Denmark – an outsider mimicking the insiders?

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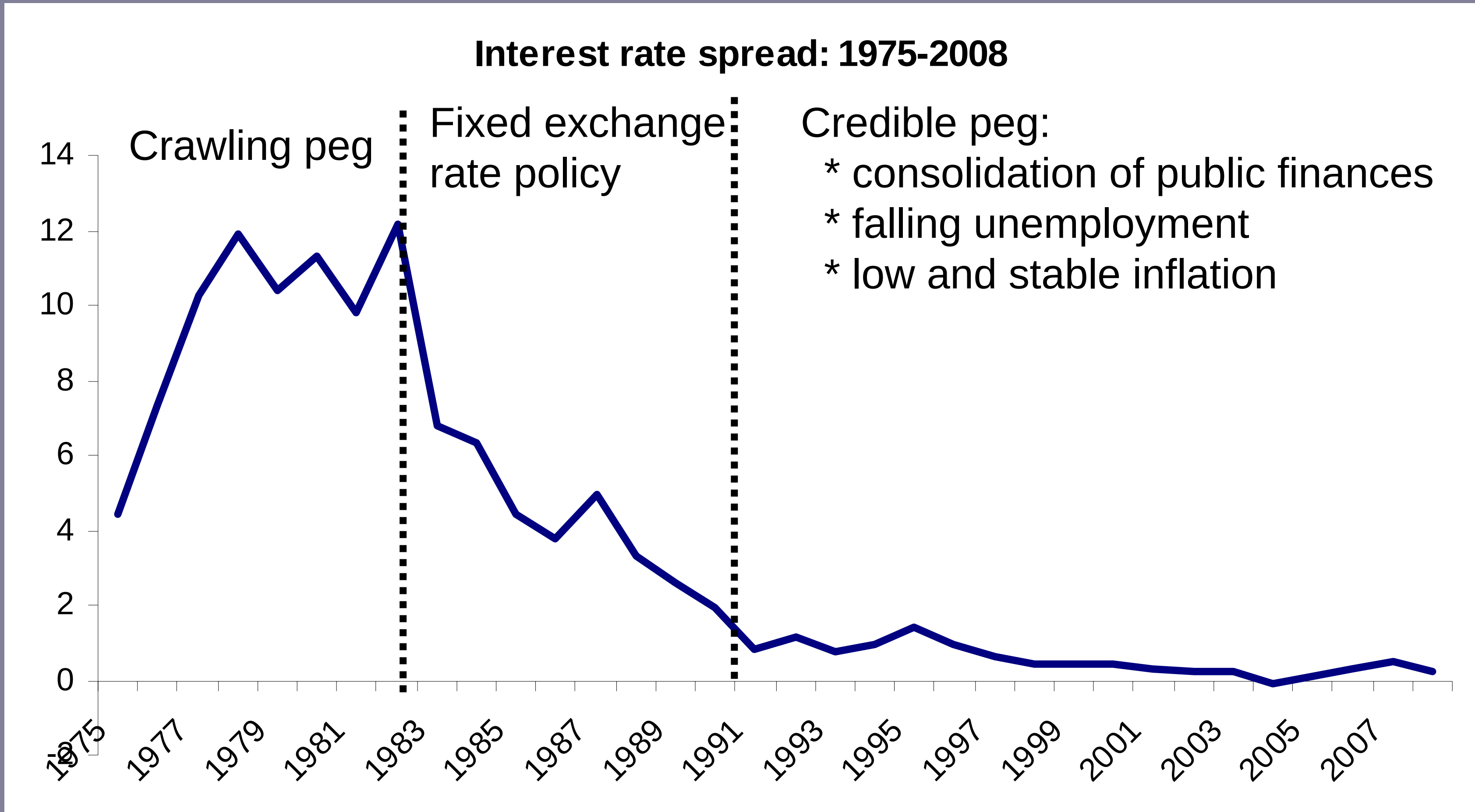
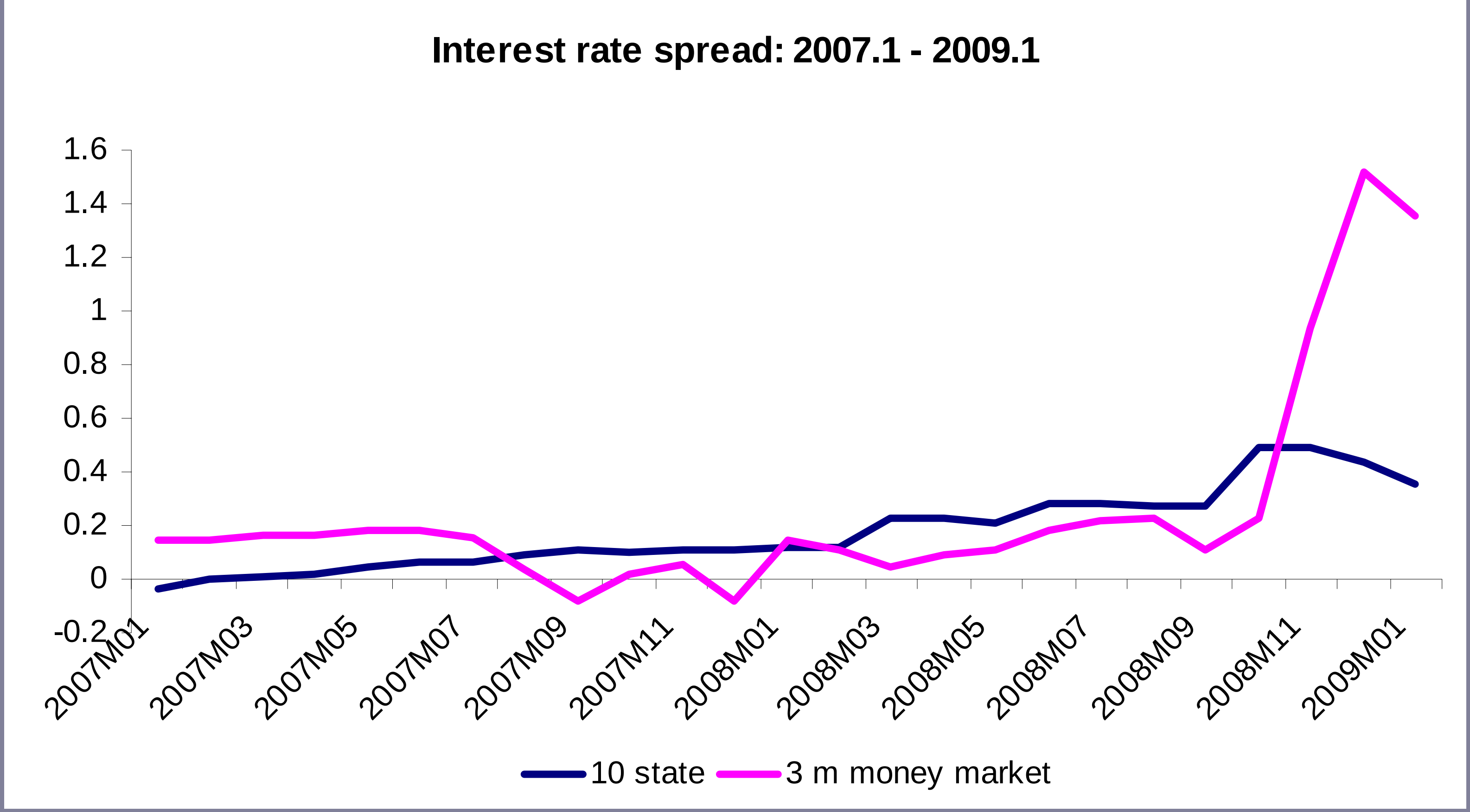
Exchange rate policy

