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January 4, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Denmark - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Denmark. This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Knöbl, ext. 74984 or Mr. S. Mitra, ext. 74980.

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INTERNATIONAL MONETARY FUND

DENMARK

Staff Report for the 1983 Article IV Consultation

Prepared by Staff Representatives for the
1983 Consultation with Denmark

Approved by L.A. Whittome and Subimal Mookerjee

December 30, 1983

I. Introduction

A staff team consisting of Messrs. A. Knöbl, H-J. Huss, M. Ishihara, and S. Mitra with, as secretary, Mrs. P. Padmore (all EUR), held Article IV consultation discussions in Copenhagen from November 2 to 14, 1983. The Danish representatives included officials of the Nationalbank, the Ministries of Economic Affairs, Finance, Industry, Energy, and Foreign Affairs, and the Statistical Office. The mission also met with the Minister of Finance, Mr. Christophersen, the Governor of the Nationalbank, Mr. Hoffmeyer, and the Permanent Secretary of the Ministry of Economic Affairs, Mr. Hansen. Mr. Tvedt, Executive Director for Denmark, attended the meetings as an observer. Denmark has accepted the obligations of Article VIII, Sections 2, 3, and 4.

A government made up of a coalition of the Conservatives and other center-right parties took office in September 1982 with command over only a minority of seats in Parliament. It was defeated in the final vote on the proposed budget for 1984 on December 15, 1983 and elections have been called for January 10, 1984. The present report of the discussions in Copenhagen was prepared before the final vote on the budget.

II. Background

Denmark's macroeconomic performance was not satisfactory in the period following the second round of oil price increases. Despite the adjustment measures taken in the period 1979-81 the imbalances in the economy were not sufficiently reduced and they worsened in 1982. The external current account remained in deficit, rising to the equivalent of 4 percent of GDP in 1982, and the public sector deficit rose sharply to the equivalent of 8 1/2 percent of GDP. In spite of high and rising unemployment, inflationary pressures, sustained by wage indexation, remained intense. The succession of large current account deficits led to a sharp rise in external debt and its servicing. In spite of a significant improvement in competitiveness over the past few years, the tradable sector has remained small. The major counterpart to the weak external performance can be found in the disappointing rate of domestic savings. The dissavings of the Central Government have been substantial, and the public sector has preempted an increasing share of domestic resources.

Against this background, and the prospect of a worsening economic situation on the basis of unchanged policies, the Government initiated a set of stabilization measures in October 1982. The fundamental strategy was to secure some further improvement in competitiveness through restraining domestic costs rather than, as in the past, by means of an active use of the exchange rate, and to promote over time the reallocation of resources to the exposed sector by fiscal restraint. The key elements of the package were firm incomes and exchange rate policies, and first steps of fiscal restraint were taken to slow down the sharp rise in the budget deficit. Wage indexation was suspended until the spring of 1985; over that period the annual increases in public sector wage and salary rates were to be limited to 4 percent, with a recommendation that a similar figure apply to private sector settlements. Nominal rates of unemployment and sickness benefits were frozen, and the annual increase in other transfer payments (excluding pensions) was to be limited to 4 percent. Some revenue-raising measures were also taken, but the budget deficit was still projected to rise in 1983, both nominally and as a proportion of GDP.

III. Recent Economic Developments and Short-Term Outlook

In response to the stabilization measures and more favorable external factors the economic situation has improved significantly in 1983. Inflation has been reduced substantially, the external current account has narrowed markedly, private investment has started to recover, and the increase in unemployment has slowed down.

An important factor behind the dampening in wage and price inflation has been the suspension of wage indexation for two years, a step widely accepted by the population. The two-year wage agreements of early 1983 were basically consistent with the guidelines of the Government. Taking into account the impact of previous settlements, higher social security contributions, and expected wage drift, the increase in hourly wage costs in the private sector is projected to decline from over 11 percent in 1982, to less than 8 1/2 percent in 1983, and some 5 percent in 1984. The increase in public sector pay was lower than in the private sector in 1983 but, due to a wage differential clause, the increases are expected to be similar in 1984. With import prices also rising more slowly the rate of increase of consumer prices was halved to some 5 percent during 1983, close to the rates of inflation in Denmark's main trading partners.

The stabilization measures also had a pronounced impact on domestic demand. After rising strongly in 1982, total real domestic demand is estimated to have changed little in 1983, as private consumption and public spending on goods and services was restrained, and stocks were reduced. On the other hand, private investment started to recover in response to rising profits and lower interest rates. The increase in overall output was sustained by a strong rise in exports, and real GDP is estimated to have risen by 2 percent in 1983, after a rise of 3 1/2 percent in 1982. This was, however, insufficient to prevent a further rise in unemployment to 10 1/2 percent of the labor force in 1983 (10 percent in 1982), though the increase slowed in the course of the year, and private sector employment appears to have stabilized.

The improvement in the external current account deficit from the equivalent of 4 percent of GDP (SDR 2 billion) in 1982 to an estimated 2 percent of GDP (SDR 1.1 billion) in 1983 is encouraging. The slowdown in domestic demand dampened imports, while exports benefitted from the lagged effects of improved competitiveness over the past three years, and Danish exporters were able to expand their export market shares further. Another important factor was a substantial improvement in the energy balance, reflecting lower oil prices and higher North Sea oil production. Finally, extraordinary sales of secondhand tonnage boosted net exports of ships. Although interest rates on the external debt declined in 1983, net interest payments continued to rise, because the U.S. dollar strengthened and foreign indebtedness increased further. In 1983 net interest payments are estimated to have been almost twice as large as the current account deficit.

Improved confidence led to a turnaround in the private sector capital account after the EMS realignment in March 1983. This allowed the authorities to relax capital controls on both foreign borrowing and lending. 1/ Sizable net private capital outflows occurred preceding the EMS realignment; subsequently substantial net capital inflows have been recorded. In the first three quarters of 1983 the private sector capital account (including errors and omissions) was close to balance compared with sizable net outflows in 1982. Maintenance of interest differentials in favor of Denmark, and strengthened confidence in the exchange rate of the krone, have been the main factors behind this change. As official foreign borrowing was not reduced commensurately with the improvement in the private sector balance of payments, gross official reserves rose strongly in 1983. They stood at SDR 3.8 billion (equivalent to 11 1/2 weeks of imports of goods and services) at end-October 1983, compared with SDR 2.1 billion at the end of 1982.

Although the central rate of the krone was revalued by about 2.4 percent against the ECU in March 1983 (largely reflecting the adjustment of the notional central rate of sterling), the effective exchange rate of the krone was hardly affected by the EMS realignment. Owing mainly to

1/ The most significant changes included residents being permitted to buy foreign bonds and to raise foreign loans for business purposes (previously limited for investment purposes only), and nonresidents being permitted to buy government bonds. From January 1, 1984, residents are free to buy foreign shares. For details see the forthcoming Recent Economic Developments on Denmark.

the strength of the U.S. dollar, the krone depreciated by 6 1/2 percent in effective terms (MERM) during the first 11 months of 1983.

The latest 1/ official projections for 1984 point to a further modest improvement in economic developments. With existing wage agreements the consumer prices are expected to rise by less than 5 percent during 1984. The tightening of fiscal policy envisaged in the budget for 1984 should help keep overall domestic demand in check, though the recovery of private investment (outside the oil sector) is expected to gain momentum. Exports should benefit from the international recovery, which, together with restrained domestic demand, would allow a further reduction in the external current account deficit to the equivalent of 1 1/2 percent of GDP. Real GDP is projected to rise by 1 1/2 percent in 1984, with stronger growth in the private sector. While private sector employment is expected to rise, unemployment may continue to rise slightly. Recent indicators and surveys suggest that the economic recovery, in particular private consumption and investment, may be stronger than the latest official forecasts suggest.

IV. Economic Policies

The basic economic strategy of the Government has remained unchanged since the last consultation. The rate of inflation is to be reduced, an objective important in itself and also helpful in bringing down the external current account deficit, which had reached a worrisome level in 1982. The authorities also intend to reverse over time the increase in the size of the public sector and the budget deficit, thereby stimulating private investment through lower real interest rates.

The Danish representatives said that on the whole external conditions had been more favorable in 1983, with lower international interest rates and oil prices. However, the pace of recovery in western Europe had been more sluggish than expected, and the sharp depreciation of the Swedish krona had not been helpful. Nevertheless, the improvement in the balance of payments in 1983 had been larger than earlier expected.

The authorities recognize that the improvements in 1983 are only first steps, and there is need for further external and domestic adjustment. Thus, the Government aims to eliminate the external current account deficit over the next three to four years, through management of domestic demand and continued pay moderation rather than through an active use of the exchange rate. For the adjustment to be durable it needs to occur against a background of rising private investment, which requires that government dissavings be reduced. The Government therefore intends to reduce the budget deficit steadfastly over the next few years. The authorities stressed that a sustained expansion of the world economy would greatly assist their adjustment efforts.

1/ October 1983.

1. Fiscal policy

The automatic effects of the deepening recession and the shift to an expansionary fiscal policy in 1981 toward expansion led to a sharp rise in public expenditure and the public sector deficit since the late 1970s. Public sector spending 1/ in relation to GDP rose from 45 percent in 1978 to 53 percent in 1982, and the public sector accounts moved from rough balance to a deficit of more than 8 1/2 percent of GDP over the same period. Income transfers, partly as a result of higher unemployment, and interest payments on the rapidly rising public debt, rose sharply. Within the public sector, the growing deficit was entirely accounted for by the sharply higher central government deficit, which rose from 3 percent of GDP in 1978 to 11 percent in 1982.

To arrest this deterioration in public sector finances, fiscal policy was tightened in 1983. The growth of nominal expenditure was restrained through incomes policy. This was in addition to real expenditure cuts from earlier plans, amounting to about 3 percent of GDP (about 2 percent affecting 1983, and 1 percent 1984). As a net result, real public sector investment was reduced by 8 percent, the increase in public sector employment was halved, and the growth in transfer payments was slowed. On the revenue side, charges of public enterprises and contribution rates to the unemployment scheme by both employees and employers were raised, and a temporary wealth tax on pension funds, which previously had been exempted from taxation, was introduced. In addition, a special income tax cut conditional on pay restraint was proposed. Even so, the central government deficit was budgeted to rise to 13 1/2 percent of GDP.

