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Minutes of Executive Board Meeting 17/50-3

3:05p.m., June 16, 2017

3. Denmark—2017 Article IV Consultation

Documents: SM/17/132 and Correction 1, and Supplement 1; SM/17/142

Staff: Hofman, EUR; Zeidane, SPR

Length: 53 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	**Alternate Executive Directors**
M. Mkwezalamba (AE)	
D. Sembene (AF)	
	D. Vogel (AG), Temporary
H. Choi (AP)	
	P. Fachada (BR)
	P. Sun (CC)
	F. Lopez (CE), Temporary
	M. McGrath (CO)
	C. Just (EC)
	S. Badirou-Gafari (FF)
S. Meyer (GR)	
	H. Joshi (IN), Temporary
	M. Psalidopoulos (IT)
	T. Tsuden (JA), Temporary
J. Mojarrad (MD)	
H. Beblawi (MI)	
	T. Manchev (NE), Temporary
	T. Gade (NO), Temporary
	A. Tolstikov (RU), Temporary
H. Alogeel (SA)	
J. Agung (ST)	
M. Panek (SZ)	
	M. Chen (UK), Temporary
	M. Sobel (US), Temporary

C. McDonald, Acting Secretary
P. Cirillo, Summing Up Officer
M. Gislen, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
European Department: A. Arvanitis, D. Hofman, E. Papageorgiou, T. Scutaru, M. Segoviano Basurto, R. Turk, Y. Xiong. Legal Department: J. Ams. Research Department: M. Dao. Strategy, Policy, and Review Department: D. Zeidane. Executive Director: M. Erbenova (EC). Alternate Executive Director: H. Razafindramanana (AF), K. Virolainen (NO). Senior Advisors to Executive Directors: A. Machmud (ST), A. Monajemi (MD), S. Rouai (SA),

M. Sanchez (FF), T. Sand (NO), B. Varga (EC). Advisors to Executive Directors: L. Andresen (SZ), K. Carvalho da Silveira (AF), P. Di Lorenzo (IT), K. Eckhorst (BR), S. Fan (CC), N. Feerick (CO), G. Gunnarsdottir (NO), B. Jappah (AE), M. Merhi (MI), C. Ong (ST), C. Rebillard (FF), C. Stewart (AP), M. Svenstrup (US).

3. Denmark—2017 Article IV Consultation

The staff representative submitted the following statement:

This statement provides information that has become available since the issuance of the staff report. The thrust of the staff appraisal remains unchanged.

Preliminary data indicate that GDP increased by 0.6 percent (q/q) in the first quarter of 2017, somewhat above the staff projection of 0.4 percent. Growth was driven by significant stockbuilding and the new data do not materially change the outlook.

The current account for 2016 was revised down to 163,803 DKK million from 168,468 DKK million, reducing the surplus from 8.1 to 7.9 percent of GDP, mostly on account of higher services imports.

The government has announced a new "2025 plan." In contrast to last year's plan, it does not provide detailed proposals but rather sets out broad policy objectives for the coming years. Specific measures remain to be negotiated, starting with the 2018 budget discussions in the autumn. The new plan continues to envisage some easing of the fiscal consolidation path, reaching structural balance by 2025. Other broad objectives maintained from the previous plan include reducing the tax burden, strengthening work incentives, and reforming education. The plan does not include staff-recommended further reforms of pensions and mortgage interest deductibility, or the incremental Allowance for Corporate Equity.

Mr. Ostros and Mr. Gade submitted the following statement:

On behalf of the Danish authorities, we would like to thank staff for candid and constructive policy discussions during the Article IV mission. The authorities appreciate staff's high quality report and analytical work, addressing topical issues for the Danish economy. They broadly concur with staff's assessment and will carefully consider the recommendations.

The Economy is Gradually Approaching a Situation with Normal Capacity Utilization

The Danish economy is experiencing stable growth and increasing employment. The foundation for growth is assessed to be solid, and the upswing is expected to continue. Private domestic demand and exports are the largest contributors to growth in 2017 and 2018, whereas growth in public demand is expected to be more modest.

The economy is close to a situation with normal capacity utilization. The overall outlook is positive, due to several reforms, especially the 2011 Early Retirement Reform, which will continue to increase labor supply in the coming years. But the increase in demand for labor may turn out to be stronger, leading to further wage pressure. This calls for additional reforms as also assessed by staff. New reforms, which increase labor supply, may help curb capacity pressures and sustain the upswing in the Danish economy. Production capacity also depends on productivity growth, which has been weak for a sustained period. Productivity is expected to increase in 2017 and 2018, but at a relatively slow pace in line with historical developments.

There is still considerable uncertainty attached to the international economic outlook, among other things due to Brexit as well as economic policy uncertainty in the United States. Monetary policy in the euro area is expected to remain extraordinarily expansionary for some time. The Danish business cycle is slightly ahead of the euro area, and the interest rate level could be too low for the Danish economy. This underscores the important role of other policies in supporting economic stability and increasing the economic supply.

Fiscal Policies Shall Contribute to Balanced Growth

The expected closing of the output gap next year implies that the ongoing gradual tightening of fiscal policy should continue to promote balanced and sustainable growth.

The structural fiscal balance is planned to improve from a deficit of 0.5 percent of GDP in 2017 to a deficit of 0.3 percent of GDP in 2018. The deficit limit in the Danish Budget Law is 0.5 percent of GDP except in cases of, e.g., severe economic downturns.

In the government’s 2025-plan (presented in May 2017) the key medium-term target is to assure structural fiscal balance in 2025. The pace of consolidation is marginally slower than in the previous plan, with the 2020-target reduced from 0 to -0.1 percent of GDP. The modest improvement in the structural balance masks larger fiscal efforts, but declines in oil and gas revenues and adverse demographics weigh on the structural improvement. The slower consolidation path should be seen in the light of an improved long term fiscal outlook and still leaves the projected path in balance or surplus in 2021-2025.

Apart from increased public investment spending in 2021-25, the 2025-plan aims to reduce both tax and government spending levels relative to GDP, notably through further reform initiatives to be agreed on over coming years. In the same vein, the 2025-plan sets a key objective of increasing potential growth by an additional ½ percentage point per year through new reform initiatives, c.f. below.

Monetary Policy—Maintaining the Peg to the Euro is the Sole Policy Objective

The authorities welcome staff's assessment that Danmarks National bank should remain ready to defend the peg. Maintaining the peg to the euro is the exclusive policy objective and hence, monetary policy rates are adjusted solely to keep the krone stable against the euro. Other considerations—such as cyclical developments in Denmark—are not taken into account when setting monetary policy rates.

Negative interest rates are now in widespread use for e.g. financial corporations, including insurance and pension companies, whereas banks have been hesitant to pass on the negative rate of interest to households and small firms. Banks' net interest income has come under pressure as lending rates, to a higher degree than deposit rates, have followed the decline in monetary policy rates. To some extent, the decline in banks' net interest income has been compensated for by higher fee income. On the expenditure side, there has been focus on increasing efficiency and reducing costs.

Financial Sector and Housing Policies

The authorities assess that the recent developments in the housing market, including the higher price increases in the largest cities, to some extent should be seen in light of developments in fundamentals, e.g. low mortgage rates, rising disposable incomes, and urbanization—and a large house price decrease in 2009.

However, highly leveraged households are vulnerable to interest rate hikes and developments in Copenhagen and Aarhus call for continued close monitoring. The Danish Financial Supervisory Authority (FSA) has already adopted measures to provide guidance to credit institutions. The government is currently assessing the DTI recommendation from the Systemic Risk

Council, and the response is expected later in June. The authorities would like to stress that the aim of recent measures is not to address rapid house price increases as stated in the staff report, but to ensure robustness of borrowers and credit institutions.

Overall, the authorities share staff's assessment that the financial system in Denmark is sound, and is in a process of implementing the remaining recommendations from the FSAP.

The authorities assess that the recent property taxation reform (May 2017) will contribute to dampen house price fluctuations, since property taxes from 2021 will be fully linked to house prices. Thereby, the property taxation reform will contribute to dampening fluctuations in household consumption and through that GDP.

The property taxation reform also includes a scheme for deferring property tax increases. The deferred payment of tax increase is a loan and, according to the government, will not in itself discourage mobility in the housing market primarily, because home owners have to pay a market based interest rate on the deferred taxes.

It is the government's view that the clause in the tax reform concerning repayment to the home owners of future tax revenue increases does not create a procyclical element, as tax reductions only occur if revenue increases structurally and permanently on a national level beyond predefined structural property tax level increases. Property taxes will therefore not be reduced during and because of a cyclical house price boom.

Productivity and Structural Reforms

Denmark experienced relatively low productivity growth over several decades, particularly in domestically oriented services. Increasing the growth potential of the Danish economy is a top priority for the government.

The government has an ongoing focus on securing efficient regulation with the aim of making it easier to operate and lowering the costs of production in Denmark. This will also allow new entrants to more easily enter the markets and increase competition. Several initiatives have already been implemented, e.g. the liberalization of the "Planning Act" and removal of the PSO-tariff as examples.

As noted by staff, the low level of domestic investments could be a contributing factor to recent slow productivity growth. As a small, open economy it is important that the taxation is internationally competitive and as noted by staff, policies such as introducing an incremental Allowance for Corporate Equity (ACE), as suggested by the former government, could support investments. At the same time, it is important to uphold the overall administrative simplicity of the tax system for both the private firms and the tax authorities. Furthermore, the government prioritizes an increased public investment spending in 2021-2025, which inter alia would provide new opportunities for investments in transport infrastructure. As noted by staff, such investments could support sustainable medium-term growth.

Technological progress is a key driver of productivity growth. Digitization and new technologies such as intelligent robots and Internet of Things can contribute to further productivity growth. Therefore, the government also focuses on providing good framework conditions so Danish companies can continue to exploit efficiency potentials through the opportunities of digitization and new technologies. As part of the effort to increase productivity, the government will present a strategy for Denmark's digital growth, which will support Denmark's position as digital frontrunner.

In the fall, the government will launch further initiatives aiming at increasing the productivity growth in Denmark.

Labor Market Policies Aimed at Increasing Labor Supply

The authorities are fully aware of the challenges regarding labor supply constraints. The government's new 2025 plan lays out the need of new reforms that increase labor market participation and productivity to prolong the recovery of the Danish economy and increase growth potential in the long run. The structural reforms implemented in the recent decade are showing clear effects. Reforms since 2008 have raised employment with more than 125,000 persons and the productive potential by 5½ percent by 2025. The new 2025-plan addresses the need for an increased labor supply in several ways, including proposals for earlier entry, stronger incentives through lower income taxes, measures aimed at attracting more workers from abroad, and further improvements in integrating refugees to the labor market.

On labor market integration of refugees the guiding principle is 'work from day one.' This calls for improved, more systematic and earlier screening of refugees' competencies, combining employment and language classes, matching refugees' placement to job opportunities, and for enhancing flexibility in provided housing. The previous government introduced an integration benefit to secure faster integration. The employment effort has been further strengthened with the latest amendments of the Integration Act, which came into effect on July 1, 2016. The overall goal of the amendments was to get refugees quickly into work after they were granted asylum.

External Sector Assessment—High Net Savings in Preparation for Demographic Changes

The authorities agree that the current account surplus is high. A current account surplus is not a policy objective, but a result of individual decisions by households and corporations. The high current account surplus partially reflects that Denmark from early on has had a focus on the challenges of future demographic changes and tried to prepare for an aging population through the build-up of labor market pensions, resulting in a private sector savings surplus. Likewise, public finances are designed to be sustainable in the long run. To some extent, the surplus also reflects the cyclical position of the economy with low investment and consumption ratios. The authorities agree with staff that the real effective exchange rate is broadly in line with fundamentals.

Mr. Meyer submitted the following statement:

We thank staff for their report and selected issues paper in the context of the Danish Article IV consultation. We also thank Mr. Ostros and Mr. Gade for their informative buff statement.

The Danish economy seems to be on a balanced growth path and has been nearing its potential. To maintain this course and support medium-term growth, capacity constraints must be lifted, especially in the labor market, through additional labor market reforms and speedier integration of immigrants, and by enhancing productivity. The more gradual fiscal consolidation as recommended by staff seems appropriate, also in view of the closing output gap. Despite continued deleveraging, household indebtedness is still high and their wealth is mostly held in illiquid assets. Therefore, ensuring the robustness of borrowers and credit institutions, and generally dampening the upward pressure on house prices using macroprudential and tax policy levers are important for financial stability.

Macroeconomic Developments

Economic growth looks stable and balanced going forward. The staff assesses that the Danish economy is near its potential and the output gap could close as early as 2018-2019. Such an uptick in the economy would be supported by the progress made in repairing private balance sheets, which makes increased private consumption and investments possible. While we agree with staff that capacity constraints are appearing in the labor market, we would also add that employment growth has been robust since 2012, underpinned by the strong expansion of the services sector. Having said this, reaching the boundaries of production presents its own risks to growth calling for renewed efforts in labor market reforms and in enhancing productivity. While the current account surplus started to decline, the surplus remains high. We agree with staff that policies to increase potential growth—especially higher domestic investment—should further reduce the savings-investment gap.

Fiscal Policies

The fiscal stance seems appropriate, although room should be made for measures enhancing the growth potential. We commend the authorities for past and future expected compliance with the requirements of the Stability and Growth Pact. Denmark's structural balance is forecasted to remain close to the medium-term target (of -0.5 percent of GDP) in 2017 and the following years. Given the cyclical position of the Danish economy, we broadly share staff's view that Denmark should aim at a gradual fiscal consolidation, conditional on the actual performance of the economy. Additional fiscal measures, as indicated in the Government's 2025 plan, could most usefully come in the form of tax reforms, such as the reduction of the labor tax wedge for low income earners and tax incentives for R&D and, considering the available fiscal space, higher investment spending. Moreover, the influx of asylum seekers over the recent years will require additional resources for educational spending in order to support their successful labor market integration.

Monetary and Financial Market Policies

We welcome the authorities' commitment to maintaining the peg, which should continue to serve the Danish economy well. We share staff's view that Danmarks National bank should focus on maintaining the peg and gradually reduce interest rate spreads as conditions allow. At the same time, we note that since the beginning of 2015, currency pressures have remained modest.

The financial sector remains sound with robust profitability, but risks emanating from the housing market warrant continued attention. The Danish authorities have made major progress in the implementation of the remaining regulatory elements and it will be important that these are completed as planned. We also agree with staff about the importance for closely monitoring the effectiveness of the implementation of the MoUs with Nordic neighboring countries on systemic bank branches. We would appreciate staff's comments regarding the impact the large portfolio of deferred amortization loans with the interest only period expiring in 2019-2020 could have on debt repayments, especially if combined with interest rate hikes.

