INTERNATIONAL MONETARY FUND

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DENMARK

2012 ARTICLE IV CONSULTATION

January 2013

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 2012 Article IV consultation with Denmark, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 5, 2012, 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 December 20, 2012. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its January 16, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Denmark.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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International Monetary Fund
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INTERNATIONAL MONETARY FUND

DENMARK

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

December 20, 2012

KEY ISSUES

Denmark's recovery from the global financial crisis is faltering and risks are weighted to the downside given the close trade and financial links to the euro area and its peg to the euro. However, growth is expected to resume in late 2012 and gain momentum in 2013. In this context, the authorities should:

- Manage the domestic impact of international capital flows arising from the peg to the euro by taking the necessary foreign exchange market intervention and policy interest rate adjustments;
- Allow automatic stabilizers to operate fully and prepare contingency plans to support the economy through discretionary fiscal policy in the event of a weaker-than-expected economy or slower-than-expected spending on investment or spending by municipal governments;
- Undertake reforms to raise potential growth including through further measures to boost competition, contain the size of government, and limit tax disincentives to work and the accumulation of human capital;
- Strengthen the financial sector through more robust capital and liquidity buffers, risk-based deposit insurance premia, and gradually phase-out deferred amortization mortgage loans; and
- Remain engaged in the development of the euro area banking union given that a well-functioning banking union would enhance the EU single market.

Denmark is well-positioned to address these policy challenges. Gross public debt is about 50 percent of GDP and its triple-A credit rating supports market access on favorable terms.

Approved By
Mahmood Pradhan and Peter Allum

Discussions took place in Copenhagen from October 25 through November 5, 2012. The staff comprised Mr. Dorsey (head), Mmes. Batini, Mordonu, Xiao, and Zoli (all EUR). Mr. Andersen and Ms. Pedersen (both OEDNO) joined parts of the mission. An advance team led by Ms. Batini and including Ms. Xiao visited Stockholm on October 24 to discuss cross-border financial sector issues.

CONTENTS

TABLES

INTRODUCTION

1. **A new center-left government took office in October 2011, but economic policy is little changed.** There is a broad political consensus on maintaining the peg to the euro and sticking to the fiscal targets needed to meet Denmark's Excessive Deficit Procedure (EDP) commitments to the EU. The new government also approved a pension reform with a phased increase in the retirement age that had been negotiated by its predecessor.

2. **Despite a faltering recovery, growth is expected to resume and gain momentum in 2013.** Output has fallen in three of the most recent five quarters, GDP remains well below pre-crisis levels, and headline inflation remains under 3 percent. However, output returned to slight positive growth in 2012 Q3.

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

4. **The exchange rate peg to the euro guides monetary policy.** Monetary policy has faced a significant challenge in defending the peg with large inflows seeking a financial safe haven in Denmark. Interest rate reductions by Danmarks Nationalbank (DN) culminated in a negative interest rate on marginal reserve deposits with the central bank in July 2012. This had the desired effect thus far, of discouraging further inflows and reducing the pressure on the DN to purchase foreign exchange reserves.

5. **Risks are substantial and clearly tilted to the downside.** Further slowdown or renewed recession in major trade partners, especially in the euro area, could weigh heavily on Danish exports. Renewed financial turmoil could raise funding costs for banks reliant on wholesale funding; a further decline in housing prices could put pressure on banks and households and depress still-weak private consumption.

6. **Nevertheless, Denmark is well-positioned to address its macroeconomic policy challenges.** Gross public debt is about 50 percent of GDP and partially offset by substantial government deposits at the DN, the current account surplus is about 5 percent of GDP, and its triple-A credit rating supports market access on favorable terms.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. The Economic and Financial Context

7. **The global financial crisis hit Denmark hard, and the recovery has been slow and unsteady.** Output fell by nearly six percent in 2009 and recovered only about one third of this loss by mid-2012. Output has fallen in three of the five quarters through 2012 Q3.

8. Denmark's slow growth predates the recent economic crisis, and the economy has underperformed its regional peers during the past two decades. Despite a sound macroeconomic framework, a highly-skilled labor force, high participation rates, and an improvement in the terms of trade over the past decade, productivity growth has been sluggish and average income growth has been less than in other northern European countries. Over the same period, wage increases have been high relative to European peers and productivity growth has been slow, leading to a large increase in unit labor costs (Figure 5 and Selected Issues, Chapter 3).

9. The 2012 budget deficit is expected to widen to 4.2 percent of GDP from 2.0 percent in 2011, reflecting one-off stimulus measures, repayment of early retirement contributions and slower than expected growth. The stimulus measures included an acceleration of capital spending into 2012 and 2013, "balanced budget" stimulus through off-budget public enterprise infrastructure to be funded by higher prices and tariffs, and various other budgetary measures (Box 1). The authorities have also introduced a ceiling on public spending at the national, regional and municipal levels from 2014 to address longstanding problems of controlling spending at sub-national levels (Box 2) and a tax policy reform to foster employment and output growth.

10. The current account remains in surplus, largely reflecting weak domestic demand since the crisis and strong net income. Denmark's current account remains positive at around 5 percent of GDP thanks to an upward trend in service exports and net income flows reflecting a strong net international investment position (Table 5). Capital inflows have been concentrated in portfolio investment, offsetting large but falling outflows of FDI and other investments. International reserves have more than doubled since end-2008, and inflows continued into the first half of 2012.

11. Monetary policy is based on maintaining a tight peg to the euro. Safe-haven inflows over the last year have pushed short-term Treasury bill yields to negative levels since late 2011. The continuing inflows and upward pressure on the exchange rate led the central bank to a series of interest rate reductions culminating in July 2012 with a shift to a negative interest rate (-0.2 percent) on banks' marginal reserves with the central bank. Together with actions taken by the ECB at around the same time, this seems to have had the desired effect of discouraging the safe-haven inflows that have led to the substantial reserve buildup. Some of the costs and benefits of these safe-haven inflows are examined in Chapter 2 of the Selected Issues paper.

12. The exchange rate valuation appears broadly appropriate. Evidence from specific indicators is mixed. The macro balance and external sustainability approaches under the External Balance Assessment (EBA) point to a moderate currency undervaluation, based on a calculation that Denmark's current account position is stronger than its estimated norm; by contrast, the real equilibrium exchange rate results point to a moderate currency overvaluation (with a correspondingly opposite view on the current account balance). Despite upward pressures from the onset of the European debt crisis, the krone has been maintained within a narrow band of half a percentage point or less relative to the euro in nominal terms.

Staff's External Balance Assessment

	EBA Estimates[a]
	Aug-12
Macro Balance	3–5[b]
Equilibrium RER	-4
External Stability	5

(a) In percent. Figures indicate deviations from the cyclically-adjusted current-account to GDP ratio (in percent) from their estimated norm.

(b) The range captures differences in the cyclically adjusted current account and the current account norm in the EBA estimates.

13. **Households and corporates are still in the process of repairing their balance sheets**. Household savings rates have risen following the bursting of a housing price bubble and the consequent decline in household net wealth (Box 3). While household net wealth is strong, gross household debt was 315 percent of disposable income in 2012 Q2, many households are net debtors, and most household assets are in the form of illiquid pension balances and real estate. The stock market rebounded to pre-crisis levels in the first half of 2012. Corporate leverage ratios have fallen with reduced borrowing from banks and increases in retained earnings.

14. **Denmark's financial system has rebuilt capital but still has substantial vulnerabilities.** Banking system assets are roughly 400 percent of GDP. Profitability and asset quality are lower than in northern and central European peer countries. Loan-to-deposit ratio and reliance on wholesale funding are high. Loan impairments are rising, especially among small- and medium-sized banks (Table 6). Chapters 3 of the Selected Issues paper assesses recent reforms and the scope for further action, and Chapter 4 considers the potential contingent liabilities to the government that are implied by current spreads and bank equity prices.

B. Outlook and Risks

15. **Staff projects 2013 growth at 0.9 percent of GDP, lifted mostly by private consumption and moderate business investment growth.** This is broadly in line with third party forecasts but somewhat below the authorities' projections. Inflation is expected to remain below 3 percent throughout the projection period thanks to a slowly-closing output gap (Table 2).

16. **Potential growth is expected to recover gradually to nearly 1½ percent over the medium-term.** Staff estimates that the combined effect of the fallout of Denmark's property market collapse and the global financial crisis shaved ½ percentage points from the trend level of Denmark's GDP. The upward trend in potential growth over the medium term largely reflects the expected recovery in investment spending. Staff's estimates and projections imply an output gap of

about 2.1 percent in 2012 that would largely close by 2017 as confidence is only gradually restored and credit conditions return to more normal levels.

17. Most risks to growth are tilted to the downside. A weaker outlook in Europe and worsening global financial conditions pose the largest downside external risks; a 1 percentage point drop in EU growth would reduce Denmark's growth by about 1 percentage point. External assets are dominated by claims on core euro area and the Nordic-Baltic region, both of which are vulnerable to tail risks in the euro area. The banking system is exposed to liquidity shocks in global financial markets due to its high reliance on wholesale funding. Negative interest rates on banks' marginal deposits with the DN could hurt bank profitability and induce disintermediation if maintained over the longer run. A sudden reversal of safe-haven capital flows to Denmark could require monetary tightening, which would hurt the recovery and make private sector deleveraging more difficult.

18. Stretched household balance sheets and domestic demand are the main domestic risks. A further decline in housing prices could have sizeable spillovers to the rest of the economy (Box 4).[1] Acceleration of bank deleveraging could also pose risks if write-downs in the Danish banking sector are higher than implied by current NPL ratios and banks reduce domestic lending to meet capital requirements.

The Authorities' Views

19. The authorities largely agree on the nature and direction of the risks. However, they do not see as much risk from household debt levels as staff, and note that households with higher debt also tend to be those with higher and more stable income.

[1] A 10-percent house price correction would deduct by about 3 percent of GDP from household balance sheets and would imply a reduction in annual consumption of 0.5–0.9 percent of GDP based on a marginal propensity to consume from wealth of 0.03 to 0.06.

Denmark: Risk Assessment Matrix[1]

	Relative Likelihood	Impact if realized
Strong intensification of euro area crisis	**Medium** Denmark's trade partners and financial ties are with countries in the euro area or closely linked to it.	**High** Deleveraging and fiscal drag could affect the outlook for the euro area with potential spillover to Danish financial institutions including through increased volatility in asset prices or increased strains on bank borrowers.
Stagnation of euro area growth	**Medium** Denmark's main trade partners are either in the euro area or are also closely linked to it.	**High** Denmark's main trade partners are either in the euro area or are also closely linked to it. Continued stagnation or recession in the euro area would depress Danish output due to reduced exports. A slowing of the pace of fiscal consolidation may be appropriate.
Stagnation of world growth	**Medium** Danish service exports (e.g., shipping) are linked to trade beyond Europe.	**High** A slowdown in demand from emerging Asia and the U.S., particularly if in addition a stagnation in the euro area, could put additional pressure on Danish exports.
Sharp fall in Danish house prices	**Low** Danish house prices have fallen significantly, but a further decline cannot be ruled out.	**Medium** A further decline in house prices would likely further dampen domestic demand through wealth effects and would result in at least some additional pressure on financial institutions through rising NPLs, possibly requiring a targeted policy response.
More acute deleveraging by the Danish banking system	**Low** A gradual deleveraging has been underway for some time, but shocks could cause it to accelerate.	**Low** If write-downs in the Danish banking sector are higher than expected, banks may have difficulties meeting capital requirements and could be forced to reduce domestic lending.
Sudden reversal of safe-haven flows	**Low**	**Low** Recent monetary policy actions to purchase foreign exchange and lower interest rates to very low levels might need to be reversed.
Note: L, M, H denote low, medium and high.		
[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff’s subjective assessment of the risks surrounding this baseline. The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities.		

POLICY DISCUSSIONS

20. Discussions focused on four areas:

- Balancing fiscal consolidation with the use of near-term fiscal policies to support of the recovery;
- Managing the domestic impact of international capital flows resulting from the peg to the euro;
- Further adapting micro- and macro-prudential policies to existing risks and the evolving EU regulatory framework; and
- Continuing measures to increase private and public sector productivity to foster longer-term growth.

A. Fiscal Policy

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

22. The authorities' medium- and long-term fiscal plans set out a prudent and strong fiscal path through 2020 provided productivity growth can be strengthened. The authorities have relatively detailed fiscal plans through 2020 and less detailed scenarios that capture the implications of trends such as demographic shifts through 2100. However, the projections would benefit from additional sensitivity analysis that could take into account a divergence between growth in real wages, spending, and productivity. In particular, the assumption of an above-trend productivity growth rate might be revisited or contingency measures could be considered in the event that the assumed increase in productivity growth does not materialize in the 2012–20 period. Staff acknowledge that specific measures to be implemented beyond 2020 would best be developed in subsequent plans; however, more sensitivity analysis in the government's very long-term scenarios could better inform those future decisions.

The Authorities' Views

23. The authorities agree on the possible downside risks, but they stress that they attach a very high priority to meeting their 2013 targets under the EDP and exiting from it in early 2014. In addition to complying with their EU agreements, the authorities believe that failing to meet the targets would undermine financial market confidence in Denmark's continued willingness to take the measures necessary to maintain fiscal sustainability. They observed that tax-based stimulus measures would be likely to have relatively low multipliers but agreed that it would be difficult to identify and implement additional good-quality capital projects. They did not plan any phase-out of existing tax preferences for housing over the medium term.

B. Monetary and Exchange Rate Policy

24. The longstanding peg to the euro has served Denmark well in anchoring inflation and minimizing exchange rate volatility vis-à-vis major trade partners. Recent safe-haven inflows have complicated the management of monetary policy in support of the exchange rate peg. The authorities' interest rate reductions, including the move to a negative policy rate, have been successful thus far in containing these inflows and reducing the pressure to accumulate reserves. However, the impact of negative rates on bank profitability and lending should be kept under review, particularly if the rate is set at a still lower level. The benefits and potential risks from negative interest rates and possible means of mitigating the impact on bank profitability by targeting the negative rates at large depositors are discussed in Chapter 2 of the Selected Issues paper.

The Authorities' Views

25. The authorities strongly reiterated their commitment to the peg to the euro, and noted that they would take whatever actions were needed in terms of interest rate measures and foreign exchange market interventions to defend it. On the negative interest rate, they agree that this is an unusual move, but they observed that the shift from a zero to a negative policy rate implies a cost to banks of only 0.02 percent of GDP for a banking system with assets of roughly 400 percent of GDP, and that such a shift in policy rates had no more adverse impact on bank earnings than a 20 basis point reduction between two positive policy rates. On the level of reserves, they noted that their commitment to the peg required them to adjust reserves and interest rates to market conditions; thus they saw no scope for a target level of reserves under the current monetary framework.

C. Financial Sector Policy

26. The staff noted the progress made in strengthening the banking sector and reducing banks' dependency on state guarantees. Three-year loans to banks are helping to replace expiring state guarantees, prudential regulations have been strengthened through the "supervisory diamond" indicators, and the activation of the new resolution procedures applying haircuts to senior bank debt has reduced the perception of an implicit government guarantee on banks. However, bank profits remain weak and estimated default probabilities have risen (Figures 8 and 9). Also, capital buffers may not be as robust as regulatory measures indicate and risk weights may understate actual risk (see Selected Issues, Chapter 4) and market prices for bank equity and credit default swaps imply significant potential fiscal risk from the banking sector (see Selected Issues, Chapter 5). In this context, the authorities should continue to monitor bank performance and funding costs closely.

27. The staff welcomed the planned creation of the interagency Systemic Risk Council to be charged with making recommendations on macroprudential policy. The Council and the entities responsible for implementing its recommendations (e.g., the economic ministries and the Financial Supervisory Authority) should have clear roles and responsibilities, consistent with their institutional mandates, and information-sharing and coordination arrangements.

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

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

30. The staff also suggested measures to strengthen crisis prevention. The strengthening of ex ante deposit insurance has been an important step, but risk-based deposit insurance premiums could further encourage sound risk management and discourage risky behavior. Also, deferred-amortization mortgage loans should be limited for macro-prudential reasons and the decoupling of taxes from real-estate values should be reconsidered as both appear to have contributed to excessive volatility in housing markets.

