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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/64

10:00 a.m., April 18, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	D. C. Templeman, Temporary
	H. G. Schneider
	T. Alhaimus
	M. Z. M. Qureshi, Temporary
	M. Sugita
	B. Goos
Huang F.	
J. E. Ismael	
	J. Hospedales, Temporary
	M. Foot
H. Lundstrom	H. Fugmann
	L. Leonard
	A. Abdallah
	P. E. Archibong, Temporary
	M. A. Weitz, Temporary
	J. E. Suraisry
	G. Ortiz
	J. de la Herrân, Temporary
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
	A. Steinberg, Temporary
C. R. Rye	
	A. A. Agah, Temporary
	A. S. Jayawardena
S. Zecchini	N. Coumbis

L. Van Houtven, Secretary
K. S. Friedman, Assistant

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Also Present

Administration Department: H. Wiesner. European Department: B. E. Rose, Deputy Director; R. K Abrams, O. J. Evans, P. L. Hedfors, J. Khallouf, M. Z. Khan, A. Knöbl, S. Mitra, E. F. Nielsen. Exchange and Trade Relations Department: J. T. Boorman. External Relations Department: J. M. Landell-Mills. Research Department: M. C. Deppler, F. Larsen. Bureau of Computing Services: W. N. Minami, Director; C. K. Rhee. Bureau of Statistics: W. Dannemann, Director; A. C. Bouter, M. S. Gill, J. B. Gupta, J. V. Levin, G. F. Loeb, J. B. McLenaghan, K. W. O'Connor, C. A. Patel, M. R. P. Salgado, E. W. Saunders. Advisors to Executive Directors: L. P. Ebrill, G. D. Hodgson, A. Ouanes. Assistants to Executive Directors: A. Bertuch-Samuels, F. Di Mauro, R. Fox, W. N. Engert, O. Isleifsson, A. R. Ismael, R. Msadek, S. Simonsen, H. van der Burg.

1. DENMARK - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Denmark (SM/86/60, 3/18/86; Cor. 1, 4/16/86; and Sup. 1, 4/8/86). They also had before them a staff report on recent economic developments in Denmark (SM/86/66, 3/26/86).

Mr. Fugmann made the following statement:

The Danish authorities appreciate the staff report which, in their view, contains a thorough and stimulating analysis of developments in and prospects for the Danish economy. They are in broad agreement with the contents of the report and with the supplementary note on recent economic policy measures.

As described in the staff report, the Danish economy has during the last three and a half years gone through a period of extensive macroeconomic and structural adjustment. Since 1982, price inflation has been reduced from more than 10 percent to about 2 percent. Wage inflation has been more than halved. Public noninterest expenditure has been reduced from 52.6 percent of GDP to about 45 percent, and the central government budget deficit has been eliminated after having peaked at 11.5 percent of GDP in 1982. The rate of unemployment has been brought down from 10.6 percent in 1983 to less than 8 percent, and 150,000 new jobs have been created in the private sector.

However, the balance of payments developments have not lived up to what was expected and desired--particularly in 1984 and 1985. Therefore, it is now the prime aim of economic policy to achieve a gradual reduction of the current account deficit. The aim remains to eliminate the deficit by 1988.

The increase in the current deficit in 1985 was due to a combination of more expansionary domestic demand than expected and a somewhat disappointing export performance.

Until a few months ago, it was believed that the incomes policy and fiscal package, which was adopted in March 1985, would lead to a dampening of domestic demand toward the end of 1985. As it turned out, this did not happen. The prime reason was that private consumption proved very buoyant due to a strong increase in employment, a more favorable real income development than expected, and a higher propensity to consume. This development was facilitated by falling interest rates and was reflected in strong demand for consumer credit. The other components of final domestic demand also grew somewhat more strongly than had been expected.

Whereas the strong increase in imports--8 percent in real terms in 1985--is not by itself surprising in view of the buoyant domestic demand, it is more difficult to explain the sluggishness of exports. The most recent revisions indicate an increase of only 3 1/4 percent from 1984 to 1985 in real terms. On reason for the disappointing development may well have been the strong expansion on the domestic market, which has diverted output away from export markets.

In the implementation of economic policy, the Government has had a general objective of creating a stable business climate. Although the Government does not believe in short-term fine tuning of demand, it is prepared to take steps to adjust economic policies when necessary. This is evidenced by the two latest adjustments, in December 1985 and March 1986, the details of which are described in the staff documents.

The Government remains convinced that the optimal way of achieving the necessary further improvement in Denmark's external competitiveness is to maintain a restrained development in money incomes. The most recent developments in this field have been slightly disappointing. Whereas only a minor overshooting of the wage guidelines for 1983 and 1984 took place, it now seems unlikely that the guideline of 2 and 1 1/2 percent for the 1985 and 1986 contract years, respectively, will be fully effective on the private labor market. One reason for this is the significant drop in unemployment, which has led to the re-emergence of bottlenecks in some parts of the labor market. Already, in December 1985, the Government took steps to alleviate the pressure in the building and construction sector, where wage pressures were strong during the second half of 1985. Further measures are being taken, mainly in the field of education and retraining. The Government is convinced that these measures and the very low rate of price inflation will secure a continued moderate wage development.

Tight fiscal policy has been another cornerstone of Danish economic policy. This policy has been applied on both the expenditure and the revenue sides, as described in the staff report. As a result, the financial position of the general government has shifted dramatically from a net borrowing requirement of 9 percent of GDP in 1982 to net lending of roughly 3 percent of GDP in 1986, thus yielding a large contribution to correcting the imbalances in the Danish economy. The shift is largely accounted for by the change in central government finances, which are expected to show a small surplus in 1986. This means that the Government's objective for the central government budget deficit has been fulfilled several years ahead of schedule. Tight fiscal policy will be continued in 1987, and present projections show that the public sector surplus will be of about the same size as in 1986.

The prospects for some further increase in the surplus in the following years should be reasonably good, provided that overall taxation can be maintained at the 1987 level and that public expenditure can continue to be kept unchanged in real terms. The shift to a public sector surplus will also mean that government indebtedness will decline, leading to a reduction of interest expenditure. This will further speed up the process of achieving an increased contribution by the public sector to a higher level of domestic savings.

The staff report notes that the economic upswing since 1983 has taken place in an environment of relatively easy money and credit conditions. As evidence, they point to the sharp decline in interest rates and relatively strong growth of money and credit aggregates.

The Danish authorities see the decline in interest rates primarily as a result of the present Government's stabilization policies, which have greatly enhanced domestic and foreign confidence in the krone. The most striking illustration of this is the very large inflow of private capital in 1985, which virtually forced down the domestic interest rate level.

The relatively high growth rates of monetary aggregates must be seen largely as an adjustment to a lower level of interest rates and to the changing structure on the financial markets. Such developments have been observed in other countries without being seen as an expression of excessive monetary ease. Particularly in a small open economy, it seems to be generally accepted that a firm exchange rate policy provides the stabilization effect expected from money supply targets in larger economies.

The staff takes a favorable view of the changes to more market oriented methods of regulation around the middle of 1985 as well as the use of the new instruments since then. During recent months, the effect of the marginal reserve requirement system has in fact been sharpened. Furthermore, measures have been taken to dampen the marketing of consumer loans, and nonbank financial intermediaries can no longer refinance lending to consumers by borrowing abroad.

It seems to be recognized in the staff report that, given the extraordinary level of private capital inflows, some downward adjustment of domestic interest rates in 1985 was reasonable. This narrowing of differentials vis-à-vis foreign interest rates has contributed to the sharp reduction of net inflows in the first months of 1986. The "underlying" level of capital flows is, however, difficult to determine due to uncertainties associated with the European Communities referendum, expectations of a European Monetary System (EMS) realignment, and uncertainty as to the fiscal measures that were in fact adopted just before Easter.

However, the fact that net capital imports have tapered off significantly, while domestic interest rates are still some 4 percentage points above DM rates, suggests that there remains some room for maneuver for domestic monetary policy without attracting an excessive amount of private capital from abroad. The Danish authorities agree with the staff that domestic monetary and interest rate policy should aim at the current account deficit being financed partly through private capital imports. However, they find it premature to raise domestic interest rates more than has been the result of the automatic effect of tightening money market conditions until a clearer picture of underlying capital movements appears.

In summary, the Danish authorities find the staff's description of monetary developments in 1985 and of the problems and policy responses in this area reasonably complete and balanced.

The recent realignment within the EMS led to an adjustment of the central rate of the Danish krone vis-à-vis the deutsche mark of 2 percent, thus partly redressing the loss in bilateral competitiveness with Germany since the previous comprehensive realignment in 1983. Together with the realignments of other EMS currencies, this meant that the average exchange rate of the Danish krone vis-à-vis the other active participants in the EMS remained largely unchanged. This result was in line with the exchange rate policy of the Danish Government.

The Danish authorities consider the maintenance of a firm exchange rate a cornerstone in their economic policy and hope and believe that it will be possible to avoid further comprehensive realignments within the EMS for a longer period. As witnessed by the experience with creeping devaluations during the period from 1979 to 1982, uncertainty with respect to the value of the Danish krone would lead to inflationary expectations, higher interest rates, and loss of business confidence.

Any discussion of the problems in the Danish economy will naturally focus on the balance of payments objective. The Danish authorities are firmly committed to the aim of a balanced external current account by 1988. They also believe that trends are emerging in the domestic economy which make the aim realistic. Thus, the investment boom during the last two years should gradually taper off as the capital stock of enterprises becomes adjusted to the changed environment. A similar effect should occur in housebuilding and in purchases of consumer durables, where the after-tax cost of borrowing to finance the acquisition of such assets will be significantly increased due to the tax reform. Furthermore, large investments in the tradables sector should gradually pay off in larger exports, which will also be enhanced by a continued favorable competitive position.

On the savings side, there will be an increased contribution from the public sector. Private savings will be enhanced by the tax reform. In addition, the Government wants to promote private savings through increased coverage of pension schemes.

Finally, it should be stressed that the improvement in the terms of trade in the wake of the fall in oil prices and in the dollar exchange rate and the ensuing dampening of price inflation will provide a better basis for the present economic policies.

Adjustment is never easy. Neither is it possible to foresee accurately how a market economy will react to a change in economic policies, particularly when the course is altered as radically as has been the case in Denmark. The rebound in private sector activity despite tight fiscal policy has clearly been beyond what was expected by the Danish Government. This has brought about a better internal balance in the economy, but has not yet yielded the expected results in correcting the external imbalance. The Danish Government expects such results to be forthcoming; should this turn out not to be the case, it is prepared to take such further steps as might be required.

Mr. Goos said that Denmark's performance over the previous several years with respect to growth, private sector activity, and employment had clearly been impressive. There had also been a marked reduction in the rate of inflation and relative exchange rate stability. The otherwise exemplary performance was marred by the sharp deterioration in the external current account, which seemed to reflect not only excessive demand pressures but also significant structural weaknesses. As the OECD had recently noted, both the poor performance in terms of export market shares and the rapid growth in imports were traceable at least partly to the narrow export base--the traditional sector still dominated export performance--and the high import elasticity of demand. The latter was probably due to the insufficient capital formation in the 1970s; the recent surge in demand for investment goods could not be met by domestic suppliers. Thus, it was not surprising that the investment boom, together with the buoyant demand for consumer durables in recent years, had caused imports to rise by almost twice as much as exports, a pattern that was unlike that of other European OECD countries. But the restructuring of the manufacturing sector and the modernization of the capital stock in the wake of the ongoing investment boom held the promise of productivity gains and increased external competitiveness in coming years, which in turn should strengthen the external current account.

