DENMARK – CONCLUDING STATEMENT OF THE 2012 ARTICLE IV MISSION
NOVEMBER 5, 2012

THE CENTRAL SCENARIO AND RISKS

1. **Despite a faltering recovery, growth is expected to resume in the second half to keep 2012 growth very slightly positive and gain momentum in 2013.** Output has fallen in three of the most recent four quarters with weak domestic demand, GDP remains well below pre-crisis levels, and headline inflation has remained at less than 3 percent. Export growth has been down, reflecting in large part the slowdown in European trade partners. Nevertheless, signs of revival in industrial production and other indicators in the third quarter suggest a turnaround.

2. **Fiscal policy has been supportive in the downturn and the recovery.** The authorities have allowed the large automatic stabilizers to operate fully and supplemented them by discretionary fiscal policy actions as the recovery began to falter in late 2011.

3. **The very tight exchange rate peg remains the objective of monetary policy.** Monetary policy has faced a significant challenge in implementing the peg with inflows seeking a financial safe haven in Denmark. Interest rate reductions by Danmarks Nationalbank culminating in July in a negative interest rate on marginal bank reserves at the central bank has had the desired effect of discouraging inflows and reducing the pressure on Danmarks Nationalbank to purchase foreign exchange reserves.

4. **Risks are substantial and clearly tilted to the downside.** Further slowdown or renewed recession in major trade partners, especially in the euro area, could weigh heavily on Danish exports. Renewed financial turmoil could reignite concerns about counterparty risk and raise funding costs for banks reliant on wholesale funding. Indicators are mixed as to whether the house price bubble that has been deflating since 2007 has bottomed out, but a further decline in housing prices could put pressure on banks and households and depress still-weak private consumption. There are broader vulnerabilities in the financial sector as well: bank profits remain low, and a number of small- and medium-sized banks continue to make losses. Capital buffers have been improved, but NPLs are high relative to Northern European peer countries, and loan impairment charges continue to weigh on bank earnings.

5. **Nevertheless, Denmark is well-positioned to address its macroeconomic policy challenges.** The current account surplus is about 6 percent of GDP; gross public debt is under 50 percent of GDP and partially offset by a substantial government deposit at Danmarks Nationalbank, and its triple-A credit rating supports market access on favorable terms.

POLICY PRIORITIES

Fiscal Policy

6. **Medium-term consolidation is appropriate, but the authorities should stand ready to take additional action to support the economy and consider a less rapid adjustment if growth falls significantly below current projections.** There is a risk that the consolidation could undercut the still weak economy, particularly if it is compounded by a repeat of underspending by sub-national governments or slower-than expected implementation of investment projects. As in the past, automatic stabilizers should be allowed to operate fully. Should additional fiscal support for the economy be needed, tax measures should be considered, in particular those that further reduce the tax wedge on labor income or increase incentives for work. On the other hand, further tax preferences for housing would be less desirable given the existing tax preferences for housing already in place. Further acceleration of public investment seems less promising given that public investment projects are slow to implement and the pool of good candidates for investment has been depleted by the earlier stimulus. However, the authorities should at a minimum be prepared to take actions within the space under current EU limits if conditions dictate.

7. **The authorities' medium- and long-term fiscal plans set out a prudent and strong fiscal path through 2020.** However, the projections would benefit from additional sensitivity analysis that could take into account a divergence between growth in real wages, spending, and productivity. In particular, the assumption of an above-trend productivity growth rate might be revisited or contingency measures considered in the event that the assumed increase in productivity growth does not materialize in the 2012-2020 period. The mission understands the authorities' view that specific measures to be implemented beyond 2020 would best be developed in subsequent plans; however, more sensitivity analysis in the government's very long-term scenarios could better inform those future decisions.

Monetary and exchange rate policy

8. **The longstanding and tight peg to the euro has served Denmark well in anchoring inflation and minimizing exchange rate volatility vis-à-vis major trade partners**. Recent safe-haven inflows have complicated the management of monetary policy in support of the exchange rate. The authorities' interest rate reductions, including the move to a negative policy rate, have been successful thus far in containing these inflows and reducing the pressure to accumulate reserves. However, the impact of negative rates on bank profitability and lending should be kept under review, particularly if the rate is set at a still lower level.

