

Nils Bernstein: Recent economic and financial developments in Denmark

Speech by Mr Nils Bernstein, Chairman of the Board of Governors of the National Bank of Denmark, at the Annual Meeting of the Danish Bankers Association, Copenhagen, 6 December 2006.

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Thank you for inviting me to speak here at the annual meeting of the Danish Bankers Association.

The Danish economy is still booming, and there is no sign of any slowdown in the near future.

The upswing started in mid-2003 and has gained momentum since then. Originally underpinned by income-tax cuts, the upswing has been gradually reinforced by the remarkable growth in the international economy. In this picture, Europe has generally lagged behind the rest of the world, but now that economic growth seems to be receding in the USA, activity is on the increase among our most important trading partners in Europe. The Danish upswing has brought unemployment down to the lowest level since the oil crisis in the 1970s.

In contrast to previous upswings, the balance of payments is still strong and the government surplus rests on a sound structural foundation.

However, a complete picture of the Danish economy also includes risks. The global imbalances are still significant, with the enormous US current-account deficit as the dominant feature. Overall, the imbalances are still generally expected to be redressed over time. The US economy is slowing down due to the receding housing market. The risk of more abrupt adjustment cannot be ruled out, though.

However, the danger signals regarding the Danish economy come from within. The future course will depend on Denmark's ability to tackle the situation. For a long time low inflation and moderate wage increases have been the order of the day in Denmark, just like in many other countries. This phenomenon is among other things the result of growing recognition of the favourable economic effects of low inflation.

Low unemployment combined with continued robust growth in the demand for Danish goods entails a risk of the pressure on the labour market leading to higher inflation. It is well-known that this can cause unemployment to rise at a later stage. Although this is not considered to be the most likely course of events, the risk of detrimental overheating of the economy is growing. Against this background Danmarks Nationalbank has recommended – and continues to recommend – measures to dampen the overall increase in demand in order to ensure sustained favourable economic development in Denmark.

Danmarks Nationalbank has noted that the government has adopted a wait-and-see approach.

As stated, the labour market will be the pivotal issue in the years to come. The number of people in the groups with the highest participation rates is declining, which sets limits to labour-force growth. All indicators point to by and large unchanged employment, in contrast to the preceding years' increases by 70,000 since 2003 when the upswing began.

The labour shortage will dampen the continued upswing.

In 2006, wage increases have been gaining momentum, and domestic price pressure has been building up gradually. It is uncertain how much this adjustment process will ultimately impact on inflation.

The housing market attracts high attention, and rightly so. We have witnessed very strong increases in real property prices, especially in the Greater Copenhagen area. The most recent indicators point to continued, but more moderate, price increases. Some of the most expensive areas show signs of slightly receding prices, and in more and more cases the price when the property was first put up for sale is later reduced.

The low interest rates have been a principal driver of the growth in housing prices.

In 1998 fixed-rate loans accounted for 80 per cent of the households' total borrowing from banks and mortgage-credit institutes. This share has now shrunk to 40 per cent. So more than half of the outstanding loans are adjustable-rate or outright variable-rate loans, and it is expected to be more expensive for borrowers to service their loans in 2007 due to the increases in short-term interest rates over the last year.

Taking into account that the households also have interest income, their net interest expenses after tax will increase by just over kr. 2 billion, or 0.3 per cent of consumption.

Interest rates have the strongest impact on activity via their effect on the timing of decisions regarding consumption and investment. Despite the higher interest rates, real interest rates after tax are still very low – barely over 1 per cent in most cases. The level of interest rates therefore still has an expansionary effect on the Danish economy.

The economic upswing is also reflected in the financial system. The banks' balance sheets are growing strongly. At the same time, profits are record-high, labour is in short supply, wages are on the increase and there have been cases of large bonus payments.

The banks' lending is growing by more than 20 per cent year-on-year. The breakdown on business lending and lending to households follows a familiar pattern. Lending to households enters the stage first in a consumption-driven upswing, and has shown double-digit growth rates since 2004. The banks have strongly penetrated the market for home financing with their mortgage loans. In addition, the risk appetite of many households has increased – supported by the marketing efforts of a number of banks. Business lending gathers steam later in an upswing when business enterprises invest more than their internal sources of financing can support. Business lending reached double-digit growth rates at the end of 2004, and growth has now reached 20 per cent year-on-year.

