Denmark—2010 Article IV Consultation, Concluding Statement of the Mission

November 1, 2010

Denmark is recovering from a deep recession. A strong and swift policy response to the global financial crisis softened its impact on the Danish economy and stabilized the banking system. The focus of fiscal policy now needs to shift to returning to a trajectory that ensures sustainability, but without putting the recovery at risk. A credible and multi-year consolidation strategy, along the lines envisaged by the government but with more emphasis on spending control, should eliminate the government deficit over the medium term. As immediate concerns about banking sector stability have lapsed, now is the time to further strengthen the sector's resilience to future shocks. Denmark's labor market model performed well during the crisis, but further reforms are needed to maintain labor supply and to boost labor productivity, including through more domestic competition.

Outlook: a steadying economy supported by a strong policy response to the crisis

1. **A modest recovery is taking hold following a deep and long recession**. After contracting by about 7 percent from the second quarter of 2008, output began to rise in the second half of 2009. The recovery in the global economy and normalization of financial markets boosted exports and confidence. This, together with fiscal stimulus and easing monetary conditions, supported output and halted a rapid rise in unemployment from low pre-crisis levels. Looking ahead, real GDP is projected to grow at about 2½ percent this year and 2 percent in 2011.

2. **The authorities' swift policy actions prevented an even deeper recession and stabilized the banking system.** Domestic demand was buttressed by large automatic stabilizers, discretionary fiscal easing of almost 4 percentage points of GDP, and major interest rate cuts in line with reductions in the ECB policy rate. Extended active labor market policies helped contain employment losses, while relatively generous unemployment benefits lessened the social impact. The banking system was fortified by a wide range of measures, including a blanket government guarantee for depositors and creditors; liquidity support; capital injections; and a temporary bank resolution scheme.

3. **However, these policies have weakened the fiscal position, moving it away from the planned pre-crisis path.** The general government balance swung from a surplus of 3.4 percent of GDP in 2008 to a deficit of 2.7 percent of GDP in 2009. The deficit is projected to further widen in 2010, to around 5 percent of GDP. Excluding cyclical and temporary components, the balance is projected to deteriorate from a surplus of around 2 percent of GDP in 2008 to a deficit of some 2 percent of GDP in 2010—about 3 percentage points of GDP worse than targeted under the medium-term fiscal strategy updated just before the crisis. Even with a return by 2015 to the pre-crisis targets for the budget balance, gross

general government debt as a share of GDP will still be some 30 percentages points higher that year than envisaged before the crisis. Accordingly, the planned pre-funding of ageing-related spending pressures will only partially materialize.

4. **Interest rates remain unusually low, and the expected tightening in monetary conditions raises vulnerabilities.** Danish interest rates will most likely increase in tandem with ECB rate hikes, negatively affecting housing and other asset prices. Highly leveraged balance sheets and variable interest rate loans leave corporates and households vulnerable to higher interest rates, with possible knock on effects to banks and the real economy.

The policy agenda: fiscal policies and structural reforms to spur growth

5. **Putting growth on a steady and sustainable path while reducing vulnerabilities will be the main challenge.** To achieve this objective, bringing fiscal policy gradually back to the pre-crisis long-term consolidation trajectory will be imperative. A credible fiscal adjustment is also essential for maintaining credibility of the exchange rate peg, which is serving Denmark well. Continued efforts to bolster financial sector stability are also essential. Resources freed through reining in public consumption growth, together with steps to boost overall efficiency, productivity, and labor supply should spur growth. Productivity gains that offset the impact of wage increases on unit labor costs would also bring the cost-related trend loss of export market shares to a halt.

Fiscal policy: a credible consolidation focused on bringing spending under control

6. **A credible adjustment strategy to reduce the general government deficit to below 3 percent of GDP by 2013 should anchor fiscal policy.** Looming spending pressures from population ageing and the large deviation from the pre-crisis fiscal trajectory require consolidation. Bringing down the deficit to below the Stability and Growth Pact's ceiling over the next three year strikes a proper balance between support for a still fragile recovery and the need to return to a sound underlying fiscal position. Further adjustment beyond 2013 will be needed to achieve structural balance in 2015—the pre-crisis target and a necessary condition for fiscal sustainability.