In the event, the conditional income tax cut did not pass parliament, although the private sector's wage agreements in spring 1983 generally met the 4 percent guideline proposed by the Government. Moreover, largely due to revenue being higher than estimated, the central government budget deficit is now estimated at about 11 1/2 percent of GDP in 1983, while the public sector deficit is estimated to have declined to about 8 percent in 1983. This development resulted mainly from improved local government finances on account of higher local income taxes.

The Danish representatives pointed out that the improvement in the public sector deficit excluding interest payments was much more pronounced, as net interest payment rose from 2 percent of GDP in 1982 to an estimated 4 percent in 1983.

The original budget proposal for 1984 envisaged a further tightening of fiscal policy by reducing the central government budget deficit in absolute terms from 1983. It included discretionary measures of the order of DKr 10 billion (almost 2 percent of GDP) in addition to the delayed impact of the expenditure cuts in 1983. The Government found it difficult to obtain the additional restraint through cuts in expenditure,

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1/ Including net interest payments.

and a number of revenue measures were proposed. The central government deficit was budgeted to decline by DKr 2 billion to DKr 59 1/2 billion (close to 11 percent of GDP) in 1984, while the public sector deficit would decline by a similar amount to DKr 41 billion (less than 7 1/2 percent of GDP). Noninterest public expenditure was estimated to rise by about 3 percent in 1984. The main restraint would be on expenditure on goods and services (which would decline by 2 percent in real terms). Investment would continue to be scaled down, to some extent reflecting demographic factors, and consumption would also decline in real terms, due partly to cuts in grants from the central to local governments. Income transfers would continue to rise more strongly, partly because of higher unemployment and social pensions. Total revenue was budgeted to rise by 6 1/2 percent on account of higher contribution rates to unemployment and sickness benefits, and a strong rise in corporate income tax as a result of higher profits. The temporary wealth tax on insurance and pension capital was replaced by a permanent tax on real yields beginning in 1984; the tax rate will be set with the aim of securing real after-tax yields of 3 1/2 percent for tax-liable insurance and pension funds as a whole (the yields on some investment would remain exempted from tax). Regarding indirect taxation, it was decided not to adjust specific duties in 1984, which would remain at the October 1983 level.

Excluding net interest payments, the public sector deficit would decline from over 4 percent of GDP in 1983 to 2 1/2 percent in 1984, while net interest payments on the public debt would rise to 5 percent of GDP in 1984. Consequently, a growing part of the deficit would be accounted for by net interest payments. Thus, while the rise in the budget deficit in recent years may have in large part reflected cyclical factors, now a large and increasing part of the deficit is structural, highlighting the need for discretionary measures if the deficit is to be reduced in the medium term.

The minority Government was unable to gain full support for the proposed budget. In a political compromise reached in late October 1983 budgetary improvements of DKr 7 billion (out of the proposed DKr 10 billion) have been agreed to. In particular, the proposals of reducing sickness benefits for higher income groups, and higher contributions to unemployment benefits were not accepted, but contributions by employees and employers to a new fund for labor market training are to be introduced. The Danish representatives said that, in addition, the proposal to reduce purchases of goods and services by 2 percent in real terms (DKr 1.1 billion) was likely to be agreed to. They also pointed out that in some areas the revenue estimates had been based on rather cautious assumptions. Official estimates made in late November 1983 suggested that the central government budget deficit in 1984 would have been limited to DKr 58 billion (10 1/2 of GDP), if the remaining savings could be secured. 1/

1/ In the event, the remaining savings measures were not agreed to and certain political parties withdrew their support for the compromise when the proposed budget was put to a final vote on December 15, 1983.

As to the medium term, the Government intends to reduce the budget deficit year-by-year and to achieve approximate balance by the end of this decade, so as to create room for a durable recovery in private investment. The Danish representatives said that this objective could only be achieved with a firm economic policy in Denmark and reasonably strong economic growth internationally. On the revenue side, a reform of the income tax system to improve incentives by reducing progressivity was unlikely to contribute toward lowering the budget deficit. This suggested that the restraint would need to be concentrated on expenditure. Although the exact areas of restraint still have to be identified, spending on goods and services would be constrained and lower inflation would allow lower interest rates, which would restrain interest payments. More generally, an economic recovery would assist the adjustment effort.

2. Monetary policy

Until 1983 the general stance of monetary policy had been tight in view of the need to protect the balance of payments, and the growth of broad money had been kept below that of nominal GDP. However, in 1982 the objective of attracting private capital inflows was not met, despite a significant increase in interest rates, and unrest in the foreign exchange market led to large outflows of short-term capital on several occasions. Bond yields were raised to very high levels (in nominal as well as real terms), to attract large domestic nonbank bond financing of the rising government deficit. The guideline on the expansion of bank advances to the private sector (annual growth of 10 percent) was generally observed during 1982.

Following the new economic package in October 1982 and the wage settlements in spring 1983, the outlook for inflation improved, leading to a significant turnaround of market sentiment on interest rates. Moreover, the swing in the private sector balance of payments after the EMS realignment in March made an easing in monetary policy possible, aimed at stimulating private investment, principally through a reduction in interest rates. The discount rate was reduced in four steps from 11 percent in October 1982 to its present level of 7 percent, initiating a decline in the banks' interest rates on loans and deposits. Bond yields declined more sharply, from the unprecedented level in September 1982 (21 percent) to 13-14 percent in recent months, though with a lower rate of inflation real interest rates declined much less. The guideline on the expansion of bank advances to the private sector was gradually tightened to an annual growth of 8 percent during 1983, and to date they have remained within this guideline. However, broad money has expanded rapidly in 1983 (23 1/2 percent during the 12 months ending September 1983), as banks financed a large share of the budget deficit through purchases of bonds. Since this increase was far in excess of the rise in nominal GDP the economy became considerably more liquid.

In judging this development the Danish representatives pointed out that there had been a substantial decline in bond yields relative to bank deposit rates, and the decline had been even more pronounced on an after-tax basis. Thus, holding of bank deposits had become less expensive relative to bonds, causing a shift from bonds into bank deposits. At least in part this represented a normalization of liquidity preferences, and in comparison with abroad, the new interest rate structure was considered to be reasonable. The mission, however, stressed that the budget deficit had remained very high, and there was a continued need for large nonmonetary financing of the budget deficit. For this purpose the interest differential between long- and short-term assets may well need to rise again.

As to the implications of recent monetary developments for the final objectives of monetary policy, namely, stability in the foreign exchange market and domestic demand management, the Danish representatives said that at present the private sector capital account was in broad balance; should capital outflows occur the high level of reserves was considered to be sufficient to counter such tendencies. Moreover, the clear policy of holding the exchange rate stable and the improved economic situation now provided less impetus to speculative outflows. The present forecast pointed to weak domestic demand, and a further improvement in the external current account in 1984. A faster growth of domestic activity could be accommodated without triggering an acceleration in inflation, given the present level of unemployment and low capacity utilization. The mission, however, emphasized that there were already signs of a pickup in activity stronger than projected only recently. Too strong a rise in domestic demand would endanger the objective of reducing the current account deficit in 1984. The effect on wage drift could also not be ignored.

The Danish representatives said that should any adverse developments become evident the authorities would react quickly. For example, short-term interest rates could be raised to counter any capital outflows. The setting of limits on the borrowing facility at the Nationalbank for banks had recently been changed from a quarterly to a monthly basis, which added flexibility to monetary management. Long-term interest rates could also be raised, but the authorities hoped that confidence would strengthen after passage of the 1984 budget in parliament, so that increased sales of bonds to nonbanks could be resumed. Indeed, the authorities felt that a further decline in interest rates to a level closer to that in the low inflation countries was desirable in order to stimulate private investment further. They hoped that further improvements in the external current account and the rate of inflation would provide some scope for lowering interest rates in 1984.

3. External debt, exchange rate, and incomes policies

The succession of large external current account deficits since the mid-1970s has led to a sharp increase in the external debt of the economy. By the end of 1982 total net external debt (including short term) had risen to SDR 16 1/2 billion (32 percent of GDP). Despite the reduction in the external current account deficit in 1983 the debt burden is estimated to rise to about 34 percent of GDP by the end of this year, reflecting in particular the appreciation of the U.S. dollar, the currency in which a large portion of the debt has been contracted. In view of the large external debt, the authorities are determined to reduce the debt burden over time, and the objective is to eliminate the current account deficit over the next three to four years and then move into surplus.

The buildup of North Sea oil and gas production over the next few years will assist this adjustment. Net of imports related to the offshore projects and dividend payments to foreign investors, the oil and gas sector is estimated to contribute slightly more than 1 percent of GDP to the desired improvement in the external current account between 1983 and 1988. Staff estimates suggest that, with the present competitive position, and growth of demand in Denmark in line with that abroad, the external current account deficit would improve over the next few years, though not sufficiently to achieve the official external objective. For this, a slower growth of demand in Denmark relative to abroad would be required (Table 1 and Chart 1). The Danish representatives were in general agreement with this conclusion, though they noted that the possibilities for fine tuning of domestic demand in the short run were limited. In either scenario the ratio of net external debt to GDP would decline over the next few years. Reflecting the amortization schedule, net debt service in relation to exports of goods and nonfactor services would fall, from about 23 percent in 1983 to less than 20 percent in 1986, but rise again slightly thereafter. It has, of course, to be borne in mind that the debt projections are very sensitive to the underlying assumptions; they should serve as no more than an illustration of possible trends.

International cost competitiveness, as measured by relative unit labor costs, has improved significantly over the past few years. Staff estimates suggest that by mid-1983 relative normalized unit labor costs, adjusted for exchange rate changes, were 20 percent lower than in early 1979. The main factor behind this improvement was several devaluations of the krone at times of general realignments within the EMS as well as movements against currencies outside the EMS. The nominal effective exchange rate of the krone depreciated by almost 23 percent over the same period. That gains in competitiveness flowing from the effective depreciation were maintained to such a large extent was due to less-than-complete wage indexation and its suspension from early 1983, and a relatively strong productivity performance, which was related, at least in part, to the disappearance of the least efficient firms.

