Nils Bernstein: Recent economic and financial developments in Denmark

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the Annual Meeting of the Danish Bankers Association, Copenhagen, 5 December 2007.

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For some years, the global financial system has been characterised by high growth and increasing business volumes. There has been considerable innovation, many new products and business concepts have emerged. Earnings have been high. The largest global banks' return on equity has been steadily increasing for a number of years and exceeded 20 per cent on average in the 1st half of 2007.

A sudden setback came over a few days in the summer. For a while the US housing market had been regarded as vulnerable. Losses on subprime mortgages were increasing, but this market was not assessed to be sufficiently large to have an impact on global financial stability. Moreover, the launch of new financial instruments seemed to have helped to spread the subprime risk among many different investors.

This assessment proved to be wrong.

Via structured credit products, investment vehicles had invested in subprime mortgages. To finance these investments, they had issued short-term securities. It turned out that large banks were closely linked to these investment vehicles via liquidity lines and/or ownership. Consequently, it was also difficult to assess the banks' potential losses on subprime mortgages, and uncertainty arose as to who ultimately bore the subprime risk.

In next to no time, some of the most liquid markets with the highest ratings came to a standstill and it became difficult to issue short-term securities guaranteed by gilt-edged banks. Throughout most of the world, banks concentrated on securing their own liquidity and were hesitant to lend excess liquidity to other banks – especially if the maturities exceeded a few days. Two German banks experienced difficulties as a result of exposures to investment vehicles. One UK bank was brought to its knees, not by subprime mortgages, but because its business model was based on regular access to financing in the financial and money markets. We even saw the unusual sight of depositors queuing outside a bank to withdraw their deposits!

This marked the beginning of the liquidity crisis that has – to varying degrees – characterised the financial and money markets in large parts of the world since July. Over the last four months, the central banks in the USA, the euro area and the UK have regularly provided collateralised liquidity to the market in order to stabilise short-term interest rates and smoothe the functioning of the money market.

There is still considerable uncertainty regarding the size of the losses and the future development. Now and then new skeletons rattle out of the closets as banks announce further subprime losses. Share prices have dropped for banks exposed to subprime mortgages. In the financial markets, there are fears that the losses will spread to other segments of the US mortgage market. Consequently, the spread between uncollateralised and collateralised money-market interest rates at long maturities remains unusually wide in many countries. Finally, the liquidity crisis has led many euro area and US banks to tighten their credit terms for several customer groups.

What are the consequences of the financial turmoil for Denmark? I will focus on two issues. Firstly, how has the development affected the Danish financial system? And secondly, what is the cyclical impact of the turmoil?

At the very short end of the money market, the international financial turmoil has not reduced the Danish banks' readiness to lend kroner to each other. There are indications of a certain increase in precautionary liquidity, but there have been no signs of tension in the short end of the money market, and Danmarks Nationalbank has not had to conduct extraordinary open market operations in this connection.

Danmarks Nationalbank's normal open market operations take place via a so-called open window. The demand for loans and certificates of deposit is met at the rate of interest determined by Danmarks Nationalbank. In other words, the counterparties have a fairly wide scope for structuring their liquidity vis-à-vis Danmarks Nationalbank. The development in the banks' and mortgage-credit institutes' accounts with Danmarks Nationalbank does not indicate any substantial increase in precautionary liquidity via this channel.

Longer-term uncollateralised money-market interest rates in kroner have increased due to the international turmoil. The fluctuations in the spread between uncollateralised and collateralised money-market interest rates have, however, been less pronounced in Denmark than in the euro area and especially the USA. Even in normal circumstances the turnover in this segment of the Danish money market is relatively limited, but naturally the higher interest rates have affected the numerous financial products linked to CIBOR and similar interest rates.

From time to time, Danish banks have had difficulties in raising dollar-denominated loans. This is not an isolated Danish phenomenon; banks in other European countries have experienced the same difficulties. Danmarks Nationalbank cannot provide liquidity facilities to cover borrowing requirements in foreign exchange since its role is primarily linked to krone-denominated liquidity. Banks with large business volumes in foreign exchange must themselves ensure adequate contingency funding plans in the relevant currencies.

Overall, the Danish money market has navigated fairly successfully through these rough waters, which ultimately shows that the Danish financial system is in good shape. Nevertheless, Denmark has been affected by the international turmoil. Financial statements for the 3rd quarter showed that Danish banks were also exposed to investment vehicles, liquidity lines and structured credit products. The exposures and losses were, however, relatively small in size.

