

**Statement by Kai Aaen Hansen, Executive Director  
for Denmark  
August 5, 1999**

My Danish authorities welcome the staff report which provides a good description of the Danish economy and gives a fair and balanced presentation of the consultation discussions in Copenhagen.

*Overview*

When the present government took office in 1993, the primary goals were to boost growth and to reduce unemployment significantly. These goals have been reached. GDP grew by more than 3 percent annually in the period 1994 to 1998, and unemployment has been halved from above 12 percent of the labor force in 1993 to less than 6 percent at present. Structural reforms of the labor market and the tax system have been essential factors behind this development.

Public finances have improved from a deficit in 1993 of almost 3 percent of GDP to an expected surplus of the same magnitude this year.

Despite the fast growth and low unemployment, wage and price increases have remained relatively modest.

The government has continued the exchange rate policy. From January 1 this year, the krone shall be kept stable vis-à-vis the euro. This strategy has gained credibility over the years, and the Danish interest rates have followed the European rates. Admittedly, a small spread exists between Danish interest rates and the euro rates.

In the short run, the main challenge for economic policy is to secure a soft landing after the strong recovery. The Danish economy is now running close to its present potential. A slowdown – especially in domestic demand – has been necessary to avoid overheating, causing inflation and a more abrupt end to the business cycle. Furthermore, the supply of labor should be increased to support growth in the medium term.

*Economic policies*

There have been no major new economic policy initiatives since the consultations took place, and the overall economic objectives are unchanged. The staff report gives an accurate description of the discussions on economic policies at the consultations. Furthermore, the report gives a balanced presentation of the major economic policy

initiatives i.a. the Whitsun Package and other structural measures, especially regarding the labor market.

Concerning the *Whitsun Package*, the report accurately describes the main objectives behind the Package. The Whitsun Package is a structural initiative that is expected to be timed appropriately in relation to the business cycle, where the intention in the short run is to dampen the growth of domestic demand. This is primarily achieved by cutting the tax value of deductible interest payments gradually towards the year 2001. It is expected that this initiative in the short run will reduce demand for houses, and thereby restrain the development in house prices. This will – through a wealth effect – reduce the rate of growth in private consumption and thereby reduce domestic demand in the short run.

As noted in the staff report, the developments in house prices – since the Whitsun Package was announced – have been more buoyant than expected. However, there are a number of indications that the package is working. Thus, there has been a marked drop in housing starts, as well as in housing sales. This indicates that the growth in house prices will be dampened in the near future.

The staff suggests that there might be a risk of “overkill”. However, it is the view of the Danish authorities that this risk is not significant. On the other hand, the developments in the housing market are, of course, monitored closely.

The structural effect of the Whitsun Package is believed to be – as recognized in the report – to raise private saving in the long run and also increase incentives to work for low wage earners.

Concerning *fiscal policy*, the Danish Government will present the central government budget proposal for the year 2000 later this month. The budget will continue the fiscal consolidation process. Furthermore, the budget – combined with the agreement between the central government and local authorities concerning the economy of the municipalities for year 2000 – should imply an overall neutral fiscal stance in 2000.

The staff has expressed concern about the tendency toward public consumption overruns. The Danish authorities recognize that in later years there has been an unfortunate tendency toward public consumption overruns. It is believed that the negotiated agreements with local authorities and improved monitoring mechanisms will reduce this problem.

In regard to *the medium term objectives of fiscal policy*, the Danish Government is committed to continuing the reduction of public debt. Public gross debt has been reduced from 78 percent of GDP in 1993 to 55 percent in 1998. The goal is to bring the gross public debt down to 40 percent of GDP by 2005. Fiscal consolidation is very important, first of all because the demographic development will intensify the pressure on public finances after 2005. The long-term strategy is to reduce public debt and thereby interest payments, to make room for increased expenditures relating to demographic changes without having to increase the tax burden.

At the consultations, the staff wondered whether part of the fiscal surplus could be used to lower the overall tax burden. As a significant reduction of the public debt is the main priority, it will not be possible to implement tax cuts until the public finances are showing a robust surplus on average over the business cycle. This leaves only a small room for tax reductions in the near future.

In general, the Danish authorities find the staff's analysis of *monetary policy* issues comprehensive and well balanced.

The *fixed exchange rate policy* has been a cornerstone in the Danish economic policy since the beginning of the 1980s. The strong commitment to maintaining exchange rate stability has effectively brought down inflation expectations and acted as a restraint on fiscal policy. After the introduction of the euro January 1, 1999, the Danish participation in ERM II constitutes the formal framework for the continuation of the fixed exchange rate policy.