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

The Authorities' Views

32. The authorities agreed in principle with the staff on financial sector reform, but emphasized the need for a level playing field among banks from different countries. On risk-based deposit insurance, they noted that they would wait to see the forthcoming EU regulations before taking action. Similarly, on treating the CRD IV standards as a floor, they would need to be guided by the final form of the CRD IV directive. Finally, they noted that the current draft of the Basel III regulations would have a severe impact on Danish financial markets through its preferential treatment of government securities relative to covered bonds, regardless of the potentially better liquidity and risk profile of the latter. Denmark has a large covered bond market but a small government bond market, reflecting the important role of Danish mortgage banks, which provide approximately two-thirds of total credit to Danish borrowers and are almost fully funded through covered bonds. They hope that this would be revised in future versions of the Basel III regulations.

33. On the proposed banking union, they largely agreed with staff and emphasized the importance of having an effective voice within the supervisory framework. Moreover, they expressed the concern that a resolution and deposit insurance mechanism could be applied in other countries to place a smaller burden on bank creditors and a correspondingly larger burden on the public sector, which would be shared across members of the union to the disadvantage of Danish taxpayers.

D. Productivity and Competitiveness

34. The mission was encouraged by the authorities' actions to address the challenges of improving competitiveness and productivity growth. In the private sector, Denmark's overall business environment is judged to be among the best in the world in international rankings. Further, the package of competition reforms announced on October 26 addresses many of the known impediments to competition in specific sectors (e.g., reducing barriers to competition in construction and pharmacies, although not restrictions on large retail stores, and measures to make public procurement more transparent and competitive). In the public sector, several measures taken in recent years to reduce the tax wedge on labor income have increased incentives for work and human capital accumulation. Also, the new system of sanctions for overspending by municipal governments has contained unplanned expansion of public spending thus far, and this should help to limit crowding out of the private sector. The work of Statistics Denmark on efficiency of public spending may provide the basis for further reforms in specific areas. (Chapter 1 of the Selected Issues paper compares expenditures with social outcome in health, education, and other areas to those in other OECD countries to identify areas for possible efficiency gains.) The report of the Productivity Commission expected in late 2013 could set out a roadmap for productivity-enhancing reforms to improve unit labor costs and competitiveness more generally.

STAFF APPRAISAL

35. **Despite a faltering recovery, growth is expected to resume and gain momentum in 2013**. Nevertheless, Denmark is well-positioned to address its macroeconomic policy challenges with its low public debt and strong credit rating.

36. **To support the recovery, the authorities should stand ready to take additional action to support the economy and consider a less rapid fiscal adjustment if growth falls below current projections or sub-national government and investment spending falls below budgetary projections**.

37. **The longstanding and tight peg to the euro has served Denmark well in anchoring inflation and minimizing exchange rate volatility vis-à-vis major trade partners and remains appropriate**.

38. **The planned creation of an interagency council charged with making recommendations on macroprudential policy and the committee charged with identifying and proposing prudential arrangements for systemic institutions are both welcome**. However, crisis prevention could be strengthened through risk-based deposit insurance premiums, limitations on deferred amortization mortgage loans, and a reversal of the decoupling of taxes from real-estate values to limit excess volatility in housing markets. The authorities should also use any flexibility in forthcoming EU directives on banking sector capital and liquidity to strengthen the resilience of the banking system, treating these directives as floors rather than targets where appropriate.

39. **The authorities' openness to the proposed EU banking union is welcome, and they should continue supporting the process of developing such a union in light of the potential benefits in terms of financial stability within the euro area**. However, more work is needed on developing an effective voice within the supervisory mechanism for non-euro-area countries and on a resolution mechanism and deposit insurance that are critical for a well-functioning banking union.

40. **The ongoing work of the Productivity Commission is welcome and the staff encourages it to lay out a set of productivity-enhancing reforms to improve unit labor costs and competitiveness throughout the Danish economy in the report planned for late 2013**.

41. **It is recommended that the next Article IV consultation with Denmark be held on the current 24-month consultation cycle.**

Box 1: Recent Fiscal Measures

In the past three years Danish governments have introduced policies to promote fiscal adjustment and long term sustainability, while, at the same time, supporting the economy.

Consolidation measures for 2011–13 in **the 2009 "Spring Package**" included higher energy taxes and a broader corporate tax base.

The 2010 Consolidation Agreement included a reduction in public consumption growth in 2011–13, a shortening of the unemployment benefit period from four to two years, and better controls on sub-national expenditures and taxes.

The 2011 retirement reforms increased the in the standard age for old-age pension from 65 to 67 over 2019–22 (previously schedules to take place over 2024–27), shortened the Voluntary Early Retirement Pension (VERP) scheme by increasing the early retirement age from 60 to 62 years over 2014–17 and further to 64 years by 2023 and allowed existing VERP contributors to exit and withdraw their contributions.

The authorities responded to the deterioration in the economic outlook for 2012 with a "Kick-start" package that frontloaded 1 percent of GDP in budgetary and public enterprise investment in 2012–13 that was originally planned for 2014–20, offsetting part of the cost by raising some excise taxes and abolishing some tax exemptions.

A June 2012 tax reform included: a gradual increase in the top tax bracket and an increase in the tax deduction for labor income from 2013 to 2022; an extra employment allowance for single parents from 2014; and an increased deduction for investment equipment through end-2013.

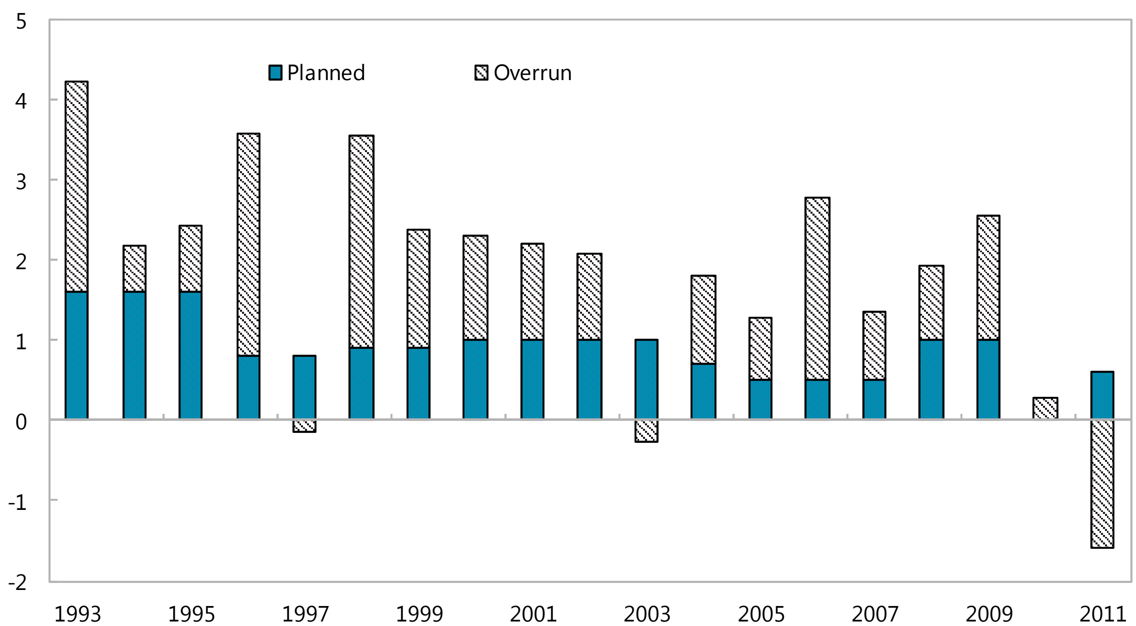
The Budget Act adopted in Spring 2012 and expected to be fully implemented in 2014 incorporates the Fiscal Compact's structural balanced budget rule into national legislation, and introduces expenditure ceilings at the national and sub-national levels on a four-year rolling basis with the Danish Economic Councils in charge of assessing if the ceilings are respected. In the case of the central government, budget overruns in one year must be compensated by reducing expenditure in the following year so that the level of debt is not affected. Collectively, the retirement reform and the reforms in the Budget Act are expect to control spending in the near-term and reduce spending in the longer term by around 2 to 4 percent of GDP.

Box 2: Municipal Government Spending Overruns: Policy Measures

After nearly two decades during which growth in public consumption almost always exceeded planned levels, often by large margins, a further tightening of the sanction mechanism for municipalities was enacted in 2010 in connection with the Fiscal Consolidation Agreement. This appears to have established effective control over such overspending for the first time in 2011. Municipalities account for almost half of public consumption expenditure, and they used to be responsible for a large share of total budget overruns.

In the period 2009–10, sanctions on municipalities for overruns relative to framework agreements led municipalities to budget their expenditure at lower level than the agreed frameworks. A further tightening of the sanction mechanism enacted in 2010—taking effect from 2011—extended the implementation of sanctions to overruns in the accounts relative to the agreed level of service expenditure (and not only budgets as previously). Sanctions are reductions in block grants to municipalities that apply both collectively and individually to municipalities.

Growth in public consumption
(Percent)

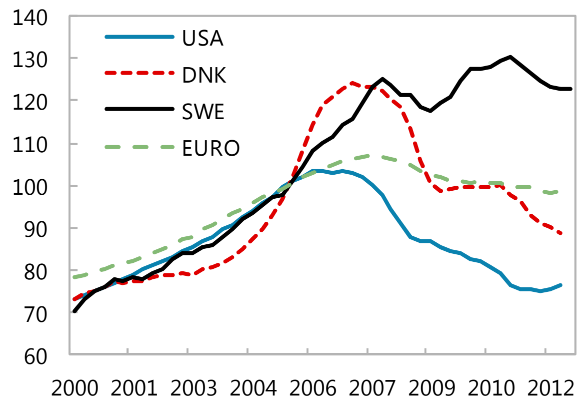


Sources: Danmarks Nationalbank and Fund staff calculations.

Box 3: How Vulnerable is Denmark's Housing Market?

The Danish housing market continued its decline through 2011 and the first half of 2012, despite a short respite in 2010. Real house prices have fallen by 26 percent since their peak in 2007Q1, after a two-year period in which prices rose by over 60 percent. Housing starts declined by 17 percent in 2011, and by 28 percent in the first half of 2012 relative to the first six months of 2011. Year-on-year prices for the residential properties fell by 5–6 percent in 2012 Q2.

Real House Prices
(Index: 2005=100)

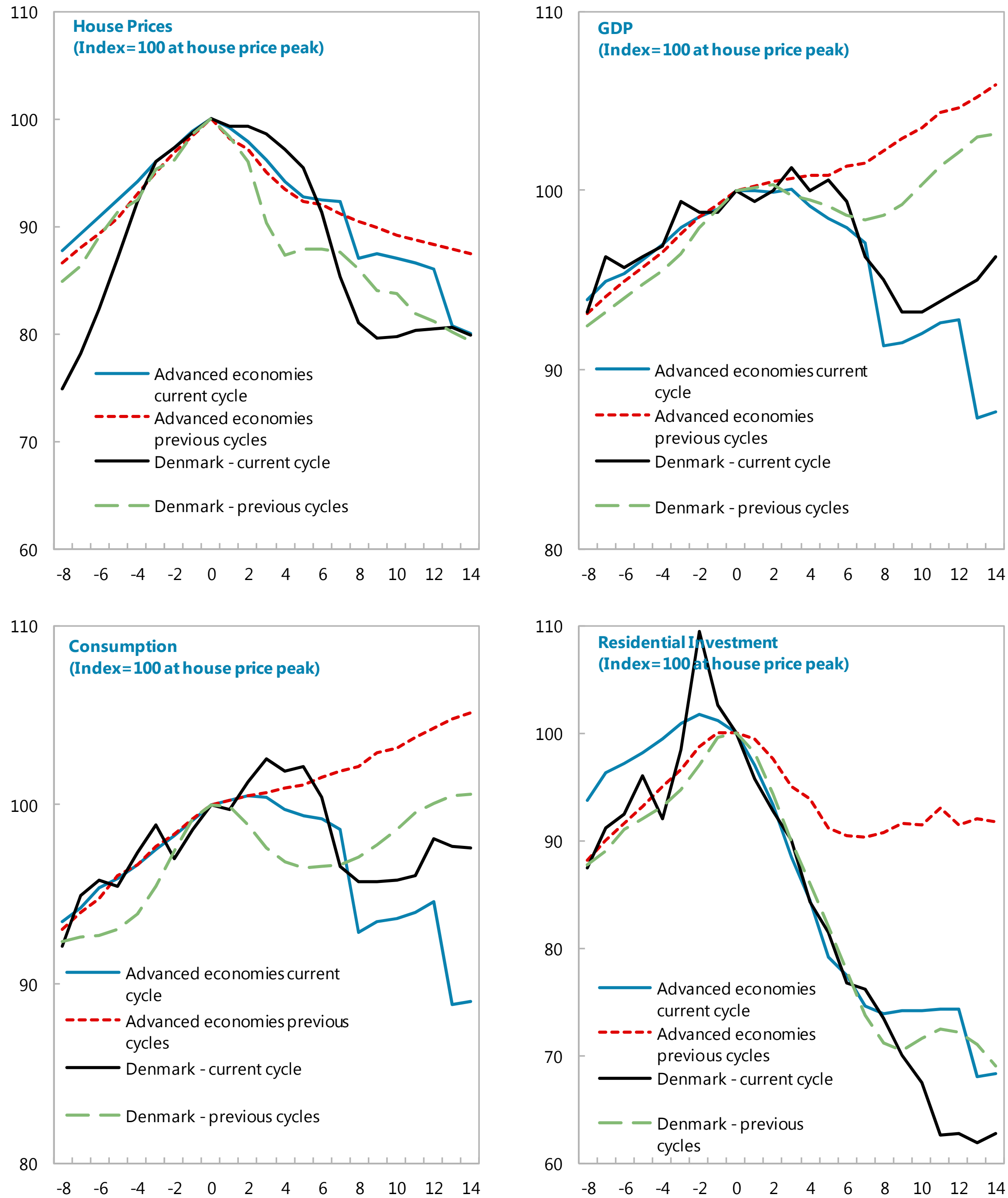


Sources: OECD and Fund staff calculations.

Indicators of house price misalignment are mixed. The price-to-income ratio and price-to-rent ratio remain above their 1970–2010 historical averages but by less than one standard deviation (0.7 and 0.9 respectively).

The housing market remains vulnerable. Mortgage loans with variable rates and deferred amortization loans (interest-only for 10 years) account for 74 and 56 percent of the mortgages respectively. Given the high debt levels of Danish households, this creates a threat of higher delinquencies should rates rise or incomes fall.

Box 3: How Vulnerable is Denmark's Housing Market? (concluded)
Denmark & Advanced Economies: Previous versus Current Housing Cycles



Sources: OECD and Fund staff calculations.

Box 4. Financial Sector Policy Initiatives

The authorities have launched a series of financial policy initiatives to bolster the banking system:

- Introduced the "supervisory diamond", which is to be phased in by end-2012 and sets limit values for banks in five special risk areas: large exposures, lending growth, a funding ratio, concentration on commercial property and liquidity ratios.

- Expanded in 2011 the collateral basis to include the banks' credit claims of good quality and introduced 6-month monetary policy loans offered monthly and offered banks the option of taking out loans with a three-year term based on DNB's collateral base in March and September 2012.

- Reformed the Deposit Insurance System in 2012 to be consistent with the revised EU Deposit Insurance Directive. In 2012, the Danish Parliament adopted a legislative amendment requiring that the bank department of the Guarantee Fund for Depositors and Investors to be funded via a fixed annual rate of 2.5 per thousand of the net deposits.

- Established a resolution framework including bail-in for banking institutions through Bank rescue package 3.

- Reform of macroprudential policy by proposing to set up a Systemic Risk Council, chaired by a Danmarks Nationalbank governor and consisting of representatives from Danmarks Nationalbank, the FSA, three economic ministries, and independent experts, to identify and address the build-up of systemic risk by recommending to competent authorities or government on a comply-or-explain basis. The Council is expected to begin operations in early 2013.

Set up a SIFI committee to clarify SIFI criteria, requirements, and crisis management framework. The committee is expected to issue its recommendations before the end of 2012.