However, Mr. Goos went on, that outcome could not be taken for granted; it would require a set of macroeconomic policies that would provide appropriate incentives to ensure that the capital goods imported from abroad would flow into the most productive activities, especially export production and import substitution. Moreover, given the technological deficit in the tradable goods sector, emphasis should be given to promoting high technology products. The authorities' program to encourage the introduction of new technology was a welcome step in the right direction and should certainly be followed up. That kind of structural change could be accomplished only if there were a sufficient supply of skilled labor. The shortages of highly qualified personnel in certain sectors of the Danish economy were a cause for concern, and he welcomed the measures that had been included in the fiscal package introduced in December 1985 to reduce bottlenecks in the labor market and to promote further education, training, research, and development.

The need to make certain structural and other medium-term adjustments should not obscure the facts that the unsustainably large external current account deficit was also a reflection of excessive demand pressures and that there was a need for tight demand management policies to reduce that deficit, Mr. Goos continued. Additional measures had been adopted in March 1986 to moderate domestic demand, and he fully agreed with the comments on that subject in the staff's appraisals. Progress in consolidating public finances had been more pronounced in Denmark than in other industrial countries. That achievement was highly commendable, and the authorities' intention to eliminate the external current account deficit by 1988 and their willingness to take additional action when needed were impressive.

He agreed with the staff's general recommendations regarding monetary policy, Mr. Goos said. Hitherto, the brunt of the adjustment burden had been borne by fiscal policy, while inflationary pressures had been contained through statutory guidelines and limitations on price increases. At the same time, however, monetary conditions had been fairly easy. While it seemed clear that monetary conditions in 1985 were a reflection partly of large capital inflows, he wondered whether the staff was implying in the third paragraph on page 14 that there had been no room for a tighter monetary policy in 1985. Chart 6 suggested that the domestic contribution to money growth had increased significantly since at least mid-1985, suggesting that the monetary expansion had not been completely beyond the authorities' control. Given the unabated rapid growth of domestic demand and the need to avoid a resurgence of price and wage pressures, he agreed with the staff that the additional fiscal tightening needed to be accompanied by an adequately restrained monetary stance. In his opening statement Mr. Fugmann had remarked that a firm exchange rate policy would provide the stabilization effect that was expected from money supply targets in larger economies. However, the success of any exchange rate policy--especially within the context of an arrangement like the European Monetary System (EMS)--was critically dependent upon the maintenance of consistent monetary policies. Indeed, the need for such consistency was particularly great in small, open economies.

Mr. Wijnholds commented that the Danish economy had continued to perform impressively over the previous year. Denmark's economic policies had clearly been among the most successful of the European countries. Denmark had achieved an enormous improvement in its public finances--far in excess of what other EMS countries had achieved--together with growth rates of GNP that had continued to be well above the European average. Moreover, inflation and interest rates had fallen rapidly while unemployment had declined significantly. Other industrial countries, particularly the smaller European ones where conditions were broadly similar to those in Denmark, could benefit from a close study of the Danish case.

However, there was a negative side to the performance of the Danish economy, Mr. Wijnholds said: Denmark's success in achieving internal balance had not been matched on the external side, and the external current account deficit had again reached an unsustainable level in 1985--5 percent of GNP. Being a small, open economy, Denmark could not afford to continue to grow more quickly than its main trading partners, especially in view of the country's already large debt service burden. Another cause for concern was wages. Despite the courageous measures that had been introduced, wage drift had contributed to a resurgence of increases in wages to a rate of some 5 percent by the end of 1985. Furthermore, the monetary aggregates had continued to grow rapidly, with broad money increasing twice as fast as nominal GNP in 1985.

The mix in Denmark of a tight fiscal policy and an accommodating monetary policy, which had been applied for a number of years, had clearly been appropriate during the recovery phase, Mr. Wijnholds commented. However, the Danish economy had been in an expansionary phase for some time, and there were increasing signs of excessive demand and of deterioration in the external position. Accordingly the tight fiscal policy and accommodating monetary policy mix was no longer justified. The recently introduced package of fiscal measures was timely and appropriate. He agreed with the staff that the willingness and ability of the authorities to take additional action were laudable. Mr. Fugmann had remarked that the rebound in private sector activity despite the tight fiscal policy had clearly been beyond what had been expected by the Government. He wondered whether private sector activity had been fairly strong precisely because of the substantial fiscal adjustment, which had created room for private sector activity and had increased confidence. It was perhaps in that area that the clearest lessons from Denmark's experience could be drawn for other countries.

The high growth rates of the monetary aggregates in Denmark should not be thought of as being of little importance as long as a firm exchange rate policy was maintained, Mr. Wijnholds said. The growth of the money supply was bound to determine the growth rate of nominal income. If high rates of monetary expansion were to continue, further pressure on the balance of payments could be expected, either through a loss of competitiveness as prices in Denmark rose faster than those in neighboring countries, or through excessive growth of demand. Given the already fairly liquid state of the Danish economy, further rapid monetary expansion could contribute to exchange rate pressures and to a reversal of the trend toward lower interest rates.

He recognized the particular difficulty in conducting monetary policy in Denmark, Mr. Wijnholds continued. As the authorities had noted, in 1985 external factors had effectively placed a ceiling on interest rates; still, high domestic interest rates coupled with confidence in the exchange rate had caused large capital inflows. The new de facto marginal reserve requirement system might enable the authorities to be more effective than hitherto in sterilizing inflows from abroad. The large capital inflows over the previous several years might have been a one-time-only event, as foreign investors had adjusted their portfolios in response to the change in the business climate and to the liberalization of Denmark's financial markets. If capital flows were to persist, the foreign exchange obtained from them could be used to prepay external debt. That move would alter the currency denomination of the external debt, as a larger share would be denominated in Danish kroner. Mr. Fugmann had noted that since capital imports had tapered off despite the considerable interest rate differential with Germany, there was still some room for maneuver in monetary policy without resulting in an immediate substantial increase in capital inflows. That statement was welcome; it was consistent with the staff's view--with which he fully agreed--that the room in which to further tighten monetary policy should be used.

He fully understood the authorities' wish to limit the adjustment of the central rate of the kronee vis-à-vis the deutsche mark to 2 percent during the recent realignment within the EMS, Mr. Wijnholds remarked. Given the present demand pressures and continued significant underlying inflation, a substantial devaluation probably would not have been effective and would have had undesirable inflationary consequences. Moreover, the authorities had had considerable difficulty in extricating themselves from the consequences of the past policy of using every opportunity to devalue the krone within the EMS. Although that policy had been abandoned, it had heavily influenced market expectations concerning the exchange rate for a long time. The authorities' policy of maintaining competitiveness primarily through domestic cost restraint was commendable and would seem credible if the present overall policy stance were broadly maintained and monetary policy were not allowed to become excessively accommodating again.

Mr. Schneider said that the adjustment of the Danish economy, which had been started in late 1982 and had been based mainly on the reallocation of resources from the household and public sectors toward private business through fiscal restraint and a firm incomes policy, had been notably successful. Private sector activity and investment had increased, the rate of inflation had fallen, and economic growth had been strong. Although other factors--the recovery of the world economy and the stability of the exchange rate--had helped, the key element had been the substantial fiscal adjustment of the previous several years. As Mr. Fugmann and the staff had indicated, the rapid reduction in the central government deficit from 11.5 percent of GDP in 1982 to nearly zero in 1985 clearly showed that fiscal adjustment had been more effective in Denmark than in any other EMS country.

During several previous Article IV consultations with Denmark, his chair had noted that the main short-term risk of the authorities' adjustment strategy was the impact that it would have on the external accounts if private consumption were not effectively controlled, Mr. Schneider recalled. In that event, there would have been no marked improvement in the external current account deficit, and the level of external debt would have been on the high side. The adjustment strategy in Denmark could be made more balanced by improving control of domestic demand, especially private demand, and by enhancing domestic savings to cover an increase in private investment. In that connection, the recent measures that the authorities had adopted were particularly welcome. Given the favorable external conditions, the recently introduced fiscal policy measures should strengthen Denmark's medium-term outlook and provide more balanced and healthy growth.

He broadly agreed with the staff appraisal and would limit his comments to the future economic policy stance in Denmark, Mr. Schneider said. He fully supported the Government's approach to fiscal tightening, which was based mainly on an increase in energy taxes and on holding real central government spending constant. Given the new measures, and assuming that domestic activity would remain strong, the staff had estimated that the public sector would record a surplus of about 3 percent of GDP in 1986. The authorities' fiscal strategy, combining expenditure reduction and tax measures, correctly included increases in indirect taxes and cuts in marginal tax rates, which should favor the expansion of business activity and create a stable business climate. As a result, the withdrawal of fiscal stimulus had not adversely affected total economic activity; indeed, it had contributed to sound and balanced growth. In addition, as Mr. Fugmann had noted, the public sector surplus should reduce the government's indebtedness, a development that would have important medium-term benefits for the economy.

In a small, open economy like Denmark's, monetary policy, especially interest rate policy, must be one of the cornerstones of the adjustment strategy, Mr. Schneider said. The relatively easy money and credit conditions of the recent past had contributed to the economic recovery, while the effects of the easy money conditions on prices had been eased by the firm incomes policy. However, as the staff had noted, the experience of 1985 had not been repeated in the sense that private capital inflows had not exceeded the external current account deficit. The narrowing of the gap between domestic and foreign interest rates that had occurred in early 1986 was likely to reduce capital inflows in the coming months. He agreed with the staff that interest rates should be flexible and sufficiently high to ensure that the 1986 external current account deficit would be covered and that the exchange rate would be supported. Higher interest rates would also have the beneficial effect of encouraging domestic private savings and curbing consumer expenditure.

He supported the authorities' commitment to maintain the stability of the krone, Mr. Schneider remarked. In Appendix I of SM/86/66 the staff had discussed the risks of the Government's fixed exchange rate policy. The staff had suggested that in view of the existing external imbalances, demand in Denmark should grow more slowly than in the country's EMS partners while the stable exchange rate policy should be maintained. He fully agreed with that position and welcomed the recent package of measures that was aimed at achieving those goals. Nevertheless, there was a continuing need for structural adjustment in both the industrial and external sectors. The weakness of the product structure of the external trade sector could explain why the ongoing domestic structural adjustment had not led to an improvement in the external current account. It was therefore important to note that the authorities had begun to address that problem by implementing a program of technological improvement.

Incomes policy was crucial, Mr. Schneider said. Given the stable exchange rate policy, Denmark's competitive position must be safeguarded by productivity increases and especially by a continuation of low wage increases. The decline in productivity in 1985--which reflected partly Denmark's poor performance with respect to export market shares--must be reversed to avoid irresistible pressures on the exchange rate and monetary policy. Finally, the authorities were to be commended for Denmark's official development assistance performance and for the recently adopted decision to increase further the volume of that assistance by 1992.

Mr. Leonard considered that Denmark had been remarkably successful over the previous several years in restructuring the economy and in reducing inflation while maintaining relatively rapid growth and rising employment. The progress in fiscal consolidation had been particularly impressive; it had resulted in a remarkable decline in the government deficit as a percentage of GDP and had released resources to the private sector, which had made good use of the opportunities that had thus been opened up for it. The authorities were to be commended on their achievements.

He generally agreed with the staff analysis, Mr. Leonard remarked. There were two sources of potential danger for the Danish economy. The first was the management of monetary policy. It was true that the task of conducting monetary policy in Denmark in recent years had been complicated by a number of factors: portfolio allocations had been adjusted with the easing of exchange controls; there had been shifts in the demand for money following the lower inflation and lower nominal inflation rates; and the fiscal readjustment and the move to a more market-oriented monetary control mechanism might have altered the previously accepted monetary relationships. Those factors were likely to result in more rapid monetary growth than would have otherwise been the case, but they need not have led to overheating of the economy. With the benefit of hindsight, it seemed evident that an excessively rapid rate of monetary and credit growth had been tolerated and that its potentially inflationary consequences had been underestimated.