Given high levels of household debt, ensuring the robustness of borrowers and credit institutions, and attenuating the asset cycle is important for financial stability. With debt over 250 percent of gross disposable income, Danish households are highly indebted. This, together with the fact that their substantial wealth is mostly illiquid, suggests high exposure of the economy to housing and financial markets conditions. We, therefore, agree with staff that to reduce these risks, tax incentives and macroprudential tools would need to be further tuned. We welcome, in this regard, the newly agreed property tax reform. However, since the adopted reform reduces the overall level of the property tax, it would have been advisable to link the reform with other measures such as the further reduction of mortgage interest rate deductibility. Moreover, further easing of rent control could help better use the existing housing stock and dampen house price increases in the medium term. The recently proposed macroprudential measures (e.g. LTV cap on variable rate loans and interest rate-only loans in the major cities) and the recommendation from the Systemic Risk Council are also welcome. At the same time, we concur with staff that further macroprudential and tax-related measures to mitigate those risks might be considered going forward.

Structural Policies

Structural reform efforts need to focus on addressing labor supply constraints and boosting potential growth. The Danish labor market is facing a shortage of certain types of labor, most importantly there is lack of workers with a vocational education. Integrating people on the margins of the labor market (including migrants or people with disabilities) remains a challenge. We welcome in this regard the measures already taken by the Danish authorities, such as incentivizing benefit recipients to (re-) enter the labor market and the tripartite agreement for a better integration of migrants. We are also encouraged by the new 2025-plan, which focuses on ways to boost potential growth by an annual 0.5 percentage point. In this context, Denmark could benefit from implementing measures to enhance productivity and private sector investment by increasing competition in the domestic services sector. Helping non-financial corporations to reduce their leverage and encouraging knowledge investment could promote investment and raise potential output. Similarly, higher public investment would be needed for instance in transport infrastructure and to meet climate, security and performance requirements.

Mr. Sembene and Mr. Mkwezalamba submitted the following joint statement:

We thank staff for the comprehensive report and commend the Danish authorities for their strong record of prudent macroeconomic policies which have supported economic recovery and progress towards growth potential. It is encouraging that economic activity is expected to strengthen further this year on the back of strong private consumption growth. However, risks associated with high household debt, a booming property market and labor shortages in certain sectors could derail the country's economic recovery. Against this backdrop, we encourage the authorities to pursue efforts towards alleviating capacity constraints, raising growth potential, and bolstering resilience to shocks. We broadly concur with staff's analysis and policy recommendations and thank Messrs. Ostros and Gade for their informative buff statement. That said, we will confine our comments to the following issues.

On the fiscal front, the Danish authorities have appropriately maintained a prudent stance. Deficits have remained low with a significant surplus registered in 2014. As noted by staff, presently there is fiscal space, and with economic growth on the low side, we view as appropriate the authorities' decision to allow for a moderate slowdown in the pace of fiscal consolidation through tax cuts. Furthermore, we agree that the authorities should consider re-balancing fiscal expenditure from consumption and transfers towards more public investment. Nevertheless, we concur that the fiscal measures should be accompanied by strong labor market reforms to address the labor supply constraints that are impeding certain sectors, notably the construction sector.

Monetary and exchange rate policies have been broadly appropriate, with the central bank focusing on maintaining the peg to the euro.

We are pleased to note that Denmark's large financial system remains sound, with capital buffers in all systemic banks exceeding regulatory thresholds. Banks, insurance companies, and pension funds have adapted well to the low interest rate environment and remain profitable. We commend the steps taken to upgrade the regulatory framework, in line with the 2014 FSAP recommendations. While we welcome the progress made towards regional coordination of large banks through the implementation of the MOUs, we encourage the authorities to start taking steps to strengthen the operational independence of the Danish Financial Supervisory Authority (DFSA) and implement an independent audit function. That said, in last year's Risk Assessment Matrix, staff rated the impact of "Brexit" on trade and financial flows in Denmark as high. We would appreciate staff's update on the current situation.

The price developments in the housing market of a few cities remain a significant risk to macroeconomic stability. We, therefore, welcome the additional macro prudential measures under consideration to address risks posed by the housing market. Capping the loan amount of variable-rate and interest-only loans for a couple of cities where prices are rising quite fast could prove helpful as recommended by staff. This notwithstanding, the increase in LTV-ceiling for vacation homes could potentially undermine ongoing efforts to reduce housing risks. The staff's comments on the cause of this change as well as on the authorities' appreciation of this development will be appreciated. We urge the authorities to introduce new policies including relaxing the rental market regulations to ease constraints to supply. Could staff comment on measures being considered to increase the supply of housing?

Regarding structural reforms, we agree with staff that remaining challenges include raising labor supply and promoting investment. We note that reform fatigue has the potential to weigh on the decision to postpone much-needed labor market reforms. However, we urge the authorities to swiftly review the unemployment benefit system to avoid discouraging entrants into the labor market. In this regard, we urge the authorities to consider implementation of measures aimed at enhancing the integration of migrants into the labor force. We encourage the authorities to follow through on the education and pension reforms laid out in the 2025 plan. Lastly, we encourage the authorities to intensify product market reforms and policies, including the timely liberalization of the Planning Act, to spur private investment.

Mr. de Villeroché submitted the following statement:

We thank staff for a comprehensive set of reports and Messrs Ostros and Gade for their insightful buff statement. We associate ourselves with Mr. Meyer's statement and would like to offer the following comments.

With growth approaching its potential, we concur with staff's assessment that the policy mix should be focused on raising potential growth. The fiscal stance for 2017, featuring a smothering of fiscal consolidation, appears adequate considering that the European targets have been reached quicker than expected and should be respected going forward. In this context, fiscal space should be used to lower the tax wedge and increase public investment. More generally, we concur with staff that capacity-enhancing reforms are a priority. Further reforms to boost the labor supply should be complemented by measures to foster firms' investment and R&D. While the Allowance for Corporate Equity (ACE) can support this, such a measure raises the question of international cooperation and potential tax optimization in case of asymmetric implementation. The staff's comments are welcome. On a different point, we would also like to know if staff identified major blocking points regarding product market reforms enhancing competition (notably for store establishment).

On the financial environment, while the banking sector appears sound and the supervisory and regulatory framework adequate, we share staff's concerns regarding the housing market. With the transformation of subsidiaries of Nordic banks into branches, we welcome the MOUs signed by the Nordic authorities to enhance regional coordination. We would welcome staff's analysis on the transmission channel of risks in the region. Moreover, if the regulatory framework has certainly been upgraded, we agree with staff on the need to push ahead with macroprudential and other policies to tackle risks stemming from the rise of house prices, in the context of high household leverage. We note that the two "diamonds" framework delivered modest impacts as well as a slight reversal in the macroprudential framework with the increase of the LTV-ceiling for vacation home. Against this background, we welcome the recently proposed cap on the DTI ratio for certain loans, the agreed tax reform and plans for reducing the mortgage interest deductibility and stress, at the same time, that there is room for a further expansion of the macroprudential toolkit as well as implementing supply policies. We also concur with staff that the monetary policy conducted by the Danmarks Nationalbank has proved adequate and we share staff's advice that the central bank should maintain the peg and continue to normalize as conditions allow.

On the external position, while we agree that a more gradual fiscal consolidation and measures to rise public and private investment would help reduce the current account surplus, we would like to offer the following complementary analysis.

We particularly appreciate the detailed external assessment presented in annex I that suggests that the external position is stronger than implied by medium term fundamentals. That said, staff appears excessively cautious when mentioning important, or even considerable uncertainties surrounding this assessment. While we understand the rationale for correcting the current account gap to reflect trade activities outside the Danish borders, we are much more skeptical regarding the need for an adjustment to reflect pension savings. The EBA current account model already includes four demographic variables. Aging speed in Denmark is actually lower than the world average, which should translate into lower pressures on the Danish pension system.

Relatedly, we welcome the analysis on the issue of corporate vs household savings, presented in box 2 of the selected issues paper. The staff argues that cross-country comparisons of household savings rates are not straightforward, and that the actual household savings rate could be as much as eight percentage points higher when adjustments are made for Denmark-specific effects related to pension contributions, taxes, and imputed rents in the calculation of household consumption. Could staff elaborate on whether such adjustments would be consistent with international guidelines (SNA 2008, ESA 2010), and what is the usual practice in peer countries? The staff also underlines the high level of the household net wealth (expressed in percent of gross disposable income) compared to peers. However, when expressed in percent of GDP, household net wealth is close to the median of other countries; what makes Denmark an outlier is the very low ratio of households' disposable income to GDP, at slightly below 50 percent, compared to 65 percent on average in the European Union. Could staff elaborate on the reasons of this large discrepancy with the rest of the EU? Finally, staff points to the difficulty of drawing a clear line between household and corporate savings. While we agree, the mechanisms at stake (ownership of firms by households, buybacks of a firm's own stocks) do not seem specific to Denmark. In addition, staff notes that for tax reasons, owners of firms often opt to retain the firms' profits as retained earnings, rather than distribute them as dividends; what is staff's assessment of the impact of these tax incentives on the current account, and on the opportunity to revisit tax incentives to address Denmark's persistent current account surplus?

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for the report and Mr. Ostros and Mr. Gade for the informative buff statement.

The ongoing economic recovery is rather slow, constrained both by relatively subdued aggregate demand and capacity constraints. The large CA surplus reflects excess savings and low domestic investment while muted inflation is indicative of tepid consumer demand, partly due to elevated household indebtedness. However, the risk of an overheated housing market poses a threat to macroeconomic stability, especially in case of interest rate shocks to household balance sheets. Overall, growth is expected to recover to its potential over the medium term on the back of low interest rates but this might exacerbate wage and inflation pressures, going forward.

The growth outlook is dependent on the pace of household and corporate balance sheet repairs and efforts taken to alleviate capacity constraints and labor shortages. External risks, such as lower growth in the euro area, global trade disruptions and tightening of global yields could hurt the recovery. With respect to domestic risks, we note that the authorities do not particularly share staff views on risks to housing market. Could staff comment on the difference of opinion?

The fiscal position is broadly balanced, with a small headline deficit. The authorities have postponed the goal of a zero-structural deficit by five years to 2025. We urge the authorities to consider incorporating staff-advised reforms of pensions as a key component of the 2025 plan. While a modest easing of fiscal stance at this juncture could serve to support growth and external rebalancing, positive supply inducing policies, especially on the taxation front, combined with the reorientation of public expenditure in favor of productive investments and labor market reforms will be needed to reinforce recovery.

Monetary policy has so far been geared to defend the krone, and FX interventions made earlier have been largely unwound. We agree that going forward, Danish policy rates should be aligned to euro area rates to ensure stability of the currency peg. Given the likely upturn in inflation, DN would also have to carefully steer monetary policy to manage both inflation expectations and the exchange rate. Could staff recommend an optimal course of monetary policy setting should inflation rise rapidly?

High level of indebtedness combined with floating rate mortgage exposures render households vulnerable to interest rate shocks. The cycle of low interest rates and credit chasing the rapidly rising housing prices should be dealt with by authorities by using additional macroprudential measures and supply enhancing policies to mitigate risks to the financial system. We commend the authorities on recent property taxation reforms aimed at stabilizing prices. These policies ought to be put in place expeditiously by the government, and concerned regulators namely, DFSA and SRC.

The Danish financial system is sound and liquid, and successfully adjusting to low interest environment. Banks have improved cost efficiency and fee earnings, and pension and insurance funds are exiting from guaranteed return products in favor of market based instruments. In view of the expansion of regional bank branches, cross border cooperation will be needed to mitigate systemic risks.

We welcome the affirmative labor market policies and the significant measures taken to improve work incentives for migrants. Integrating migrants through education and building competencies will spur labor participation. Structural reforms to accelerate productivity growth can be enabled by encouraging investment in knowledge based enterprises and by incentivizing corporate deleveraging. Proactive efforts to reduce the debt bias of investments through harmonization of tax treatments would support economic activity. The liberalization of the Planning Act to foster competition and relaxation of onerous regulations in network sectors' including retail markets, can boost productivity. Could staff comment on the likely impact of the provisions of the new 2025 plan on labor employment going forward?

We wish the authorities the very best in future endeavors.

Mr. De Lannoy and Mr. Manchev submitted the following statement:

We thank staff for the comprehensive set of papers and Messrs. Ostros and Gade for their insightful buff statement. Denmark's economy is in its fourth year of recovery, but the delayed supply side response poses challenges to the medium-term developments. We welcome the authorities' efforts to improve the financial stability during recent years and their continued engagement in sound policies to overcome capacity constraints. Since we generally agree with the staff's assessment and fully associate ourselves with Mr. Meyer's statement, the following comments are given for emphasis.

We note the considerable uncertainties in the staff's external sector assessment. Additional analysis of important country specific factors, not captured by the EBA model, provide a better understanding of Denmark's current account. We are reassured by the assessment that the external imbalances will decline in the medium-term. The staff, however, should be more specific on the effects that each factor plays in their baseline scenario, given the measurement issues related to the trading activities by residents outside the country, the nature of Denmark's exchange rate and monetary regimes, the already high levels of domestic pension savings and public investment, and the agents' high sensitiveness to the interest rates and differentials. Can staff provide further clarity on the productive public investment, which can substantially boost the economic potential in Denmark?

Finally, we welcome the implemented macroprudential policies aimed at preserving financial stability, given the housing market trends. Nevertheless, the persisting excess demand on the rental market is spreading to other segments of the housing market, adding to the upward pressure on house prices. Given the vulnerabilities stemming from the relatively high households' indebtedness and the mortgage market sensitiveness to interest rates, we encourage the authorities to speedily progress with the implementation of the structural measures aimed to alleviate housing pressures by making more efficient use of the existing rental housing stock.

Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for a well-written set of papers, and Messrs. Ostros and Gade for their informative buff statement. We broadly share staff's appraisal and associate ourselves with Mr. Meyer's Gray. We would like to provide the following comments.

Unlocking growth potential requires to address capacity constraints in capital and labor supply. Danish economy is growing at a steady pace but risks are tilted to the downside. Regardless of the exact size of the output gap, that in Denmark is subject to particularly large uncertainties, GDP per capita remains below the pre-crisis level and in recent years the rates of capital accumulation and overall labor productivity have been on a downward trend, with a negative total factor productivity growth rate since the global financial crisis. Therefore, we take favorable note that the authorities are prioritizing support to long term growth through productivity enhancing reforms; to this aim, appropriate consideration should be given to an increase in competition in the domestic services sector and in the network industries.

