

## INTERNATIONAL MONETARY FUND

### Denmark—2004 Article IV Consultation Concluding Statement of the Mission

Copenhagen, March 30, 2004

1. Denmark has experienced a slowdown in economic activity beginning in 2001, but economic fundamentals remain sound. Mirroring trends in Europe and abroad, growth in Denmark over the past three years has been below potential, and the economy contracted over the second and third quarters of 2003. However, the size of the slowdown, both in terms of activity and unemployment, was contained by the low-interest rate environment and the automatic fiscal stabilizers that helped to support household income and demand. With a healthy underlying fiscal position, the working of automatic stabilizers did not threaten medium-term fiscal targets. Furthermore, Denmark continues to enjoy high labor force participation rates and low unemployment. Inflation is well under control, and the external current account remains in surplus.
2. The mission expects that growth will pick up in 2004 to a rate of just under 2 percent (taking account of the recent fiscal measures), but there are downside risks. Private consumption spending should lead the recovery, as tax cuts increase disposable income, and there should also be positive wealth effects from improving equity markets and still-strong housing prices. The rebound in consumption in the fourth quarter of last year was a positive sign. However, a delay in the turnaround of unemployment could dampen consumer confidence. In addition, the near-term prospects for growth in Europe may worsen, especially if the euro appreciates further, and this could affect external demand for Danish exports and the upturn in consumer and business confidence.
3. With the uncertain timing and strength of the recovery, the package of measures introduced by the Government on March 16 provides a helpful impetus for growth. The package brings forward reductions in personal income taxes that had been planned for 2005-07, increasing households' disposable income, and improving incentives to work. The suspension of special pension contributions in 2004 and 2005 will also augment disposable income at least temporarily, and it increases the tax base. The package should have only a limited impact on fiscal balances this year - with the surplus expected to stay unchanged from last year at around 1¼ percent of GDP- and it is consistent with medium-term fiscal objectives as well. In all, the mission considers that the package is likely to provide an impetus to growth of perhaps 0.2 percent of GDP, depending on how much of the disposable income consumers decide to spend.
4. At the same time, Denmark has been well-served by focusing on medium-term fiscal targets, and relying on large automatic stabilizers to support demand during downturns. Discretionary counter-cyclical policy should be kept as an exceptional response to avoid

creating an expectation of fine tuning and short-term fixes that could weaken the effectiveness of the medium-term fiscal framework.

5. Denmark has already made considerable progress in preparing for the fiscal pressures from aging, and the medium-term fiscal framework provides an important anchor for policy. The targets are set with the objective of maintaining the Danish welfare system as the population ages, while finding space to reduce the overall tax burden. Plans for the medium term concentrate appropriately on containing growth in public consumption expenditure and increasing employment.

6. The targets for growth in government consumption should help to contain the relative size of government, freeing productive resources for private sector use. Preliminary results from 2003 suggest that the tax freeze and spending targets are having a disciplining effect. Pressures for more spending will continue to be high, however, particularly in health care. If slippages occur, the authorities may want to consider further enhancements to the mechanisms for local government spending discipline, including by extending the legally binding rule for tax-freeze compliance to the municipal level. Basing medium-term spending policy on explicit nominal expenditure targets could also be considered. That could instill more discipline and be more transparent and monitorable than a target defined in real terms. Finally, consideration should be given to introducing user fees to better align the demand for scarce public resources with need. Revenues from user fees could also provide additional room for cuts in distortionary taxes.

7. With a labor force participation rate that is already high by international standards, achieving the targeted increase in Denmark's employment will require strong efforts. Recent initiatives are steps in the right direction, and the government is aware that additional measures will be needed. Further efforts that directly affect the incentives to work will have the greatest impact. Additional reductions in labor income taxation are desirable, and un-freezing the ceiling on property valuation for tax purposes would provide space for such reductions.

8. Measures to increase employment among specific groups with lower employment rates should also be considered. Early retirement schemes have substantially reduced labor force participation among those 60 and over, and creative solutions to further improve incentives to continue to work among this age group are needed. Steps to speed students' progress through the education system would also contribute, as would making education and activation programs more responsive to labor market needs. Moreover, continuing efforts to better integrate immigrants into the active labor force are needed.

9. The mission welcomes the establishment of the Welfare Commission with a mandate to analyze and stimulate the public debate on the options for maintaining the protections of Denmark's welfare system, while at the same time ensuring both fiscal sustainability and intergenerational equity. Regarding the Structural Commission, the mission agrees that increasing the size of local governments and a redistribution of responsibilities has the

potential for more effective provisioning of public services and economies of scale. Careful planning and a phased transition will help to limit adjustment costs.

10. Denmark's economic growth rate over the medium term will depend not only on increasing labor supply, as above, but also on continued improvements in the competitiveness of product markets. Denmark has made progress in strengthening competition laws and liberalizing markets over the last few years, including in the energy sector. However, further enhancements in competition will be needed, particularly as the momentum for product and labor market reform picks up in neighboring countries. Among others, there are likely to be gains from reform in the construction, transportation, retail and wholesale sectors.

11. Denmark's external competitiveness has been adequate to generate a continuing current account surplus. However, wages in Denmark have risen more rapidly than in partner countries over the last several years, and the euro has appreciated. In this respect, the recent decline in Denmark's export trade share during the latter half of 2003 bears watching. Labor cost pressures, if unchecked, could slow the recovery in employment and put a brake on medium-term growth. It is therefore important that there be appropriate moderation in upcoming local wage negotiations. The central framework agreement for annual growth in labor costs of 3-3½ percent over the next three years is a positive development.

12. Denmark's exchange rate system, under which the krone is kept stable against the euro, provides a valuable anchor for expectations and discipline on economic policies. Variation around the central parity has been minimal, and interest rates follow those in the euro area with only a small, stable spread, attesting to the strength of the system.

13. The financial system in Denmark has weathered the slowdown well, and is in good position to support an upturn in activity. While housing prices continue on an upward trend, the increase has been less than in some other countries and prices do not seem out of line with fundamentals. The increasing use of adjustable rate and deferred amortization mortgages seems to have contributed a small amount to the increase in prices. The mission expects that they will also add to the sensitivity of the economy to changes in short term interest rates.

14. The mission takes note of Denmark's leadership in development assistance and encourages the continuation of this policy in the future. Although aid as a share of gross national income has fallen slightly in recent years, the mission welcomes the policy of maintaining development assistance at a level representing at least 0.7 percent of gross national income—still among the highest of any country.