7. **From this perspective, the authorities' May 2010 consolidation package is overall appropriate.** The package includes measures of some 1½ percentage points of GDP, to be implemented during 2011–13. They are equally divided between spending reductions and revenue increases and aim to bring down the deficit to below 3 percent of GDP by 2013. The measures are somewhat frontloaded, which will establish credibility but will not hamper the recovery—given the delayed multiannual effects of the large fiscal easing in 2009–10.

8. **However, a greater emphasis on reducing public sector consumption would have been preferable.** The tax burden is already very high, raising concerns that a further increase will exacerbate negative impacts on work incentives. A major tax reform approved in 2009,

the composition of the May 2010 package's revenue measures and a welcome reduction in the duration of unemployment benefits mitigate this impact. Still, one of the authorities' main objectives before the crisis was to avoid increasing the tax burden and limit the share of public sector consumption in GDP. Although reliance on containing public consumption growth—an objective rarely achieved in Denmark in recent years—may be very challenging and could raise concern about missing the 2011 government deficit target, it is more appropriate given long-term spending pressures.

9. **Reining in public consumption spending is complicated by the allocation of spending responsibilities across levels of government in Denmark.** Municipalities are responsible for more than half of general government spending and enjoy a large degree of spending autonomy, including in the social welfare area. In spite of yearly central-municipal agreements to limit spending, public consumption at the municipal level has persistently exceeded budget targets, including in 2010 by a sizeable amount. The agreement between the central government and the municipalities for 2011 freezes municipal welfare spending in real terms relative to the 2010 budgets, and introduces welcome additional reporting requirements—preparation of half-year accounts in particular—and enhanced collective and individual sanctions.

10. **Additional initiatives are needed to ensure compliance with the 2011 central-municipal agreement and the related general government deficit target.** There is scope for strengthening the monitoring of municipal budget execution and the sanctions regime. Measures could include a requirement to provide accurate and up-to-date quarterly budget execution data, a more systematic monitoring of municipalities with a poor budget execution track record, and immediate corrective actions when spending overruns materialize during the course of the year. To give a higher profile to the yearly central-municipal agreements and to generate a broader policy discussion on their content, a more systematic assessment could be considered before and after the budget year, including an analysis of their contribution to achieving Convergence Programme objectives. This evaluation could be in the form of an independently prepared regular report.

Financial policy: scope for further strengthening banking sector resilience

11. **The authorities' actions and the improvement in economic conditions have restored stability to the financial system**. Profits have strengthened, reflecting growing net interest income and lower write-downs. Large exposures have been brought down. And, aided by market normalization and official support, solvency ratios have improved and liquidity strengthened. Still, some medium-size banks remain vulnerable—with funding dependent in part on official guarantees. Recent stress tests confirm the adequacy of capital ratios of major banks to withstand deterioration in the economic environment. Absent significant negative shocks, the authorities' guarantees and capital injections provide a two to three year period in which financial institutions will be able to rebalance positions and revise business models.

12. **The financial crisis has, however, exposed weaknesses in the financial system.** Reminiscent of previous episodes of fragility, banks increased leverage, misinterpreted credit risks and lent too much. Some medium-size banks expanded aggressively, accumulating large concentrated exposures, to real estate projects in particular. Larger externally oriented banks, following the model of other global financial institutions, expanded internationally and increased dependency on wholesale funding.

13. **In response, the authorities have taken important steps to strengthen financial sector supervision.** The Financial Supervisory Authority (FSA) has sharpened the focus on assessing the viability of institutions' business models, strengthened the transparency of its supervisory activities, and expanded its cross-border collaboration. The establishment of a *"supervisory diamond"*, which examines various bank ratios against benchmark thresholds, is especially welcomed. It provides a simple template with which to gauge bank risks and rein in excessive exposures. In addition, more frequent and extended collaboration with the Danmark Nationalbank (DN) helps identify potential risks and improve overall prudential supervision. Similarly, the recently signed Nordic cooperation agreement on cross-border financial stability, crisis management and resolution strengthens information sharing and coordination, and increases preparedness to handle problems at cross-border banks.