The cost competitive position of Danish industry appeared to be fairly strong. However, as relative wage cost developments had not always shown a very close relationship with developments in export market shares, the Danish representatives tended to look directly at developments in market shares. Danish exporters have been able to gain market shares in recent years (an estimated 10 percent in manufacturing between 1979 and 1982), while the rise in import penetration appeared to have been halted. Import penetration for industrial products stood at close to 50 percent in 1981-82, only slightly higher than four years earlier. All in all, the Danish representatives judged the development of competitiveness in the recent past as satisfactory, despite the large Swedish devaluation in October 1982, and the low rate of increases in labor costs in Germany. Even so, they felt that some further improvement in competitiveness over the medium term would be required to achieve their external objectives. The Government is determined to achieve such an improvement through cost restraint, since a devaluation would undermine the prospects for moderation in wage and price increases. The Danish representatives said that the exchange rate policy seemed to enjoy widespread support, including support in industry. The objective is to keep the ECU rate of the krone stable, though movements in the effective exchange rate would also be taken into account.

It was clear that the aim of achieving external adjustment through domestic restraint required continued pay moderation and firm demand management. The Danish representatives stressed that under existing agreements wage developments were already largely determined until the spring of 1985. With underlying productivity increases of the order of 3 to 4 percent per annum, cost competitiveness would at least not deteriorate or could even improve slightly in 1984. The wage guidelines for the 1983 negotiations had been fixed at a rather late stage, in October 1982, and it was an open question whether any guidelines for the post-spring 1985 period should be announced sooner in order to affect negotiations. These matters were highly political and had not as yet been discussed. Of relevance in this context was the timing of the eventual legislation permanently abolishing wage indexation. It was recognized that any pay policy needed to be backed by adequately firm demand management. In this respect, the mission stressed the importance of continued fiscal adjustment, and of the need to reduce the recent rapid growth of monetary aggregates.

4. Policies on trade, industrial subsidies, and aid

The Danish authorities are firm adherents to a liberal policy for trade in goods and services as the best instrument for achieving structural adjustment and economic growth. They have, therefore, consistently sought to combat protectionist pressures within the EC and to minimize reliance upon voluntary restraints or other forms of trade barriers. Protectionist pressures within Denmark have been minimal and they have been countered. Selective industrial support measures are much less of a feature of the Danish economy than in many others, though the shipbuilding sector and certain other export sectors have been the beneficiaries of loans at below-market interest rates; in recent months, the subsidy element of such loans has been markedly reduced. Export credit facilities for ships and other exports follow the OECD Understanding on Export Credits for Ships and Consensus arrangements.

The Danish trading system has remained open and liberal, with the principal exceptions being trade in agricultural products and textiles, within the obligations of membership of the EC. The Multifiber Arrangements to which the EC is a party govern trade in textiles and clothing; in addition, administrative arrangements affect trade with various Mediterranean countries in these items. Thus, 30-35 percent of total Danish imports of textiles and clothing is subject to the above regimes. Through the EC, Denmark participates in the GSP with special advantages being extended to the least developed countries; Denmark has consistently supported further liberalization of the GSP. LDCs account for about 10 percent of Danish imports. Denmark remains a highly open economy for the import of services and, in general, Danish exporters of services have encountered few problems in foreign markets.

Denmark's official development assistance has remained above the UN target, amounting to 0.73 percent of GNP in 1983 and is projected to be 0.74 percent in 1984 and remain at that level for the next four years. Aid is concentrated at the low income LDCs and is divided equally between bilateral and multilateral forms. In the future assistance to the least developed countries will be exclusively in the form of grants.

V. Staff Appraisal

Faced with a worsening economic situation, as evidenced by increasing deficits on the external current account and the central government budget, rising wage inflation, and high unemployment, the new Government introduced a set of stabilization measures in October 1982. Inflation was to be tackled directly through a firm incomes policy, and stability in the exchange rate and initial steps of fiscal restraint were taken in order to break the trend of a sharply rising budget deficit. The main aim was to promote a gradual reallocation of resources toward the tradable sector so as to attain external balance and a higher level of employment. The impact of the stabilization measures in 1983 has been marked. A pronounced moderation in wage costs has led to a halving of the rate of inflation during the year. This, plus more favorable external factors, and the lagged effects of improved competitiveness over the last three years, led to a significant reduction in the external current account deficit. Confidence has strengthened, business investment has started to recover, and private sector employment appears to have stabilized.

The authorities recognize these are only the first steps and there is need for continued adjustment. The net external debt, equivalent to about one third of GDP, has risen to a level that calls for a further improvement in the external current account, and the official aim is to eliminate the current account deficit over the next three to four years and then move into surplus. The authorities intend to achieve this adjustment through management of domestic demand and continued pay moderation rather than through an active use of the exchange rate. The buildup of oil and gas production will help, but some further improvement in competitiveness is judged necessary to achieve the external objective at a more satisfactory level of employment. The authorities agree that continued improvement in the external accounts will also require domestic demand in Denmark to rise by less than that abroad.

The implications for policy seem to be clear. With a broadly stable exchange rate the desired improvement in competitiveness requires that cost inflation in Denmark be lower than in Denmark's trading partners.

Thus, continued pay restraint will be vital, but the authorities expect that relatively strong productivity growth will assist in this respect. They also recognize that rising private investment will require a reduction in government dissavings, and the Government intends to reduce the budget deficit steadfastly over the next few years. The speedier the reduction, the lower real interest rates can be and will need to be, and the greater will be the consequent boost to private investment. The exchange rate and inflation objectives also constrain monetary policy, as an undue decline in interest rates would sooner or later put pressure on the exchange market.

The budget proposal for 1984 represents a further step in the direction of fiscal correction. For the first time in many years the central government deficit has been budgeted to decline from the estimated outturn in the preceding year, which is itself below the original estimate. Even so, at about to 10 1/2 percent of GDP, the deficit remains very high. On the spending side, the restraint is concentrated on noninterest expenditure on goods and services, while income transfers will continue to rise in real terms (partly because of rising unemployment). On the revenue side the overall tax burden is to be largely unchanged though fees and contributions will be raised, while specific duties will fall in real terms. As to additional savings measures, even in the original budget proposal the Government found it difficult to concentrate on expenditure restraint, and in the political compromise reached in late October, the emphasis shifted towards revenue-raising measures, including one that adds to labor costs. In the staff's view, it would have been desirable to have placed the additional restraint on expenditure.

The political agreement reached in late October will not, on present estimates, be sufficient to achieve the objective of a nominal decline in the central government deficit in 1984. The staff stresses the importance of finding additional measures to meet the budget objective, not least for reasons of confidence. It will also be vital for this purpose to adhere closely to the overall spending plans, and to reduce the deficit further should economic growth in 1984 be stronger than presently foreseen.

Looking beyond 1984, the staff strongly supports the objective of reducing the budget deficit year-by-year. Although the exact areas of restraint have not yet been identified, the Government's long-term objectives on tax reform, aimed at improving incentives, suggest that the restraint needs to be concentrated on the expenditure side. This would, indeed, be appropriate as public spending in terms of GDP in Denmark, now at about 54 percent, is amongst the highest in the OECD countries.

The swing in the private sector balance of payments allowed monetary policy to be eased in 1983, with the aim of stimulating private investment. In the process of easing, bond yields have fallen in relation to bank deposit rates, and the decline has been even more pronounced on an after-tax basis. This has led to a shift in public preferences away from bonds toward bank deposits, and as banks have financed a large part of the budget deficit through bond purchases, the growth of broad money has risen strongly. As a result, the economy has become more liquid. While it is difficult to judge at this time the extent to which this development represents a normalization of liquidity preferences, clearly there are risks that, if continued, the rapid monetary expansion could threaten the external current account objective and the overall balance of payments. While expectations in financial markets may stabilize, some steepening of the yield curve in the relevant segments could be required to stimulate bond sales outside the banking system.

A further dampening in domestic cost increases will be vital to achieve continued external adjustment and a low rate of inflation. The competitive position of industry has strengthened significantly since 1979 and has led to gains in export market shares, but some further improvement is judged by the authorities to be required in the medium term for the satisfaction of the external objectives. The moderation in pay settlements this year and that projected for 1984 is encouraging but it will be crucial to strengthen wage restraint beyond the spring of 1985. In this regard, strong guidance on public sector pay (without clauses on differentials), and abolition of wage indexation will be important. An advance announcement of pay policy for that period could be helpful in building the consensus required as well as influencing expectations favorably in the labor and financial markets. A firm stance on demand management would also assist in limiting wage drift and would enable the authorities to approach the 1985 wage round with a rate of inflation not dissimilar to that of Denmark's main trading partners.

In summary, the staff finds it encouraging to note the process that has begun in correcting the imbalances besetting the economy and, in common with the authorities, supports the objective of extending the adjustment steadfastly over the next few years. The major challenge over both the short-term and in a medium-term perspective, which will involve difficult political decisions, is undoubtedly posed by the state of public finances; it will be crucial to progressively tighten the fiscal stance in the next few years. The policy of a firm exchange rate for the krone together with the sought-for external adjustment will require continued wage moderation. A continuation of recent rates of monetary expansion would sooner or later call the present exchange rate policy into question.

The recent liberalization of capital controls--in both directions--promotes market efficiency and better integration with international capital markets. The staff commends Denmark's general adherence to the principles of free trade within the obligations of the EC. Selective support to industrial and other export sectors is less of a feature in Denmark's economy than in many other countries, and while the special financial schemes have continued to expand, the subsidy element has declined. It is also notable that Denmark's aid to less developed countries is expected to continue to exceed the United Nations' target.

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

of the budget deficit through bond purchases, the growth of broad money has risen strongly. As a result, the economy has become more liquid. While it is difficult to judge at this time the extent to which this development represents a normalization of liquidity preferences, clearly there are risks that, if continued, the rapid monetary expansion could threaten the external current account objective and the overall balance of payments. While expectations in financial markets may stabilize, some steepening of the yield curve in the relevant segments could be required to stimulate bond sales outside the banking system.

A further dampening in domestic cost increases will be vital to achieve continued external adjustment and a low rate of inflation. The competitive position of industry has strengthened significantly since 1979 and has led to gains in export market shares, but some further improvement is judged by the authorities to be required in the medium term for the satisfaction of the external objectives. The moderation in pay settlements this year and that projected for 1984 is encouraging but it will be crucial to strengthen wage restraint beyond the spring of 1985. In this regard, strong guidance on public sector pay (without clauses on differentials), and abolition of wage indexation will be important. An advance announcement of pay policy for that period could be helpful in building the consensus required as well as influencing expectations favorably in the labor and financial markets. A firm stance on demand management would also assist in limiting wage drift and would enable the authorities to approach the 1985 wage round with a rate of inflation not dissimilar to that of Denmark's main trading partners.

