FOR AGENDA

SM/93/264

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December 30, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Denmark - Staff Report for the 1993 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1993 Article IV consultation with Denmark, which is tentatively scheduled for discussion on Friday, January 28, 1994.

Mr. Vittas (ext. 38790) or Mr. Corker (ext. 38354) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Commission of the European Communities (CEC), the GATT Secretariat, and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

DENMARK

Staff Report for the 1993 Article IV Consultation

Prepared by the Staff Representatives for the
1993 Article IV Consultation with Denmark

Approved by J. R. Artus and Jan van Houten

December 28, 1993

I. Introduction

A staff team consisting of Messrs. Vittas, Corker and Stephenson, Ms. Meehan (all EU1) and Mrs. La Torre (EU1, assistant) visited Copenhagen during October 27 to November 5, 1993 to conduct the 1993 Article IV consultation discussions. Meetings were held with the Ministers of Finance and Economic Affairs, the Governor of the Danmarks Nationalbank, senior officials of these and other ministries and agencies, and representatives of the trade unions, the employers' association and the banking sector. Mr. Bergo, Executive Director for Denmark, attended some of the meetings.

Denmark was on the bicyclic consultation cycle and, with the termination of the bicyclic procedure, was placed on the 12-month consultation cycle. The last (interim) consultation took place in February 1991. A full consultation was to have taken place in 1992 but was postponed as a result of the temporary, across-the-board shift in consultation cycles due to staff shortages. 1/ Denmark has accepted the obligations of Article VIII, Sections 2, 3, and 4.

The present coalition Government, led by the Social Democrats, came to power in January 1993. A general election is due by December 1994. Danish voters voted in favor of ratification of the Maastricht Treaty (with agreed opt-out clauses) in May 1993, eleven months after narrowly rejecting the Treaty.

II. Background and Prospects

Up to the early 1980s, Denmark had used occasional devaluations of the krone to improve its competitive position and ease the external constraint to growth. Disappointment with the results of this approach--which in

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1/ There has been no full Article IV consultation with Denmark since February 1990 (concluded at EBM/90/73 on May 11, 1990). A short staff visit took place in March 1993 to discuss recent developments and policies.

supported initially by substantial progress in redressing fiscal imbalances, contributed to a dramatic fall in the rate of inflation, improved competitiveness and profitability in the tradables sector, and a marked turnaround in the external position. By the early 1990s the inflation rate was the lowest in the EC, the external current account had swung to a sizable surplus (after some 30 years of uninterrupted deficits), and the external debt to GDP ratio had begun to fall steeply (Charts 1 and 2). However, the increase in real GDP during 1987-1992, at an average annual rate of about 1 percent, fell short of potential and unemployment rose steadily to reach new record highs (Chart 3).

The lackluster growth performance in 1987-1992 occurred despite a rapid expansion of exports that raised Denmark's share of its main export markets. It reflected a protracted weakness of consumer spending as well as a significant decline in private investment, particularly in housing and the nontradables business sector. The lack of buoyancy of domestic demand was due initially to tax changes which eliminated incentives for borrowing and precipitated a sharp reversal of an asset price boom and credit-financed spending spree that Denmark had enjoyed in the mid-1980s. More recently, however, the high real interest rates that have been required to support the commitment to the hard currency policy, along with weak business and consumer confidence, have sustained the upward trend in the private savings rate thus delaying further the recovery in spending.

Economic conditions have deteriorated further during 1993 as the effects of continued weakness in domestic demand have been compounded by a fall in exports stemming from the recession in continental Europe and a modest appreciation of the krone. As a result, real GDP is estimated by the staff to have fallen slightly in 1993 leading to the emergence of a significant output gap and a further rise in the unemployment rate (to about 12 1/2 percent by the end of the year). 1/ Meanwhile, the rate of inflation, which had averaged around 2 percent in 1990-92, has receded further, reflecting a fall in import prices and virtual stability of domestic labor costs (Chart 4). The external current account has continued to show a large surplus as the decline in exports has been counterbalanced by a contraction of import volumes and an improvement in the deficit on invisibles.

Sluggish economic activity, rising unemployment and a gradual easing of the fiscal stance since the late 1980s have contributed to a reversal of the improvement in the fiscal position that had been achieved previously. By 1993, the general government financial deficit had reached some 4 percent of GDP, compared to a surplus averaging 2 percent of GDP in the mid-1980s, and Denmark's comparatively high public debt ratio--which had been reduced only modestly during the earlier period of fiscal consolidation--had resumed its upward trend (Chart 5). The general government deficit is officially

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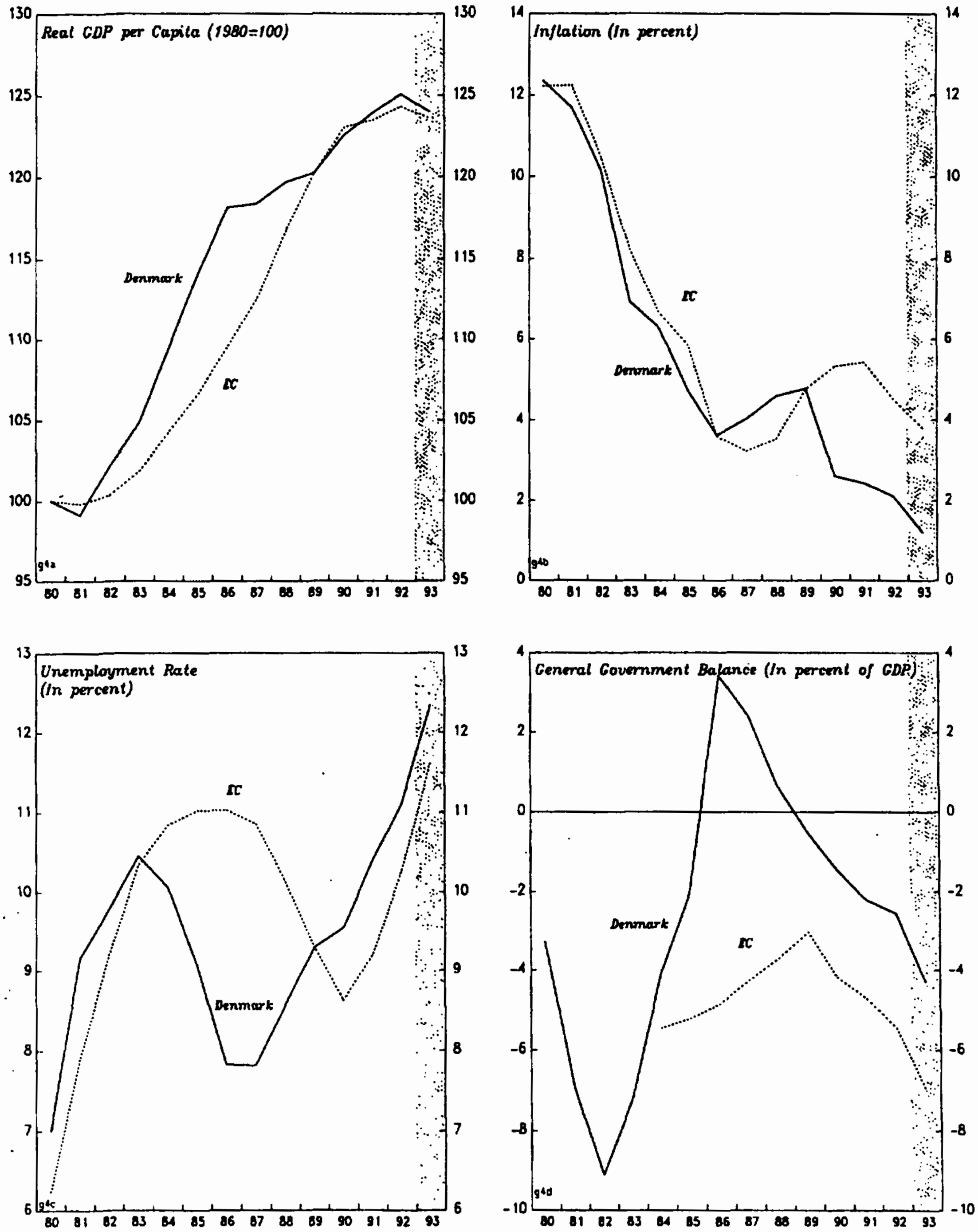
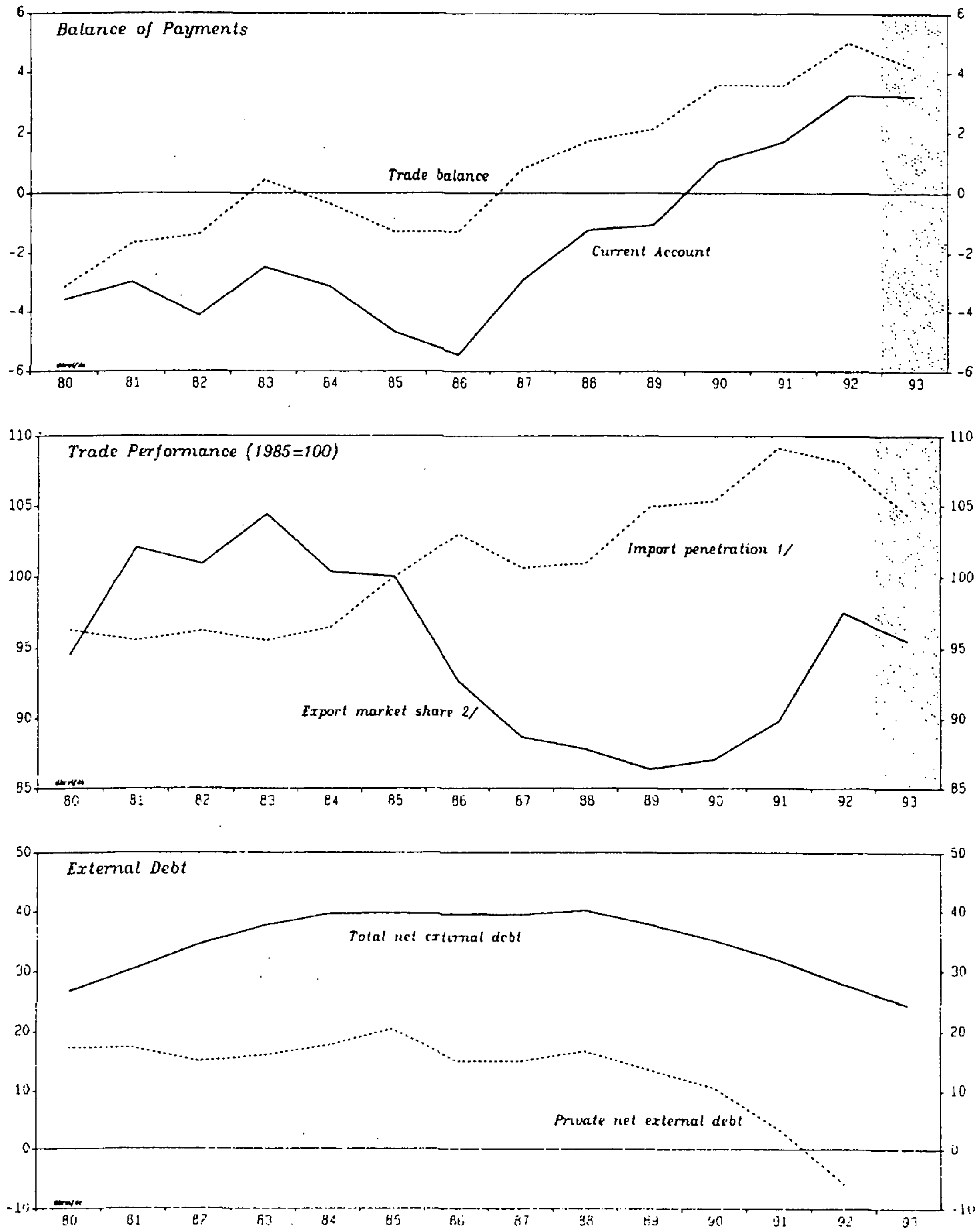
1/ Staff estimates suggest that the output gap was comparatively small up to 1992 before widening to about 3 percent of potential output in 1993.