Box 5. Implementation of Past Fund Advice

The last Article IV consultation was concluded by the Executive Board in December 2010. Since then, action has been taken in several important areas covered by past Fund advice.

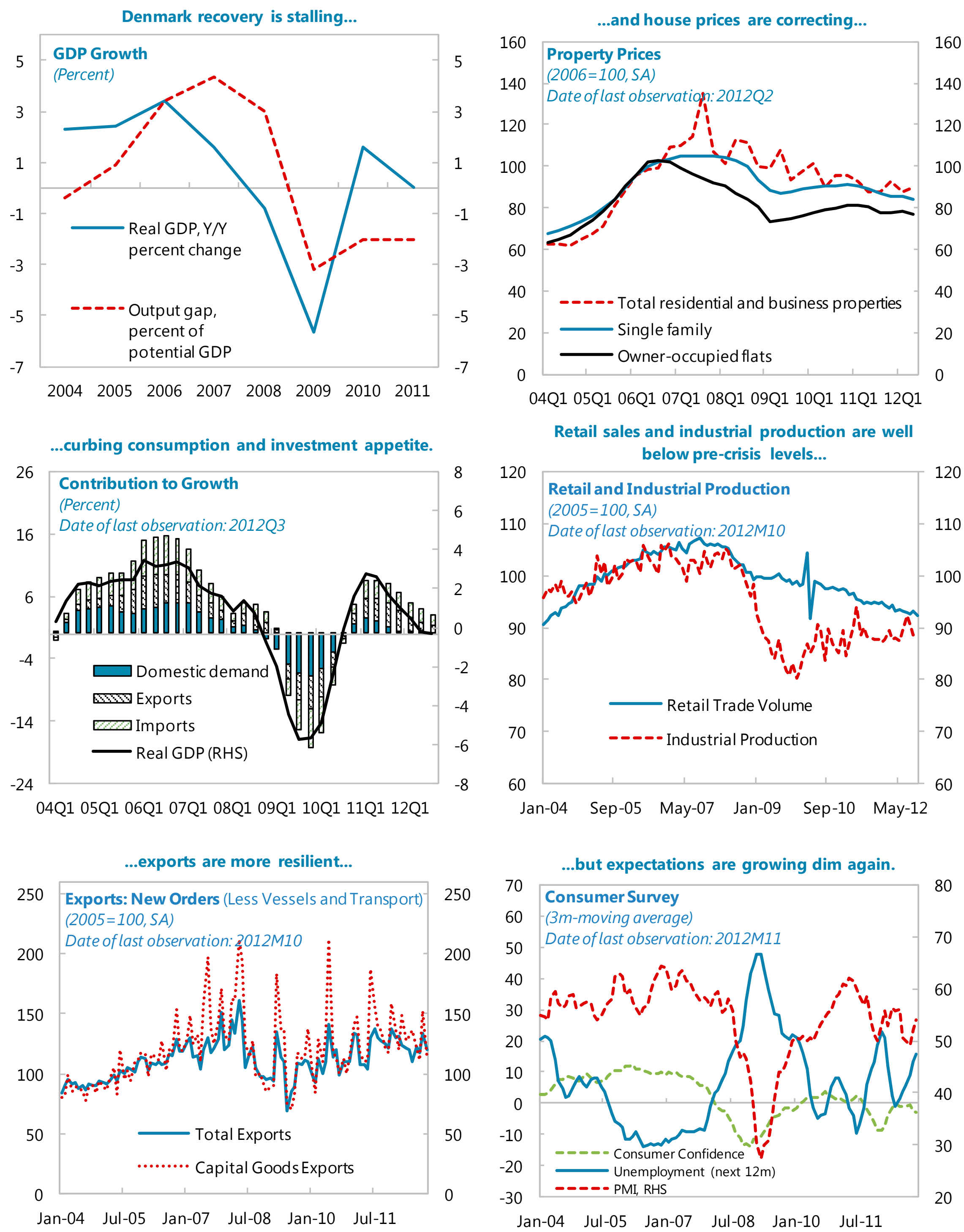
- Fiscal policy: The authorities have embraced a credible consolidation strategy to reduce the general government deficit to below 3 percent of GDP in 2013, in line with past Fund advice. A combination of discretionary fiscal measures and freely-operating ample automatic stabilizers supported weaker-than-expected economic growth during 2010–12. The authorities have also stepped up reforms that addressed persistent overruns in local spending, including through a reinforcement of sanctions.

- Financial sector: Progress has been made in reducing banks' dependency on state guarantees; prudential regulations have been strengthened through implementation of the "supervisory diamond" indicators, and the activation of the new resolution procedures applying haircuts to senior bank debt has reduced the perception of an implicit government guarantee on banks.

- Labor markets: Fund advice including steps towards phasing out early retirement schemes and reforming sickness and disability leave benefits was echoed by reforms undertaken by the authorities. The reform of the Voluntary Early Retirement Program (VERP) cut the maximum period to receive early retirement pensions in the VERP from five to three years. Also, the period of receiving unemployment benefits was reduced from four to two years and the required number of months in work to be eligible for unemployment benefits was increased.

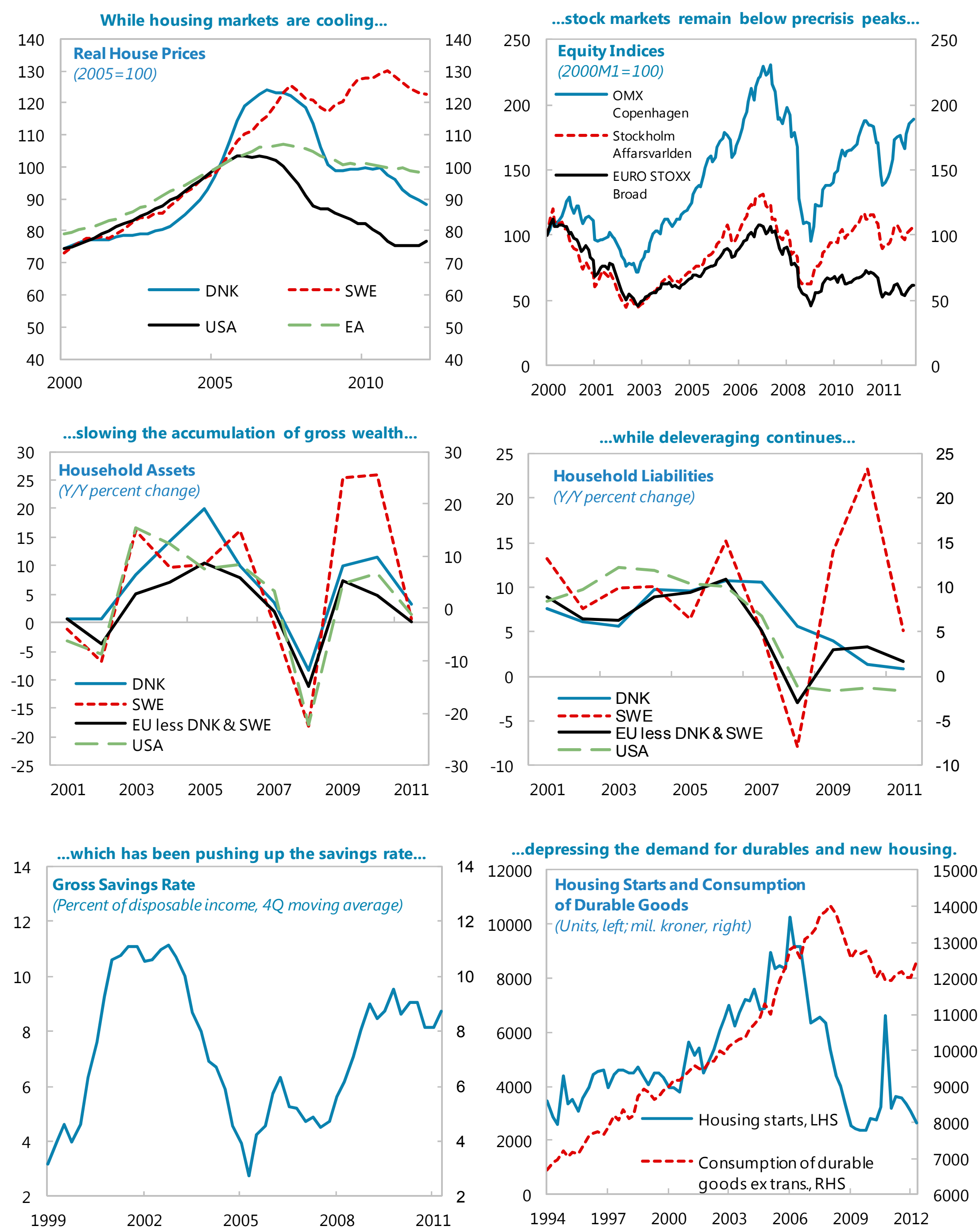
- Competitiveness: The Competition Authority has issued in October 2012 a package aimed at strengthening competition. Also, a Productivity Commission was set up in 2012 by the new government and its independent report is expected by the end of 2013.

Figure 1. Denmark's Slowing Economy



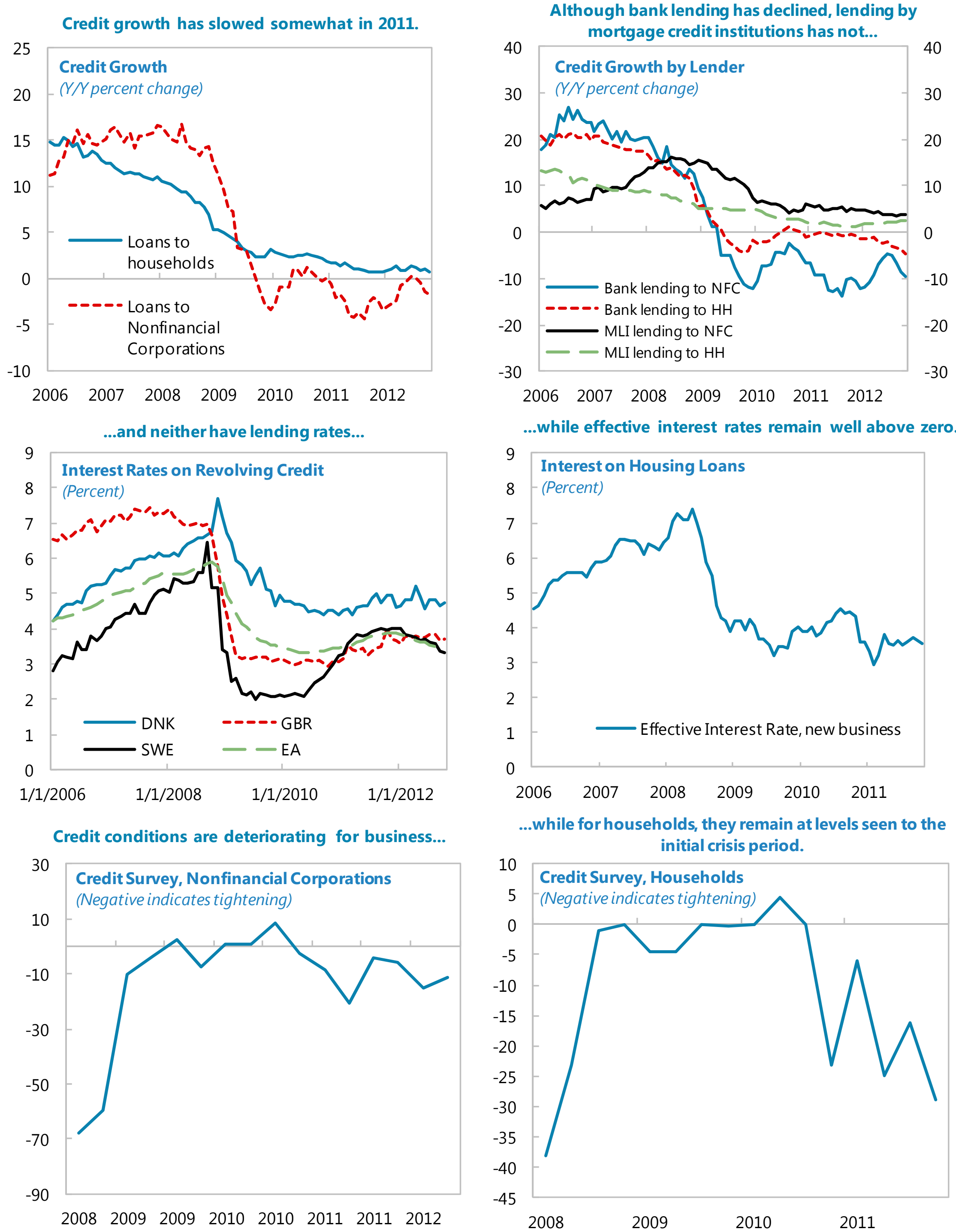
Sources: Haver Analytics, IMF World Economic Outlook, and Fund staff calculations.

Figure 2. Denmark: Household Balance Sheets and Consumption



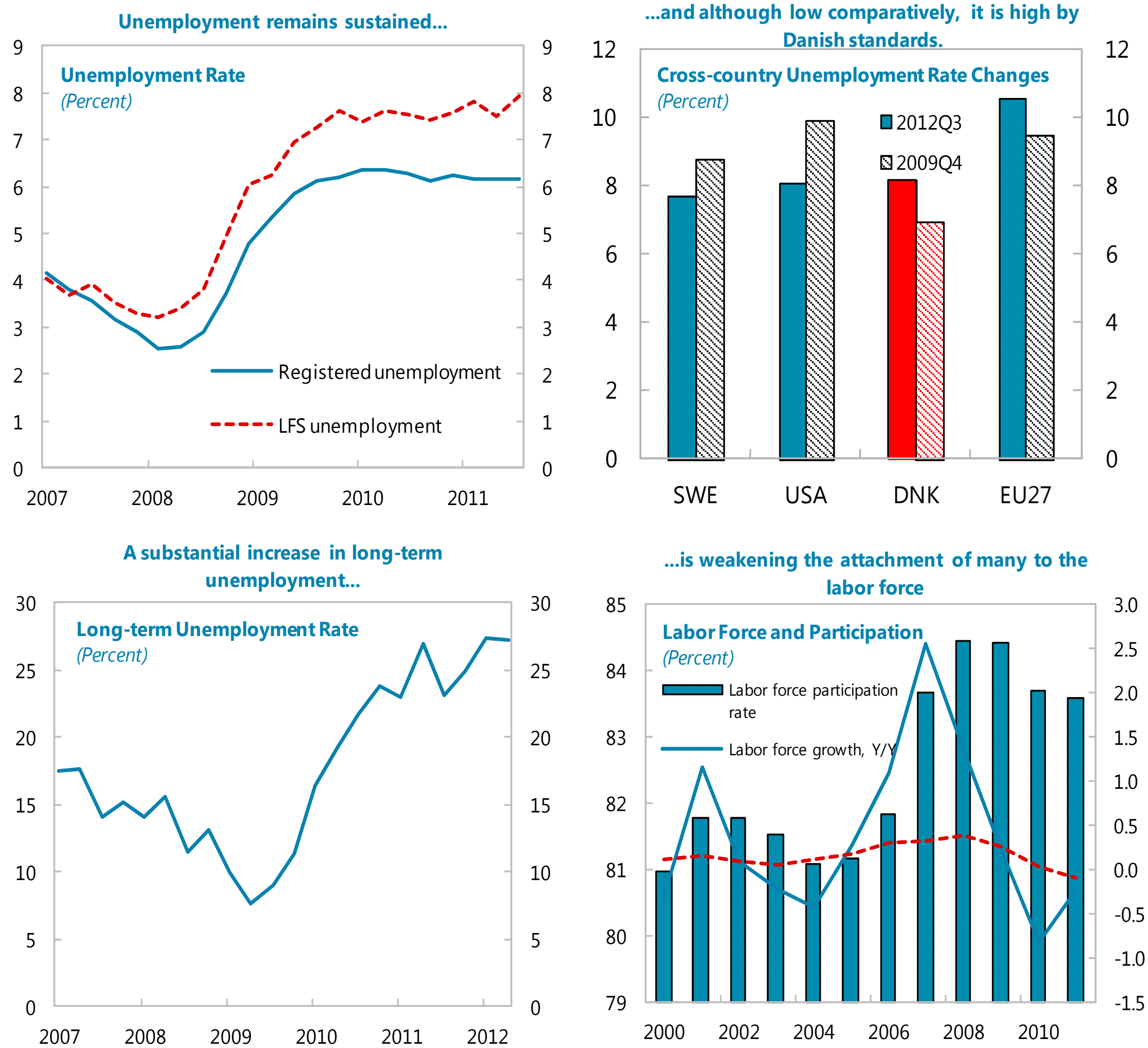
Sources: Haver Analytics, OECD, and Fund staff calculations.

