

Strong initial conditions have placed the Danish economy in a good position to meet the challenges ahead

Overall, the Danish economy is in a healthy position, just around a cyclical peak. Hence, the difficulties experienced in parts of the Danish banking sector are not rooted in domestic macroeconomic imbalances.

Economic activity and employment are at very high levels, following the recent upturn. Unemployment has been reduced to an extraordinarily low level of 1½ per cent of the labour force. And both the current account and public finances show sizeable surpluses.

Despite strong increases in domestic demand until late last year, the current account has remained in surplus and stood at 1 per cent of GDP in 2007.

The public sector budget has been in surplus for several years reflecting a strategy of consolidation during good times. In 2007, the government surplus was 4.8 per cent of GDP and outstanding central government debt constituted 26 per cent of GDP by the end of 2007. The public sector surplus is expected to be above 3 per cent of GDP in 2008. Correcting for temporary factors and the strong business cycle, the structural budget balance is estimated at 1½ per cent of GDP in 2008.

This leaves the Danish economy in a better position than many other countries. The strong state of the Danish economy – and the strength of the banking sector – was also emphasised by the IMF, when concluding its Article IV consultation of Denmark on Thursday last week.

Denmark is thus in a good position to weather the recent international financial turmoil. Some dampening of demand pressures would serve to bring economic activity in line with the estimated production potential. In the present juncture, the timing of the international slowdown thus helps to achieve a soft landing, and allow the fiscal policy stance to be slightly expansive in 2009.

Inflation – which has risen as in most other countries following global increases in food and energy prices – is likely to taper off throughout the rest of 2008. And with a strong surplus on public finances, automatic stabilisers are free to work.

While developments in the Danish housing market have attracted some attention, it is neither caused by, nor causing, the financial turmoil in Denmark. Also, households are in a solid net wealth position, and only a very small share of homeowners is technically insolvent. Furthermore, household real incomes are expected to increase by approx 2 per cent annually despite higher inflation, and while rising, forced sales are still at a very low level.

So far, the direct effects of the financial crisis have been relatively modest in Denmark, because Danish banks have limited exposures to sup-prime assets and generally appear well consolidated.

The main channels of contagion have, as in several other countries, been an increase in risk aversion and a drying-up of liquidity, which have increased short-term interest rates and shut down parts of the interbank market.

Some small and medium sized banks have been exposed to refinancing risk and thereby forced into a process of restructuring, which has so far evolved in an orderly fashion through private takeovers, although in a few cases in cooperation with the Danish Central Bank and the Danish Government.

However, in recent weeks an increasing number of banks have experienced problems, when rolling over their funding. The Danish Central Bank has established several additional temporary liquidity facilities, which have eased liquidity constraints. Despite these measures, short term funding markets remain extremely tight. Accordingly, the Danish financial system is presently exposed to significant liquidity risks with potential systemic implications. If such a scenario were to unfold, severe macroeconomic effects could be hard to contain.

On that background the package, which have been put forward, intends to effectively address the evolving liquidity shortage, while adhering to market principles and minimizing international spillovers. The package is also designed to limit problems related to moral-hazard in the banking sector, and minimize the risks to, and impact on, public finances.