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IMF Executive Board Concludes 2008 Article IV Consultation with Denmark

On December 19, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Denmark.[1]

Background

The global financial crisis exacerbated a cyclical slowdown that had begun in early 2007, after a long upswing. The slowdown began when Denmark's housing boom ended and residential investment declined. It gained momentum when the financial crisis raised borrowing costs and depressed export growth, consumer confidence, and investment.

The crisis has put financial markets under strain, but most Danish banks, including the half dozen largest, started out with healthy capital buffers which have helped them cope. Direct effects of the crisis were modest because exposures to risky assets were small and because Danish subsidiaries of foreign banks were protected by tight restrictions on intra-group exposures. The main channels of contagion were indirect: increasing risk aversion and a liquidity freeze, which affected all banks, hit small and medium-sized banks particularly hard, leading to a number of mergers and takeovers.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The labor market continued tightening after the end of the boom, and unemployment—which began rising only in October 2008—is still close to a historic low. Wage growth picked up in mid-2007 and has remained strong, reflecting tight labor market conditions and a generous public sector wage agreement in 2008. Inflation—keeping pace with wage growth—started rising in late 2007, and accelerated to just under 5 percent in mid-2008, with food and energy prices rising rapidly. External competitiveness is adequate, but current trends—faster wage growth and slower productivity growth than in trading partners—are unsustainable.

Denmark's fiscal position is among the strongest in the EU. A gradual reduction in the expenditure ratio, combined with the recent economic boom, led to large surpluses, enabling the government to substantially reduce its debt burden. Consequently, interest spreads on government debt are low.

Economic growth is expected to remain weak through 2010 before recovering gradually. But weaker-than-expected global growth or higher interest rates could drive the economy into a recession.

Executive Board Assessment

Executive Directors commended the authorities for policies that have enabled Denmark to weather the global crisis well. Nevertheless, conditions remain fragile because of market liquidity constraints and the weakening regional and global outlook, increasing the risk of a severe economic downturn. Directors concurred that the authorities face the combined challenges of steering the economy during a period of substantial growth deceleration; supporting financial stability; and persevering in their decade-long effort to strengthen fiscal sustainability.

Directors considered that the exchange rate peg of the krone to the euro has served Denmark well, anchoring inflationary expectations and keeping interest rates close to those in the euro zone. Macroeconomic policies therefore need to be set in light of Denmark's participation in the European Exchange Rate Mechanism (ERMII). Directors welcomed the authorities' prudent fiscal policy stance, underpinned by a strong rules-based framework, and their readiness to raise interest rates in response to pressures on the peg arising from financial markets' shift in favor of holding risk-free liquid assets.

Directors considered that the proposed 2009 budget strikes a good balance between allowing growth to slow in the face of record low unemployment and rapid wage growth, and cushioning the economy from a severe recession. They viewed the moderate positive fiscal impulse in the budget proposal, added to Denmark's strong automatic stabilizers, as an appropriate response to the increased risk of a hard landing. Directors emphasized that, along with progress on structural reforms, wage growth needs to slow if firms are to rebuild profitability and secure Denmark's competitiveness and export market share.

Directors commended the authorities for their bold response to the financial crisis, and viewed the new liquidity facilities as comprehensive. The proactive and collaborative approach to bank resolution has helped prevent contagion during a period of exceptionally fragile confidence.

Directors welcomed the new financial stability act, noting that it establishes clear rules and sound incentives for the banking system, helping to secure creditor confidence while safeguarding public resources. The act improves incentives for prudent behavior—including through a temporary dividend moratorium—provides powers to the Danish Financial Supervisory Authority (DFSA) to punish excessive risk-taking, and encourages the private sector to find timely solutions for problem banks. Directors welcomed provisions that level the playing field with respect to cross-border banking operations.

Directors emphasized the importance of intensifying financial sector surveillance and supervision under current financial market conditions. They pointed in this context to potential vulnerabilities stemming from the housing sector and from regional spillovers. Directors welcomed the supervisory authority's initiative to monitor liquidity risk more intensively and comprehensively, and stressed the importance of ensuring that it has the resources to fulfill its expanded mandate under Basel II. They took positive note of the ongoing discussions on a new banking package with the aim of preventing a credit crunch by injecting new capital into the banking sector, subject to adequate safeguards.

