October 2006
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Denmark: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Denmark

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with Denmark, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 26, 2006, with the officials of Denmark on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 8, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 29, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Denmark.

The documents listed below have been or will be separately released.

Selected Issues Paper
Financial System Stability Assessment

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

DENMARK

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Denmark

Approved by Alessandro Leipold and Adrienne Cheasty

September 8, 2006

Consultation discussions were held in Copenhagen during June 16–26, 2006. The mission included Mr. Hilbers (head), Ms. Zhou, Mr. Lundback, Mr. Tchaidze (all EUR), and Mr. Wajid (MFD). Mr. Hollensen, Senior Advisor in the Nordic-Baltic Executive Director's office, attended the meetings. The mission met with the Chairman and Governors of the Danish National Bank (DNB); the Deputy Permanent Secretary of the Ministry of Finance; the Director General of the Danish Financial Supervisory Authority (DFSA); senior officials of the government, the DNB, the DFSA, and the Competition Authority; representatives of the Economic Council, the Globalization Council, and the Parliamentary Committee on Finance Affairs; and representatives of the industry sector, the banking sector, the Association of Mortgage Banks, the academic community, employers' organizations, and trade unions.

A coalition of Denmark's Liberal Party and Conservative Party continued to form the government after elections in February 2005. The next parliamentary elections will take place no later than February 2009.

The authorities released the mission's concluding statement, and there was a press conference by the mission at the end of its stay. The authorities have agreed to the publication of the staff report.

Denmark has accepted the obligations of Article VIII (Appendix I) and subscribes to the Special Data Dissemination Standard, and data provision is adequate for surveillance (Appendix II). Data in this report reflect information received by August 2, 2006. More recent data may be obtained directly from the following sources:

Danish National Bank .... http://www.nationalbanken.dk
Danish Ministry of Finance .... http://www.fm.dk
Danish Financial Supervisory Authority .... http://www.finanstilsynet.dk
Economic Council .... http://www.dors.dk
Statistics Denmark.. http://www.dst.dk
Eurostat... http://www.europa.eu.int/comm/eurostat
Information and documentation on Danish economic statistics may also be found at the Special Data Dissemination Standard website of the IMF.................................. http://dsbb.imf.org

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EXECUTIVE SUMMARY

The Danish economy has been doing very well lately but is now faced with the risk of overheating. Economic activity in 2005 and early 2006 was strong, driven in part by rapidly appreciating house prices, and unemployment has reached record low levels. The macroeconomic policy options to cool the economy are limited given ERM2 participation and the already strong fiscal position. A combination of continued public expenditure restraint, a rapid implementation of measures to increase labor supply, wage moderation, and actions to avoid unbalanced housing market developments will be required to maintain macroeconomic and financial stability.

Key issues

Short-term outlook. Growth is expected to continue at a strong but slower pace in 2006, followed by a further moderation in 2007-08, assuming a gradual slowdown in private consumption and investment. This forecast is based on continued prudent fiscal policies and wage moderation.

Fiscal policy. Tight control over public expenditures is required to avoid contributing to demand pressures. The authorities' intention to abstain from further tax cuts in 2007 is welcome for cyclical reasons, but the current tax freeze is unnecessarily rigid. A revenue-neutral combination of a decrease in personal income taxation and an increase in real estate taxes would support labor supply and financial stability, but lacks political support.

Monetary and exchange rate policy. The fixed exchange rate system—the peg of the krone to the euro—continues to serve Denmark well by anchoring inflationary expectations and imposing discipline on fiscal and structural policies.

Structural policies. The welfare agreement reached on June 20, 2006 marks an important step toward preparing Denmark for the implications of an aging population. However, the measures in the agreement aimed at increasing labor supply in the short run could have been stronger. Initiatives to enhance competitiveness appear generally well placed, although their costs will need to be contained.

Financial sector. The financial sector assessment conducted in the context of the FSAP indicated an overall resilient and well-supervised financial system, but close monitoring of the housing market and continued strict adherence to supervisory rules will be required.

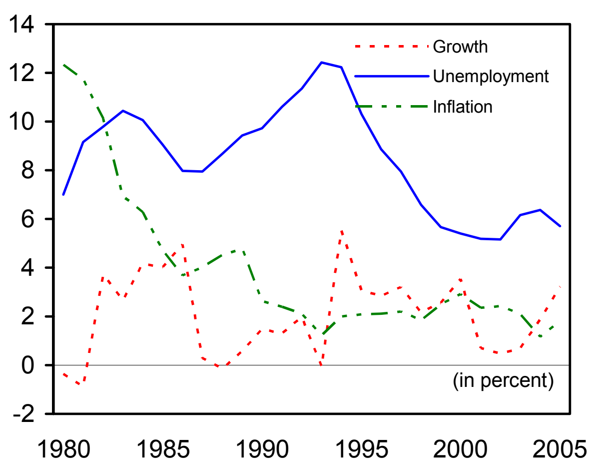
I. INTRODUCTION AND BACKGROUND

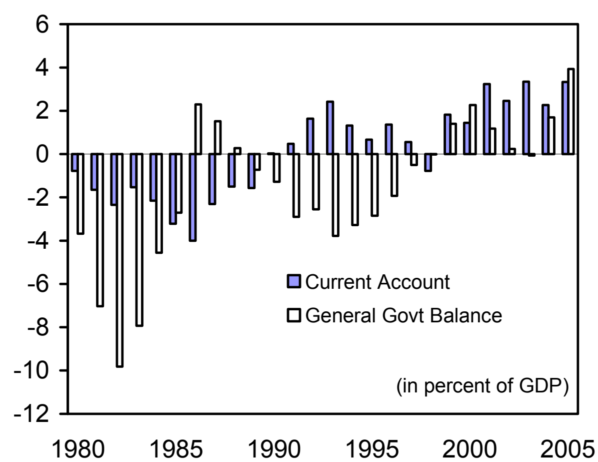
1. **The Danish economy underwent major changes over the last two decades.** In the early 1980s, the economy suffered from chronically high inflation and unemployment rates, unsustainable budget deficits, and large current account deficits. A macroeconomic stabilization program was adopted in the mid-1980s, followed by structural reforms in the early 1990s. As a result, economic performance has since been much more favorable with significant growth during the late 1990s, sustained by labor market reforms that reduced structural unemployment. Fiscal consolidation and the buoyant economy turned large fiscal deficits into sizable surpluses, and the public debt-to-GDP ratio fell sharply. As Denmark registered current account surpluses, the foreign debt position improved markedly.

2. **Memories of bad times and the payoffs of reforms cemented a strong nationwide consensus on the need for prudent economic policies.** In addition, a strong sense of equity allowed for a combination of labor market flexibility, an extensive social safety net, and active labor market policies: the so-called flexicurity model, now part of the public debate on labor market reform in several other European countries.

3. **Since 2001, Denmark has oriented its economic policies further toward fiscal consolidation and augmenting labor supply.** A key objective of the current coalition government is to achieve long-term sustainability of public finances and an increase in the labor supply in response to the pressures from an aging population. Key elements of the framework include real public expenditure norms and a tax freeze. This framework and the underlying objectives have been supported by the Fund (Box 1).

Difficult times in the past provided the basis for reforms, and a clear turn for the better





Box 1. Key Fund Policy Recommendations and Implementation

During previous consultations, the Executive Board has commended the authorities for their record of sustained structural reform and strong fiscal policy, based on a medium-term framework that resulted in fiscal surpluses and a sizable reduction in public debt.[1] Overall, policy implementation in the past period has been consistent with Fund policy advice.

Fiscal policy. The Fund has recommended that improving spending discipline be given priority. The government has made efforts to this end and public consumption growth has been low, although spending ceilings were exceeded.

Monetary and exchange rate policy. The Fund has viewed the peg of the krone to the euro as a central pillar of Denmark's macroeconomic stability strategy. Although overall competitiveness has been considered healthy, the Fund has cautioned against the risk that labor costs outstrip productivity growth. In the event, social partners have agreed on relatively modest wage increases in recent years.

Structural policies. The Fund has commended the strong performance of the Danish labor market, while encouraging the authorities to prepare additional reforms, including a reduction in incentives for early retirement, to alleviate labor supply constraints and lower structural unemployment. Recently, an important welfare reform agreement was reached, which includes adjustments in the retirement schemes and labor supply measures.

Financial sector. The Fund has welcomed Denmark's participation in the Financial Sector Assessment Program (FSAP) in 2005-06.

[1] Public Information Notice 04/84 at http://www.imf.org/external/np/sec/pn/2004/pn0484.htm.

II. Recent Economic Developments

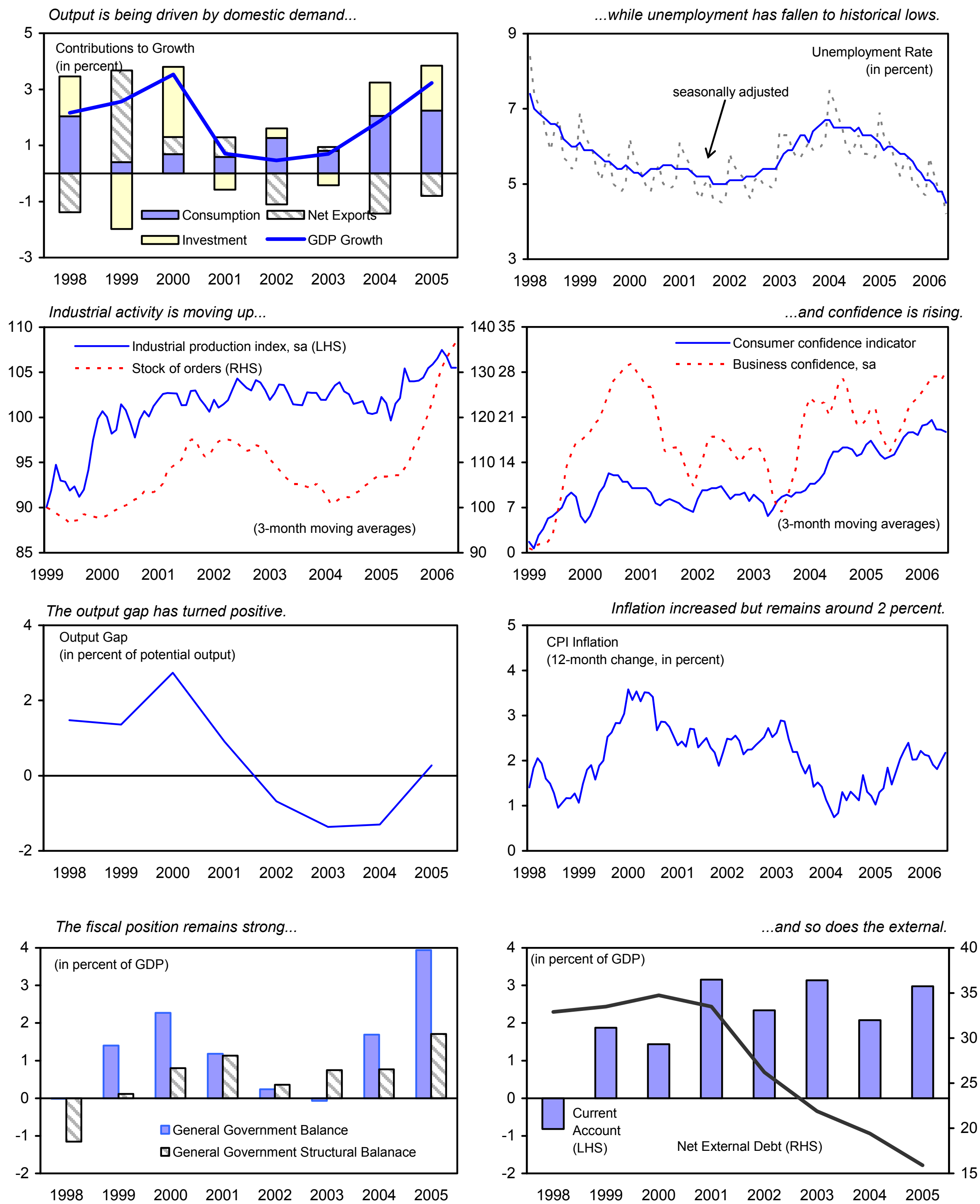
4. **The economy expanded rapidly in 2005, propelled by strong domestic demand** (Figure 1). Real GDP rose by 3.2 percent, well above the growth rate of the euro area (1.3 percent). Private consumption was boosted by high real disposable income, owing to tax reductions in 2004, low interest rates, new types of loans (e.g., interest-only loans), and house price developments. Rising house prices also spurred double-digit residential investment growth. Real public consumption growth decelerated slightly in 2005, but remained well above the 0.5 percent target in the fiscal framework. Exports and imports grew sharply, with the external sector contributing negatively to growth.

Denmark: Contributions to GDP Growth, 2000–05

	2000	2001	2002	2003	2004	2005
Real GDP growth	3.5	0.7	0.5	0.7	1.9	3.2
Domestic demand	3.0	0.0	1.6	0.6	3.2	3.9
Consumption	0.7	0.6	1.3	0.8	2.0	2.2
Public	0.6	0.6	0.5	0.1	0.4	0.3
Private	0.1	0.0	0.7	0.7	1.7	1.9
Fixed investment	1.4	-0.3	0.0	0.4	0.9	1.9
Inventories	1.1	-0.3	0.3	-0.8	0.3	-0.3
Net exports	0.6	0.7	-1.1	0.1	-1.4	-0.8
Exports	5.4	1.5	2.0	-0.6	1.3	3.8
Imports	-4.8	-0.8	-3.1	0.7	-2.8	-4.6

Source: IMF staff calculations

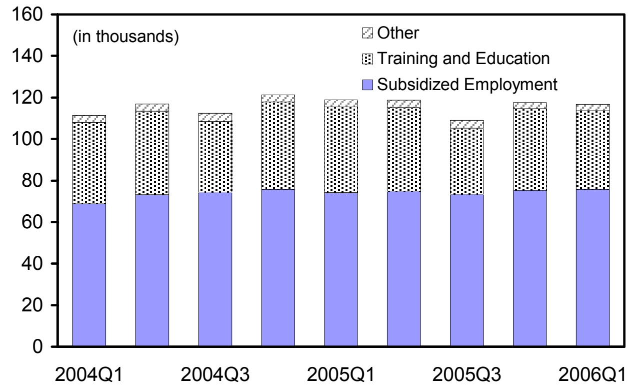
Figure 1. Denmark: Macroeconomic Indicators



Sources: Statistics Denmark, National Bank of Denmark, and IMF staff calculations.

