a commitment to “active Danish participation in the upcoming international work to strengthen cooperation in combating money laundering across countries”.
- Recent examples of such international work include:
- A June 2019 meeting of Nordic central bank governors, for which Fund staff provided a presentation on anti-money laundering and combating the financing of terrorism (AML/CFT) supervision in the region; and
- The May 2019 formation of a permanent working group of the financial supervisory authorities of all the Nordic-Baltic states to maintain regular contact and exchange experiences and information with the goal of bolstering their effectiveness in combating money laundering.
- At a bilateral level, the 2019 *Report on the Danish Financial Supervisory Authority’s (DFSA’s) Supervision of Danske Bank as Regards the Estonia Case* indicates that in both 2007 and 2013 Russia’s Central Bank was in contact with the Danish and Estonian financial supervisory authorities regarding suspect transactions at Danske Bank’s Estonian branch.

Housing sector

19. *Could staff further elaborate on the overall tax scheme on real estates (transfer tax, property tax etc.) in Denmark and the authorities' policy direction on it?*

- In 2017 the government announced changes to the property and land tax systems to end the property valuations freeze in place since 2002. Under the new system, to be introduced in 2021, property tax amounts will again rise proportional to house price increases, thus eliminating the procyclical impact of the freeze. However, to protect homeowners from tax increases while they occupy their home, the payment of tax increases after 2021 are deferred until the home is sold. Another feature of the new system is that future property tax revenues above an expected structural target will be used to lower tax rates, thereby potentially creating a new element of procyclicality although specific modalities are yet to be decided.
- The tax relief for mortgage interest deductibility is comparatively high and has no cap, while capital gains on owner-occupied housing are exempted from taxation. This makes the tax treatment of owner-occupied housing very favorable compared to other savings vehicles than in most other OECD countries (Figure).
- That said, the OECD assess “the framework for taxation of immovable property as well designed”. Denmark is among only three OECD countries (Australia and Estonia in addition) with a pure land tax, considered one of the most efficient taxes. In addition, the recent property tax reform will ensure valuations are updated every second year and maintains an element of progressive taxation.”
- In our discussions with the outgoing government they said that no additional changes to real estate taxation are foreseen until 2021.

Marginal Effective Tax Rates Across Asset Types, 2016
(Percent)



Source: OECD.

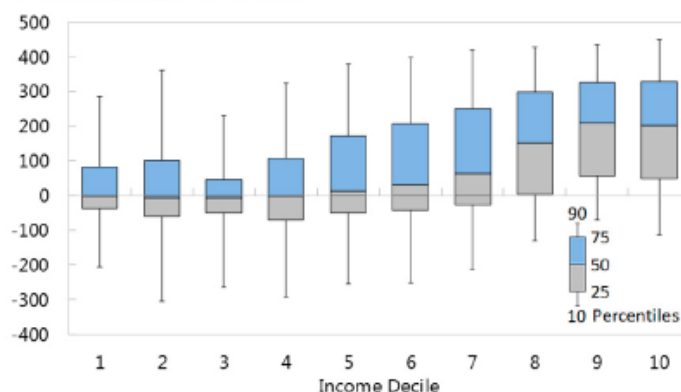
20. *Could staff indicate how household debt is divided between high-income and low-income groups and the implications for risks in the financial sector?*

- **Vulnerabilities are not evenly distributed across households.** The median net-debt-to income level for households in the first 5 income deciles is around zero—a positive attribute. However, within this income groups, there some households are indebted at high levels with net debt to income higher than 100 percent. The

households with higher debt relative to their income are generally wealthier, with the median debt-to-income ratio of the tenth income-decile households (that is, households with the highest 10 percent of incomes) at 256 percent.

Figure 11. Household Net Debt per Income Decile¹

(Percent of income after tax, 2015)



Source: Danmarks Nationalbank using registry data from Statistics Denmark.

¹ Net debt is debt minus financial assets plus pension savings.