- Fixed exchange rate policy since 1982 (EMS, ERM and ERM II- narrow band)
- Referenda on EMU: 1992, 2000
- A new referendum?
- Staying out = political decision, hence important to safeguard credibility of exchange rate policy

From crawling peg to credible peg



Financial crises: significant widening of interst rate spread



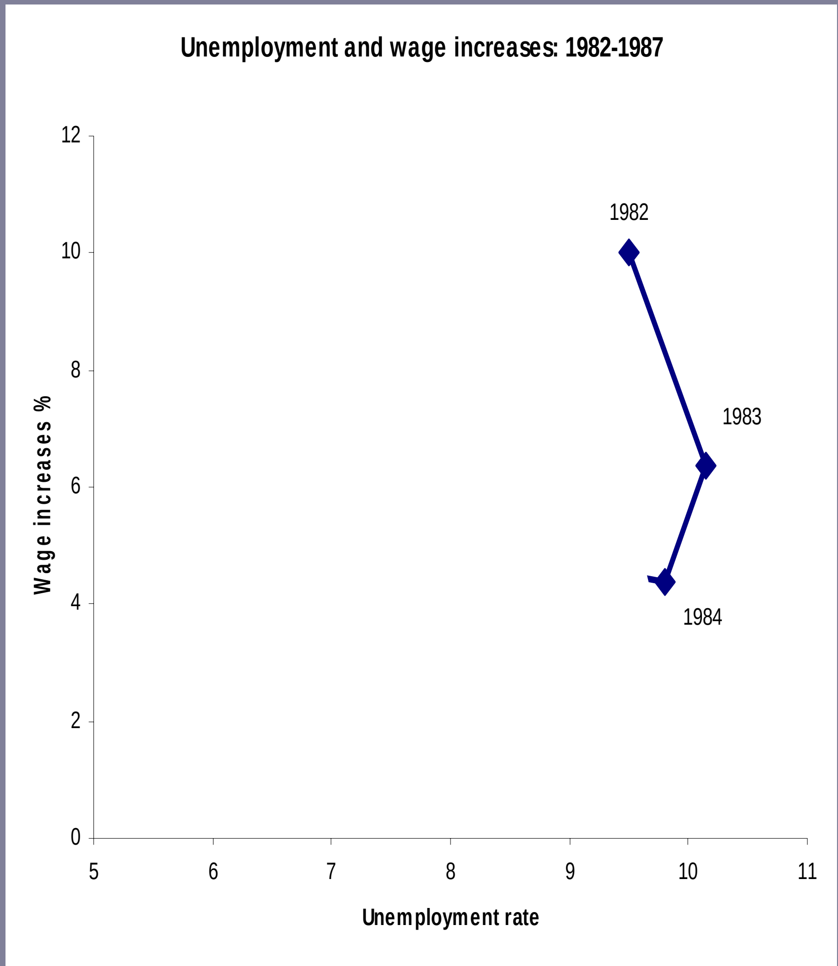
A brief flashback

- Mid 80s: Establishing credibility
  - abandonning indexation,
  - tight wage and price control,
  - fiscal tigthening
  - liberalisation of capital markets

  = Huge drop in interest rates

- Booming domestic demand
- Current account deficits
- High wage increases (9% in 1987 despite unemployment rate at 10 %)
- Evident that structural problems were present

The 1987 episode



An eye-opener

- policy makers
- labour market organizations ("fælleserklæringen")

"Rather a job-party than a wage party"

Fiscal policy and a fixed exchange rate policy

- Pegging to D-mark/Euro = implicit inflation target = Euro inflation target
- Main macro instrument = fiscal policy
- Fiscal policy requirement: reach the inflation target
- Explicitly recognized in policy making

1990s

- Economic progress: Falling unemployment
- Continuous fear that wage increases may come out of control (do not repeat the 1987 incidence!)
- 1997 – anticipatory fiscal tigthening!

”The fixed exchange rate policy is supported by a tight fiscal policy. Even though there is no actute risk that the economy overheats, there are some worrying signals which make it necessary to dampen growth in domestic demand to ensure a more moderate development in costs”