CHART 1
Denmark
Comparative Economic Developments



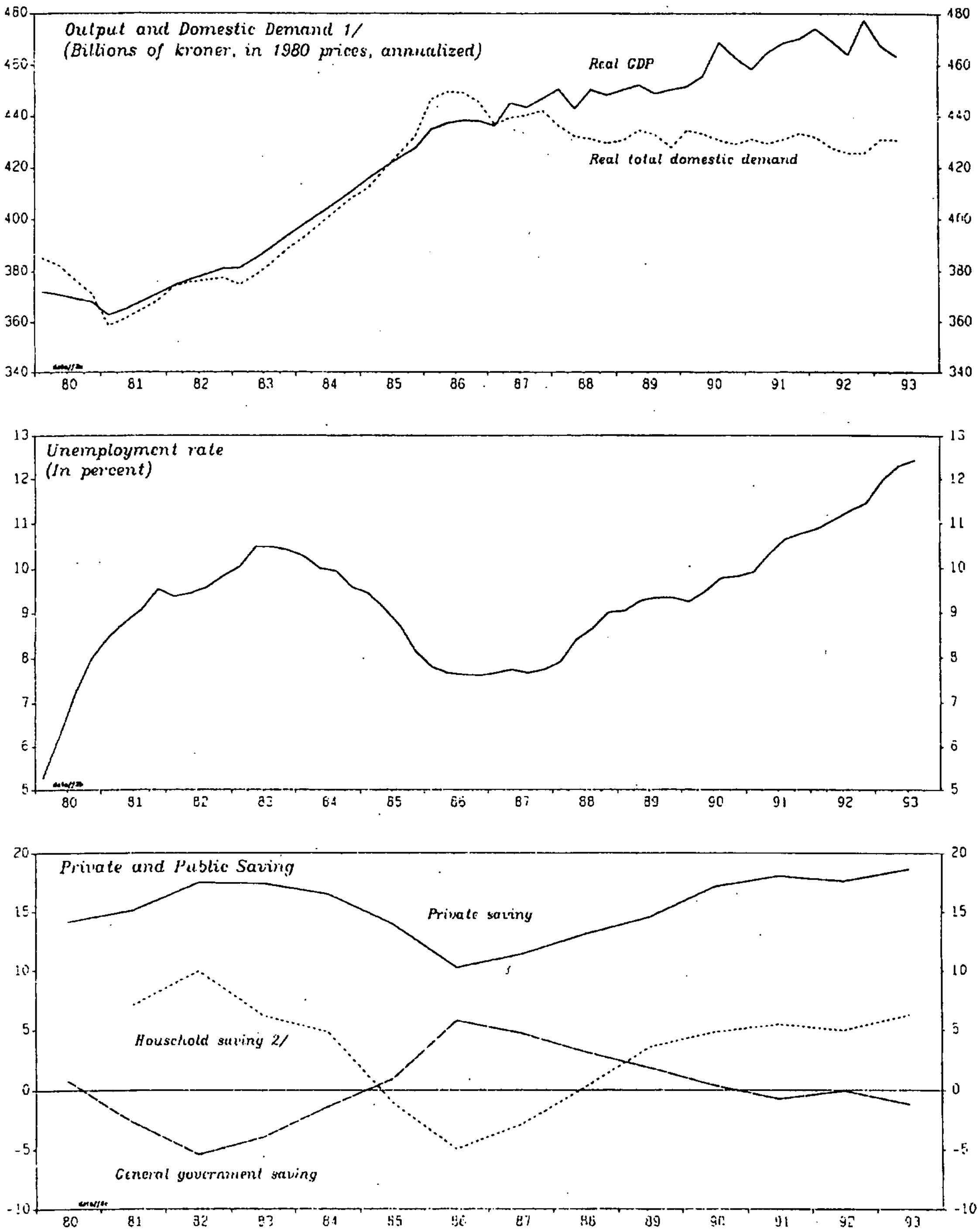
Sources: IMF, World Economic Outlook; and staff projections.

CHART 2
Denmark
External Developments
(In percent of GDP)



Sources: IMF, World Economic Outlook; and staff projections.
1/ Ratio of imports of goods and nonfactor services to GDP in constant 1980 prices.
2/ Ratio of exports of goods (volume) to a weighted index of trading partners' non-oil import volumes.

CHART 3
Denmark
Output, Unemployment, and Savings



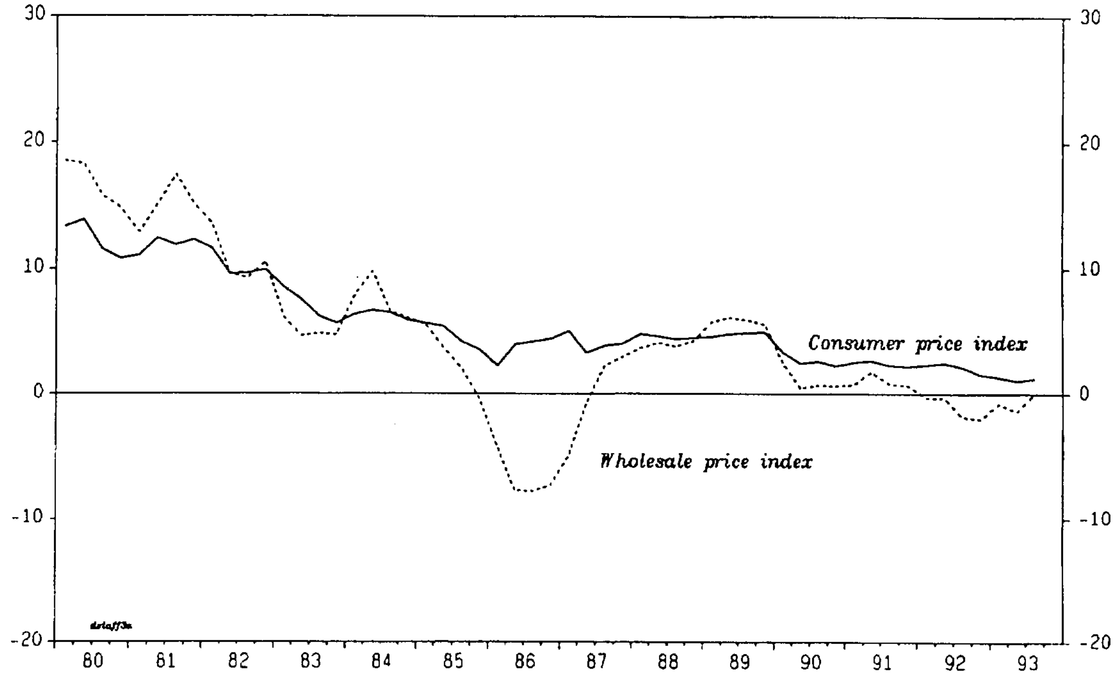
Sources: DSTB database.
1/ 1980-1986 based on annual data.
2/ Household savings as percent of disposable income.

