Nils Bernstein: Challenges ahead for the Danish economy

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the Annual Meeting of the Danish Bankers Association, Copenhagen, 6 December 2010.

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The world economy is slowly emerging from the crisis. Global developments are diverse, with strong growth in the Asian emerging economies and parts of South America and slower growth in the old industrialised countries. It remains uncertain to which extent private consumption in the USA and Europe will take over when the government stimulus programmes expire and the necessary fiscal consolidation starts. High rates of unemployment and uncertainty about the future will dampen private consumption. Investment will gradually begin to fuel the economy again, while the contribution from stock rebuilding will fade away.

In Germany and Sweden – Denmark's two largest export markets – growth has been surprisingly positive so far. For Denmark, Danmarks Nationalbank expects growth in the coming year to be just under 2 per cent, driven by moderate increases in private consumption, business investments and exports.

The outlook is still subject to considerable uncertainty. The economy is presumably more likely to underperform than to exceed expectations.

The developments on the Korean Peninsula remind us how strongly we can be influenced by uncontrollable events far from our part of the world.

In Europe we have recently witnessed at close hand what the consequences can be when markets lose confidence in the ability of sovereign states to manage their own debt problems. First it was Iceland, then Latvia, then Greece and now Ireland. Where will it all end?

Fortunately, Europe has so far been willing and able to lend a hand in collaboration with the IMF. But if confidence is to be restored, the member states in question must make drastic cuts in public-sector wages, pensions, etc. while also raising taxes substantially. This goes hand in hand with social unrest and loss of international reputation.

Denmark is also facing a number of fiscal challenges. They are not as severe as in many other countries, but nevertheless they must be addressed in time so that they do not grow. The economic recovery plan deals with the period until 2015, but after that adverse demographics will increase the government deficit for many years – unless action is taken.

If we in Denmark are to avoid government debt growing to unmanageable proportions in the long term, we will need to increase taxes, adding to the already heavy tax burden, and put a much tighter rein on public spending than ever before. In addition, we need labour market reforms to boost the supply of labour substantially. The sooner we start implementing such reforms, the better. This will give us more room for manoeuvre.

Danmarks Nationalbank eagerly awaits the forthcoming plan that will chart Denmark's economic policy course until 2020. Confidence in the Danish economy will be strengthened, if broad agreement can at least be reached on the scope of the challenge.

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The financial system is recovering. If the Danish economy develops in line with our expectations, the banks will generally be resilient to the coming losses. But in view of uncertainty concerning the economic outlook , several banks would be wise to build up further buffers.

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Now that the Danish banks are emerging from the crisis, it is also time to consider how we can prepare ourselves better for future financial crises.

At the end of September the general government guarantee covering the banks' unsecured creditors expired. Happily for us all, this took place without major problems. But the sector is not yet standing on its own two feet. The government has injected kr. 46 billion in subordinated capital and given guarantee commitments for a further kr. 364 billion. As these schemes expire, they must be replaced by market-based solutions. At the same time, the banks must prepare for tighter regulation and supervision in future.

The challenge is to ensure a robust financial system that can survive without government assistance next time a crisis occurs.

Credit will be more expensive and harder to come by. Banks, companies and households will all have to accept a higher equity share when operating a business or purchasing a home.

This is not a purely Danish challenge. Many international forums are working hard to define common standards for the financial system to make it more robust and self-contained. However, the future international standards may not be sufficient to ensure a robust and self-contained Danish financial system in due time. Or perhaps they will not take Danish experience into account to a sufficient degree.

Let me mention a few areas that will be important to consider in a Danish context.

The Basel Committee's proposals for new liquidity rules and the status of mortgage bonds when calculating the new liquidity buffer have for good reason been prominent in the Danish debate. Efforts are still underway to amend key elements of the rules. But I think the sector will have to face the fact that self issued bonds cannot be included in the calculations.

And after all, if you want a sound liquidity buffer, it does actually make sense that the value of this buffer is – as far as possible – independent of your own situation.

The stable financing requirement has been postponed until 2018. The debate on the consequences for adjustable-rate loans has died down. On several occasions, Danmarks Nationalbank has expressed its concern about the refinancing risk on these very popular loans. The idea behind the stable financing requirement has indeed been to reduce this type of refinancing risk. Although the proposal has been postponed, this risk is very real in Denmark. Some banks spread out their auctions over the year, while others have, unfortunately, not come that far with existing loans. Spreading out the auctions is a good principle, but not sufficient to solve the basic problem. A solution needs to be found before 2018.

The global financial crisis has evolved differently from country to country. But there have been common traits – such as property market developments. Rapidly rising property prices, very strong housing and property investments and high lending growth for financing such investments have all contributed to the financial crisis. That has also been the case in Denmark.

The Danish banks that have succumbed to the crisis or have been close to the brink have all been characterised by very high lending growth and an almost aggressive exposure to the property sector. These factors contributed heavily to the build-up of systemic risk in the years leading up to the crisis.

The Basel Committee has proposed that the financial institutions not only hold an extra capital buffer on a permanent basis, but also hold a countercyclical capital buffer. In good times, when lending growth is high, restrictions may be imposed on disbursement of dividend if the accumulated reserves are insufficient. This will dampen strong cyclical upswings. When the tide turns, the additional reserves are released.

It is still uncertain whether this model will be sufficient to address the role of the property market and its financing in relation to financial stability in Denmark. Several countries have tightened or are thinking of tightening the conditions for mortgaging real property or the capital requirements imposed on the lender. Such instruments come in many shapes and can be linked to cyclical developments.

It will be a challenge to develop efficient economic instruments in a world with free flows of capital – not least within the EU. This openness is a great advantage to Denmark, but as Danmarks Nationalbank sees it, we need to consider whether we can introduce instruments in this area that will support financial stability. Preferably such instruments should be a kind of automatic stabilisers. If not – they should be available to the Danish Financial Supervisory Authority and Danmarks Nationalbank.

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The financial crisis led to a very important piece of legislation in Denmark. The general government guarantee has been replaced by a winding-up scheme for banks – known as Bank Rescue Package III – that provides for orderly winding-up of banks that cannot continue as going concerns under their existing ownership. From society's point of view it is, as I have previously underscored, not important whether the individual bank survives, but whether sound activities can continue without interruption. People must be able to access their accounts, use their debit cards, pay their bills on time, etc. Unfortunately, the current legislation does not make it mandatory for banks to join the scheme, but merely to decide at a general meeting whether they want to join the scheme now. If they say no, this generates uncertainty as to whether they will join if the need arises.

During its recent visit, the IMF took a positive approach to the Danish winding-up scheme and recommended that banks which do not join beforehand are subjected to additional capital requirements. I hope we find a voluntary solution, and today I will merely encourage banks to join the scheme at their forthcoming general meetings.

With this well-intentioned advice I would like to express my appreciation to the Danish Bankers Association and its members for our cooperation over the past year.

Thank you for your attention.