A neutral fiscal stance could finance selected interventions. The authorities intend to marginally relax the long term fiscal consolidation path while remaining compliant with the SGP provisions. In this context, public investment projects in transport infrastructure and a reduction in the labor tax wedge for low income earners can relax current constraints. Moreover, higher public investment will reduce the large saving-investment gap underlying the current account surplus. We would welcome staff's elaborations on possible policy options to reduce this gap from the saving side, for instance through a reduction in the tax advantages for occupational plans. Measures like tax credits or a promotion of the collaboration between public and private research bodies can help to increase spillovers from already high R&D spending. We support the authorities' current work to further improve the efficiency of active labor market policies and to boost labor supply, especially among the most skilled segments of the workforce, and to enhance the employability of disadvantaged groups, like people with a non-EU migrant background.

At the same time, economic resilience can be improved by reducing private sector high debt. While domestic demand is projected as rising, a stagnant labor productivity hamper wage growth despite labor markets bottlenecks; thereby, inflation remains low and, given the large savings, consumption appears mainly financed by exceptionally high borrowing, with risks of abrupt reversals in case of a correction in real estate values or of an interest rate hike. The large financial sector is solid and profitable; yet, the economy is vulnerable to a normalization of the monetary policy, especially if inflation does not pick up in the wake of possibly higher interest rates. Thus, policy measures discouraging the debt bias in the economy are needed, starting by complementing the property tax reform by a reduction of the mortgage interest deductibility or by introducing an incremental Allowance for Corporate Equity, which can also incentivize private investments. Additional macroprudential measures might be considered if needed, including a more stringent DTI ratio than the current one and the setting up of a minimum amortization period.

Mr. Alogeel and Mr. Rouai submitted the following statement:

We thank staff for a well-written set of reports and Mr. Ostros and Mr. Gade for their informative buff statement. We broadly share staff conclusions and policy recommendations and would limit our remarks to a few issues.

The Danish economy is reaching its potential and capacity constraints are gradually increasing because of weak productivity growth and low domestic investments levels. The staff is making a number of sensible recommendations to reform the labor market and promote structural reforms to increase investment and productivity growth. The staff projects that investment will rebound as a result of rising construction activity and improved balance-sheet (paragraph 9). Can staff clarify how this assessment is consistent with the analysis in paragraphs 34-35 and also with the trend for investment in Table 1, which shows a decline over the medium-term in gross fixed investment and a rather small improvement in gross domestic investment which may be due to the revision of the data series compared to the last year's Article IV consultation? While still on investment, could staff elaborate on the reasons behind the doubling to 5.2 percent of GDP of gross fixed investment in 2016 (Table 1)?

On the macroeconomic policies stance, we agree with staff on the merit of a slower pace of fiscal consolidation, combined with strong labor market reforms and a rebalancing of fiscal expenditures towards more productive public investment to raise potential growth. We also consider that the peg to the euro has served Denmark well and should continue.

The only main area of concern is the housing market with the rising house prices in an environment of low mortgage interest rates and supply constraints. In this regard, while we welcome the authorities' efforts to reduce potential risks through the recent property tax reform and the introduction of the debt-to-income limit, we agree with staff on the need for additional macroprudential measures and supply policies to safeguard macrofinancial stability and reduce the risk of further build-up of housing debt.

Finally, we note that the financial system remains sound and we welcome the authorities' efforts to upgrade the financial regulatory framework and promote regional coordination. Could staff elaborate on the conclusion in paragraph 25 that "all systemic banks have capital buffers in excess of regulatory minima" and if such conclusion remains consistent with the recent indication by the central bank that the systemically important financial institutions (SIFIs) have a capital shortfall of kr. 2.9 bn at the end of 2019 in order to meet all the SIFI capital buffer requirements and a few non-SIFIs fell short of minimum capital requirements under its adverse stress test scenario?

With these remarks, we wish the authorities further success.

Mr. Dajani and Mr. Lopez submitted the following statement:

We thank staff for its insightful reports and Messrs. Ostros and Gade for their helpful buff. We mainly agree with staff's assessment and recommendations. We associate ourselves with Mr. Meyer's statement and would like to add some specific comments.

Economic growth continues to be moderate but more balanced than in recent years, supported by robust private consumption and stronger investment, in a context of employment expansion, wage increases and loose financial conditions. It is expected that the output gap will be closed in 2017 or 2018, although low productivity growth continues to be a major challenge. The main economic risk relates to the high level of households' debt, which make them vulnerable to disruptive adjustments in house prices and interest rates.

The current account surplus, although recently declined, remains high. We note the authorities' view on the external imbalance as an aggregate result of individual decisions by households and firms. Nevertheless, this behavior may partly correspond to an excessive saving—above fundamental justifications—and/or to a lack of willingness to invest domestically, i.e. to excessive capital exports, despite the strong business environment. It would be useful to analyze the persistence of this phenomena and to what extent this behavior relates to weak productivity and low returns on investments. In this context, structural reforms would help to create a positive loop of higher productivity, higher investment and higher potential growth, helping to reduce the saving-investment gap.

Fiscal stance has been rightly accommodated to the decreasing output gap. Medium-term fiscal plans to slow the path of consolidation, in line with EU rules, seem appropriate. This strategy should have a growth-friendly focus, including tax reform and spending measures to support investment (private and public) and innovation, foster labor force participation and enhance refugee integration. These actions would help to ease inflationary pressures, reduce supply constraints in the labor market, increase productivity and adjust the sizeable current account surplus.

As we have highlighted in the past, high levels of mortgage debt and housing market overheating are the main sources of concern. The large share of variable-rate and deferred-amortization loans, along with the increasing leverage of low-income borrowers pose risks to economic and financial stability, since households are more sensitive to interest rate hikes, losses in income and house price declines. As the monetary policy stance—tightened by the krona peg—remains highly expansionary, the authorities should strengthen the macro-prudential toolkit and deploy a full range of instruments to prevent excessive borrowers' leverage and enhance the resilience of households and banks. To further mitigate risks and reduce price fluctuations in the housing market, measures to facilitate housing supply, eliminate distortive tax incentives to debt-financed home ownership, and enhance rental market flexibility would be advisable.

Mr. Lischinsky and Mr. Vogel submitted the following statement:

We thank the staff for its reports and Mr. Ostros and Mr. Gade for their helpful buff statement.

We welcome Denmark's developments in terms of economic activity and employment, as well as the expected fiscal results for the near future, starting with an important reduction of the primary deficit in 2018. Meanwhile, the economic performance and positive confidence could have contributed to the increase of risks and challenges. Bottlenecks for skilled workers may affect medium-term growth, as well as house price increases and the high household debt, seem to be substantial challenges to be addressed.

Considering Denmark's current and expected fiscal and debt indicators, we agree with the staff that the country's public finances are broadly sustainable and there is fiscal space. The slower consolidation path appears to be a sensitive decision, which is compatible with the staff's suggestion of establishing some shifts in the composition of spending. Furthermore, we fully agree with the recommendation of making more resources available for the education of migrants, which, as noted in the staff report, could help raise labor supply.

Chapter I of the selected issues paper (Household balance sheet structure in Denmark and sensitivity to rising rates) makes a clear analysis, among others, of the puzzle of high households' assets accumulation and the low saving rate. As noted, Denmark's household assets are to a great extent the counterpart in household debt. The increasing trend of house prices and the high level of household debt entails substantial risks for the country. Given the health the financial system shows, we share the staff's view that even though the housing market does not seem to entail a huge risk for the financial system, it constitutes substantial macroeconomic risks. Increases in interest rates and/or declining house prices may be significant shocks for Denmark. Therefore, we welcome the authorities' decision to undertake measures to address these risks, although we perceive some differences between the authorities and the staff, as the buff statement notes that "the authorities would like to stress that the aim of recent measures is not to address rapid house increases as stated in the staff report, but to ensure robustness of borrowers and credit institutions." The staff's further comments are welcome on this difference and, in general, on the perspectives of house prices.

Labor market policies in Denmark, which are oriented to increase the supply of labor, will continue to increase labor supply in the coming years. The reforms since 2008, including the Early Retirement reform in 2011, are expected to contribute to labor supply towards 2020, with close to 5 percent of the labor force. Projections between 2017 and 2020 show that the reform will mostly increase the number of skilled workers, then those with higher education, and lastly unskilled workers, highlighting the need for special training and education policies for this group. We note from the buff statement that new reforms are planned to increase labor supply with the new 2025-plan to strengthen work incentives and reform education oriented to curb capacity pressures and sustain the upturn of the economy.

Given the importance of increasing labor supply, both early retirement and old age retirement ages have been increased and the time refugees are incorporated to the labor force has been shortened. The life expectancy indexation (LEI) is decided by the Danish Parliament (Folketinget) every five years. Based on the LEI, changes are planned for early retirement and old age retirement. With regards to refugees' employment, experience tells that those refugees that go quickly into work are the first to return home when conditions improve in their country of origin. At the same time, a recent study shows that refugees in the United States end up paying more in taxes than they receive in welfare benefits after eight years of living in the country.[1]

Over several decades, productivity in Denmark has grown slowly even though the economy continues to be highly competitive. The Global Competitiveness Index, 2016-2017 puts the country in 12th place. We concur with the buff statement that production capacity depends on productivity growth, which has been weak for a sustained period, particularly in domestic-oriented services. However, more than 70 percent of the labor force

[1] Evans, W.N. and Fitzgerald, D. (June 2017) National Bureau of Economic Research (NBER) WP 23498. The economic and social outcomes of refugees in the United States: evidence from the ACS (American Community Survey). http://www.nber.org/papers/w23498

is in the service sector where productivity is traditionally low. Productivity is expected to increase in 2017 and 2018, at a relatively slow pace in line with historical developments by opening spaces such as the “Planning Act” and improving PSO-tariffs, and including service sectors oriented towards the domestic market, such as retail and construction.

We concur with staff that the low level of domestic investments could be a contributing factor in recent slow productivity growth, as productivity increases are mainly associated with new investments. Technological progress is a key driver of productivity growth; hence, we welcome the authorities’ focus on providing a framework to firms to incorporate the benefits of digitalization and new technology. In turn, strong training and skill enhancement in digitalization and new technologies should be delivered to all workers, but particularly the unskilled, to avoid “technological” unemployment.

Exports continue to be one of the largest contributors to growth and to the current account surplus. In a country where the financial sector is 7 times its GDP, the relation between the current account surplus, the savings surplus, the negative interest rate, and the exchange rate, which is slightly appreciated, is important. Could staff explain how the interest and exchange rates interact with the twin surpluses? The Financial Account is composed of Direct Investment, Portfolio Investment, Financial Derivatives, and Other Investment, which constitute the bulk of the Financial Account. Could staff clarify what account “Other Investment” comes under?

With these comments, we wish Denmark and its people every success in their future endeavors.

Mr. Beblawi and Ms. Merhi submitted the following statement:

The Danish economy has recovered and growth is approaching potential even though economic performance has been relatively weaker than before the crisis. Risks to the outlook are substantial and largely on the downside, stemming from capacity constraints, highly indebted households, as well as from rapid rising housing prices. We agree with staff assessment that economic policies should alleviate capacity constraints and lift potential growth while containing risks. We would like to focus on the following issues:

Monetary policy is fully dedicated to maintaining the peg with the euro, and hence, monetary policy rates are adjusted solely to keep the krone stable against the euro, as elaborated in Mr. Ostros and Mr. Gade's informative buff. However, this comes at a price of very low imported interest rate, with almost five years into negative rates, that is likely adding fuel to the house price increases. We concur with staff that as conditions in the euro area normalize, it would be appropriate to gradually reduce spreads relative to the ECB.

Given Denmark's fiscal space, it would be appropriate to slowdown the fiscal consolidation and shift spending composition to productive public investment to raise growth potential. However, the authorities should be ready to tighten fiscal policy if growth accelerates faster than expected. We note the government's intention to delay meeting its zero-structural balance objective by 5 years to provide room for maneuver over the next few years.

As highlighted in the report, the financial system is sound and well capitalized. We welcome the progress made in upgrading the regulatory framework. However, the continued increase in house prices remains a source of concern as it increases the risk of another correction in the housing market further down the road. The authorities need therefore to remain vigilant and closely monitor developments in the housing market, especially that banks and mortgage institutions have substantial direct exposures to the housing market (approximately 90 percent of GDP) and given that there remains a significant proportion of households who have very high debt-to-income ratio above 400 percent. We welcome the introduction of caps on loan-to-value in Copenhagen and Aarhus areas, as well as the recent property tax reform to limit the procyclicality of house price fluctuations. Nevertheless, more additional macroprudential tools should be implemented to diminish a build-up of systemic risks and prevent excessive accumulation of households' debt. While the authorities indicated that they could potentially consider at some later date reducing the mortgage interest deductibility, we would be interested to learn whether they might consider increasing the down payment requirement to at least 10 percent as recommended by staff.

With these comments, we wish the authorities the best in their reform agenda.

Ms. Pollard and Mr. Sobel submitted the following statement:

The staff conclude that the outlook for the Danish economy is for continued moderate growth but with substantial domestic and external risks. We agree on the outlook but see risks as more moderate than do staff. Nevertheless, we broadly concur with the policy recommendations to raise potential growth. Measures to increase labor supply, including through better integration of migrants, and to boost investment are key. We support staff's recommendations on shifting the composition of fiscal outlays to boost growth and support the authorities slower pace of consolidation.

We focus the rest of our remarks on two areas where we have a somewhat different view from staff—household debt and the external sector. First, staff noted that Denmark's household debt as a share of disposable income is the highest of the OECD countries. The net worth of these households as a share of disposable income is also among the highest of the OECD countries, reducing the macroeconomic risks the debt. Further, the Selected Issues Paper on household balance sheets shows that debt is concentrated in high income households. The staff's analysis indicates that rising interest rates likely would have an overall modest effect on consumption but could have substantial impacts on highly indebted households. In our view, this risk is mitigated by the likelihood that higher interest rates would occur during a period of stronger growth and employment. In addition, while staff consider the possibility of rising interest rates on deposits, we think the analysis should consider higher returns on the full range of household assets which through the wealth effect could further mitigate the impact on consumption by lowering the need to save.