In summary, the staff finds it encouraging to note the process that has begun in correcting the imbalances besetting the economy and, in common with the authorities, supports the objective of extending the adjustment steadfastly over the next few years. The major challenge over both the short-term and in a medium-term perspective, which will involve difficult political decisions, is undoubtedly posed by the state of public finances; it will be crucial to progressively tighten the fiscal stance in the next few years. The policy of a firm exchange rate for the krone together with the sought-for external adjustment will require continued wage moderation. A continuation of recent rates of monetary expansion would sooner or later call the present exchange rate policy into question.

The recent liberalization of capital controls--in both directions--promotes market efficiency and better integration with international capital markets. The staff commends Denmark's general adherence to the principles of free trade within the obligations of the EC. Selective support to industrial and other export sectors is less of a feature in Denmark's economy than in many other countries, and while the special financial schemes have continued to expand, the subsidy element has declined. It is also notable that Denmark's aid to less developed countries is expected to continue to exceed the United Nations' target.

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

Denmark. Table 1. Illustrative Medium-Term Debt Projections 1/

	1982	1983	1984	1985	1986	1987	1988
Current account (in percent of GDP)	-4.0	-2.1	-1.5	-1.3	-1.1	-1.0	-0.8
Total external debt, net 2/ (in percent of GDP)	32.2	34.0	33.4	32.3	30.7	29.2	27.7
Debt service ratio, net 3/	21.4	23.4	23.2	21.4	19.3	20.2	20.7

Source: Staff estimates.

1/ Corresponding to moderate demand management in Denmark, Case B (see note below). Developments under Case A (slower growth of domestic demand) and Case C (faster growth of domestic demand) are illustrated in Chart 1.
2/ Net medium- and long-term debt (excluding equity capital) and net short-term debt (including official reserves).
3/ Net interest payments plus amortization on medium- and long-term debt minus amortization received on medium- and long-term assets, in percent of exports of goods and nonfactor services.

Note: The illustrative medium-term debt projections have been based on the following main assumptions: For 1983 and 1984, they are consistent with the latest official projections. For 1985-88, output of other industrial countries is assumed to grow at 3 percent and their GDP deflator at 5.5 percent per annum. The real price of oil is assumed unchanged during 1985-88. Three scenarios are postulated for domestic demand; (A) domestic demand is held back to rise by 1 percentage point less than in other industrial countries, i.e., 2 percent; (B) domestic demand is assumed to rise at the same rate as in other industrial countries, i.e., 3 percent; and (C) domestic demand is assumed to rise by 1 percentage point faster, i.e., 4 percent. The relative competitive position of the economy is assumed unchanged from its current position. Interest rates are assumed to decline gradually from their current levels to be positive in real terms by 2 percent on short-term debt and by 4 percent on long-term debt after 1984.

The effects of oil and gas production in the North Sea on the current account balance are explicitly taken into account. The net effect comprises savings on net oil/gas imports as well as additional imports related to the offshore projects and dividend payments to foreign investors. From a negative contribution equivalent to 0.3 percent of GDP in 1983 (reflecting the buildup of investment in the North Sea), the net impact is projected to rise to a positive one of 1.0 percent of GDP in 1988.

The simulations are quite sensitive to the underlying assumptions, of which relative growth rates and interest rate developments are of particular significance. The effects of different growth of demand in Denmark as compared to that abroad are illustrated in Chart 1. Interest rates 1 percentage point higher than assumed during 1985-88 would raise both the net debt service ratio and the ratio of net external debt to GDP by about 1 percentage point in 1988.

Fund Relations with Denmark

(As of November 30, 1983)

Date of membership:	March 30, 1946
Status:	Article VIII
Quota:	SDR 465 million (Denmark has consented to the increase in its quota under the Eighth General Review to SDR 711 million).
Fund holdings of Danish kroner:	SDR 322 million or 69.1 percent of quota. Denmark has not made any purchases from the Fund since 1957. Denmark contributed a total of SDR 2.2 million to the oil facility subsidy account and has agreed to contribute SDR 1.5 million to the supplementary financing facility subsidy account.
Denmark's holdings of SDRs:	SDR 180 million or 100.7 percent of net cumulative allocation.
Gold distribution:	222,516 fine troy ounces (four sales).
Last consultation:	Article IV consultation discussions were held October 12-22, 1982. The staff report (SM/82/229) was considered by the Executive Board at EBM/83/10 (1/12/83).
Exchange system:	Denmark has participated in the exchange arrangements established under the European Monetary System from March 13, 1979. Under this system each country maintains the exchange rate of its currency in relation to currencies of other participating countries within margins of 2.25 percent (in the case of Italian lira, 6 percent) of cross rates derived from central rates expressed in ECUs.

Denmark: Basic Data

Area and population		Population	Area in square kilometers
Denmark	) January 1, 1983	5,116,000	43,070
Greenland	)	51,903	2,200,000
Faroe Islands (1982)		44,083	1,400

GDP (at market prices) in 1982: DKr 470 billion (current prices); per capita SDR 9,981

	1980	1981	1982	1983 1/	1984 1/
Demand and supply (volume changes in percent)					
Private consumption	-3.2	-1.5	1.8	1.0	--
Public consumption	4.3	2.3	4.1	1.3	-1.5
Gross fixed investment	-11.6	-16.7	6.0	2.0	1.0
Housing	-16.9	-25.8	-13.0	5.0	12.0
General Government	-13.6	-18.3	-10.1	-12.0	-9.0
Business sector	-8.1	-11.8	18.5	4.5	-0.5
Of which:					
Business investment (excluding oil sector, public enterprises, ships)	...	-25.0	-3.0	6.5	10.0
Change in stocks 2/	-0.8	-0.1	0.6	-0.6 3/	0.6 3/
Total domestic demand	-3.9	-3.5	3.8	0.4 3/	0.6 3/
Exports of goods and services	6.0	6.4	2.3	4.5	2.0
Imports of goods and services	-4.8	-1.8	2.8	0.5	-0.5
Gross domestic product	-0.4	-0.7	3.6	2.0	1.5
Labor market (in thousands)					
Employment (national accounts basis)	2,427	2,392	2,394	2,393	2,399
Registered unemployment rate (in percent)	7.0	9.2	10.0	10.5	11.5
Prices and incomes (annual percentage change)					
Consumer prices	12.3	11.7	10.1 4/	7.1 4/	5.3
Wage and salary bill	9.8	8.1	11.5	8.3	...
Real disposable wage income 5/	-4.7	-4.3	-0.8	-2.3	-1.1

1/ Official estimates and forecasts unless otherwise stated.
2/ Changes as a percentage of previous year's GDP.
3/ Staff estimates.
4/ Average of January-October 1983 compared to that of the corresponding period in 1982.
5/ Average blue-collar worker in the private sector.

Basic Data (cont'd.)	1980	1981	1982	1983 1/	1984 1/
Public finance (in percent of GDP)					
Public sector revenue	46.0	45.1	44.2	45.9	46.0
Public sector expenditure	49.0	51.9	52.9	54.2	53.4
Public sector financial balance	-3.0	-6.7	-8.7	-8.2	-7.4
Central government budget (in billions of Danish kroner)					
Deficit 2/	20.2	37.3	53.0	59.6 3/	58.2 3/
(in percent of GDP)	(5.4)	(9.0)	(11.2)	(11.6)	(10.6)
Net financing requirement	30.3	41.3	52.6	57.5	55.7
Debt repayment	18.8	24.1	29.3	57.5	60.0
Gross financing requirement	49.1	65.4	81.9	115.0	115.7
Interest rates (end-of-period)					
Official discount rate	11.0	11.0	10.0	7.0 4/	...
Bank overdraft rate	17.2	18.3	17.6	13.8 5/	...
Average bond yield	18.6	19.4	19.4	13.6 4/	...
		(Oct. 1982-Sept. 1983)			
Factors affecting broad money (change over 12-month period, in percent of broad money outstanding at end of the previous period)					
Domestic credit	15.5	18.3	25.5	29.2	...
Of which:					
Central Government	10.5	13.5	16.0	19.6	...
Private sector (including local government)	7.1	5.5	10.8	12.3	...
Foreign factors	-7.4	-8.7	-13.7	-5.5	
Broad money	8.1	9.6	11.8	23.6	...

1/ Official forecast as of October 1983.
2/ Deficit on current, investment, and lending account.
3/ November estimates.
4/ October 1983.
5/ September 1983.

Basic Data (cont'd.)	1980	1981	1982	1983	1984
Balance of payments (in billions of SDRs)					
Exports, f.o.b.	13.1	13.7	14.2	...	...
Imports, f.o.b.	-14.7	-14.5	-14.9	...	...
Trade balance	-1.6	-0.8	-0.7	-0.3	...
Net services and transfers	-0.2	-0.7	-1.3	-0.8	...
Current balance	-1.8	-1.5	-2.0	-1.1	-0.8
Official borrowing, net	1.3	1.0	2.6	...	...
Private capital including errors and omissions	0.3	-0.2	-0.7	...	...
Capital balance	1.6	0.8	1.9	...	...
Current deficit in percent of GDP	3.6	3.0	4.0	2.0	1.5
Competitiveness indicators (annual percentage change for manufactures)					
Relative unit labor costs	-8.3	-11.4	-2.7	1.6 2/	...
Relative export unit value	-3.7	-2.7	-1.7	3.0 2/	...
Volume of exports	10.4	5.6	1.9	5.3	5.3
Market shares	4.6	3.6	-1.0	3.8	...
Terms of trade (all goods excluding ships and aircraft)	-8.3	-3.0	-1.0	1.5	...
Net external debt (end-of-period; in billions of Danish kroner)					
Public sector, net	61.0	78.0	109.0	...	...
Private sector, net	64.5	69.5	68.8	...	...
Asets	35.0	39.5	44.0	...	...
Liabilities	99.5	109.0	112.8 3/	...	...
Of which:					
Short-term liabilities	24.5	34.5	36.5	...	...
Net foreign assets of the banking system (-)	-25.5	-23.5	-25.0	...	...
Net external debt	100.0	124.0	152.8	...	...
(in billions of SDRs)	(13.0)	(14.5)	(16.5)	(...)	...

