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April 8, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Denmark - Staff Report for the 1986 Article IV Consultation

The attached supplement to the staff report for the 1986 Article IV consultation with Denmark has been prepared on the basis of additional information.

Mr. Knöbl (ext. 8821) or Mr. Hedfors (ext. 8830) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

DENMARK

Staff Report for the 1986 Article IV Consultation
Supplementary Information

Prepared by the European Department

Approved by L.A. Whittome and J.T. Boorman

April 7, 1986

I. Introduction

Subsequent to the completion of the Staff Report for the 1986 Article IV consultation with Denmark (SM/86/60, 3/17/86), the Danish authorities have implemented a major new package of fiscal measures. The new measures were prompted by the realization that domestic demand had been notably more buoyant and the external balance weaker than perceived even as recently as last December. In addition, external conditions have changed, with the price of crude oil dropping sharply and the U.S. dollar falling further against the Danish krone.

II. Recent Developments

The revised official estimates now available for 1985 indicate an even more buoyant domestic economy than the authorities had previously thought. ^{1/} Private consumption is estimated to have risen by 3 1/2 percent in real terms, led by consumer durable spending, and both business fixed investment and residential construction advanced more rapidly in the second half of 1985 than was initially estimated. Total domestic demand thus rose by 4 3/4 percent in 1985--against a figure in the Staff Report of 4 percent--while an even weaker foreign balance kept the growth of real GDP at 3 percent. These altered estimates for 1985 reflect in particular the buoyancy of domestic demand at the end of the year.

The buoyancy appears to have carried over into 1986. In January 1986, the volume of retail sales (seasonally adjusted) was 2 percent higher than in December 1985 and 5 percent above the level a year earlier. In the first two months of 1986, the Danish trade deficit widened further by some DKr 1.2 billion relative to the same period in 1985. Reflecting declining oil prices and the falling dollar, and despite the buoyancy of domestic activity, price inflation has continued to fall. Consumer prices had increased by 3.6 percent during 1985

^{1/} National accounts figures for 1985 presented in the Staff Report were staff estimates based on qualitative information provided by the authorities.

current account in the course of 1988 and a small surplus by 1990, and in addition a central government surplus of roughly 3 percent of GDP by 1990--in turn implying a public sector surplus of significantly larger magnitude by the end of the decade.

IV. Appraisal

The authorities have now accepted the view that more substantial progress in reducing the current account deficit needed to be made in 1986 and that therefore additional measures were required at an early stage. The further decline in oil prices since the fiscal package last December provided an obvious opportunity for energy taxes to be raised again in order to dampen the growth of consumer demand. The willingness and ability of the Danish authorities to take additional fiscal action is laudable.

The further fiscal tightening should move the public sector into significant surplus in 1986, and should moderate the growth of domestic demand so helping to ensure that the oil-price induced terms of trade gain does in fact generate a substantial reduction in the external current account deficit. Of course, this will also depend on whether the additional fiscal tightening is accompanied by an adequately restrained monetary stance. The recent diminution of private sector capital inflows together with the weakening of the krone within the narrow EMS band suggest that external factors no longer prevent a tightening of monetary policy. The staff welcomes the measures already taken, and believes that the room for a tighter monetary policy stance should be utilized.

In the staff's judgment, the recent package of measures should provide a foundation for the achievement of a progressive reduction in the current account deficit over the next few years, provided that an adequate competitive position is maintained. The staff supports the authorities' implicit recognition in their medium-term projections that a sustained and significant public sector surplus is likely to be needed for the achievement of external balance.

Table 1. Denmark: Selected Economic Data

(Percentage change)

| | 1984 | 1985 Est. <u>1/</u> | 1986 Proj. <u>1/</u> |
|---|-------|------------------------|-------------------------|
| Private consumption | 2.7 | 3 1/2 | 2 1/4 |
| Public consumption | -0.6 | 1 1/4 | -1/2 |
| Gross fixed investment | 12.5 | 14 | 10 |
| Final domestic demand | 3.4 | 4 3/4 | 3 |
| Inventory investment | (0.9) | (--) | (1/4) |
| Total domestic demand | 4.3 | 4 3/4 | 2 3/4 |
| Exports of goods and services | 3.8 | 3 1/4 | 3 1/2 |
| Imports of goods and services | 6.2 | 8 | 4 1/4 |
| GDP | 3.5 | 3 | 2 1/2 |
| External current account balance (in percent of GDP) | -3.2 | -4.6 | -2 3/4 |
| Public sector balance (in percent of GDP) | -4.2 | -1.5 | 3 1/4 |
| Central government balance (in percent of GDP) | -7.7 | -4.3 | 1/4 |
| Consumer price inflation (in percent) | 6.3 | 4.7 | 2 1/2 |
| Unemployment rate (in percent of labor force) | 10.0 | 9.0 | 7 3/4 |

Source: Data provided by the Danish authorities.

1/ Figures for 1985 and 1986 are official estimates and projections.