We do agree that risks in the housing sector need to be closely monitored and efforts to constrain the rise in housing prices are welcome. Given the rise in no amortization mortgages in recent years, we agree with staff that the authorities should consider minimum amortization requirements. Policies aimed at increasing the supply of housing would also be welcome. We appreciate Messrs. Ostros and Gade's clarification in their buff statement that the property tax reform will not reduce housing mobility.

Second, we thank staff for the detailed analysis of Denmark's external sector. However, our chair cannot help but strongly reemphasize that the reasoning behind staff's qualitative judgments and adjustments to the EBA model, especially in cases of surplus countries, seem arbitrary, lacking in substantiation and oriented toward minimizing the gaps between the EBA model norm and the actual current account surpluses. In Denmark's case, staff invoke a number of questionable judgments to reduce the gap between the actual current account surplus and the EBA norm – merchanting trade, demographics in the EBA model and fully-funded pension systems. To the extent these are relevant issues, they need to be addressed by the EBA team, rather on a country team-by-team basis, to ensure greater consistency across the Fund.

Turning specifically to the Denmark adjustments we would like more information from staff on how they consider demographic factors. As Figure 4 illustrates, over half of Denmark's exports are to other European Union countries and the same applies to its imports. Yet, a 2015 report on aging in the European Union indicates that Denmark is aging much less rapidly than most other EU countries, with the working age population not reaching its peak until 2055 compared to the EU average of 2013 and the old age dependency ratio rising by 14 percentage points by 2060, compared to the EU average of 22 percentage points.

We also would appreciate comments from staff on what factors account for a persistently higher ratio of savings to GDP than investment in Denmark. A September 2016, European Union report highlights policy changes that occurred in the late 1980s aimed at encouraging private saving and reducing consumption and investment. More recently, the gap between saving and investment has increased as investment has failed to recover following the global financial crisis, a point highlighted by staff. While structural reforms may boost domestic investment, we think greater public investment can also play a role.

On merchanting, which accounts for the bulk of the staff's adjustment, the staff's reasoning is unclear to us. Let us assume for argument's sake that a Danish company buys and sells commodities in a foreign currency overseas and earns a profit which is returned in the foreign currency outside of Denmark. It is not clear to us how such a transaction impacts the underlying saving and investment dynamic in Denmark and the current account norm.

Mr. Mojarrad and Mr. Monajemi submitted the following statement:

We thank staff for the high-quality set of papers and Messrs. Ostros and Gade for their insightful buff statement.

With the economy moving close to potential, the growth deceleration in 2016, accompanied by strong labor market, is indicative of capacity constraints becoming more binding. House prices continue to rise rapidly in urban areas, even as wage pressures remain subdued, despite recent increases. The fiscal policy stance has tightened, and the current account surplus–despite its reduction in 2016–remains large. While the outlook is for continued moderate growth with gradually rising inflation from its currently low level, substantial downside risks remain, including from increasing labor shortages, continued house price inflation, lower-than-expected euro-area growth, and political uncertainties. The authorities are encouraged to build on their strong track record of sound policies to help sustain the economic recovery, reduce potential financial sector vulnerabilities, and raise medium-term growth prospects. We agree with the thrust of the staff appraisal and offer the following comments.

Considering Denmark’s sustainable public finances and large fiscal space, we support slowing down the pace of consolidation to facilitate cuts in the high tax burden, and reaching structural fiscal balance by 2025. Given the exchange rate peg, fiscal policy should be tightened if growth turns out to be substantially faster than expected. We agree that shifts in the composition of fiscal outlays towards productive public investment would help raise growth potential. Investment in the development of additional housing in the larger cities and upgrading of the transport infrastructure could help reduce house price pressures.

Monetary policy is appropriately focused on preserving the exchange rate peg. We note the indication by Messrs. Ostros and Gade that the Danish business cycle is slightly ahead of the euro area and that the interest rate level could be too low for the economy. Should cyclical divergence increase, tensions between fiscal and monetary policies could arise, and we wonder whether fiscal policy has the necessary agility to respond promptly to this development. The staff’s comments would be appreciated.

We note that negative interest rates have had only a limited impact on the profitability of banks and mortgage credit institutions, as rising fee income offsets lower net interest margins. While we concur with staff recommendation for normalization of interest rates as allowed by market conditions and exchange rate pressure, we invite staff to comment on likely adverse effects of prolonged negative interest rates, especially given the high retirement savings in Denmark.

Rapid house price increases in urban areas could pose macroeconomic and financial stability risks. While recent agreement on property taxation reform would reduce the procyclical impact of the current valuation freezes from 2021, it could also reduce mobility and the agreed option of tax cuts. We encourage the authorities to adapt the Systemic Risk Council’s recent recommendation to cap the maximum loan amount of variable-rate and interest-only loans in the Copenhagen and Aarhus areas. It could be further strengthened by applying a general cap to all loans with tighter limits for interest only and variable rate instruments, as recommended by staff. Introducing amortization requirements, raising the existing down payment requirement, reducing the tax deductibility of mortgage interest expenses, and easing housing supply constraints would also help ease housing price pressure.

Against the background of a generally sound financial system, we commend ongoing progress in upgrading the regulatory framework and implementing the 2014 FSAP recommendations. Effective implementation of the memoranda of understanding with Nordic neighbors on systemic branches is also important in view of the interconnectedness of the regional banking system. The authorities are encouraged to strengthen the operational independence of the financial supervisor (DFSA), including by lengthening the terms of board members, and activating the DFSA's independent internal audit function.

The authorities' efforts to further increase labor supply through new proposals regarding the pension and education reforms in the 2025 plan are encouraging. Eliminating the availability of unemployment benefits to fresh graduates would help promote faster labor market entry. Enhancing the integration of migrants through more training and education would increase labor supply, and we welcome the recent shift of focus on education of migrants.

Boosting investment, especially in knowledge-based sectors, could help raise productivity while reducing the current account surplus. In this regard, reducing firms leverage, including by limiting the debt bias in the tax system, would be helpful. Product market reforms also remain crucial, and we agree with staff that relaxing strict regulations in some network sectors would also help increase competition and productivity growth.

Mr. Agung and Ms. Ong submitted the following statement:

We thank staff for a comprehensive set of reports, and Messrs. Ostros and Gade for their informative buff statement. The Danish economy has recovered well and is approaching potential. Growth is moderate but steady, the output gap is close to zero, and unemployment is close to its long-run equilibrium. Looking ahead, we encourage the authorities to remain watchful of emerging vulnerabilities, particularly in the housing market, and to prioritize measures to raise potential growth. We broadly concur with the thrust of staff's assessment and offer the following comments for emphasis.

While the financial system remains sound, housing market risks bear close monitoring. We welcome the authorities' progress in enhancing the financial regulatory framework for banks. The Danish banking system appears robust; banks are well-capitalized, non-performing loans are on the decline, and profitability has been trending upward even though interest margins have fallen amidst a negative interest rate environment. Could staff elaborate on the sources of increased fee income that have boosted profitability? Do they entail any potential new risks for Danish banks? We encourage authorities to remain proactive regarding potential risks from the residential real estate market at a time when household debt remains high. We tend to agree with staff that the brisk pace of house price increases in urban areas, coupled with the increase in variable-rate and interest-only mortgages (Figure 3), could portend the emergence of pockets of vulnerability in the housing market. We further note staff's assessment that the impact of recent supervisory measures to enhance banks' risk management and underwriting standards have had only limited impact. We agree that the Systemic Risk Council's recommendation for a limited DTI cap would be useful in reinforcing lending standards, and further concur with staff's recommendation to broaden the scope of the DTI limit and consider other complementary macroprudential tools, such as loan-to-value and minimum amortization requirements.

For an economy operating close to capacity, sustained growth will hinge on the authorities' ability to increase labor supply and enhance productivity. We commend the authorities for the substantive labor market reforms that they have undertaken in recent years to increase labor supply, as noted in the buff. As the labor market continues to tighten, we see merit in staff's recommendation to further promote labor participation among the young and old through further education and pension reforms. Could staff comment on where Denmark's labor force participation rates currently stand vis-à-vis peer countries? Could staff also elaborate on the estimated boost to labor supply and growth that could result from improved migrant integration and the implementation of the education and pension reforms? We note that TFP growth in Denmark has yet to recover since the crisis. In this regard, we look forward to the liberalization of the Planning Act to boost competition and efficiency in the retail market. We also welcome the authorities' focus on technology as a driver of productivity growth, as discussed in the buff, and look forward to the government's strategy for Denmark's digital growth.

We note staff's judgment that the Danish external position is substantially stronger than warranted, and welcome their acknowledgement of the considerable uncertainty surrounding the assessment. We support the authorities' commitment to defending the euro peg, which has served the Danish economy well, and agree that interest rates should continue to be normalized as market conditions permit. We note positively staff's consideration of country-specific factors contributing to a structurally higher current account balance in Denmark, including its large financial sector. We note that the assessment of the CA gap does not account for Denmark's fully-funded and largely mandatory pension system. Does staff have any estimates of the likely impact on the CA gap if this were taken into account? We underscore that given the EBA's methodological limitations, staff judgment will remain critical in interpreting the assessment results.

Mr. Panek and Ms. Andresen submitted the following statement:

The Danish economy has recovered from crisis, based on considerable reforms in the past years and supportive policies. The economy continues to grow at low but steady pace, supported by strong private consumption and rising private investment. As the economy is reaching its full potential, we support the authorities' policy of continued gradual fiscal tightening in line with Danish and EU budget rules, as outlined in the helpful buff statement by Messrs. Ostros and Gade. From a policy perspective, addressing vulnerabilities in the housing sector, capacity constraints, and low productivity are important going forward.

Further measures are needed to reduce ongoing vulnerabilities in the housing sector. The authorities have already taken important steps, such as the recently agreed property tax reform. However, more efforts are necessary to safeguard macrofinancial stability, such as adopting targeted macroprudential measures. The authorities' proposal of a debt-to-income limit would be a step in the right direction. However, we support staff's recommendation to go a step further and apply a general cap to all loans, with tighter limits on more risky instruments such as interest-only loans. Moreover, we see merit in amortization and higher down payment requirements. Finally, alleviating supply constraints by adopting measures to increase the availability of rental apartments would further help to reduce upward pressure on house prices.

Addressing capacity constraints in the labor market requires a comprehensive set of measures. We welcome the labor market reforms envisaged in the context of government's new "2025 plan." The proposals for lower tax cuts and measures to promote earlier entry to the labor market have the potential to raise labor supply and reduce capacity constraints. We look forward to the concretization of these proposals. We further welcome the authorities' efforts to improve the integration of migrants into the labor market.

To tackle low productivity, efforts should focus on mitigating the corporate debt bias and on the economy's innovation potential. Firm leverage continues to be very high in Denmark in comparison with other European countries, which might reduce corporate ability and willingness to invest. High corporate debt levels also pose a risk in the context of rising interest rates going forward. We therefore support staff's recommendation to reduce the high level of corporate debt by measures such as introducing an incremental Allowance for Corporate Equity (ACE). Further, encouraging knowledge-related investment could further help to boost innovation and thus increase productivity.

The current prudent monetary and exchange rate policies remain appropriate. Although currency pressures have eased somewhat, we agree with staff that heightened policy uncertainties in the United States and Europe continue to be risk factors for upward pressure. Therefore, we are of the view that the authorities' prudent monetary and exchange rate policies remain warranted. A normalization of interest rates should depend on a reduction of external pressures, particularly in the euro area.

Mr. Just and Mr. Varga submitted the following statement:

We thank staff for the well-written papers and Messrs. Ostros and Gade their helpful buff statement. We commend the authorities for their continued circumspect economic management and encourage them to progress further with reducing the imbalances resulting from the housing market and to address the low growth potential by targeted public investment. We broadly share staff's appraisal and associate ourselves with the statement by Mr. Meyer.

We see merit in the authorities' decision to delay their zero structural balance objective, as this will create room for reforms which can also increase potential growth. Reducing the labor tax wedge, increasing tax incentives for R&D and boosting public investment should be key objectives. We note that a recent revision of national accounts data considerably reduced the 2015 fiscal deficit and lifted GDP. Can staff explain the causes behind this revision and how other indicators are affected?

We believe that the exchange rate peg of the Danish krone to the euro continues to serve Denmark well. As inflation is well contained and pressure on the exchange rate appears to have abated reflecting reduced political risk emanating from the euro area, we agree that a normalization of monetary policy appears appropriate subject to market conditions. Even though the policy rate has remained in negative territory for an extended period of time, the Danish financial sector has successfully adapted to this environment and kept its profitability by increasing fee income and reducing operational expenditures. In addition, Danish banks have significant operations abroad, which contribute to their profitability. Does staff have any information about the share of domestic and foreign profit in the banking sector?

We welcome the progress on upgrading the regulatory framework and encourage the authorities to further implement the remaining 2014 FSAP recommendations. Nonetheless, considering the Danish financial sector's large scale, complexity and close interlinkages to its Nordic neighbours, we encourage the authorities to strengthen the independence of the Danish Financial Supervisory Authority (DFSA) and provide the necessary resources to deliver its mandate, especially with respect to the ongoing structural changes concerning large regional banks. This will give confidence to the host authorities of Danish banks that the quality of supervision, as well as legal mandates and regulatory powers are commensurate with this task.

The housing market continues to be the most worrying imbalance of the Danish economy. House prices continue their upward trend, especially in Copenhagen and other major metropolitan areas, where faster property price increases coincide with relatively rapid increases in new mortgage lending. Danish households are highly indebted and hold most of their assets in illiquid forms, which adds to their vulnerability to interest rate shocks. We commend the authorities for the recently agreed property tax reform; nevertheless, we deem it crucial to introduce macroprudential safeguards to curb the risks of unstable credit expansion, including a general loan cap, minimum amortization requirements, and reducing the tax deductibility of mortgage interest expenses. As unemployment is low and in view of possibly rising wages, we see momentum for the authorities to act on staff's long-standing recommendation to eliminate tax incentives and to reduce the reliance of the economy on wealth effects from housing. Taking Ireland, Spain and the United Kingdom as examples for having already implemented this reform, can staff elaborate on what are the real effects of phasing out mortgage deductibility on the mortgage markets?