Denmark had benefited from a coincidence of circumstances that had helped to offset the inflationary pressures, Mr. Leonard commented. The weakness of agricultural prices and of import prices in general--which had recently been reinforced by the fall in petroleum prices--had been of considerable benefit. The growth of pay costs under the statutory incomes policy had been contained fairly tightly, as the level of unemployment had fallen slightly but had remained relatively high. The staff felt that the monetary policy stance was excessively lenient, and he agreed with the staff that the authorities should orient monetary policy along more cautious and restrained lines. That effort would have the benefit of maintaining the credibility that the Government had built up through the fiscal restraint and its commitment to a firm and stable exchange rate. Therefore, the recent steps that the authorities had taken, which were outlined in Mr. Fugmann's opening statement, were welcome.

The external accounts were the second area of potential instability, Mr. Leonard remarked. As was to be expected in an economy that was as open as Denmark's, excess domestic demand was as likely to be reflected in a growing external current account imbalance as in rising prices. In fact, the current account deficits in Denmark had been growing, and he agreed with the staff's conclusion that sooner or later those deficits and the sizable external debt would, in the absence of corrective action, undermine the authorities' fixed exchange rate policy. Accordingly, in addition to the monetary restraint, fiscal tightening was needed, so that domestic savings could be brought more into line with the financing needs of domestic investment. The authorities had taken steps to move in that direction in the package of measures that they had adopted in March 1986.

The way should be open for reasonably balanced growth and rising employment, provided that two conditions were met, Mr. Leonard continued. First, the growth of nominal pay levels must be closely contained. The successful operation of incomes policy in recent years had been a major factor in securing growth and rising employment at a time when fiscal policy had been strongly contractionary. He hoped that when present pay arrangements expired in 1987, the same restraint in pay developments would be evident in the future. Second, the investment boom that had started in 1982 should result in an increase in exports. He was pleased that investment in machinery and equipment by the industrial sector since 1983 had increased sharply, and that, while much of the investment in 1983 had been aimed at modernization, the trend in 1984 had been toward enlarging capacity. The potential to increase output existed, and, since domestic demand was being curbed, it should be exploited in order to increase Denmark's share of world trade.

Provided that the conditions that he had described were met, he was more confident than the staff about Denmark's medium-term external prospects; the goal of current external balance might be reached more easily than the staff expected, for three reasons, Mr. Leonard commented. First, the oil price had fallen much lower than the staff had assumed in making its simulations, and the lower price would have benefits on the import side. Second, the recent fiscal measures and the tightening of monetary policy should have reduced domestic demand adequately. Third, given the capacity conditions and the level of competitiveness, exports were likely to be higher than the staff had projected.

He was puzzled by the staff's suggestion that the authorities should seek to cover the external current account deficit by attracting private capital inflows, Mr. Leonard said. Such a policy might be justifiable as a temporary expedient. However, since by their nature such inflows were likely to be volatile and to be reversed with interest rate or other changes, more lasting means of covering the deficit would have to be found or the deficit itself would have to be eliminated through adjustment measures.

Denmark's commitment to a liberal trade policy, its firm support of a new GATT round, and its resistence of protectionist pressures were commendable, Mr. Leonard remarked. The country's record of official development assistance was admirable, and he welcomed Denmark's decision to increase its aid annually with a view to reaching the Government's target of 1 percent of GDP by 1992.

Mr. de la Herrán said that, with the exception of the external sector, the behavior of the Danish economy in 1985 had been remarkable: the rate of inflation had continued its downward trend, reaching 3.6 percent in 1985, and was projected to fall to 2 percent in 1986; and the fiscal sector had achieved a remarkable turnaround since 1982, recording a comfortable surplus in 1986 compared with a deficit of 9 pecent of GDP just three years previously. The reasons for that success were the positive conjunction of both the sound economic policies undertaken by the authorities and favorable external factors, especially the depreciation of the dollar, lower interest rates, and the abrupt drop in oil prices. Nevertheless, the continued buoyancy of domestic demand had resulted in a marked deterioration in the external current account.

An improvement in the external current account deficit had been expected in 1985, but the results had been disappointing, Mr. de la Herrán said. Correcting the external imbalance remained the major challenge facing the authorities. The objective of eliminating the external current account deficit by 1988 was highly commendable but seemed optimistic. The trade gap had been widening in recent years, and during the first six months of 1986 it had further deteriorated. While the decline in the dollar and in petroleum import prices would have substantial beneficial effects on the external current account, it could also help to fuel stronger domestic demand, thereby jeopardizing the success of the measures that the authorities were taking to tighten their policy stance. The persistent large external current account deficit could be linked to the loose monetary conditions that had been required to maintain a stable exchange rate for Denmark's currency within the EMS. The authorities had clearly shown their intention to maintain strict discipline in the exchange rate area, and Mr. Fugmann had stressed that a firm exchange rate was a cornerstone of the authorities' economic policy stance. The authorities were not using the exchange rate as an effective tool to maintain competitiveness, and he wondered whether the objective of maintaining a firm exchange rate was consistent with the objective of reducing the external current account deficit. Mr. Fugmann should comment further on his statement that in a small open economy it seemed to be generally accepted that a firm exchange rate policy provided the stabilization effect expected from money supply targets in larger economies.

The evolution of the fiscal sector had been impressive, and the authorities were to be commended for their achievements in that area, Mr. de la Herrân considered. The series of fiscal packages that had recently been introduced were a reflection of the fiscal adjustment effort. Far from being complacent, the authorities had demonstrated that they would continue their fiscal retrenchment, as was clearly evident in the fiscal package approved in March 1986. Their attitude was welcome, as the sharp improvement in public finances had been more than offset by the increase in the private sector deficit, which in turn reflected the total financial deficit, which was equivalent to the external current account deficit. The emphasis should be placed on providing incentives to increase savings in order to match the financing needs resulting from the boom in private investment. He hoped that future taxation plans would take those factors into account and provide sufficient room in which to increase public and private savings.

One of the main factors in the buoyance of domestic demand was the loose monetary policy, under which the monetary aggregates had been growing rapidly, Mr. de la Herrân observed. Despite the expansionary monetary policy, inflation had been kept at acceptable rates. The international environment had had a favorable effect on domestic prices in Denmark, but that fact alone could not explain price behavior in the country unless there had also been excess capacity in the Danish economy. The relatively high rate of unemployment despite the investment boom suggested that there was excess capacity in Denmark. However, the staff had implied that pressures on capacity and prices might be building up. Accordingly, the authorities' intention to maintain a more stringent monetary policy was appropriate. The authorities seemed to have some difficulty in controlling the monetary aggregates because of the effect of private capital inflows on the monetary base. Accordingly, interest rate policy must be monitored carefully in order to keep interest rates as high as possible while avoiding excessive capital inflows that could conflict with the effort to meet the monetary targets.

Mr. Suraisry remarked that since late 1982, the authorities had been pursuing a strategy designed to reorient the economy toward the private sector in general and toward the tradable goods sector in particular. The policy mix associated with that strategy had involved a combination of a tight fiscal policy and an accommodating monetary policy supplemented by incomes restraint and a commitment to maintaining the value of the krone within the EMS. In many respects, that strategy had been remarkably successful.

As his chair had stressed on previous occasions, when pursuing a policy of fiscal retrenchment a member must create an environment in which the private sector would willingly take up the slack, Mr. Suraisry continued. The Danish authorities had been particularly successful in that respect: the public sector fiscal deficit had declined from 9 percent of GDP in 1982 to 1 3/4 percent in 1985, and government expenditure had been restrained; despite that sharp fiscal retrenchment, the Danish economy--fueled by an investment boom--had grown robustly over the previous two years, and in marked contrast to the experience of its EMS neighbors, Denmark had experienced sizable increases in total employment over the previous two years. Apparently the strength of the authorities' commitment to the adjustment process had succeeded in instilling considerable confidence in the economy. That confidence was reflected in the behavior of capital inflows, which, although weak in recent months, had generally been strong throughout the current recovery.

The authorities were to be commended for those achievements, Mr. Suraisry said. However, the external current account deficit had remained large and was a cause for concern, given Denmark's sizable external debt. In addition, after declining in 1983 and 1984, real wages had begun an upward trend that could erode Denmark's competitiveness, particularly in 1987, if moderation was not encouraged in the biennial wage negotiations in 1986. The recent decline in the shares of exports going to Denmark's traditional European partners should be monitored closely, since the recent depreciation of the U.S. dollar might reverse Danish export gains in the United States. It seemed clear that, despite the recent, welcome realignment of the krone/deutsche mark exchange rate, the Danish authorities faced significant challenges if the recent pace of economic expansion were to be sustained.

Those challenges had implications for economic policy in both the short and medium term, Mr. Suraisry remarked. In the medium term, the key appeared to be an increase in domestic savings, and he welcomed the authorities' commitment to reduce the top marginal income tax rates and to limit interest deductibility. He also welcomed their efforts to encourage private pension schemes since, over the longer run, those efforts might have a larger positive impact on savings than increases in the return on savings. Such measures could be usefully reinforced by further efforts to increase public savings. He was encouraged to note that, as a result of the recently adopted fiscal package, the public sector fiscal balance was projected to register a surplus of 3 1/4 percent of GDP in 1986. That achievement was remarkable and implied that the objective of balancing central government finances would be attained well in advance of the 1990 target date. It also implied that the public sector was moving from being a net user to being a net supplier of savings. Much of the projected improvement in the fiscal balance in 1986 was to be accomplished through an impressive 3 1/2 percentage point reduction in the ratio of spending to GDP.

However, the excessive reliance on increased energy taxes in the recent tax package was a cause for concern, Mr. Suraisry went on. Given the strategy of encouraging private sector activity and the need to improve the export competitiveness of Danish industry, the benefits of lower oil prices should be fully passed through to the private sector. By relying on such taxes, thereby precluding lower inflation rates, the authorities might complicate their efforts to encourage wage moderation. In addition, by having future energy taxes reflect automatically future changes in the price of oil, the outlook for the performance of government revenues automatically became uncertain. Hence, the staff's strong encouragement for increased energy taxes was surprising.

Monetary policy had tended to play a relatively passive role in Denmark, Mr. Suraisry noted. Monetary developments had reflected developments on the real side of the economy. Lower interest rates abroad and strong international confidence in the Danish economy had resulted in capital inflows that in turn had helped to stimulate the investment boom and had resulted in rapid monetary expansion. There was evidence of a buildup of liquidity on the monetary side. That development should be closely monitored. The authorities' shift to a more market-oriented monetary control mechanism was welcome. The proposed change in interest deductibility provisions in order to bring Denmark's financing costs more in line with those of its neighbors was also welcome.

The authorities were to be commended for their commitment to a liberal trade policy, their generous official development assistance, and their commitment to increase that assistance to the equivalent of 1 percent of GDP in 1992, Mr. Suraisry said.

In general, the authorities were to be commended for their overall achievements thus far, Mr. Suraisry commented. The main challenge they faced was to sustain the progress that had been made. Mr. Fugmann's statement that the objective of eliminating the external current account deficit by 1992 was still thought to be feasible, was encouraging.

Mr. Foot said that he agreed that the authorities were to be commended for the successful overall performance of the economy in recent years and for the way in which that success had been achieved. It was also reasonable to assume that the authorities would be able to face up to the remaining problems, particularly on the external front, and would react quickly and substantively--as with the March 1986 adjustment measures, which had been adopted just three months after the previous policy package--in response to changing circumstances.