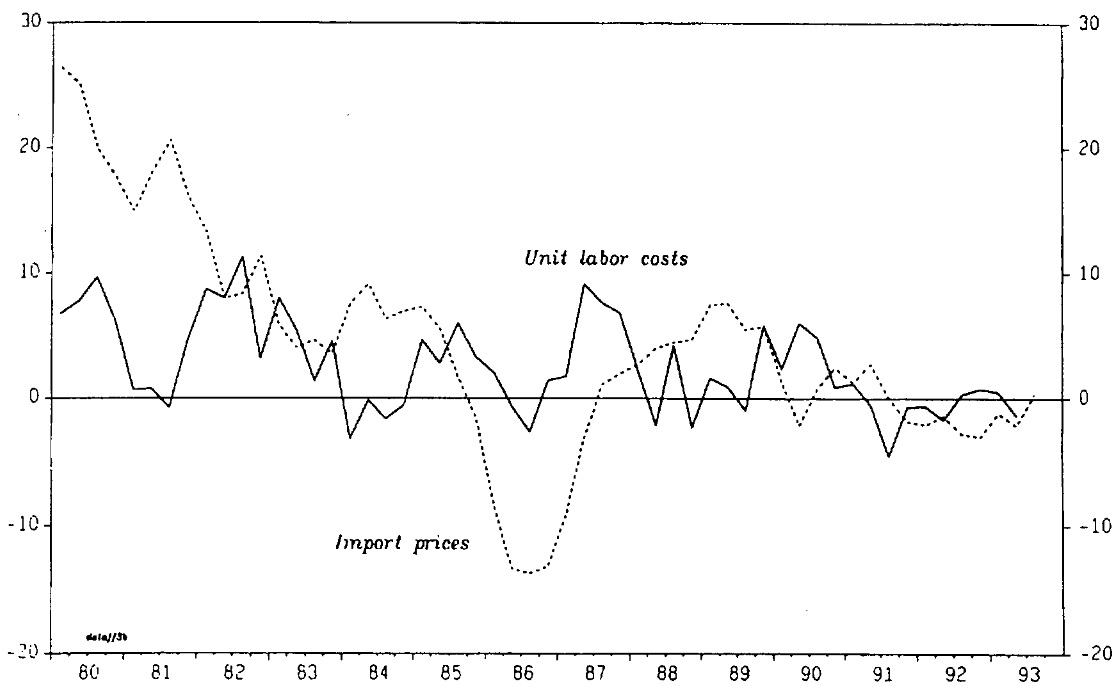
CHART 4

Denmark

Price and Cost Inflation

(Percent change from the same quarter of the previous year)





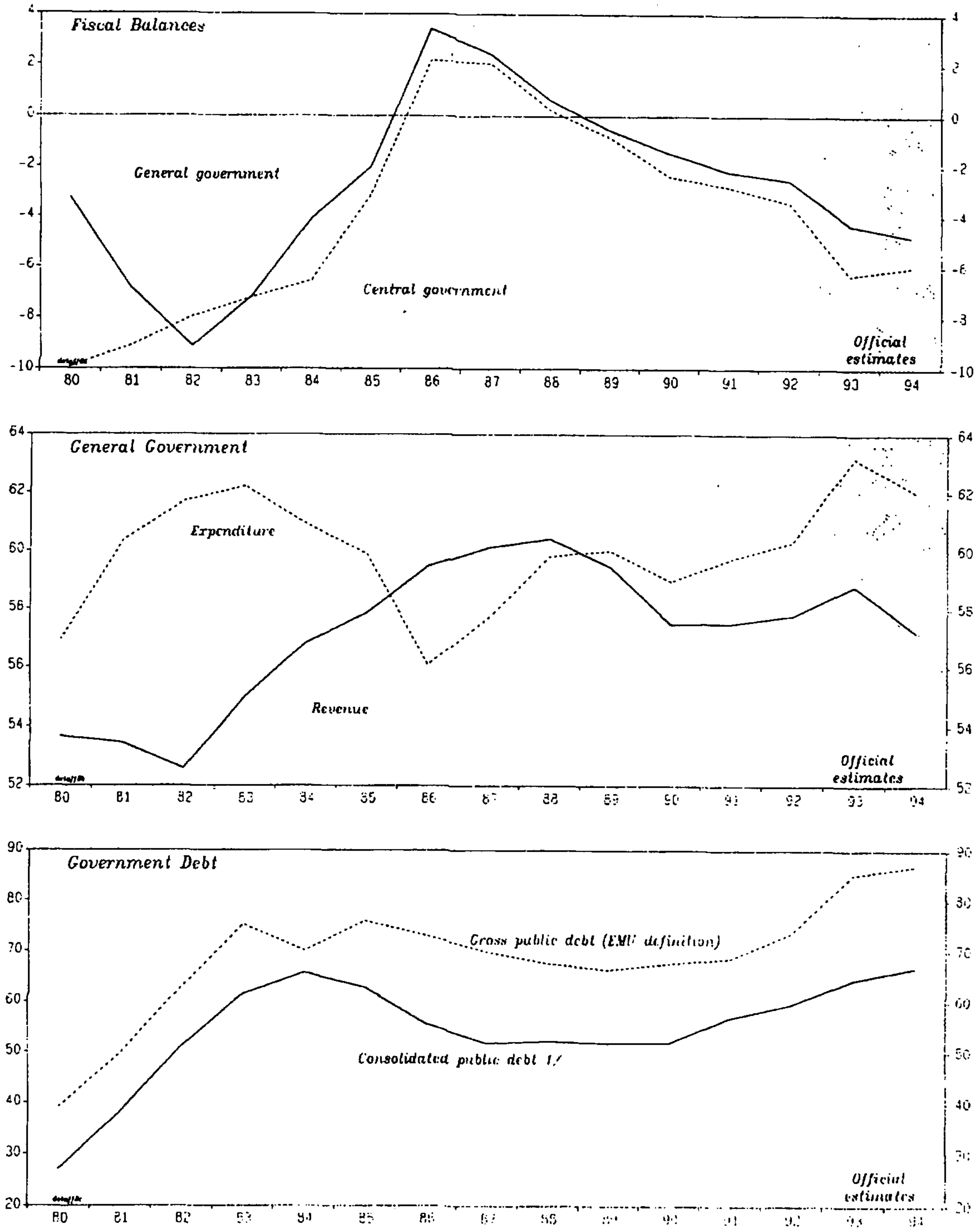
Sources: OECD; and DSTB database.

CHART 5

Denmark

Fiscal Developments

(In percent of GDP)



Sources: IMF, World Economic Outlook; and official estimates.

1/ Including Social Pension Fund's holdings of non-government bonds and government deposits at the central bank.

projected to rise further to 4 3/4 percent of GDP in 1994, mainly as a result of a large package of measures that is being introduced to stimulate economic growth.

Interest rates and the spread vis-à-vis equivalent rates in Germany had been on a downward trend up to the middle of 1992, reflecting the decline in inflation and the increased credibility of the authorities' commitment to a stable exchange rate. This trend was abruptly interrupted with the onset of turbulence in the ERM around the middle of 1992. During the subsequent year, the krone experienced several bouts of selling pressure. In all instances, the authorities did not hesitate to raise short-term interest rates sharply while simultaneously intervening in the foreign exchange market to support the currency (at times intramarginally in concert with other central banks). During these episodes, short-term interest rate differentials with Germany widened markedly. The decline in long-term interest rates was reversed, albeit briefly, in the fall of 1992 and the spread with German bond yields widened to about 2 percentage points (Chart 6). However, bond yields fell sharply during 1993 and by mid-year the differential with German yields had returned to its historically low level of 1/2 percentage point.

For several weeks after the adoption of the wider (15 percent) fluctuation margins in the ERM, official short-term interest rates were kept close to their high crisis levels. Since late-August, however, they have been lowered in a number of steps and by mid-December they were somewhat below their pre-crisis levels. Long-term bond yields have continued their downward trend and, at about 6 1/4 percent, they are currently more than 3 percentage points lower than in mid-1992, with the spread vis-à-vis German yields remaining around 50 basis points. However, short-term interest rate differentials remain higher than prior to the ERM crises. 1/ Moreover, interest rates are still high in real terms and the yield curve is inverted at the short end of the maturity spectrum. While there has been an acceleration of monetary growth during 1993, bank lending has continued to fall (Chart 6).

The krone appreciated by about 7 percent in nominal effective terms in the year to June 1993, owing to the devaluations of other EMS and Nordic currencies (Chart 7). However, its real appreciation was limited to 5 percent reflecting Denmark's comparatively slow pace of price and cost inflation (Chart 8). The krone depreciated by about 5 percent in effective terms immediately after the shift to the wide intervention margins but has

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1/ Due to the presence of a few dominant domestic banks, there is a degree of segmentation of the domestic money market which makes it difficult to put a precise figure on the interest differential with Germany. At end-November, the authorities estimated the differential to be 1 to 1 1/4 percent although the differential was wider for certain money market rates and below 1 percent for treasury bills. Since then, the differential has narrowed further.

subsequently recovered much of this loss. In late 1993, it was about 2 1/2 percent below its central parity against the deutsche mark and its real effective exchange rate (as measured by relative unit labor costs) was close to its level prior to the ERM crises. 1/

The latest official forecast calls for GDP to grow by 3 percent in 1994, with the unemployment rate falling by about 1 percentage point. The forecast is predicated on the view that large tax cuts that are being introduced in January 1994 in the context of a tax reform, in conjunction with the steep fall of long-term interest rates, will lead to a major improvement in the disposable income and cash flow position of households, thereby stimulating a sharp acceleration in consumer spending. 2/ In addition, a recovery in residential construction and business investment and a pick up in exports are envisaged. The growth in wages and unit labor costs is expected to remain low. Nevertheless, the rate of inflation is forecast to accelerate to 3 percent, mainly due to increases in indirect taxes.

The staff is less optimistic about the short-term growth prospects and projects an increase in real GDP of about 2 percent in 1994. This would barely be adequate to arrest the rise in unemployment. The staff forecast recognizes that the fall in bond yields to date and the improvement in the financial position of households have laid the foundation for a resumption of domestic demand growth. However, it assumes that high real interest rates and the relatively high level of spare capacity in the economy will limit the strength of the pick up in GDP. In view of the slack in labor and product markets, the staff projects inflation to remain subdued (at about 2 percent in 1994). On both the official and the staff forecast, competitiveness will improve perceptibly in 1994, with the current account showing a surplus of about 2 percent of GDP and Denmark's net external debt falling further to about 20 percent of GDP (as compared with nearly 40 percent of GDP in 1988).

III. Report on the Policy Discussions

The discussions focused on the policies the authorities are pursuing to promote recovery and reduce the high level of unemployment. The official strategy involves a large but temporary fiscal stimulus in the near term, complemented by labor market reforms that are aimed at reducing structural unemployment over the longer term. Recovery would also be assisted by a

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1/ The real exchange rate has fluctuated about a broadly constant level since 1987, the time of the last krone devaluation within the ERM.