Raising labor supply and boosting domestic investment are key to increase the capacity of the economy. Better integrating the high number of migrants and bringing their education level to that of peer countries, can effectively address labor shortages over the medium term. In addition, integration into society can prevent possible social, political and security risks in the future. We appreciate staff's sensible policy advice on how to promote investment and raise potential output and would encourage staff to actively follow-up with the authorities whether they are considering implementing them in forthcoming surveillance discussions.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for the informative papers and Mr. Ostros and Ms. Gade for their helpful buff statement. The Danish economy has recovered from the crisis, but growth is slow. Unemployment is declining and the first signs of capacity constraints are emerging in some sectors. Despite the low interest rates environment, the financial system remains sound and resilient. At the same time, rising housing prices and high household debt expose economy to interest rates risks. The authorities should continue their efforts to alleviate demand pressures, raise potential growth, and bolster resilience to shocks.

The authorities' strategy of growth-friendly fiscal consolidation was successful, resulting in faster than envisaged progress towards medium-term consolidation goals. Therefore, it could be feasible to slow somewhat the pace of consolidation to provide room for reduction of high tax rates and implement reforms aimed at raising labor supply. The authorities should consider allocation of additional resources to productive public investment and migrants' education and training.

Denmark's financial system has adjusted successfully to low interest rates – banks remain liquid, well-capitalized, and profitable. We welcome progress in upgrading regulatory framework and implementation of the EU regulation. However, recent developments in the Danish and Nordic financial sectors, including transformation of subsidiaries of major banks into branches, require closer supervisory cooperation and information sharing between home and host countries.

Developments in the real estate markets require continued close monitoring. In 2016, house prices continued to grow, in some areas at a double-digit rate. Given very high household debt and substantial share of adjustable rate mortgages, these developments present an obvious macro-financial risk. Therefore, we agree that the authorities should consider further macro-prudential measures aimed at restraining excessive mortgage lending, including property tax reforms, limits on the debt-to-income ratio, and increase of the downpayment requirement to at least 10 percent.

Labor supply constraints are increasingly becoming a bottleneck for growth. The recent labor market and pension reforms have contributed to improved labor market flexibility and labor supply, but their effect is insufficient. Further tax reforms and steps to encourage participation of long-term unemployed and improve education and training of migrants are needed.

Business environment in Denmark is considered to be among the best in the world, but productivity growth is lagging, especially in TFP. The staff point to low investment as an important factor contributing to low productivity growth. Therefore, Denmark would benefit from investment-enhancing measures, including harmonization of taxation, reducing corporate leverage, and support for high-tech investments. Reduction of barriers to entry and relaxing strict regulations in the service sector may also help to boost productivity.

Mr. Fachada and Mr. Eckhorst submitted the following statement:

We thank staff for the reports and Mr. Ostros and Mr. Gade for their statement. Denmark continues to benefit from sound macroeconomic policies, but the economy appears to be close to potential. We broadly agree with staff on the need to alleviate capacity constraints through labor market policies, public infrastructure investment and incentives to research and development (R&D) that spurs private sector innovation and increases competitiveness. We also agree that surging house prices remain a source of financial sector vulnerability that requires close monitoring.

Rebalancing public spending towards investment could raise potential growth over the medium-term. Denmark enjoys enough fiscal space to delay meeting the zero-structural balance objective and adopt capacity-enhancing fiscal measures, such as tax incentives to R&D. Although we agree with staff that the country can spend more on infrastructure to reduce capacity constraints, we would like additional information on the relatively lower “quality of specific components of public infrastructure” that leave room for improvement mentioned in paragraph 15. The staff’s comments are welcome. We note that even with the delay in achieving the zero-structural balance by 5 years to 2025, the public sector debt is expected to remain on a clear downward path and well below the Stability and Growth Pact (SGP) benchmark.

Rising employment accompanied by reported labor shortages in some sectors reinforce the need for labor market reforms. However, an already high retirement age (67) and high labor participation rate (around 80 percent), including among women, limit the scope of possible policies. That said, we broadly agree on the importance of making more public resources available for the integration and education of migrant workers and for active labor market policies (ALMP), especially aimed at apprenticeships and training to improve job-seeker skills. Can staff briefly discuss how much of the labor shortages are due to skills mismatch?

Monetary policy continues to focus on maintaining the peg with the euro. Interventions on the foreign exchange market—massive at times—combined with interest rate adjustments have helped sustain the peg in a period of volatile financial conditions. Separately, the trade and investment activities by Danish firms abroad and increasing returns on foreign held financial assets contribute to the large current account surplus. We note that staff assesses Denmark's external position to be stronger than implied by medium term fundamentals.

Increasing housing prices reveal significant supply and demand imbalances. We urge the authorities to remain vigilant to financial stability risks stemming from house prices increases and welcome analyses to introduce additional macroprudential measures to mitigate risks. We tend to concur with staff on the importance of introducing debt-to-income limits and minimum amortization requirements. Like staff, we underscore that the recent increase in the loan-to-value ceiling for vacation homes runs counter to the efforts to reduce risks stemming from the housing market.

Denmark's sound financial system reflects the country's strong financial stability efforts and improving regulatory framework. Banks meet regulatory standards, are liquid and profitable despite lower interest margins due to negative interest rates. We take note also that insurance firms and pension funds appear to have been able to respond to the low interest rate environment.

Mr. Choi and Mr. Stewart submitted the following statement:

We thank staff for an interesting set of papers which address several useful topics for authorities, and thank Mr. Ostros and Mr. Gade for their forthright buff statement. Denmark's continuing growth is testament to the authorities' long track record of prudent macroeconomic and social policies. Nevertheless, the authorities' can further bolster growth and reduce potential risks through a few policy measures. The reasonably modest pace of fiscal consolidation appears appropriate, prudential regulators have been responding to emerging risks—although more could be done—and further labor market reforms will build on previous reforms and help alleviate capacity constraints.

The moderate tightening in the fiscal stance is appropriate given the ongoing recovery and imminent closure of the output gap. Any slowing in the pace of consolidation should be strictly preconditioned on labor market reforms or used to address a significant cyclical slowdown (given Denmark's otherwise constrained monetary policy).

With respect to labor market reforms, while we congratulate the authorities on their previous efforts which are bearing fruit, additional reforms will help improve the durability of the recover and make growth more inclusive. In particular, it would be worth re-examining the work-related unemployment insurance available to graduates. We would also encourage a broad-based response to improving the integration of new migrants given the persistence gaps in unemployment rates between natives and non-natives. As such, we would support both staff's suggestion around improving the validation of foreign degrees and removing restrictions on asylum seekers accepting jobs, in addition to the subsidized apprenticeships favored by the authorities.

The authorities have shown a willingness to address emerging risks to financial stability, and more could be done. We note that household debt has not been rising and there has been little reported change in credit standards. We also support the point made in the buff that the objective of policy is not to restrain house prices but to protect households and financial institutions. Notwithstanding these considerations, the overall environment is still too generous towards debt funding of housing when you consider the deductibility of mortgage interest, the lack of capital gains on primary residences and the monetary policy stance. Now would be a good time to address some of the taxation elements to improve the overall resilience of Danish balance sheets.

We also welcome the staff's analysis on the potential consumption effects of changes in interest rates, and look forward to additional research on this topic. The analysis could benefit from a discussion on the presence, or absence, of mortgage prepayment buffers to evaluate the claim that variable-rate mortgages are riskier than fixed-rate mortgages and that their share of banks' portfolios should be capped. We wonder, for example, whether the prevalence of such buffers explains why the sensitivity of consumption to interest rates is considerably smaller in some other countries where variable rate loans predominate.

The amount of attention given to Denmark's external balance assessment is a good benchmark for other reports, in the same way that staff's openness to country-specific factors was apparent in the Article IV for Iceland. Nevertheless, we are confused by staff's advice about slowing the rate of fiscal consolidation and raising investment with reference to the perceived effects on the current account surplus when there are no identified policy gaps. As this Chair has said many times before, reducing a current account surplus or deficit should not be a policy goal in and of itself. This is particularly important as the IMF, and policymakers around the world, have a vital role in elevating the public discourse about trade and capital flows. Beyond this, we question whether the promotion of additional investment—while inherently useful advice to boost potential growth—might further increase the current account surplus in the medium term if Danish firms becomes even more competitive.

More generally, staff also acknowledge that the high surplus is largely driven by Danish entities outside of the country and higher returns on overseas' investments. We note, for example, that offshore trading by Danish firms—of goods that might never enter Denmark—are alone responsible for a trade surplus of about 4 percent of GDP. We also appreciate staff's acknowledgement that the EBA models cannot capture these aspects. To reduce the amount of uncertainty in the future, we would appreciate it if staff did more research on how we should measure, interpret and model cross-border flows in the presence of such activities. Could staff provide the Board with an insight into any work that they are planning on undertaking to address these measurement issues?

Mr. Sun and Mr. Fan submitted the following statement:

We thank staff for a set of comprehensive papers and Messrs. Ostros and Gade for the buff statement. Denmark's economic output surpassed its pre-crisis level in 2014, improvement in labor market and wages have boosted private consumption and pushed up inflation. To raise productivity and potential growth, reforms are needed in the labor market, the corporate sector and the household sector, among others. We broadly agree with the thrust of the staff's appraisal and limit our comments to the following for emphasis.

While temporary easing of the fiscal consolidation is appropriate, growth-enhancing reforms are desirable. We welcome the authorities' 2025 plan aimed at reducing both tax and government spendings relative to GDP. The plan is key to ensure the structural fiscal balance by 2025. Fiscal space could be used to increase public investment, but under the current circumstance, revenue mobilization relies on several internal and external factors. We therefore encourage the authorities to closely monitor the development of domestic reforms, external policies and market conditions, and take necessary measures to make the gradual fiscal consolidation successful.

Further policy action is warranted for a healthy development of the housing market, and regional cooperation is central to ensure financial stability. The recent house price increase in large cities is perhaps a result of urbanization, among others. However, high leverage in the housing market could be risky not only to the housing sector but also to the banking system. This calls for close monitoring and policy actions when necessary. It is good to note that the authorities have adopted measures to guide the credit institutions and reformed the property tax to contain house price fluctuation. Other measures that can also be considered include the use of debt-to-income limit, the application of a general cap to all loans, amortization requirements, and raising the down payment requirement.

Given the significance of the Danish financial system in the economy, whose total assets account for 700 percent of GDP, and its highly interconnectedness with its Nordic neighbors, it is essential to have close cooperation and collaboration with other financial regulators to contain cross-border risks. We welcome the MoUs with counterparts in the region and encourage strengthened macroprudential management.

To address the bottleneck for growth, increasing labor supply and productivity are key. Building on the progress of the structural reforms implemented by the government in recent years, Denmark needs to enhance reforms in the labor market and to increase productivity for long-lasting growth. The authorities have introduced comprehensive measures including cap on total amount of benefits, tax cut for low-wage earners, and retirement age extension. The education and pension reforms as outlined in the 2025 plan is crucial to promote labor participation among the young and elderly. Measures for attracting workers from abroad including integrating refugees into the labor market are also important. The negative growth of Danish TFP is another challenge, but raising productivity is a complicated issue and needs to be addressed in many ways. We agree with staff that more knowledge-based and education-based investment and liberalization of the Planning Act are needed, and more public investment, especially on growth-friendly infrastructures should be encouraged in addition to relaxing regulations in the service sector.

Mr. McGrath and Mr. Feerick submitted the following statement:

We thank staff for their reports and Messrs. Ostros and Gade for their useful and timely buff statement. Denmark's economy, public finances and financial sector all appear in reasonably good health. However, there are pockets of vulnerabilities and staff identify a series of reforms which would buttress the progress made to date. We agree with the thrust of staff's assessment and offer the following brief points for emphasis.

The economy continues to grow at a steady, if somewhat muted, pace. The key going forward will be to undertake a suite of structural reforms which can facilitate inclusive and increased potential growth rates. The short-term outlook is relatively favorable, driven by personal consumption and investment. Employment prospects continue to improve and the unemployment rate is now around the estimated NAWRU. This presents a policy challenge to the authorities, as vacancy rates are rising and labor shortages have been identified as an impediment to production. The staff put forward a series of sensible proposals to increase participation rates and to assist in the integration of migrants that are not in the workforce. We also note from the buff statement that the authorities' new 2025 Plan identifies measures aimed to increase participation and productivity. The staff's views on these measures and their efficacy would be appreciated.

Rapid house price growth could pose a risk to economic and financial stability A large correction in house prices could significantly dampen consumption, given high household leverage and the illiquid nature of household assets. While we note from staff, that volatile house prices and high household leverage have not historically had negative effects on financial stability, and that bank capital ratios are strong, ongoing careful monitoring of developments is still warranted. On macroprudential rules, we agree with staff that it may be useful to now consider adjusting the policy levers, such as the introduction of a larger minimum down payment. The recent proposal from the Systemic Risk Council, on individual institution limits on new lending for interest only and/or variable rate loans with a DTI of greater than four in geographically targeted areas, also merits strong consideration.

Mr. Ozaki and Mr. Tsuden submitted the following statement:

We welcome that Denmark's economy is on a steady recovery path supported by a strong private consumption and private investment, against the negative interest rates and ongoing improvements in the value of household assets. However, the challenges remain, including labor capacity constraints, rising house price and heighten external risks. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

It is encouraging that the fiscal consolidation progress has been faster than earlier envisaged. We support the authorities to slow the pace of fiscal consolidation modestly to improve potential growth including facilitating capacity-enhancing reforms. However, given the increasing resistance to reform, we urge authorities to take a vigilant approach to achieve effective reform results.

Structural Policy

We agree with staff that product market reforms and policies to support investments could improve productivity. We welcome that the authorities are conducting several reforms to support investments, including the liberalization of the Planning Act and new utilities strategy. We urge the authorities to boost reforms including introducing incremental ACE, promoting knowledge-related investment tax measures, and relaxing regulations in retail trade and some network sectors.

External Sector

We note the staff's assessment that Denmark's external position is stronger than implied by medium-term fundamentals. We also take note of the authorities' view on the current account large surplus that it was the aggregated result of individual decisions by households and firms in a free market economy.

In this regard, we would appreciate it if staff could elaborate more on the two adjustment factors, including the rationale and whether the same adjustment is applied to the country under same (similar) conditions, from the perspective of evenhandedness application among member countries?

The representative from the European Central Bank submitted the following statement:

We thank staff for their Reports and also Mr. Ostros and Mr. Gade for their buff statement. We associate ourselves with the statement by Mr. Meyer.

Regarding the macroeconomic situation, we broadly share staff's assessment and outlook for continuing and firming, albeit moderate, growth. We expect that inflation will continue to rise steadily over the coming years, as the effect from oil prices dissipates and the output gap closes. Regarding the assessment of risks, we agree with staff that currently downside risks, which stem mostly from external factors (slower-than-expected external growth and geopolitical developments), outweigh the upward ones. The main domestic risks are related to high household indebtedness and the large share of adjustable rate mortgages.