External sector

21. *Finally, we note that the considerable uncertainties in the staff's external sector assessment continue. Deeper analysis of the important country-specific factors of that provided in Annex IV of the report, including on the effects that each factor plays in the staff's assessment and policy recommendations, would be desirable. Staff's comments are welcome.*
- EBA models, like all models, are unlikely to have a perfect fit and residuals can be due to numerous factors. Some of the residuals are known to relate to measurement issues and structural features, and staff has been developing (including as part of last year's EBA refinements) complementary tools to assess the role of these factors to better ascertain whether residual reflect excess imbalances or features not fully captured by the model. Yet, because data are limited in many cases, or there is no consensus yet on how to address some factors, these factors can only be explored outside of the EBA model for now.
 - There are several important country-specific factors that the EBA current account model doesn't seem to reflect well for Denmark:
 - First, Denmark's large pension contributions arising from the ongoing transition to the fully-funded retirement system), create significant structural savings. The effect of higher mandatory individual savings on the national savings rate is subject to some debate. Some research finds that there is little evidence that countries that implement defined-contribution reforms have higher trends in saving rates after the reform.

Cross-sectionally, countries with pay-as-you-go systems tend to have lower saving rates, and this effect increases with the coverage rate on the system.^[1] The current account surplus is attributable to a large private sector savings surplus, i.e. it is the result of many decentralized decisions. Since the early 1990s, the social partners in Denmark have concluded agreements on contributions to labor market pensions in order to ensure higher income for pensioners than state old age pension alone. In the build-up phase, contributions exceed pay-outs.

- Second, measurement issues related to merchanting and offshore processing trade need also be considered, given their dominant role in Denmark's trade balance. As analysis by the Danish central banks shows, globalization can complicate the interpretation of developments in imports, exports, investment income and GDP, because these may be influenced by firms' head office location and internal accounting structure.^[2] Additional research also shows that because merchanting firms reinvest their earnings abroad to expand their international activities, this practice raises national savings in the home country without increasing domestic investment. This results in a significantly large current account surplus.^[3]
- Third, data limitations and lack of disclosures by multinational corporations for their pricing practices for R&D costs and other non-standard activities complicate the estimation of their effect on the current account.
- While there are diverging views on how this would affect the current account estimation, staff has taken these uncertainties into consideration in its advice to the authorities and would not alter its views that structural policies aimed at raising investment and boosting productivity would be welcome, including through a gradual improvement in capital markets access to equity finance for SMEs. This would also help reduce the surplus further.

22. *We wonder if staff could share their estimates of how much the CA gap would be adjusted after accounting for these country specific factors and whether this would alter the policy advice?*

- Same answer as above

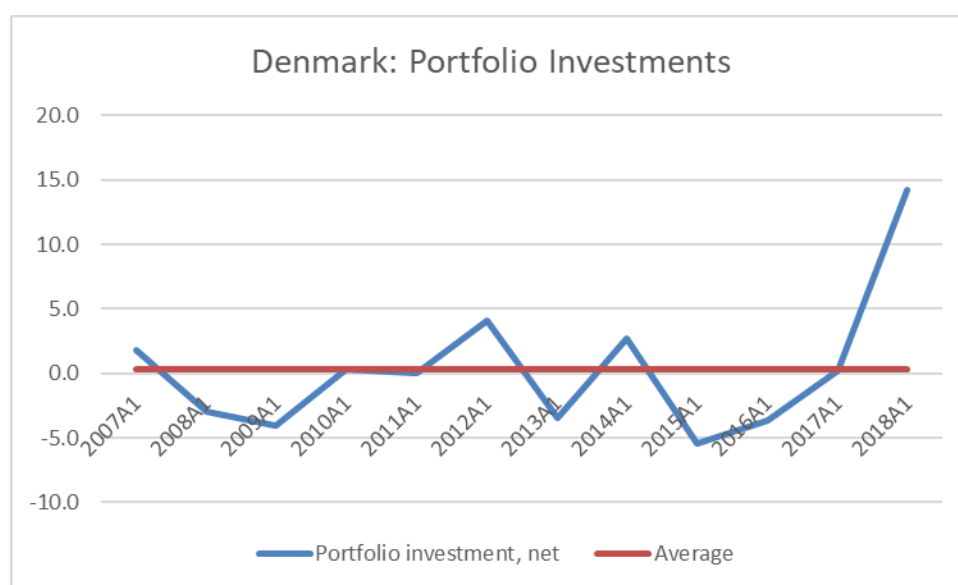
23. *Finally, on a more technical note, with regard to the balance of payments, we wonder what could be the drivers behind the highly volatile portfolio and other investments. In addition, we are surprised by the relatively high net errors and omissions. Staff comments would be welcome.*

^[1] Samwick 2000

^[2] DN 2015

^[3] *Merchanting and Current Account Balances*. Beusch and others. Working Paper No. 140. Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, 2013.