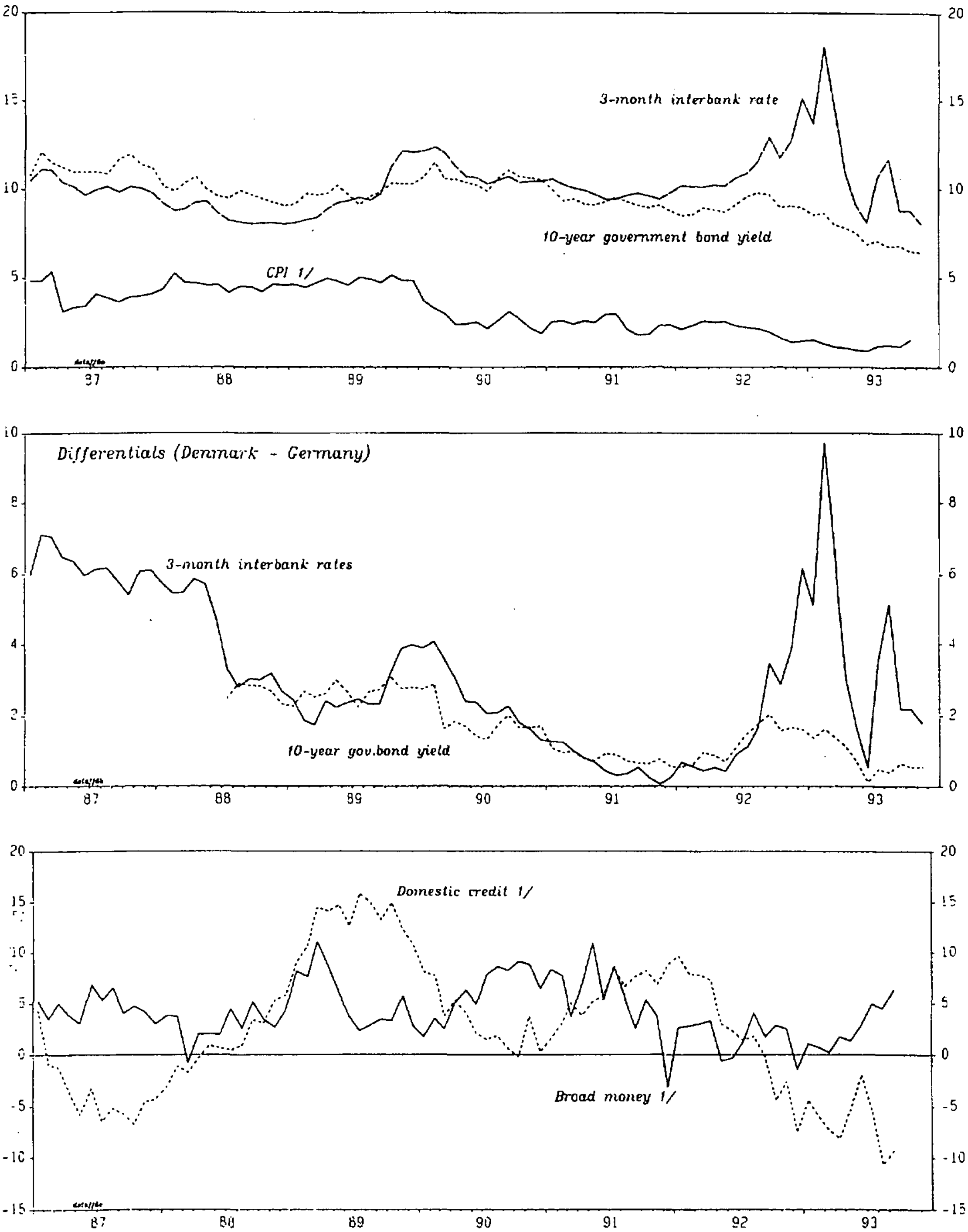
2/ The fall in long-term interest rates is inducing households to refinance outstanding mortgage loans. The stock of these loans is very large. In many cases, refinancing is accompanied by an extension of the maturity of the loans which enhances the improvement in the cash flow position of households.

CHART 6

Denmark

Interest Rate and Monetary Developments

(In percent)



Sources: IMF, International Financial Statistics;

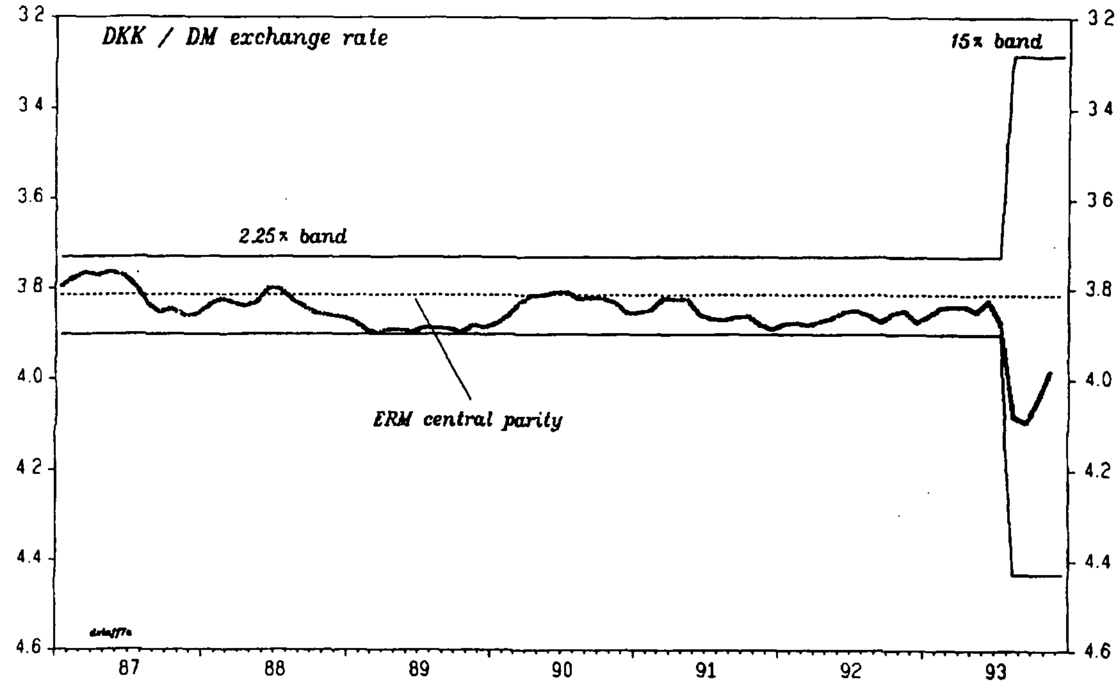
1/ 12-month percentage change.

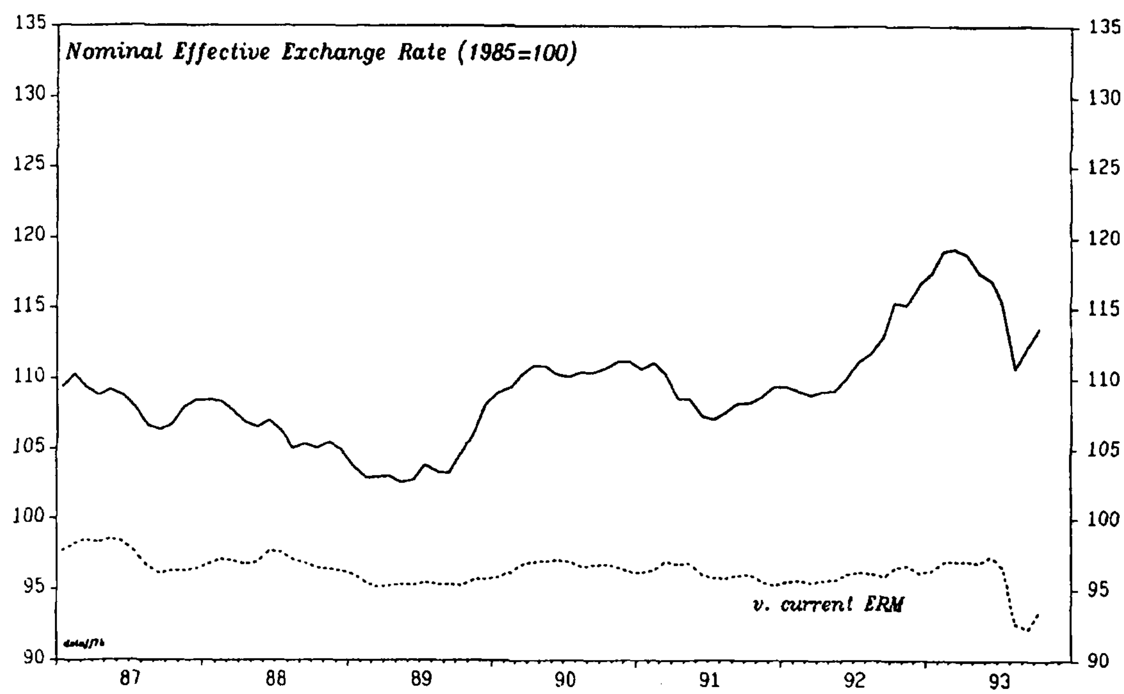
CHART 7

Denmark

Exchange Rate Developments

(1985 = 100)