1/ Staff estimates based on official projections.
2/ First half of 1983 compared with the first half of 1982.
3/ Excluding equity capital.

Basic Data (cont'd.)	1980	1981	1982	1983	1984
Debt service ratio, net (in percent of exports of goods and nonfactor services)	12.7	15.0	21.4	23.4 1/	
Foreign reserves (end of period; in billions of Danish kroner)				(Oct.)	
Gross official reserves 2/	25.9	23.5	25.0	40.8	
Official liabilities	-0.5	-0.3	-0.7	-0.3	
Gross official reserves, in millions of SDRs 3/	2.7	2.2	2.1	3.8	
				(Jan.-Oct.)	
Exchange rate					
Danish kroner per SDR: period average	7.34	8.34	9.20	9.67	
Danish kroner per SDR: end of period	7.67	8.53	9.25	10.04	
Changes in MERM effective rate: period average	-7.0	-10.0	-5.4	-1.3 4/	
Change in MERM effective rate: end-of-period	-4.6	-7.2	-4.0	-6.7 5/	

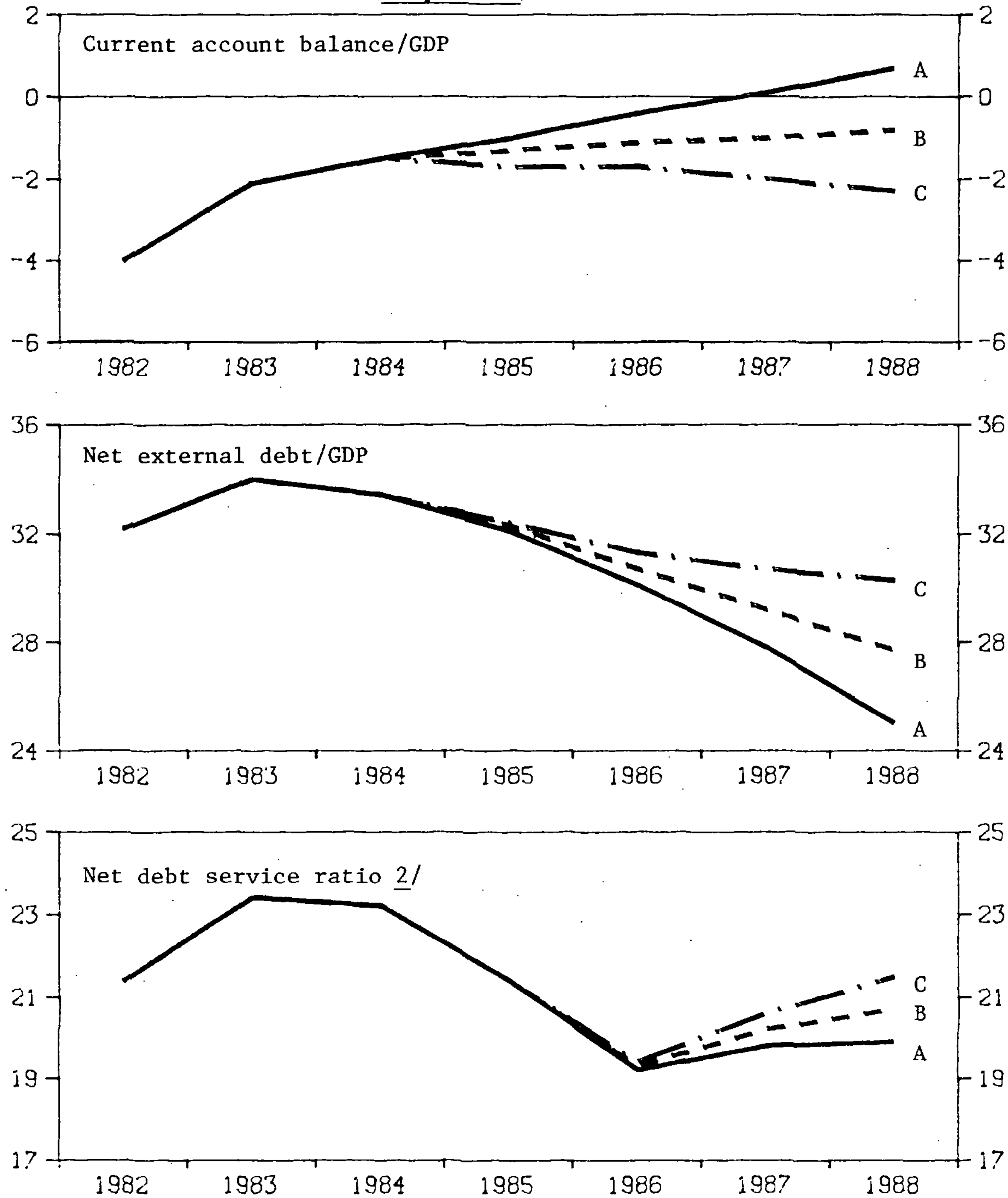
1/ Staff estimates.
2/ Gold at national valuation.
3/ Gold at SDR 35 per ounce.
4/ Average during January-October 1983 over the 1982 average.
5/ During the first 11 months of 1983.

CHART 1

DENMARK

Illustrative Debt Projections 1/

(In percent)



Source: Staff estimates.

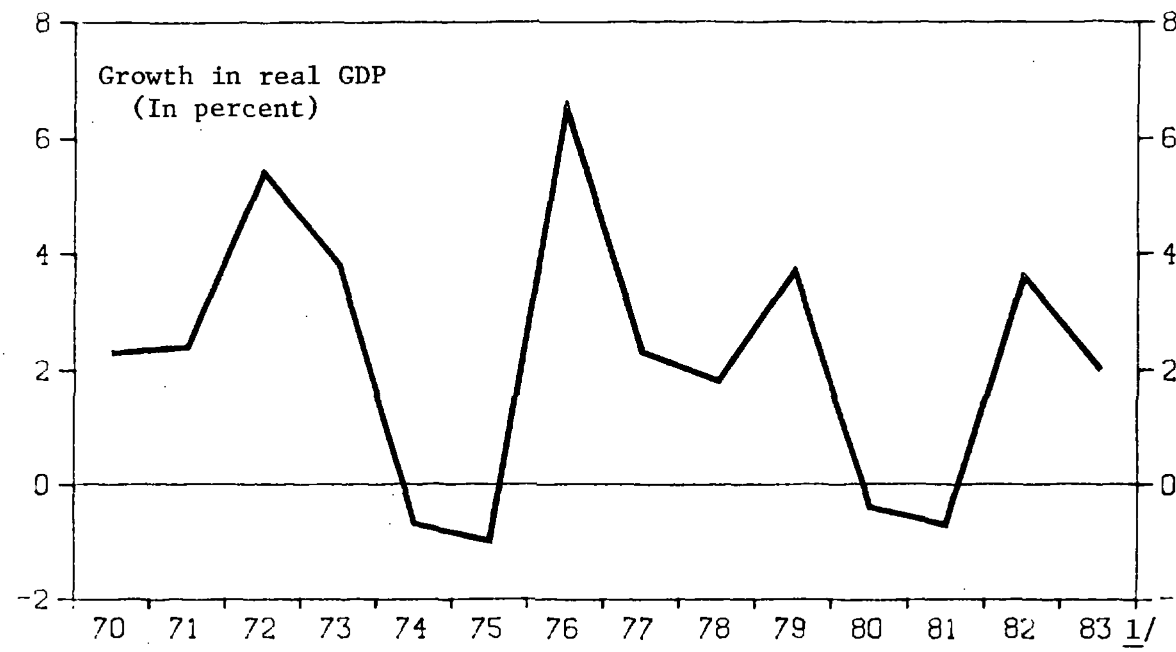
1/ A - Growth of domestic demand at 2 percent per annum during 1985-88.
B - Growth of domestic demand at 3 percent per annum during 1985-88.
C - Growth of domestic demand at 4 percent per annum during 1985-88.
Further explanations are contained in Table 1.

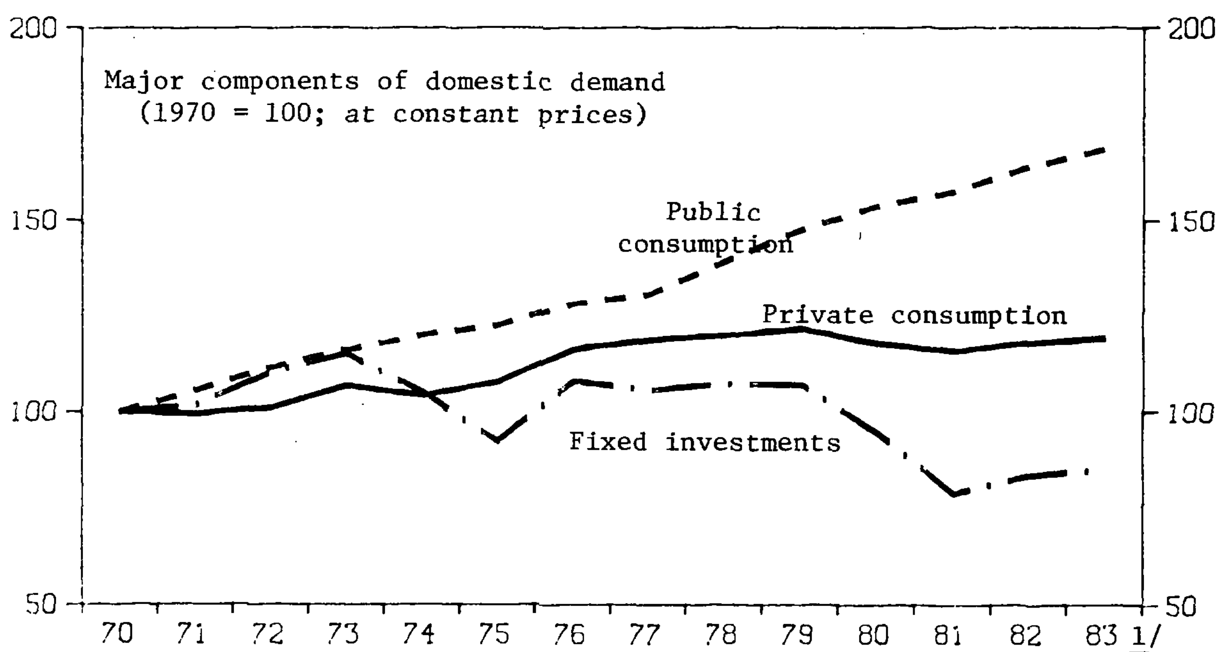
2/ In percent of exports of goods and nonfactor services.