On the external side, he wondered whether the detailed information in Table 25 on page 73 of SM/86/66 on the direction of Denmark's trade provided any indication of the authorities' ability to take full advantage of their apparently competitive external position to correct the external imbalance, which was the main challenge facing the authorities, Mr. Foot continued. In recent years, Danish exports had grown particularly rapidly only to the United States, and the exchange rate movements of the previous six months would of course make it more difficult for Danish exports to continue their success in the United States. In addition, Danish exports to Germany had increasingly fallen short of Danish imports from that country, and the recent changes in EMS rates were unlikely to change that position significantly. As a result, he agreed with the staff and

Mr. Fugmann that adequate restraint of domestic demand in Denmark was the main way in which the authorities could achieve the desired improvement in the external current account.

Other less important policy keys should not be ignored, and he was worried by the recent news that the welcome decline in the level of umemployment in Denmark from 9.5 percent in 1984 to 8.1 percent in 1985 had shown that there were bottlenecks in the supply of labor even though an unemployment rate of 8 percent would have been regarded as exceptionally high 10 or 15 years previously, Mr. Foot commented. Labor supply bottlenecks were a potential problem in many European countries, and he hoped that future reports on Article IV consultations with Denmark would review the progress that was made in the various training and labor market schemes that the staff had described in SM/86/66 and would assess more clearly the significance of the labor supply bottleneck in the recent relatively sluggish performance of exports. The progress of the investment boom should also be monitored, especially to ensure that investments were appropriate.

The authorities appreciated the need to consolidate and further improve upon their remarkable transformation of the fiscal position, Mr. Foot said. However, the overall tax burden in Denmark had risen sharply in recent years and was substantial. As he understood it, the 1987 tax reform package was part of a complex political and economic agreement. It seemed desirable at least to maintain the fiscal position in the coming several years without delaying the needed reduction in the tax burden.

The authorities should maintain a fairly tight monetary policy, especially in view of their reliance on private capital inflows to finance the external current account deficit, Mr. Foot remarked. He agreed with Mr. Leonard's comments on the balance that should be struck in that respect. As Mr. Fugmann had mentioned, the rate of growth of many of the monetary aggregates might not in itself provide much information and would be difficult to interpret in a period of rapidly changing financial markets. However, experience in the United Kingdom suggested that the present changes in the capital markets in Denmark would tend to fuel the demand for credit by the private sector both because they increased the supply of credit and because they reduced the cost of financial intermediation. Official responses--such as the marginal reserve requirement scheme--had their place, and the United Kingdom had used a similar approach during much of the 1970s, although that approach had had to be abandoned in 1980/81 in face of the growing competition among a wide range of increasingly homogenous financial institutions. Similar competition in Denmark was reflected in the efforts of a major Danish mortgage finance intermediary to expand into the U.K. mortgage finance market in recent months. In such circumstances the authorities might use as a monetary control instrument either the general level of short-term interest rates or tax changes, such as the recent extension of taxation to previously untaxed financial institutions. Differential deposit requirements and other similar instruments would not be particularly effective in Denmark's situation.

On the major shift in the currency composition of Denmark's external debt described on pages 63-64 of SM/86/66, Mr. Foot said that with the benefit of hindsight, and assuming the continuation of current exchange rates and interest rates, it was possible to conclude that the restructuring of the debt in 1985 could prove to be expensive. Presumably the composition of Denmark's reserves had also changed, and he wondered whether there were any indications of changes in the currency composition of the debt of Denmark's private sector. If the restructuring had proved to be a mistake, it was a natural one and one of the very few that the authorities apparently had made over the previous five years. Finally, the authorities were to be commended for their liberal trade and official development assistance policies.

Mr. Templeman remarked that in general the authorities had continued to make commendable progress toward reaching the medium-term goals that they had set in 1982. Progress had been made both in comparison with past performance in Denmark and in achieving greater convergence with Denmark's partner European Communities (EC) countries. In 1986, the rate of inflation apparently was approximately 2 percent, GDP was expected to grow at a moderate rate of 2 1/2 percent, employment was likely to rise for the fourth year in a row, the unemployment rate should continue to fall, the central government and the public sector accounts should move into surplus, and the external current account deficit should decline to less than 3 percent of GDP. Furthermore, in 1985, Denmark had reduced its rate of inflation to the EMS average, and Denmark was estimated to have strengthened its fiscal position far more than any other EMS country in 1982-86. Nevertheless, there were some underlying causes for concern about the durability of the authorities' accomplishments, mainly because of the extent to which wage and price pressures had had to be contained through statutory controls, the continued pervasive influence of the large public sector deficit, and the continued shortfall in domestic private savings.

The staff report appropriately stressed the importance of the recovery of business profitability and the boom in business fixed investment, Mr. Templeman continued. Those developments had helped Denmark to achieve a moderate rate of economic growth and job creation and had improved the prospects for an adequate supply-side response to the growth of domestic and foreign demand over the medium term. Developments in employment had been difficult throughout the rest of Europe but were heartening in Denmark, where employment had grown by nearly 2 1/2 percent in 1984 and 1985 and the unemployment rate had fallen to about 8 percent. Wage restraint in Denmark had helped profitability and had fostered the rapid growth of gross fixed investment of about 12 1/2 percent in 1984, about 14 percent in 1985, and an estimated 10 percent in 1986.

However, private savings had failed to keep pace with the growth of private investment, resulting in substantial dependence on foreign savings, Mr. Templeman said. All of the rise in the total domestic savings rate in recent years had been due to the sharp reduction in the negative savings of the public sector. The dependence on foreign savings in 1985 had actually exceeded that of 1982. The drop in world oil prices in 1986 and the strengthening of the external current account had reduced Denmark's dependence on foreign savings, but he continued to worry whether domestic private savings would grow sufficiently in the longer run to sustain an adequate rate of investment.

Business profitability in recent years had been a function of the introduction and maintenance of wage, profit, and price controls, Mr. Templeman noted. The inability to reach a consensus on wages in 1985, the consequent resort to statutory limits on wages, and the evidence presented by Mr. Fugmann that the wage guidelines for the 1985 and 1986 wage contract years might not be fully effective, as well as the continuation of limits on prices and profits, raised questions about the future performance with respect to costs and price inflation. The decision to extend the suspension of wage indexation into 1989 would further postpone the return to free collective bargaining. The staff reports contained concise references to the effectiveness and the effects of the controls on wages, profits, and dividends, and a further comment on the application of those controls and on the possibility that they were building distortions into the system would be helpful.

The sharp reduction in the fiscal deficit and in negative public savings since 1982 had made a substantial contribution to the improved overall savings/investment balance, Mr. Templeman remarked. In addition, the tax reform agreed in mid-1985 was designed partly to improve incentives for private domestic savings. However, a number of questions and doubts naturally came to mind. First, although the turnaround in the fiscal deficit since 1982 had been remarkable and had included substantial cuts in the ratio of spending to GDP, the overall size of the public sector remained substantial. For example, in 1986, even taking into account the results of the December 1985 and March 1986 fiscal measures, the ratios to GDP of revenues and expenditures would exceed 50 percent. Second, although the tax reform was meant to increase incentives to private savings, the maximum marginal income tax rate would fall only from 73 percent to 68 percent and the maximum marginal rate on interest income would still be 50 percent. Third, the corporate tax rate had been raised from 40 percent to 50 percent in 1985 to offset the cut in social security contributions by businesses. Fourth, the staff apparently believed that there was still room in which to encourage personal savings by further reducing the tax deduction allowed for interest payments. Further comments on those developments would be welcome. The staff should also comment on the realism of Denmark's objective of achieving persistent fiscal surpluses in coming years in order to achieve the necessary balance between domestic savings and investment.

In its report the staff had conveyed an undercurrent of concern about the adequacy of Denmark's international competitive position in the light of the continued strong domestic demand and the appreciation of the Danish krone, Mr. Templeman continued. The Executive Board had expressed the same concern during the previous Article IV consultation with Denmark. There was still some uncertainty about Denmark's competitiveness because of the continued external current account deficit and the substantial accumulation of foreign debt. The improvement in Denmark's terms of trade owing to the decline in the world price of oil, and the effects of recent fiscal measures in restraining demand should substantially reduce the current account deficit in 1985 and improve the prospects for deficit reduction in the future. However, the underlying external position might remain unsatisfactory. He sympathized with the authorities, who wished to preserve competitiveness through cost restraint rather than by depending excessively on currency devaluation. Healthy growth in European markets, especially Germany, would be helpful. Prior to the recent EMS realignment, Denmark had apparently suffered some loss of price competitiveness. Over the medium term, continued uncertainty about relative domestic demand pressures within the EC and elsewhere suggested that exchange rate flexibility might still need to remain a policy option for the Danish authorities. A further comment on Denmark's competitive position in the wake of the recent EMS realignment would be useful.

Possible use of the exchange rate option was also relevant with respect to Denmark's monetary policy, Mr. Templeman said. The authorities' determination to hold the exchange rate constant in 1985, at a time when large capital inflows had been recorded, had considerably limited the authorities' ability to contain the growth of the money aggregates, and M1 had risen by 26 percent and M2 by 16 percent. The recent tightening of monetary policy was therefore welcome, and he agreed that the recent slowing of capital inflows and the weakening of the krone had opened up the possibility of greater restraint in the growth of the money aggregates in 1986. The movement toward market-oriented monetary instruments in 1985 with the abolition of lending guidelines and of central bank borrowing tranches was welcome.

The authorities had made great strides in a number of areas in recent years, Mr. Templeman considered. However, some serious problems remained with respect to labor relations, the domestic private savings effort, and the continued large and pervasive public sector.

Mr. de Forges remarked that the developments in oil prices and in the exchange rate of the U.S. dollar had strongly influenced Denmark's open economy. The authorities had responded in a timely fashion to those changes by adopting strong measures. They had shown that they were willing to take advantage of favorable developments to improve further the Danish economy. However, the recent measures, as well as developments in 1985, should be seen in the context of the broad adjustment effort that the authorities had maintained since 1982. The results of that effort were impressive: price and wage inflation had been dramatically reduced; the share of public expenditure in GDP had been substantially lowered; the central government deficit had been curtailed, and unemployment had recently begun to decline rapidly.

However, as Mr. Fugmann had noted, private consumption remained very buoyant, and the performance of private savings and of exports had been weak, Mr. de Forges commented. As the authorities themselves had noted, the adjustment process had not yet been completed, and despite the encouraging recent developments in the external position, there was little room for maneuver in the management of economic policy. The current phase seemed to be a transitory one in which the authorities must prevent an overheating of the economy that would offset some of the positive results of their adjustment efforts in recent years. It would be essential to be certain that the investments that had been made in recent years--owing partly to the broadening of the export base--would have positive effects on the trade balance. To that end, the authorities should take advantage of the recent improvement in the terms of trade to lower domestic production costs. Wage and salary negotiations that were scheduled to take place at the beginning of 1987 would be of crucial importance.

The recently adopted package of fiscal measures was commendable, Mr. de Forges considered. It should accelerate the process of eliminating the central government deficit, which should partly offset the low level of private savings. The recent agreement on an understanding concerning monetary policy after considerable discussion of the matter between the authorities and the staff was welcome. The level of interest rates remained a difficult issue, and flexibility in interest rate policy should be maintained. Finally, the authorities were to be commended for their active and increasing participation in the area of official development assistance.

Mr. Rye said that he agreed with the staff's conclusions. The staff report presented a balanced picture of economic developments in Denmark and appropriately gave an implicit endorsement of the authorities' policies.