Figure 3. Denmark: Credit Market Developments



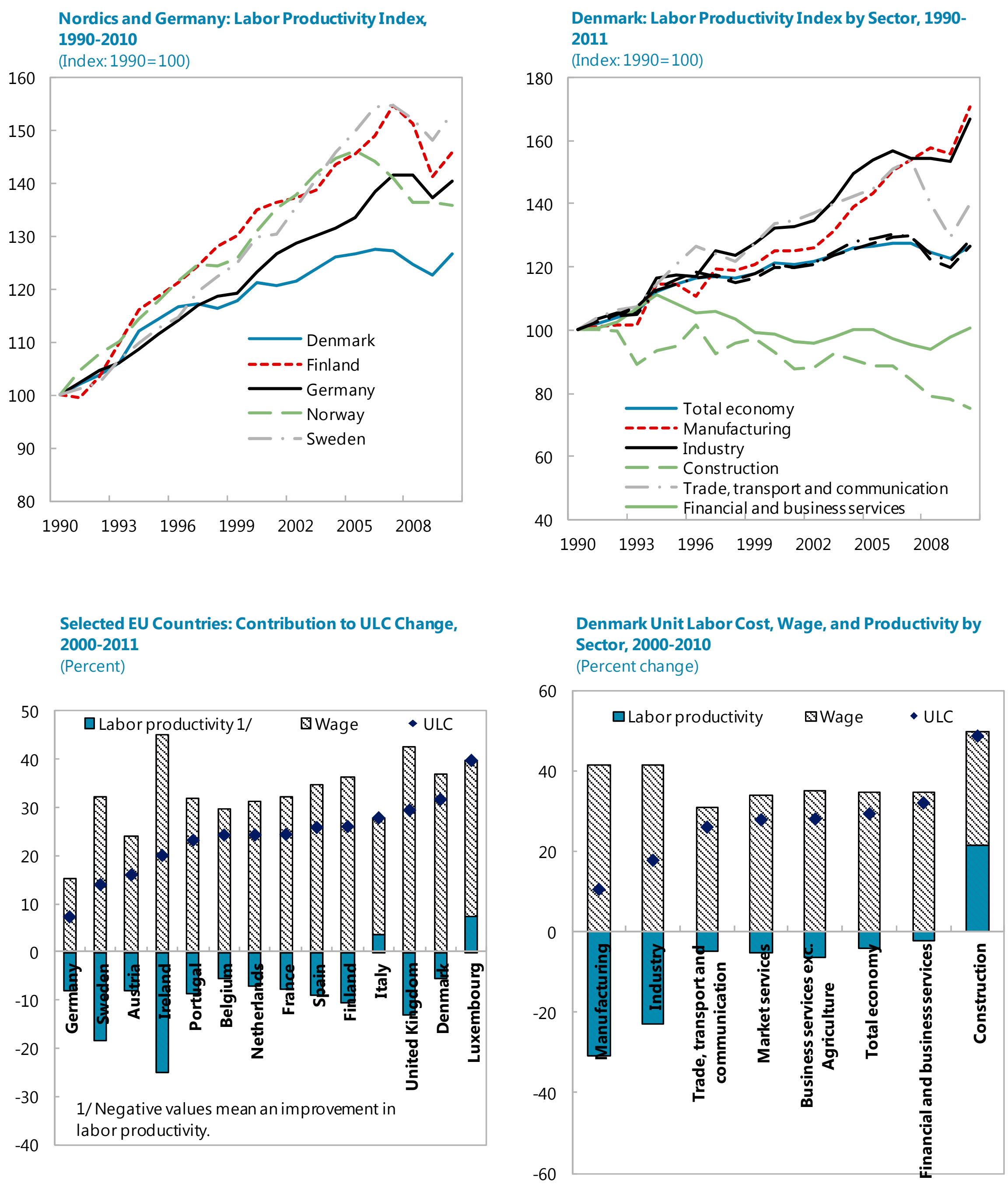
Sources: Danmarks Nationalbank, European Central Bank, Haver Analytics, Statistics Denmark, and Fund staff calculations.

Figure 4. Denmark: Labor Market Developments



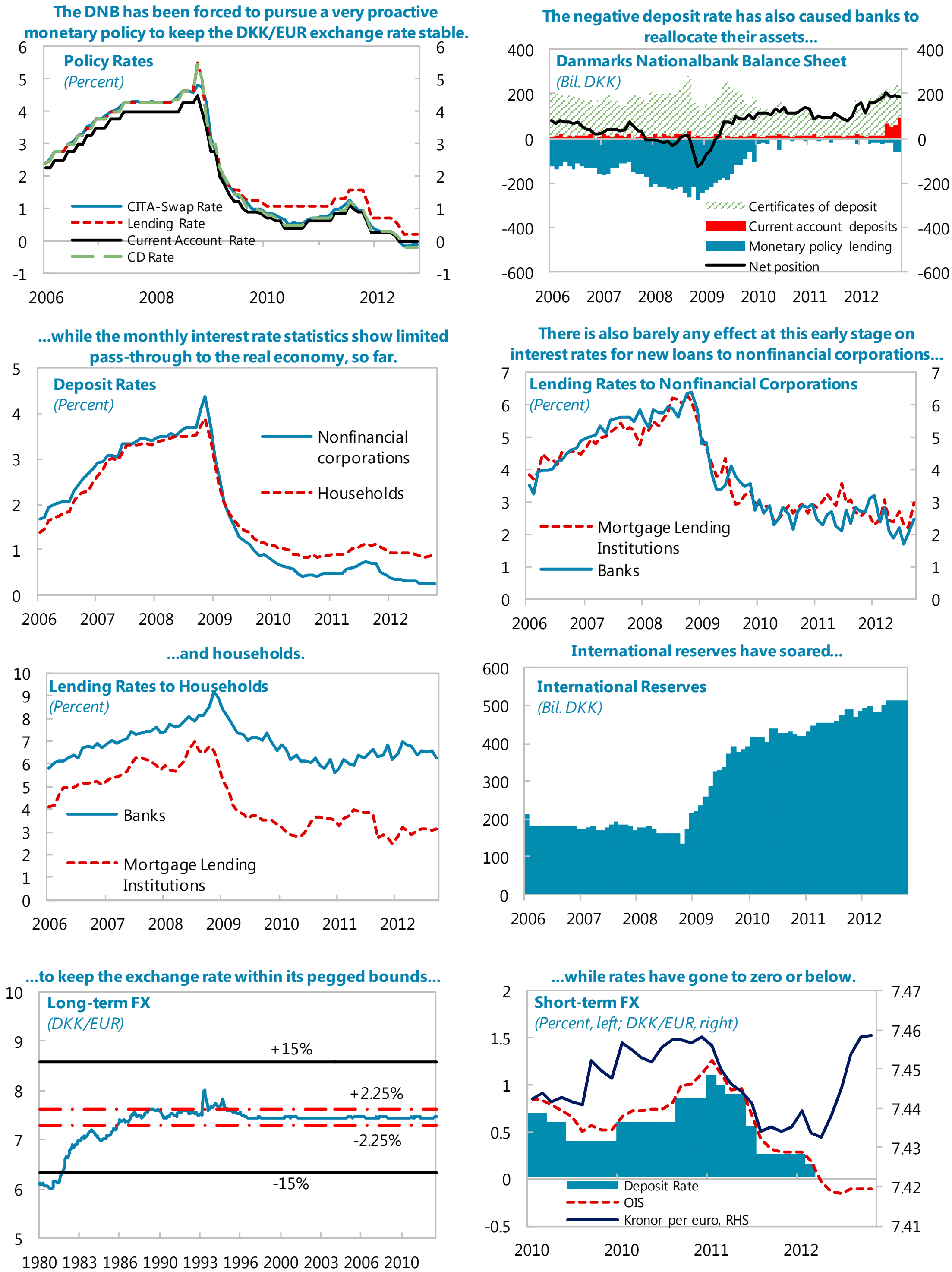
Sources: Haver Analytics, OECD, and Fund staff calculations.

Figure 5. Labor Productivity and Unit Labor Cost



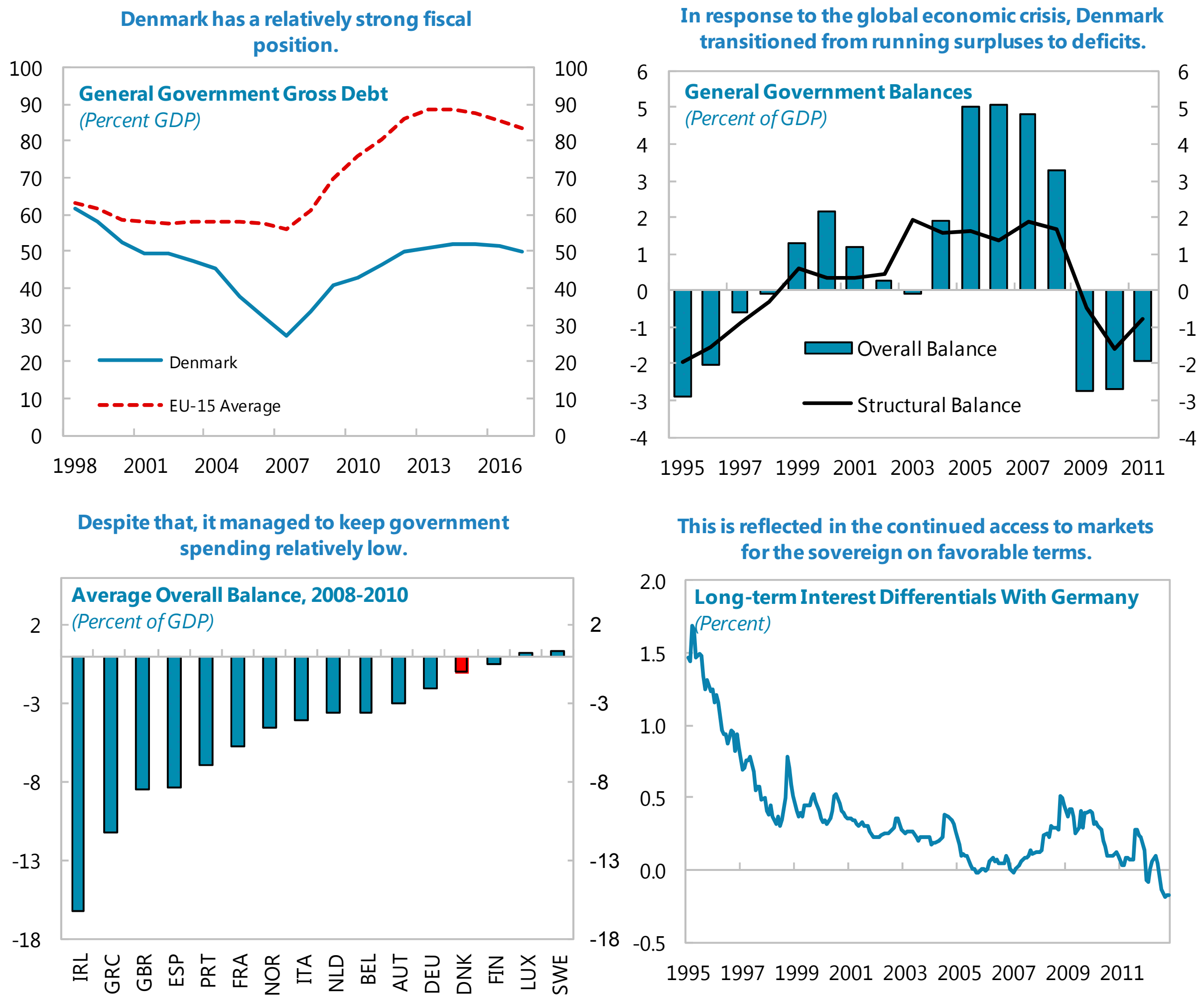
Sources: OECD, Statistics Denmark, and Fund staff calculations.

Figure 6. Monetary Policy Developments



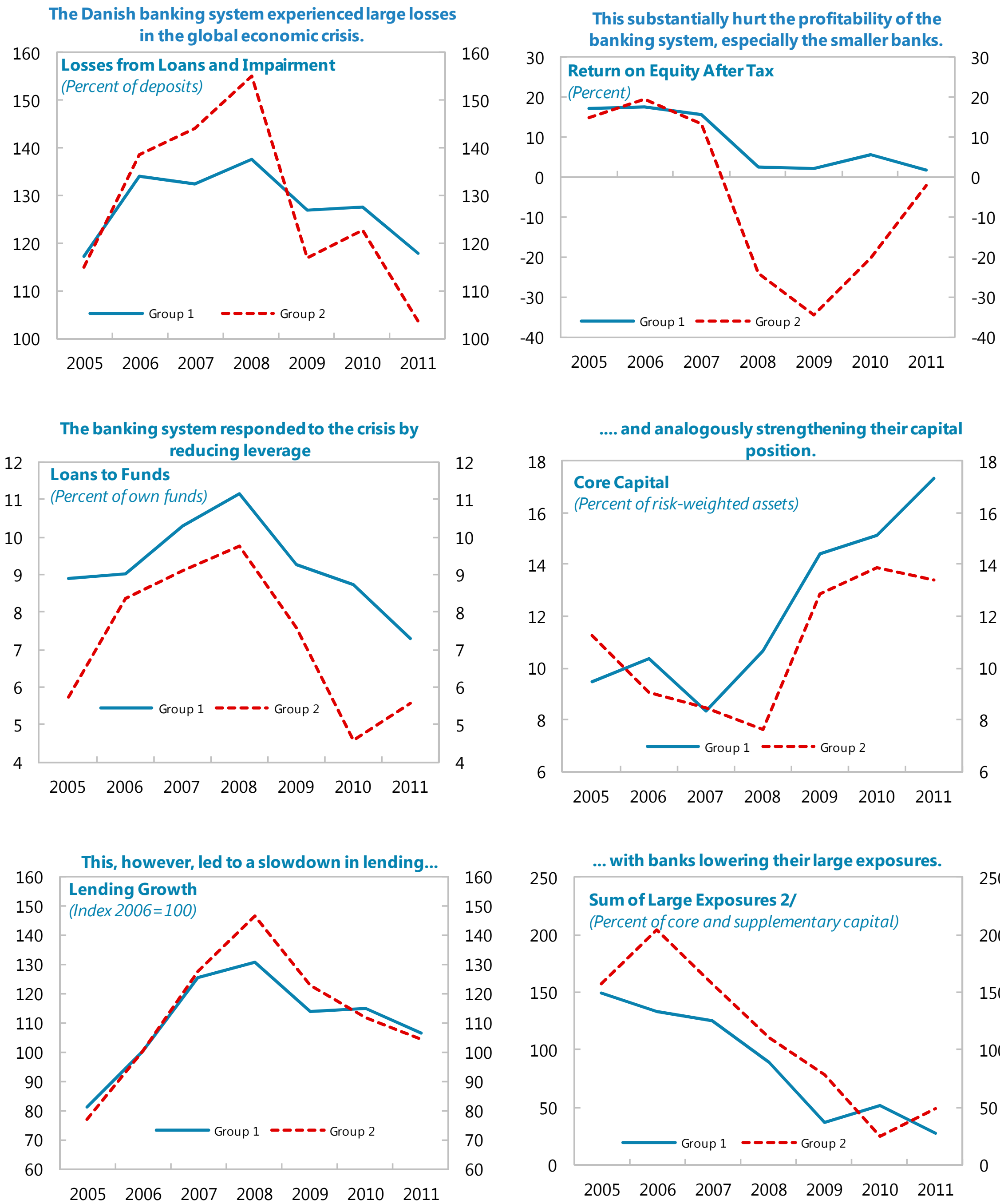
Sources: Danmarks Nationalbank, European Central Bank, Haver Analytics, Statistics Denmark, and Fund staff calculations.