The high rate of growth in lending is an average for all banks. There is considerable dispersion. For some banks lending increases by more than 50 per cent year-on-year.

The strong growth in lending is clearly reflected in the composition of the banks' balance sheets. The difference between banks' lending and deposits has increased considerably in recent years. Total lending now exceeds total deposits by a three-digit billion kroner amount. So the banks have become increasingly dependent on financial markets to raise money-market loans from other banks and to issue securities both nationally and internationally. The individual bank will also find it important to maintain access to these sources of financing. These sources are more sensitive than traditional deposits to changes in market conditions and the assessment of the individual bank's financial performance. This could make the banks more vulnerable.

The Minister of Economic and Business Affairs is finalising a bill which will enable banks to issue covered bonds on an equal footing with the mortgage credit institutes. You may ask why it is necessary to change the Danish system of financing real property via the mortgage-credit institutes. The Danish mortgage credit system is a well-functioning and stable system, which has given owners of real property access to financing on capital-market terms, with a transparent cost structure.

Let me be blunt. This change has been imposed on us, and it does have its positive elements. It increases competition between Danish financial institutions, and gives them access to operate on the same terms and conditions as foreign credit institutions. It should also be born in mind that the amendment will not entail radical changes in Danish home financing overnight. Many adjustments have already taken place in the last couple of years. Here, I have in mind the "mortgage loans" launched by the banks with great success. Seen in this perspective, covered bonds issued by banks can promote financial stability as a stable source of financing mortgage loans, thereby covering the large deposit deficit in a more satisfactory manner.

When the covered bond legislation is amended, Danmarks Nationalbank prefers a simple, robust model. The banks have called for abolition of the current restrictions on redemption profiles and maturities. We support this wish, and at the same propose that the threshold for housing loans be reduced to 70 per cent of the property value. This would also make it easier for the institutes to comply with the requirement that a loan based on covered bonds must never exceed 80 per cent of the collateral value for the entire duration of the loan. If this entails some degree of tightening, that is not entirely unintentional.

In connection with the work on covered bonds, two committees have been set up to deal with the balance principle and "joint funding", respectively. Danmarks Nationalbank's position is that the Danish balance principle could be adapted and made more flexible to bring it more in line with modern risk-management principles. In that connection it is important that a new balance principle provides the same degree of security as the existing system.

Joint funding is an important issue to many of you who are present here. Market conditions dictate that issuance of bonds at favourable prices requires large volumes. At the same time, it is the wish of the Danish Bankers Association "that throughout the customer relationship the customer perceives the

bank as the creditor for the loan and thereby the customer's banker, even though the bank in fact just administers the loan on behalf of the funding company".

I understand that it is important for the individual bank that decisions can be made locally at the counter. However, I am not quite sure to which extent this would require changes to fundamental legal principles. Banks already act as intermediaries on behalf of other legal entities such as investment associations, insurance companies, etc. Ultimately it is up to the Ministry of Justice to assess whether this request can be met.

It is Danmarks Nationalbank's assessment that the Danish banking system is currently robust . Profits are extremely good, and buffers are large, albeit declining. For the banks overall, the buffers in relation to the statutory minimum capital requirement have over the last three years fallen from 7.5 to 4 per cent of lending and guarantees.

The regulation of the Danish banking sector is undergoing major changes in current years. The accounting rules have been changed so that loans can only be written down on the basis of an objective value assessment. Provisions can no longer be made on the basis of the prudent accounting principle. In 2007, the new capital-adequacy rules will come into force, so that the solvency ratio of a credit institution will be calculated on the basis of risk weights that better match the actual risk on the portfolio. The statutory capital requirement will be lower in actual terms, but will fluctuate more.

I would like to emphasise that the amendments to the accounting rules and to the capital-adequacy rules mean that legislation does not to the same degree as previously provide for reserves in credit institutions. This responsibility has to a large extent been transferred to the boards and managements, and it is very important that they establish an adequate buffer when determining the solvency ratio of the individual credit institution.

Finally, I would like to say that Danmarks Nationalbank is pleased to note the good performance of the financial sector, which reflects the sound Danish economy. On behalf of Danmarks Nationalbank, I would like to thank you for our fine cooperation.