- Denmark is a small open economy with a large financial sector (605 percent of GDP in 2017) and no restriction on capital flows. Authorities explained that fluctuation in portfolio investments, which are marked-to market, can be caused by portfolio management decisions of pension funds and banks. Further, many foreign investors participate in the domestic financial market by buying for instance mortgage covered bonds. However, over the years the portfolio investment position averages itself out close to zero (Figure).



- On large errors and omission, authorities explained that this has been an issue that they are puzzled as well (as also noted by Eurostat) and on which they are currently working on. A project using micro-founded data is going on right now where authorities are looking deeper into large corporations that contribute to the current account and their financial account recording as well as transactions in patents. Authorities also noted that activities in “merchanting and offshore processing trade abroad” could also cause these large errors among other things.
24. *We agree with staff’s assessment that Denmark’s external position is moderately stronger than fundamentals based on the EBA current account model. We note, however, that the REER model shows a different assessment. In cases such as this, we urge staff to be more explicit on why REER models are less relevant and subject to greater uncertainty to help ground the headline conclusions. Staff comments would be appreciated.*
- Staff takes a holistic approach to assess the external position of a given country. Generally, the estimates from the CA and REER models point towards the same assessment, but in some cases, they can give conflicting signals. In such cases, more weight is generally given to the current account model, which displays a more stable

relationship than the REER models, as exchange rates are inherently more difficult to model. Moreover, since no single model can capture all the characteristics of the external sector, staff assessments necessarily rely on other data and indicators as well as well-grounded judgment. This includes considering (potentially) omitted country-specific factors, such as specific factors that may constraint savings investment, as explained in Annex IV.

- There are several reasons, why the REER model might have limitations. For example, the REER-index model includes country fixed effects and as such is unable to capture some of the slower moving-structural features that affect external positions. Similarly, these regressions have difficulties in capturing structural breaks; e.g., in Denmark due to its insertion into global value chains and engagement in merchanting. Note that all models carry uncertainty and need to be used with judgement (e.g. to correct for measurement biases).
25. ***Despite the decrease from 8 percent of GDP in 2017 to 5.8 percent of GDP in 2018 Denmark’s current account surplus remains high. Subdued investment seems to be the main contributor to persistent surplus. “Merchanting” trade also comprises a large share of the current account surplus in Denmark. The earnings of merchanting firms are usually reinvested abroad at the expense of the domestic investment¹. Does this effect feature in the calculation of the current account norm by staff and what would be the policy advice for promoting investment under these circumstances?***
- This is a valid point, as the EBA CA norm calculation doesn’t feature “retained earnings” as a variable in its regression. Some of the residuals are known to relate to measurement issues and structural features, and staff has been developing (including as part of last year’s EBA refinements) complementary tools to assess the role of these factors to better ascertain whether residual reflect excess imbalances or features not fully captured by the model. Yet, because data are limited in many cases, these factors can only be explored outside of the EBA model for now. See below table from the EBA methodology update (IMFWP 2018).

Annex I: Comparison of EBA Current Account Model Specifications Across Vintages

		2013 Model	2015 Model	2018 Model
Fundamentals	Demographics	Aging speed ^{1/}	Aging speed ^{1/} Aging speed * OADR (unscaled) OADR * Aging speed (unscaled)	Prime-age savers share Life expectancy Life expectancy * future OADR
	Institutions	ICRG-5 subindices	ICRG-5 subindices	ICRG-All 12 subindices
	Measurement	Financial center dummy ^{2/}	Financial center dummy ^{2/}	Complementary tool : estimates magnitude of retained earnings and inflation biases
Policies	Credit	Demeaned Credit-to-GDP	Demeaned Credit-to-GDP	Detrended Credit-to-GDP with HP filter
	FXI	Spot FX intervention	Spot FX intervention	Spot and derivate FX intervention Simplified instrumentation
	Structural			Complementary tool : estimates whether product and labor market distortions explain model residuals

Note: Table focuses only on variables whose specification has changed in 2013.