We commend Denmark for complying with the rules of the Stability and Growth Pact (SGP) in recent years and agree with staff that the use of any available fiscal space should aim at measures that raise labor supply and productivity. Given the cyclical position of the Danish economy, fiscal policy does not need to stimulate aggregate demand further. To support potential output, additional fiscal measures could most usefully come in the form of tax reforms, such as the reduction of the labor tax wedge for low income earners and tax incentives for R&D, as well as higher investment spending.

We concur with staff analysis of the financial sector, which remains sound with robust profitability, but share the concerns raised by staff regarding housing market issues. The Danish authorities have made major progress on the implementation of the remaining regulatory elements (e.g. BRRD/MREL, CRR/CRD IV, Solvency II) and it will be important that these are completed as planned. We also agree with staff about the importance for closely monitoring the effectiveness of the implementation of the MOUs with Nordic neighboring countries on systemic bank branches. Housing market-related concerns link primarily to households' indebtedness and sensitivity to interest rate reversals. In this context, recently proposed macroprudential measures (e.g. LTV cap on variable rate loans and interest rate-only loans in the major cities) and the proposed property tax reform are to be welcome. At the same time, and also keeping in mind the ESRB housing market-related warnings from December 2016, we concur with staff that further macroprudential and tax-related measures to mitigate those risks might be considered going forward.

We share the staff view that labor supply policies and structural reform efforts need to focus on addressing labor supply constraints and boosting potential output growth. Increasing labor market bottlenecks are materializing and we therefore welcome the measures already taken, such as incentivizing benefit recipients to (re-) enter the labor market and the tripartite agreement for a better integration of migrants. On potential output, particular focus is warranted on productivity growth which has fallen further since the crisis. We share staff's view that reducing leverage and encouraging knowledge investment could promote investment and raise potential output. We also agree that a greater harmonization of the tax treatment of various types of financing could reduce the debt bias in the tax system and promote equity financing. Regarding product market reforms, we welcome and concur with the staff analysis of potential productivity gains from easing regulation in network and retail sectors, and the government's initiative to liberalize the "Planning Act" for improving competition in the construction and utilities sectors.

Mr. Meyer made the following statement:

The Danish economy seems to be on a balanced growth path and has been nearing its potential. To maintain this course and support medium-term growth, capacity constraints must be lifted, especially in the labor market and by enhancing productivity. Despite continued deleveraging, household indebtedness is still high, and the wealth is mostly held in illiquid assets. Therefore, ensuring the robustness of borrowers and credit institutions, and generally dampening the upward pressure on house prices using macroprudential and tax policy levers are important for financial stability.

On fiscal policy, we commend the authorities for past and future expected compliance with the requirements of the Stability and Growth Pact.

The fiscal stance seems appropriate. Some room could be made for measures to enhance growth potential. Additional fiscal measures, as indicated in the government's 2025 plan, could most usefully come in the form of tax reforms and higher investment spending.

On fiscal policy, most gray statements were in line with the staff appraisal. I was a bit surprised by the key messages, which highlights the recommendation to slow the pace of fiscal consolidation. As I understand it, almost all Directors find the slowing of fiscal consolidation planned by the authorities to be appropriate, especially provided that reforms are taken to raise labor supply, and these are adopted. If the summing up is in that direction, I have no problem. I found it awkward in the key messages.

We share the staff's view that the central bank should focus on maintaining the peg to the euro, which should continue to serve the Danish economy well, and gradually reduce interest rate spreads as conditions allow.

Finally, on the external sector, while the current account surplus started to decline, it remains high. We agree with the staff that policies to increase potential growth, especially higher domestic investment, should further reduce the savings-investment gap. With this, I wish the authorities all the best.

Mr. Just made the following statement:

We thank the staff for an engaging report on Denmark and the answers to technical questions. We associate ourselves with Mr. Meyer's intervention. We will focus our remarks on the staff's external balance assessment (EBA), which we highly appreciated.

In general, we have a feeling that model-based EBA results for small open economies produce a range of results, which give rise to a plethora of interpretations depending on the size of the current account.

A mechanical reporting of these results is not satisfactory and probably also of limited value for the policy discussion. Hence, we welcome when country mission teams dig deeper and try to get a better understanding of the factors that may explain other drivers of current account dynamics that the EBA models do not capture. In this sense, we agree with Mr. Choi and Mr. Stewart that the EBA for Denmark could be a good benchmark for other reports. The analysis is intuitive and transparent. It does not fall into the normative good-and-bad trap of the current accounts discussion. Importantly, it considers country-specific circumstances. This will require a degree of qualitative judgments, but unlike Ms. Pollard and Mr. Sobel, we found the adjustments to the EBA model by the mission team overall reasonable, as we expect the country mission team to have a good understanding of the country it is working on. This is what bilateral surveillance is about. The staff even comes up with policy recommendations on how to address the current account surplus. While this may be sensible in this particular case, we are uncomfortable framing such recommendations in a current account context for countries that do not deliberately influence distorted policies to gain an unfair competitive advantage.

To conclude, echoing Mr. Choi and Mr. Stewart, we would appreciate if the staff did more research on how to better capture such current account drivers such as cross-border flows related to investments, or longer-term saving trends related to demographics in the EBA model to ensure greater consistency. Nevertheless, this should not substitute for a team's qualitative judgments and possible adjustments to the EBA model provided that both are done transparently and reasonably.

Mr. Choi made the following statement:

We thank the staff for the enjoyable and informative reports, which are different from other Article IV papers. I lend my support to Mr. Just's intervention on the external sector assessment. The staff has done a good job in carefully reviewing Denmark's external sector, including consideration of the country's specific factors.

I would add one additional comment and two technical issues. In our gray statement, I highlighted our interest in the Fund doing more work on understanding factors that influence the measurement, interpretation, and modeling of the external sector. Reading through other gray statements, several other chairs would support this. This could help reduce the uncertainty around the external assessment. It would help the EBA team improve its analysis, given the high amount of model uncertainty, and it would provide more information on the relative importance of various factors for our consideration. Hence, we would strongly encourage the Fund to work with the OECD and other bodies on these issues.

Turning to technical issues, I mentioned the measurement issues. This Article IV report highlights the issue of measurement that is done in outside border trading activity, for example, the merchanting and processing. The EBA methodology has no way to capture these outside border activities because there are no variables to capture these activities in the current account norm, so it is natural to reflect this as a country-specific factor.

I also would like to raise the measurement issues on the other front. As I briefly mentioned in our gray statement for the Board Work Program meeting, which will be discussed next Monday, around 87 countries of our membership reported the processing trade size in merchanting. That means even some big countries did not report this merchanting and outsourcing. That means they overestimate or underestimate their current account balance. In this sense, one has to be careful on the measurement of the current account balance. The Strategy, Policy, and Review Department (SPR) and the Research Department (RES) should do most of the research on these issues. This is the point I would like to recommend.

This Article IV report rightly mentioned that the EBA methodology cannot capture outside border trade activities. It was from the Article IV papers.

I have another technical question. This Article IV external sector assessment does not include the reserve adequacy because it is difficult to see the size of reserves, how many months of import cover there are because the balance of payments table did not mention it. I am wondering about that.

The other one is the movement of the real effective exchange rate. In a previous report, the index was 2010 at 100, but this Article IV shows the average index between '95 to 2016. Do we have any idea about why the staff used a different index in calculating the earlier movement?

I would like to ask SPR staff about the criteria for using modifiers such as "strong" vis-à-vis "substantially," "moderately," "broadly" when assessing the external sector. In our Board discussion on Pakistan, there was some discussion about a moderately stronger external sector. I want to know the criteria for these modifiers.

I would like to highlight again that this assessment is quite a good example to understand the country-specific situation.

Mr. Badirou Gafari made the following statement:

I also thank the staff for the interesting and comprehensive analyses, as well as their answers to technical questions. I would also like to associate myself with Mr. Meyer's intervention.

I would like to come back on one point, which is a question of external position analysis. We appreciate the detailed external assessments conducted by the staff. A bit unlike two of our previous Directors, we would see merit in more homogeneity in the external sector assessments. In particular, we believe that the qualitative and judgmental adjustments made in the case of surplus countries are not always convincing, and in the case of Denmark, we are not fully convinced. We would like to see that the specific questions that were raised in the case of Denmark, but also the case of other countries, should be addressed in a more consistent manner with a wide perspective and not on a country-by-country basis. That does not mean that we do not see any scope for judgment. We always have to rely on the staff's judgment, but as much as possible, all these questions that are raised for several countries should be taken into account directly into our methodology.

The discussion shows that the technical briefing that we will have a week before the discussion on the External Sector Report (ESR) will be interesting and helpful for us to better understand the methodology and the possible improvements. It also shows that it is important that the staff continue to fine tune the methodology in order to have continued improvement and to perhaps reduce the discrepancy that can exist.

The representative from the European Department (Mr. Hofman), in response to questions and comments from Executive Directors, made the following statement:[2]

In my remarks, I will comment on two issues that Directors have raised in their gray statement—the differences in view in the assessment of housing risks, and the external balance assessment. I will then return to a few of the remarks that were made in the Board.

Some Directors asked about differences between the authorities' assessment of the housing market and the staff's assessment. Let me clarify that the staff is not concerned about rising house prices per se. We worry about the potential risks that arise from rapidly rising house prices in a specific context of very high household debt, elevated credit growth in some regions, and the widespread presence of variable-rate and interest-only loans. This combination could pose macroeconomic and financial stability risk in the case of shocks to the housing market, for instance, when interest rates rise. The staff recommends containing such risks through a combination of macroprudential, taxation, and housing supply measures.

From our discussions in Copenhagen, it is our impression that the authorities' assessment is not all that different, although admittedly there are differences of degree, including among the authorities themselves, and especially regarding the need for measures.

It basically boils down to this. While the staff, the Danish Central Bank, and the Systemic Risk Council worry more about the economic risks of doing too little, the government places a heavier weight on the political risks of doing too much.

Turning to the external sector, one Director asked what accounted for the persistent saving-investment imbalance. I would like to note that the savings surplus is a relatively recent phenomenon which has mostly emerged

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

since the global financial crisis. Indeed, for a long period during the 1970s and 1980s, Denmark had current account deficits. The current account gradually turned to a small surplus only during the 1990s, including because of pension reforms which helped increase old age savings.

More recently, the gap between saving and investment has widened substantially, and as we detail in the staff report, this appears to be mainly because of increased savings and reduced investment by the corporate sector in the aftermath of the crisis.

Several Directors inquired about the external balance assessment and the treatment of Denmark-specific factors. I will start with the pension system. The staff estimates that the mandatory funded pension system adds 1½ to 2½ percent of GDP to the current account surplus through higher household savings. In the context of our external balance assessment, however, the EBA model captures household overall retirement savings by the country's demographic structure irrespective of the pension system. In the staff's view, this may not be sufficient, but corrections to reflect the contribution of the pension system while keeping the cross-country consistency of the EBA model estimations would be difficult and therefore have not been made. We note, however, that the absence of adjustments for the pension system contributes to the uncertainty surrounding the assessment.

We did make adjustment for two factors, in close collaboration with the EBA team. First, while the EBA provides for a multilateral, consistent, and sophisticated treatment of demographics, it may underestimate the need for life-cycle savings in countries such as Denmark with a current high old-age dependency ratio but relatively high fertility rates. We made a half percent of GDP adjustment to correct for such underestimation.

Second, we made adjustments for specific measurement issues. Part of these emanate from large offshore trading activities or merchanting. Such activities are often associated with measurement issues, including because a share of the companies conducting these trades, though being considered residents of the country, are effectively owned by foreigners. Problems arise in particular when multinationals engage in these activities.

From an empirical point of view, a pioneering study by the Swiss National Bank has estimated that all other things equal, current account balances are about 3 percent of GDP higher in countries with significant merchanting trade abroad. This empirical finding was used as the basis for the adjustment applied by the staff. A modest further adjustment of a half percent was made for measurement issues arising from the offshore activities of Denmark’s large financial sector. It is my understanding that similar adjustments are being made for other countries under similar conditions.

Finally, there was a question about further work planned on these issues. The staff will continue to develop a better understanding of measurement issues surrounding current account balances, including in Denmark, and the upcoming informal Board meeting on the ESR will provide an opportunity to discuss broader work planned in this regard.

I would like to return to two specific points made here at the table. First, on the portrayal of the staff’s advice with respect to fiscal consolidation and the pace of fiscal consolidation in the staff report. The discrepancy here comes from the fact that at the time of the mission and at the time of the drafting of the staff report, there was no specific government plan in this regard. We were waiting for the plan to be released, and that plan was released at the end of last month. We have reported on this in the staff statement. Now slowing the pace of consolidation is the government’s plan; but at the time of writing, this was what we recommended that the government do.

On reserve adequacy, like last year, we have chosen not to do a formal reserve adequacy assessment for Denmark because Denmark has various policy tools to manage the exchange rate; Reserves is one tool, but interest rate policy is another. In recent history, when there have been pressures, these were mostly appreciation pressures, occasionally because of safe haven flows, and having higher reserves and reserve adequacy was not a relevant factor in addressing these episodes.

On the specific technical question on the REER assessment and the basis for that, we will respond bilaterally.

The staff representative from the Strategy, Policy, and Review Department (Mr. Zeidane), in response to questions and comments from Executive Directors, made the following statement:

A few Directors raised the issue of consistency and the adjustment made to the EBA methodologies. I want to reassure Directors that we gave the same scrutiny to Denmark’s external sector assessment that we do for the ESR countries, and we will have the opportunity to discuss the ESR in the coming days. It has been reviewed by SPR and by the EBA team from SPR and RES. This is why, for example, the private pension system has not been incorporated in the adjustment for the external sector this year; and this is why we ended up with, compared to last year, a bottom line assessment of the external sector position that finds that it is stronger than warranted by fundamentals. That is the way we did the assessment for Denmark this year, and in the review work we will look for countries with large imbalances to make sure that the methodology adjustments we make to the current account and the current account norm are consistent with what we do with other countries.

There was also a question from Mr. Choi on whether the two adjustments we made are also made in other countries, and the answer is yes. Broadly, there are two adjustments—one for demographics and the other one for mismeasurement of the current account. In terms of mismeasurement, we did a similar adjustment for Korea, Sweden, and Switzerland. The EBA team will be working on revamping the methodology this fall, and so they will have the opportunity to see whether some of this can be incorporated in the way the methodology works. But they will look to the data issues and how these issues can be solved.