He agreed with the staff that the turnaround in the public sector balance from a deficit equivalent to 9 percent of GDP in 1982 to a surplus of 3 1/4 percent in 1986 was remarkable, Mr. Rye continued. The Danish authorities had been able to move further and faster in the area of fiscal consolidation than those of any other industrial country. The fiscal achievement was also remarkable in terms of its consequences: the massive withdrawal of fiscal stimulus at the sharp rate of more than 3 percent a year seemed to have had no adverse effects on the Danish economy; indeed, both GDP and new jobs had grown at a healthy rate. He agreed with Mr. Wijnholds that the authorities' fiscal policy had positive consequences for the private sector, and, as Mr. Foot had mentioned, the correction of serious economic imbalances need not, and often should not, be approached in a gradual manner. Developments in Denmark confirmed the point that he and some other Executive Directors had occasionally made--that the appropriateness of fiscal stimulus was open to serious question. While it was always dangerous to generalize from the experience of a particular country, it was perhaps unnecessary to worry about the consequences of further fiscal consolidation in more significant economies, such as Japan's.

The very strength of the Danish economy had caused some difficulty with the balance of payments, Mr. Rye remarked. The staff and the authorities seemed to feel that the EMS arrangement imposed a constraint on exchange rate policy that was somewhat irksome in the present circumstances. While he would certainly not advocate a return to the era of predictable programmed devaluations, an increase in flexibility in Denmark's exchange rate might be useful. In sum, the authorities were to be commended for turning around their economy to the extent that, in a number of respects, Denmark was an object lesson for many other members.

Mr. Huang noted that the authorities' remarkable economic achievements over the previous several years included a significant reduction in the rate of inflation, an increase in investment, a decrease in unemployment, and an improvement in the budgetary position. However, the main achievement was the elimination of the central budget deficit, which had peaked at 11.5 percent of GDP in 1982. All those achievements were attributable to the strenuous efforts of the authorities to maintain extensive macroeconomic and structural adjustment. The achievements thus far would contribute to the elimination of the remaining weaknesses in the economy.

The major weakness in the economy was the rapid increase in recent years in the external current account deficit, Mr. Huang continued. That deficit had increased sharply, from DKr 18 billion in 1984 to DKr 28 billion in 1985, or from 3 percent of GDP in 1984 to 4.5 percent in 1985. The main goal of Danish economic policy in 1986 was to achieve a gradual reduction in the external current account deficit. He wondered why that deficit had risen so quickly. Apparently the deterioration of the competitive position owing to the falling dollar would in itself not account for the rapid rate of increase in Denmark's current account deficit. While the negative effect of the falling dollar in 1985 on Denmark's exports should not be overlooked, it should not be exaggerated either. In fact, Danish exports of goods and services had increased by 3.8 percent in 1985, the same rate of increase as in 1983 and 1984. Accordingly, the sharp increase in the external current account deficit seemed to have occurred mainly because import growth had exceeded export growth. Imports had risen by 0.3 percent in 1983, 6.2 percent in 1984, and 7.5 percent in 1985, mainly because of the extraordinary growth of domestic demand in 1985. It was clear that a considerable reduction in the external current account deficit could be achieved only if the growth in domestic demand was constrained, and he was pleased that the authorities had been introducing policies to that end.

Tight fiscal and monetary policies were needed to constrain domestic demand growth, Mr. Huang went on. The rapid growth of domestic demand in 1985 had been due mainly to the rapid increase in investment and not to the rise in consumption. Private consumption had increased by only 2.7 percent in 1984 and 3.1 percent in 1985 and public consumption had fallen by 0.6 percent in 1984 before rising by 1 percent in 1985; gross fixed investment had increased rapidly, by 12.5 percent in 1984 and by 14 percent in 1985. It was clear that the increase in imports and the consequent increase in the external current account deficit in 1985 had been closely associated with the sharp increase in investment. Business fixed investment had grown by 40 percent in 1982-85, and manufacturing investment had grown even more rapidly. In addition, business investment in recent years had been supported by an extraordinary volume of private capital inflows. Given those factors, tight economic policies should be aimed mainly at the growth in investment expenditure rather than the growth in consumption expenditure, although appropriate constraint on wages would be important. In the circumstances, it seemed imperative for the authorities to postpone any plans to lower the overall level of taxation and to increase taxes--especially on energy--if the authorities were to be able to exercise effective constraint on domestic demand. In addition, a high level of interest rates should be maintained by a tight monetary policy in order to constrain investment demand and to attract some private capital inflows to cover the external current account deficit. In sum, Denmark's economic performance in 1985 had been good, despite the excessive domestic demand. The authorities' macroeconomic and structural adjustments were highly commendable.

Mr. Zecchini said that the performance of the Danish economy in 1985 and in the first part of 1986 seemed rather encouraging, as some of the major imbalances had been reduced without curtailing the rate of economic growth that had been achieved in 1984. The unemployment and inflation rates had both declined, and gross fixed investment had kept expanding at a rapid rate. That combination of good results seemed to undermine the widely accepted idea that inflation could be reduced only at the cost of an increase in unemployment. The achievements in Denmark were traceable to the significant restructuring of the economy that had been under way since 1982. In that context, a crucial role had been played by the specific mix of economic policies that the authorities had maintained. While incomes policy had borne the responsibility for constraining domestic inflationary pressure and for supporting external competitiveness in the face of the nominal exchange rate depreciation, fiscal adjustment had helped to control domestic demand expansion, thereby leaving room in which monetary policy could be kept less stringent than would otherwise have been required. That approach had permitted a lowering of interest rates that had paved the way for the current investment boom.

It was reassuring that, in the case of Denmark, the staff had recognized the importance of an economic strategy based not only on the traditional instruments of fiscal, monetary, and exchange rate policy, but also on incomes policy, Mr. Zecchini remarked. He hoped that, with that new awareness, the staff would draw the necessary conclusions for the design of adjustment programs for other economies.

Despite the substantial progress that had been achieved in 1985, Denmark still faced the major task of reducing the high level of external debt by balancing its external current account over the coming several years, Mr. Zecchini continued. The authorities had not made any step forward in that direction in 1985, as the current account deficit had risen to more than 4 1/2 percent of GDP. Accordingly, he agreed with the authorities and the staff that external adjustment had to be given priority over other economic objectives. The problem facing the authorities was to find the means with which they could restore a balance between national investment and saving.

The staff report suggested that the excess of investment over saving should be reduced in 1986 as a result of a compression of total domestic demand expansion, Mr. Zecchini remarked. According to the data provided by the authorities, domestic expansion was expected to grow by 2 3/4 percent in 1986, compared with the 4 1/4 percent previously projected by the staff on the basis of assumptions that were slightly different from those assumptions that had been made by the authorities. According to the official projections, the slowing of growth of domestic demand should be derived mainly from the deceleration in the rate of growth of fixed investment and public consumption, while private consumption would slow more gradually. However, it was not clear to him which measures the authorities intended to introduce in order to contain domestic demand expansion or how the staff viewed the authorities' latest projections. For example, why should the rate of increase in fixed investment be expected to fall more rapidly than the rate of increase in private consumption?

The information on the more recent perspectives of incomes policy would be helpful, Mr. Zecchini continued. The need to check consumption expenditure growth implied that wages and salaries should not be allowed to benefit substantially from the improvement in the external terms of trade. The greater the improvement, the more cautious the incomes policy should be. Should that caution fail to materialize, fiscal policy would have to assume a more active role in the authorities' present strategy.

The authorities' objective of stabilizing public expenditure as a ratio to GDP seemed to be fully consistent with their objective of generating positive saving by the public sector, Mr. Zecchini remarked. In contrast, it was not clear whether the policy on revenue was fully adequate. Reductions in oil and commodity import prices should be offset by increased taxes on consumption--particularly energy consumption--to restrain domestic demand. Moreover, although it was necessary to carry out the recently agreed tax reform in order to rationalize the tax system, attention should be paid to the need to avoid any possible decline in the tax burden--as measured by the ratio of tax revenue to GDP--in coming years. Any reduction could jeopardize the achievement of the amount of public net saving that, under the authorities' strategy, represented the main contribution to balancing the external current account.

At the same time, a greater effort should be made to analyze and influence the saving pattern of the private sector in order to enhance private savings, Mr. Zecchini went on. For example, it would be useful to assess the extent to which the development of the comprehensive welfare system had negatively affected the propensity to save in the household sector. It would also be useful to estimate the expected quantitative impact of the recent tax reform on private savings. Should the saving pattern prove to be rigid, a heavier burden should be placed on the public sector in the effort to generate enough savings to eliminate the external imbalance.

The rather accommodating monetary policy stance that had been evident in 1985 should not be continued in 1986, Mr. Zecchini considered. Monetary policy should be aimed at restraining domestic demand and at attracting capital inflows. The recent decline in interest rates in the EEC and the depreciation of the Danish krone vis-à-vis the deutsche mark as a result of the latest EMS realignment had created more room for a flexible interest rate policy than was suggested on pages 20-21 of the staff report. Given the apparent recent improvement in external competitiveness, the authorities did not necessarily have to aim at relatively high interest rates, especially as the high levels could substantially affect the expansion of fixed investment.

Mr. Agah remarked that the new strategy that the authorities had adopted in the fall of 1982, which was aimed at reducing the imbalances in the economy, seemed to have had positive results, especially in the internal sector. Since the previous Article IV consultation with Denmark (EBM/85/43, 3/18/85), there had been further achievements in private sector activity, employment, and in the containment of inflation. The external deficit, however, had remained difficult to suppress and had grown at the end of 1985, causing some overheating of the economy.

Despite the rigidities in the labor market, the authorities' policies had resulted in a strong recovery in 1985 characterized particularly by a rebound in fixed business investment and manufacturing activity, Mr. Agah continued. Real GDP had grown by 3 percent in 1985, and wage restraint had led to an increase in profitability. At the same time, lower interest rates had resulted in an increase in the demand for capital goods and consumer durables.

In the face of the widening external current account deficit owing to the strong domestic demand, the authorities had introduced in December 1985 a package of fiscal measures designed to realign Denmark's cost structure with most of its EMS partners, Mr. Agah noted. The fiscal position had improved substantially since 1982; the fiscal deficit was equivalent to 1.75 percent of GDP in 1985. Expenditure restraint had continued to be the main element of the authorities' approach to fiscal management, particularly with respect to social transfers, public investment, and wages. Selective tax measures, affecting mainly personal income tax and social security contributions, had also helped to reduce the budget deficit. The policy of fiscal restraint had been continued in 1986 and had been further strengthened by increased taxes on the energy sector. The increase in total public spending was to be limited to 1 percent in nominal terms in 1986. The effectiveness of the fiscal reform should be enhanced by the firm monetary policy. However, monetary policy in Denmark was constrained by the country's adherence to a fixed exchange rate system and by the liberalization of capital controls.

The strength of domestic demand had been a major factor in 1985 in the limited export performance of the economy, as a considerable portion of total production had been diverted to home consumption, Mr. Agah observed. Restoring balance to the external current account by 1988 was an essential feature of the authorities' scenario. Austere demand management together with an improvement in the competitive position vis-à-vis Denmark's EMS partners seemed necessary in the rest of 1986 and in 1987. The latest data showed real growth in total domestic demand of 4.5 percent in 1985 compared with GDP growth of 3 percent. Because the buoyancy of demand had carried over into 1986, the trade deficit had widened in the first quarter of that year compared with the same period in 1985. That development had led the authorities to adopt a new package of fiscal measures in March 1986 and to tighten the banking regulation prohibiting financial institutions from borrowing abroad.

As an EC member, Denmark was committed to a liberal trade policy, Mr. Agah remarked. Denmark had worked with some of its EEC partners to resist the protectionist pressure in the EC region and was actively engaged in the determination of the modalities for the new multilateral trade negotiations.