Lending by Danish banks has increased substantially in recent years, and some have seen growth rates in excess of 30 per cent. Earnings have been high and losses low. Particularly mortgage loans to homeowners have grown significantly.

Growth in lending has been so strong that a large deposit-loan gap of more than kr. 400 billion has accumulated. This is the amount by which the banks' lending exceeds the deposits from customers. Consequently, the Danish banks have to rely on the financial and money markets as sources of financing. Developments abroad over the summer have shown that it can be risky to base one's business on such financing. The price of market financing may change rapidly, and the markets may "dry up". The international liquidity crisis has provided an opportunity to test the contingency funding plans and review the business strategy in the light of the findings.

It is not as easy as it used to be for the Danish banks to finance their growth via the financial and money markets. Financing has become more expensive, and the rising costs of financing will undoubtedly be reflected in the banks' earnings and the prices charged to customers. Growth in lending remains high, but declining. Some banks have adopted a less aggressive business strategy and put their expansion plans on hold. Others have expressed intentions to reduce their commitments to international investment vehicles, liquidity lines and structured credit products due to reputational risk.

Developments have shown that strategies based on double-digit growth rates cannot simply be extended. The strong growth in lending to the corporate sector entails a greater risk of losses to the banks. This risk is rising, but from a very low level.

Unpleasant surprises can never be ruled out, but the economy is still favourable. And the financial statements for the 3rd quarter also showed that the banks' earnings remain high. Solvency is generally sound, and writedowns are low. Viewed in that perspective, Danmarks

Nationalbank is currently of the opinion that the international turmoil may serve as a "useful" wake-up call for the Danish banks. The necessary adaptations to the changing circumstances can be made in a timely manner without any serious costs to the large majority of the banks or to the economy as a whole.

What is the cyclical impact of the turmoil?

Growth in the global economy has been unusually high in recent years. However, the turmoil in the financial markets has given rise to concern about the future development.

Growth has declined in the USA, although the crisis in the US mortgage market and the derived financial turmoil has not yet been fully reflected in the rest of the economy. So far, the upswing is set to continue in Europe and Asia, and the outlook is also positive for Africa and Latin America. Oil prices have risen strongly in recent months and have put a damper on growth prospects while also adding to inflationary pressures.

Until now, the international organisations have reduced their growth forecasts only moderately – except in respect of the USA, where growth in 2008 is now predicted to be less than 2 per cent – but no recession is foreseen. Clear concerns are expressed as to whether the uncertainty linked to the financial markets and the downturn in the housing market – not only in the USA – will spread to the rest of the economy, thereby further curbing growth in the USA and also affecting Europe.

In a Danish perspective, the outlook for the export markets remains positive, but with a downward trend.

Denmark is still in a strong boom with a hot labour market and capacity pressures on large parts of the economy.

The rate of unemployment remains surprisingly low.

The tight labour market means that the capacity pressure will remain high, although growth in demand is expected to moderate somewhat. This pressure has led to a surge in imports and in recent quarters also to a higher rate of wage increase and higher domestic price pressure, reflecting the fact that wages and prices normally react to cyclical developments with a substantial time lag. A potential setback may therefore be prolonged if the cost level at the outset is too high compared with abroad.

The high temperature in the economy at the moment entails a major risk that this will be the case.

On account of the fixed-exchange-rate policy, interest rates in Denmark are aligned with those of the euro area, which is not as far into the economic cycle as Denmark is. Contrary to expectations, interest rates have not risen recently. This is due to the turmoil in the financial markets.

In this situation it would be somewhat remarkable if the Danish government still proposes an expansionary fiscal policy in 2008. When preparing the new Finance Bill for 2008, the government should reassess its fiscal policy with a view to easing the pressure on the economy. Omitting to do so may entail tougher requirements at a later stage.

Next spring will bring collective bargaining within the public sector. Among public-sector employees there are expectations of sizeable pay rises, supported by recent years' shortage of labour and focus on the quality of public-sector services.

Several political parties have spoken in favour of an extraordinary wage boost for large or small groups of public-sector employees via a special pool of funds earmarked for this purpose.

I would like to issue a strong warning against making wage bargaining in the public-sector labour market a parliamentary issue at this stage. The risk that the parties will attempt to outdo one another is imminent, and premature intervention by the politicians prevents genuine bargaining. This could set a very unfortunate precedent.

As if that was not enough, next spring will also see collective bargaining in the financial sector. I therefore take this opportunity to point out that the results in this sector may send a signal to the rest of the labour market.

Finally, I would like to thank the Danish Bankers Association for our fine cooperation. I look forward to continuing along the same positive lines.