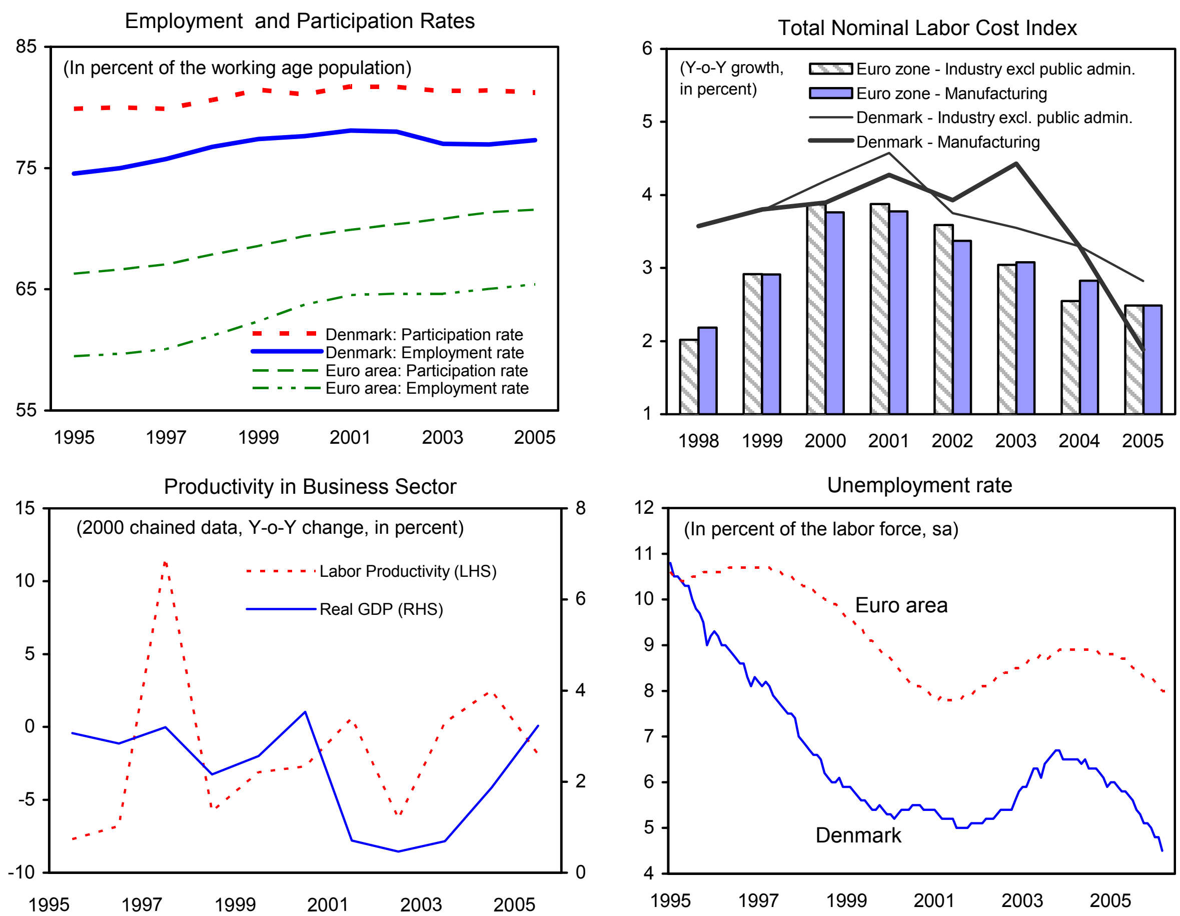
5. **The unemployment rate fell to 4.5 percent in June, the lowest level in 30 years** (Figure 2). Strong growth and a flexible labor market contributed to a notable pickup in employment (about 1 percent). Labor market conditions have consequently tightened: in both the construction industry and the financial sector, labor shortages appear to have emerged. Despite the decline in unemployment, the number of participants in labor market programs remains stubbornly high, representing 4.4 percent of the labor force at end-2005.

Denmark: Full-Time Participants in Active Labor Market Programs



Sources: Statistics Denmark and IMF staff calculations.

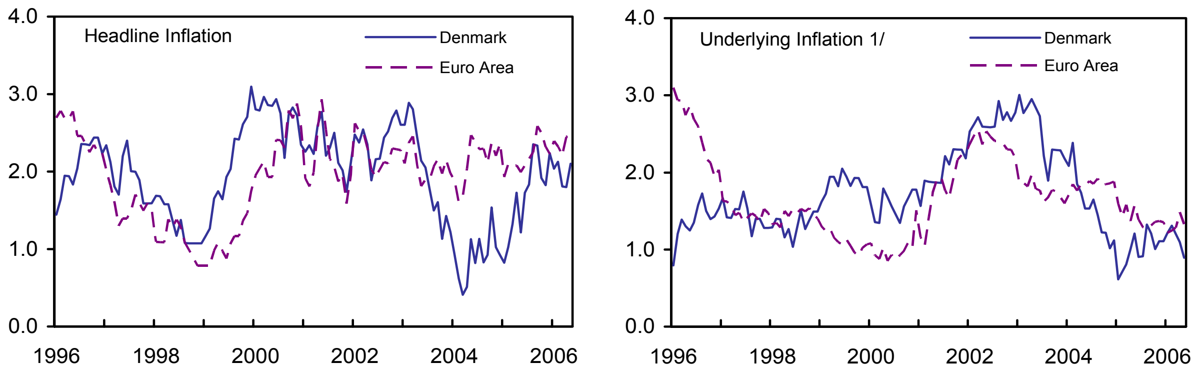
Figure 2. Denmark: Employment, Unemployment, and Participation Rate



Sources: OECD, Analytical database; and Employment Outlook 2000; Eurostat; staff calculations; and data provided by the authorities.

6. **Inflation remains contained, but is catching up with that in the euro area.** With relatively low wage growth over the last two years, inflation has been lower than the euro area average since the beginning of 2004. However, with both core and headline inflation showing an upward trend, this gap almost disappeared in 2005 (Figure 3). The recent rise in harmonized inflation to 2.1 percent in June resulted mainly from some transitory factors, including large increases in energy and food prices.

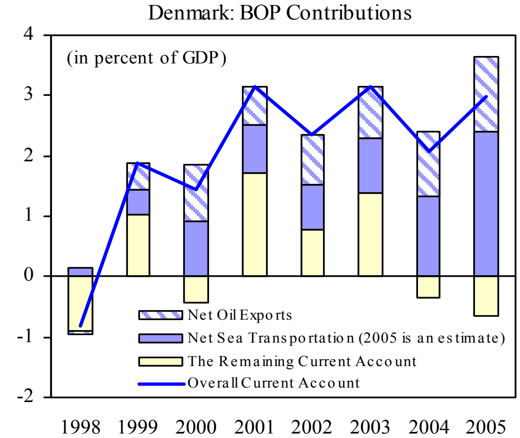
Figure 3. Denmark: Price Developments
(12-Month Growth Rate; Harmonized CPI)



Sources: IMF, IFS; and Cronos database.
1/ Overall harmonized index excluding energy, food, alcohol and tobacco.

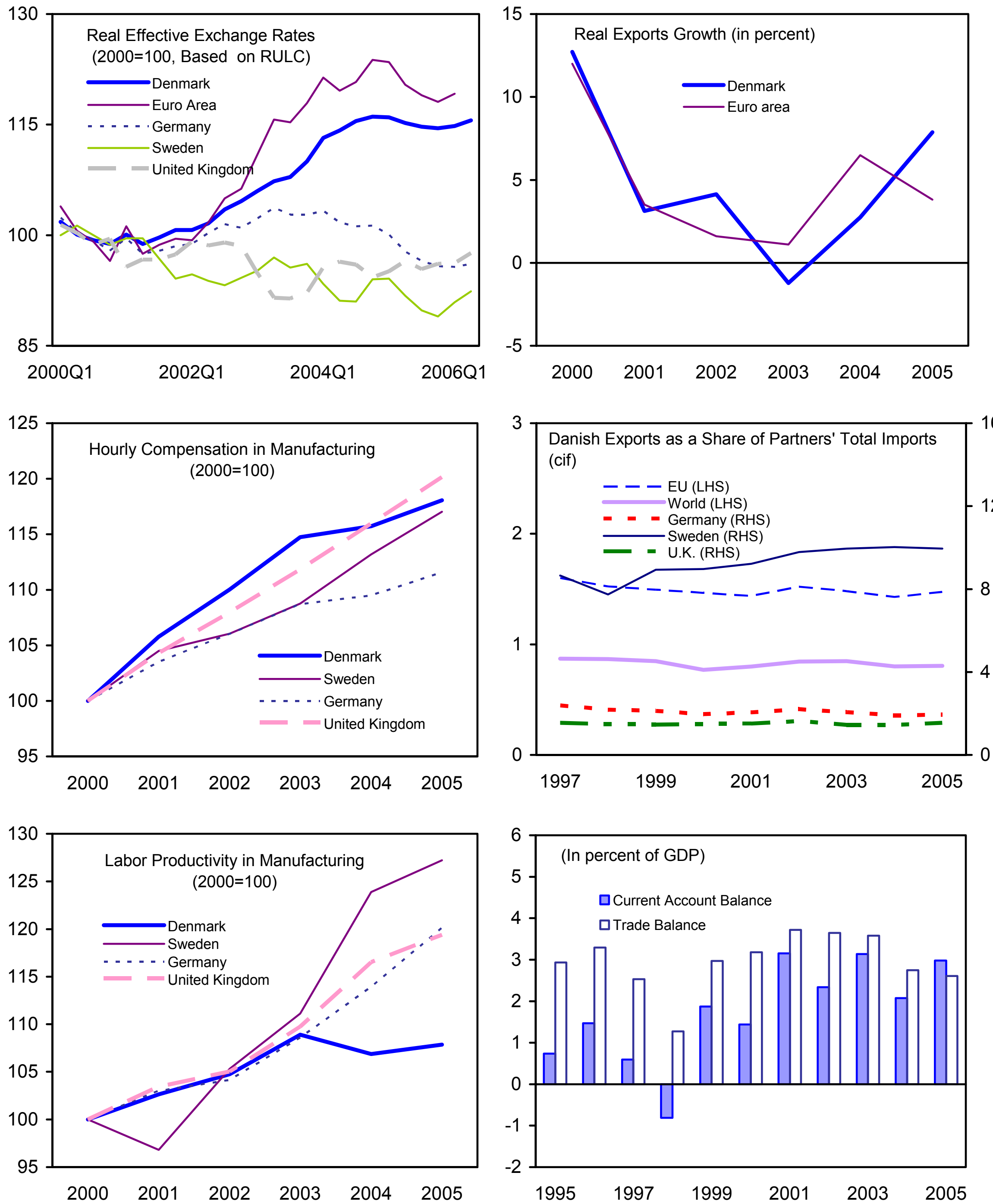
7. **Denmark's external competitiveness appears adequate, despite a 15 percent real appreciation of the krone during 2001–04.** The Danish krone participates in ERM2 with margins of 2¼ percent vis-à-vis the euro. While the krone's REER appreciation has been more contained than that of the euro (25 percent), it has exceeded that of some key trading partners. Nonetheless, the upswing in Danish exports has been relatively strong, trade and current account surpluses have been sustained,[1] and Danish export shares in both world and EU markets have held up well. Although Danish labor productivity growth in manufacturing lagged behind its key trading partners (Germany, Sweden, and the United Kingdom) in 2004-05—largely due to cyclical factors—the increase in labor costs has come down as well, in line with Germany but more than in Sweden and the United Kingdom (Figure 4). Overall, unit labor costs in Denmark rose more than those in Germany and Sweden,

Denmark: BOP Contributions



[1] The current account has been in surplus since 1998, although net of sea trade and oil exports it has shown small deficits in recent years. The boycott of Danish goods by the population of certain Islamic countries in early 2006 had a limited macroeconomic impact, as exports to these countries account for only about 3 percent of total Danish exports.

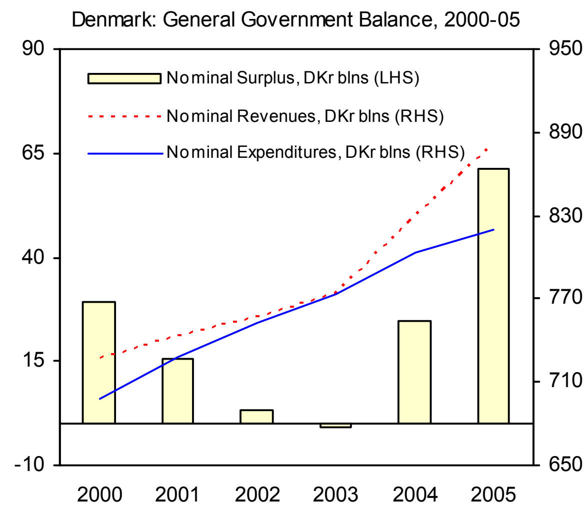
Figure 4. Denmark: Competitiveness Indicators



Sources: IMF, WEO, DOT, and IMF staff estimates.

but in line with the average of the euro area. Moreover, the appreciation during 2001–04 was reversed at the beginning of 2005, and the REER has depreciated slightly since then.

8. **A large fiscal surplus was achieved in 2005 (3.9 percent of GDP),** much higher than budgeted and than the 2004 surplus of 1.7 percent of GDP. This was due to strong revenue growth (6.4 percent), largely attributable to high revenues from pension return and corporate income taxation, including revenues from the oil-and-gas related activities in the North Sea. In addition, government expenditures declined as a percentage of GDP. Given that revenue developments were mainly cyclical, the structural balance shows a smaller improvement (0.9 percentage point of GDP). General government debt came down further to 36 percent of GDP at end-2005. Denmark's fiscal performance stands out in a European context (Figure 5).



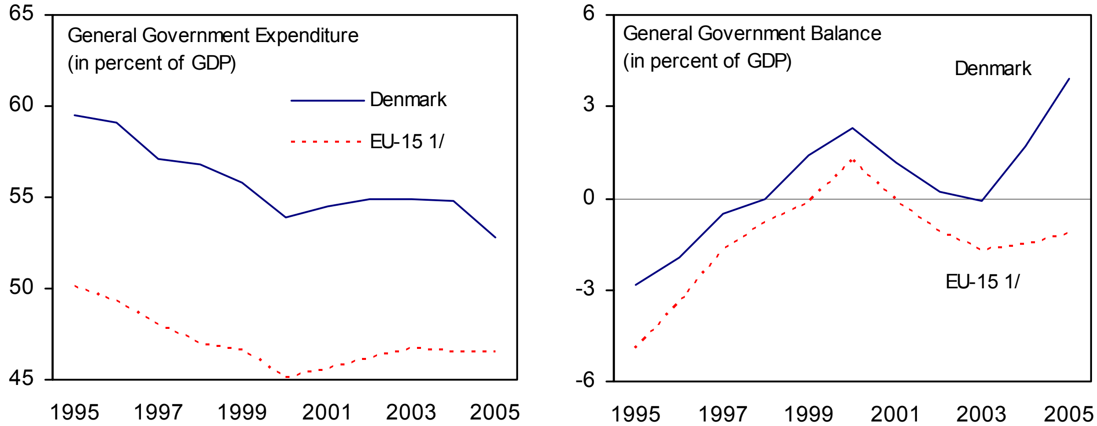
General Government Account
(percent of GDP)

	2003	2004	2005	changes 05-04
Total Revenues	54.8	56.5	56.7	0.2
Personal Income Taxes	22.3	21.7	21.5	-0.2
Labor Market Contributions	4.4	4.4	4.3	-0.1
Pension Return Taxes	0.4	1.6	2.0	0.5
Company Taxes	2.9	3.2	3.6	0.4
VAT	9.6	9.8	10.0	0.2
Social Contributions	1.2	1.2	1.1	-0.1
Interest and Dividends	1.4	1.5	1.3	-0.2
Other revenues	12.6	13.1	12.9	-0.3
Total Expenditures	54.9	54.8	52.8	-2.0
Public Consumption	27.5	27.6	27.1	-0.5
Transfer Incomes	17.3	17.2	16.4	-0.7
Public Subsidies	2.3	2.3	2.3	0.0
Interest Expenditures	3.4	3.1	2.6	-0.5
Public Investment	1.6	1.9	1.7	-0.1
Other Expenditures	2.8	2.8	2.7	-0.1
Balance	-0.1	1.7	3.9	2.2
Structural Balance	0.7	0.8	1.7	0.9

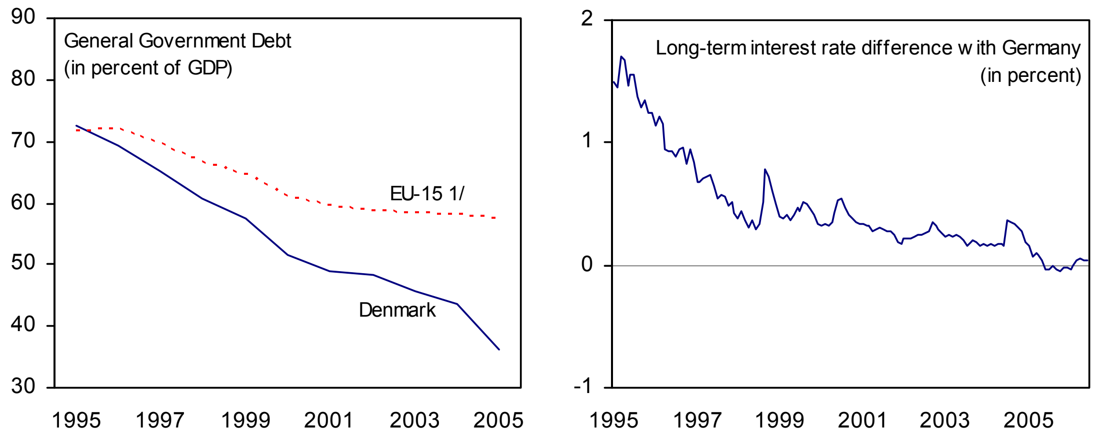
Source: Statistics Denmark; and IMF staff calculations.