CHART 2

DENMARK

OUTPUT AND MAJOR COMPONENTS OF DOMESTIC DEMAND





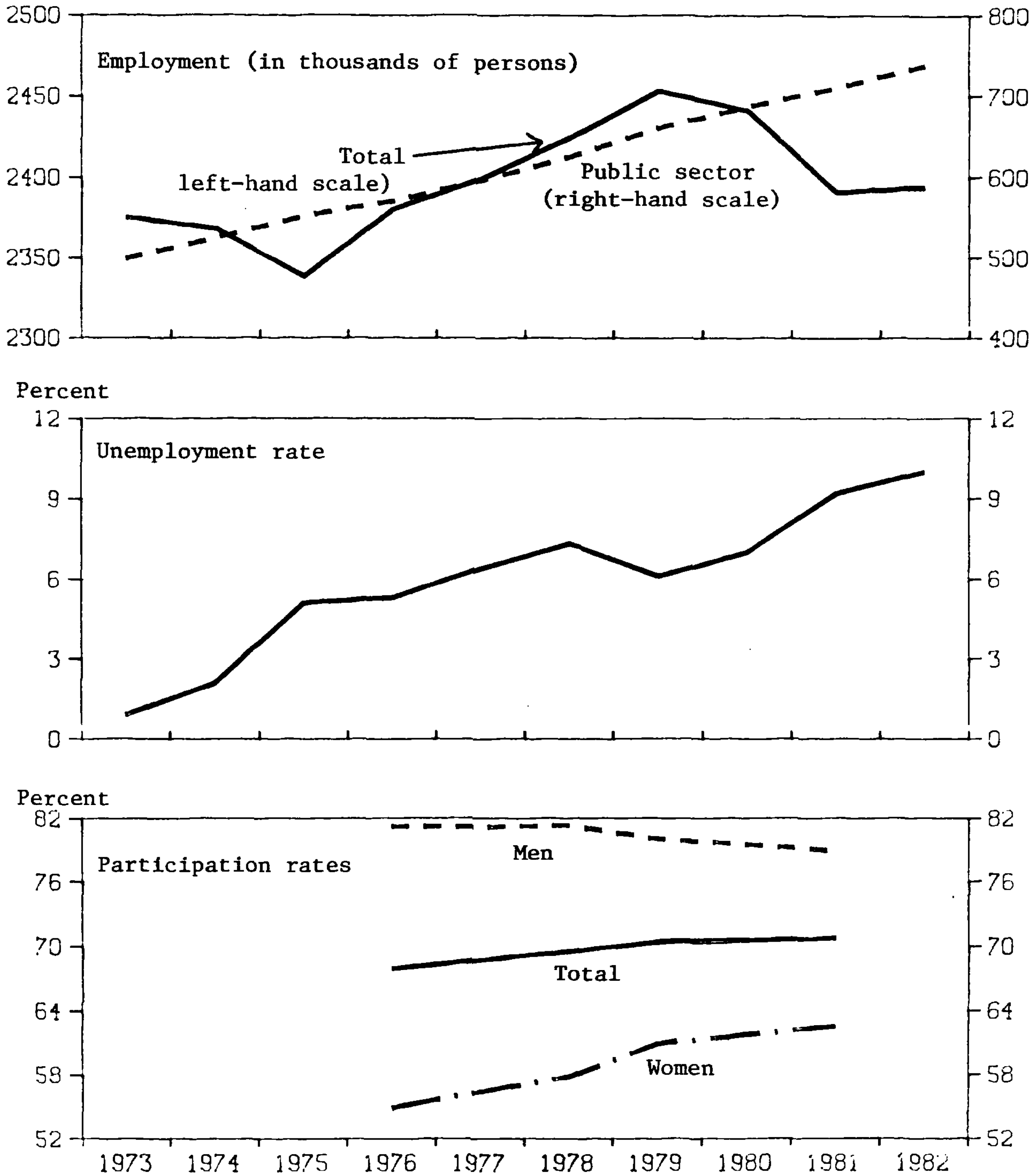
Source: Data provided by the Danish authorities.

1/ Estimates of October 1983.

CHART 3

DENMARK

MAJOR INDICATORS OF LABOR MARKET



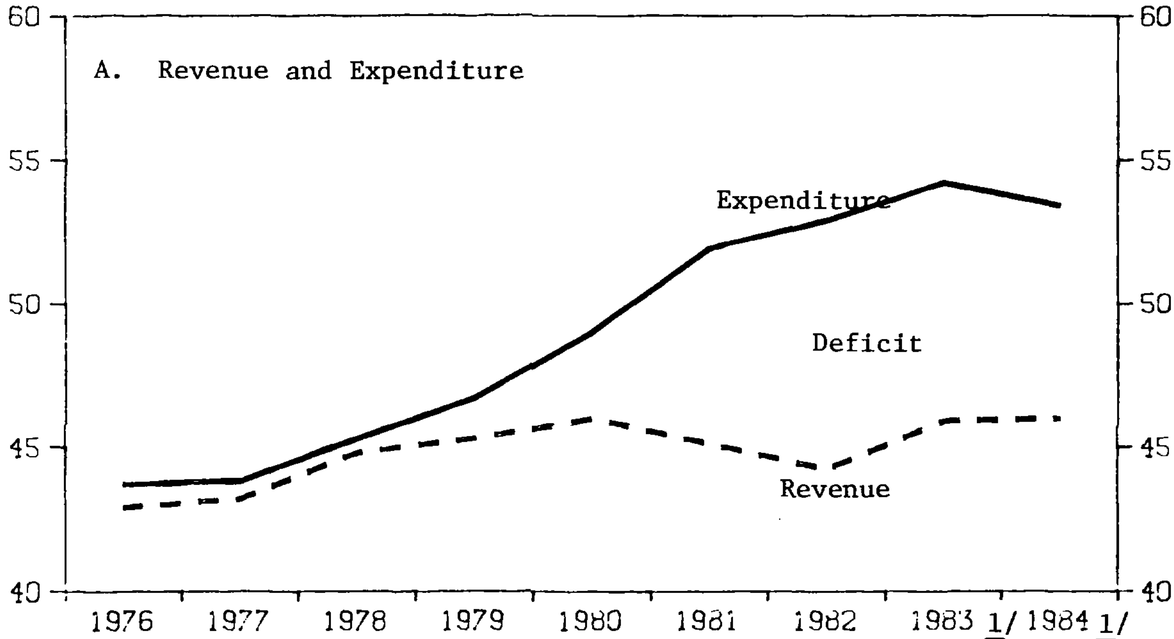
Source: Danmarks Statistik, Statistisk Tiårsoversigt, 1983.

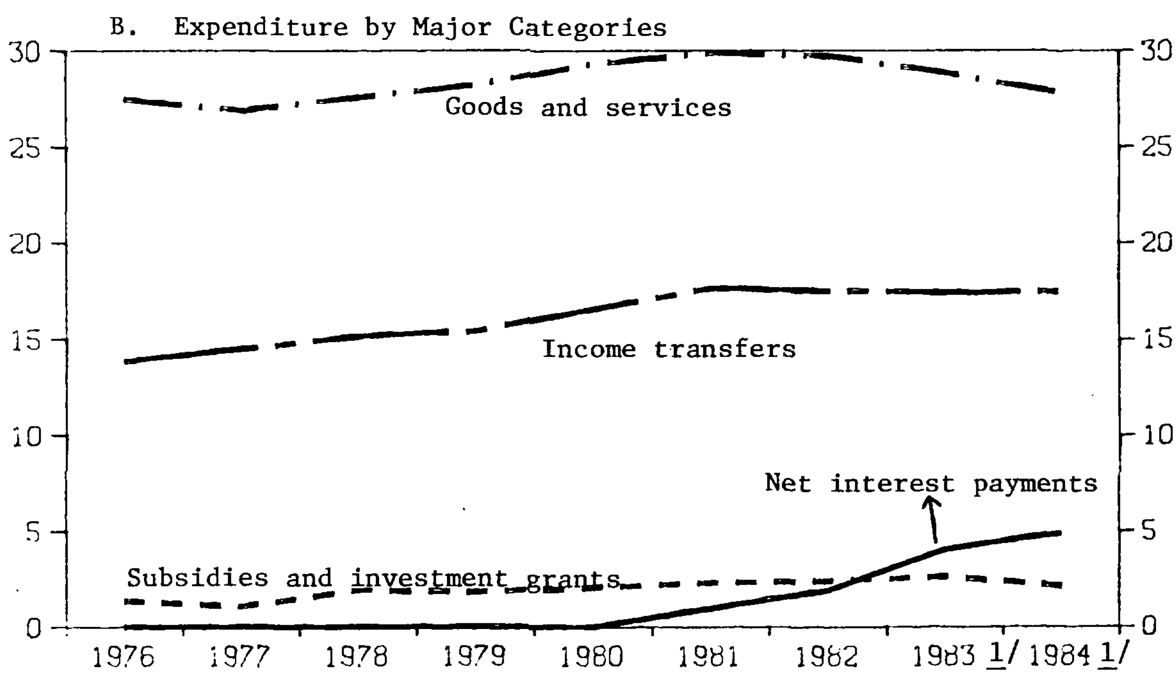
CHART 4

DENMARK

PUBLIC SECTOR BUDGET

(In percent of GDP)