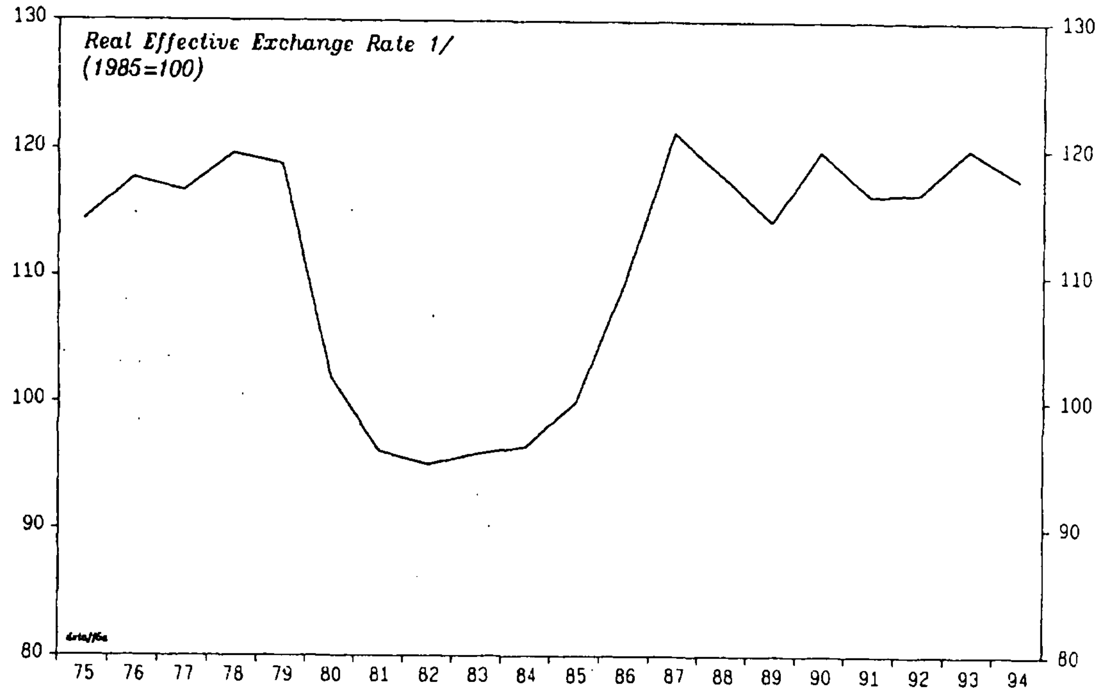


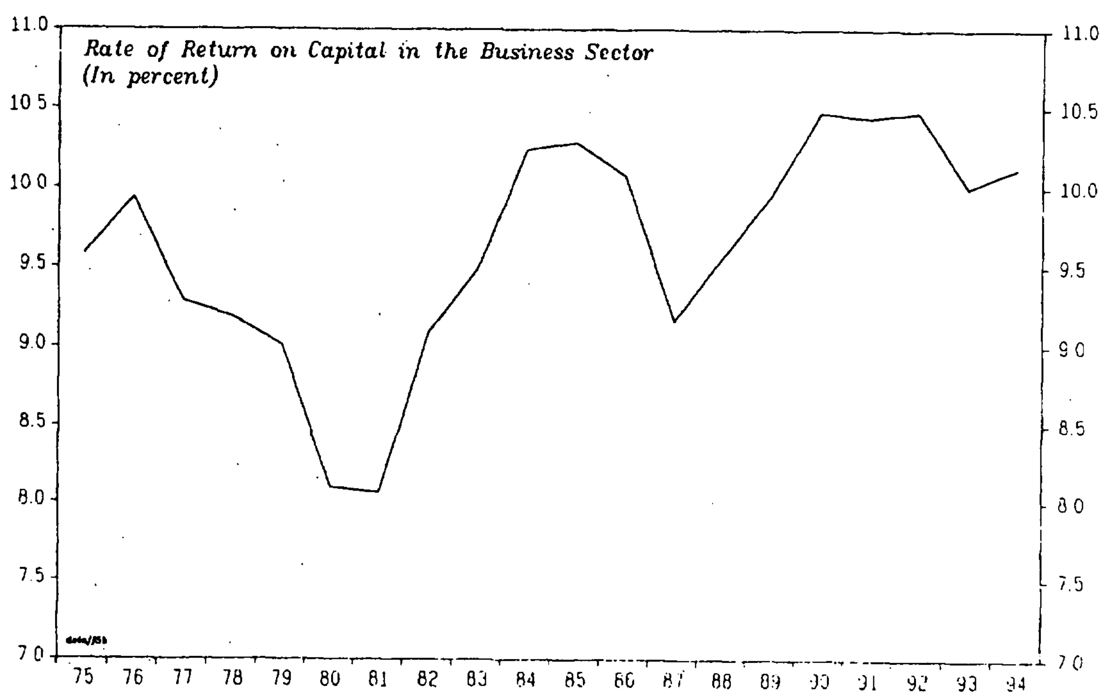
Sources: IMF, International Financial Statistics; and staff calculations.

CHART 8

Denmark

Competitiveness Indicators





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

1/ Based on relative unit labor costs.

further gradual easing of monetary conditions to the extent permitted by the need to maintain stability in foreign exchange and bond markets.

1. Fiscal policy

The authorities noted that the principal objectives of fiscal policy are to reduce the public debt burden significantly over the medium-term, to support monetary policy in its task of maintaining low inflation, and to prevent recessionary conditions from persisting. In current circumstances, the last of these goals was being stressed, but this was not viewed as inconsistent with the other fiscal policy objectives given that there was at present little risk of a reemergence of inflationary pressures and that the bulk of the fiscal deficit (and the associated rise in the public debt) was of a cyclical nature. 1/

The discretionary fiscal measures in the 1994 budget are equivalent to 1 1/4 percent of GDP. They include substantial across-the-board cuts in marginal income tax rates, the bringing forward of public investment projects, steps to stimulate a recovery in the long-depressed housing market and measures to expand education and retraining programs. The authorities emphasized that the fiscal stimulus was intended to be temporary. The loss of revenue from the tax cuts would be almost totally recouped over the period 1995-98 through increases in indirect taxes, a broadening of the tax base and the phased introduction of social security contributions. Public investment would fall back to earlier planned levels and most of the other programs would be in effect for only a limited period of time.

The staff agreed that the fiscal package had several attractive features but questioned the need for such a large fiscal stimulus at this phase of the business cycle. Moreover, the staff was concerned that the increase in the fiscal deficit could exceed the budget projections significantly. This could have unsettling effects on financial markets and limit the scope for lowering interest rates and restoring a more balanced policy mix. Officials acknowledged that both the timing and the size of the stimulus may have been influenced to some extent by electoral considerations. However, the government's paramount concern was to provide a boost to activity that was sufficiently large and broad-based to restore confidence in the private sector. This would hopefully reverse the "wait and see" attitude that had characterized consumer and business behavior in recent years and help enhance the direct impact of the package on disposable incomes and economic activity.

1/ The authorities estimate the structural component of the general government deficit in 1993 to be between zero and 1 percent of GDP, depending on the precise assumption about the level of structural unemployment. The staff's estimate of the structural deficit in 1993 is about 2.5 percent of GDP.

The authorities agreed with the staff that a failure of economic growth to meet official projections would confront them with difficult policy choices but indicated that their response would depend on the reasons for the growth shortfall. If the weaker growth continued to be associated with a rising propensity to save in the private sector, and was accompanied by falling inflation, the case for at least letting the automatic stabilizers operate fully would be strong. On the other hand, if lower-than-expected growth reflected weak external demand or was accompanied by an increase in inflationary pressures (for example, because of adverse reactions of financial markets to the high fiscal deficit), action to contain the weakening of the public finances would be taken.

In reviewing medium-term fiscal prospects, the authorities noted that it was their intention to balance the budget over the course of the business cycle with a view to bringing down the public debt burden. To that end, the growth in public expenditure would be contained to well below that of GDP. Indeed, in the official baseline medium-term scenario, which is to be highlighted in Denmark's EMU convergence program, the government expenditure to GDP ratio would fall by 9 percentage points during the remainder of the current decade. This would permit the budget to return to surplus by the year 2000, when spare capacity in the economy would have been eliminated, and facilitate some further reduction in the tax burden. The debt/GDP ratio would also be falling rapidly although it would remain above the 60 percent Maastricht criterion.

The staff recognized that the authorities' objectives were appropriately ambitious but noted that the baseline scenario was based on assumptions about economic growth (over 3 percent a year) and progress in reducing structural unemployment (to less than 7 percent of the labor force) that appeared overly sanguine. Moreover, questions could be raised about the feasibility of containing expenditure growth to the extent envisaged in the scenario given likely pressures for increased spending in such areas as health and education.

In response, the authorities observed that the pressures on expenditures were not likely to be notably strong in the next 10-15 years because of favorable demographic trends and also because of the recent sharp fall in long-term interest rates which would have its full impact in reducing debt service costs over the medium term (given the long average maturity of the debt and the absence of prepayment clauses). Moreover, the fact that female labor force participation had already reached a high level in Denmark meant that the substantial increases in social programs normally associated with rising participation had already occurred. Beyond the early part of the 21st century, demographic trends would indeed become less favorable and this made it even more important to consolidate the public accounts over the next 10 years. As to the realism of the medium-term growth and unemployment assumptions, the authorities stressed that even under less favorable assumptions, the deficit would decline significantly and fall below the Maastricht criterion by 1998. 1/ This was partly because the deficit is extremely sensitive to cyclical conditions so that even modest growth above potential and a small decline in unemployment would strengthen the fiscal accounts markedly.

2. Monetary policy

The authorities recalled that over the years the pursuit of exchange rate stability within the ERM had provided a helpful framework for addressing financial imbalances and establishing low inflation. Despite its short-term costs in terms of high interest rates, the hard currency policy had enjoyed strong political and popular support even during periods of tension in the foreign exchange markets. This had made it easier to raise short-term interest rates to the level required to restore stable conditions in the currency markets.

The authorities observed that the recurrent pressures on the krone had reflected almost entirely steps by nonresidents to cover the exchange risk stemming from their large holdings of krone-denominated government bonds. In their view, the loosening of the fiscal stance (actual or prospective) had not played any significant role in explaining such pressures, except perhaps for a brief period in February 1993 when there had been some uncertainty about the policy intentions of the new government. Officials stressed, in this respect, that Denmark's underlying fiscal position was stronger than that of most other industrial countries, that the increase of the fiscal deficit was comparatively small and that its time limited nature was well understood, at least by domestic participants in the foreign exchange market. Moreover, the continuous downward trend in long-term interest rates suggested the absence of any significant concerns about the fiscal position.