Figure 5. Denmark: Fiscal Developments in a European Perspective

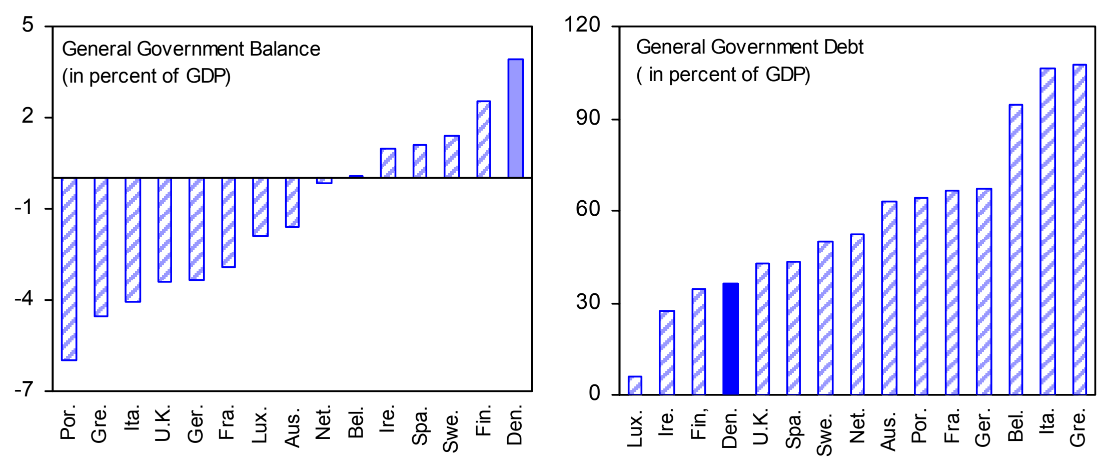
Public expenditures are still high, but have declined, and the deficits have turned into surpluses...



...resulting in substantial debt reduction and an elimination of the interest spread vis-à-vis Germany.



In 2005, Denmark's fiscal position was one of the strongest in the EU-15.



Source: DNB, IFS, and WEO.
1/ Unweighted average.

9. **Policy interest rates follow those of the ECB and monetary conditions are accommodative** (Figure 6). Denmark is a long-standing member of ERM2, and the small spreads in interest rates vis-à-vis the euro area and the narrow movements of the krone around the parity underline the credibility of the peg. The DNB follows official interest rate changes by the ECB closely and intervenes only to smooth exchange rate movements. The lending rate and the rate of interest for certificates of deposit were raised by 10 basis points in February due to an outflow of foreign exchange, inter alia as a result of Danish institutional investors' purchases of foreign shares and securities. The monetary conditions index (MCI) has recently bottomed out. Low interest rates have stimulated credit growth, which reached 14.6 percent in April 2006. More than 60 percent of credit is extended to households, underpinning a significant appreciation of house prices. The increase in household indebtedness and the wider use of adjustable rate mortgages have raised households' exposure to changes in short-term interest rates. While household debt (at more than 200 percent of disposable income) is high by international standards, debt-servicing costs remain contained due to low interest rates, and net debt is low.

10. **Asset prices rose rapidly and the profitability of financial institutions is at record high.** The Danish stock market index went up by 37 percent in 2005, with one third of the growth attributable to the rising shares of the large container shipping company Maersk.[2] House prices appreciated by 21.6 percent following an increase of 10 percent in 2004 (Box 2). Banks and mortgage credit institutions posted record profits with a substantial contribution from fee income due to securities trading and refinancing of mortgage loans and supported by low provisions. Insurance companies and pension funds also did well due to higher returns from equities, bonds, and real estate holdings.

III. Report on the Discussions

11. **The Danish economy performed very well in 2005 and early 2006, and the discussions focused on the risks of overheating and possible policy responses.** Although recent indicators point to modest inflation, current account and fiscal surpluses, and moderate wage increases, the authorities and mission agreed that there are signs of cyclical pressures building up. There are labor shortages in certain sectors, rapid credit growth is fueling strong increases in house prices and boosting private consumption and imports, and inflation has been increasing from low levels to the euro area average. Policy options are limited given the exchange arrangement, the tax freeze, and structural conditions that cannot be changed overnight. The discussions were aimed at identifying appropriate policy responses, both to short-term macroeconomic risks and long-term structural challenges.

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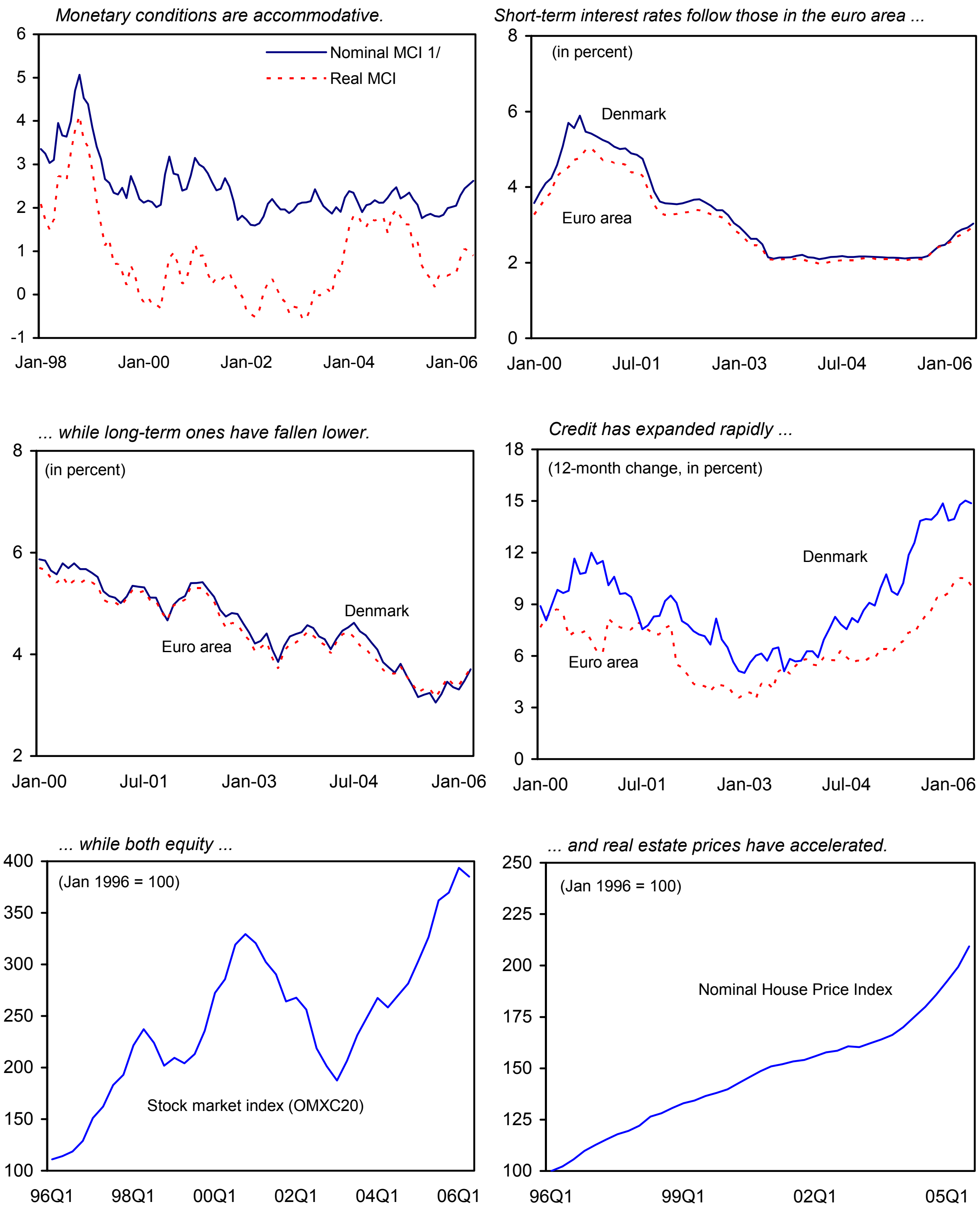
[2] During the first half of 2006, the Danish stock price index came down by about 5 percent.

Figure 6. Denmark: Monetary and Financial Indicators



Sources: National Bank of Denmark, International Financial Statistics.
1/Monetary conditions indices are calculated as weighted averages of the 3-month interest rates and the detrended effective exchange rates, with respective weights of 0.75 and 0.25.

Box 2. Developments in the Danish Housing Market 1/

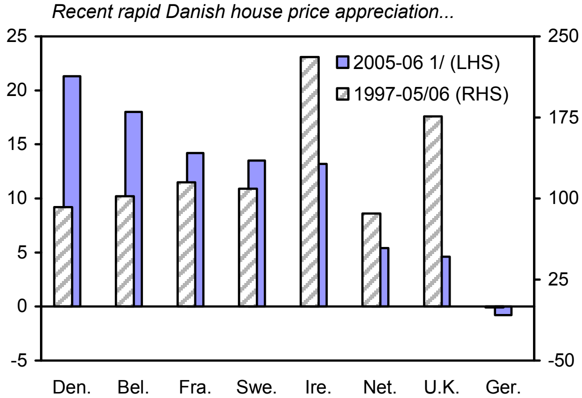
House prices in Denmark have appreciated rapidly in recent years. After a prolonged period of rather moderate price increases—during which house prices in many other European countries increased more rapidly—there was a sharp acceleration of Danish house prices in recent years. In 2005, house prices in Denmark rose by more than 20 percent, which was one of the highest rates of increase worldwide.

The process is driven by both general and Denmark-specific factors. The accompanying background study shows that a variety of factors have contributed to the increase in Danish house prices. Until recently, the pace of appreciation could largely be explained by general factors, such as increases in real disposable income and declines in interest rates. These, however, fail to explain the most recent acceleration of house prices. But there are two additional, Denmark-specific factors at play: the housing finance market and the taxation system.

The Danish mortgage-financing system is very efficient and has developed an array of new products. The system, which shares certain characteristics with the U.S. system in terms of easy refinancing options and an active mortgage-linked securities market, is very efficient, resulting in low transaction costs. In addition, a number of new products were launched in recent years, including flexible-interest and interest-only loans. These products, because of their (initially) lower debt servicing obligations, have increased the amounts borrowed.

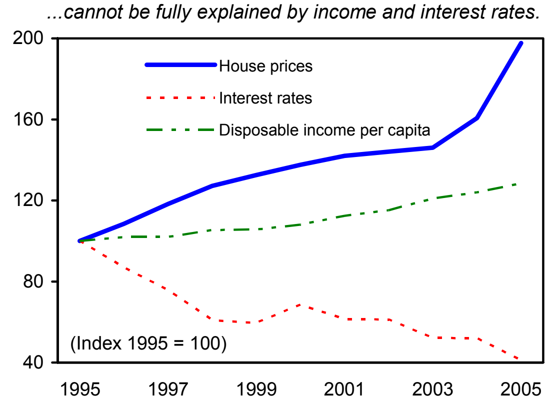
The tax regime for housing has provided additional support for the housing market in recent years. Under the general tax freeze, not only the tax rates applicable to housing are frozen, but also the underlying values to be applied. For the real estate tax, these values are essentially set at the 2002 levels. Thus, the recent sharp increase in house prices has not resulted in a nominal increase in the real estate taxes due.

Recent rapid Danish house price appreciation...



Source: The Economist, based on national sources.
1/ Latest 12 month increase.

...cannot be fully explained by income and interest rates.



Sources: AMECO, BIS, IFS, and staff estimates.

1/ Based on the selected issues paper on housing market developments in Denmark.

A. Outlook and Risks

12. **In both the authorities' and staff's projections, growth is estimated to continue at a strong but slower pace in 2006, followed by a further moderation in 2007–08**. Economic activity is likely to moderate in 2006 because of high capacity utilization and rising interest rates, while the effects of the 2004 tax cuts are petering out. Growth is expected to gradually return to its potential (around 2 percent) in 2007–08, but this is conditional upon continued wage moderation and prudent fiscal policies. Inflation is projected to remain around 2 percent, supported by the exchange rate peg. Helped by continued high oil prices, the current account and government balances are expected to remain in surplus, albeit less so than in 2005.

13. **The short-term risks to this benign outlook are generally considered on the upside.** A further reduction in the already low unemployment rate may give rise to tensions in the labor market. Upward wage pressures are already evident in the construction and financial sectors; social partners noted that these pressures had resulted in increases in fringe benefits. In addition, the housing market has yet to show clear signs of a slowdown, although the authorities indicated that supply has recently increased somewhat. Furthermore, there are pressures to loosen the fiscal policy stance in light of the large 2005 surplus.

14. **At the same time, there are downside risks, in particular with regard to the housing market.** With household debt at internationally high levels, most of which covered by real estate collateral, any significant slowdown in the Danish housing market would have a substantial effect on growth in domestic demand, both directly through wealth effects on consumption, and indirectly through its impact on consumer confidence.

15. **On the external side, the Danish economy is sensitive to the exchange rate, the oil price, and its position in international sea trade.** A further appreciation of the euro might negatively affect the trade balance. As a net exporter of oil, Denmark has benefited from the recent sharp increases in oil prices: in 2005, high oil prices significantly contributed to the budget and current account surpluses. In addition, the economy—and in particular the export sector—is strongly affected by the performance of the shipping industry, which has benefited from the rapid growth in international trade, but similarly is vulnerable to changing market conditions.

16. **There was broad agreement on the importance of continued wage moderation to reduce overheating risks and maintain Denmark's competitiveness.** The authorities noted that Denmark scores highly on most indicators for external competitiveness, but were well aware that the margins in international trade are small and that significant wage increases would erode Denmark's external position. Social partners noted that they have so far been able to agree on relatively moderate wage increases with an eye on international trends and

the impact of globalization. They agreed that wage moderation would help reduce the risk of overheating and wage-price spirals, but also noted strong upward pressures.