Figure 7. Denmark: Fiscal Developments in a European Perspective



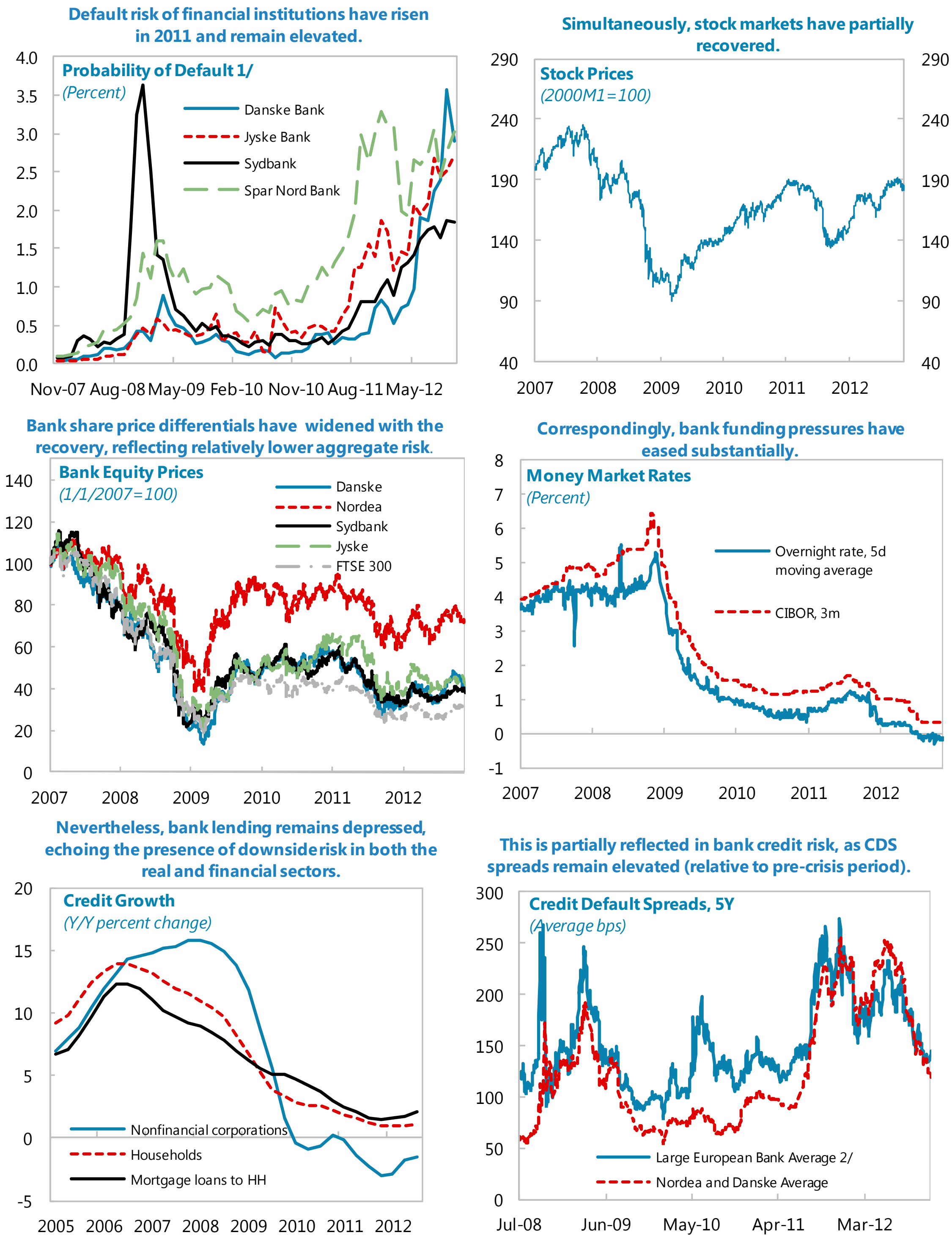
Sources: Denmark Ministry of Finance, Danmarks Nationalbank, ECOFIN, IMF World Economic Outlook, Statistics Denmark, and Fund staff calculations.

Figure 8. Denmark: Banking System Indicators 1/



Sources Danish Financial Supervisory Authority and Fund staff calculations.
1/ Group 1 institutions include banks with total assets greater than DKK 50 billion. This includes: Danske, Jyske, Nordea, Nykredit, and Sydbank. Group 2 institutions include banks with total assets under DKK 50 billion.
2 / The sum of large exposures is the sum of assets and off-balance-sheet items that, after a reduction for secured exposures, exceeds 10% of the combined core capital and supplementary capital.

Figure 9. Denmark: Developments in the Financial Sector

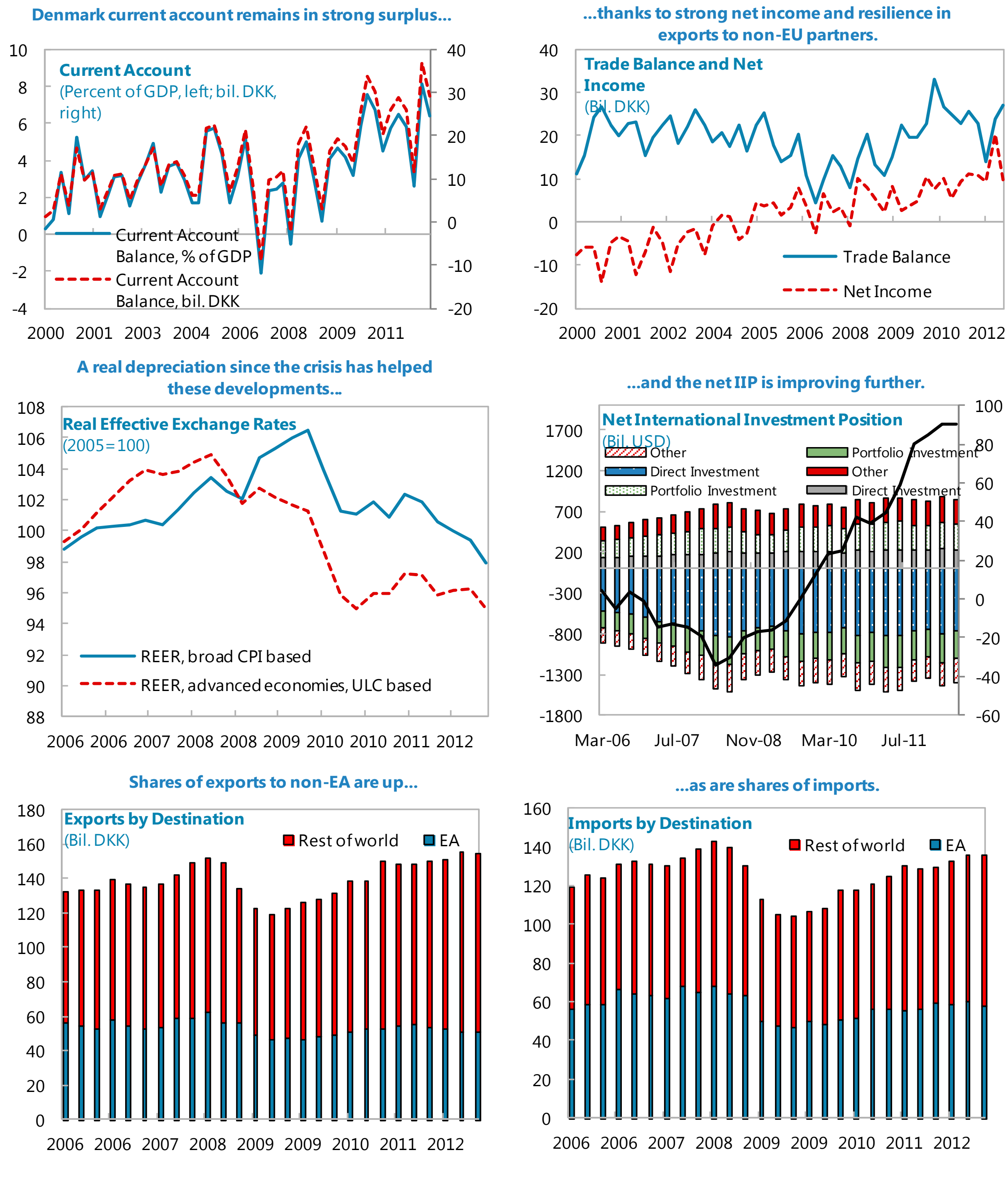


Sources: Bloomberg, Danmarks Nationalbank, Moody's KMV, Statistics Denmark, and Fund staff calculations.

1/ Refers to Moodys KMV.

2/ Average of RBS, HBOS, HSBC, UBS and Barclays.

Figure 10. External Developments



Sources: Haver Analytics and Fund staff calculations.

Table 1. Denmark: Selected Economic and Social Indicators, 2009–17

	2009	2010	2011	2012 proj.	2013 proj.	2014 proj.	2015 proj.	2016 proj.	2017 proj.
Supply and Demand (change in percent)									
Real GDP	-5.7	1.6	1.1	-0.4	0.9	1.3	1.5	1.5	1.5
Net Exports 1/	1.2	0.0	0.7	-1.0	-0.1	0.1	0.1	0.1	0.1
Domestic demand	-4.7	0.6	-0.2	0.9	1.3	1.6	1.7	1.7	1.7
Private Consumption	-3.6	1.7	-0.5	1.0	1.4	1.6	2.0	2.0	2.0
Gross fixed investment	-15.9	-2.4	2.8	2.1	2.0	2.0	2.2	2.3	2.3
Gross national saving (percent of GDP)	20.3	22.7	23.2	22.5	22.0	21.6	21.4	21.3	21.1
Gross domestic investment (percent of GDP)	18.2	17.0	17.4	17.8	17.9	18.0	18.0	18.1	18.2
Potential output	0.4	0.3	0.4	0.4	0.5	0.6	1.1	1.1	1.3
Output gap (in percent of potential output)	-3.2	-2.0	-1.3	-2.1	-1.8	-1.1	-0.8	-0.4	-0.2
Labor Market (change in percent)									
Labor force	-2.2	0.4	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Employment	-4.9	-1.1	0.4	0.3	0.4	0.8	0.6	0.5	0.5
Unemployment rate (in percent)	6.1	7.5	7.6	7.6	7.6	7.2	7.0	6.8	6.6
Prices and Costs (change in percent)									
GDP deflator	0.7	4.1	0.6	2.0	1.9	1.8	1.8	1.8	1.9
CPI (year average)	1.3	2.3	2.8	2.6	2.0	2.0	2.0	2.0	2.0
Unit labor costs (manufacturing)	5.4	-1.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Public finance (percent of GDP)									
Central government balance	-2.0	-2.5	-2.0	-4.3	-2.5	-2.3	-1.7	-1.4	-0.3
General government revenues	55.2	54.8	55.5	54.3	54.6	52.9	53.2	52.7	53.7
General government expenditure	58.0	57.5	57.4	58.5	57.1	55.1	54.9	54.0	53.9
General government balance	-2.8	-2.7	-2.0	-4.2	-2.5	-2.2	-1.7	-1.4	-0.3
General government structural balance (percent of potential GD	-0.4	-1.4	-0.7	-1.0	0.0	-0.6	-0.6	-0.5	-0.1
General government primary balance 2/	-2.1	-2.0	-1.2	-3.4	-1.9	-1.7	-0.9	-0.6	0.4
General government gross debt	40.7	42.7	46.4	49.9	51.2	52.2	52.6	52.4	51.5
Money and Interest rates (percent)									
Domestic credit growth (end of year)	-1.8	1.6	-1.4	…	…	…	…	…	…
M3 growth (end of year)	4.5	7.9	-5.9	…	…	…	…	…	…
Short-term interest rate (3 month)	1.8	0.7	1.1	…	…	…	…	…	…
Government bond yield (10 year)	3.6	2.9	2.7	…	…	…	…	…	…
Balance of payments (in percent of GDP)									
Exports of goods & services	49.7	46.9	48.4	49.3	49.7	50.1	50.4	50.4	50.4
Imports of goods & services	-45.8	-43.6	-45.3	-46.5	-46.8	-47.1	-47.5	-47.5	-47.5
Trade balance, goods and services	3.8	3.3	3.1	2.8	2.9	2.9	2.9	2.9	2.9
Current account	3.4	5.9	5.6	5.2	5.0	5.0	5.2	5.3	5.5
Exchange rate									
Average DKK per US$ rate	5.4	5.6	5.4	…	…	…	…	…	…
Nominal effective rate (2000=100, ULC based)	105.9	102.0	101.2	…	…	…	…	…	…
Real effective rate (2000=100, ULC based)	102.0	96.4	96.6	…	…	…	…	…	…

Social indicators (Reference year)

GDP per capita, PPP (current international $) (2011): $41,015; At-risk-of-poverty rate (2010): 18.3 percent.

Sources: Danmarks Nationalbank, Eurostat, IMF *World Economic Outlook,* Statistics Denmark, World Bank WDI, and Fund staff calculations.

1/ Contribution to GDP growth.

2/ Overall balance net of interest.

Table 2. Denmark: Medium-term Scenario, 2009–17

(Percentage change, unless otherwise indicated)

	2009	2010	2011	2012 proj.	2013 proj.	2014 proj.	2015 proj.	2016 proj.	2017 proj.
Real GDP	-5.7	1.6	1.1	-0.4	0.9	1.3	1.5	1.5	1.5
Real domestic demand	-4.7	0.6	-0.2	0.9	1.3	1.6	1.7	1.7	1.7
Private consumption	-3.6	1.7	-0.5	1.0	1.4	1.6	2.0	2.0	2.0
Public consumption	2.1	0.4	-1.5	0.0	0.7	1.5	0.8	0.8	0.8
Fixed investment	-15.9	-2.4	2.8	2.1	2.0	2.0	2.2	2.3	2.3
Net exports 1/	1.2	0.0	0.7	-1.0	-0.1	0.1	0.1	0.1	0.1
Exports	-9.5	3.0	6.5	1.5	4.4	4.3	4.4	4.4	4.4
Imports	-12.3	3.2	5.6	3.5	4.9	4.4	4.5	4.5	4.5
Current account 2/	3.4	5.9	5.6	5.2	5.0	5.0	5.2	5.3	5.5
Inflation									
Consumer Prices	1.3	2.3	2.8	2.6	2.0	2.0	2.0	2.0	2.0
Labor market									
Employment	-4.9	-1.1	0.4	0.3	0.4	0.8	0.6	0.5	0.5
Average unemployment rate	6.1	7.5	7.6	7.6	7.6	7.2	7.0	6.8	6.6
Public finance									
General government balance 2/	-2.8	-2.7	-2.0	-4.2	-2.5	-2.2	-1.7	-1.4	-0.3
General government structural balance 3/	-0.4	-1.4	-0.7	-1.0	0.0	-0.6	-0.6	-0.5	-0.1
General government gross debt 2/	40.7	42.7	46.4	49.9	51.2	52.2	52.6	52.4	51.5
Output gap 3/	-3.2	-2.0	-1.3	-2.1	-1.8	-1.1	-0.8	-0.4	-0.2

Sources: Danmarks Nationalbank, Statistics Denmark, and Fund staff calculations.

1/ Contributions to growth.

2/ In percent of GDP.

3/ In percent of potential GDP.