14. **Nevertheless, additional actions should be undertaken to further bolster financial sector stability.**

- New Basel III regulations, including higher capital and liquidity ratios, will help curb incentives for excessive risk taking, while reinforcing buffers. Once the exact Basel III parameters are determined, the authorities should evaluate the need for further capital top ups.

- The supervisory diamond's usefulness as an enforcement tool could be enhanced by proactively requiring *pre-approval* of any breeches. Application of supervisory capital charges upon breeches may forestall the buildup of large exposures—especially within medium-size banks.

- DN/FSA collaboration projects on monitoring financial sector risks, including liquidity and funding positions, could be further strengthened—notably with regard to exposures to wholesale funding.

- DN/FSA should also, in cooperation, prepare for new macro-prudential regulation and supervision activities and requirements, including those stemming from EU-level initiatives.

- Concrete and precise arrangements regarding intervention modalities and burden sharing responsibilities should be implemented within the Nordic-Baltic cooperation agreement.

15. **It is imperative that all banks accept the new resolution system.** The new scheme, which replaces a temporary arrangement introduced in response to the banking crisis, is in line with best practices. At their next general shareholder meetings, banks have a choice whether to be governed by the new scheme or remain under corporate bankruptcy procedures in the event of insolvency. Quick and orderly resolution is essential to minimize costs and safeguard the functioning and stability of the financial system during a period of turmoil, as the recent crisis highlighted. The authorities should use moral suasion and supervisory capital charges to ensure that all institutions opt for the scheme.

16. **New Basel III proposals create uncertainties for the mortgage bond market.** This market serves as the main tool for liquidity management in Denmark, reflecting its depth and limited supply of government bonds. It proved its resilience during the crisis. However, proposed Basel III regulations would limit the extent to which mortgage bonds can serve as liquid assets. The proposals, still under discussion, are unnecessary from a Danish point of view, and would cause banks to significantly reduce their mortgage bond holdings and shift to other, possibly inferior, assets to meet liquidity requirements. At both the international and the national level, efforts will have to be made to prepare for the implementation of the proposals, as finally approved.

Labor markets and productivity: boosting growth through higher labor supply and more efficient resource allocation

17. **Although the labor market has performed well during the crisis, further structural reforms are needed to maintain labor supply.** The market is flexible and has handled business cycle shifts with symmetrical adjustments in gross unemployment and no sign of an increase in structural unemployment. However, labor supply is projected to decline over the medium term due to demographic developments. Labor shortages already surfaced during the pre-crisis period and played a significant role in the economy's overheating in 2006–07. Pre-crisis labor market reforms and the 2009 tax reform helped address labor supply issues. Agreed pension reforms will bolster labor supply as well, but they do not take effect until 2019. Also from a fiscal perspective, more immediate measures, including steps aimed at phasing out early retirement schemes and reforming sickness and disability leave benefits, are needed.

18. **A combination of lower productivity and wage growth has pushed up unit labor costs.** Some easing of unit labor cost growth was observed recently, and exchange rate movements have offset some of the impact of higher unit labor costs on export volumes. A significant portion of the underlying decline in labor productivity appears to be linked to the efficiency of resource allocation. Reforms that increase competition and accelerate firm exits and entry, particularly in services, should help in the diffusion of knowledge and increase productivity in both the non-tradable and tradable sectors. Similarly, measures that increase the return to education, at higher skill levels in particular, will help reallocate resources to more productive areas. Denmark's flexible labor market supports productivity overall.

However, investment in firm-specific human capital appears relatively low, as also suggested by relatively high public spending on life-long learning, and could, in some instances, be related to high turnover.

* * * * * * *

We are grateful for the warm welcome extended by everybody we have met during our mission and for the open and stimulating discussions.