B. Fiscal Policy

17. **The mission emphasized that fiscal policy should continue to be guided by prudent medium-term objectives.** The current framework—based on the Plan 2010 agreed in 2001—aims at reaching a structural surplus over the medium-term of ½–1½ percent of GDP to ensure fiscal sustainability in an environment of aging (Appendix III). This could create room for a reduction in the (high) tax rates, some of which were already effected in 2004, when the personal income tax was reduced by adjusting brackets and deductions. The medium-term framework has enabled an impressive decline in the debt-to-GDP ratio and related interest expenditures. The authorities are planning to update the fiscal projections (Plan 2010) toward the end of this year and issue a new fiscal framework (Plan 2015) in the course of 2007; the mission emphasized the importance of maintaining the current strong focus on the sustainability of public finances in the medium to long term.

18. **So far, it has proved difficult to adhere to the agreed expenditure norms, with public consumption growth exceeding the targets in 2004 and 2005.** The authorities noted that expenditure pressures stem largely from local governments exceeding their spending limits. Furthermore, in line with the new welfare proposals, real public expenditure growth targets are likely to be revised upward to about 1 percent per year. The mission expressed concern that, under the current cyclical circumstances, additional expenditures risk adding to the already strong demand pressures. The authorities noted that there would be no proposals for tax cuts in 2007—an intention welcomed by the mission.

19. **The authorities emphasized that the current tax freeze serves its purposes.** As part of the medium-term framework, the authorities have committed themselves to a tax freeze since 2002 to contain the overall level of taxation, and also as an instrument to control expenditure, in particular at the local level. While these arguments are valid, the mission argued that the current system whereby not a single tax rate can be increased—even where it would allow other, more harmful tax rates to come down—is overly rigid. The authorities felt that any relaxation of the freeze would risk further hikes in taxation, which would be more harmful to the economy.

20. **The mission proposed increasing real estate taxation and reducing income taxation correspondingly to support both labor supply and financial stability.** The current real estate taxation, based in part on fixed tax rates applied to below-market, frozen real estate values, provides an unnecessary and potentially even damaging stimulus to the housing market. At the same time, high marginal personal income tax rates that kick in at relatively low levels constrain labor supply.

21. **The authorities saw several drawbacks.** Increases in real estate taxation would put downward pressure on the housing market, and might result in liquidity problems among certain taxpayers. The mission noted that the process would have to be predictable and carried out responsibly, and that past experiences in other countries such as the United Kingdom had shown that gradually tightening the tax treatment of housing would not necessarily result in significant price pressures. More generally, the authorities reiterated their political economy concerns about "opening the box" with regard to tax rates.

22. **An important local government reform operation is under way.** It aims at improving the quality of service through a more efficient use of resources by merging local governments into larger entities, and by more clearly assigning responsibilities among different levels of government. The reform could also help the central government in the medium term to keep a tighter control over local expenditures. The mission welcomed the streamlining operation, but pointed to upward pressures on expenditures in the short run. The authorities noted that measures were in place to control these costs.

C. Monetary and Exchange Rate Policy

23. **There was agreement that the fixed exchange rate system continues to serve Denmark well.** The authorities noted that the peg to the euro, which helps anchor inflationary expectations, is a primary element in their stability-oriented policies. The margins around the central rate are small, as are interest rate differentials with the euro area, reflecting market confidence in the peg. The authorities expressed their continued strong commitment to the peg, a key role of which lies in the discipline it imposes on macroeconomic and structural policies, thereby contributing to the strong fiscal performance. The mission noted the key importance of this disciplinary impact for the success of the peg.

24. **The DNB has closely followed official interest rate movements by the ECB.** The mission noted that raising the rates in line with possible future rate increases by the ECB would be suitable in light of cyclical circumstances in Denmark. It was also noted that the pass-through of changes in interest rates on the economy has become quicker with the enhanced availability of adjustable rate products, in particular in housing finance.

D. Welfare Reform and Structural Issues

25. **During the mission's visit, the main political parties reached an important agreement on welfare reform** (Box 3). The mission welcomed the agreement, which aims at preparing Denmark for the implications of an aging population. In particular, the agreed gradual increase in the retirement and early retirement ages to 67 and 62 years respectively, while linking retirement ages to life expectancy over the longer term, will help Denmark in maintaining sustainable public finances in the medium to long term.

Box 3. Key Elements of the Welfare Agreement 1/

The agreement includes a variety of measures aimed at later retirement:

- Gradually higher age thresholds in early retirement and public pension schemes:

  (i) Early retirement age raised from 60 to 62 years during 2019-22;
  (ii) Public pension age raised from 65 to 67 years during 2024-27;
  (iii) Retirement ages indexed to the mean life expectancy of 60 year olds as of 2025.

- More flexible early retirement scheme, e.g., through opt-in until 15 years before the early retirement age;
- Adjustments in age limits, etc., related to higher retirement ages;
- Improved job opportunities for older workers;
- Strengthened prevention and workplace health and safety standards;
- Abolition of age-discriminating barriers in the labor market.

In addition, the package includes:

- Efforts to reduce unemployment, including among immigrants and descendants;
- Measures focused on earlier study completion;
- Other measures, including the promotion of secondary education, life-long learning, research, innovation, and entrepreneurship.

1/ Source: www.fm.dk.

26. **The agreement also included some measures aimed at increasing labor supply in the short run.** This involves measures to shorten the educational track, reduce the extended length of unemployment benefits for older workers, increase participation of immigrants in the workforce, and reduce restrictions on foreign workers. The authorities noted that the agreed steps aimed at increasing labor supply in the short term will be helpful. The mission agreed, but also found that, due to a weakening in order to reach a compromise, the measures would not be sufficient to remove bottlenecks. In addition, the mission commented that adoption of a number of recommendations of the Welfare Commission[3] on taxation and the introduction of user fees in the health sector would have been welcome. The authorities noted that the introduction of new user fees is a circumvention of the overall tax freeze unless matched by corresponding tax reductions.

[3] http://www.velfaerd.dk.

27. **The Globalization Council recently issued its report, which reflects an open and positive approach toward globalization.**[4] It includes a large number of recommendations to strengthen Denmark's competitiveness, mostly through increased spending on education, research and development (R&D), and by improving the business climate. The welfare agreement builds on these recommendations. However, the mission noted that, when unfocused and rushed, additional public spending on R&D could be inefficient and would be unhelpful from a cyclical perspective, and therefore expenditures should be linked to clear targets and phased in carefully. In addition, there would be an important role for the private sector in contributing to the efforts.

28. **Product market deregulation in Denmark is well underway**. While it compares favorably to other European countries, and is almost on a par with the United States, the authorities are aware of the need to further increase competition in the infrastructure and public service sectors. Product market reforms proceeded during the past two years, with further liberalization of the energy market and partial privatization of the public postal services. Consumers can now choose gas and electricity suppliers, and prices are more market-based. Competition in the public service sector has been enhanced by allowing the entry of private companies in certain sectors. The mission advised the authorities to use the opportunity of the strong economy to move ahead forcefully with remaining reforms in product and service markets.

29. **The mission participated in a seminar on the merits of the Danish flexicurity model.** This model has attracted international attention for its ability to generate employment and a high level of social security (Box 4). It combines a flexible labor market, generous unemployment benefits, and active labor market policies (Figure 7). Labor market flexibility and active labor market policies have indeed contributed to a significant reduction in unemployment, but the mission noted that high spending on the unemployed has been financed inter alia through a large tax wedge on labor income. However, high costs and moral hazard problems may impede the effective implementation of the flexicurity model. The authorities were well aware of both the advantages and drawbacks of the system, and emphasized that in particular the easy hiring and firing rules have strong historical roots and acceptance in the Danish society.

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[4] http://www.globalisering.dk/page.dsp?area=52.

Box 4. The Danish Flexicurity Model:
Can it be emulated by other European countries?[1]

The Danish labor market model, the so-called flexicurity model, has been widely praised for its association with a low unemployment rate and a high standard of social security for the unemployed. Within this model, a high degree of labor market flexibility coexists with a high level of social protection that is engendered by generous unemployment benefits and active labor market policies. With most European countries facing chronically high unemployment rates but the needed labor market reforms often encountering strong political opposition, the flexicurity model looks increasingly attractive to policymakers in Europe.

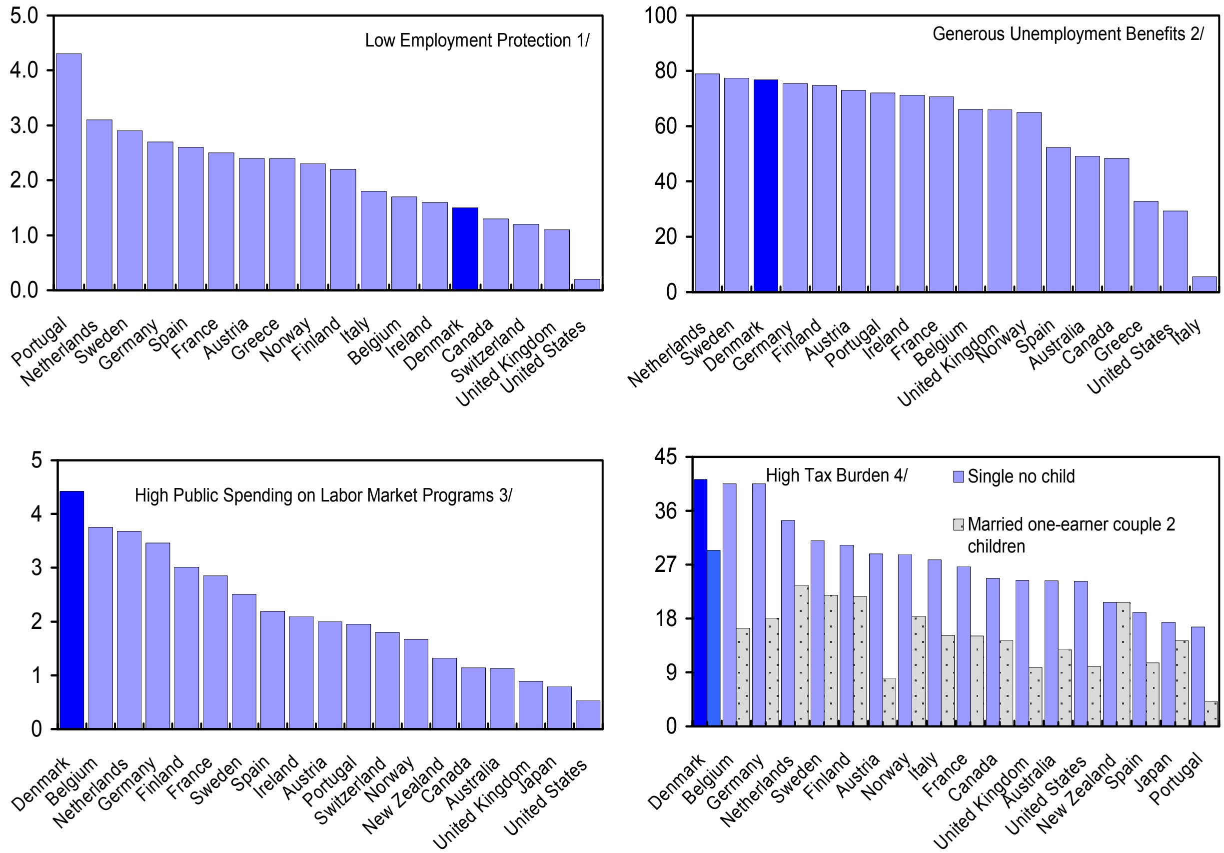
Should and can the Danish model be adopted by other European countries to reduce unemployment? The answer is not obvious. First, Denmark has traditionally had a combination of a flexible labor market and a high level of income protection. Nevertheless, in the early 1980s Denmark experienced high and rising unemployment and inflation, chronic current account deficits, and mounting public deficits. Only after unemployment benefits and labor market policies were tightened, did unemployment come down. Furthermore, other countries have been able to reduce their high unemployment rates to low levels with rather different social models (e.g., Sweden, Ireland, and the United Kingdom).

Often overlooked is the high cost of implementing the Danish model. The tax burden in Denmark is high, and the country has one of the largest tax wedges on labor income among European countries; this is, inter alia, necessary to finance its high spending on labor market programs and unemployment benefits (more than 5 percent of GDP per year). As most countries that are tempted to adopt the Danish model will typically start from a high unemployment level, a move toward the Danish model will, in the short run, trigger a sharp increase in the cost of unemployment benefits and active labor market policies, thereby widening the tax wedge, with an adverse impact on labor demand and supply. Using a calibrated model for France as an example, the selected issues paper finds that implementation of the flexicurity model could be costly, and reduction in structural unemployment during the first few years may be limited.

Nonetheless, certain elements of the Danish model could usefully be studied and considered by other countries. Among others, they include the trade-off between the population's willingness to accept labor market flexibility and the presence of a well-functioning social safety net, and the accompanying need to develop effective labor market policies in order to avoid high costs and perverse incentives. The Danish government's constant awareness and analysis of the challenges facing the flexicurity model, and its ability to respond to them with policy actions are noteworthy in this regard. For instance, since the economic crisis in the early 1980s, reforms have been implemented to shorten the maximum period for participation in active labor market programs and tighten the eligibility criteria for unemployment benefits.

1/ Based on selected issues paper "Danish for All? Balancing Flexibility with Security: the Danish Flexicurity Model".

Figure 7. Key Elements of the Danish Flexicurity Model



Source: OECD.
1/ OECD index on employment protection legislation (EPL) for regular jobs (2003). Higher numbers indicate stricter EPL.
2/ Average net replacement rate over 5 years of unemployment and includes social benefits (2004).
3/ In percent of GDP (2003).
4/ Income tax plus employee contributions less cash benefits, as percent of gross wages (2004).

E. Financial Sector Issues

30. **The FSAP judged the financial system to be generally sound, resilient, and well supervised, but noted the risks associated with an overheating of the economy and the housing market** (Box 5). The mission noted that the booming housing sector warranted close monitoring, strict application of supervisory regulations, and continued campaigns to raise public awareness of the risks involved in overborrowing. It recommended that any easing of capital requirements be done gradually, and that supervisors make use of their authority to require additional capital in individual cases. It also called for further strengthening of the autonomy of the Danish Financial Supervisory Authority (DFSA)—by giving it a statutory basis and granting it greater control over its supervisory budget—and for strengthening of some aspects of governance in financial institutions and cross-border supervision.

Box 5. Denmark FSAP—Main Findings

The Fund conducted an assessment of the Danish financial system under the Financial Sector Assessment Program. The exercise spanned two missions, in November 2005 and May 2006. The results were discussed in the Article IV mission, and are summarized in the accompanying Financial System Stability Assessment paper, which also includes five financial sector ROSCs.

The financial system is generally resilient and well supervised, underpinned by an effective legal and financial infrastructure. In 2005, banks and mortgage credit institutions posted record profits, reflecting substantial fee income from securities trading and refinancing of mortgage loans and low provisions. Insurance companies and pension funds also did well due to higher returns from equities, bonds, and real estate holdings. The life insurance and pension fund segments have addressed the recent problems stemming from issuance in the past of contracts with high guaranteed returns in a low-yield environment. However, they continue to sell products with guaranteed returns that later may cause problems, which requires continued diligence by the DFSA. To forestall any potential problems in the financial sector, the FSAP mission recommended that

- any easing of capital requirements allowing for further expansion of credit be done gradually, and supervisors make greater use of their regulatory authority to require additional capital as appropriate in individual cases; and
- efforts to better monitor, compile information, and model the impact of various shocks be intensified through a buildup of the stress testing capacity at the DFSA.

