Nils Bernstein: Danish economy developments and the 2020 plan

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the annual meeting of the Association of Danish Mortgage Banks, Copenhagen, 27 April 2011.

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Growth in the global economy remains robust and is increasingly self-sustained. As regards 2011, the International Monetary Fund has lowered its growth expectations for the USA, Japan and the UK a little, while expectations for Germany have been adjusted upwards. Factors such as the high energy and commodity prices are expected to curb growth.

The rising energy and commodity prices have contributed to higher inflation worldwide, not least in many developing countries. In the euro area, inflation stood at 2.7 per cent in March, which is considerably above the medium-term target of just below 2 per cent.

In the assessment of the European Central Bank, inflationary risks in the euro area are on the upside. Against this background, the ECB raised its lending rate by 0.25 percentage point at the beginning of this month, after having kept it constant at a very low level for almost two years. Danmarks Nationalbank followed suit.

The debt crisis in the EU is still evolving. Portugal has now – some people might say finally – applied to the EU and the IMF for financial assistance. Matters are further complicated by the uncertain political situation in Portugal, where a caretaker government is in charge until the election in June. It has been indicated that the assistance package will impose more stringent conditions than the reform package which brought down the Portuguese government – and that broad political agreement must be reached before the election. Viewed on the basis of developments in yield spreads, there seems to be a decoupling of market assessments of the situation in the three troubled member states – Portugal, Ireland and Greece – on the one hand, and the rest of the euro area – including Spain and Italy – on the other hand. This is positive and gives us reason to hope that the debt crisis in the EU can be contained.

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Turning to the Danish economy, the upswing is also becoming more evident here. The negative growth in the 4th quarter of 2010 seems to have been a one-off. Danmarks Nationalbank expects growth in 2011 to be just below 2 per cent, which is actually above the EU average. Household disposable income is set to develop at a substantially weaker pace than last year, but on account of the currently very low consumption and investment ratios – combined with strong growth in some of Denmark's largest export markets – we still expect some growth in private consumption and business investment. Momentum in the Danish economy is presumably so strong that a gradual increase in short-term interest rates to a more normal level is unlikely to trigger an economic reversal, although it will, viewed in isolation, have a dampening effect.

The positive outlook is supported by developments in the labour market. Gross unemployment had been flat for a while, but fell by 3,000 in February. It is probably too optimistic to expect similar declines in the coming months, but the figures do indicate that unemployment has peaked at a considerably lower level than previously expected. Right now it is only slightly above its structural level.

So there is no need to ease fiscal policy relative to the plans laid down for the next couple of years. In the current situation, expansionary fiscal policy could easily strengthen cyclical trends rather than smoothing them, as it did in the boom years before the financial crisis. That would not be expedient.

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A few weeks ago, the Danish government presented its 2020 plan. The plan quantifies the challenges that we must meet if we are to ensure balanced public finances in 2020. It also includes proposals for tackling these challenges. I welcome that.

Some of the assumptions behind the 2020 plan are highly ambitious, not least the target of very low growth in public spending in the next decade. However, it is essential to keep growth in public spending under control if we are to achieve balanced public finances. Otherwise we will be heading for unsustainable debt developments that will amplify the problems. Unlike many other countries, Denmark has little room for manoeuvre on the revenue side as taxes are already high. Consequently, balance must be achieved by reining in expenditure.

If we look at the development in public consumption as a ratio of GDP over the last 50 years – from the introduction of the welfare state until today – two facts stand out. Firstly, public consumption has increased relative to total output throughout the period – except in the first 4 years of the Schlüter government in the 1980s. Secondly, it is worth noting that the rising trend has continued, irrespective of the colour of the government.

It is not surprising that growth in public consumption was strongest in the first 25 years of the welfare state, when the educational level and participation rate of women increased rapidly. That has not been the case in the last 25 years. Yet public consumption as a ratio of total output has still risen, albeit at a slower rate. My conclusion is that in Denmark there is an ingrained pressure to solve problems by increasing public spending, both among politicians and in the population in general. Altering that will require a radical change of attitude; statutory control mechanisms to cap public spending as a ratio of GDP could be the first step. It will be difficult – extremely difficult! But it is unavoidable.

Even if all the proposals in the 2020 plan were to be adopted, we will be facing a lengthy period of sustained government deficits after 2020. So although the deficit remains well below the 3-per-cent limit in the baseline scenario presented by the government, we still risk being hit by large government deficits in connection with the cyclical downturns that tend to occur from time to time. For this reason it is important to have automatic stabilisers in place that can curb cyclical fluctuations.