1/ Aging speed is defined as the 20 year ahead change in old age dependency ratio (OADR)

2/ Applied only to Switzerland and the Netherlands.

Productivity and investment

26. *We missed a discussion on product market reforms. Could staff provide an update on reforms undertaken including progress on deregulation efforts.*

- In last year's report, we discussed that as part of the Growth and Development Strategy published in November 2015, the government lifted some of the strict rules concerning shop size and location contained in the Planning Act. It also gave municipalities a greater role in planning within a more flexible administrative framework. The floor cap of 2,000 m² for specialty goods stores (those selling books, electronic goods, clothes and furniture) in cities was removed, and the floor cap of grocery stores was increased from 1,000 to 2,000 m² in community centers and from 3,500 to 5,000 m² in cities. These reforms are expected to facilitate the establishment of larger, more productive stores, offering a bigger product range and lower prices.
- While revisions to the Planning Act include, among other things, relaxing store-size and location restrictions. These do not extent to hypermarkets, which are seen as a

potential threat to commercial activity in the inner cities. Further liberalizing store size rules could unlock additional efficiencies and help raise productivity.

- In 2017, the government established a Management Commission, which will provide recommendations on improving the quality of public management and proposed reallocating funding to higher education institutions with the purpose of targeting degrees with relatively better employment prospects. Progress has also been made on incentivizing cooperation between businesses and universities, with the purpose of stimulating knowledge transfer and investment in R&D. A new R&D super-deduction is also being phased in. The Strategy for Denmark's Digital Growth launched beginning of 2018 includes important public-private initiatives to improve digitalization, such as the Technology Pact, SME Digital, and Digital Hub. These initiatives are going on and we mentioned them in paragraph 42 of the SR.
- On the taxi act, we mention briefly in the staff report that it has been revised but falls short of enabling competition through disruptive companies (Annex VIII).
- However, besides the revision in the planning act, the taxi act, and the promising initiatives under the strategy for Denmark's Digital Growth no further deregulation efforts were made this year.

27. *We commend the authorities for introducing business-oriented reforms and setting-up Danish Growth Fund as a one-stop shop for SMEs financing. In this regard, could staff explain the differences between Danish Growth Fund and Danish Growth Capital Funds?*

- Vækstfonden (**the Danish Growth Fund**) today manages a variety of different mandates to provide capital to primarily Danish SMEs. Vækstfonden has three primary instruments: 1) Direct equity investments in Danish businesses (the original mandate of Vækstfonden, when it was set up 1992), 2) funds and funds-of-funds investments and 3) Debt financing (loans and guarantees). Regarding the funds' investments, it is not a legal requirement that the funds *only* invest in Danish businesses, but a part of the purpose of investing in funds outside of Denmark is to attract international investments to Denmark from the targeted funds.
- A new initiative has been the launch of new loan product at Vækstfonden (the Danish Growth Fund), which has been in effect since January 2019. The new initiative follows from a political agreement¹ from May 2018 between the Government and the Danish Peoples party regarding a reform of the system for public business promotion. A part of the agreement was to make Vækstfonden (The Danish Growth Fund) the one-stop shop for access to (market-based) finance for entrepreneurs and SMEs and the Danish Innovation Fund the one-stop shop for public *grants* to facilitate innovation, R&D and development of new businesses.
- **The Danish Growth Capital Fund** with the aim to make risk capital available to entrepreneurs and SMEs. Phase I was established in 2011 (fully invested) with EUR 551M under management. Phase II was established in 2015 with EUR 400 M

under management. These funds provide diversified access to well-performing SMEs in Denmark and the Nordics.

Labor market

28. *How is the structural rate of unemployment calculated?*

- The structural rate of unemployment is the rate that is consistent with constant price inflation (non-accelerating inflation rate of unemployment (NAIRU)), given current economic conditions. We used the OECD estimates, which deploys a Kalman filter technique in a Phillips curve framework.