The mission found a high degree of compliance with international supervisory standards. Going forward, smaller capital cushions of many supervised institutions, new supervisory techniques (Basel II), and international coordination poses challenges for the DFSA. Against this backdrop, the FSAP mission noted that:

- The autonomy and accountability of the DFSA could be entrenched by providing a statutory basis and granting the agency greater budgetary autonomy. With respect to the latter, separation of its regulatory and supervisory budget could be considered.
- The resources available to the DFSA should be considered in light of the need to expand the agency's capacity to verify banks' internal models to calculate liable capital, undertake stress testing, and combat money laundering, which could entail reputational risk for the financial sector.
- While the regulatory framework has worked well in the current environment, it could benefit from certain refinements by upgrading the guideline on internal controls to an Executive Order and broadening the coverage of fit-and-proper requirements.

31. **The authorities agreed with the thrust of the FSAP and noted that they were already following up on some of its recommendations.** In particular, they indicated that, in line with the mission's recommendations, they had cautioned banks to carefully review their internal capital allocation plans to take into account emerging risks. This is to be followed up in the normal supervisory process. In addition, the DFSA had sent a letter to the financial institutions cautioning them about the risks related to the housing market, including those pertaining to new financing instruments.

32. **The authorities indicated that they were planning to formalize the DFSA's role in a statutory provision, as recommended by the mission.** They noted, however, that prospects for the agency's formal budgetary autonomy were not promising since there were few precedents for it in Denmark and a mechanism to provide the agency with additional resources, as warranted, was already in place. They observed that they were evaluating the mission's other recommendations concerning the governance of financial institutions and planned to respond after a careful consideration of the related costs and benefits. The authorities and the financial institutions appeared well aware of the need for contingency planning to address potential threats to business continuity.

IV. Staff Appraisal

33. **The Danish economy has been doing very well lately but is now faced with the risk of overheating.** Economic activity in 2005 and early 2006 was strong, driven in part by rapidly appreciating house prices, and unemployment has reached record low levels. The macroeconomic policy options to cool the economy are limited given ERM2 participation and the already strong fiscal position. A combination of continued public expenditure restraint, a rapid implementation of measures to increase labor supply, wage moderation, and actions to avoid unbalanced housing market developments will be required to maintain macroeconomic and financial stability.

34. **Growth rates are expected to come down gradually during 2006–08, but there are risks.** High capacity utilization and rising interest rates will slow economic activity, and growth is estimated to return to its potential (around 2 percent) in 2008, but this is conditional upon prudent fiscal policies and wage moderation. Risks to this outlook are both on the upside and downside. A further reduction in the already low unemployment rate may give rise to tensions in the labor market and overheating. At the same time, a significant slowdown in the housing market could have a substantial negative effect on growth in domestic demand. On the external side, the economy is sensitive to the exchange rate, the oil price, and the country's position in international sea trade.

35. **Continued wage moderation will be key to moderate demand pressures and maintain international competitiveness.** Upward wage pressures are already evident in the construction and financial sectors. There seems to be a willingness among social partners, at least for now, to agree on relatively modest wage increases, with an eye on international trends and competitiveness. It is important that this consensus be maintained during the upcoming round of wage negotiations.

36. **Fiscal policy should continue to be guided by prudent medium-term objectives.** The current framework aims at reaching structural surpluses of ½-1½ percent of GDP. This framework has enabled an impressive decline in the debt-to-GDP ratio and related interest expenditures. With the recent favorable economic developments and the agreement on welfare reform, there is a risk that the framework will be weakened when it is updated in the

period ahead. A continued strong focus on the medium-term sustainability of public finances, based on realistic assumptions about the economy and the impact of structural reforms, will be required.

37. **Containing expenditure growth will be essential in the current cyclical circumstances.** It has proved difficult, in particular for local authorities, to adhere to the agreed expenditure norms, with public consumption growth exceeding the targets in 2004 and 2005. In line with the new welfare proposals, real public expenditure growth targets are likely to be revised upward. Additional expenditures would add to the already strong demand pressures in the short run. In the same vein, the intention not to introduce tax cuts in 2007 is appropriate and welcome.

38. **The tax freeze has been effective but is unnecessarily rigid.** It has helped control upward pressures on taxes and expenditures. However, its lack of flexibility has resulted in real estate taxation—based on frozen real estate values—that provides an unnecessary stimulus to the housing market. At the same time, high marginal personal income tax rates that become effective at relatively low income levels constrain labor supply. Increasing real estate taxation and reducing personal income taxes correspondingly would augur well for sustainable economic growth and financial stability.

39. **Denmark's exchange regime continues to serve the country well.** The euro peg anchors inflationary expectations and has a strong disciplinary effect on other economic policies, while the resulting level of competitiveness appears appropriate. Recent monetary tightening in line with the ECB will help counter cyclical pressures.

40. **The welfare agreement, reached by major political parties in June, marks an important step toward preparing Denmark for aging.** The agreement will help Denmark maintain sustainable public finances in the long term. Regrettably, the measures aimed at increasing labor supply in the short run were weakened to achieve consensus, thereby leaving cyclical pressures partly unaddressed. Nonetheless, the agreed measures should be implemented promptly.

41. **The Danish flexicurity model deserves praise but comes with a price**. The model has attracted international attention for its ability to combine a flexible labor market, high unemployment benefits, and low unemployment. However, it should be noted that it involves costly active labor market policies and generous benefits, which makes it less applicable to countries with high unemployment and weak public finances.

42. **The FSAP has found the Danish financial system to be generally healthy and well supervised.** In view of the risk of overheating, the authorities are advised to heighten supervisory vigilance and adopt a cautious approach toward any reduction in capital buffers. It would also be important to strengthen the DFSA's statutory and budgetary autonomy, to

further build up its stress testing capacity, and to focus on governance in financial institutions and cross-border supervision.

43. **Close monitoring of the housing market is required.** The sharp increase in house prices in recent years cannot be fully explained by developments in income and interest rates. Favorable tax treatment and the introduction of new financial instruments are likely to have contributed to the rise in prices. The situation warrants close monitoring, strict application of supervisory regulations, and effective consumer information about risks.

44. **Denmark's generous provision of foreign aid is welcome.** Denmark is committed to maintaining development assistance at the internationally high level of 0.8 percent of gross national income.

45. It is proposed that the next Article IV consultation be conducted on the 24-month cycle.

Table 1. Denmark: Selected Economic and Social Indicators, 2000-07

	2000	2001	2002	2003	2004	2005 prel.	2006 proj.	2007 proj.
Supply and Demand (change in percent)								
Real GDP	3.5	0.7	0.5	0.7	1.9	3.2	2.7	2.3
Net Exports 1/	0.6	0.7	-1.1	0.1	-1.4	-0.8	-0.1	0.3
Domestic demand	3.2	0.0	1.7	0.6	3.3	4.1	3.3	2.1
Private Consumption	0.2	0.1	1.5	1.6	3.4	3.9	3.2	2.3
Gross fixed investment	7.4	-1.4	0.1	2.0	4.5	9.4	6.5	3.0
Gross national saving (percent of GDP)	22.6	23.5	22.7	22.8	22.3	23.6	23.7	23.7
Gross domestic investment (percent of GDP)	21.2	20.4	20.4	19.6	20.2	20.8	21.5	21.4
Labor Market (change in percent)								
Labor force	-0.1	0.5	0.1	-1.1	-0.2	-0.2	0.2	0.2
Employment	0.2	0.7	0.1	-2.1	-0.4	0.5	1.2	0.1
Unemployment rate (in percent)	5.4	5.2	5.2	6.2	6.4	5.7	4.8	4.9
Prices and Costs (change in percent)								
GDP deflator	3.0	2.5	2.3	1.9	2.2	2.6	2.5	1.7
CPI (year average)	2.9	2.4	2.4	2.1	1.2	1.8	1.8	2.0
Unit labor costs (manufacturing)	-0.5	3.1	1.9	0.3	2.8	0.5	0.2	0.5
Public finance (percent of GDP)								
General government revenues	56.2	55.7	55.1	54.8	56.5	56.7	54.0	53.3
General government expenditure	53.9	54.5	54.9	54.9	54.8	52.8	51.4	50.8
General government balance	2.3	1.2	0.2	-0.1	1.7	3.9	2.6	2.5
General government structural balance 2/	0.8	1.1	0.4	0.7	0.8	1.7	1.5	1.6
General government primary balance	4.9	3.5	2.5	1.9	3.3	5.2	3.6	3.4
General government gross debt	51.7	48.8	48.4	45.6	43.7	36.2	31.8	28.0
Money and Interest rates (percent)								
Domestic credit growth (end of year)	11.5	9.5	5.1	6.3	8.9	14.9	...	...
M3 growth (end of year)	-5.2	7.7	11.9	11.3	2.7	14.2	...	...
Short-term interest rate (3 month)	4.9	4.6	3.5	2.4	2.1	2.2	...	...
Government bond yield (10 year)	5.7	5.1	5.1	4.3	4.3	3.4	...	...
Balance of payments (in percent of GDP)								
Exports of goods & services	46.6	47.2	47.2	45.0	45.2	48.3	49.4	48.6
Imports of goods	40.5	40.6	41.4	38.9	40.3	43.4	44.8	43.8
Trade balance, goods and services	6.0	6.6	5.8	6.1	4.9	4.9	4.7	4.8
Of which: net oil exports (US$ bln)	1.5	1.0	1.4	1.8	2.6	3.2	3.2	3.2
Current account	1.4	3.1	2.5	3.2	2.3	3.0	2.2	2.3
Exchange rate								
Exchange rate regime				ERM2 Participant				
Average DKr per US$ rate	8.1	8.3	7.9	6.6	6.0	6.0	...	...
Nominal effective rate (2000=100, ULC based)	100.0	101.5	102.7	107.4	108.9	108.4	...	...
Real effective rate (2000=100, ULC based)	100.0	101.3	103.7	108.1	113.9	113.7	...	...

Social indicators (Reference year)
GDP per capita (2005): $48,000; **At-risk-of-poverty rate** (2004): 11 percent.

Sources: IMF, World Economic Outlook; National Bank of Denmark; Denmark Statistics; OECD; Eurostat; and IMF staff projections.
1/ Contribution to GDP growth.
2/ Structural balance is balance corrected for cyclical revenues and expenditures.

Table 2. Denmark. Medium-term Scenario, 2003-11
(Percentage change, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP	0.7	1.9	3.2	2.7	2.3	2.0	2.0	2.0	2.0
Real domestic demand	0.6	3.3	4.1	3.3	2.1	2.0	2.0	2.0	2.0
Private consumption	1.6	3.4	3.9	3.2	2.3	2.0	2.0	2.0	2.0
Public consumption	0.2	1.5	1.3	1.0	1.0	1.0	1.0	1.0	1.0
Fixed investment	2.0	4.5	9.4	6.5	3.0	3.0	3.0	3.0	3.0
Change in stocks 1/	-0.8	0.3	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 1/	0.1	-1.4	-0.8	-0.1	0.3	0.2	0.2	0.2	0.2
Exports	-1.2	2.7	7.9	5.1	5.0	4.7	4.7	4.7	4.7
Imports	-1.7	6.4	10.4	5.8	4.7	4.7	4.7	4.7	4.7
Current account 2/	3.1	2.1	3.0	2.2	2.3	2.3	2.4	2.4	2.5
Inflation									
Consumer Prices	2.1	1.2	1.8	1.8	2.0	1.8	1.7	1.7	1.7
Labor market									
Employment	-2.1	-0.4	0.5	1.2	0.1	0.1	-0.1	-0.1	-0.2
Average unemployment rate	6.2	6.4	5.7	4.8	4.9	5.0	5.1	5.2	5.2
Public finance									
General government balance 2/	-0.1	1.7	3.9	2.6	2.5	1.7	1.4	1.1	1.0
General government structural balance	0.7	0.8	1.7	1.5	1.6	1.6	1.4	1.1	1.0
General government gross debt 2/	45.6	43.7	36.2	31.8	28.0	25.3	23.0	21.0	19.2
Output gap 3/	-1.4	-1.3	0.3	1.2	0.9	0.5	0.1	0.0	0.0

Sources: Denmark Statistics, National Bank of Denmark, and IMF staff estimates.

1/ Contributions to growth
2/ In percent of GDP
3/ In percent of potential output