Table 3. Denmark: Public Finances, 2009–17
(in percent of GDP)

	2009	2010	2011	2012 proj.	2013 proj.	2014 proj.	2015 proj.	2016 proj.	2017 proj.
General Government									
Total Revenues	55.2	54.8	55.5	54.3	54.6	52.9	53.2	52.7	53.7
Personal Income Taxes	26.6	24.8	24.9	20.5	22.0	21.5	21.5	21.5	22.6
Labor Market Contributions	4.8	4.6	4.5	4.5	4.5	4.4	4.4	4.4	4.4
Pension Return Taxes	0.5	2.1	2.1	2.4	1.1	1.0	1.0	1.0	1.0
Company Taxes	2.3	2.8	2.8	2.9	3.0	3.3	3.3	3.3	3.3
VAT	10.2	9.8	9.9	10.1	10.2	10.2	10.2	10.2	10.1
Social Contributions	1.0	1.0	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Interest and Dividends	1.9	1.6	1.6	1.5	1.5	1.5	1.5	1.5	1.5
Other revenues	8.0	8.1	8.6	11.5	11.4	10.1	10.4	9.9	9.9
Total Expenditures	58.0	57.5	57.4	58.5	57.1	55.1	54.9	54.0	53.9
Public Consumption	31.0	30.2	29.5	29.9	30.0	30.2	30.0	29.8	29.7
Transfer Incomes	17.0	17.2	17.4	17.8	17.5	17.2	17.0	17.0	17.1
Public Subsidies	2.6	2.5	2.5	2.4	2.1	2.1	2.1	2.0	2.0
Interest Expenditures	2.2	2.1	2.1	2.0	1.8	1.7	2.0	1.9	1.9
Public Investment	2.1	2.2	2.1	2.4	2.1	1.9	1.9	1.9	1.9
Other Expenditures	3.1	3.3	3.7	4.1	3.6	2.0	1.9	1.4	1.3
Balance	-2.8	-2.7	-2.0	-4.2	-2.5	-2.2	-1.7	-1.4	-0.3
Primary balance 1/	-2.1	-2.0	-1.2	-3.4	-1.9	-1.7	-0.9	-0.6	0.4
Structural balance 2/	-0.4	-1.4	-0.7	-1.0	0.0	-0.6	-0.6	-0.5	-0.1
Gross Debt	40.7	42.7	46.4	49.9	51.2	52.2	52.6	52.4	51.5
Memorandum Item									
Gross Domestic Product	1665	1761	1792	1820	1871	1929	1993	2060	2130

Sources: Statistics Denmark and Fund staff calculations.

1/ Overall balance net of interest.

2/ In percent of potential GDP.

Table 3a. Denmark: Statement of General Government Operations, 2009–17

(Bil. Danish Kroner)

	2009	2010	2011	2012 proj.	2013 proj.	2014 proj.	2015 proj.	2016 proj.	2017 proj.
General Government									
Total Revenues	919.6	964.5	993.8	988.2	1021.6	1020.2	1060.6	1084.6	1143.0
Personal Income Taxes	442.9	436.6	446.5	373.1	411.6	414.7	428.6	442.9	481.4
Labor Market Contributions	79.6	80.9	81.1	81.9	84.2	84.9	87.7	90.6	93.7
Pension Return Taxes	8.8	36.5	38.1	43.7	20.6	19.3	19.9	20.6	21.3
Company Taxes	38.8	48.9	49.8	52.8	56.1	63.7	65.8	68.0	70.3
VAT	169.0	173.1	177.8	183.8	190.8	196.8	203.3	210.1	215.1
Social Contributions	16.4	17.7	18.1	16.4	16.8	17.4	17.9	18.5	19.2
Interest and Dividends	31.3	27.9	29.1	27.3	28.1	28.9	29.9	30.9	32.0
Other revenues	132.8	142.9	153.3	209.3	213.3	194.6	207.4	203.0	210.0
Total Expenditures	965.7	1011.9	1028.8	1065.2	1068.2	1063.5	1094.1	1112.5	1148.6
Expense	930.9	974.0	990.3	1021.5	1028.9	1026.8	1056.2	1073.3	1108.1
Public Consumption	515.7	531.1	528.1	543.2	561.6	583.0	598.6	614.6	632.6
Social Benefits	283.8	303.7	312.3	323.9	327.4	331.8	338.9	350.2	364.3
Public Subsidies	43.1	44.4	45.7	43.7	39.3	40.5	41.9	41.2	42.6
Interest Expenditures	36.7	36.9	37.6	36.4	33.7	32.8	39.9	39.1	40.5
Other Expenditures	51.6	57.9	66.7	74.3	66.9	38.7	37.0	28.2	28.2
Net Acquisition of Nonfinancial Assets	34.8	37.9	38.5	43.7	39.3	36.7	37.9	39.1	40.5
Gross operating balance	-11.3	-9.5	3.6	-33.4	-7.4	-6.6	4.4	11.3	34.9
Net lending/borrowing	-46.1	-47.4	-34.9	-77.1	-46.7	-43.3	-33.4	-27.8	-5.6
Net financial transactions	-46.1	-47.4	-34.9	..	..	..	..	..	..
Net acquisition of financial assets	95.3	38.1	44.0	..	..	..	..	..	..
Currency and deposits	-76.2	-15.9	62.2	..	..	..	..	..	..
Securities other than shares	77.9	13.1	3.5	..	..	..	..	..	..
Loans	35.6	-0.1	6.4	..	..	..	..	..	..
Shares and other equity	1.7	2.6	2.3	..	..	..	..	..	..
Other financial assets	56.4	38.3	-30.4	..	..	..	..	..	..
Net incurrence of liabilities	141.1	85.5	62.8	..	..	..	..	..	..
Currency and deposits	0.3	0.3	0.0	..	..	..	..	..	..
Securities other than shares	97.3	76.4	62.6	..	..	..	..	..	..
Loans	5.0	5.4	0.2	..	..	..	..	..	..
Other liabilities	38.5	3.4	0.0	..	..	..	..	..	..
Discrepancies 1/	*0.2*	*0.0*	*16.1*	..	..	..	..	..	..
Primary balance 2/	-2.1	-2.0	-1.2	-3.4	-1.9	-1.7	-0.9	-0.6	0.4
Structural balance 3/	-0.4	-1.4	-0.7	-1.0	0.0	-0.6	-0.6	-0.5	-0.1
Gross Debt	40.7	42.7	46.4	49.9	51.2	52.2	52.6	52.4	51.5
Memorandum Item									
Gross Domestic Product	1665	1761	1792	1820	1871	1929	1993	2060	2130

Sources: Statistics Denmark and Fund staff calculations.

1/ Discrepancy due to time difference in nonfinancial and financial data.

2/ Overall balance net of interest.

3/ In percent of potential GDP.

Table 3b: Denmark: General Government Financial Balance Sheet, 2009–11

(In billions of Danish Kroner)

	2009				2010				2011	
	Opening balance	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance
Net worth and its changes	....	....	....	....	....	....	....	....	....	....
Nonfinancial assets	....	....	....	....	....	....	....	....	....	....
Net Financial Worth:	**107.6**	**-45.9**	**12.8**	**74.6**	**-47.4**	**1.8**	**29.0**	**-34.5**	**-54.0**	**-59.5**
Financial Assets	**834.0**	**95.3**	**-1.1**	**928.2**	**38.1**	**23.9**	**990.2**	**44.0**	**8.8**	**1,043.0**
Currency and deposits	299.8	-76.2	0.2	223.8	-15.9	0.0	207.9	62.2	0.0	270.1
Securities other than shares	18.7	77.9	2.4	98.9	13.1	8.7	120.8	3.5	6.8	131.1
Loans	126.8	35.6	0.3	162.7	-0.1	-0.3	162.3	6.4	0.3	168.9
Shares and other equity	262.6	1.7	-0.1	264.1	2.6	12.8	279.5	2.3	2.0	283.9
Other financial assets	126.2	56.4	-3.8	178.7	38.3	2.7	219.7	-30.4	-0.3	189.0
Liabilities	**726.5**	**141.1**	**-13.9**	**853.7**	**85.5**	**22.1**	**961.2**	**78.4**	**62.8**	**1,102.4**
Currency and deposits	14.2	0.3	0.0	14.5	0.3	0.0	14.8	0.2	0.0	14.9
Debt securities	490.5	97.3	-14.7	573.1	76.4	21.7	671.1	73.4	62.6	807.1
Loans	113.5	5.0	0.8	119.3	5.4	0.4	125.2	3.0	0.2	128.3
Other liabilities	108.3	38.5	0.0	146.8	3.4	0.0	150.2	1.9	0.0	152.1
Memorandum items:										
Net financial worth (in % of GDP)	6.1			4.5			1.6			-3.3
Financial assets (in % of GDP)	47.6			55.8			56.2			58.2
Liabilities (in % of GDP)	41.4			51.3			54.6			61.5
GDP nominal prices	1,753.2			1,664.8			1,761.1			1,791.5

Sources: Eurostat, Statistics Denmark, and Fund staff calculations.

Table 4. Denmark: Balance of Payments, 2009–17

	2009	2010	2011	2012 proj.	2013 proj.	2014 proj.	2015 proj.	2016 proj.	2017 proj.
					Bil. DKK				
Current Account	56.5	103.6	101.2	93.9	93.2	96.6	103.3	109.7	116.5
Balance on Goods	47.4	53.4	55.3	44.3	47.1	48.6	51.9	54.7	57.7
Merchandise exports f.o.b.	486.6	533.2	593.2	595.3	620.4	642.1	669.8	698.6	728.7
Merchandise imports f.o.b.	-439.3	-479.8	-537.9	-551.0	-573.3	-593.5	-617.9	-643.9	-671.0
Balance on Services	20.8	49.0	40.8	34.2	30.2	31.6	34.5	37.6	40.7
Exports of services, total	300.7	349.0	357.8	357.3	367.1	373.7	384.3	395.1	406.2
Imports of services, total	-279.9	-300.0	-317.0	-323.1	-336.9	-342.1	-349.7	-357.5	-365.5
Balance on Income	17.3	33.0	36.6	47.5	48.8	50.3	52.0	53.8	55.6
Receipts	137.2	151.4	158.6	170.8	175.6	181.0	187.1	193.3	199.9
Expenditures	-120.0	-118.4	-122.0	-123.3	-126.8	-130.7	-135.1	-139.6	-144.3
Current transfer, net	-28.9	-31.7	-31.6	-32.1	-33.0	-34.0	-35.1	-36.3	-37.6
Capital and Financial Account	-38.1	0.2	-82.9	-93.9	-93.2	-96.6	-103.3	-109.7	-116.5
Capital transfer, net	-0.3	0.5	4.7	4.8	4.9	5.1	5.2	5.4	5.6
Financial Account	-37.8	-0.3	-87.6	-98.7	-98.1	-101.6	-108.5	-115.1	-122.0
Direct investment, net	-12.7	-64.3	-3.4	-45.5	-46.8	-50.2	-47.8	-45.3	-46.9
Abroad	-33.9	0.6	-71.5	-63.7	-65.5	-69.4	-67.8	-65.9	-68.2
In Denmark	21.1	-64.9	68.1	18.2	18.7	19.3	19.9	20.6	21.3
Portfolio investment, net	69.7	-12.0	21.3	-126.6	-130.1	-134.2	-138.6	-143.3	-148.1
Assets	-126.3	-91.9	20.5	-127.4	-131.0	-135.0	-139.5	-144.2	-149.1
Liabilities	196.0	79.9	0.8	0.8	0.8	0.9	0.9	0.9	1.0
Other investment, net	63.7	74.5	-53.4	-18.2	-18.7	-18.9	-19.5	-20.2	-20.9
Reserve assets	-172.1	-26.2	-55.9	87.6	93.5	97.4	93.2	89.2	89.2
Net errors and omissions	18.5	103.8	18.3	0.0	0.0	0.0	0.0	0.0	0.0
					(Percent of GDP)				
Current Account	3.4	5.9	5.6	5.2	5.0	5.0	5.2	5.3	5.5
Balance on Goods	2.8	3.0	3.1	2.4	2.5	2.5	2.6	2.7	2.7
Merchandise exports f.o.b.	29.2	30.3	33.1	32.7	33.2	33.3	33.6	33.9	34.2
Merchandise imports f.o.b.	-26.4	-27.2	-30.0	-30.3	-30.6	-30.8	-31.0	-31.3	-31.5
Balance on Services	1.2	2.8	2.3	1.9	1.6	1.6	1.7	1.8	1.9
Exports of services, total	18.1	19.8	20.0	19.6	19.6	19.4	19.3	19.2	19.1
Imports of services, total	-16.8	-17.0	-17.7	-17.8	-18.0	-17.7	-17.5	-17.4	-17.2
Balance on Income	1.0	1.9	2.0	2.6	2.6	2.6	2.6	2.6	2.6
Receipts	8.2	8.6	8.9	9.4	9.4	9.4	9.4	9.4	9.4
Expenditures	-7.2	-6.7	-6.8	-6.8	-6.8	-6.8	-6.8	-6.8	-6.8
Current transfer, net	-1.7	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
Capital and Financial Account	-2.3	0.0	-4.6	-5.2	-5.0	-5.0	-5.2	-5.3	-5.5
Capital transfer, net	0.0	0.0	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Financial Account	-2.3	0.0	-4.9	-5.4	-5.2	-5.3	-5.4	-5.6	-5.7
Direct investment, net	-0.8	-3.7	-0.2	-2.5	-2.5	-2.6	-2.4	-2.2	-2.2
Abroad	-2.0	0.0	-4.0	-3.5	-3.5	-3.6	-3.4	-3.2	-3.2
In Denmark	1.3	-3.7	3.8	1.0	1.0	1.0	1.0	1.0	1.0
Portfolio investment, net	4.2	-0.7	1.2	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0
Assets	-7.6	-5.2	1.1	-7.0	-7.0	-7.0	-7.0	-7.0	-7.0
Liabilities	11.8	4.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net	3.8	4.2	-3.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Reserve assets	-10.3	-1.5	-3.1	4.8	5.0	5.1	4.7	4.3	4.2
Net errors and omissions	1.1	5.9	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Net oil and oil-related exports	0.7	0.8	0.4	...	...	...	...	...	...
Net sea transportation receipts	1.7	3.4	2.8	...	...	...	...	...	...
Current Account net of items above	1.0	1.7	2.4	...	...	...	...	...	...
Gross External Debt	188.9	190.4	183.1	...	...	...	...	...	...
Gross Domestic Product	1664.8	1761.1	1791.5	1819.8	1871	1929	1993.4	2059.9	2130.2

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

Table 5. Denmark: Net International Investment Position, 2005–11

(percent of GDP)

	2005	2006	2007	2008	2009	2010	2011
ASSETS	203.3	207.3	221.5	214.1	243.5	262.0	265.5
Direct investment	53.1	51.4	55.3	58.7	66.3	70.1	74.0
Equity & investment fund shares	36.6	35.5	38.4	37.1	43.7	46.9	47.4
Debt instruments	16.4	15.9	17.0	21.6	22.6	23.2	26.6
Portfolio investment	80.5	87.4	90.2	70.4	92.3	103.9	99.8
Equity & investment fund shares	36.2	45.8	46.9	25.7	36.8	43.5	41.3
Debt securities	44.3	41.6	43.3	44.7	55.5	60.3	58.5
Fin. deriv. (other than reserves)	5.5	2.9	0.0	4.7	1.3	2.1	6.8
Other investment	50.3	54.8	65.7	67.5	59.7	61.4	57.4
Reserve assets	13.9	10.8	10.3	12.8	23.9	24.5	27.5
LIABILITIES	199.5	207.6	227.4	219.3	239.9	249.5	238.3
Direct investment	47.5	46.1	48.3	45.8	47.9	44.7	45.1
Equity & investment fund shares	32.6	29.5	32.0	29.1	29.8	28.0	28.2
Debt instruments	14.9	16.6	16.3	16.7	18.2	16.7	16.9
Portfolio investment	86.0	87.1	91.2	82.1	102.5	111.5	107.5
Equity & investment fund shares	20.1	21.8	24.9	13.8	20.8	29.7	25.2
Debt securities	65.9	65.3	66.3	68.4	81.7	81.9	82.3
Other investment	65.9	74.4	87.9	91.4	89.5	93.3	85.6
NET INVESTMENT POSITION	3.8	-0.3	-5.8	-5.2	3.6	12.4	27.2
Direct Investment	5.5	5.3	7.0	12.9	18.4	25.4	28.9
Portfolio Investment	-5.5	0.3	-1.0	-11.7	-10.2	-7.7	-7.7
Other Investment	-15.7	-19.6	-22.2	-23.9	-29.7	-32.0	-28.3

Sources: International Financial Statistics and Fund staff calculations.