Financial Sector Policy

9. **Progress has been made in strengthening the banking sector and reducing banks' dependency on state guarantees.** Three-year loans to banks are helping to replace expiring state guarantees, prudential regulations have been strengthened through the "supervisory diamond" indicators, and the activation of the new resolution procedures applying haircuts to senior bank debt has reduced the perception of an implicit government guarantee on banks. However, stress in the system (e.g., as reflected in CDS spreads and ratings) has increased over the past year, in part reflecting European developments, and this requires a continued robust policy response.

10. **The plan to improve the institutional framework through the creation of an interagency committee charged with making recommendations on macroprudential policy is welcome.** The planned Systemic Risk Council and the entities responsible for implementing its recommendations (e.g., the economic ministries and the Financial Supervisory Authority) should have clear roles and responsibilities, consistent with their institutional mandates, and information-sharing and coordination arrangements.

11. **The creation of an interagency committee to develop prudential arrangements for systemically-important financial institutions (SIFIs) is a positive step.** This could keep Denmark at the forefront of bank resolution regimes in the EU. The potential inclusion of a bail-in framework would be appropriate, but reducing the risk posed by large institution will take time, and the pace of implementation of higher capital requirements will need to take into account the possible contractionary impact of deleveraging.

12. **Banks should continue to build robust capital and liquidity buffers.** The flexibility embedded in EU regulations should be used to design strong macroprudential and microprudential policies, treating Basel III and the CRD IV regulations as floors. Banks have made progress in shoring up regulatory capital ratios, but they should continue to retain earnings, raise new equity, and improve capital ratios through an orderly deleveraging. Large banks might also be required to report capital and risk-weighted assets on the Basel III definitions in addition to the current regulatory definitions to demonstrate their ability to meet more stringent future requirements.

13. **Crisis management and prevention could be further strengthened.** The strengthening of ex ante deposit insurance has been an important step, but risk-based deposit insurance premia could further encourage sound risk management and discourage risky behavior. Also, interest-only mortgage loans might be limited and the decoupling of taxes from real-estate values might be re-examined as both appear to have contributed to excessive volatility in housing markets.

14. **Denmark's openness to the creation of a banking union in Europe is welcome.** By enhancing stability, a well-functioning euro area banking union would generate positive spillovers to other EU members, and especially to Denmark with its tight financial links with the euro area and peg to the euro. A well-functioning banking union would also enhance the functioning of the EU single market for financial services benefiting the Danish banking system over the medium term, including through improved coordination of supervision. However, the mission team recognizes the authorities' legitimate concerns about having material representation on supervisory issues, on which steps are being considered to strengthen the governance of the EBA and enhance the voice of those that opt in within the ECB. The mission also recognizes the authorities' views that a resolution mechanism and deposit insurance are critical for a well-functioning banking union. Pending a clear road map and timetable on these matters, the team urges the authorities to continue supporting the process of developing the banking union.

Productivity and Competitiveness

15. **The mission is encouraged by the authorities' actions to address the challenges of improving competitiveness and productivity growth.** In the private sector, Denmark's overall business environment is judged to be among the very best in the world in international rankings. Further, the package of competition reforms announced on October 26 addresses many of the known impediments to competition in specific sectors (e.g., construction and pharmacies). In the public sector, several reforms in recent years to reduce the tax wedge on labor income have increased incentives for work and human capital accumulation. Also, the new system of sanctions for overspending by sub-national governments has contained unplanned expansion of government spending thus far, and this should help to limit crowding out of the private sector. The work of Statistics Denmark on efficiency of public spending may provide the basis for further reforms in specific areas of the sector, and the report of the Productivity Commission expected late next year could set out a roadmap for productivity-enhancing reforms to improve unit labor costs and competitiveness more generally.

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16. The mission team is grateful for the warm welcome extended by everyone we have met during our mission and the excellent cooperation and open and stimulating discussion.