Denmark's admirable record of official development assistance was well established, and its technical assistance to developing countries was exemplary, Mr. Agah commented. In 1986, the level of official development assistance in terms of GDP had increased to 0.82 percent. The level was expected to reach 1 percent in 1992. Denmark's aid was evenly distributed between multilateral and bilateral programs and continued to be directed to poor developing countries with the intention of improving agricultural programs in general and increasing food production in particular by taking advantage of Denmark's experience in that area.

Mr. Jayawardena said that Denmark's recent policy stance had been remarkably successful. As the success of developing countries' adjustment efforts depended crucially upon progress in industrial countries, the developments in Denmark were particularly welcome, and he hoped that they could be sustained in the future and that other industrial countries would make similar progress.

Underlying the successful adjustment of the Danish economy was the remarkable fiscal adjustment, which had been engineered by a combination of strong expenditure restraint--which had included even traditional social expenditures--and by revenue enhancement that had been readily absorbed by the dynamic private sector, which had been given incentives through tax reform and the national policy of wage containment, Mr. Jayawardena remarked. The courageous stance of the Danish authorities contrasted sharply with the cautious approach of other industrial countries, which claimed that structural rigidities made it difficult for them to introduce appropriate fiscal adjustment. Certain favorable external circumstances had helped Denmark, but he agreed with Mr. Wijnholds that Denmark was an example for other smaller industrial countries; indeed, Denmark was an example for industrial and developing countries alike.

He too was concerned about the weakness of Denmark's external current account and welcomed the measures that had been adopted in March 1986 to strengthen further the fiscal position and were a reflection of the usefulness of monetary policy in containing domestic demand, Mr. Jayawardena said. Mr. Wijnholds had wisely cautioned that the recent capital inflows might be a one-time-only development resulting from portfolio adjustments. Those inflows might have been encouraged by the fact that Denmark had been a rare oasis of stable economic policies and exchange rates. The capital inflows seemed to be a reward for the clearly established long-term policies and objectives of the Danish authorities and of their relentless pursuit of adjustment, which had inspired confidence. Since external developments were less volatile than they had been in recent years, it might be advisable for Denmark to look inward for savings and to look outward for higher earnings. In that connection, the staff's preference for the generation of more savings by the public sector was somewhat worrying. In his view, monetary and incomes policy could be used more effectively to generate increased private sector savings.

Denmark's long-standing commitment to free trade--despite the constraints of its EC membership--was exemplary, Mr. Jayawardena remarked. The authorities' success in resisting protection and their admirable record of resource transfers to less fortunate countries were welcome; Denmark's official development assistance exceeded the modest minimum target that had been set by the United Nations. The authorities' emphasis on directing their aid flows to the poorest segments of the developing world was also welcome.

Mr. Qureshi said that he, like Mr. Suraisry, had been struck by the staff's unqualified support for raising energy taxes in Denmark in the wake of the large drop in the price of oil. As Mr. Suraisry had noted, the March 1986 fiscal package relied heavily on an increase in energy taxes. In making the case for raising those taxes the staff had noted that the decline in oil prices had provided an obvious opportunity to increase energy taxes in order to dampen the growth of consumer demand. He wondered whether it was really obvious that raising energy taxes in the present situation in Denmark was appropriate. At the least, there were arguments for and against raising taxes on oil, and they should be carefully assessed before a judgment in favor of raising those taxes was reached. Raising energy taxes would dampen growth in demand and improve the fiscal position, but it would obstruct the passing through of the beneficial effects of lower oil prices to domestic enterprises, thereby limiting the possible increase in profitability resulting from the oil price drop. The increase in energy taxes also had implications for the competitiveness of Denmark's domestic industries. There was no discussion of such arguments in the staff report.

It had been suggested that the improvement in Denmark's terms of trade owing to the oil price reduction would likely lead to a further expansion of domestic demand and intensify wage pressure, Mr. Qureshi remarked. It was not clear to him that there was an obvious causal connection between lower oil prices and intensified wage pressure. Lower oil prices could directly reduce the rate of price increase in Denmark, thereby dampening demand for higher wages. Moreover, lower oil prices would help to improve profitability and productivity of domestic industries, thereby increasing the potential in the economy for noninflationary increases in wages. Finally, in the Managing Director's summing up on the latest world economic outlook discussion and in the Interim Committee's most recent communiqué it was suggested that advantage should be taken of the decline in oil prices to stimulate noninflationary growth; to that end, members should not lose the opportunity to pass through to the private sector the full positive effects of lower oil prices.

Mr. Zecchini remarked that Mr. Qureshi's point was well taken. However, Denmark had a long history of substantial external indebtedness and external current account deficits. In those circumstances, if taxation on oil consumption was ruled out, he wondered what other adjustment mechanisms the authorities could use. The external competitiveness of the enterprise sector was important, and it could easily be ensured through the use of various fall-back mechanisms. But the authorities had already taken important steps to restructure public finances, and there were rigidities in the way of any effort to promote privatization.

Mr. Suraisry said that it was important to consider whether the problems facing the Danish economy should be solved through short-term mechanisms or long-term ones. Apparently Denmark faced a long-term problem of competitiveness that could not be solved by short-term measures. In 1985, exports of goods and services had grown by only 3 1/2 percent, an unsatisfactory performance, especially in view of Denmark's large external debt and the sizable external current account deficit. Denmark was well advised to encourage exports. In that connection, the authorities were obviously constrained by their exchange rate policy, and they were understandably emphasizing efforts to reduce costs, especially through wage moderation. However, another important step was to contain the cost of increasing profits; permitting the benefits of lower energy costs to be passed through fully to producers would reduce the costs of production, would increase profits, and would make Denmark's goods and services more competitive. That approach was probably the best way in which to bolster imports and reduce the external current account deficit. Fine tuning of the economy would not be effective.

Mr. Qureshi remarked that the staff report did not contain an adequate discussion in defense of the staff's recommendation concerning energy taxes. Mr. Zecchini apparently felt that raising energy taxes was the only available means by which the Danish authorities could address the external deficit and further improve the fiscal position. He doubted whether the situation in Denmark limited the authorities to a single reasonable means of eliminating the external imbalance and improving the fiscal position. The fiscal deficit had been continually reduced since 1982; the overall public sector deficit had been the equivalent of 9 percent of GDP in 1982, and a surplus was projected for 1986. Even without the March 1986 fiscal package, a public sector surplus in 1986 would have been feasible as a result of measures other than increased energy taxes.

Mr. Zecchini commented that the staff analysis suggested that a reduction in domestic absorption would contribute to the adjustment of the external current account. That conclusion should be kept in mind in considering the various ways in which total domestic demand could be reduced. Incomes policy had helped to bring domestic demand expansion in line with the objective of reducing the external current account deficit. He had not meant to indicate that increased taxation of energy consumption was the only means available to the authorities in their effort to reduce the external imbalance, but he continued to wonder what steps the authorities could reasonably take if energy tax increases were ruled out. Mr. Suraisry had commented that the fiscal adjustment was on course as a result of the measures that had been introduced in 1985, prior to the improvement in the terms of trade. However, it could not be taken for granted that the fiscal adjustment would remain on course, and the staff had made some telling points in expressing its doubts about the adequacy of the authorities' present policy approach. Accordingly, he had meant to draw attention to the need to take steps in various sectors--including energy taxation at the consumption level.

Mr. Fugmann remarked that the point of departure for the March 1986 fiscal package had been the fact that the authorities had clearly underestimated the strength of domestic demand as well as the size of the external deficit in December 1985, when the previous policy package had been introduced. The authorities had also had in mind the effects of the decline in the dollar exchange rate and in oil prices, which had provided at least the prospect of a significant further increase in domestic demand that, in the authorities' view, would have intensified pressure on domestic prices and wages. Under those circumstances an increase in energy taxes had seemed fairly obvious to the authorities. Domestic energy prices in Danish krone terms were now approximately at the level of March 1985, when the unusually strict incomes policy package had been adopted. He was surprised how easily the hard-earned lessons of the 1970s seemed to have been forgotten. At the various international conferences that he had attended since 1973, many different countries, including OPEC countries, had advised oil importers to conserve energy because oil was a depletable resource. Over the years, Denmark had invested heavily in energy conservation, and although Denmark had significantly reduced its dependence on imported oil during the previous ten years, no one in Denmark would wish to see the country become more vulnerable to external shocks than absolutely necessary. In the light of Denmark's medium-term needs and the possibility of a new energy crisis in the 1990s, the size and contents of the March package was sensible and justified and he was happy that the staff shared this view.

Mr. Suraisry said that he supported measures to conserve energy. His point was that increased energy taxes might not be in the best interest of efficient economic management in Denmark. He doubted whether increased taxation on oil consumption would help to improve the economy over the long run. Permitting the benefits of the lower oil prices to be passed through to the private sector could make a long-term contribution to the economy. In any event, economic fine tuning had not proved to be an effective management technique. This has been our consistent position. For example, during the lastest world economic outlook discussion, Mr. Nimatallah had suggested that a relaxation of fiscal policy efforts in Germany and Japan in order to increase the growth rates of those countries might not be the best possible contribution that those countries could make to the world economy in the medium term. It would be preferable for those countries to maintain their present growth rates of about 3 1/2 percent rather than to act at the present stage to reduce those rates somewhat and then have to take further actions in the future to reduce those growth rates somewhat below the present level.

Mr. Archibong remarked that the Danish economy remained basically buoyant, having benefited steadily from the continuous macroeconomic and structural adjustment over the previous three years. Economic activity had expanded, and the growth of real GDP--estimated at 3 percent in 1985--represented a significant achievement in the face of the relatively disappointing export performance and the unexpectedly buoyant import growth, which had resulted in a widening of the external current account deficit.

The staff and Mr. Fugmann had explained that the authorities were prepared to take the steps needed to correct the imbalances in the economy, Mr. Archibong continued. In line with the Government's objective of strengthening the private sector, measures designed to improve the business environment and to encourage investment had been implemented. The main objective of the ongoing restructuring effort was to increase private sector activity. Some success in that area had already been achieved; there had been a noticeable shift in the relative size of the public sector resulting in the growth of private sector activity. A significant growth of business investment had aided the absorption of a relatively large proportion of the labor force in the private sector, which had led to a decline in unemployment from 10.6 percent in 1983 to 8 percent in 1986, when public sector activity had been substantially reduced as a part of a determined effort to eliminate the fiscal deficit.

The authorities' strategy of maintaining a strong competitive position through a firm incomes policy, substantial fiscal retrenchment, and easy monetary conditions reflected in steep declines in interest rates was already having the desired effect and had generated a sustained investment boom, Mr. Archibong remarked. However, the authorities should take steps to ensure labor market harmony. The suspension of the automatic cost of living adjustment of wages and salaries should be maintained in order to decelerate wage increases further as a part of the effort to contain inflation. He hoped that the ongoing bargaining process would result in a negotiated wage and salary agreement that would reflect market realities and enhance the competitiveness of the economy.

The rapid growth of domestic demand and the further deterioration in the external accounts were the most urgent problems facing the authorities, Mr. Archibong considered. The most worrying aspect of the present situation was that additional domestic demand pressure could strengthen import growth, generate increasing wage pressure, and divert output from exports to the domestic sector, thereby worsening the already disappointing balance of payments performance. It was against that background that he welcomed the tightening of fiscal and monetary policy in March 1986 that was aimed at moving the public sector into surplus in 1986 and at moderating the growth of domestic demand. Depending upon the cooperation of labor, recent tax increases--including the new energy taxes--could curb domestic demand and generate substantial additional revenue. The remarkable improvement on the revenue side coupled with the reduction in the ratio of spending to GDP should shift the public sector balance to a surplus for the first time in many years.