Directors noted the impressive achievements of the authorities over the past two decades in reconciling the costs of supportive social safety nets for an aging population with the demands of long-term fiscal sustainability. While recognizing that further progress will involve difficult choices, they encouraged the authorities to take additional measures on both the tax and benefits sides toward closing the long-term fiscal gap.

Directors commended Denmark for maintaining a generously high level of official development assistance, including in the current difficult environment.

Denmark: Selected Economic and Social Indicators

	2004	2005	2006	2007	2008 proj.	2009 proj.
Supply and Demand (change in percent)						
Real GDP	2.3	2.4	3.3	1.6	0.0	0.0
Net Exports 1/	-2.0	-1.1	-2.1	-0.3	-0.8	0.0
Domestic demand	4.1	4.3	5.1	1.6	1.3	0.0
Private Consumption	4.7	3.8	4.4	2.4	1.8	0.8
Gross fixed investment	3.9	4.7	13.3	3.1	-0.5	-3.5
Gross national saving (percent of GDP)	23.2	24.8	24.7	24.0	24.4	23.1
Gross domestic investment (percent of GDP)	20.4	20.8	22.3	22.9	22.9	22.4
Potential output	1.3	1.8	1.8	1.3	1.2	1.1
Output gap (in percent of total output)	-0.5	0.1	1.6	2.0	0.8	-0.3
Labor Market (change in percent)						
Labor force	-0.2	0.1	1.0	0.1	0.2	0.3
Employment	-0.4	0.9	2.2	1.3	1.2	-1.1
Unemployment rate (in percent)	5.8	5.1	3.9	2.8	1.8	3.2
Prices and Costs (change in percent)						
GDP deflator	2.3	2.9	2.0	2.0	4.7	2.0
CPI (year average)	1.2	1.8	1.9	1.7	3.4	2.3
Unit labor costs (manufacturing)	-2.9	-0.4	1.6	3.1	2.4	0.6
Public finance (percent of GDP) 2/						
General government revenues	56.7	58.0	56.8	55.6	53.9	51.3
General government expenditure	54.8	53.0	51.8	51.1	50.9	51.2
General government balance	1.9	5.0	5.0	4.5	3.0	0.0
General government structural balance 3/	1.6	2.6	2.7	3.2	2.3	1.3
General government primary balance	3.4	6.2	5.9	5.0	3.3	0.5
General government gross debt	43.8	36.4	30.6	26.1	22.0	21.5
Money and Interest rates (percent)						
Domestic credit growth (end of year)	8.9	14.9	14.1	13.0	---	---
M3 growth (end of year)	2.7	14.3	11.4	17.0	---	---
Short-term interest rate (3 month)	2.1	2.2	3.1	4.3	---	---
Government bond yield (10 year)	4.3	3.4	3.9	4.4	---	---
Balance of payments (in percent of GDP)						
Exports of goods & services	45.4	49.0	52.0	52.3	55.4	56.6
Imports of goods	40.5	44.1	48.9	50.2	52.9	54.8
Trade balance, goods and services	4.9	4.9	3.0	2.1	2.5	1.7
Of which: net oil exports (US$ bln)	2.6	3.2	3.8	3.8	3.8	3.8
Current account	3.1	4.4	3.0	1.1	1.5	0.8
Exchange rate						
Exchange rate regime			ERM2 Participant			
Average DKr per US$ rate	6.0	6.0	5.9	5.4	---	---
Nominal effective rate (2000=100, ULC based)	108.9	108.4	108.7	110.9	---	---
Real effective rate (2000=100, ULC based)	113.0	112.4	113.9	119.2	---	---

Social indicators (Reference year)
GDP per capita (2006): $50,818; **At-risk-of-poverty rate** (2006): 12 percent.

Sources: IMF, World Economic Outlook; Danmarks Nationalbank; Statistics Denmark; OECD; Eurostat; and IMF staff projections.
1/ Contribution to GDP growth.
2/ Figures for 2008–09 reflect Ministry of Finance estimates and projections as of December 2008; pre-2008 information is from Statistics Denmark.
3/ In percent of potential GDP.