With monetary policy directed solely at maintaining exchange rate stability, the monetary and financial stance of the economy can, from time to time, be somewhat more accommodative than warranted from a purely domestic cyclical perspective. In Denmark, however, movements in short-term interest rates have only a limited direct effect on domestic demand. Thus the relatively marked, and from a cyclical point of view, undesirable, easing of monetary and financial conditions which was observed during the last months of 1998 and in the beginning of 1999 was almost exclusively caused by movements in the effective exchange rate and long-term interest rates. At present, the easing of financial conditions has been partly reversed by the upswing in long-term interest rates since February 1999.

It is obvious that the Danish opt-out clause to EMU does not allow Denmark to reap the full benefits of the European internal market in terms of increased competition, lower transaction costs, greater price transparency, etc.

Furthermore, as a consequence of the opt-out, some risk premiums on interest rates are likely to prevail, especially during periods of exchange rate turmoil, where short-term interest rates will be raised in order to maintain exchange rate stability. As short-term interest changes have only a modest impact on economic activity, occasional and temporary currency unrest does not in itself constitute a major problem, provided the economic fundamentals remain sound.

It is acknowledged that the Danish opt-out and the participation in ERM II offer a limited scope for the narrowing of the long-term interest differential to Germany. It is important to emphasize, however, that the current differential is not the relevant measure of the cost of opting out. Long-term interest rate differentials also persist within the euro area, reflecting varying degrees of credit and liquidity risks.

Taken together, it is the assessment of the Danish authorities that the economic costs in terms of the interest rate differential of opting out of EMU are only modest under normal

circumstances. The comparatively strong performance of the Danish economy since 1993 gives an indication of the fact that the monetary policy framework, now as a member of the ERM II, has served the Danish economy well, as emphasized in the present report from the staff.

With regard to *labor and product markets*, a number of reforms have been implemented in recent years. The strategy behind the Danish labor market reforms has been to enhance labor market flexibility by increased education and training. Furthermore, work incentives have been strengthened by lowering marginal income taxes – especially for low income workers – and stricter availability rules. The labor market reforms have reduced structural unemployment, and unemployment has been reduced significantly, with wage increases being relatively modest. The challenge now is to increase labor supply and improve incentives to stay longer in the labor force.

In the product markets, the Competition Act has been strengthened, publicly owned enterprises have been privatized, and a number of sectors, e.g., telecommunications, electricity and bus transport, have been liberalized to a substantial degree. However, the Danish Government acknowledges that there is scope for enhancing competition through further liberalizations.

#### *Recent developments*

Since the mission took place, a number of statistics have been published.

National account figures for the first quarter of 1999 and revised figures for 1995 to 1998 were published at the end of June.

GDP growth has been dampened in line with national and staff projections. GDP growth year-on-year fell to 1 percent in the first quarter of 1999, as destocking contributed negatively to GDP growth.

The negative stock building partly explains the low level of import of goods in the first quarter of 1999, hence the improvement of the trade balance is expected to be less pronounced during the rest of 1999.

Gross fixed investments increased more than anticipated, which was primarily due to large increases in machines and equipment. Despite the slowdown in production, employment rose further, and labor productivity is thus performing poorly.

The annual increases in wages have continued to edge up. The increase in the private sector hourly wage index was 4.7 percent in the first quarter of 1999.

The accelerating wages reflect that unemployment has fallen continuously, and is now below structural unemployment. The unemployment rate was 5.7 percent in June 1999.

However, a turning point in unemployment is expected to occur in 1999, as the decelerating production is projected to lower employment eventually.

Recent consumer price index figures are in line with projected price inflation, around 2 ½ percent in 1999 and 2000. Consumer price inflation in June was 2.4 percent, and is expected to increase during 1999, as raw materials prices feed through. Inflation is expected to abate slightly during 2000 due to less impact from excise duties and slowdown in demand.

Following the increase in the first quarter of 1999, house prices were expected to level off during the rest of 1999. However, some preliminary information points to a continued rise in house prices in the second quarter of 1999, but, in our assessment, this is mainly due to composition effects and seasonal effects.

Consumer confidence has improved further, but the level is as low as in the recession year 1993. New car registrations fell further in the second quarter, and the most recent retail sale figures also indicate a dampening of private consumption growth.

The recent increase in long-term interest rates will contribute to ease demand pressure in the housing market and in other parts of the domestic economy.

In conclusion, recent statistical information supports the view that the Danish economy is on its way to a soft landing.