Forecasting developments in the international petroleum market was difficult, and the authorities' revised estimates based on an average oil price of $17-18 per barrel in 1986 might be on the high side, Mr. Archibong remarked. A lower average oil price for 1986 seemed possible and could have considerable benefits for both the balance of payments and inflation performance, provided that domestic demand pressure was sufficiently contained.

Given Denmark's commitment to a fixed exchange rate within the framework of the EMS and to liberal capital movements, there seemed to be little room for maneuver in monetary policy, Mr. Archibong said. In the circumstances, the scope for an independent monetary policy--particularly efforts at stabilization through the use of the money supply targets--had clearly diminished. That development probably explained the authorities' increased reliance on fiscal and incomes policy in their effort to restrain the domestic economy. A further comment on the role of monetary policy in the Danish economy would be helpful.

Denmark's continued adherence to the principle of free trade was welcome, Mr. Archibong stated. The authorities' active resistance to protectionist pressures was commendable. Denmark's development assistance was the equivalent of 0.82 percent of GDP in 1986. Denmark was one of the few countries that had exceeded the U.N. aid target of 0.7 percent of GDP. The authorities were to be commended for their generous official development assistance, and other countries, particularly the larger ones, should follow Denmark's example.

The staff representative from the European Department recalled that the question had been raised whether there had been any room in which to tighten monetary policy in 1985. The domestic contribution to money growth had risen in the second half of 1985 after a further fall in interest rates in mid-1985. At that time, the authorities had decided to cease resisting the influence of large capital inflows on the level of interest rates. If they had continued to resist by maintaining higher interest rates, the domestic contribution to money growth would have been smaller but the foreign contribution would have been greater; in that event, the rate of money growth might have been slower, but only by a little. If there had been any room in which to tighten monetary policy in 1985, it had been very limited. However, the situation had subsequently changed somewhat: some scope for a tighter monetary stance had re-emerged in recent months.

The staff and the authorities believed that the external current account deficit should be reduced over time and eventually eliminated, the staff representative continued. Meanwhile, however, and given the present strong domestic demand pressure, the staff felt that the existing room in which to tighten monetary policy should be used. That conclusion was consistent with the staff's comment on the need for private inflows to cover the external current account deficit. As long as the overall balance of payments was in deficit, room for a tighter monetary policy would remain.

The restructuring of Denmark's external debt had been started in 1984 and had been continued in 1985 with a view to reducing the interest cost of the debt, the staff representative explained. Another aim of the restructuring was to reduce the dollar share of the debt. The shift in 1985 in the currency composition of the debt included the effects of exchange rate movements. Accordingly, it reflected both the move out of the dollar and recent exchange rate movements. With the benefit of hindsight, it was clear that the timing of the shift of the currency composition of Denmark's external debt had not been ideal from the authorities' viewpoint.

The controls on profits, prices, and dividends could be seen as a gesture to labor that had been made when the incomes policy had been imposed in the spring of 1985, the staff representative commented. The controls were in practice less severe than they appeared to be.

The staff considered that the tax reform was a step in the right direction, the staff representative remarked. A greater effort--resulting in lower marginal rates and a reduction of the tax deductibility of interest payments--would have been useful but had not been politically feasible.

Commenting on the competitive position of the Danish economy after the EMS realignment, the staff representative said that, as Mr. Fugmann had noted, the krone had been lowered against the deutsche mark and the guilder by 2 percent but had been left virtually unchanged against the average of the EMS currencies. As a result, the realignment had partly offset the loss in bilateral competitiveness against the currencies of the low-inflation countries but had left Denmark's overall competitive position unchanged. The overall competitive position after the realignment was nevertheless weaker than it had been in 1985 because of the movement of the U.S. dollar. Success in achieving external adjustment in the future would therefore have to depend on relative demand restraint and on the authorities' success in restraining domestic cost pressures. The recently adopted fiscal measures should be particularly helpful in that regard.

In assessing the appropriateness of an increase in energy taxes in Denmark, the staff had had in mind the strong domestic demand pressures, the large external debt, and the sizable external current account deficit, the staff representative from the European Department explained. The staff had discerned the need to dampen domestic demand and to help to ensure that the gain in the terms of trade would improve the external current account position. The increase in the energy tax was far from being the only fiscal measure that the authorities had introduced in 1986. Public spending in terms of GDP was to be reduced in 1986 by 3 1/2 percentage points owing to a significant adjustment in expenditure. Danish industry was largely unaffected by the energy taxes, which were leveled mainly at the retail and consumption levels. The wage pressure in Denmark was due partly to the overheating in some sectors of the economy. The increased energy taxes might help to limit the overheating, thereby possibly dampening somewhat the wage pressure.

The staff representative from the Exchange and Trade Relations Department commented that there was no certainty that the decline in the oil price was permanent. Much of the investment in the late 1970s and early 1980s by countries that were heavily dependent on oil imports was to rationalize obsolete capital stock in the wake of the substantial oil price increases. Reversing that trend in the immediate future in the absence of confidence about the permanence of the decline in oil prices would certainly raise questions about the efficiency of investment in the coming several years.

Mr. Fugmann remarked that the authorities had expected more parallel external and domestic adjustment than had actually occurred. The authorities had recorded a public sector surplus well ahead of schedule and had begun to make a resolute effort to attack the external current account deficit. The most worrying aspect of recent developments was the performance of exports, although there was no obvious explanation for that performance. Export performance had been basically satisfactory through 1984 but had been disappointing in 1985 and thus far in 1986. The authorities did not believe that the disappointing performance had been caused by unsatisfactory overall competitiveness but perhaps the cause was an excessively strong pull from domestic demand. The country composition effect on exports had been unfavorable but the commodity composition effect had been fairly favorable. However, relative to other European countries in 1985, it was the strong growth in imports that had distinguished the Danish performance rather than export developments. The promotion of high-technology export production was being set in motion in Denmark, but that approach would involve a policy of picking winners, something that the present Government did not wish to do. Moreover, there was considerable risk in high-technology production. From an economic point of view it was just as important that such production could increase efficiency of the production of existing output and contribute to the efficient production of new products.

The main issue in the monetary policy area was how much room the authorities had for maneuver, Mr. Fugmann said. He agreed with the staff that at present there might be more room than hitherto in which to maneuver. In 1985, the authorities had had to face the question whether they should reintroduce capital controls or permit interest rates to fall following significant capital inflows. The pressure--exerted mainly outside the Government--to reintroduce capital controls had been resisted. Some tightening of monetary policy through interest rate adjustments might take place in the future, but only a small adjustment seemed to be required.

In his opening statement he had stressed that in a small, open economy it seemed to be generally accepted that a firm exchange rate policy provided the stabilization effect expected from money supply targets in larger economies, Mr. Fugmann recalled. Given the absence of capital controls, the Danish authorities felt that they could not have much control over the money supply. Adherence to a firm exchange rate policy provided discipline to other economic policies that in larger economies would be provided by adherence to a money supply target. The Danish authorities felt that they could not maintain such discipline through adherence to a money supply target in their small and open economy. There seemed to be no room for any greater flexibility in exchange rate policy at present. The authorities did not believe that exchange rate policy should be a substitute for appropriate domestic policies, and they felt that they had maintained appropriate domestic policies in recent years. They strongly believed that their firm exchange rate policy was one of the main factors in their success on the inflation and interest rate fronts and in the increase in confidence.

The quality of investment in Denmark had been high, Mr. Fugmann commented. As in any small and open economy, investment in Denmark was directed mainly toward the tradable goods and import substitution sectors. Much of the increased investment in Denmark had been directed to the manufacturing sector. Hence, neither the quality nor the trend of investment in Denmark had been a cause for concern.

For some time, the authorities had been expecting a dampening of demand and an associated slowing of investment, Mr. Fugmann remarked. Since a reasonable level of investment had been restored in Denmark in relation to GDP and compared to the 1960s and 1970s, there was now an expectation of a slowdown in investment in the coming period.

It was incorrect to conclude that the favorable wage and price trends in Denmark were the result mainly of restrictions and controls, Mr. Fugmann stated. There were no restrictions on dividends, and the restrictions on profits, wages, and prices were not severe as evidenced by wage and profit developments. The authorities had recognized that sectors in the economy in addition to labor should contribute to the effort to contain wages and prices. Employers were permitted to pass on wage increases to prices only to the extent covered by the statutory incomes package.

The size of the public sector had been declining, Mr. Fugmann said. It was expected to decline further if the authorities maintained in 1987--the fifth consecutive year--an unchanged level of real expenditure by the Central Government. Even with the minor reduction in the overall tax burden resulting from the tax reform, total public expenditure in 1987 would be reduced to 47 percent of GDP, compared with 54 percent in 1983.

The tax reform, including the reduction in marginal tax rates and in interest rate deductibility, should have a positive effect on private savings, Mr. Fugmann remarked. At present, the authorities saw no need to tighten further their policy stance; much would depend on developments on the external front during the rest of 1986. The welfare system probably led to a reduction in private savings, and the authorities were therefore seeking ways in which to stimulate such savings, as no significant reduction in the welfare system was devised beyond what was needed. Private savings should be increased, but that achievement seemed possible only in the medium or longer run. Meanwhile, savings would have to come mainly from the public sector. There were no obvious means of significantly increasing private savings. At present, the authorities were encouraging the introduction of private pension schemes, which might play a role in the next round of wage negotiations. The concern of some Executive Directors about Denmark's heavy reliance on external savings was understandable.

It was difficult to pinpoint the lessons that could be learned from Denmark's experience in recent years, and especially from the positive effects on the economy of the withdrawal of fiscal stimulus, Mr. Fugmann said. To some extent, noneconomic factors had probably played a role. During the ten years after the first oil crisis, Denmark had maintained economic policies that had proved not to be fully adequate; there had been increases in taxation and a growing burden on the population with no visible lasting results through 1982. The new Government had been able to introduce in just a few months more fundamental measures than all the governments during the previous ten years. The new Government's swift and resolute action, which had been facilitated by the uneasiness that was widely felt in late 1982 at the onset of the international debt crisis, had helped to restore confidence in the Danish economy.

Mr. Leonard commented that the withdrawal of fiscal stimulus had clearly had a significant effect on the economy. However, certain circumstances that were peculiar to Denmark might have helped to offset that effect. For example, the incomes policy had permitted a significant increase in profitability that had stimulated investment. In addition, the monetary policy had been accommodating, and it might have helped to dampen wage pressure. He agreed with Mr. Templeman that the incomes policy might have introduced rigidities into the economy that would become particularly evident in the medium term.

Mr. Zecchini said that in commenting on the effect of the withdrawal of fiscal stimulus in Denmark he had underscored the particular policy mix that the authorities had maintained. In that connection, he agreed with Mr. Leonard's comments. The fiscal retrenchment in Denmark had taken place in a period in which monetary policy had not been as stringent as it should have been. The lesson of the Danish experience was that members should adopt the policy mix that was appropriate to their particular circumstances, including their room for maneuver within their own national context. It was wrong to believe that fiscal retrenchment could be achieved under any circumstances. The Danish experience suggested that a particular social environment could provide room in which to maintain an effective incomes policy, thereby providing scope for adjusting fiscal as well as monetary policy.

Mr. Templeman remarked that the Danish experience suggested that the reduction of the fiscal deficit should not be considered in isolation. The aim should be to encourage a swift response by the private sector, and, in that connection, expectations played an important role.