This is the main background to Danmarks Nationalbank's proposal to phase out deferred-amortisation loans and to let property value tax develop in step with house prices. Both proposals would contribute to dampening fluctuations in the housing market and hence in the economy overall.

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In addition to strengthening public finances, we need to boost growth in the Danish economy. I am chiefly thinking of measures to increase potential output. This is not achieved through expansionary fiscal policy, but through structural reforms to improve the economic framework conditions and increase the supply of labour.

Phasing out the early retirement scheme is an example of such a reform. Discussions tend to centre on how much this step might improve public finances. That is indeed an important aspect, but we often forget that phasing out the scheme is also likely to contribute to increasing potential growth in the economy in the phasing-out period by preventing a decline in the labour force. In other words, phasing out the early retirement scheme can contribute both to improving public finances and to strengthening the growth potential of the economy, thereby providing a permanent wealth gain. Few alternative measures can match that.

Potential growth is the determining factor for how difficult it will be to achieve the 2020 plan's target of reducing public consumption as a ratio of cyclically adjusted GDP from 29 to 27 per cent. The lower the potential growth, the more painful the process will be. In the coming decades demographics are against us. Productivity developments will be of paramount importance to growth in the Danish economy.

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The extraordinary measures introduced by the European Central Bank to supply liquidity to the market during the crisis led to a period of very low market interest rates in the euro area. Spreads to the corresponding Danish interest rates widened, leading to capital inflows and a tendency for the krone to strengthen. To keep the krone stable against the euro, Danmarks Nationalbank purchased foreign exchange in the market in the 1st half of 2010 and on several occasions lowered its interest rates unilaterally. From the spring of 2010, only the rate of interest on certificates of deposit and the current-account rate were lowered, while the lending rate was kept unchanged, so that the spread to the ECB's benchmark interest rate remained 0.05 percentage point.

Liquidity conditions in the euro area are now normalising, and euro area money market interest rates are, once again, approaching the ECB's benchmark interest rate. To the extent that higher market interest rates in the euro area lead to pressure on the krone, Danmarks Nationalbank will follow its usual practice, including raising interest rates if necessary. This will apply to both lending and deposit rates. We have no plans to deviate from the principle of operating with a margin between the rate of interest on certificates of deposit and the lending rate.

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Public debate sometimes focuses on the high gross debt of Danish households relative to GDP or to household disposable income. But the households' pension and housing wealth is also high. The fact that the assets are less liquid than the liabilities entails a certain degree of vulnerability.

The high gross debt is primarily reflected in household mortgages. This, in turn, should be viewed against the background of the efficient Danish mortgage credit system, which differs materially from those seen in most other countries.

Despite their high gross debt, Danish households have weathered the financial crisis. Losses in the banking sector have been limited seen in relation to the crisis in the early 1990s, and have only to a small extent been attributable to the household sector. Mortgage arrears ratios are also low and declining.

All the same, I believe that the resilience of the households should be strengthened on account of their high debt ratios. After all, tax cuts, special pension savings disbursements and very low interest rates might not be on the agenda the next time a crisis comes knocking on our door. High debt goes hand in hand with a risk of technical insolvency and lack of mobility.

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Since it became possible to issue covered bonds – in Denmark known as SDOs – instead of traditional mortgage bonds in 2007, these bonds have accounted for an increasing share of the outstanding volume of mortgage bonds – currently 60 per cent. As you know, SDOs are subject to the condition that the value of the individual loan must never exceed 80 per cent of the underlying collateral. If house prices go down, the mortgage banks must pledge top-up collateral. One way of financing this is by issuing less collateralised junior covered bonds. The proceeds are used to buy e.g. government securities that are pledged as top-up collateral. In our estimate, a 10-per-cent fall in house prices entailed a need for top-up collateral amounting to around kr. 25 billion in 2008. By 2010, this figure had risen to an estimated kr. 100 billion plus, mainly due to the more widespread use of SDOs. Consequently, Danmarks Nationalbank is pleased to note that the minister for economic and business affairs has met the wish to look into this issue. The risk is increasing and should be addressed in time. Danmarks Nationalbank has on previous occasions pointed to the option of reducing the borrowing limit in connection with mortgage credit.

Another familiar issue is refinancing risk in connection with adjustable-rate loans – in both kroner and euro. Spreading the refinancing auctions over the year reduces the volume of adjustable-rate loans affected if an auction date coincides with a complete or partial market crash. Danmarks Nationalbank welcomes the invitation from the Association of Danish Mortgage Banks and the Danish Mortgage Banks' Federation to work with them to identify the possibilities of reducing the refinancing risk on adjustable-rate loans.

With these words I would like to thank the Association of Danish Mortgage Banks and its members for our successful cooperation during the past year.

Thank you for your attention.