Table 6. Denmark: Financial Soundness Indicators, 2007–2012Q2

Group 1

	2007	2008	2009	2010	2011	2012Q2
Solvency ratio	11.6	14.3	17.7	18.0	20.4	20.2
Core capital ratio	8.4	10.7	14.4	15.1	17.3	17.4
Return on equity before tax (percent of own funds)	18.7	3.0	3.7	7.1	2.9	2.0
Return on equity after tax (percent of own funds)	15.5	2.5	2.2	5.6	1.7	1.4
Income/cost ratio	1.99	1.09	1.08	1.21	1.10	1.13
Interest rate risk (percent of core capital)	2.0	2.1	1.5	0.6	0.3	0.3
Foreign exchange position (ratio to core capital)	3.9	4.4	3.0	3.4	2.7	3.0
Foreign exchange risk (ratio to core capital)	0.2	0.1	0.2	0.1	0.2	0.1
Loans and impairment losses over deposits	132.4	137.6	126.8	127.5	117.7	134.9
Excess coverage as a percentage of the liquidity requirement	97.4	70.3	153.4	139.9	113.9	126.7
Sum of large exposures (percentage of core plus supp. capital	125.3	89.1	36.2	50.9	27.4	14.3
Annual impairment ratio	-0.04	0.61	1.46	0.94	0.87	0.48
Growth in loans (Q/Q)	25.4	4.0	-12.7	1.1	-7.3	9.7
Gearing	10.3	11.1	9.3	8.7	7.3	7.9
Annual earnings per share (nominal value DKK 100) before ta	227.6	14.2	27.4	66.5	21.0	-7.2
Book value over net asset value	1527.1	1456.7	1476.8	1548.8	1412.5	1425.7
Price over net asset value (nominal value DKK 100)	10.4	8.7	21.5	23.4	25.9	
Price over book value (nominal value DKK100)	1.9	0.5	1.0	1.1	0.6	0.4

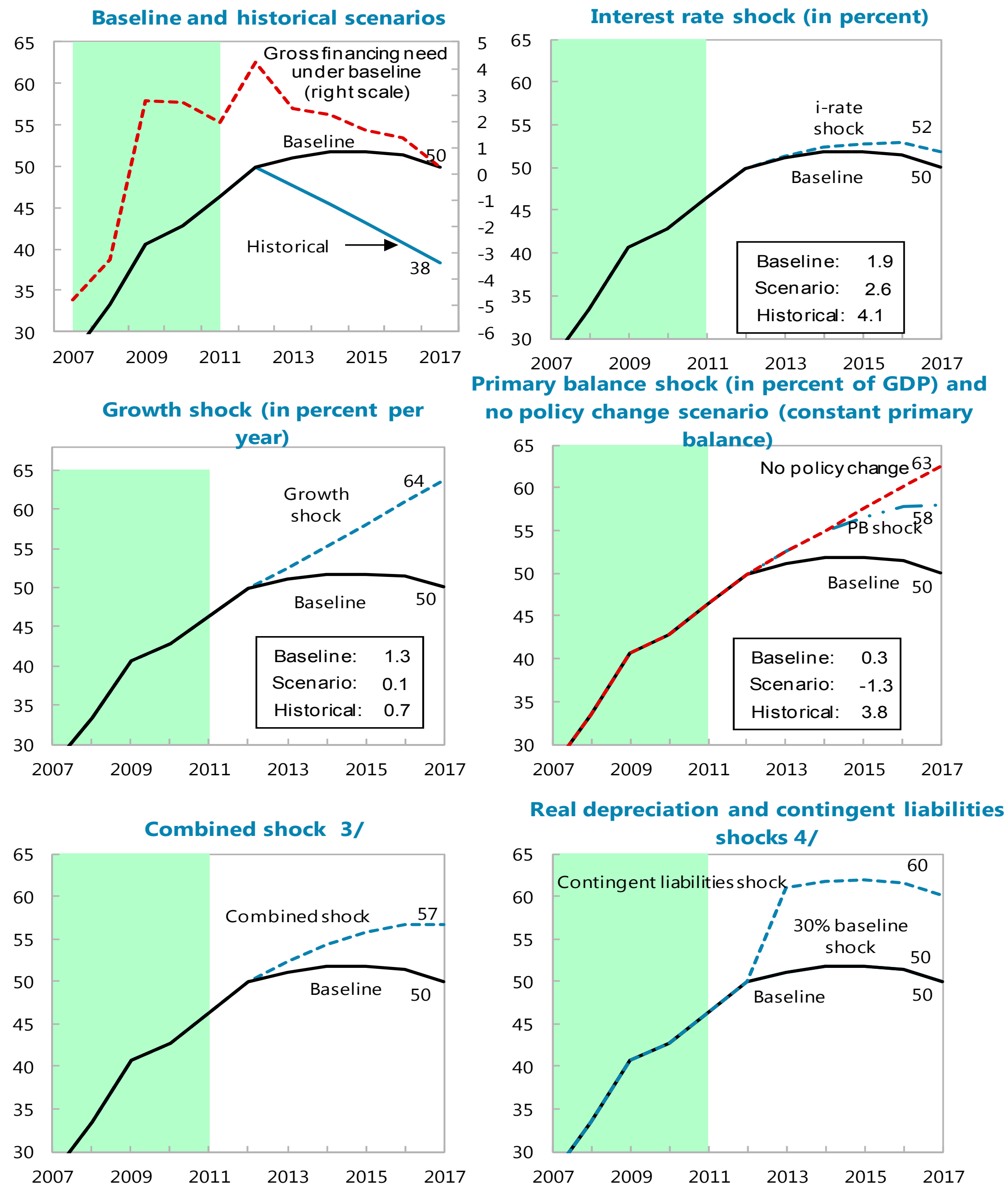
Group 2

	2007	2008	2009	2010	2011	2012Q2
Solvency ratio	11.4	10.2	15.4	16.3	15.4	16.6
Core capital ratio	8.5	7.6	12.8	13.9	13.4	14.6
Return on equity before tax (percent of own funds)	16.8	-26.7	-43.3	-21.2	-2.5	-0.1
Return on equity after tax (percent of own funds)	13.1	-24.0	-34.5	-20.4	-2.2	-0.2
Income/cost ratio	1.63	0.56	0.52	0.71	0.94	1.04
Interest rate risk (percent of core capital)	1.8	1.7	0.7	0.7	-0.2	-0.1
Foreign exchange position (ratio to core capital)	15.7	9.0	3.3	17.7	19.5	11.8
Foreign exchange risk (ratio to core capital)	0.1	0.1	0.2	0.3	0.7	0.9
Loans and impairment losses over deposits	144.1	155.0	116.7	122.6	103.5	94.0
Excess coverage as a percentage of the liquidity requirement	105.4	112.2	172.8	206.5	198.4	210.4
Sum of large exposures (percentage of core plus supp. capital	157.3	110.1	78.5	24.2	48.8	37.7
Annual impairment ratio	0.08	2.59	5.61	4.47	2.16	0.94
Growth in loans (Q/Q)	27.4	15.0	-16.3	-8.8	-7.0	-11.1
Gearing	9.1	9.8	7.6	4.6	5.6	4.7
Annual earnings per share (nominal value DKK 100) before ta	128.7	-96.6	-21.7	-173.2	-15.1	20.0
Book value over net asset value	974.3	998.6	870.5	525.4	1189.0	547.7
Price over net asset value (nominal value DKK 100)	11.6	40.4	20.4	15.3	10.0	
Price over book value (nominal value DKK100)	1.4	0.6	0.8	1.3	0.9	1.6

Sources: Finanstilsynet and Fund staff calculations.

Note: Group 1 banks are those with working capital of DKK 65 billion or higher; Group 2 banks have working capital between DKK 12 billion and DKK 65 billion.

Denmark: Public Debt Sustainability: Bound Tests 1/ 2/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

DENMARK

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 20, 2012

Prepared By | European Department

CONTENTS

FUND RELATIONS

AS OF AUGUST 31, 2012

I. Membership Status: Joined: March 30, 1946; Article VIII

II. General Resources Account:

	SDR Million	Percent Quota
Quota	1,891.40	100.00
Fund holdings of currency (Exchange Rate)	1,300.52	68.76
Reserve Tranche Position	590.89	31.24
Lending to the Fund		
New Arrangements to Borrow	375.05	

III. SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	1,531.47	100.00
Holdings	1,462.18	95.48

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements: None

VI. Projected Payments to Fund[1]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.01	0.07	0.07	0.07	0.07
Total	0.01	0.07	0.07	0.07	0.07

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. **Exchange Arrangements:** Denmark participates in the European Exchange Rate mechanism II (ERMII) with a central rate at DKr 746.038 per €100. The standard width of the fluctuation band in ERM II is +/-15 percent. However, due to its high degree of convergence, Denmark has entered into an agreement with the European Central Bank (ECB) and the euro area member states on a narrower fluctuation band of +/- 2.25 percent. This means that the krone can only fluctuate between DKr 762.824 per 100 euro and DKr 729.252 per €100.

Denmark has accepted the obligations of Article VIII, Sections 2(a), 3 and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, apart from those imposed solely for the preservation of national or international security, as notified to the Fund by the National Bank of Denmark in accordance with Executive Board Decision No. 144-(52/51). Currently, in accordance with relevant UN resolutions and EU regulations, Denmark maintains measures to regulate the freezing of funds, other financial assets, and economic resources of certain persons and entities associated with Osama bin Laden, the Taliban, the Al-Qaida network, Slobodan Milosevic and persons associated with him, and persons indicted by the International Criminal Tribunal for the Former Yugoslavia. There are restrictive measures against Uzbekistan and Lebanon. Certain restrictive measures, including the freezing of funds of certain individuals and entities, are maintained against Afghanistan, Belarus, the Democratic Republic of Congo, Côte d'Ivoire, Guinea, the Islamic Republic of Iran, Iraq, the Democratic People's Republic of Korea, Liberia, Libya, Myanmar, Somalia, Sudan, Syria, and Zimbabwe. Measures have been taken against Egypt concerning the freezing of funds of certain individuals and entities. Measures have been taken to prohibit the payment of certain claims by Iraq, Libya, and the Haitian authorities.

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. 10/365) was discussed by the Executive Board on December 13, 2010, and released under Public Information Notice (PIN) No. 10/160 (December 16, 2010). A staff team comprised of Mr. Dorsey (head) and Mmes. Batini, Mordonu, Xiao, and Zoli (all EUR) visited Copenhagen during October 25–November 5, 2012 to hold discussions for the 2012 Article IV consultation. Ms. Pedersen and Mr. Andersen (both OED) joined the mission.

Outreach: The team met with representatives of the private sector, labor unions, the largest banks and other financial institutions.

Press conference: The mission held a press conference after the concluding meeting on November 5, 2012

Publication: The staff report will be published.

IX. **Technical Assistance**: None.

X. **Resident Representative**: None.

STATISTICAL ISSUES

Data provision is adequate for surveillance. The country has a full range of statistical publications, many of which are on the Internet. The quality and timeliness of the economic database are generally very good. The country subscribes to the Fund's Special Data Dissemination Standard. Metadata are posted on the Dissemination Standards Bulletin Board.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE (AS OF OCTOBER 2, 2012)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	9/12	10/1/12	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	7/12	10/1/12	M	M	M
Reserve/Base Money	7/12	9/7/12	M	M	M
Broad Money	7/12	9/7/12	M	M	M
Central Bank Balance Sheet	7/12	10/1/12	M	M	M
Consolidated Balance Sheet of the Banking System	7/12	10/1/12	M	M	M
Interest Rates[2]	8/12	9/7/12	D	D	D
Consumer Price Index	8/12	9/17/12	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Q1 2012	7/27/12	A	A	A
Revenue, Expenditure, Balance, and Composition of Financing[3]—Central Government	2009	04/10	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2009	04/10	A	A	A
External Current Account Balance	Q2 2012	9/17/12	M	M	M
Exports and Imports of Goods and Services	Q2 2012	9/17/12	M	M	M
GDP/GNP	Q2 2012	9/10/12	Q	Q	Q
Gross External Debt	11/07	04/10	Q	Q	Q
International Investment Position[6]	Q1 2012	9/14/12			

1/ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
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/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7/ Daily (D), weekly (W), monthly (M), quarterly (Q), annual (A), irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 13/08
FOR IMMEDIATE RELEASE
January 24, 2013

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Denmark

On January 16, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Denmark.[1]

Background

Denmark's near-term economic outlook is expected to improve as the economy is on the road to recovery from the global financial crisis. Output is projected to have declined by 0.4 percent in 2012, but modest growth is expected to resume in 2013, lifted mostly by private consumption and moderate business investment growth.

A combination of discretionary fiscal measures and freely-operating generous automatic stabilizers supported weaker than expected economic growth during 2010–12. The monetary policy response to safe-haven inflows has helped to reduce the need for foreign exchange purchases to maintain the peg to the euro. In the financial sector, prudential regulation has been strengthened through implementation of the 'supervisory diamond' initiative as well as through the reduction of banks' dependency on state guarantees.

Risks are weighted to the downside given the close trade and financial links to the euro area, worsening global financial conditions as well as domestic vulnerabilities stemming from house price developments and adverse developments in the domestic financial sector. Fiscal

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

consolidation efforts may weigh on future growth unless the deleveraging process that is ongoing in the private sector does not reverse on the back of resuming confidence.

Executive Board Assessment

Executive Directors noted that Denmark's recovery from the global financial crisis is faltering, notwithstanding the authorities' strong policy response, which has included a mix of expansionary fiscal policy and labor market reforms. While growth is expected to resume in 2013, downside risks persist, stemming mainly from a further slowdown in major trade partners or a worsening of the outlook for financial and real estate markets. Directors agreed that Denmark is well positioned to address its macroeconomic policy challenges, with its low public debt, net creditor status, and strong credit rating.

Directors supported Denmark's medium-term fiscal consolidation plans. They welcomed recent fiscal measures and the reforms addressing overruns in local spending, including a reinforcement of sanctions. They broadly agreed that, if growth falls significantly below current projections, the authorities should allow automatic stabilizers to operate fully and consider additional support to the economy within the space permitted by EU commitments. In this context, a number of Directors underscored the importance of meeting the 2013 targets under the EU Excessive Deficit Procedure and exiting from it in early 2014 for maintaining market confidence.

Directors agreed that the longstanding peg to the euro has served Denmark well and remains appropriate. They noted, however, that the recent shift to negative policy rates—to contain capital inflows and support the peg—poses challenges for monetary policy and carries risks if maintained for a prolonged period. They encouraged careful monitoring of these issues.

Directors welcomed the authorities' initiatives on macro-prudential and crisis resolution policies, including the creation of the interagency Systemic Risk Council. Banks' dependency on state guarantees has been reduced, and prudential regulation has been strengthened. However, continued vigilance is warranted and there is scope for additional strengthening of the financial sector through more robust capital and liquidity buffers, risk-based deposit insurance premia, limits on deferred amortization mortgage loans, and a reversal of the decoupling of taxes from real estate values to limit excess volatility in housing markets. Directors welcomed the authorities' engagement in the development of a European banking union.

Directors commended the authorities' actions to address the challenges of improving competitiveness and productivity growth. Additional reforms to raise potential growth would include further measures to boost competition and limit tax disincentives to work and to the accumulation of human capital. In this context, Directors looked forward to the findings of the Productivity Commission on productivity enhancements, including in the public sector.

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 (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with Denmark is also available.