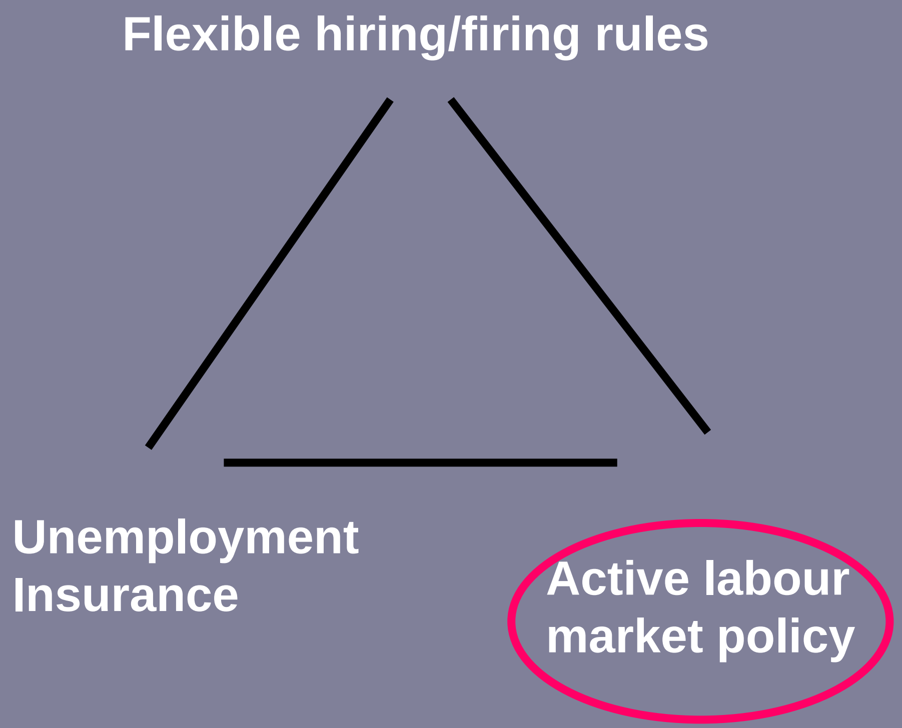
TINA also goes out

- EMU membership – need for reforms, monetary policy independence is lost (TINA)
- Also applies if staying out - needed to support the credibility of exchange rate peg
- Sequence of labour market reforms during the 1990s – trial and error – falling unemployment made it possible to pursue a more supply oriented policy

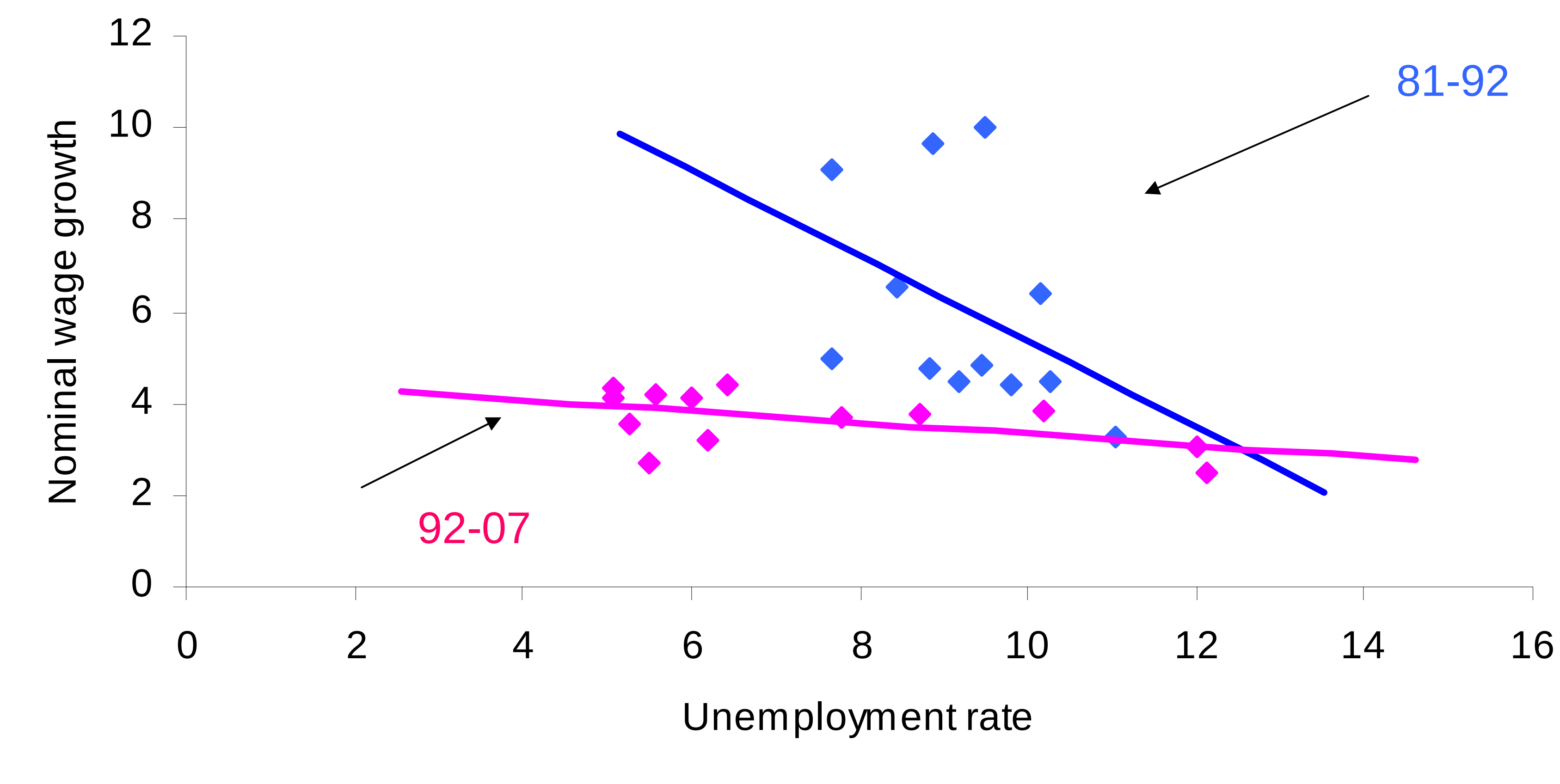
Labour market reforms in the 1990s

- Shorter duration of the benefit period
- Stricter eligibility conditions
- Activation (workfare)