The authorities were of the view that the breakdown of the narrow band arrangement did not reflect technical shortcomings of the system and might have been avoided if the perception had not spread among market participants that the political will to defend the ERM had diminished. They noted that, along with several other ERM countries, Denmark had opposed the shift to the wider fluctuation bands out of concern that it might lead over time to a drift away from stability-oriented policies and risk accentuating the problem of abrupt, and highly disruptive, adjustments in European exchange rates. In the event, the transition to the new arrangements had proved less difficult than expected and the authorities had come to share the judgment that a return to a narrower band arrangement would not be advisable until several preconditions had been met. These included a high degree of convergence of economic policies and performance among ERM countries, a

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1/ This alternative scenario in which the fall in structural unemployment is assumed to be fairly limited and economic growth is assumed to average 2 1/4 percent a year, is closely in line with the staff's baseline projection described in Appendix I.

revival of economic growth in Europe and a clarification of the currency intervention responsibilities of participating countries.

Since these conditions seemed unlikely to be met soon, the authorities had focused attention on how best to adjust the conduct of monetary policy to the new arrangements. They stressed that the main objectives of monetary policy, in particular its firm orientation to the core ERM currencies and to the control of inflation, had not changed. 1/ Accordingly, the option of aggressive cuts in interest rates and benign neglect toward the exchange rate, which could spark a sell-off of Danish bonds by nonresidents and risk destabilizing both the bond and the foreign exchange markets, had been firmly rejected. In fact, initially little action was taken to exploit the room for lowering interest rates. However, it was also decided not to intervene in the foreign exchange market to support the krone, which at first fell noticeably vis-à-vis all other ERM currencies, and to avoid any action that might suggest pursuit of any specific exchange rate target, such as for example an early return of the krone to within its previous ERM band. At the same time, the authorities made use of their flexible program of Eurocurrency borrowing to replenish external reserves and repay all outstanding liabilities to ERM partners. This removed any need to purchase foreign exchange in the market and thus allowed market forces to play a comparatively large role in determining the evolution of the exchange rate.

The authorities added that they had begun to unwind the earlier increases in official interest rates only after market conditions had stabilized. They were pleased to note that progress in this respect had been substantial and had coincided with a recovery in the exchange rate of the krone and continued falls in long-term bond yields. Officials remarked that, because of the significance of the mortgage bond market in Denmark, bond yields are more important determinants of economic activity than short-term interest rates, although the latter are also important especially for the financing of the working capital requirements of the business sector.

The staff recognized that the need to restore calm in foreign exchange markets and to avoid a rekindling of inflationary expectations had made it appropriate to pursue a policy of gradual rather than abrupt reductions in interest rates. It noted, however, that monetary conditions remained tight suggesting that there was still considerable scope for further cuts in interest rates. The authorities replied that the market had to be given time to digest the changes which had been made so far, but it was their intention to take advantage of opportunities to lower interest rates further

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1/ The absence of alternative reliable or widely accepted nominal anchors for monetary policy, such as monetary or inflation targets, reinforces the authorities commitment to continue to orient monetary policy to the core ERM currencies. However, the main motivation behind this commitment is the belief that broad exchange rate stability is essential not purely for the control of inflation but to sustain progress toward European economic and monetary integration.

in the future. They would, however, be reluctant to allow interest rates to fall below those in Germany, not least because Danish corporations have a substantial amount of revolving foreign debt and there would be a risk that as Danish interest rates approached German levels the debt would not be rolled over thereby precipitating undue downward pressures on the krone. Moreover, the prospective further decline in interest rates in Germany and convergence of its inflation rate to that of Denmark argued against any attempt to decouple interest rate policy.

The authorities reiterated their view, shared by the authorities of the other ERM countries, that fundamentals did not warrant a change in ERM central parities. They readily accepted that the loss of competitiveness in late 1992 engendered by the depreciation of other European currencies had been unhelpful and may well have contributed to the speculative pressures on the krone by generating doubts in the minds of some market participants about the sustainability of the krone's central rate in the ERM. They were nevertheless confident that, even without the assistance of recent exchange rate movements, competitiveness would have recovered gradually, given Denmark's low rate of inflation and the likelihood that inflationary pressures in the devaluing countries would sooner or later flare up.

The staff agreed that the level of competitiveness appeared adequate. It suggested, however, that some short-run variability in the exchange rate of the krone should not be viewed as a cause for concern, especially because if prudent policies were pursued it would not be inconsistent with continued reliance on present parities for guiding the conduct of monetary policy over the medium-term. For their part, officials indicated that while they expected the krone to return eventually to its previous narrow fluctuation band they did not attach a high priority to the early achievement of this objective. They added that a reversal of the recent tendency of the krone to strengthen would pose a difficult dilemma but their inclination would be not to resist it unless it entailed a clear threat to price stability.

The authorities observed that Denmark will participate fully in the transitional stage of EMU which comes into operation on January 1, 1994. This is not expected to require any significant changes in domestic arrangements for the conduct of monetary policy as there was already no recourse to monetary financing of the budget deficit and Danmarks Nationalbank already enjoyed full autonomy on interest rate decisions. However, because of the "opt-out" clause in the Maastricht Treaty, Denmark will not be able to participate in stage III of EMU (the move to full monetary union) unless a referendum determines otherwise.

Denmark has avoided the crises that beset the banking systems in other Nordic countries mainly because it has applied strict prudential standards on financial institutions well before such standards became the norm internationally. In addition, the boom and bust cycle in asset prices has not been as pronounced in Denmark as elsewhere and the recession has been fairly shallow. Officials noted that although provisions against bad loans have increased markedly in recent years, they were not notably out of line with earlier cyclical experience. In light of declining profitability the banks have intensified their efforts to restructure balance sheets, cut their costs and raise new capital and have been able to weather their difficulties without any injection of public money.

3. Structural policies

In recent years, Denmark completed the liberalization of domestic and external financial markets (largely through implementing EC directives) and reformed the corporate and indirect tax systems bringing rates more into harmony with those in EC partner countries. The authorities noted that they have an active agenda to continue structural reforms. At the beginning of 1994, a number of initiatives aimed at tackling high structural unemployment will be introduced and a far ranging tax reform will be implemented.

The labor market reforms focus on active labor market expenditure programs and are targeted at reducing skill mismatches and increasing turnover in job markets. 1/ To this end, steps are being taken to ensure participation of the unemployed in active labor market programs for the sake of maintaining or enhancing skills rather than simply as a means for extending access to unemployment benefits. In addition, some 20,000 (rising to 60,000 in the longer run) new training places are to be provided, and leave-of-absence arrangements are to be extended. A pilot scheme is also being launched to subsidize employment in the household services sector, an activity which is at present largely outside the formal economic sector.

The authorities explained that the leave arrangements were intended in part to enhance job opportunities for the long-term unemployed. Thus, workers will be able to take leave not only for training but also for general (sabbatical) purposes for up to 1 year and receive government support equivalent to 80 percent of their unemployment benefit entitlement. A parental leave scheme is also to be introduced, for a trial period of 3 years, with those participating receiving 70 percent of their unemployment benefit rate. Unlike the other two schemes, where participation will require the mutual consent of employers and employees, parental leave will be a right for all employees with children under 8 years old subject to a certain minimum work qualification period. Some 20,000 workers are expected to take advantage of the leave-of-absence arrangements next year.

The staff noted that while the reforms might raise labor market turnover and on-the-job training, the leave proposals might work to increase rather than alleviate skill shortages, raise labor costs, and ultimately lower employment opportunities particularly for certain groups in the labor force such as parents with young children. More generally, the staff

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1/ Appendix III to the forthcoming Recent Economic Developments paper discusses the labor reform package in more detail and describes the factors behind Denmark's high level of structural unemployment, estimated by the authorities to amount to 8 percent to 9 percent of the labor force.

suggested that a significant inroad into the problem of structural unemployment would not be feasible without substantial reforms of Denmark's generous unemployment compensation system. 1/

The authorities concurred that the effect of the new measures on structural unemployment might be modest if the take up of training and leave of absence opportunities fell short of expectations or employers did not find temporary replacements for workers on leave. However, they observed that problems of shortages due to leave take up were unlikely to be widespread in a period of slack labor markets. Regarding the effects of greater job turnover on labor costs, the authorities noted that possible cost increases could be defrayed by government subsidies to employers taking on unemployed workers. Officials agreed that the generosity of the unemployment compensation system dampened job search incentives and had also contributed to a compressed wage structure by raising the reservation wage for unskilled workers. They added, however, that the Government had firmly rejected the idea of cutting unemployment compensation because in its view the social costs greatly outweighed the benefits of lower unemployment. In this regard, studies had shown that it would take a very large cut (about 30 percent) in benefit levels to reduce the unemployment rate by 1 percentage point.

The authorities noted that the tax reform had several objectives including to lower marginal income tax rates significantly, broaden the tax base, decrease tax evasion and avoidance, increase the transparency between labor market programs and their costs, and to use the tax system to give greater emphasis to environmental concerns. 2/ In addition, final passage of the new tax law, which has been on the agenda for several years, will end uncertainty in the housing market (where the decline in the tax deductibility of interest payments had been expected to be larger).

The main item of the reform is a substantial cut in marginal income tax rates at all income brackets. This will be partly offset by the phased introduction of social security contributions on labor incomes to finance labor market programs. However, even when the new social security contributions are fully in place in 1998, marginal tax rates on labor income will have been lowered substantially, and the top marginal income tax rate will have been reduced from about 69 percent to about 58 percent.

The authorities stated that it was of vital importance for Denmark that the Uruguay Round be brought to a successful conclusion before the end of 1993 with a global, comprehensive and balanced agreement that would ensure growth in a large number of economic sectors. It was for this reason that the Danish Government had worked energetically and constructively within the

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1/ For low paid workers, the replacement ratio is about 90 percent. The duration of benefits is also very long (up to 7 years).

2/ An Appendix chapter to the forthcoming Recent Economic Developments paper provides details of the new tax reform measures.

