

Bodil Nyboe Andersen: Recent economic developments in Denmark

Speech by Mrs Bodil Nyboe Andersen, Governor of the National Bank of Denmark, at the Annual Meeting of the Association of Danish Mortgage Banks, Copenhagen, 29 April 2004.

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The Danish economy has shown very positive trends in the last decades even though economic growth has been modest recently. Various governments have implemented a number of structural reforms since the beginning of the 1980s. As a result, the Danish economy is today extremely robust with strong economic fundamentals.

The fixed-exchange-rate policy, which was introduced in 1982, has been a cornerstone of this development. However, a sustainable and credible fixed-exchange-rate policy requires that the rest of the economic policy and the structural conditions are in order.

In Denmark this called for a number of economic reforms that began in the 1980s. The cost-of-living adjustment was abolished and the central-government finances improved. The deductibility of interest payments was restricted and interest taxation reduced. All of these factors contributed to breaking expectations of a devaluation-inflation spiral.

However, breaking these expectations took its toll and, as many people in the financial sector may still recall, the years around 1990 were lean years for Denmark.

On the other hand, these measures resolved some of the structural problems that had burdened the Danish economy for many years.

Since the beginning of the 1990s Denmark has seen stable growth with declining inflation, lower interest rates and the accumulation of solid surpluses on both public finances and the balance of payments, as well as gradual expansion of pension savings.

In recent years Denmark has seen strong growth in real wages, and at the same time Danish companies have successfully carried out rationalisation measures. Even though unemployment has been increasing for a period of time, unemployment has been low on a European scale in the last 5-10 years. This indicates that the structural reforms already implemented in the labour market have contributed to enhancing the flexibility of the Danish economy.

In international assessments and comparisons it is noted that Denmark has successfully applied a long-term and medium-term orientation to its economic policy without resorting to short-term fiscal-policy measures. Most recently, the IMF delegation that visited Denmark in March this year described this as follows in their conclusions:

“At the same time, Denmark has been well-served by focusing on medium term fiscal targets, and relying on large automatic stabilizers to support demand during downturns. Discretionary counter-cyclical policy should be kept as an exceptional response to avoid creating an expectation of fine tuning and short-term fixes that could weaken the effectiveness of the medium-term fiscal framework.”

Why focus on medium-term economic policy? Why is it recommended to refrain from fine-tuning via fiscal policy?

Because experience shows that detailed management of economic development is hard to achieve by adapting fiscal policy on an ongoing basis.

Not only is it difficult to make short-term predictions of economic development, it is also difficult to obtain an accurate picture of the current situation. We get a myriad of statistics, for example national accounts data, that are published rather quickly, with a dedicated effort. However, the short publication deadline means that the data will often have to undergo very extensive revision a few months later. This is especially problematic around a cyclical reversal when even minor revisions may give rise to a very different interpretation.

Unemployment represents a key indicator, which is timely as well as accurate. Consequently, unemployment plays a central role in the cyclical analysis and in the debate on the structure of economic policy.

However, the unemployment rate should not be readily interpreted as a reflection of the cyclical situation.

Firstly, experience shows that changes in employment lag behind cyclical trends. A cyclical reversal is reflected in the unemployment rate some months after the reversal actually takes place. Normally about six months on average, but the number of months varies considerably.

Secondly, the unemployment measure comprises both the unemployed who will be able to quickly find employment when economic growth picks up, and those who will not be able to find employment so quickly. The latter group, called structural unemployment, is not easily affected by an upswing created by a fiscal stimulus. It must be influenced via structural-policy measures targeted at mobility, education, unemployment benefit, activation, tax, etc.

In practice, however, it is impossible to draw a distinction between structural and cyclical unemployment. And such a distinction is by no means permanent over time. Most people believe that structural unemployment in Denmark has declined over the last decade.

Since cyclical unemployment is not easily defined, it is obviously difficult to aim to abolish it.

Finally, another uncertainty in connection with fiscal fine-tuning is how quickly a fiscal adjustment is reflected in the demand for labour. Studies indicate that it may take a number of years before the economic effect of a fiscal-policy measure peaks. By then the cyclical situation may be quite different from when the measure was adopted.

Therefore, it is very difficult to apply even an approximately correct dosage of fiscal activism.

Still, it is hard for governments to refrain from fiscal activism, as they will often be under pressure to make adjustments, from political players as well as from professional organisations and the media.

In good times there will be pressure to relax fiscal policy by lowering taxes rather than to let the automatic stabilisers work to improve the government surplus. At a weak point in the economic cycle there will also be pressure to relax fiscal policy in order to stimulate economic growth.

Denmark has avoided this kind of fiscal activism for a number of years, and only minor adjustments have been made in connection with the annual Finance Acts.