Short-term insurance elements maintained, but incentives strengthened



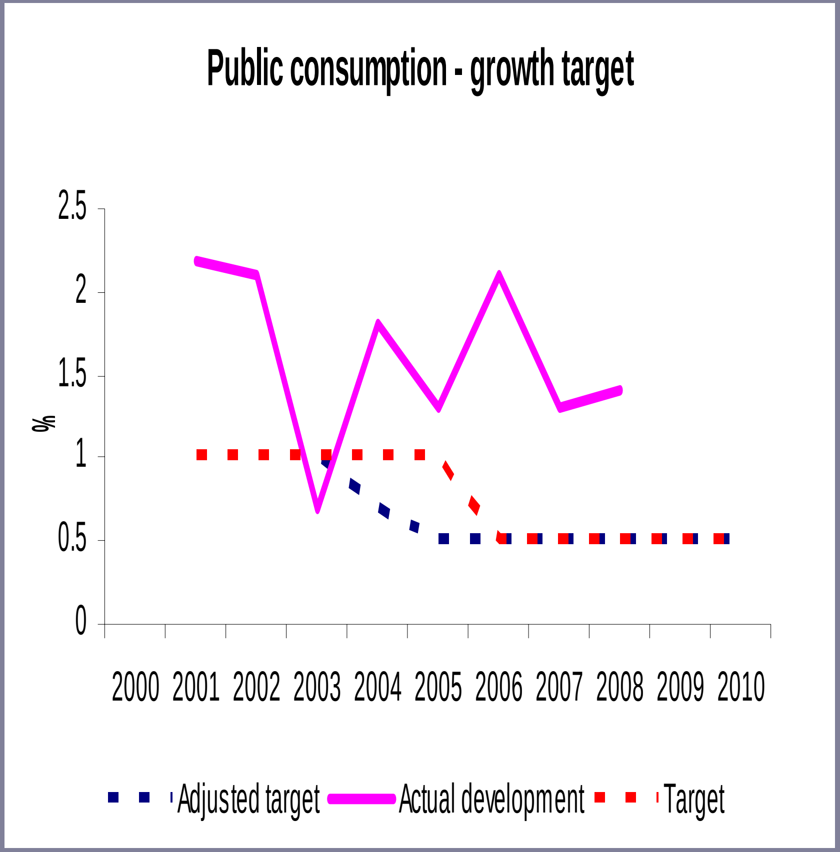
Structural shifts – Phillips curve

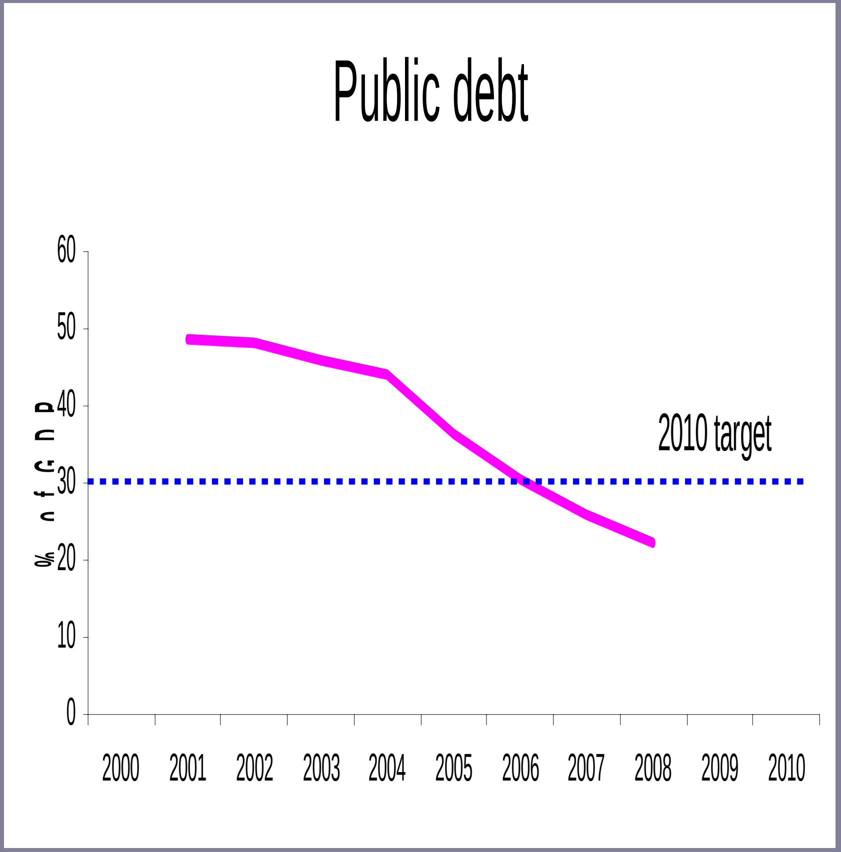


Fiscal policy framework

- Focus on fiscal sustainability problems from late 1990s
- 2010-plan: A preparation plan to cope with approaching demographic shifts
- Targets:
  - Reducing public debt
  - Public consumption (real) growth

2010-plan = consolidation plan



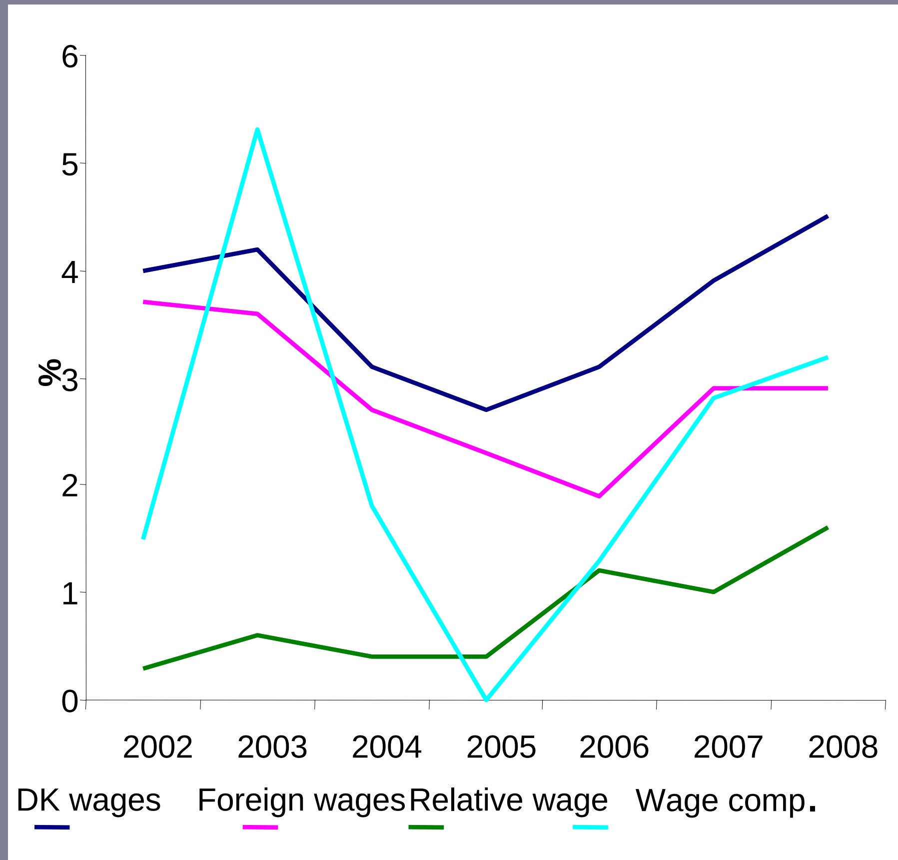


Fiscal policy framework - II

- Welfare reform: later retirement…from 2019!
- 2015-plan: less explicit on targets
  - 2015: public consumption not to exceed 26½ % of GDP (is passed already now)
  - Structural budget balance between ¾ and 1¾ % of GDP
  - Need for employment increase = 2-3% - but instruments are unspecified – tax or labour market reform?

Prior to financial crises

- Gradual but steadily: ”overheating” building up
- Wage competitiveness has systematically been eroded
- Depreciating memory of the importance of fiscal restraints?



Current challenges

- Reform agenda at a stalemate?
  - Labour market reforms
  - Tax reform

- Financial crises:
  - Share the same challenges with respect to financial sector + recession as most other countries
  - Experience: Difficult to avoid that high unemployement translates into a persistent fall in labour force participation