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, 5 December 2011.

*   *   *

Thank you for inviting me to speak here today.

During the autumn, economic activity has dampened in the advanced economies, especially in the euro area, and the outlook has been adjusted downwards. But there are considerable differences from country to country. Generally, growth remains reasonable in countries with sound public finances and external balances, such as Germany and Sweden, while it is low in countries with large internal and external imbalances, particularly the debt-ridden countries in southern Europe.

The downward adjustment of growth prospects reflects several factors. Firstly, the European sovereign debt crisis has by no means been resolved, in fact it intensified over the summer, and in the USA there is great uncertainty about medium-term fiscal plans. Secondly, consumer and business confidence has declined in many countries. Households and firms continue to consolidate, partly in the light of falling stock indices and housing prices. Thirdly, the combination of sustained financial turmoil, lower growth expectations and pressure from the financial markets means that several countries have had to speed up fiscal consolidation.

Viewed in isolation, fiscal policy is procyclical at the moment, which means that it contributes to further dampening of growth. On the other hand, more expansionary fiscal policy would push up interest rates. Combined with large government debts this means that tightening is the only option. Many countries are now paying the price for their previous slack approach to economic policy. Among other things, this is reflected in an increase in unemployment to more than 10 per cent in the euro area and 9 per cent in the USA. In the hardest hit euro area member states unemployment now exceeds 20 per cent. Especially young people find it difficult to gain a foothold in the labour markets, which favour those who already have a job.

The near-term outlook is unusually uncertain. Lower confidence among households and firms and in the financial sector often points to a decline in activity. And indeed, the latest forecasts from the OECD and the EU predict only a moderate upswing in the USA, while the euro area overall is expected to stagnate, with a risk of growth at or below zero. Tackling the challenges in the heavily indebted member states is essential to dampening uncertainty and paving the way for growth in the euro area.

And now let me turn to the Danish economy. Growth was sound in the 2nd quarter, but according to preliminary data GDP dived in the 3rd quarter, to a level 0.3 per cent lower than in the same period of 2010. This reflected not only weak export growth, but also a decline in government spending as the public sector sought to balance its finances. The growth pattern has generally been very uneven in recent years, so data for a single quarter should be interpreted with caution.

Nevertheless, the overall picture is that the Danish economy, like the world economy, is slowing down. This situation is likely to continue well into 2012, and we do not expect growth in Denmark to pick up in earnest before 2013. Our forecast does not operate with a speedy resolution of the debt crisis. On the other hand, we do not foresee a total collapse either. In technical terms, we assume that Europe will muddle through somehow.

We should be careful not to paint too gloomy a picture of the Danish economy. Although we expect a small rise in unemployment in the near future, the Danish labour market is doing relatively well. Employment has declined a little since the beginning of 2010, and unemployment is only slightly above its structural level. Private consumption is weak, but this reflects consolidation rather than lack of funds in the households.

It is satisfactory that the new government is planning to reduce the government deficit to less than 3 per cent of GDP in 2013 and to improve the structural balance by 1.5 per cent of GDP in 2011–13, as the EU recommends. Add to this the support for important labour market reforms – the partial phasing-out of the early retirement scheme and reduction of the entitlement period for unemployment benefits. This will contribute to increasing structural employment considerably, thereby countering the demographically driven reduction of the labour force.

It is evident that the 2012 Finance Bill does not provide for any improvement of the structural government budget balance next year. This makes it even more important to tighten up in 2013 in order to maintain the fiscal stance.

Anyone who is interested in current affairs can see that the euro area is in an economic and political crisis. For almost two years the arrow has been pointing in the wrong direction. More and more member states are struggling with mounting debts and high interest rates. This reflects the market participants' lack of confidence in these member states' ability to set their own houses in order. Several member states have applied for and received external financial assistance – on conditions that stretch social structures to the limit. In Greece and Italy, democratically based governments have been sidelined, and Belgium has been without a real government for more than one year – although this is for other reasons.

But what really gives cause for concern is that the solutions negotiated by the heads of government have, so far, not been able to halt an increasingly serious development, despite repeated promises to do whatever it takes. Time will show what that is – but the solutions agreed on are proving to be difficult to implement.

It is by no means easy. After all, it is about what and how soon each member state must deliver in return for support from the community. And indeed, is it at all possible to strike a balance that will be politically acceptable while also soothing the markets?

But let us get one thing straight. The necessary economic adjustments will take place, either through managed political processes or via relentless market demands if the politicians give up.

Personally I still believe that political solutions will be found. The alternative would be chaos, and the historic European project would come tumbling down. The judgement of future generations would be too harsh to bear.

Where does all this leave Denmark? Unfortunately, we cannot do much to stem the negative tide from the outside world. A small, open economy such as Denmark's is severely affected when export markets contract and fiscal options are limited. But thanks to relatively low government debt and broad political agreement to reduce the government deficit we have managed to weather the worst financial storms so far. In the short term, we cannot simply grow our way out of this situation. We can support our export potential through responsible economic policies combined with collective agreements to counter the prolonged loss of competitiveness, and we can introduce reforms that will provide a sound basis for the upswing which will come at some point. Finally, we must do our utmost to ensure that interest rates can remain low, as this cushions the weak economy.