Danmarks Nationalbank's comments on the government's so-called "spring package" should be viewed in this light. I take this opportunity to repeat our comments issued in connection with the publication of Danmarks Nationalbank's Annual Report.

"Danmarks Nationalbank finds that there is no pressing need to implement measures to adjust economic development. Fiscal policy is already slightly expansionary, interest rates are historically low, and most observers share the view that an upswing is in the making.

Although the unemployment rate is still low, both by international comparison and in a historical Danish perspective, it is on the increase.

The widespread political view is therefore that extensive relaxation of fiscal policy is needed.

Denmark's economic situation is very robust with a government surplus, a considerable current-account surplus, a highly stable krone rate and low inflation. Against this background we have to acknowledge that today the economic scope for implementing reasonable measures exists.

The government's plan may turn out to be too expansionary, which is too early to assess. However, especially in this light it is important that the plan applies a combination of temporary measures and moves forward already adopted relaxations. This limits the potential adverse consequences in connection with maintenance of the medium-term objective of expanding the supply of labour, limiting the increase in public expenditure and reducing the government debt."

These comments on the government's plan were made in a current context about six weeks ago. Nevertheless, they are a good reflection of Danmarks Nationalbank's overall position that the overriding priority is to maintain the medium-term economic policy. This also requires more reforms to be implemented to reduce structural unemployment and thus ensure that Denmark will continue to be among the countries with a low unemployment rate.

The general course of the economy is of great significance to mortgage credit, as was seen around 1990. In addition, mortgage-credit legislation was previously often used as an element of economic policy. A case in point is the introduction of so-called mixed loans in the mid-1980s.

The beginning of the 1990s saw new adjustments to the acts, but this time the purpose was to stimulate economic development. This implied liberalisation of the rules.

Furthermore, the last decade or so has been characterised by extensive waves of conversion which have helped to reduce the homeowners' interest costs in step with the general global decline in interest rates in that period.

The introduction and widespread use of adjustable-rate loans have also contributed to this, and at the same time short-term interest rates have been lower than long-term interest rates.

Finally, the introduction of the so-called deferred-amortisation loans has meant that the homeowners' debt service can be limited to interest payments for a number of years. In other words, deferred-amortisation loans represent an easier way of achieving the same results as with supplementary mortgage credit.

The gradual liberalisation has made it easier for existing homeowners to weather situations of financial tightness. When social events altering the ability to meet payments occurred, many homeowners came through by remortgaging or raising supplementary mortgage credit, and society was spared many problems.

In recent years new homeowners have made extensive use of the new mortgaging opportunities in such a way that they can be expected to be more vulnerable in the future. This applies both when the homeowners' net income is reduced and when the level of interest rates in the economy rises significantly.

What will happen in the coming years? The scope for relaxing the borrowing conditions seems to be exhausted - unless interest payments are frozen. Indeed, in view of the current level of interest rates further significant relaxations in this respect can hardly be envisaged. On the contrary, everybody is talking about the risk that interest rates will increase.

The coming years will then show who have successfully advised their customers about the consequences of interest-rate changes or changes in the customers' ability to meet payments - and who have merely been sales men.

The basic principles of mortgage credit in Denmark have been retained in the many adjustments to mortgage-credit legislation over the years.

The mortgage-credit institutes are intermediaries providing loans on the basis of bonds. The credit risk is "pooled" so that the bondholders are not dependent on one single borrower's ability to meet payments. However, the interest-rate risk still rests on the borrowers and bondholders, respectively, not on the mortgage-credit institute.

This is different from the home-financing system in the USA, which is otherwise similar to the Danish system in that the borrower may remortgage by redeeming the loan when interest rates decline. In the USA the conversion risk is to a large extent assumed by two privileged institutes with a large proportion of the housing loans on their balance sheets. These institutes have encountered significant risk-management problems as a consequence of interest-rate fluctuations. They have thus had to conduct very extensive hedging in the bond market, among other things, and this again has led to pronounced volatility in the bond market.

Denmark did not experience a similar increase in volatility.

At international meetings we are sometimes asked why this increase did not happen in Denmark. One explanation is our balance principle, which ensures that the conversion risk is spread out on a large number of investors rather than being concentrated on a few mortgage-credit institutes.

The next question is then: why did Denmark introduce the balance principle?

This is not quite as easy to answer. When the mortgage-credit system was founded there were no clearly expressed considerations about the balance principle. What happened was that the borrowers joined forces - just like the cooperative movement in other areas of the economy - to be able to provide joint collateral and issue standardised bonds.

The balance principle has been a cornerstone of the mortgage-credit system in Denmark for more than 100 years. Since then the authorities - including Danmarks Nationalbank - have come to appreciate it to such a degree that they have again and again resisted the request from the mortgage-credit institutes to relax the balance principle.