29. *Additionally, staff uses the OECD's structural unemployment rate, which remains flat at around 6 percent while the observed rate stays around 5 percent, suggestive of a positive output gap. Does staff envisage a fall in structural unemployment linked to those structural reforms?*

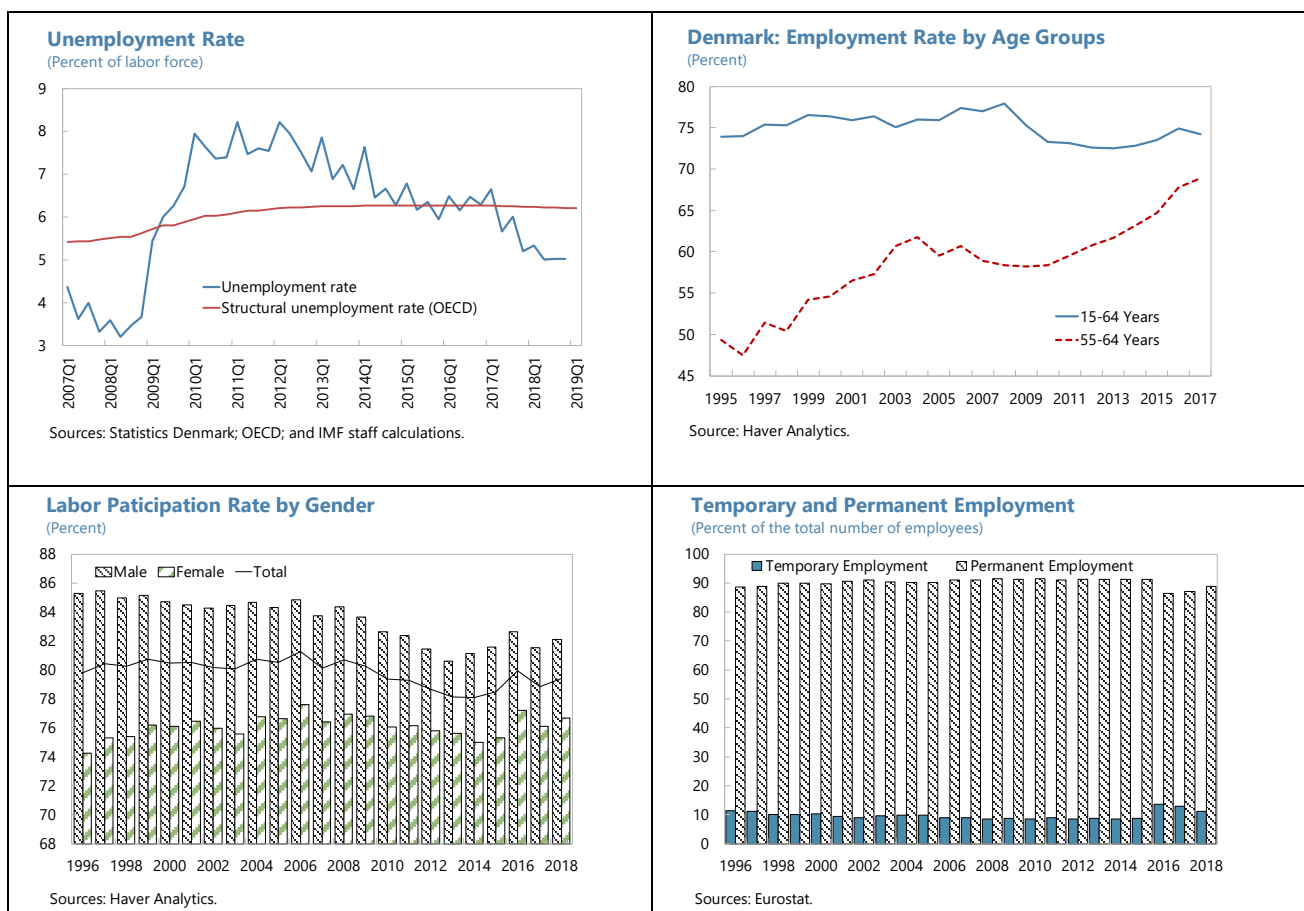
- The OECD estimates used by staff don't provide a projection beyond 2020. That said, we expect ongoing structural reforms to lead to a fall in the structural unemployment rate, but the effects are subject to uncertainty.