Community toward a position of the EU that would facilitate ambitious and liberal results in all areas. Although the Blair House agreement had not been viewed as a fully balanced outcome from Denmark's perspective, the authorities had recognized it as an important compromise and had not supported a renegotiation. Denmark had also taken the view within the EU that the best way to assist countries in transition in their efforts to establish stable democracies and well-functioning market economies is to give them market access. It has supported the conclusion of trade agreements between the EU and several of these countries, notwithstanding the anxieties that exist within some sectors of the Danish economy about the effects of increased competition from low income countries. Denmark also welcomed the European Economic Area agreement and the application of EFTA countries to join the EU.

Overseas development assistance (ODA), which is composed largely of grants, amounted to 1 percent of GDP in 1992, making Denmark one of the most generous donors among all industrial countries. Official policy is to maintain ODA at 1 percent of GDP over the medium term.

IV. Staff Appraisal

In recent years, Denmark has made major progress in strengthening its domestic and external financial position. The current account of the balance of payments has swung from a persistent deficit to a comfortable surplus and net external indebtedness has fallen markedly. At the same time, domestic cost pressures have been sharply curtailed, allowing the rate of inflation to fall below that in other EC countries and buttressing the competitive position of the tradables sector at a time when the effective exchange rate of the krone had shown a tendency to appreciate. Domestic demand, however, has remained sluggish as economic agents have given priority to financial consolidation in the face of high real interest rates and the considerable uncertainty about the future associated with rising unemployment and recurrent turmoil in foreign exchange markets. Thus, despite a strong export performance in the period up to 1992, economic growth has been subdued, unemployment has risen markedly and the improvement in the public finances that had been achieved previously has been largely dissipated. Moreover, growth came to a standstill during 1993 as exports declined in response to the recession in other European countries and the loss of competitiveness engendered by the depreciation of the currencies of a few important trade partners.

The macroeconomic outlook suggests continuation of the recent good inflation and balance of payments performance. Prospects for a resumption of economic growth have also brightened as a result of the sharp reduction in long-term interest rates over the past year, the lowering of income taxes associated with the reform of the tax system, and the recent partial recouping of the losses in external competitiveness experienced in 1992. It is uncertain, however, whether the increase in economic activity in 1994 will be sufficiently robust to reduce the unemployment rate significantly. In these circumstances, macroeconomic policies can play a useful role in facilitating recovery. However, it is important that they do so in a cautious way so as not to jeopardize the gains in financial stability achieved in recent years. Moreover, a balanced policy mix will be required to ensure that the recovery in demand is broad based and therefore sustainable.

The strategy that the authorities have chosen to promote a revival of domestic demand entails a substantial fiscal stimulus in 1994, equivalent to over 1 percent of GDP. This stimulus is intended to be temporary and is associated with reforms of the tax system that are likely to enhance economic incentives over the medium-term. Some concern must nevertheless be expressed about the size of the fiscal package which risks to constrain the room for needed reductions in interest rates, especially if the increase in government borrowing and the public debt in 1994 were to exceed the official projections. An unequivocal commitment by the authorities to adhere to the borrowing limits envisaged in the budget would alleviate this concern and solidify the positive outlook for interest rates, thereby increasing the chances that the hoped-for improvement in business and consumer confidence will indeed materialize. Moreover, once recovery is firmly under way, it will be important to give high priority to the task of consolidating the public finances. In this respect, the official goals of balancing the budget over the business cycle, reducing the relative size of the public sector, and lowering markedly the public debt burden are laudable. However, their realization is likely to require a much greater effort at containing public expenditure (particularly for social transfers) than is implicit in the official medium-term fiscal projections.

The widening of the ERM fluctuation margins has provided scope to bring monetary conditions closer into line with domestic requirements and thereby to support economic recovery. The authorities have acted cautiously in exploiting this scope in view of their concern to avoid reactions in the bond and foreign exchange markets that might have rekindled inflationary pressures. However, they have also refrained from targeting the exchange rate and taken steps that obviated the need for official intervention in the foreign exchange market. This pragmatic approach has worked well to date: it has contributed to the early restoration of stable market conditions while also permitting short-term interest rates to fall markedly. Nevertheless, monetary conditions remain tight for this stage of the economic cycle, as indicated inter alia by high real interest rates and the partly inverted shape of the yield curve. It is therefore appropriate to continue to test exchange and bond market reactions to further cuts in interest rates with a view to matching the anticipated decline in German interest rates and indeed eliminating the spread vis-à-vis these rates. From a medium-term perspective, the present central rate of the krone within the ERM appears appropriate and should continue to provide a useful nominal anchor for the conduct of monetary policy. In this context, however, short-term variations in the exchange rate should not be cause for concern, as long as prudent financial policies are being pursued.

While demand management policies deserve attention in the current circumstances of significant slack in labor and product markets, the main challenge confronting the authorities remains a lowering of the high level of structural unemployment. Success is essential if growth is to be sustained at a satisfactory rate in the medium-term without the early re-emergence of capacity constraints, and if substantial consolidation of the public finances is to be achieved before the aging of the population imposes new demands on public services.

The concern of the authorities to ease structural problems in the labor market has been manifested in a willingness to seek out, and implement, new solutions. Some of the new initiatives are likely to contribute over the medium-term to reducing skill mismatches and may also strengthen to some extent job search incentives. However, most of the new measures would mainly help reduce recorded unemployment through work sharing and may not have lasting beneficial effects on the functioning of the labor market. Indeed, they may discourage employers from hiring particular groups within the labor force, increase labor costs, and ultimately reduce rather than increase employment. Moreover, none of the new schemes addresses the problem of inadequate job creation at the low end of the labor market. It is clear that more needs to be done to ensure meaningful progress in reducing structural unemployment. In particular, substantial changes in the benefit system would be required to permit an across-the-board lowering of the cost of employing unskilled labor and a more differentiated wage structure.

On other structural matters, the authorities deserve praise for the many steps that they have taken to reform the tax system, for their strong commitment to free trade and for their liberal stance within the EC toward imports from the former eastern bloc. Denmark also merits special commendation for its continuing generous provision of overseas development assistance.

It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Medium-Term Scenarios

This annex describes a number of medium-term scenarios for the Danish economy. 1/ The scenarios indicate that if little progress is made in lowering structural unemployment, the pace of sustainable growth will be modest with a robust recovery risking a revival of inflation and a deterioration of competitiveness. Without a decline in structural unemployment, non-inflationary growth is unlikely to be sufficiently rapid to meet the authorities' objective of eliminating the budget deficit, notwithstanding measures to recoup the fiscal stimulus planned for 1994. The analysis also suggests that, under a fairly wide range of assumptions, a large part of the external current account surplus is structural.

1. The baseline scenario

The baseline scenario is based on announced policies and the latest WEO assumptions about the external economic environment. Specifically, it assumes that the fiscal stimulus in 1994 is eventually reversed, as planned, and that there is a further gradual decline in interest rates during 1994. However, it also assumes that the new labor market policies will have only a marginal impact on the rate of structural unemployment which is assumed to remain around 10 percent of the labor force.

In the scenario, output growth averages about 2 1/2 percent a year which is estimated to be sufficient to restore the economy to full capacity utilization by 1998. The growth path would be associated with inflation staying around 2 percent (Table 1). Wage increases would accelerate from less than 2 1/2 percent in 1993 to over 4 percent in 1998 as the gap between actual and structural unemployment was fully eroded, but the rise in unit labor costs would be contained to below 2 percent a year because of productivity growth. External competitiveness is assumed to be largely unchanged from current levels over the course of the scenario.

Output growth would be led initially by strong growth in domestic demand due to a recovery in private sector investment and a strengthening of consumer demand. With modest increases in real wages, at least initially, the latter would imply some fall in the personal savings rate from its currently high level. Strong growth in domestic demand would be associated with a pick up in import growth that would initially exceed that of exports despite a revival in export market growth. In time, import growth would ease as domestic demand growth slowed. Thus, the current account surplus would tend to diminish somewhat as a percent of GDP in the mid-1990s but, supported also by declining net investment income payments abroad as

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1/ The scenarios are based on staff analysis of the level and growth of potential output, the level of structural unemployment, the relationship between inflation and unemployment, the sensitivity of trade flows to changes in competitiveness and a simple model of the general government accounts. Appendices I and II to the forthcoming Recent Economic Developments paper describe these relationships in more detail.

Table 1. Denmark: Medium-Term Baseline Scenario

	1992	1993	1994	1995	1996	1997	1998
			(percentage change)				
Output and demand:							
Domestic demand	-0.6	-0.7	2.9	2.9	2.8	2.5	2.5
Private consumption	1.4	0.8	1.9	2.6	2.8	2.6	2.7
Govt. consumption	1.2	1.9	1.8	1.7	1.7	1.5	1.3
Fixed investment	-10.3	-6.5	4.5	5.9	4.6	3.6	3.2
Net exports 1/	1.7	0.1	-0.6	--	-0.1	0.2	0.2
Exports (goods & NFS)	4.0	-3.0	1.4	3.6	3.7	3.7	3.5
Imports (goods & NFS)	0.3	-4.0	3.4	4.5	4.7	3.9	3.6
GDP	1.1	-0.5	2.0	2.7	2.5	2.5	2.5
Unemployment 2/	11.1	12.3	12.3	11.7	11.2	10.6	10.0
Consumer prices	2.1	1.3	1.9	2.0	1.8	2.0	2.2
Manufacturing earnings	2.9	2.2	2.1	3.3	3.8	4.0	4.3
External current account balance 3/	3.2	3.3	2.5	2.5	2.4	2.6	2.8
General Government: 3/							
Revenue	58.2	58.9	58.4	58.1	58.0	58.0	57.7
Expenditure	60.8	63.3	63.6	62.7	61.8	60.6	59.7
Balance	-2.6	-4.4	-5.3	-4.6	-3.7	-2.7	-1.9
Gross debt 4/	73.5	85.2	87.9	89.4	90.2	89.7	88.5
Memorandum items:							
Potential GDP	1.7	1.6	1.6	1.9	1.9	1.9	1.9
Output gap 5/	-1.0	-3.1	-2.7	-1.9	-1.3	-0.7	--

1/ Contribution to growth.
2/ In percent of labor force.
3/ In percent of GDP.
4/ Maastricht definition.
5/ Actual minus potential GDP as a percent of potential GDP.

overseas liabilities were reduced, it would subsequently widen and by 1998 be about 2 3/4 percent of GDP.