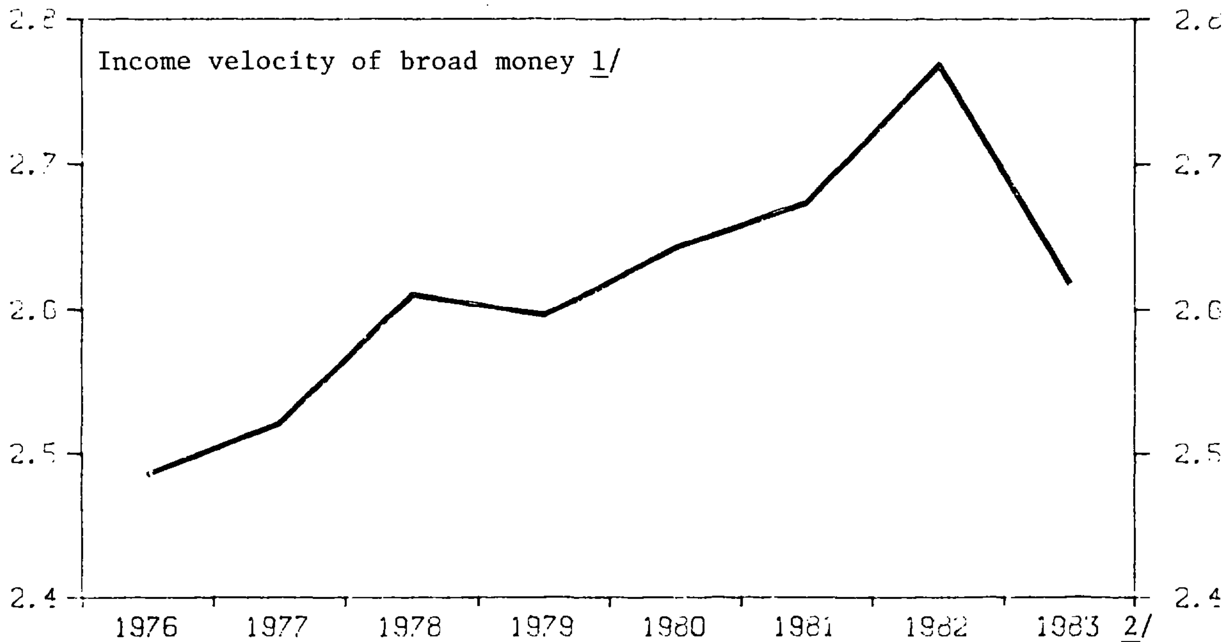
Source: Data provided by the Danish authorities.

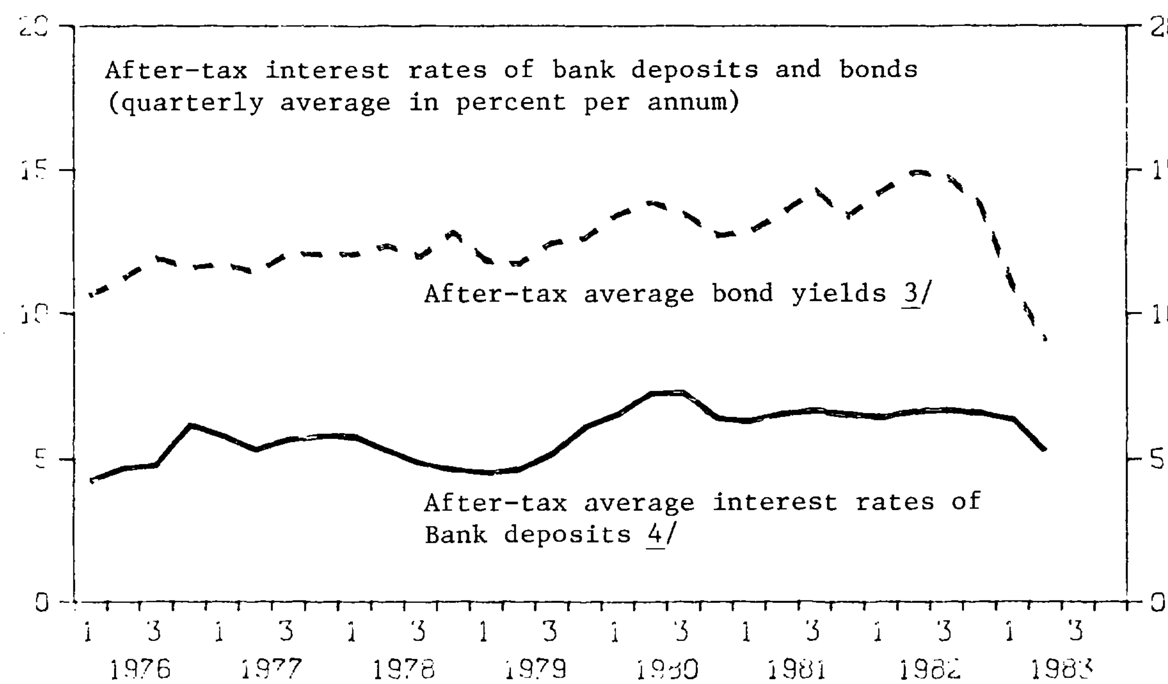
1/ Official estimates as of October 1983.

CHART 5

DENMARK

INCOME VELOCITY OF BROAD MONEY, AND AFTER-TAX
INTEREST RATES OF BANK DEPOSITS AND BONDS





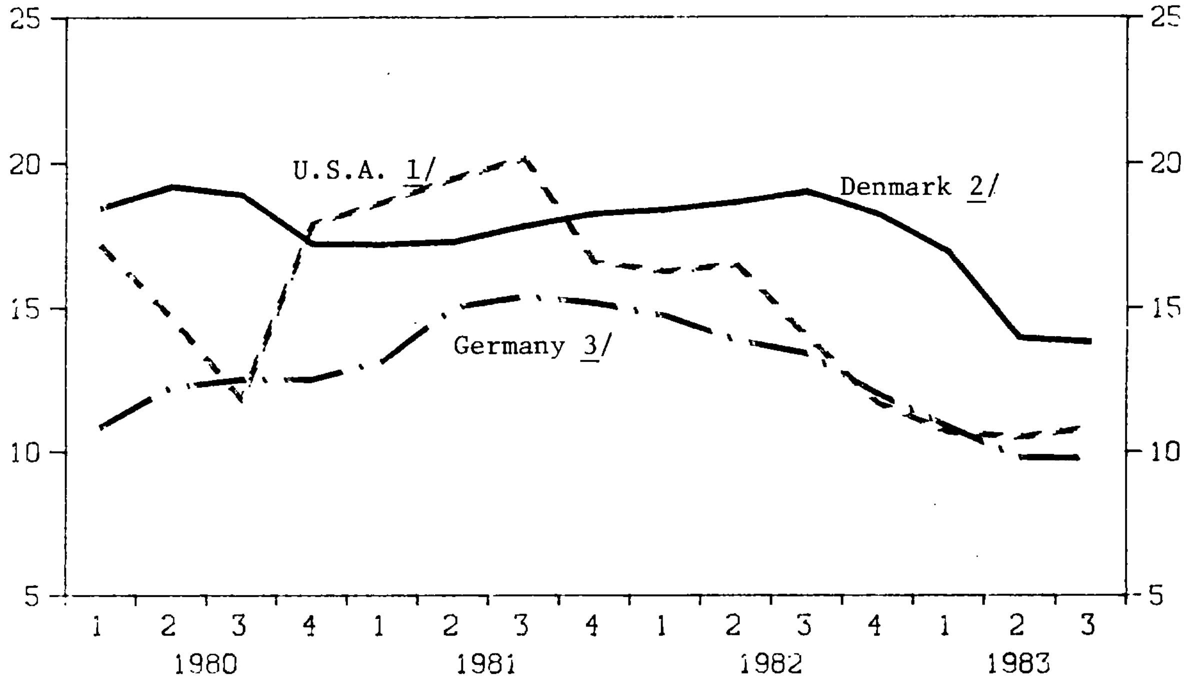
Source: Data provided by the Danish authorities.
1/ GDP at current market prices divided by monthly average of broad money.
2/ Based on the estimated GDP at current market prices in 1983 and the monthly average of broad money during the first nine months of 1983.
3/ Average bond yields after 40 percent tax.
4/ Quarterly interest payments of commercial and savings banks after 40 percent tax, divided by average daily outstanding amounts of bank deposits (excluding tax-privileged time deposits) during the quarter.

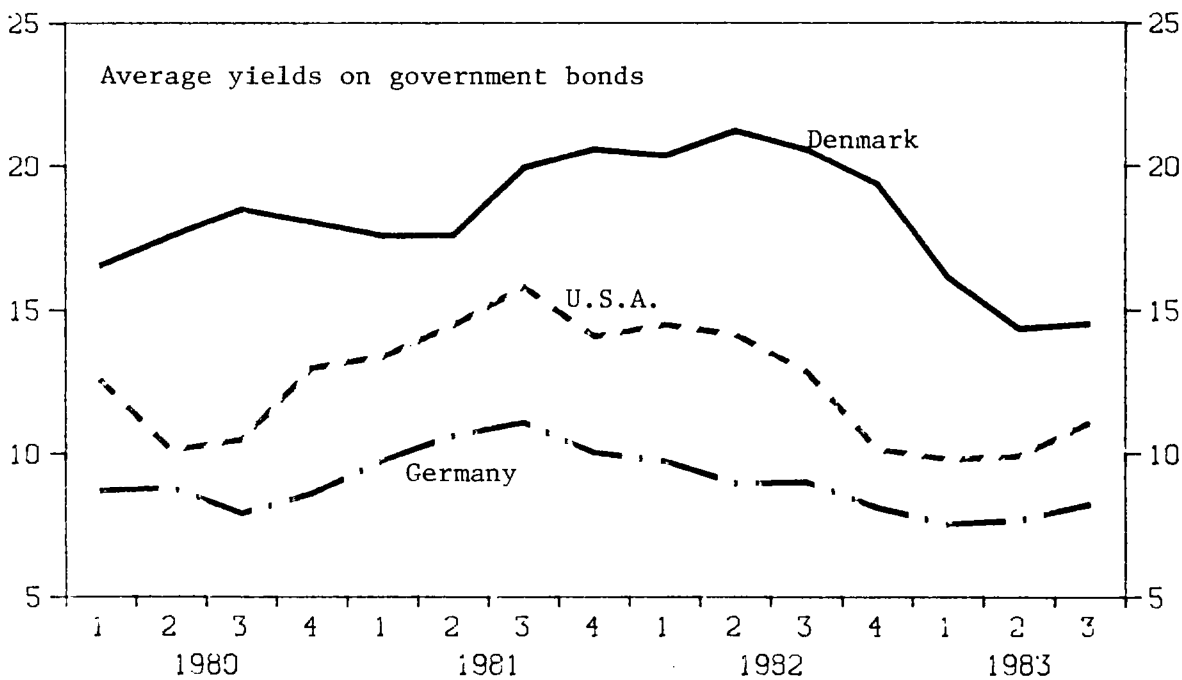
CHART 6

DENMARK

DOMESTIC AND FOREIGN INTEREST RATES

(Quarterly average in percent)