Metaphorically speaking, we must do what small ships do in a gale: we must reef the sails and lie hove-to until the wind abates – and in the meantime we can do a little tidying up and clear the ship; that is the gentlest solution for the crew, the passengers and the vessel.

I am fully aware that this is not exactly a heroic approach. But we should bear in mind that the situation in Denmark, including the level of unemployment, is better than in most of the countries we usually compare ourselves with. So maintaining the current wealth level in the face of the crisis would be no mean feat. We should not harbour unrealistic ambitions of growth that cannot be achieved in the present circumstances.

The sovereign debt crisis leaves its mark in practically all areas, and the European banks play a major role in the crisis. In the EU, the largest banks were stress tested in the summer of 2011, and in the autumn a capital test was performed of the banks with market valuation of government securities. The banks should have a Core Tier 1 ratio of 9 per cent as a buffer against the storm. If they do not meet this requirement, they should seek to raise capital and retain profits. Ultimately, government capital injections may be required.

Moreover, there is agreement in the EU that it should be possible for member states to decide to provide more individual government guarantees to their banks on uniform conditions, along the lines of the scheme we have applied in Denmark.

Indeed, Bank Rescue Package 2 means that there is still heavy government involvement in the Danish banking sector by way of both government capital injections and individual government-guaranteed bond loans. These measures are temporary and were intended to provide the necessary breathing space to adjust the capital base, sources of funding and business models.

Right now it looks as if the Danish banks will generally be able to stand on their own feet when the government guarantees expire. The banking sector is reasonably well capitalised. This is what Danmarks Nationalbank's stress test shows, and it is confirmed by the European stress and capital tests.

All the same, some banks still have a weaker point of departure and will find it difficult to obtain funding when the government-guaranteed loans expire. One reason could be that they still hold bad assets, combined with a weak capital base. This is where the Financial Stability Company could be relevant.

In Danmarks Nationalbank's view, Denmark should not address these specific problems by deciding to introduce general access to government guarantees, as provided for by the ECOFIN. This will merely extend the life of an unsustainable business model.

One element of a solution that does not involve new government guarantees is Danmarks Nationalbank's expansion of the collateral basis to include banks' lending of good quality. This will provide a last-resort funding opportunity for the banks. At the same time, this lending may be included in the banks' liquidity, even if it has not been pledged to Danmarks Nationalbank, provided that the requirements are met. In Danmarks Nationalbank's opinion new government guarantees should not be discussed before all existing possibilities have been exhausted.

Sector surveys in recent months have indicated that it has become harder for businesses to find funding.

Danmarks Nationalbank's lending survey also shows that credit policies have been tightened a little more lately – both for households and for the corporate sector. Notably, loan approval charges have been adjusted. The widening of the interest-rate margin is a natural and – in the current situation – necessary way for the banks to increase earnings. Funding has become harder to come by and more expensive. The markets have increased the capital requirements, and the risk of losses has increased.

Incidentally, it looks as if banks and mortgage banks have increasingly begun to differentiate between customer groups on the basis of risk profiles. So there is no doubt that certain firms and sectors are finding it harder to obtain loans.

Total lending by banks and mortgage banks to the corporate sector remains relatively high, and it would not be right to speak of a general credit crunch. The recent trend toward further tightening should be monitored closely.

Naturally, banks must perform the necessary credit assessments of projects, but good credit assessments are performed individually, not en bloc. I think you need to keep in mind that if a general credit crunch arises, this could lead to solutions that are not necessarily in your long-term interest.

Finally, I would like to touch upon a few technical issues. As you know, Danmarks Nationalbank primarily influences the money markets through its short-term monetary-policy instruments.

In the euro area, there have been several signs of tensions in the money markets in recent months. The same has been the case in Denmark, where the slightly longer money-market interest rates have at times risen due to sluggishness in the exchange of liquidity.

The money-market interest rates determine the exchange rate of the krone. So, to support the fixed-exchange-rate policy, Danmarks Nationalbank will now supplement its monetary-policy instruments with liquidity-adjusting lending in kroner. This instrument can be used as and when required. The rate of interest and maturity of such loans will reflect market conditions. Loans may be granted against pledging of assets included in Danmarks Nationalbank's collateral basis, or as FX swaps against foreign exchange as collateral. Danmarks Nationalbank may allocate liquidity by auction or conduct bilateral lending transactions with individual counterparties. Such instruments are also used by other central banks in their liquidity management.

The modalities of any such loans, including maturities and allocation procedure, will be determined when the loans are offered.

Finally, I would like to express my appreciation to the Danish Bankers Association and its members and chairman for our good and fruitful cooperation over the last year.

Thank you for your attention.