Denmark: Selected Economic and Social Indicators, 2006–17

	2009	2010	2011	2012 proj.	2013 proj.	2014 proj.	2015 proj.	2016 proj.	2017 proj.
Supply and Demand (change in percent)									
Real GDP	-5.7	1.6	1.1	-0.4	0.9	1.3	1.5	1.5	1.5
Net Exports 1/	1.2	0.0	0.7	-1.0	-0.1	0.1	0.1	0.1	0.1
Domestic demand	-4.7	0.6	-0.2	0.9	1.3	1.6	1.7	1.7	1.7
Private Consumption	-3.6	1.7	-0.5	1.0	1.4	1.6	2.0	2.0	2.0
Gross fixed investment	-15.9	-2.4	2.8	2.1	2.0	2.0	2.2	2.3	2.3
Gross national saving (percent of GDP)	20.3	22.7	23.2	22.5	22.0	21.6	21.4	21.3	21.1
Gross domestic investment (percent of GDP)	18.2	17.0	17.4	17.8	17.9	18.0	18.0	18.1	18.2
Potential output	0.4	0.3	0.4	0.4	0.5	0.6	1.1	1.1	1.3
Output gap (in percent of potential output)	-3.2	-2.0	-1.3	-2.1	-1.8	-1.1	-0.8	-0.4	-0.2
Labor Market (change in percent)									
Labor force	-2.2	0.4	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Employment	-4.9	-1.1	0.4	0.3	0.4	0.8	0.6	0.5	0.5
Harmonized Unemployment rate (in percent) 2/	6.1	7.5	7.6	7.6	7.6	7.2	7.0	6.8	6.6
Prices and Costs (change in percent)									
GDP deflator	0.7	4.1	0.6	2.0	1.9	1.8	1.8	1.8	1.9
CPI (year average)	1.3	2.3	2.8	2.6	2.0	2.0	2.0	2.0	2.0
Public finance (percent of GDP)									
Central government balance	-2.0	-2.5	-2.0	-4.3	-2.5	-2.3	-1.7	-1.4	-0.3
General government revenues	55.2	54.8	55.5	54.3	54.6	52.9	53.2	52.7	53.7
General government expenditure	58.0	57.5	57.4	58.5	57.1	55.1	54.9	54.0	53.9
General government balance	-2.8	-2.7	-2.0	-4.2	-2.5	-2.2	-1.7	-1.4	-0.3
General government structural balance (percent of potential GDP)	-0.4	-1.4	-0.7	-1.0	0.0	-0.6	-0.6	-0.5	-0.1
General government primary balance 3/	-2.1	-2.0	-1.2	-3.4	-1.9	-1.7	-0.9	-0.6	0.4
General government gross debt	40.7	42.7	46.4	49.9	51.2	52.2	52.6	52.4	51.5
Money and Interest rates (percent)									
Domestic credit growth (end of year)	-1.8	1.6	-1.4	...	...	...	...	...	...
M3 growth (end of year)	4.5	7.9	-5.9	...	...	...	...	...	...
Short-term interest rate (3 month)	1.8	0.7	1.1	...	...	...	...	...	...
Government bond yield (10 year)	3.6	2.9	2.7	...	...	...	...	...	...
Balance of payments (in percent of GDP)									
Exports of goods & services	49.7	46.9	48.4	49.3	49.7	50.1	50.4	50.4	50.4
Imports of goods & services	-45.8	-43.6	-45.3	-46.5	-46.8	-47.1	-47.5	-47.5	-47.5
Trade balance, goods and services	3.8	3.3	3.1	2.8	2.9	2.9	2.9	2.9	2.9
Current account	3.4	5.9	5.6	5.2	5.0	5.0	5.2	5.3	5.5
Exchange rate									
Average DKK per US$ rate	5.4	5.6	5.4	...	...	...	...	...	...
Nominal effective rate (2000=100, ULC based)	105.9	102.0	101.2	...	...	...	...	...	...
Real effective rate (2000=100, ULC based)	102.0	96.4	96.6	...	...	...	...	...	...

Social indicators (Reference year)
GDP per capita, PPP (current international $) (2011): $41,015; At-risk-of-poverty rate (2010): 18.3 percent.
1/ Contribution to GDP growth.
2/ Eurostat definition.
3/ Overall balance net of interest.

Statement by Benny Andersen, Executive Director for Denmark and
Gitte Wallin Pedersen, Senior Advisor to the Executive Director
January 16, 2013

On behalf of the Danish authorities, I would like to thank the staff for the candid and constructive policy discussions in Copenhagen during the Article IV mission. My authorities appreciate the high quality papers and broadly concur with staff's analysis and assessment. They will carefully consider the recommendations.

Economic Outlook

The recovery of the Danish economy was discontinued last year. GDP looks to have contracted by nearly ½ percent, despite large stimulus to private demand from economic policy and despite home owners having benefited from Denmark's status as a "safe haven", which has driven down interest rates to extraordinary low levels. However, both consumers and businesses have been very cautious in their spending, probably reflecting, to a large extent, the uncertainties in the international economy, in particular those emanating from the sovereign debt crisis. Not much support has come from external demand, either.

Despite the decline in production last year, the unemployment rate has only increased slightly and is still considerably lower than in previous periods of weak economic cycles. That points to a well-functioning labor market characterized by many new job openings and relatively low long-term unemployment, when compared to both historical and international levels.

The situation is expected to improve in 2013 and 2014. Overall, the Danish authorities expect GDP to grow by 1.2 percent in 2013 and 1.6 percent in 2014 – one quarter of a percentage point above IMF staff's estimates for both years. While this is a relatively modest growth, it will be sufficient to bring about a gradual improvement in the labor market, with rising employment and a reduction in unemployment from mid-2013.

Growth this year is mainly driven by economic policy stimulating private domestic demand. However, private consumption growth is expected to be moderate, as some households still need to consolidate their balance sheet. From 2014, growth is expected to become more selfsustaining; with exports taking over as the main driver of growth as Danish export markets gain momentum.

Export growth is helped by a significant slowdown in wage growth in the private sector, which has remained well below wage growth abroad over the last 1½ years. However, the ability of companies to benefit from growth in export markets is still hampered by past years' loss of competitiveness. Since 1995, the Danish wage growth has been out of sync with productivity growth for extended periods of time and, as also noted by IMF staff, the very large current account surplus of around 5 percent of GDP is mainly related to net income flows and weak imports due to weak domestic demand, not to strong exports.

Net income from abroad has risen substantially over the past 10 years along with Denmark's transition from a debtor to a creditor nation. The net income flows have stimulated domestic demand and thereby contributed to an upward pressure on wages and deteriorating wage competitiveness. While this may hold back income generated from exports, the high net income flows expand the potential for higher spending of households and companies.

The short-term outlook is, of course, associated with considerable uncertainty. The risks are very much related to developments abroad. The Danish authorities' forecast assumes that Denmark maintains its status as a "safe haven" until conditions in the financial markets have been normalized. Rising interest rates could have adverse effects on the whole economy, in particular for the housing market where the on-going stabilization remains fragile.

As in many other countries, normalization of the business cycle following the set-back in 2008-09 is likely to take time. In Denmark's most recent Convergence Programme, submitted to the EU in April 2012, the cyclical situation is projected to normalize with a closing of the output gap by 2018. Prior to the crisis, the Danish economy was characterized by very high capacity utilization and gauging by the output gap, the current slack in the economy is estimated by the Danish authorities at around 2¾ percent of GDP.

The stretched-out period of recovery partly reflects the expansion of household and corporate balances throughout the 2000s, in particular related to the housing market bubble, and the loss of wealth in private and financial institutions following the downturn. Consequently, the need to consolidate private sector balances has dampened demand from households and companies. Experience from previous financial crises shows that the recovery from such crises takes longer compared to other downturns.

There are several indications that some realignment of the imbalances built up during the boom years has taken place, and that the size of the imbalances built up in the Danish economy up until 2007 has been reduced. This is a precondition for normalization of the cyclical position to take place. Incomes are high and considerable saving is taking place, especially in the corporate sector, and the interest rates are very low, which has stabilized the housing market. However, the exact timing and path of a normalization of the business cycle is difficult to predict.

The report addresses the growth rate in the standard of living in Denmark. However, the conclusion is a bit too gloomy. Adjusted for gains in the terms-of-trade and net income from abroad, the growth in the Danish standard of living has been in line with comparable countries over the past 15 years. Net foreign wealth is now 30 percent of GDP and net income from abroad has gone from an outlay of 3-4 percent of GDP to a net income of 4 percent of GDP.

Fiscal Policy

Economic policy is planned to support growth and employment within the framework of a healthy and responsible fiscal policy that meets the requirements in the EU recommendation and the new Danish Budget Law. A sound and credible fiscal policy is important to maintain confidence in Danish economic policies and to keep low interest rates that support growth and employment.

Based on the Danish government's most recent Economic Survey from December 2012, developments in public finances are expected to be in line with the EU recommendation, according to which the structural budget balance must be improved by 1½ percent of GDP from 2010 to 2013 and the actual budget deficit must be reduced to below 3 percent of GDP by 2013.

The dampening effect on activity from fiscal consolidation is, however, offset by a number of stimulus measures that do not directly affect public finances, or which have only a limited impact. This includes, among other things, an investment window, according to which companies can write off 115 percent of (certain) investments in 2013.

Overall, economic policy is estimated to provide a significant contribution to growth and employment in 2013. Fiscal policy and other economic policy measures from 2012 onwards are thus estimated to increase the GDP level by 0.8 percent in 2013 (measured by the multiannual effects), while the effect on employment is estimated at around ½ percent (15,000 persons).

Fiscal policy for 2014 will not be set and finalized until the 2014 budget is put forward and adopted. Based on technical assumptions, economic policy is estimated to have a neutral effect on activity in 2014, while the public deficit in 2014 is estimated to be close to the 3 percent of GDP limit set forth in the Stability and Growth Pact. This implies that the fiscal room for manoeuvre is very limited since the correction of the excessive deficit in 2013 in line with the EU recommendation has to be sustainable, implying that the deficit has to stay below 3 percent of GDP going forward.

The Budget Law, which was adopted in the Danish Parliament in 2012, introduces binding expenditure ceilings for state, regions and municipalities from 2014. In order to allow automatic stabilizers to operate freely, the highly cyclical unemployment-related expenditure is not covered by the expenditure ceilings. Also, public investments are outside the ceilings. Under the Budget Law, the annual structural deficit must not exceed ½ percent of GDP, in accordance with the requirement in the European Fiscal Compact, except in extraordinary circumstances.

The medium-term fiscal strategy is embodied in the government's 2020-Plan from May 2012. The 2020-Plan presents the government's reform program and determines the possible annual growth rate of public consumption given that fiscal policy must fulfill the targets of obtaining structural budget balance in 2020, ensuring fiscal sustainability and keeping a debt level safely below the EU limit of 60 percent of GDP. The Danish government has announced a precautionary principle, implying that the actual growth rate in public consumption must comply with these fiscal targets, given the projected revenues only including policies and reforms that have already been adopted by Parliament. Additional growth in public consumption, based on future reform plans, cannot be implemented before the reform is adopted by Parliament. The precautionary principle and the 2020-Plan thus contribute to ensure the credibility of Danish fiscal policy.

Monetary and Exchange Rate Policy

The Danish authorities share the view that the longstanding peg to the euro has served Denmark well in anchoring inflation and minimizing exchange rate volatility vis-à-vis major trade partners. The inflation rate is low and stable and inflation expectations are well anchored, thus representing a key component of the Danish stability-oriented macroeconomic policy.

The intensified government debt crisis in some European countries in the second half of 2011 resulted in safe haven flows from domestic and foreign investors and a strengthened upward pressure on the krone. To counter this, Danmarks Nationalbank conducted intervention purchases in the foreign-exchange market for considerable amounts – 91 billion kroner (approximately 5 percent of GDP) from August 2011 to June 2012. In the same span of time, Danmarks Nationalbank shadowed the two downward reductions in ECB policy rates and furthermore lowered rates unilaterally 5 times.

At the end of May, with effect from the beginning of June 2012, Danmarks Nationalbank lowered the rate on the current account, which is used for settlement of payments, to 0 percent, and the rate on certificates of deposits was lowered to 0.05 percent. When the ECB lowered its rates by 0.25 percentage points on 5 July 2012, Danmarks Nationalbank was bound to introduce negative monetary-policy rates to keep the interest-rate spread unchanged. Negative rates were implemented by lowering the rate on certificates of deposits to -0.20 percent while leaving the rate at 0 percent on the current account. The limits for current-account deposits were expanded in order to reduce the strain of a negative interest rate on certificates of deposits on the banks. In order to ensure a simple and transparent implementation, the principle that the limits are determined on the basis of the banks' activities in the money market has not been changed.

Transmission to market rates and the krone rate has been clear since the introduction of the negative interest rate on certificates of deposit. Danmarks Nationalbank has not conducted intervention purchases of foreign exchange since July 2012, and the krone has weakened around 0.3 percent to a level close to the central rate against the euro in the ERMII. In the period following the rate reductions, confidence in the handling of the government debt crisis in some European countries has increased, which lead to a general strengthening of the euro.

Today, the banks hold certificates of deposit amounting to approximately 150 billion kroner. On an annual basis, this entails limited interest expenses in the range of 300 million kroner corresponding to 0.02 percent of GDP. So far the banks have not introduced negative retail rates on deposits for the private and corporate sectors. In a few instances, firms have had negative interest rates on deposits, primarily special short-term time deposits. The banks' lending margins have by and large remained unchanged since the introduction of negative interest rate on certificates of deposits.

The turnover for overnight money-market loans has declined after the introduction of negative monetary policy rates, but not to unprecedented levels. The decline should be seen in light of the expansion of the limit on current-account deposits, which has improved the banks' ability to manage liquidity fluctuations via the current account. On the other hand, the turnover has been supported by the fact that the banks have an incentive to lend in the market rather than to buy certificates of deposits at negative rates.

The circulation of large bank notes has remained stable since the introduction of negative monetary-policy rates.

Danmarks Nationalbank considered the possibility of negative monetary-policy rates before the actual introduction. In February 2012, Danmarks Nationalbank posted a technical description of the handling of potentially negative monetary-policy interest rates on its website, while the financial sector was directly informed.

Danmarks Nationalbank carefully monitors developments on an on-going basis and is prepared to implement further measures if needed, including adjustments to the monetary-policy instruments.

Likewise, Danmarks Nationalbank is prepared for a reversal of capital flows, and has previously been able to manage the exchange rate of the krone in times with substantial outflows, as it was the case during the financial crisis in the autumn of 2008.

Financial Sector Issues

The Danish authorities overall find the staff report and the related material balanced in relation to issues on the Danish financial sector.

There are, however, some issues which my authorities would like to clarify further.

Staff concludes that the government guarantee schemes and the state funded capital injections have enhanced the perception of the existence of an implicit government guarantee on the financial sector. Staff concludes that after bank rescue packages 1 and 2, Denmark has enacted and implemented bank rescue package 3 allowing for haircuts on senior debt. Haircuts have been imposed on creditors when ailing banking institutions have wound up using bank rescue package 3. (Banking institutions wound up using bank rescue package 3, which constitutes 1 percent of total assets of the Danish banking sector.) However, Denmark is one of very few EU member states – if not the only one – that has imposed haircuts on creditors. Consequently, it is the perception among e.g. rating agencies that the probability for future bailouts in Denmark is lower. This is reflected in the low systemic support uplift included in the rating of Danish institutions compared to institutions in other countries. This is also noted in the Staff Report (p.10).

In relation to the treatment of covered bonds in the Basel III proposal on the LCR, staff states that the Danish authorities' concerns have been addressed. However, this conclusion seems premature. The LCR as defined in the final Basel III still gives preferential treatment to government debt. This poses a challenge for jurisdictions with low public debt. More importantly, the current euro debt crisis has revealed the inappropriateness of this approach. Furthermore, it does not reflect the actual performance of government and covered bonds. Hence, in a joint working paper by Danmarks Nationalbank and the BIS, it was concluded that Danish covered bonds were as liquid as Danish government bonds during the crisis. At this stage, the CRDIV/CRR is still being negotiated in Europe. It is very important that the calibration of the LCR is based on a thorough analysis of the different assets liquidity characteristics and a range of assets are to be tested by the European Banking Authority according to different objective liquidity criteria. By a delegated act, starting from 2015, the Commission can regulate where different assets should be placed in the different levels of the liquidity buffer according to the results of these tests. Final agreement between the Council and the European Parliament is pending.

On the European banking union, staff is correct in assessing that the Danish government is positive regarding the creation of a banking union in Europe. However, it is important to note that the Danish government has not yet decided on the issue of Danish participation in the single supervisory mechanism and the banking union. This decision would depend on a cost/benefit analysis of the complete banking union, thus depending on its remaining elements, notably the coming proposal on a common resolution mechanism for member states participating in the single supervisory mechanism.

Productivity

In the medium-term projection, productivity is assumed to grow by 1.2 percent per year in 2014-2020, corresponding to the average productivity growth in 1991-2013.

Denmark has experienced a significantly lower productivity growth since the mid-1990s than most other OECD-countries. As pointed out by Staff, an important explanation is a relatively low level of competition, especially in the service sector, and several measures addressing this issue have been taken in the competition reforms announced in October 2012.

The Government has set up a Productivity Commission to look into the reasons for the slow productivity growth and put forward recommendations to enhance productivity. The Productivity Commission will present their work and proposals by the end of 2013. Among the Commission's tasks is to analyze the productivity in the public sector.