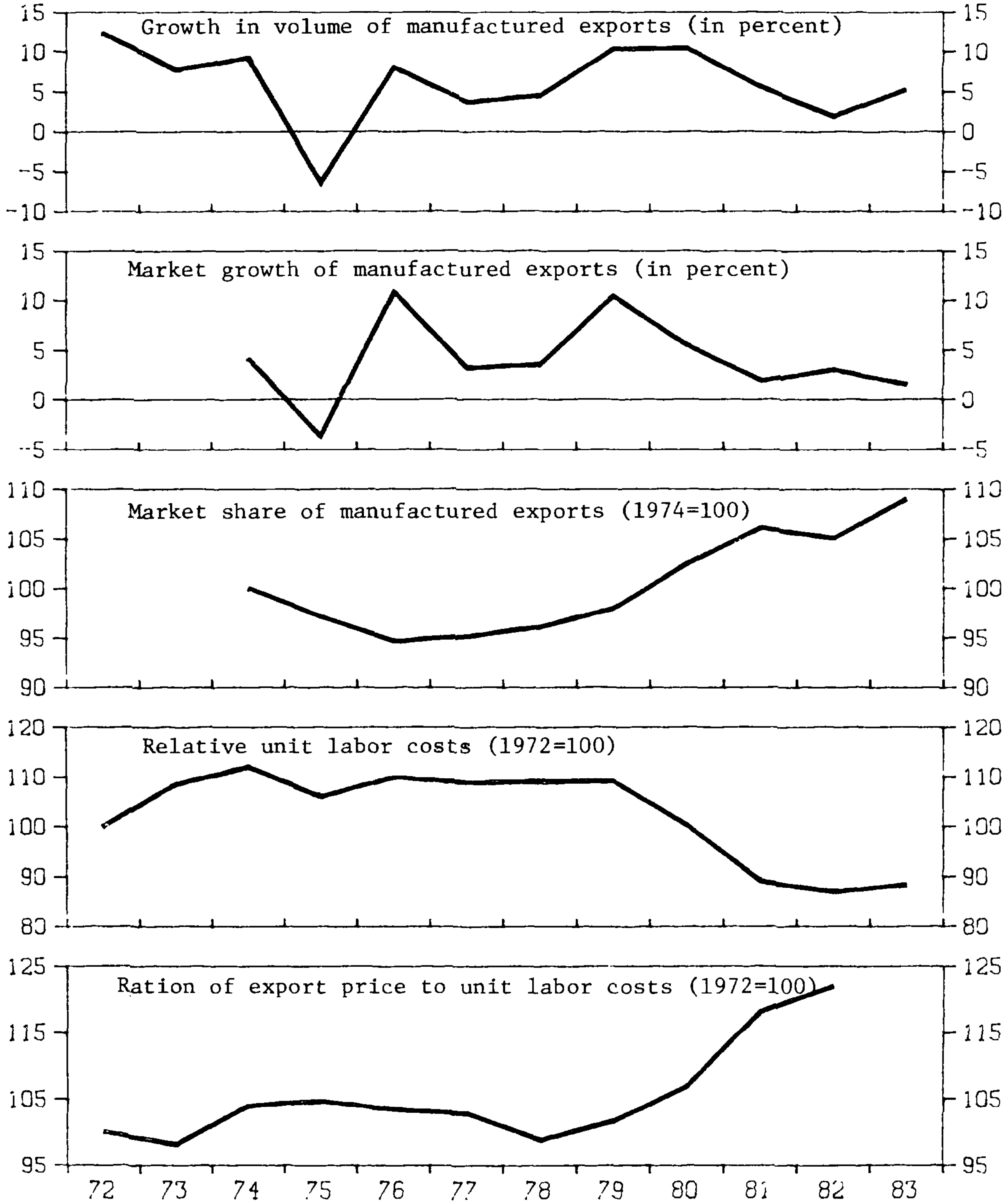
Sources: Danmark Nationalbanks, Monetary Review; Deutsche Bundesbank, Monthly Report, and IMF, International Financial Statistics.

1/ Prime lending rates.
2/ Overdraft facilities.
3/ Average interest rates on credits in current account (under DM 1 million).

CHART 7

DENMARK

MAJOR INDICATORS OF MANUFACTURED EXPORTS



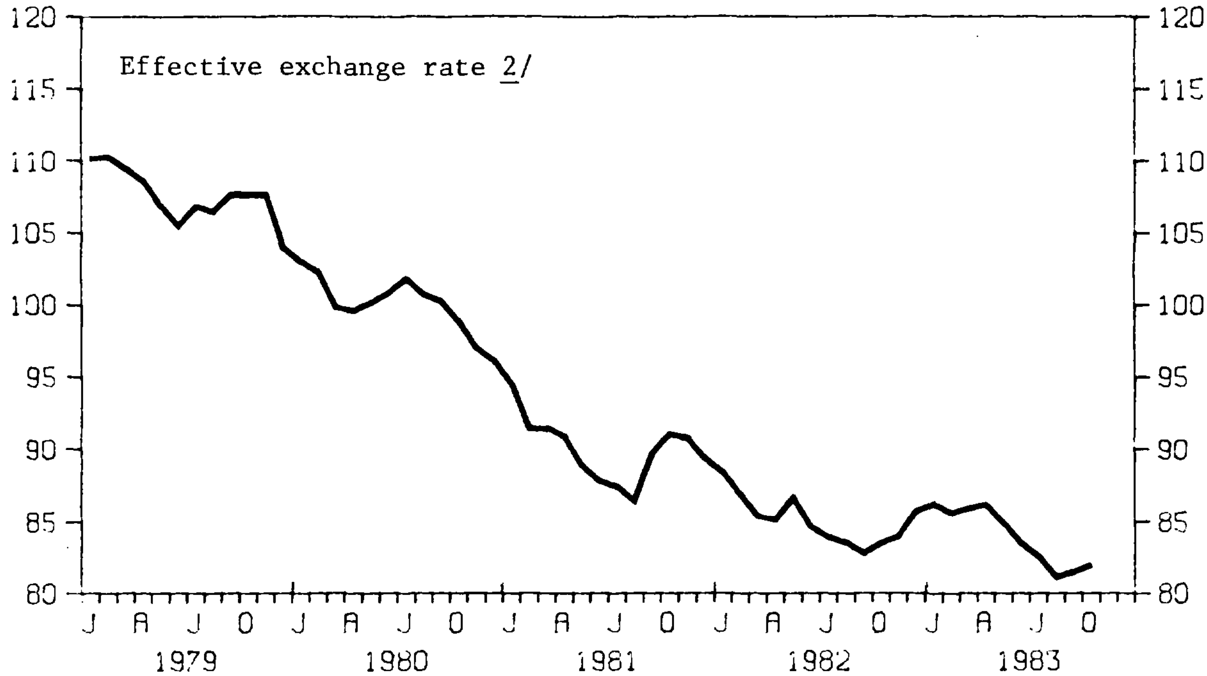
Sources: OECD, Economic Outlook; IMF, International Financial Statistics, and staff estimates.

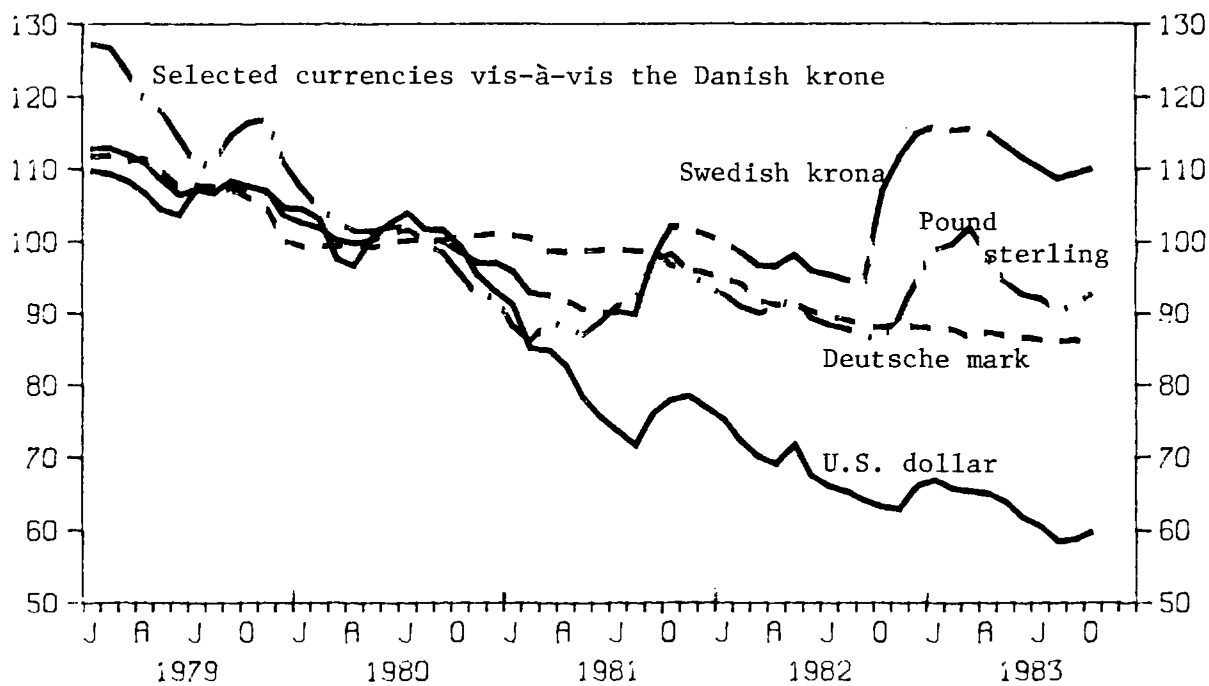
CHART 8

DENMARK

EXCHANGE RATES 1/

(Indices: 1980 = 100)





Source: IMF, International Financial Statistics.

1/ Decrease in index means depreciation of DKr.
2/ Based on the Fund's multilateral Exchange Rate Model (MERM).