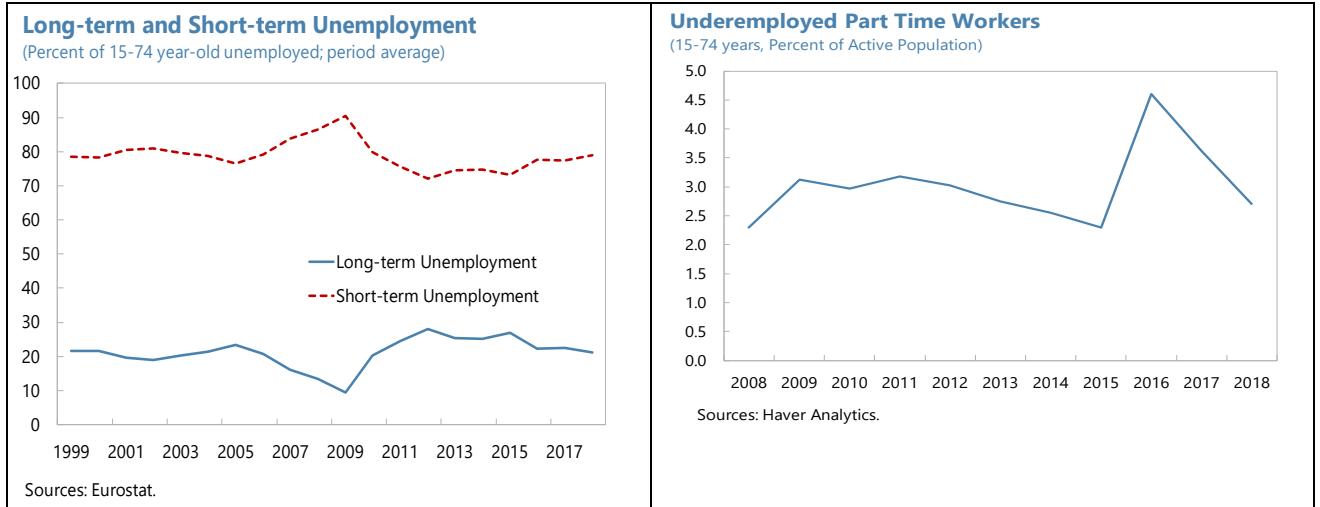
30. *The aging population is projected to increase healthcare costs substantially and we note the staff comment that long-run sustainability hinges on continued implementation of pension reform. In this context, could staff elaborate more on the authorities' pension reform plan.*

- A large pension reform in 2011 increased the statutory retirement rate from 65 to 67 (effective 2019–22) and indexed the retirement age to life expectancy (effective 2025). Access to the voluntary early retirement scheme has been scaled back since January 2012. More recent initiatives include the 2018 tax reform that increased deductions for pension contributions. In May 2019, authorities announced plans for a new senior pension initiative that would allow for early retirement for people with disabilities and who are unable to work. While the population that might be affected by this change is likely small, the plan would lower the official early retirement age by up to six years for qualified workers. Details are rather vague and whereas the proposal will be implemented will depend on a new government, which has not been formed yet.

31. *Besides, we are aware that the "job rotation" program of Denmark has been highly praised for getting people in employment and improving the skills of labor force. We wonder about staff's view or assessment on this program's contributions to Danish labor market policy targets.*

- Under the job rotation scheme, employers receive a hiring subsidy for an employee on training and an unemployed person is employed as a substitute. The scheme aims to get people into employment while improving the skills of permanent staff. Available studies suggest that job-rotation on average makes the participants enter into regular employment faster than they otherwise would have done (EC 2015). According to Eurofound, uptake in these schemes, however, has been low in recent years, due to the “job-first” approach that job centers are taking. The “job-first” approach means that the job centers give priority to sending the unemployed to a full-time job and not in part-time employment. Job rotation is also mostly used in companies with unskilled or low-skilled workforce.
32. *We would appreciate more detailed data on the labor market – e.g. time-series of labor participation ratio (male/female), employment rate, unemployment rate, forms of employment data (short-term vs. long-term, temporary vs. permanent, underemployment rate).*
- Please see below.





33. *In what ways can the business-oriented growth policy support expansion of the knowledge sector?*

- Denmark's business-oriented growth policy can support expansion of the knowledge sector by incentivizing digitalization, innovation, research and development. The launch of the Digital Hub Denmark, the Technology Pact, and the Danish National Strategy for Artificial Intelligence provide incentives for adopting new technologies. Another focus of the business-oriented growth policy is on education and skills development and international recruitment of qualified labor—these can also support expansion of the knowledge sector.