Table 3. Denmark: Balance of Payments, 2002-11

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
					(in billions of DKr)					
Current Account	34.1	45.8	33.3	46.3	35.8	39.9	41.4	43.3	46.4	48.8
Balance on Goods	64.3	64.1	55.1	49.5	43.7	45.2	45.1	45.1	45.7	45.7
Merchandise exports f.o.b.	437.3	424.5	447.7	497.2	531.2	538.2	551.7	566.2	581.8	601.6
Merchandise imports f.o.b.	-373.0	-360.4	-392.6	-447.7	-487.5	-493.0	-506.7	-521.1	-536.0	-555.8
Balance on Services	17.8	23.1	19.8	29.7	32.6	36.9	40.0	43.6	47.6	51.8
Exports of services, total	209.1	206.5	218.9	250.9	277.4	289.1	304.3	320.5	337.9	358.5
Imports of services, total	-191.3	-183.4	-199.2	-221.1	-244.7	-252.2	-264.2	-277.0	-290.3	-306.7
Balance on Income	-24.7	-17.5	-13.9	-7.5	-11.7	-12.2	-12.6	-13.1	-13.6	-14.1
Receipts	75.9	73.6	76.5	150.4	121.8	126.8	131.5	136.4	141.4	146.7
Expenditures	-100.6	-91.0	-90.4	-158.0	-133.5	-139.0	-144.2	-149.4	-155.0	-160.8
Current transfer, net	-23.3	-24.0	-27.7	-25.4	-28.8	-30.0	-31.1	-32.3	-33.5	-34.7
Capital and Financial Account	-17.6	-47.0	-122.8	-57.8	-35.8	-39.9	-41.4	-43.3	-46.4	-48.8
Capital transfer, net	1.1	0.0	0.2	1.5	1.6	1.7	1.7	1.8	1.8	1.9
Financial Account	-18.7	-47.0	-123.0	-59.3	-37.4	-41.5	-43.1	-45.1	-48.2	-50.7
Direct investment, net	7.4	9.9	-0.5	-24.7	11.8	12.3	12.7	13.2	13.7	14.2
Abroad	-44.9	-8.0	62.1	-57.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
In Denmark	52.3	17.8	-62.6	32.5	11.9	12.3	12.8	13.3	13.8	14.3
Portfolio investment, net	-36.2	-143.4	-147.3	-183.3	-153.6	-159.9	-165.9	-171.9	-178.3	-185.0
Assets	-1.4	-21.9	-42.9	-75.1	-38.5	-40.1	-41.6	-43.1	-44.7	-46.4
Liabilities	-34.8	-121.5	-104.4	-108.2	-115.1	-119.8	-124.3	-128.9	-133.7	-138.6
Other investment, net	18.1	72.2	-41.7	12.7	16.9	17.6	18.2	18.9	19.6	20.4
Reserve assets	-45.4	-30.8	6.2	11.8	-11.9	-15.0	-15.6	-16.6	-18.6	-20.1
Net errors and omissions	-16.5	1.2	89.4	11.5	0.0	0.0	0.0	0.0	0.0	0.0
					(percent of GDP)					
Current Account	2.5	3.2	2.3	3.0	2.2	2.3	2.3	2.4	2.4	2.5
Balance on Goods	4.7	4.5	3.8	3.2	2.7	2.7	2.6	2.5	2.4	2.3
Merchandise exports f.o.b.	31.9	30.1	30.5	32.0	32.5	31.6	31.2	30.9	30.6	30.5
Merchandise imports f.o.b.	-27.2	-25.6	-26.8	-28.8	-29.8	-28.9	-28.7	-28.5	-28.2	-28.2
Balance on Services	1.3	1.6	1.3	1.9	2.0	2.2	2.3	2.4	2.5	2.6
Exports of services, total	15.2	14.7	14.9	16.1	17.0	17.0	17.2	17.5	17.8	18.2
Imports of services, total	-13.9	-13.0	-13.6	-14.2	-15.0	-14.8	-15.0	-15.1	-15.3	-15.6
Balance on Income	-1.8	-1.2	-0.9	-0.5	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Receipts	5.5	5.2	5.2	9.7	7.4	7.4	7.4	7.4	7.4	7.4
Expenditures	-7.3	-6.5	-6.2	-10.2	-8.2	-8.2	-8.2	-8.2	-8.2	-8.2
Current transfer, net	-1.7	-1.7	-1.9	-1.6	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
Capital and Financial Account	-1.3	-3.3	-8.4	-3.7	-2.2	-2.3	-2.3	-2.4	-2.4	-2.5
Capital transfer, net	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Financial Account	-1.4	-3.3	-8.4	-3.8	-2.3	-2.4	-2.4	-2.5	-2.5	-2.6
Direct investment, net	0.5	0.7	0.0	-1.6	0.7	0.7	0.7	0.7	0.7	0.7
Abroad	-3.3	-0.6	4.2	-3.7	0.0	0.0	0.0	0.0	0.0	0.0
In Denmark	3.8	1.3	-4.3	2.1	0.7	0.7	0.7	0.7	0.7	0.7
Portfolio investment, net	-2.6	-10.2	-10.0	-11.8	-9.4	-9.4	-9.4	-9.4	-9.4	-9.4
Assets	-0.1	-1.6	-2.9	-4.8	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Liabilities	-2.5	-8.6	-7.1	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0
Other investment, net	1.3	5.1	-2.8	0.8	1.0	1.0	1.0	1.0	1.0	1.0
Reserve assets	-3.3	-2.2	0.4	0.8	-0.7	-0.9	-0.9	-0.9	-1.0	-1.0
Net errors and omissions	-1.2	0.1	6.1	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:					(percent of GDP)					
Net oil and oil-related exports	0.8	0.8	1.1	1.2	...	...	...	...	...	...
Net sea transportation receipts	0.7	0.9	1.3	2.4	...	...	...	...	...	...
Current Account net of items above	0.9	1.5	-0.1	-0.7	...	...	...	...	...	...
Gross External Debt	121.4	125.6	131.5	146.4	151.7	158.3	165.3	172.1	178.5	184.7
Net External Debt	27.1	23.1	22.6	21.2	19.4	17.8	16.4	15.0	13.5	12.1

Sources: National Bank of Denmark, Statistics Denmark, and IMF staff calculations.

Table 4. Denmark: Net Investment Position, 2000-05
(in percent of GDP)

	2000	2001	2002	2003	2004	2005
Assets	150.7	152.6	144.2	157.6	168.4	194.1
Direct investment abroad	45.3	49.3	44.7	43.4	44.3	48.2
Portfolio investment abroad	52.7	53.9	44.6	53.6	63.2	80.0
Other investment abroad (incl. financial derivatives)	43.0	38.0	40.5	44.2	45.7	52.0
Reserve assets	9.7	11.5	14.5	16.3	15.2	13.9
Liabilities	167.5	169.2	160.6	169.7	174.1	192.5
Direct investment into Denmark	45.6	47.5	42.8	42.4	40.2	41.5
Portfolio investment into Denmark	66.7	70.8	65.7	67.3	74.8	85.5
Other investment into Denmark	54.9	50.5	51.9	59.8	58.9	65.3
Reserve assets	0.3	0.4	0.3	0.3	0.1	0.2
Net investment position	-16.8	-16.5	-16.4	-12.1	-5.7	1.6
Direct investment abroad	-0.3	1.8	1.9	1.1	4.1	6.6
Portfolio investment abroad	-14.0	-16.9	-21.1	-13.6	-11.6	-5.5
Other investment abroad (incl. financial derivatives)	-11.9	-12.6	-11.4	-15.5	-13.2	-13.3
Reserve assets	9.4	11.1	14.2	16.0	15.0	13.8

Sources: National Bank of Denmark and IMF staff calculations

Table 5. Denmark Public Finance, 2002-11
(in percent of GDP)

	2002 Actual	2003 Actual	2004 Actual	2005 Prelim.	2006 Staff	2007 Staff	2008 Staff	2009 Staff	2010 Staff	2011 Staff
General Government										
Total Revenues	55.1	54.8	56.5	56.7	54.0	53.3	52.3	52.0	51.6	51.3
Personal Income Taxes	22.6	22.3	21.7	21.5	20.9	20.8	20.7	20.5	20.3	20.2
Labor Market Contributions	4.5	4.4	4.4	4.3	4.3	4.3	4.2	4.2	4.2	4.1
Pension Return Taxes	0.1	0.4	1.6	2.0	0.3	0.6	0.8	0.9	1.0	1.0
Company Taxes	2.9	2.9	3.2	3.6	3.8	3.4	2.7	2.7	2.7	2.7
VAT	9.6	9.6	9.8	10.0	10.0	10.0	9.9	9.8	9.8	9.8
Social Contributions	1.2	1.2	1.2	1.1	1.1	1.0	1.0	1.0	1.0	1.0
Interest and Dividends	1.5	1.4	1.5	1.3	1.2	1.1	1.2	1.2	1.2	1.2
Other revenues	12.8	12.6	13.1	12.9	12.5	12.0	11.8	11.6	11.4	11.3
Total Expenditures	54.9	54.9	54.8	52.8	51.4	50.8	50.6	50.6	50.5	50.3
Public Consumption	27.3	27.5	27.6	27.1	26.7	26.6	26.5	26.4	26.3	26.3
Transfer Incomes	16.7	17.3	17.2	16.4	15.9	15.7	15.7	15.8	15.9	15.9
Public Subsidies	2.5	2.3	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.2
Interest Expenditures	3.8	3.4	3.1	2.6	2.2	2.0	1.8	1.7	1.6	1.5
Public Investment	1.7	1.6	1.9	1.7	1.8	1.7	1.7	1.7	1.7	1.7
Other Expenditures	2.9	2.8	2.8	2.7	2.7	2.8	2.8	2.8	2.8	2.8
Balance	0.2	-0.1	1.7	3.9	2.6	2.5	1.7	1.4	1.1	1.0
Primary balance	2.5	1.9	3.3	5.2	3.6	3.4	2.3	1.9	1.5	1.3
Structural balance	0.4	0.7	0.8	1.7	1.5	1.6	1.6	1.4	1.1	1.0
Gross Debt	48.4	45.6	43.7	36.2	31.8	28.0	25.3	23.0	21.0	19.2
Central Government										
Total revenues	34.8	34.6	36.3	37.0	34.4	34.0	33.0	32.7	32.3	32.1
Total expenditures	34.6	34.2	34.3	32.7	31.9	31.5	31.4	31.3	31.3	31.1
Balance	0.25	0.40	2.04	4.27	2.56	2.49	1.6	1.4	1.1	1.0

Source: Statistics Denmark and IMF Staff calculations.

Table 6. Denmark: Indicators of External and Financial Vulnerability, 2000-05

	2000	2001	2002	2003	2004	2005
External Indicators						
Exports (annual percentage change, in U.S. dollars)	-2.6	0.0	10.1	18.2	12.9	7.8
Imports (annual percentage change, in U.S. dollars)	-2.3	-1.3	13.6	17.6	17.0	10.3
Terms of trade (annual percentage change)	0.9	0.0	1.2	0.8	0.5	1.5
Current account balance (percent of GDP)	1.4	3.2	2.3	3.1	2.1	3.0
Inward portfolio investment (in percent of GDP)	3.5	6.5	2.7	3.2	4.1	8.0
Inward foreign direct investment (percent of GDP)	20.6	6.9	3.8	1.3	-4.3	2.1
Official reserves (in billions of U.S. dollars, end-of-period)	15.0	18.1	27.7	38.1	40.1	33.9
Official reserves in months of imports	2.8	3.4	4.1	4.8	4.4	3.9
Exchange rate per U.S. dollar (period average)	8.06	8.32	7.87	6.58	5.98	5.99
Financial markets indicators						
Public sector debt (Maastricht definition)	51.7	48.8	48.4	45.6	43.7	36.2
3-month T-bill yield (percent)	4.9	4.6	3.5	2.4	2.1	2.2
3-month T-bill yield (real, percent)	2.0	2.3	1.1	0.3	1.0	0.4
Spread of 3-month T-bill over EURIBOR (percentage points)	0.5	0.4	0.2	0.0	0.0	0.0
10-year government bond yield (percent)	5.7	5.1	5.1	4.3	4.3	3.4
10-year government bond yield (real, percent)	2.7	2.7	2.6	2.2	3.1	1.6
Spread of 10-year government bond rate with Germany (percentage points)	0.4	0.4	0.4	0.5	0.6	0.2
Stock market index (period average)	301.7	294.4	236.0	218.8	269.4	340.5
Financial Soundness Indicators						
Capital Adequacy						
Regulatory capital to risk-weighted assets (Tier 1+Tier 2)	12.7	12.9	13.5	13.9	13.4	13.2
Tier 1 capital to risk-weighted assets	9.9	9.6	10.2	10.7	10.7	10.2
Capital (net worth) to assets 1/	6.7	6.2	5.7	5.9	5.7	5.7
Asset Composition and Quality						
Sectoral distribution of lending to residents						
Nonfinancial companies	28.9	32.7	30.9	35.9	36.0	33.8
Financial institutions	30.3	27.3	31.8	26.2	22.2	26.1
General government	2.3	2.6	2.5	2.9	2.8	2.4
Households	37.1	36.1	33.9	34.2	37.8	36.2
Other	1.3	1.3	0.8	0.8	1.2	1.6
Geographical distribution of lending to non-residents						
Euro area	26.7	27.8	24.3	21.1	20.6	20.0
Great Britain	26.8	22.8	23.3	26.6	28.4	26.1
Sweden	14.6	21.3	24.8	26.4	29.0	29.5
Norway	4.9	8.4	10.3	8.4	8.7	10.0
USA	5.1	5.4	5.2	5.1	3.2	4.2
Other countries	22.0	14.4	12.1	12.3	10.1	10.2
Nonperforming loans to gross loans and guarantees	0.5	0.5	0.6	0.6	0.5	0.3
Nonperforming loans to gross loans	0.7	0.7	0.9	0.8	0.7	...
Nonperforming loans net of provisions to Tier 1 capital	0.9	1.3	2.0	2.0	1.8	...
Provisions to nonperforming loans	81.1	76.5	66.5	63.0	66.0	...
Stock of total provisions to total gross loans	2.5	2.3	2.2	2.3	1.5	1.0
Loan loss provisions made during the year to total gross loans	0.3	0.4	0.3	0.4	0.1	0.0
Sum of large exposures to Tier II capital 2/	103.2	128.8	133.8	139.1	139.7	146.1
Foreign currency loans to total loans *	...	...	...	35.9	38.9	42.2
Loans to assets	73.7	70.0	67.9	68.3	66.4	66.0
Credit growth	14.8	7.4	1.5	4.6	14.2	24.7
Earnings and Profitability						
ROA before tax	...	1.1	1.0	1.2	1.3	1.3
ROA after tax	...	0.8	0.7	0.9	0.9	1.0
ROE before tax	...	17.3	16.7	20.8	17.7	21.2
ROE after tax	...	12.8	12.1	15.4	13.7	16.3
Net interest income to gross income	63.1	69.9	72.1	66.9	64.4	67.7
Net fee and commission income to gross income	27.8	26.5	26.4	25.2	28.9	32.3
Noninterest expenses to gross income	66.4	61.1	62.3	57.3	60.6	61.4

Table 6. Denmark: Indicators of External and Financial Vulnerability, 2000-05 (concluded)

Liquidity						
Liquid assets to total assets (exclusive of interbank lending)	4.3	5.3	7.7	8.0	6.1	7.4
Liquid assets to total assets (inclusive of interbank lending) 3/	29.6	25.0	28.3	29.3	26.6	30.2
Liquid assets to short term liabilities 4/	110.7	91.6	112.3	117.0	103.3	120.6
Gross loans to deposits	114.1	113.8	109.4	103.3	105.4	115.3
Liquidity coverage as a percentage of the requirement	...	152.8	153.1	189.5	176.9	140.1
Net external liabilities to total liabilities 5/	2.0	7.4	8.9	12.1	10.5	13.4
Sensitivity to Market Risk						
Interest rate loss exposure to Tier 1 capital 6/	2.6	3.5	2.6	3.4	1.8	1.5
FX exposure to Tier 1 capital 1 7/	6.4	7.3	8.4	7.6	5.2	5.9
FX exposure to Tier 1 capital 2 8/	0.1	0.1	0.1	0.1	0.1	0.3
Net position in equities to capital	36.9	31.2	24.1	28.1	29.9	19.9
Net position in financial derivatives to capital 9/	-3.6	-1.6	-7.7	-7.5	-6.9	0.1
Earnings per share	0.7	0.9	0.9	1.2	1.2	1.7
Market value to book value ratio	...	0.9	0.9	1.3	1.6	1.9
Indicators for other sectors						
Number of corporate bankruptcies 10/	175.0	214.0	188.0	232.0	225.0	226.0
Real estate price index (1995=100) 11/**	162.1	171.5	195.1	190.4	226.3	261.0

Sources: FSA, National Bank of Denmark, Statistics Denmark, IFS.

1/ Shareholders' equity to total assets.

2/ Large exposures are defined as the sum of assets and off-balance-sheet items that, after a reduction for secured exposures, exceeds 10 percent of the combined Tier II and Tier III capital.

3/ Included in liquid assets are on balance sheet cash, loans to MFIs and bonds with original maturity of less than a year.

4/ Included in short-term liabilities are deposits available on demand and time deposits with original maturity of less than a year .

5/ Bank external liabilities net of external assets to total liabilities.

6/ Loss as a percent of Tier I capital due to an increase in interest rates by 100 bps.

7/ FX Indicator 1 is calculated as the largest amount of the short-term currency exposures and the long-term currency exposures.

8/ FX Indicator 2 adjusts the foreign currency exposure for fluctuations in the exchange rates vis-à-vis the Danish krona.

9/ Balance sheet financial derivative assets net of financial derivative liabilities to capital and reserves.

10/ Bankruptcies total in all industries, monthly data, seasonally adjusted.

11/ Residential and business property index.

Note:

(*) As of July 2005.

(**) As of September 2005.

Appendix I: Denmark—Fund Relations

(As of June 30, 2006)

I. **Membership Status**: Joined March 30, 1946. Denmark has accepted the obligations of Article VIII.

II. **General Resources Account**:

	SDR Million	Percent Quota
Quota	1,642.80	100.00
Fund holdings of currency	1,508.20	91.81
Reserve Tranche position	134.60	8.19

III. **SDR Department**:

	SDR Million	Percent Allocation
Net cumulative allocation	178.86	100.00
Holdings	43.47	24.30

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None.