The recovery of output would be associated with falls in cyclical government expenditures while interest payments would decline as average debt service costs adjusted toward current bond yields. Thus, assuming growth in non-cyclical expenditures was contained to that of potential GDP, the ratio of general government expenditures to GDP would decline by some 4 percentage points between its peak in 1994 and 1998. The ratio of revenues to GDP would decline by a small amount in this period mainly because of falling interest receipts. Overall, the general government deficit would decline to 2 percent of GDP in 1998 when the economy is assumed to have fully recovered. At that stage, the general government gross debt ratio would be on a slowly declining path.

2. Alternative scenarios

Two alternative scenarios have been constructed. In the first, it is assumed that fiscal policy would be eased further in 1995 and 1996 in an attempt to reduce high unemployment. 1/ The policy is assumed to contribute to higher economic growth in these years so that the unemployment rate is lowered 1 3/4 percentage point below the baseline level in 1996 to less than 9 1/2 percent. However, at this level, inflation would begin to rise in the absence of success in reducing structural unemployment and monetary conditions would be tightened to bring the economy back on to a sustainable path. Nevertheless, even though output growth would slow significantly below the baseline level in 1997 and 1998, inflation would continue to exceed the baseline rate (Table 2).

In this scenario, the current account position would deteriorate somewhat due to weaker competitiveness but would remain in surplus throughout the medium term. The fiscal deficit would also be significantly larger in 1998 than in the baseline, largely on account of the extra expenditures.

In the second alternative scenario, it is postulated that successful labor market polices would be pursued that would reduce the rate of structural unemployment to 8 percent by 1998. As a consequence, GDP growth of about 3 percent a year would be feasible without giving rise to higher inflation. Faster growth would be associated with a stronger recovery in private consumption and investment and a greater surge in imports. Nevertheless, the current account surplus would still amount to 1 3/4 percent of GDP in 1998.

1/ The scenario assumes that, relative to the baseline, non-cyclical, non-interest government expenditures would be 1 percent of GDP higher in 1995 and 1 1/2 percent of GDP higher in 1996.

Table 2. Alternative Medium-Term Scenarios, 1994-98

(In percent)

	Baseline	Alternative scenarios: Further fiscal stimulus	Alternative scenarios: Falling structural unemployment	Official baseline scenario
		(Averages for 1994-98)		
Real GDP growth	2.4	2.4	2.9	3.5
Domestic demand growth	2.7	3.0	3.4	4.2
		(End period value)		
Consumer price inflation	2.2	3.6	2.2	2.6
Unemployment rate				
actual	10.0	10.0	8.0	8.1
structural	10.0	10.0	8.0	...
Output gap 1/	--	--	--	...
Current account 2/	2.8	1.9	1.8	1.9
General government:				
Revenue	57.7	57.9	57.7	...
Expenditure	59.7	61.7	58.1	...
Balance	-1.9	-3.8	-0.4	-0.3
Gross debt	88.5	87.5	83.1	83.0

1/ Actual minus potential GDP as a percent of potential GDP.
2/ In percent of GDP at end period (1998).

In the second scenario, the general government deficit would be practically eliminated by 1998 at which point the debt ratio would be some 5 percentage points below the baseline level. The greater deficit reduction would reflect additional falls in unemployment-related government expenditures and in the ratio of non-cyclical expenditures to GDP--assuming real non-cyclical expenditure growth were contained to that of potential GDP. The amount of deficit reduction would be similar to that in the official convergence program projection which is based on medium-term growth in excess of 3 percent a year and a fall in the unemployment rate to 8 percent by 1988. However, in the official projection, the fall in the deficit would reflect a much more pronounced fall in the expenditure-GDP ratio which would be offset to some extent by a decline in revenues as a percent of GDP.

Denmark--Basic Data

Area in square kilometers:	43,094
GDP (at 1992 market prices)	DKr 867 billion (per capita SDR 19,303)
Labor force (1992 average):	2.9 million
Exchange rate (October 1993):	DKr 1 = US$0.15

Social and demographic indicators

Population (Jan 1993):	5.18 million	Infant mortality (aged under 1 per 10,000 live births; 1991):	78
Life expectancy at birth (1986/90)		Population per physician:	363
Male:	71.9	School years completed:	8.6
Female:	77.7		

Economic Indicators

Official forecasts	Average 1983-87	Average 1988-91	1992	1993 1/	1994 1/
	(Annual percentage change unless otherwise indicated)				
National accounts (at constant prices)					
GDP	3.0	1.2	1.2	-0.5	2.0
Total domestic demand	3.1	-0.4	-0.6	-0.7	2.9
Private consumption	3.0	0.1	1.4	0.8	1.9
Public consumption	1.0	--	1.2	1.9	1.8
Gross fixed investment	7.8	-2.7	-10.3	-6.5	4.5
Imports of goods and nonfactor services	3.9	3.3	0.3	-4.0	3.4
Exports of goods and nonfactor services	3.7	7.1	4.0	-3.0	1.4
GDP in nominal terms	8.5	4.5	3.2	0.9	3.7
GDP deflator	5.4	3.2	2.0	1.4	1.6
Selected domestic indicators					
Unemployment rate (in percent of labor force)	9.0	9.4	11.1	12.3	12.3
Earnings in manufacturing	6.2	4.6	2.9	2.2	2.1
Productivity in manufacturing	-0.6	2.1	2.1	0.6	2.4
Consumer prices	5.1	3.6	2.1	1.3	1.9
Broad money	12.7	2.5	-1.2	...	...
Domestic credit	14.0	6.3	-7.5	...	...
Money market interest rate	10.9	9.7	11.4	11.1	7.0
Long-term bond yield	12.1	10.0	9.5	7.3	6.5

Sources: Danmarks Statistik, Danmarks Nationalbank, International Financial Statistics, and staff projections.

1/ Staff projections.

Denmark - Basic Data Cont'd.

	Average 1983-87	Average 1988-91	1992	1993 1/	1994 1/
	(Annual percentage change unless otherwise indicated)				
General government					
Revenues	11.5	3.3	4.4	-1.9	2.8
Noninterest expenditures	8.0	4.9	6.2	4.4	3.6
Overall general government balance (in percent of GDP)	-1.5	-0.9	-2.6	-4.4	-5.3
Fiscal impulse (+ indicates expansion in percent of GDP)	-0.8	+0.4	--	+0.5	+1.2
Selected external indicators					
Nominal effective exchange rate (appr. = +)	1.2	0.1	2.5	3.9	-1.8
Real effective exchange rate (appr. = +)(relative normalized unit labor costs) 2/	4.3	-0.2	-0.3	3.0	-2.0
Export volume, industry	4.6	6.7	7.2	-3.5	3.0
Market growth	7.0	5.7	1.4	-0.3	1.3
Terms of trade	1.3	0.1	0.8	0.5	-1.6
	(In billions of Danish kroner)				
Balance of payments					
Trade balance	-2.1	22.7	43.5	40.0	33.0
Net interest payments	-25.3	-32.6	-34.5	-31.0	-28.0
Current account balance	-23.2	1.3	28.1	28.2	23.0
(in percent of GDP)	(-3.7)	(0.1)	(3.2)	(3.3)	(2.5)
Net capital flows	31.0	-5.9	-29.2	...	...
Change in reserves, Dkr billion	7.8	-4.6	-1.1	...	...
Official reserves:					
SDR billion	4.6	6.4	8.1	6.5 3/	...
In weeks of imports	13.1	15.2	18.0	...	...
	(In percent)				
Net external debt (in percent of GDP; end-period)	39.1	36.2	27.8	...	...
	(In percent of GDP)				
Gross savings ratios					
Private sector	13.9	15.7	17.5	18.6	18.6
Gross investment ratio	18.9	17.6	15.1	13.8	14.7
Household 4/	0.4	3.5	4.9	6.2	6.0

Sources: Danmarks Statistik, Danmarks Nationalbank, International Financial Statistics, staff projections, and staff estimates.

1/ Staff projections.
2/ Staff estimates.
3/ October 1993.
4/ In percent of disposable income.

Denmark: Fund Relations
(As of November 30, 1993)

I. Membership Status: Joined 3/30/46; Article VIII as from 5/1/67.

II. General Resources Account:	SDR Million	% Quota
Quota	1,069.90	100.0
Fund holdings of currency	758.68	70.9
Reserve position in Fund	311.23	29.1
Operational budget transfers (net)	1.40	

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	179.86	100.0
Holdings	118.58	66.3
Designation plan	--	--

IV. Outstanding Purchases and Loans: None.

V. Financial Arrangements: None.

VI. Projected Obligations to the Fund (SDR Million; based on existing use of resources and present holdings of SDRs): None.

VII. Exchange Rate Arrangement:

Denmark participates in the exchange rate mechanism of the European Monetary System (EMS). It maintains 15 percent fluctuation margins vis-à-vis the currencies of other participants.

Denmark continues to apply exchange restrictions vis-à-vis Iraq, which were notified to the Fund under Decision 144-(52/51) on September 10, 1990 (EBD/90/286) and vis-à-vis the Federal Republic of Yugoslavia (Serbia/Montenegro), which were notified to the Fund under Decision 144-(52/51) on July 7, 1992 (EBD/92/164). Otherwise, the exchange regime is free of restrictions.

VIII. Article IV Consultations:

Denmark was on the bicyclic consultation cycle and, with the termination of the bicyclic procedure, was placed on the 12-month consultation cycle. The staff report for the last Article IV Consultation (SM/90/67) was discussed at EBM/90/73 (May 11, 1990). An interim consultation took place in February 1991.