Mr. Rye said that it would be wrong to assume from the Danish experience that monetary policy could be independent of fiscal policy. The Danish authorities' ability to bring their fiscal policy back on course had enabled them to maintain a more accommodating monetary policy than would otherwise have been possible. They had been able to adjust both monetary and fiscal policy, thereby creating a better overall economic and financial framework.

Mr. Wijnholds recalled that during a recent discussion Mr. Rye had remarked that gradual policies yielded gradual results. The experience of Denmark suggested that strong policies resulted in rapid results.

The staff representative from the European Department remarked that in addition to the fiscal retrenchment, the incomes policy, and the accommodating monetary policy, Denmark had been characterized by the establishment of a strong competitive position at the time of the fiscal retrenchment. As a result, the private sector had been able to respond quickly to the fiscal adjustment.

Mr. Suraisry considered that in examining the possible lessons of the Danish experience Executive Directors should distinguish between developing countries and industrial countries. The experience of Denmark was likely to be repeated in some industrial countries owing to the availability of entrepreneurs and the strength of the private sector--which could pick up the slack following fiscal retrenchment--in those countries. The situation in developing countries was not as conducive to positive results following fiscal retrenchment. Developing countries lacked the entrepreneurs that could take up the slack caused by the retrenchment.

Mr. Qureshi said that efforts to derive lessons from the recent Danish experience should be approached with caution. Other cases had suggested that policy directions and results other than those in the case of Denmark were possible.

The Acting Chairman made the following summing up:

Executive Directors praised the Danish authorities for the substantial achievements of their strategy of economic reconstruction, which had produced a rapid shift of resources to the private sector and a powerful investment boom. The economic recovery had been strong, the rates of cost and price inflation had been cut, employment had surged and unemployment declined, the size of the public sector had been reduced, and the public sector deficit eliminated.

Directors noted that in 1985 and early 1986 economic activity and domestic demand had remained more buoyant than had been anticipated. Directors agreed that the consequent further widening of the current account deficit together with the emerging labor market bottlenecks and cost pressures in some sectors of industry were sources of concern; they therefore welcomed the authorities' fiscal packages of December 1985 and March 1986, which were designed to curb the growth in domestic demand. Directors noted that the strength of the investment boom had been remarkable, although until recently the increase in domestic savings had been less strong than the increase in private sector investment. They judged that policy should ensure that investment was financed to an increasing extent from domestic sources.

Noting that external debt was comparatively high for an industrial country, Directors concurred with the official aim of eliminating the external current account deficit and judged that the recent packages of measures should provide a foundation for a progressive reduction in that deficit over the next few years. Directors expressed concern about the weak export performance in 1985, which was possibly related to a diversion of production to the domestic market because of the strength of domestic demand.

However, several Directors added that the deterioration in the external current account also reflected structural weaknesses including, in particular, the narrow export base and the high import elasticity. They observed that maintenance of the present competitive position would require a greater degree of wage restraint than had been achieved in 1985, as well as the avoidance of labor market bottlenecks.

Directors noted that the past policy of a largely unchanged average rate against the ECU had been maintained in the recent EMS realignment. Directors generally endorsed the Danish strategy of maintaining external competitiveness through restraint of domestic costs.

Directors applauded the remarkable fiscal adjustment which had shifted the public sector from a deficit of 9 percent of GDP as recently as 1982, to an expected surplus of 3 1/4 percent of

GDP in 1986, and had contributed to a decline in the relative size of the government sector. This adjustment has been farther and faster than that of any other industrial country and has been associated with an investment boom, an increase in employment, and strong economic growth. Directors commended the continuing policy of spending restraint which in 1986 was expected to keep spending broadly constant in real terms for the fourth successive year. Directors welcomed the authorities' willingness to take additional measures and agreed, especially given the rapid growth of domestic demand and the widening current account deficit, that the recent tightening was appropriate, although a few Directors questioned the use of new energy taxes as a means of increasing revenues. The package of fiscal measures helped to ensure that the terms of trade gain induced by the oil price decline would in fact lead to a reduction in the external current account deficit. Some Directors hoped that by means of continuing restraint on spending, it might prove possible in the future to cut the heavy tax burden without weakening the generation of domestic savings. Directors welcomed the planned tax reform to take effect from 1987 and expected that it would strengthen the incentive to save, enhance the scope for monetary policy, and help rationalize the structure of taxation.

Directors welcomed the move toward a more market-oriented monetary policy. They noted the decline of interest rates in 1985. A number of Directors suggested that, on balance, monetary policy had perhaps been too accommodative in the past year. The weakening of capital inflows in more recent months indicated that room for a tightening of monetary policy had re-emerged and should be utilized. Directors welcomed recent measures in this direction, and emphasized that monetary policy should now shoulder a larger share of the burden of restraining domestic demand. If capital inflows were to become excessive, it was suggested that they could be offset, for instance, through prepayment of foreign debt.

Directors commended the Danish authorities' commitment to an open trading system and their firm support for a new GATT round. They also praised Denmark's development assistance record, which continued to exceed the United Nations target and is expected to rise significantly above it over the medium term.

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

2. FUND STATISTICS - REVIEW

The Executive Directors considered a staff paper on the second annual review of Fund statistics (SM/86/55, 3/11/86).

Mr. Steinberg remarked that the staff paper assessed the Fund's statistics basically from the viewpoint of the Bureau of Statistics. The paper was highly technical and factual in nature and contained considerable useful information. The regular statistical publications referred to in the paper constituted the Fund's most important output for external use. They provided a large--perhaps the largest--international economic data base for analytical purposes and in so doing promoted the Fund's reputation around the world. The Bureau of Statistics, which prepared, published, and maintained the high standards of those publications, should be commended for its efforts. The large circulation of the publications was evidence of the broad demand for the data concerned by a variety of users. It was therefore in the Fund's interest to strengthen and enhance that aspect of its work by constantly improving the coverage, currentness, and most important, the quality of the data in its publications.

The most recent improvement in the Fund's published data would enable users to relate developments in interest rates on bank deposits and bank credits to changes in inflation and exchange rates, Mr. Steinberg noted. In the future, it might also be useful to circulate a world table on real interest rates, a subject that had been often discussed by the Executive Board.

Another important addition to the Fund's published data was exchange rates of a secondary and tertiary nature, Mr. Steinberg commented. The coverage of that new data should be expanded, and there should be some indication--perhaps in the form of a footnote--of the extent to which such rates were being applied. Such information was significant for the conversion of any flow of economic activity--particularly that of the national accounts components--from domestic currency into a comparable U.S. dollar value.

Commenting on the Bureau's planned future work on statistics, Mr. Steinberg said that the list of new supplements was promising, particularly the supplement on external debt. The issue of external debt would unfortunately be of great interest for some time, and good statistical coverage of external debt would be useful not only to check developments in countries that were already heavily in debt, but also to identify any potentially heavily indebted countries. A supplement on external debt would be important not only for the data that it would contain but also for its definitions, sources, and methodology. The Fund was not necessarily in the best position to collect such data, but collaboration with the World Bank and other organizations--to avoid duplication--the progress that was being made in the Fund on international banking statistics, and the information gathered by Fund missions could place the Fund in a pivotal role in consolidating and analyzing the various inputs. A further staff comment on a possible debt data supplement would be helpful. In the event that the supplement could not be provided in the future because of budgetary constraints, it might be advisable to circulate the methodology and any available data forthwith for internal reference.

He fully supported the efforts of the Bureau of Statistics to provide technical assistance, Mr. Steinberg stated. His own experience showed that users of data usually did not question the quality of the data and assumed that it met their expectations. It was the responsibility of the Bureau of Statistics to ensure the adequacy and quality of data. In many cases, those efforts might involve frequent short visits to countries to ensure that the quality of data was maintained despite changes in policy and personnel.

There had not been adequate collaboration between the Bureau of Statistics and the area departments, Mr. Steinberg considered. That problem had been evident ever since the Fund had begun collecting data, and several attempts to solve it had been made with only limited results. In 1985, Executive Directors had expressed the hope that an integrated data base in the Fund would be a part of the effort to improve the collaboration between the area departments and the Bureau of Statistics. As was stated in the budget, the main function of the Bureau of Statistics was to assemble and maintain statistics for the purpose of economic analysis within the Fund and for publication. Presumably the order of those objectives--with the emphasis on analysis within the Fund--was deliberate. While the size of the audience outside the Fund for Fund statistics was discussed at length in the staff paper, the extent to which the area departments used the Bureau of Statistics's data base for staff reports was not discussed. The staff paper touched on that matter only briefly in implying that the less than satisfactory collaboration between the area departments and the Bureau of Statistics was the result of inadequate communication and training. He hoped that the progress that had been made on the development of the new economic information system (EIS) and some additional staff courses would significantly improve that collaboration. However, his discussions with individual staff members had convinced him that the gap was more substantial than was suggested in the staff paper. The lack of use of the Bureau's data base by the staff for country programs and consultations might be interpreted by external users of the data as a manifestation of the unsatisfactory quality of the Fund's data base. In addition, members might feel that there was a duplication of effort because they had to report data to both the Bureau of Statistics and the area departments.

The fact that the problem of collaboration between the Bureau of Statistics and the area departments had existed for some time should not discourage Executive Directors from making further effort to solve it, Mr. Steinberg continued. The process of improving collaboration could require additional resources in the short run, but in the end it should save resources by reducing the present duplication of effort. It could also improve the currentness of the Fund's publications by providing for statistical information from the area departments to be incorporated in the publications when the need to maintain confidentiality permitted. Improved collaboration could facilitate the process of revising and updating the world economic outlook; the need for such revisions and updates had been strongly felt in recent months. Collaboration within the Fund could also support the institution's efforts to cooperate with the World Bank, could provide management with an updated integrated system, and could improve the quality of data used within the Fund as well as in the Fund's publications. He was pleased to learn from the staff that a few staff members in area departments had already taken the trouble to harmonize their own country data base with the base developed by the Bureau of Statistics. In the process they had influenced country officials to adapt the officials' national presentation to the Fund's approach; as a result, the three data systems had become closely related and were easily reconcilable with each other.

The issue of collaboration between the area departments and the Bureau of Statistics was a managerial issue, rather than a technical one, Mr. Steinberg said. Resolving that issue would be facilitated by the introduction of a better computer system and software, like the EIS, but those improvements might not be sufficient. A redefinition of concepts and a reallocation of responsibilities within the Fund might also be needed together with an adjustment in the evaluation of staff performance to encourage such efforts. A new committee to deal with that issue should be established.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/63 (4/16/86) and EBM/86/64 (4/18/86).

3. AUDIT COMMITTEE - FY 1986

The Executive Board confirms the nomination by Jordan of an auditor to serve on the 1986 External Audit Committee. (EBAP/85/301, Sup. 2, 4/15/86).

Adopted April 17, 1986

4. JAMAICA - TECHNICAL ASSISTANCE

In response to a request from the Bank of Jamaica for technical assistance to review proposed changes in central banking and banking legislation, the Executive Board approves the proposal set forth in EBD/86/107 (4/11/86).

Adopted April 16, 1986

5. PEOPLE'S REPUBLIC OF MOZAMBIQUE - TECHNICAL ASSISTANCE

In response to a request from the Bank of Mozambique for technical assistance to provide training in conjunction with the World Bank's offer to finance microcomputers to assist in the compilation of monetary statistics, the Executive Board approves the proposal set forth in EBD/86/105 (4/10/86).

Adopted April 16, 1986

6. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/91 (4/15/86).

Adopted April 17, 1986

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/93 (4/15/86) and EBAP/86/94 (4/16/86) and by an Advisor to Executive Director as set forth in EBAP/86/93 (4/15/86) is approved.

APPROVED: January 6, 1987

LEO VAN HOUTVEN
Secretary