VII. **Exchange Rate Arrangements**:

Denmark participates in the Exchange Rate Mechanism 2 (ERM2). It maintains 2¼ percent fluctuation margins vis-à-vis the euro with a central fixed rate at DKr 746.038 per €100.

In accordance with UN resolutions and EU restrictive measures, Denmark applies targeted financial sanctions under legislation relating to Al-Qaeda or Taliban, and individuals, groups, and organizations associated with terrorism; certain persons associated with the former Government of Iraq and its state bodies; specific assets of certain persons associated with to important government functions in Myanmar; funds related to military activities in Somalia; funds in relation to Mr. Milosevic and those persons associated with him; funds, other financial assets and economic resources of individual members of the Zimbabwe Government and natural or legal persons associated with them; certain claims by Libya, Liberia, Sudan, Republic of Congo, and the Haitian authorities. These restrictions have been notified to the Fund under Decision 144-(52/51).

VIII. **Article IV Consultation**: Denmark is on the 24-month consultation cycle. The staff report for the last Article IV consultation (IMF Country Report No. 04/240) was discussed at EBM/04/76 (August 2, 2004).

IX **Technical Assistance**: None.

X. **Resident Representative**: None.

Appendix II: Denmark—Statistical Issues

The quality and timeliness of the economic database are very good and adequate for surveillance purposes. Denmark has a full range of statistical publications, all of which are on the Internet. Denmark subscribes to the Fund's Special Data Dissemination Standard (SDDS). Metadata are posted on the Dissemination Standards Bulletin Board.

The authorities have introduced new data on monetary financial institutions that conform to the *ESA95* and expanded the set of financial institutions covered in the National Bank's statistical bulletin. This permits monitoring of some categories of financial institutions not previously covered (e.g. money market funds, small banks, and cooperative banks), allowing a more thorough assessment of the financial sector. Some of the financial account data come from this enhanced source. Data for the central bank and other depository corporations are reported to STA on a timely and regular basis. The ECB framework, which is used by the authorities for reporting monetary data to STA, provides comparable detail as the Standardized Report Forms developed by STA.

DENMARK: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(AS OF AUGUST 2, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	6/30/06	7/5/06	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/06	5/06	M	M	M
Reserve/Base Money	6/06	7/06	M	M	M
Broad Money	6/06	7/06	M	M	M
Central Bank Balance Sheet	6/06	7/06	M	M	M
Consolidated Balance Sheet of the Banking System	6/06	7/06	M	M	M
Interest Rates[2]	6/30/06	7/5/06	M	M	M
Consumer Price Index	6/06	7/06	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005	4/30/06	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2005	4/30/06	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2005	4/06	A	A	A
External Current Account Balance	3/06	4/06	M	M	M
Exports and Imports of Goods and Services	3/06	4/06	M	M	M
GDP/GNP	Q1 2006	7/06	Q	Q	Q
Gross External Debt	Q4 2005	5/06	Q	Q	Q

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

Appendix III: Denmark—Debt Sustainability Analysis

This Appendix analyses the medium-term (2006–11) sustainability of general government debt and external debt of the overall economy.

External debt sustainability. Denmark's external position is strong reflecting a series of current account surpluses since 1990 (with the exception of a small deficit in 1998). The net investment position turned positive in 2005 (see Table 4), while net external debt declined from 34 percent of GDP in 2001 to 21 percent in 2005 (see Table A1). Under the baseline scenario it will decline further, reaching 12 percent in 2011. The alternative scenarios and bound tests indicate that this result is rather robust, rising only by two percentage points of GDP under the worst scenario (a shock to the non-interest current account).

Public sector debt sustainability. In a similar vein, a history of fiscal surpluses has reduced the public sector debt to 36 percent of GDP from 49 percent in 2001 (Table A2). Under the baseline scenario, which assumes that the tax freeze remains in effect, it will decline further to 19 percent in 2011. Under the relevant stress test scenarios the level of debt reaches at most 24 percent of GDP in 2011.

Table A1. Denmark: External Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	33.7	27.1	23.1	22.6	21.2	**19.4**	**17.8**	**16.4**	**15.0**	**13.5**	**12.1**	**-0.3**
2 Change in external debt	-1.2	-6.6	-4.0	-0.5	-1.5	-1.7	-1.6	-1.5	-1.4	-1.5	-1.4	
3 Identified external debt-creating flows (4+8+9)	-3.8	-4.3	-4.1	-2.8	-1.4	-3.5	-3.5	-3.4	-3.4	-3.5	-3.5	
4 Current account deficit, excluding interest payments	-4.8	-3.9	-4.1	-3.0	-3.6	-2.9	-3.1	-3.1	-3.0	-3.1	-3.1	
5 Deficit in balance of goods and services	-6.6	-6.0	-6.2	-5.1	-5.1	-4.7	-4.8	-4.8	-4.8	-4.9	-5.0	
6 Exports	47.1	47.1	44.8	45.4	48.1	49.4	48.6	48.5	48.4	48.4	48.7	
7 Imports	40.5	41.1	38.6	40.3	43.0	44.8	43.8	43.6	43.6	43.5	43.8	
8 Net non-debt creating capital inflows (negative)	0.7	-0.9	-1.3	-0.6	2.9	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	
9 Automatic debt dynamics 1/	0.3	0.5	1.4	0.8	-0.7	0.2	0.3	0.4	0.4	0.3	0.3	
10 Contribution from nominal interest rate	1.6	1.4	0.9	0.7	0.6	0.7	0.7	0.7	0.7	0.6	0.6	
11 Contribution from real GDP growth	-0.2	-0.1	-0.2	-0.4	-0.7	-0.5	-0.4	-0.3	-0.3	-0.3	-0.3	
12 Contribution from price and exchange rate changes 2/	-1.1	-0.7	0.7	0.5	-0.6	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	2.7	-2.3	0.1	2.3	-0.1	1.7	1.9	2.0	2.0	2.0	2.0	
External debt-to-exports ratio (in percent)	71.5	57.6	51.6	49.8	44.0	39.3	36.7	33.8	30.9	27.9	24.8	
Gross external financing need (in billions of US dollars) 4/	22.2	11.6	10.0	22.4	21.3	21.2	19.3	18.6	16.9	14.7	12.5	
in percent of GDP	13.8	6.6	4.7	9.1	8.2	7.7	6.5	6.0	5.2	4.3	3.5	
Scenario with key variables at their historical averages 5/						**19.4**	**16.4**	**12.9**	**9.4**	**6.1**	**2.7**	**-1.0**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.7	0.5	0.7	1.9	3.2	2.7	2.3	2.0	2.0	2.0	2.0	
GDP deflator in US dollars (change in percent)	-0.7	8.1	22.0	12.3	2.6	3.4	5.0	2.5	2.4	2.6	2.7	
Nominal external interest rate (in percent)	4.7	4.5	4.0	3.5	2.8	3.6	4.1	4.2	4.3	4.4	4.5	
Growth of exports (US dollar terms, in percent)	1.7	8.6	16.8	16.1	12.2	9.1	5.7	4.3	4.4	4.7	5.4	
Growth of imports (US dollar terms, in percent)	0.4	10.3	15.3	19.6	13.0	10.5	5.1	4.3	4.3	4.5	5.4	
Current account balance, excluding interest payments	4.8	3.9	4.1	3.0	3.6	2.9	3.1	3.1	3.0	3.1	3.1	
Net non-debt creating capital inflows	-0.7	0.9	1.3	0.6	-2.9	0.7	0.7	0.7	0.7	0.7	0.7	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table A2. Denmark: Public Sector Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing primary balance 9/**
1 **Baseline: Public sector debt 1/**	48.8	48.4	45.6	43.7	36.2	**31.8**	**28.0**	**25.3**	**23.0**	**21.0**	**19.2**	**0.6**
o/w foreign-currency denominated	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.3	0.3	
2 Change in public sector debt	-2.9	-0.4	-2.8	-1.8	-7.6	-4.4	-3.8	-2.7	-2.3	-2.0	-1.8	
3 Identified debt-creating flows (4+7+12)	-2.8	-1.6	-1.3	-3.6	-6.4	-4.4	-3.8	-2.7	-2.3	-2.0	-1.8	
4 Primary deficit	-5.2	-4.0	-3.3	-4.8	-6.5	-4.8	-4.5	-3.5	-3.1	-2.7	-2.5	
5 Revenue and grants	55.7	55.1	54.8	56.5	56.7	54.0	53.3	52.3	52.0	51.6	51.3	
6 Primary (noninterest) expenditure	50.5	51.1	51.5	51.7	50.2	49.3	48.8	48.8	48.9	48.9	48.8	
7 Automatic debt dynamics 2/	2.4	2.4	2.0	1.2	0.1	0.3	0.7	0.8	0.8	0.7	0.7	
8 Contribution from interest rate/growth differential 3/	2.4	2.4	2.2	1.3	0.1	0.3	0.7	0.8	0.8	0.7	0.7	
9 Of which contribution from real interest rate	2.8	2.7	2.5	2.1	1.5	1.3	1.4	1.4	1.3	1.2	1.1	
10 Of which contribution from real GDP growth	-0.4	-0.2	-0.3	-0.8	-1.3	-0.9	-0.7	-0.6	-0.5	-0.5	-0.4	
11 Contribution from exchange rate depreciation 4/	0.0	0.0	-0.1	-0.1	0.0	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	-0.1	1.2	-1.5	1.7	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	87.7	87.9	83.1	77.4	63.8	58.8	52.4	48.3	44.2	40.7	37.5	
Gross financing need 6/	-1.2	-0.2	0.1	-1.7	-3.9	-2.6	-2.5	-1.7	-1.4	-1.1	-1.0	
in billions of U.S. dollars	-1.9	-0.4	0.2	-4.1	-10.2	-7.2	-7.5	-5.2	-4.6	-3.8	-3.7	
Scenario with key variables at their historical averages 7/						**31.8**	**27.7**	**23.5**	**19.2**	**14.7**	**10.1**	**0.3**
Scenario with no policy change (constant primary balance) in 2005-2010						**31.8**	**27.7**	**23.8**	**19.8**	**15.6**	**11.4**	**0.4**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.7	0.5	0.7	1.9	3.2	2.7	2.3	2.0	2.0	2.0	2.0	
Average nominal interest rate on public debt (in percent) 8/	8.1	7.9	7.2	7.0	6.2	6.3	6.5	6.7	6.9	7.0	7.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.6	5.6	5.3	4.8	3.6	3.8	4.8	5.1	5.3	5.4	5.5	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.1	5.7	19.7	9.9	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.5	2.3	1.9	2.2	2.6	2.5	1.7	1.6	1.6	1.6	1.6	
Growth of real primary spending (deflated by GDP deflator, in percent)	2.4	1.7	1.5	2.3	0.2	0.8	1.4	2.0	2.2	2.1	1.9	
Primary deficit	-5.2	-4.0	-3.3	-4.8	-6.5	-4.8	-4.5	-3.5	-3.1	-2.7	-2.5	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Denmark

On September 29, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Denmark.[1]

Background

The Danish economy underwent major changes over the last two decades. A macroeconomic stabilization program adopted in the mid-1980s was followed by structural reforms in the 1990s. The fixed exchange rate regime helped anchoring inflation expectations and imposed discipline on macroeconomic and structural policies, contributing to the strong fiscal performance.
In recent years, fiscal policy, guided by prudent medium-term objectives, resulted in budget surpluses and a significant decline in public debt as a share of GDP. Following a decade of current account surpluses, foreign debt also fell markedly.

After a period of slow growth, the Danish economy accelerated in 2004–05, driven by domestic demand, and registered a growth rate of 3.2 percent in 2005, more than twice that of the Euro area. Private consumption was boosted by high real disposable income owing to tax reductions in 2004, low interest rates, and house price developments. Sharply rising house prices also spurred double-digit residential investment growth. Real public consumption growth decelerated

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.
On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

slightly in 2005, but remained well above the 0.5 percent target. Exports and imports grew sharply, and the current account reached a surplus of 3 percent. Staff forecast growth of around 2¾ percent in 2006, slowing down to about 2¼ in 2007.

Inflation remains contained, but is catching up with that in the euro area. The unemployment rate fell to 4.5 percent in June 2006, the lowest level in 30 years. Strong growth and a flexible labor market contributed to a notable pickup in employment. Labor market conditions have consequently tightened, and in both the construction industry and the financial sector labor shortages appear to have emerged. Despite the decline in unemployment, the number of participants in labor market programs remains high. In June, agreement was reached on a reform of the welfare system, including future increases in retirement ages and labor supply measures.

In 2005 the fiscal surplus reached 3.9 percent, much higher than budgeted and than the surplus in 2004. This was due to strong revenue growth, largely attributable to high revenues from pension return and corporate income taxation, including revenues from the oil-and-gas related activities in the North Sea. In addition, government expenditures declined as a percentage of GDP. Given that revenue developments were mainly cyclical, the structural balance shows a smaller improvement. General government debt came down further from about 44 percent of GDP at end-2004 to 36 percent of GDP at end-2005.

Policy interest rates have followed the recent increases by the ECB. Asset prices rose rapidly in 2005 and the profitability of financial institutions is at record high. Banks and mortgage credit institutions posted record profits with a substantial contribution from fee income due to securities trading and refinancing of mortgage loans. Denmark participated in the Financial Sector Assessment Program (FSAP) in the course of 2005–06.

Executive Board Assessment

The Executive Directors commended the authorities' record of stability-oriented policies and welcomed the economy's recent strong performance, with high growth rates and low unemployment. Directors viewed that recent interest rate increases and capacity utilization constraints should contribute to a gradual slowing in growth rates in the period ahead. Continued public expenditure restraint, and measures to increase labor supply and moderate wages will reduce the risk of overheating associated with tensions in the labor market and domestic demand pressures. Directors observed that developments in the housing market should be closely monitored.

Directors emphasized that fiscal policy should continue to be guided by prudent medium-term objectives. They noted that the current framework, which aims at reaching structural surpluses of ½–1½ percent of GDP, has enabled an impressive decline in the debt-to-GDP ratio. Directors cautioned against a weakening of the framework when it is updated in the period ahead, and stressed the need for a continued strong focus on the medium-term sustainability of public finances, based on realistic assumptions about the economy and the impact of structural reforms.

Directors expressed concern that an upward revision in real public expenditure growth targets, in line with the new welfare proposals, would add to the demand pressures in the short run. They supported the authorities' intention not to introduce tax cuts in 2007, noting that the tax freeze has helped control upward pressures on taxes and expenditures, and has been a useful disciplinary device. Directors observed, however, that constrained tax flexibility has resulted in property taxation that is partially frozen in nominal terms, which has provided an unnecessary stimulus to the housing market. At the same time, high marginal personal income tax rates, which become effective at relatively low income levels, constrain labor supply. A gradual and predictable elimination of the partial nominal property tax freeze, aimed at avoiding a shock to the market, and a corresponding reduction in personal income taxes would be supportive of sustainable economic growth.

Directors agreed that Denmark's exchange regime continues to serve the country well by anchoring inflationary expectations and imposing discipline in other economic policy areas. They considered the overall level of competitiveness appropriate, and noted that the recent monetary tightening in line with the ECB would help counter cyclical pressures.

Directors emphasized the importance of continued wage moderation to temper demand pressures and maintain international competitiveness. They welcomed the willingness of social partners in recent years to agree to responsible wage increases, with an eye on international trends and competitiveness, and encouraged them to maintain this consensus during the upcoming round of wage negotiations.

