

Nils Bernstein: Denmark's economy against the background of the financial sector crisis

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the Annual Meeting of the Danish Bankers Association, Copenhagen, 8 December 2008.

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Thank you for inviting me to speak today. I will try to look forward.

First I would like to talk about the economy. For the first time since World War II, there are widespread concerns that the industrialised world will see a fall in output next year. Large parts of the global economy are in – or heading for – a recession. Naturally, Denmark is not unaffected by this situation, as we export one third of all our output. Moreover, consumers are tightening their purse strings. Widespread talk about a crisis, tough times and falling housing prices affect the propensity to buy.

It is a bit of a paradox. On the one hand it may seem sensible for us as individual consumers to show restraint and save a little "for a rainy day", but on the other hand this sensible behaviour may be negative for the economy overall. Pessimism can be self-fulfilling if we all look on the dark side. There is no reason to do so. Actually, next year most households will see a sizeable increase in their real disposable incomes due to sustained high wage increases and lower taxes. At the same time, inflation is expected to be lower.

We expect zero growth and rising unemployment next year, but nevertheless, it is important to remember that Denmark goes into recession from a situation with low unemployment, extensive labour shortages and relatively high wage increases. Many comparable countries are in a very different situation. In the USA and many euro area member states, the economy is reversing at a time when unemployment is considerably higher. This difference is essential in terms of the economic-policy approach chosen. The fact that Denmark has not launched packages of fiscal stimulants, as many other countries have, reflects responsible economic policy – not the opposite.

When will the tide turn again? When will we see renewed progress? Most forecasters believe that the global economy will turn sometime during 2009. In Denmark's case we may have to wait until 2010. But let me emphasise that such estimates are subject to exceptionally high uncertainty.

So far, there are no indications that the current real economic development in Denmark can be labelled a "crisis" – provided that we act sensibly. Let us save the word "crisis" for a time when we are really in trouble.

The financial sector, on the other hand, is in a crisis. A combination of external problems and self-inflicted plagues has landed the financial sector in a situation where financial stability is at risk.

Looking ahead, when we discuss how to avoid a repetition of this untenable situation, it is important to remember what caused it. Not least the banks' deposit deficits have made it necessary for the central government to step in and guarantee deposits and loans to the tune of kr. 4,200 billion. The business model increasingly applied by banks since the millennium rollover is not viable in its present form.

The crisis will affect the future structure and regulation of the financial sector. It is yet too early to draw detailed conclusions, the causes must be analysed first. However, there is no doubt that the capital-to-risk requirements imposed on the financial institutions will be tightened. New transparency requirements will be imposed on financial institutions, and

liquidity management will, undoubtedly, also be tightened in the future. And these requirements will not be voluntary. The weaknesses in the system will not simply pass over. We need to do something about the underlying factors that have landed us in this pickle!

At Danmarks Nationalbank we will consider how we can contribute better to strengthening financial stability in future. In this respect, we believe that we must work more closely with the Danish Financial Supervisory Authority, so that we together gain optimum insight into the risks of the banks and address weaknesses in a timely manner. We need to go on the offensive. In my opinion, the last six months have disclosed a need for more direct regulatory control of banking activities.

In the very short term a new banking package is being discussed, which is to inject new capital into the banking sector. The background is concerns as to whether the banks are currently able to fulfil their necessary role in society as intermediaries between savers and creditworthy borrowers.

So far, the central government's guarantee for all deposits with and unsecured claims against the banks has created a good foundation for the banks once again to obtain financing in the national and international financial markets.

However, what started off mainly as a liquidity crisis could turn into a genuine credit crisis.

The turmoil in the international financial markets will make it all but impossible for many banks to attract new capital. At the same time, there are many indications that Danish banks will need extra capital in the near future, as losses mount.

If nothing else is done, the banks will go on the defensive and cut their activities, thereby reducing the balance-sheet total to meet the capital requirements. Even creditworthy customers will find it difficult to obtain financing for sound projects.

At the end of 2007, the excess solvency of the banking sector as a whole was around kr. 90 billion. This would be sufficient to cover aggregate losses amounting to just over 3 per cent of all lending and guarantees. Losses of that magnitude are not unrealistic if we look at previous periods of recession.

In addition, part of the banks' subordinated loan capital matures in 2009 and 2010 – approximately kr. 10 billion in each of these years.

Furthermore, the crisis comes in the wake of a period of unusually large increases in lending by banks. In Denmark, the banks' lending amounted to almost 9 times their equity capital at the end of 2007. The same ratio in 2003 was almost 7, which was also the average for the preceding 30 years. If new capital is not attracted, a return to that gearing ratio requires a 25 per cent reduction in lending.

This pattern is not unique to Denmark, but is seen in many countries. In a situation where banks cannot raise new capital in the markets, many countries have chosen to inject capital into the banking sector by launching government rescue packages. This is in accordance with the conclusion of the European Council summit on 15 and 16 October, reaffirming the Council's commitment that in all circumstances the necessary measures will be taken to preserve the stability of the financial system, inter alia by providing the financial institutions with capital resources so that they can continue to finance the economy properly.

Overall, EU recapitalisation totals 280 billion euro.

The effect of various national capital injections has been that the core capital of international banks has increased from around 9 per cent to around 11 per cent. You could say that the international benchmark for banks' core capital has risen.

Against that background, Danmarks Nationalbank believes that it is necessary for Denmark to introduce a temporary facility to supplement the capital that can be raised in the private market, so that well-run Danish banks gain access to temporary financing on conditions that

resemble those in the market as closely as possible. This has been done in other countries, and it should be done in good time, before it becomes obvious to everyone that it is required.

But there is time to consider e.g. the criteria and conditions to be applied. The facility should be in place early in the new year. In this way we will be able to contribute to a stable financial system in a period when the usual channels are closed.

As I said, the aim is to avoid an actual credit crunch in Denmark, i.e. a situation in which even creditworthy borrowers – households and businesses – are refused loans, with a negative impact on the real economy.

A capital injection must ensure that banks have sound buffers. In the opinion of Danmarks Nationalbank we need to aim for a higher core capital ratio so that losses can be absorbed.

This initiative will not solve all problems, but it may prevent further negative effects on the economy. As you know, the Danish Contingency Association and the government have already promised to cover all losses on lending to banks. A capital injection would reduce such losses and would thus serve as damage control.

On top of the financial crisis, we were hit by severe currency unrest in October – the first such incident for more than 10 years. The unrest was not due to factors in the real economy and shows that when a global financial crisis occurs, a price must be paid for not adopting the euro. The currency unrest led to a considerable outflow of capital in a very short time, resulting in falling foreign-exchange reserve and a significant widening of the yield spread to the euro area.

Monetary policy interest rates in Denmark are solely aimed at supporting the fixed-exchange-rate policy; a policy that has served Denmark well. It is based on the experience from the 70s and early 80s. If the yield spread to the anchor currency is too narrow, further private capital imports are required.

With these words I would like to say “thank you” for our good and productive cooperation in 2008 to the Danish Bankers Association – its members, its Chairman, its Executive Board and its employees.