The second adjustment we made was on demographics, and a similar adjustment was also made in the case of Sweden in the ESR. One Director asked more specific questions about why, in his country's case, aging speed was a parameter in the EBA methodology. Directors will see a more detailed explanation, including with the case of Denmark, in the upcoming ESR. We tried to make sure that we treat this adjustment in a consistent way. We will be paying attention to all countries with significant imbalances to make sure that what we do is consistent with what we do in the EBA methodology.

There was a question about the guidance to the staff on the way we do the assessment. The focus is not on the exchange rate, but on the external position. We look to the current account, and we derive from the current account the gap, and if the gap is between -1 to 1, it is broadly in line. If it is between 1 and 2, it is moderately stronger or moderately weaker on the negative side. Between 2 and 4 it is stronger, and above 4, it is significantly stronger. That is the classification we do. We can share with Directors the Guidance Note on that. But the focus is on the external position, and so that is the way we do the bottom line assessment of the external position.

Mr. Choi made the following statement:

I thank the staff for its explanation and its further effort to elaborate on the assessment. I would like to highlight two points. The first one is that there should be consistent, evenhanded treatment of all members; so when the staff takes into consideration the outside border activities, it is not broadly considered throughout all the membership as far as I am concerned. The staff mentioned that the Korea case is just BPM6 and retained earning issues, not these outsourcing/merchanting issues. Later, I want to see whether the staff treated all members equally or not.

The second point is on the measurement issues I raised. If there should be an overestimation, there should also be some underestimation. In the overestimation, the staff tries to account for country-specific factors, which is good. On the other hand, every activity has some residual. Otherwise, there will be huge errors and omissions. I would urge the staff to more thoroughly look into the measurement issues, whether the current account balance is correctly measured or not. The staff highlights that it is a globally consistent approach, but based on wrong measurement, the staff cannot say it is globally consistent, so I strongly urge the staff to look into that issue more closely.

Mr. Sobel made the following statement:

Turning to the EBA discussion, our gray statement speaks for itself. I want to associate myself with Mr. Badirou Gafari's remarks. The United States is a strong supporter of the EBA process. We believe it is valuable as a process, but we have our critiques of the process, and we believe it needs to be better understood and more transparent and probably improved.

I find the EBA country adjustments particularly confusing as a general rule in this institution. Take pension systems, for example. On page 41, the staff states that at present, the EBA current account methodology does not take differences in pension systems into account. This is a question we have raised in Denmark, Malaysia, and the Netherlands. People have to save for retirement, but if they have a social security system, that is a form of savings. If the staff says it is not taking pension systems into account, maybe I do not understand the plain English wording of what the staff is saying, but it sounds like by not taking them into account, the staff is not counting that toward savings. Therefore, the EBA model would indicate that one has to save more; and therefore it sounds like the staff is double counting on the need for savings. I personally believe this institution is biased towards excess saving when it comes to fiscal policy, to external policy advice. It is a huge flaw in the way this institution thinks about the international monetary system and the asymmetric adjustment process. But it sounds like what the staff just said is that it will double count on the need for savings, which leads to excess savings.

The staff stated that it applies the same scrutiny to all countries. In my oral remarks on Thailand, I noted that our office looked at the major surplus countries that this institution has reviewed under the EBA process, and we found what we regarded as a systemic bias. In the large surplus countries, by the time the staff got through explaining its discretionary ad hoc adjustments—why it is that this surplus was different in each case—when one discards all these factors, takes into account all these factors, it is broadly in line with fundamentals or slightly above fundamentals when there are these whopping surpluses. This goes to my excess savings point and whether the staff is far too comfortable with excess savings and too eager to explain away large current account surpluses with sophisticated economic reason. When the staff says that it is consistent and it is all reviewed by SPR and the EBA team, that is good, but that does not comfort me if I am not comfortable with the model and then the discretionary use of adjustments by staff. Consistency is good, but being consistently wrong is not good.

I find merchanting confusing, but maybe I need to get a crash course in balance of payments accounting methodology, so I will do that bilaterally. I was looking at the report while I was sitting here, and there is another point that goes to my view that this institution is far too comfortable with excess saving. I started wondering what is the net public debt in Denmark, and I could not find it in the text, but maybe that is just my deficient reading. But I was looking it up on the internet, and it is very low, so even if gross public debt is around 40 percent, the net debt is around 10 percent, according to what I found on the internet. That suggests that there is plenty of fiscal space in a country like that unless the staff can tell me why net debt is completely irrelevant. I have said this in the case of the Netherlands and many other countries. I have been consistent with the European Department. Tell us what net debt is and why that is irrelevant. This paper from the European Department once again failed to do that.

Mr. Meyer made the following statement:

As this is getting to be more a general policy discussion, I thought I would intervene. This chair had to look at the external assessment, and we came out much closer to Mr. Just and Mr. Choi in looking at this. Let me explain why. The staff did a good job to look at the model and then bring in its judgment to determine that there are no discernable signs of policy distortions. I have been reading the gray statement by the U.S. chair, and I was a bit surprised by what I read because what we do in the EBA assessment is a multilaterally consistent global exercise, and it is impossible to bring in all the country-specific elements into one model that is used for all countries. My

> understanding of the EBA methodology is that we try to bring in the most important elements; but then we cannot change the EBA model to the characteristics of all the member states, and that is why judgment is extremely important, and we believe the staff did a good job in this report.
>
> In general, our plea to the staff is with the increased attention to the external assessment—and the International Monetary and Financial Committee has asked management and the staff to be even more rigorous in that regard—that the staff be transparent and clear about the methodology and about what the model can tell us and what it cannot. For that reason, judgment might be even more important today than in the past when we do external assessments.

Mr. Badirou Gafari noted that the staff had stated that it had done a similar adjustment for several countries, including Sweden and Switzerland. He asked if the staff had made similar adjustments for countries that were in deficit.

The staff representative from the Strategy, Policy, and Review Department (Mr. Zeidane) responded that they did not have data for specific countries and would respond bilaterally.

The staff representative from the European Department (Mr. Hofman), in response to further questions and comments from Executive Directors, made the following additional statement:

> I would like to respond to two points that were made. On the pension systems, I do not believe it is an issue of double counting. The point that we make is that different pension systems, different pension setups, can influence the extent to which populations save adequately for old age and retirement. The demographics variable in the EBA model, even though it is theoretically a sensible approach, does not take those behavioral differences based on different pension systems into account. In Denmark specifically, we do not believe there is excess saving for retirement. In fact, the overall pension system seems balanced and sustainable but does not have a surplus.
>
> On fiscal space, we agree that there is fiscal space, and we say so in the report. When we talk about low net debt—and we have also discussed this in some other countries, particularly in Finland—this is partly a reflection of pension savings on the asset side. But we agree there is fiscal space.

Mr. Gade made the following concluding statement:

On behalf of my Danish authorities, I thank Directors for their statements and constructive input, as well as concerns, which I will convey to my authorities. My authorities broadly concur with the staff's assessment and will carefully consider the staff's recommendations.

I would like to elaborate on some of the issues that were raised in gray statements and also in some statements today. They revolve mainly around alleviating capacity constraints, price developments in the housing market, and also household debt.

On capacity constraints, the Danish economy is experiencing stable though moderate growth, and the economy is getting close to its potential capacity. Alleviating capacity constraints is therefore a top priority for the authorities, and it is one of the main objectives of the government's recent 2025 plan.

The plan aims to increase structural employment further through earlier entrance of young people into the labor market; fewer people on public benefits; better integration of refugees, international recruitment; stronger incentives, including taxation, to stay in the labor force longer; and an increase in the average numbers of worked hours.

Another aim of the plan is to increase the productivity level further, and the government intends to lift public investments in e.g infrastructure and digitization and to ensure a sound framework for corporations to fully utilize new technology and globalization.

In total, the plan aims to increase annual GDP growth from about 1.5 percent to around 2 percent toward 2025. While the plan appears less specific than the former government's plan in November, specifics will be added, and the plan may be a better fit in the current political environment. In spite of the means being less specific, the main objective of alleviating capacity constraint, as well as the overall objective, remains a broadly supported political objective.

On house price developments, the authorities are closely monitoring house price developments having also learned from the house price boom and bust in the recent decade. Increases in house prices are still far from being as rapid as they were in the previous boom period and to a large extent reflect underlying fundamentals. They are also concentrated in urban areas where supply is also rapidly increasing but targeted measures are needed.

As indicated in the Danish central bank's financial stability review, which was issued this week, there is a risk of speed blindness. The recent agreement on the property tax reform was a broad-based political agreement in the right direction of dampening house price fluctuations, and the tax reform will be felt more in areas that have experienced rapid price increases. Macroprudential measures also indirectly have an effect on house price developments, but their primary objective is to ensure the robustness of borrowers and lenders.

That brings me to my third point on household debt. While households are deleveraging, debt remains high in Denmark, but they do have substantial net wealth. Household debt and interest rate sensitivity may be more of an economic stability issue rather than a financial stability issue. Leveraged households should be seen in the context of a longstanding and highly developed mortgage system and also its interlinkages with the pension system and the banking sector.

The system has worked well and has proven resilient even in periods of substantial financial stress like the latest economic and financial crisis. Compared to the previous boom-and-bust period, financial institutions are much better capitalized today. The authorities have taken some macroprudential measures and are currently considering additional measures such as a targeted debt-to-income ratio cap. The staff's many recommendations in this respect are appreciated as valuable input.

It may also be worth pointing out that the financial sector has taken its own initiative to strengthen incentives to move into longer-dated and fixed-rate mortgages while also raising capital levels.

Finally, on the EBA methodology, this is a general issue, and we share many of Directors' concerns that the methodology suffers important shortcomings. Some of them were mentioned today. It does provide a common reference point, but to be a valuable method, it is crucial to retain some flexibility for country teams to apply judgment and relevant corrections where they are needed. We also look forward to the briefing on the methodology in July, and the staff's ongoing work to improve the methodology.

I would like to conclude by sincerely thanking Mr. Hofman and his team for their work on Denmark. This was Mr. Hofman's last mission to Denmark, and during his tenure as mission chief for Denmark, he and his team have always candidly pushed the authorities that little bit further, with highly relevant analysis and recommendations. This is both respected and highly appreciated. My authorities wish Mr. Hofman all the best in his future role in the Fund, but they also look forward to continuing to work with this analytically strong team.

The Acting Chair (Mr. Zhang) noted that Denmark is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the steady momentum in the Danish economy and the strong labor market performance, but noted that growth has remained slow and output is approaching potential. They concurred that policy efforts should focus on alleviating capacity constraints, raising potential growth, and bolstering resilience to shocks.

They agreed it would be appropriate to slow the pace of fiscal consolidation somewhat to facilitate tax cuts, provided that strong new labor market reforms are also implemented to raise labor supply. They recommended shifts in the composition of fiscal outlays towards productive public investment to help raise growth potential. Directors believed that a tighter fiscal stance would be needed if growth turned out substantially stronger than expected. Directors agreed that monetary policy should focus on maintaining the peg, and continue to normalize interest rates as conditions allow.

Against the backdrop of ongoing rapid house price increases in urban areas and high household debt levels, Directors welcomed the recently agreed property tax reform to end the current procyclical valuation freezes. While also welcoming the Systemic Risk Council's debt-to-income limit proposal, they considered that the limit could be broadened to cover all loans, irrespective of their terms, with tighter limits for interest-only loans and variable rate instruments. Directors called for further policy action to contain risks from the housing market, including by introducing amortization requirements; raising the down payment requirement; further reducing mortgage interest deductibility; and easing regulations that constrain housing supply.

Directors commended the authorities for the good progress on upgrading the financial regulatory framework. They welcomed the MOUs with Nordic neighbors on systemic branches, and urged the authorities to implement them and evaluate their effectiveness after one year. Directors underscored the importance of strengthening the independence of the financial supervisor (DFSA), including by lengthening the terms of its board members.

Directors concurred that unlocking labor supply is a key challenge for Denmark. They emphasized the need to follow through on education and pension reforms to promote labor participation among young and relatively older individuals. Directors suggested eliminating unemployment benefits for new graduates to help promote faster job entry, while enhancing the integration of migrants would also help increase labor supply.

Directors called for further reforms to liberalize product markets and raise investment. They recommended the authorities introduce an incremental Allowance for Corporate Equity (ACE) to reduce the debt bias in the tax system, and to promote knowledge-related investment through direct funding or tax credits. Directors welcomed the liberalization of the Planning Act and the new utilities strategy. They suggested further relaxing strict regulations in retail trade and some network sectors to further boost competition and productivity growth.

Directors broadly agreed that the external position is stronger than implied by fundamentals, while recognizing that this assessment is subject to important uncertainties. They noted that recommended policies to slow fiscal consolidation and raise private and public investment would help reduce the current account surplus.

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

APPROVAL: February 6, 2018

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Growth, Outlook, and Risks

1. ***The staff projects that investment will rebound as a result of rising construction activity and improved balance-sheet (paragraph 9). Can staff clarify its investment projection is consistent with the analysis in paragraphs 34–35 and also with the trend for investment in Table 1, which shows a decline over the medium-term in gross fixed investment and a rather small improvement in gross domestic investment which may be due to the revision of the data series compared to the last year's Article IV consultation? Could staff elaborate on the reasons behind the doubling to 5.2 percent of GDP of gross fixed investment in 2016 (Table 1)?***

- The average annual growth in investment over 2017–22 is projected at 3.1 percent, which is substantially higher than the -0.4 percent average growth recorded over 2008–16. Accordingly, over the projection horizon, the share of investment in GDP gradually rises to above 21 percent, up from around 18 percent after the crisis. Investment growth in 2016 was high, at 5.2 percent, mostly because of exceptionally strong residential investment growth of 11 percent, related to rising demand for housing in urban areas.

2. ***That said, in last year's Risk Assessment Matrix, staff rated the impact of "Brexit" on trade and financial flows in Denmark as high. We would appreciate staff's update on the current situation.***

- Risks from the negotiation of post-Brexit arrangements remain significant and are included in the RAM as part of a broader risk spectrum of "policy uncertainty and divergence," in line with the Fund's current Global Risk Assessment Matrix.