Directors welcomed the welfare agreement, reached by major political parties in June, which marks an important step toward preparing Denmark for aging, and maintaining sustainable public finances in the long term. They urged the authorities to implement forcefully the agreed measures.

Directors noted that the Danish flexicurity model has worked well, contributing to Denmark's low unemployment. At the same time, they observed that it involves costly benefits and active labor market policies, which may make it less applicable to countries with high unemployment and weak public finances. Nonetheless, the model merits study by other countries, as a possible way to increase labor market flexibility.

Directors welcomed the outcome of the FSAP, which found the Danish financial system to be generally healthy and well supervised. In an environment of rapid credit growth, the authorities were advised to heighten supervisory vigilance and adopt a cautious approach toward any reduction in capital buffers. Directors underscored the importance of strengthening the supervisor's statutory and budgetary autonomy, its stress testing capacity, and efforts regarding governance in financial institutions and cross-border supervision.

Directors noted that the recent sharp increase in house prices cannot be fully explained by developments in income and interest rates. They noted that favorable tax treatment and the introduction of new financial instruments are likely to have contributed to the rise in prices. Directors recommended close monitoring of the housing market, strict application of supervisory regulations, and effective consumer information about the risks of overborrowing.

Directors commended Denmark's generous official development assistance, which amounts to the internationally impressive level of 0.8 percent of gross national income in 2006.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2006 Article IV Consultation with Denmark is also available.

Denmark: Selected Economic Indicators

	2001	2002	2003	2004	2005 prel.	2006 proj.
Real Economy						
Real GDP (change in percent)	0.7	0.5	0.7	1.9	3.2	2.7
Domestic demand (change in percent)	0.0	1.7	0.6	3.3	4.1	3.3
CPI (change in percent, year average)	2.4	2.4	2.1	1.2	1.8	1.8
Unemployment rate (percent)	5.2	5.2	6.2	6.4	5.7	4.8
Gross national saving (percent of GDP)	23.5	22.7	22.8	22.3	23.6	23.7
Gross domestic investment (percent of GDP)	20.4	20.4	19.6	20.2	20.8	21.5
Public Finance (percent of GDP)						
Central government balance	0.2	0.2	0.4	2.0	4.3	2.6
General government balance	1.2	0.2	-0.1	1.7	3.9	2.6
General government structural balance	1.1	0.4	0.7	0.8	1.7	1.5
General government gross debt	48.8	48.4	45.6	43.7	36.2	31.8
Money and Interest rates (percent)						
Short-term interest rate (3 month)	4.6	3.5	2.4	2.1	2.2	...
Government bond yield (10 year)	5.1	5.1	4.3	4.3	3.4	...
Balance of payments (in percent of GDP)						
Trade balance, goods and services	6.6	5.8	6.1	4.9	4.9	4.7
Of which: net oil exports (US$ bln)	1.0	1.4	1.8	2.6	3.2	3.2
Current account	3.1	2.5	3.2	2.3	3.0	2.2
FDI (net, percent of GDP)	-1.2	0.5	0.7	0.0	-1.6	...
Official reserves (US$ billion, net)	17.9	24.8	34.4	36.9	35.7	....
Gross external debt (percent of GDP)	124.8	121.4	125.6	131.5	146.4	...
International investment position (percent of GDP)	16.7	17.4	13.3	9.0	-1.6	...
Exchange rate						
Exchange rate regime			ERM2 Participant			
Average DKr per US$ rate	8.3	7.9	6.6	6.0	6.0	...
Nominal effective rate (2000=100, ULC based)	101.5	102.7	107.4	108.9	108.4	...
Real effective rate (2000=100, ULC based)	101.3	103.7	108.1	113.9	113.7	...
Fund Position (as of June 30, 2006)						
Holdings of currency (in percent of quota)						91.8
Holdings of SDRs (in percent of allocation)						24.3
Quota (in millions of SDR)						1,642.8

Sources: National Bank of Denmark; Denmark Statistics; Eurostat; and IMF staff projections.

Statement by Tuomas Saarenheimo, Executive Director for Denmark and Ole Hollensen, Senior Advisor to Executive Director September 29, 2006

On behalf of our Danish authorities, we would like to thank the Fund's staff team for candid and constructive policy discussions in Copenhagen during the Article IV and FSAP missions. They appreciated the circulated set of high quality papers addressing topical issues for the Danish economy. Our authorities broadly concur with staff's analysis and assessment and will carefully consider the recommendations.

Outlook and Risks

The Danish economy has performed quite well for some time and is presently experiencing a strong recovery with buoyant employment growth, record low unemployment and significant surpluses on both the fiscal and external balance. Our authorities expect—as does staff—a continued strong GDP growth of 2.7 percent in 2006, down from 3.6 percent in 2005 against the backdrop of increasing interest rates and high capacity utilization. In 2007, GDP growth is assumed to moderate further in line with a soft landing.

As stated by staff, risks to the outlook are mainly related to factors that enhance the risk of overheating. Hence, one concern is that labor shortages become more pronounced. The unemployment rate is now at the lowest level in more than 30 years and further reductions would tend to imply stronger wage pressure. In the 2nd quarter of 2006, wage increases accelerated slightly, exceeding 3 percent (y/y) for the first time in 2 years. The strongest wage increase, 4.4 percent y/y, was reported for wages in the construction sector. The authorities are aware of the possible implications of labor shortages, and the recently agreed welfare reforms include elements to increase labor supply also in the short run. Another important risk relates to developments in the housing market, where the last two years have been characterized by large increases in real estate prices. The accompanying activity boost in the construction sector and the rise in household demand—induced by wealth effects—have to a large extent contributed to the increase in domestic demand. However, a significant increase in the supply of dwellings for sale and a slower pace of sales during this summer indicates that the interest rate increases since the fall of 2005 have now had a more visible effect on the housing market. In the official forecast a pronounced deceleration in the growth of housing prices is anticipated. Overall, our authorities concur with staff's assessment that continued wage moderation is very important in reducing overheating risks and that close monitoring of the housing market is required.

Fiscal Policy

Staff shows concern about pressures to loosen fiscal policy given the large general government surplus reaching a record high of 3.9 percent of GDP in 2005. The Danish authorities fully understand this concern and the government's proposal for the 2007 fiscal bill, submitted in late August, points to a slight tightening of fiscal policy if the present plans for a significant decline in public investments materialize. Furthermore, the authorities have stressed the need for public expenditure control, referring to the present situation with GDP growth rates exceeding potential growth and taking into consideration long-term fiscal sustainability and the need to reduce public debt. Indeed, the large fiscal surpluses are to be used to bring down the public debt consistent with the Plan 2010. This is important considering the business cycle conditions and the long-term challenges that are related to ageing of the population. In this context it is important to note also that the current Plan 2010 leaves no scope for new tax reductions that are not fully financed.

Our authorities welcome staff's support for the medium term fiscal framework based on the Plan 2010. The Plan 2010 contains guidelines for economic policy in order to ensure long-term fiscal sustainability in light of an ageing population (including a shrinking work force), and requires yearly structural surpluses of ½-1½ percent of GDP on average. Achieving structural surpluses in this range ensures the necessary reduction of public debt. Due to the strength of the Danish economy, public debt is brought down faster than in the path set out in the original Plan 2010. The authorities have announced an intention to update the fiscal framework in 2007 covering the period up to at least 2015 and reflecting the recently agreed welfare reforms. In line with the Plan 2010, long-term fiscal sustainability will also be the main focus of the new medium-term plan.

Together with the rapid repayment of public debt, the historical June 2006 ”Agreement on future prosperity and welfare and investments in the future” (*Welfare Agreement*) helps to ensure fiscal sustainability. In light of globalization and the efforts required to ensure continued growth and prosperity in the future, the Welfare Agreement includes an earmarked amount of DKK 2 billion in 2007 increasing to DKK 10 billion in 2012 (approximately 0.5 percent of GDP) to be invested in research, education, innovation and entrepreneurship. Staff worries about the timing of this increased expenditure in a situation with considerable domestic demand and high capacity utilization. As such, the welfare reforms should be seen as a package of different initiatives aiming at increasing the labor force in the short and long run. As a consequence of the increased expenditures, real public consumption growth will exceed the assumed growth rate in the Plan 2010 by 0.5 percentage point and amount to 1.0 percent in the years 2007-2010. A real growth rate of 1 percent corresponds to slightly less than the average public consumption growth in the period 2001-2005 and is half the average growth rates of public consumption of 2 percent per year in the 1990's.

The Danish tax freeze, which is also a part of the medium term fiscal framework, serves as a means to control the tax burden and to dampen public expenditure growth. Staff considers the tax freeze effective but unnecessarily rigid, referring to the inability to carry out revenue neutral tax adjustments. In the present situation with large wealth accumulation in the housing market and potential gains from a larger labor supply, staff favors a reduction of labor income taxation financed by increased real estate taxation. The Danish authorities find that the advantages of the tax freeze in its current form exceed the drawbacks and attach weight to the simple and widely understood purpose of the tax freeze making it a credible and strong commitment device.

The authorities welcome staff's support for the ongoing local government reform that is implemented in order to ensure a more efficient public sector structure. The issue of transformation costs related to the reform has been dealt with in the yearly budget negotiations with municipalities and counties. It is agreed that most expenses can be kept within the current expenditure ceiling. However, in 2006 there has been a one-off increase in local government expenditure level of approximately DKK 0.5 billion due to certain transformation costs. In 2006-2007 a special lending pool has been set aside for municipalities and counties to meet the necessary costs of new investments.

Monetary and Exchange Rate Policy

Our authorities welcome the assessment that the Danish fixed-exchange rate policy continues to serve Denmark well. The peg to the Euro helps anchoring inflationary expectations and is thus a cornerstone of the stability oriented economic policy. In this respect it is important to note that inflation has been very stable around a level corresponding to ECB's definition of price stability for many years. At the same time competitiveness is sound as witnessed by the combination of a low level of unemployment and a healthy surplus on the current account. The advantages of the discipline that the peg imposes on social partners and on fiscal and structural policies seem to outweigh the theoretical disadvantage that interest rates do not correspond fully to cyclical conditions in Denmark.

DNB closely follows interest rate movements by the ECB. We agree with staff that any future rate increases by the ECB would be welcome in light of cyclical circumstances in Denmark. The pass-through of changes in interest rates on the economy has become quicker with the more widespread use of adjustable rate products, in particular in housing finance.

Welfare Reform and Structural issues

The Welfare Agreement represents a historical response to the long-term challenges due to ageing of the population and our authorities welcome staff's support for the reform. The introduction of a variety of measures to enlarge the labor force has given a significant contribution to ensure long term fiscal sustainability for many decades ahead. The Welfare Agreement includes, among other things, measures to increase the retirement age. The early retirement age will be raised from 60 to 62 years during 2019–2022 and the statutory public pension age will be raised from 65 to 67 during 2024–2027. In addition to this, a mechanism to adjust retirement ages in line with the increase in life expectancy is introduced. This mechanism will be introduced in 2015 with effect from 2025. At the same time, the Agreement includes measures to increase labor supply in the short run. These measures include efforts to reduce unemployment among older workers and immigrants, earlier completion of education and easier access for foreign workers to the Danish labor market etc.

The Welfare Agreement is not as far reaching as proposed by the Danish Welfare Commission, but the Danish authorities consider the reform an important step in the right direction and well composed. With the Welfare Agreement the Danish economy seems well prepared to meet the challenges of the future.

Financial Sector Issues

The FSAP exercise confirms that the Danish financial system appears resilient and is well supervised, underpinned by an effective legal and financial infrastructure. There is good coordination between the various domestic institutions responsible for financial sector stability.

The Danish government will thoroughly consider the recommendation concerning the institutional set up of the Danish Financial Supervisory Authority. However, decisions concerning the budget of an agency such as the DFSA are a matter for the Parliament as part of the annual revision of the Danish National Budget. The DFSA is allocated increased resources when given new assignments.

On the basis of analyses and stress tests, the DNB's most recent Financial Stability Report concluded—in line with the Fund—that the financial institutions are still robust and that there are currently no black clouds on the horizon that could threaten financial stability in Denmark. Stress tests will in the future be given higher priority in the DNB's assessment of financial stability. It should also be noted that the DFSA is developing the use of stress tests for monitoring the soundness of financial institutions.

The new Basel II capital requirements could, for institutions which apply for the use of the internal rating based approaches for credit risk and advanced measurement approach for operational risk, imply potentially large decreases in the minimum capital requirements. To ensure that any large potential decrease in capital requirement will be gradual, the Danish regulation has included floors that set the maximum decrease in capital requirements for institutions using the advanced methods in 2007, 2008 and 2009, in accordance with the EU Capital Requirement Directive. Furthermore the DFSA will have the possibility of setting additional capital requirements in individual cases.

The DFSA will consider issuing executive orders instead of guidelines. The benefits of such executive orders will have to be viewed against the increased costs that these may imply for the supervised entities. However, there are definitely supervisory benefits in upgrading the guidelines to legislation. Specifically, regarding the recommendation to extend the field of the "fit-and-proper" regulation to all key staff, and not just board members, our authorities generally concur that it could be useful if the DFSA had the possibility to take action towards unfit staff members. However, it also seems an unnecessary burden on the financial institutions if such key staff members should have a "fit-and-proper" approval in advance. Such measures would also claim a considerable part of resources from the DFSA, and it is in the opinion of the DFSA doubtful whether the benefits will exceed the costs.

It must be stressed that Denmark is at an advanced stage in the implementation of the 3rd Money Laundering Directive. The implementing act has been adopted by the Parliament. Parts of the act have already entered into force. The remaining parts enter into force on January 1, 2007. The necessary implementing measures will enter into force on this date as well. The examination has thrown light on some shortcomings and the examination has, therefore, been very helpful for the implementation and the work related to formulating the administrative provisions.

The FSAP confirms that the Danish payment and securities settlement systems are safe and efficient. The DNB and the DFSA will thoroughly analyze the recommendations for improvements.

Other Issues

The flexicurity model analyzed in the selected issues paper combines a flexible labor market, high unemployment benefits and active labor market policies. It has been very successful in reducing unemployment in Denmark. As noted by staff though, the model is costly and sensitive to moral hazard problems. Still, the Danish authorities find that the flexicurity model can serve as inspiration for countries struggling with high unemployment.

When considering the public spending on labor market programs in figure 7 in the main report and in figure 4 of the selected issues paper, we find that the diagram may overstate the size of the tax wedge in Denmark compared to other countries. While income taxes are high in Denmark compared to most other Western European countries, social security contributions are relatively low. Hence a diagram that included employers' social security contributions would increase the tax wedge for all countries, but more so for countries other than Denmark. The data also deducts cash benefits from the tax burden of a wage earner. This is highly questionable since such cash benefits are means tested and, therefore, cannot be considered a negative tax. Comparisons across countries of such data are, therefore, particularly difficult.

As staff's analysis in the other selected issues paper shows, Danish house prices have increased considerably during the last couple of years, with nominal growth rates of 9 percent in 2004 and 17 percent in 2005. Staff's analysis suggests that the acceleration of house prices is not fully explained by high income growth and falling interest rates. Both an effectively functioning mortgage market with a number of new products and the tax system and the tax freeze have contributed to the increase in house prices. The Danish authorities are aware of the risks of over borrowing in the housing market and are monitoring the development closely in order to prevent possible imbalances.

Since 1978, Denmark has consistently provided development assistance of more than 0.7 percent of GNI, among the highest of any country. For the coming years, the Government will ensure that Denmark's ODA does not fall below 0.8 percent of GNI.