Fiscal Policy

3. ***We note that a recent revision of national accounts data considerably reduced the 2015 fiscal deficit and lifted GDP. Can staff explain the causes behind this revision and how other indicators are affected?***

- On November 15, 2016, Statistics Denmark published a revision to the annual national accounts for the period 1966–2015. The revision incorporates new sources and methodologies regarding foreign trade, public consumption, employment, and hours worked. The revisions resulted in both a higher level of GDP as well as higher

GDP growth, especially for the most recent years. The GDP revision also impacted the 2015 fiscal balance (including because of the larger denominator), but subsequent revisions to the fiscal accounts—mostly related to volatile pension yield tax receipts—account for the larger share of the downward revision of the 2015 fiscal balance since last year.

4. ***Can staff provide further clarity on the productive public investment, which can substantially boost the economic potential in Denmark? Although we agree with staff that the country can spend more on infrastructure to reduce capacity constraints, we would like additional information on the relatively lower "quality of specific components of public infrastructure" that leave room for improvement mentioned in paragraph 15. The staff's comments are welcome.***

- With greater demand for housing in the urban areas (where the employment opportunities are), productive investment could in particular include the development of land and housing in these areas. Relatedly, there will also be a need for associated infrastructure (e.g., schools, hospitals, etc.). Meanwhile, indicators by the World Economic Forum on the quality of public infrastructure suggest room for some upgrading the infrastructure relative to other countries, notably for rail transport systems and ports. All such public investments would help facilitate labor mobility and trade activity, thereby helping boost Denmark's economic potential.

Monetary and Exchange Rate Policies

5. ***Could staff recommend an optimal course of monetary policy setting should inflation rise rapidly?***

- Monetary policy in Denmark is exclusively aimed at preserving the exchange rate peg, which functions as the monetary anchor. In this setup, inflation in Denmark would be expected to converge over time with inflation in the euro area, though short-term deviations will occur depending on country specific circumstances. To prevent over-heating in situations where demand exceeds the productive capacity of the economy, fiscal policy is the main macroeconomic policy lever available to the authorities. Therefore, staff recommends that the authorities tighten fiscal policy faster if growth were to be substantially stronger than currently envisaged and capacity constraints intensify.

6. ***Should cyclical divergence increase, tensions between fiscal and monetary policies could arise, and we wonder whether fiscal policy has the necessary agility to respond promptly to this development. The staff's comments would be appreciated.***

- A tightening of fiscal policy could be effected by reducing public consumption, delaying tax cuts, postponing public investment projects, or by implementing faster, or deeper, reforms to transfers (such as those related to the education system).

Housing Policies

7. ***This notwithstanding, the increase in LTV-ceiling for vacation homes could potentially undermine ongoing efforts to reduce housing risks. The staff's comments on the cause of this change as well as on the authorities' appreciation of this development will be appreciated.***

- The increase in the LTV ceiling has been presented by the authorities as a way to support the ongoing recovery in the market for vacation homes. The authorities also consider that household debt associated with vacation homes is currently relatively small, so that the risks of the regulatory loosening would be contained. The staff agrees that vacation home debt is only a small part of total household debt, but considers the change a step in the wrong direction given the broader issues surrounding the housing market. The staff recommends a consistent policy to contain housing risks.

8. ***We urge the authorities to introduce new policies including relaxing the rental market regulations to ease constraints to supply. Could staff comment on measures being considered to increase the supply of housing?***

- The authorities have taken some action in recent years with respect to rental market regulation such as changes to the refurbishment regulations and reduction of contract termination requirements. Furthermore, in Copenhagen there have been some new commercial and residential developments in recent years. However, in staff's view more can be done to further ease rental regulation (e.g., rules on social housing often allow tenancies to be passed down to children of original tenants), relax strict zoning regulations, and re-evaluate procedures for land development.

9. ***The staff argues that cross-country comparisons of household savings rates are not straightforward, and that the actual household savings rate could be as much as eight percentage points higher when adjustments are made for Denmark-specific effects related to pension contributions, taxes, and imputed rents in the calculation of household consumption. Could staff elaborate on whether such adjustments would be consistent with international guidelines (SNA 2008, ESA 2010), and what is the usual practice in peer countries?***

- The cited estimates of the impact of Denmark-specific adjustments to the savings rate are from a recent working paper by Statistics Denmark staff. Their adjustments were done on national-level data, but using additional information on household consumption and income, sourced from the macroeconomic model of Statistics Denmark. If similar adjustments were made for other countries, their savings rates may also change but we are not aware of similar exercises for other countries that do this.

10. ***What makes Denmark an outlier is the very low ratio of households' disposable income to GDP, at slightly below 50 percent, compared to 65 percent on average in the European Union. Could staff elaborate on the reasons of this large discrepancy with the rest of the EU?***

- The large share of household current taxes in Denmark (27 percent of GDP in 2016) makes it an outlier for its disposable income relative to other major economies (the share is 16 percent of GDP in Sweden for instance), and relative to the average for the European Union (10 percent of GDP).

11. ***Taking Ireland, Spain and the United Kingdom as examples for having already implemented this reform, can staff elaborate on what are the real effects of phasing out mortgage deductibility on the mortgage markets?***

- Evaluating the effect of the phase out of the mortgage interest deductibility is not straightforward for Ireland and Spain, because the policy change occurred during the crisis. Many factors contributed to the lower demand for house purchases, and mortgage borrowing, in these countries. In the United Kingdom the deductibility was removed almost two decades ago (2000), in a very gradual fashion, with the deductibility rate effectively at zero long before it was phased out altogether. More generally, empirical work suggests that mortgage interest deductibility has a limited effect on dampening price volatility in the housing market (Blöchliger et al. (2015), "The Stabilization Properties of Immovable Property Taxation: Evidence from OECD countries," OECD Working Papers, No. 1237).

Financial Sector Policies

12. ***We would appreciate staff's comments regarding the impact the large portfolio of deferred amortization loans with the interest only period expiring in 2019-2020 could have on debt repayments, especially if combined with interest rate hikes.***

- Household credit has historically not presented major direct risks to banks in Denmark, and recent stress tests by the authorities continue to support that. More important are the macroeconomic risks associated with household indebtedness—in particular, risks to consumption. The staff explores this channel in the Selected Issues chapter and estimates that while a 100 bps rate increase in lending rates would have a modest effect on consumption overall (0.7 percent decrease), certain groups at risk—such as highly-levered households or households with adjustable rate and interest-only mortgages—would be faced with substantially stronger cuts in consumption. The expiration of interest-only periods in future years presents similar risks, but staff did not make estimates of these owing to data constraints.

13. ***We would welcome staff's analysis on the transmission channel of risks in the region.***

- The Nordic economies have large banking systems in aggregate and they are closely interconnected with a handful of large systemic banking groups being active across the region. While Nordic banks are well-capitalized generally, their size relative to the Nordic economies, reliance on wholesale funding, and common vulnerabilities relating to high household debt and rising house prices mean that the close financial integration of banking systems can propagate shocks throughout the region quickly. The MOUs are a welcome addition to the supervisory toolbox of regional regulators.

14. ***Could staff elaborate on the conclusion in paragraph 25 that "all systemic banks have capital buffers in excess of regulatory minima" and if such conclusion remains consistent with the recent indication by the central bank that the systemically important financial institutions (SIFIs) have a capital shortfall of kr. 2.9 bn at the end of 2019 in order to meet all the SIFI capital buffer requirements and a few non-SIFIs fell short of minimum capital requirements under its adverse stress test scenario?***

- The staff's assessment is based on the reported actual capital positions of the banking system in 2016, which are well-above regulatory minima (20.7 percent of risk-weighted assets in Tier 1 capital, and 23.2 percent of risk-weighted assets in regulatory capital; compared to an average 14 percent of all-in minimum capital for SIFIs in 2017, and around 16 percent full-loaded minimum capital for SIFIs in 2019). The central bank's assessment, in contrast, reflects the results of stress tests, and refers to the (in the event rather small) capital shortfall under a severe recession scenario. The starting point for the capital position considered in the stress test is around the same level as the reported level in the staff report.

15. ***While we concur with staff recommendation for normalization of interest rates as allowed by market conditions and exchange rate pressure, we invite staff to comment on likely adverse effects of prolonged negative interest rates, especially given the high retirement savings in Denmark.***

- Banks have generally been able to adjust to the low interest rate environment by raising administrative margin fees, cost-cutting, and achieving operational efficiencies—and Danish banks remain very profitable.

- Negative interest rates have challenged pension funds and insurance firms, but they also have partly adjusted by shifting away from guaranteed-return to more market-based products. Stress tests conducted by EIOPA also concluded that insurance firms would be less affected in stress scenarios than their international peers, partly as their interest-rate sensitivity is hedged with derivatives.

16. ***Could staff elaborate on the sources of increased fee income that have boosted profitability? Do they entail any potential new risks for Danish banks?***

- Mortgage-credit institutions have been able to generate higher fee income by increasing their mortgage administration margins by 50 to 75 bps. Other banks have been able to rely on greater asset management and investment bank activities, which have also increased fee generation. Some of these fee increases (particularly the mortgage administration margins) generated calls from the public for greater regulation, which has prompted new legislation to improve communication of margin changes. The challenge of low rates is not unique to Denmark, but Danish banks have been able to adjust quicker than banks in other European countries. Nevertheless, maintaining profitability in an environment of low rates and low growth remains an ongoing challenge for Danish banks, and could lead to increased risk taking.

17. ***Does staff have any information about the share of domestic and foreign profit in the banking sector?***

- Most Danish banks, in particular the mortgage banks, are domestically-focused and derive most of their revenue in the country. The main exception is Danske Bank, which in 2016 held about half of its assets overseas. Danske Bank also generated almost half of its 2016 net income outside of Denmark (DKK 9.5 billion, or about 0.5 percent of GDP).

Productivity and Structural Reforms

18. ***Could staff comment on where Denmark's labor force participation rates currently stand vis-à-vis peer countries?***

- Denmark's labor market participation rate, at around 79 percent, is high from an international perspective and compares to an average of 73 percent for the EU28. Participation rates for the elderly similarly exceed European averages, but participation rates for the young are closer to those of peers.

19. ***Could staff also elaborate on the estimated boost to labor supply and growth that could result from improved migrant integration and the implementation of the education and pension reforms? Could staff comment on the likely impact of the provisions of the new 2025 plan on labor employment going forward? We also note from the buff statement that the authorities' new 2025 Plan identifies measures aimed to increase participation and productivity. The staff's views on these measures and their efficacy would be appreciated.***

- In the new 2025 plan, the government has set a goal of increasing employment by 60,000 people by 2025. No detailed proposals are provided, however, as specific measures remain to be negotiated, starting with the 2018 budget discussions in the autumn. The broad policy objectives to cut income taxes and reform education grants should—depending on the eventually agreed modalities—help toward achieving the employment objectives. The new government plan does not include further reforms of pensions, which would have also expanded labor supply. Regarding the new initiatives on productivity, notably in the area of digitalization, these plans were not yet available during the mission and continue to need further elaboration by the authorities. The staff will seek to further discuss these initiatives as soon as more concrete proposals are ready.

20. ***Can staff briefly discuss how much of the labor shortages are due to skills mismatch?***

- The staff does not have precise quantitative estimates of skills mismatches. However, during the team's discussions with the authorities and social partners, skills mismatches were flagged as a growing concern, most notably in the construction sector where skilled labor needs to be attracted from abroad.

21. ***The Allowance for Corporate Equity (ACE) … raises the question of international cooperation and potential tax optimization in case of asymmetric implementation. The staff's comments are welcome.***

- One possible concern with ACE is that it may create (international) tax planning opportunities—however these largely resemble existing tax avoidance schemes. In general, negative spillovers can be contained and mitigated by counter measures and there should be limited need for international coordination. For a more elaborate discussion, see e.g., International Monetary Fund, 2016. Taxation, leverage, and Macroeconomic Stability, Policy Paper.[3]

[3] https://www.imf.org/external/np/pp/eng/2016/100716.pdf

22. ***On a different point, we would also like to know if staff identified major blocking points regarding product market reforms enhancing competition (notably for store establishment).***

- The revisions to the Planning Act include, among other things, relaxing store-size and location restrictions. These do not extent to hypermarkets, however, which are seen as a potential threat to commercial activity in the inner cities. Further liberalizing store size rules could unlock additional efficiencies and help raise productivity. Beyond the retail sector, staff continues to recommend closing the product market regulation gap between Denmark and the European frontier in some network sectors such as passenger rail and postal services, which could also strengthen competition and significantly increase productivity.

External Sector

23. ***Could staff explain how the interest and exchange rates interact with the twin surpluses?***

- The negative interest rate may have positively contributed to the CA surplus, in particular as it reduces the return on foreign holdings of Danish assets (such as government bonds), which, other things equal, strengthens the income account. The real effective exchange rate is an essential part of the current account adjustment process. Under a fixed exchange rate regime, as in Denmark, adjustment happens through changes in domestic prices and wages. These domestic prices are determined by market forces in Denmark and the long history with the peg has demonstrated that, in the longer run, domestic prices are flexible enough to facilitate required adjustment.

24. ***The Financial Account is composed of Direct Investment, Portfolio Investment, Financial Derivatives, and Other Investment, which constitute the bulk of the Financial Account. Could staff clarify what account "Other Investment" comes under?***

- In Denmark, "other investment" mainly reflects cross-border flows related to operations of the banks, such as foreign loans and deposits. These flows are relatively large, owing to Denmark's large financial sector with substantial oversea activities, in particular by one large bank.

25. ***The staff notes that for tax reasons, owners of firms often opt to retain the firms' profits as retained earnings, rather than distribute them as dividends; what is staff's assessment of the impact of these tax incentives on the current account, and***

on the opportunity to revisit tax incentives to address Denmark's persistent current account surplus?

- The staff considers that such tax incentives—which are not unique to Denmark—primarily affect the distribution of savings between the household and nonfinancial corporate sectors. It is less evident that these tax incentives also impact the overall level of savings, and thus the current account.

26. ***We would welcome staff's elaborations on possible policy options to reduce the current account gap from the saving side, for instance through a reduction in the tax advantages for occupational plans.***

- The staff projects the savings rate to gradually decline over the medium term, as continued moderate growth and a strong labor market would help boost household income and consumption. Product market reforms such as further deregulation in retail trade may also raise consumption. The staff do not see a clear need for reducing pension savings, as there is no strong evidence to suggest that retirement savings are higher than needed. It is also worth noting that, while, as in many other countries, there are tax advantages related to pension savings, pension contributions under the occupational plans are mandatory, and, at least at the individual household level, do not directly depend on such advantages.

- Note: Other questions regarding the external balance assessment and the differences between the authorities and staff in their assessments of housing risks will be addressed during the meeting.