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, 3 December 2012.

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The sovereign debt crisis is still leaving its mark on the world economy, especially in the euro area. While the US economy seems to be in a moderate upswing, the euro area economy is shrinking. GDP growth has been negative in the last two quarters and the outlook for the 4th quarter is not bright. Even the German economy, which until recently had been less severely affected by the problems in Southern Europe, seems to be slowing down. The Swedish economy is holding its ground, but is also seeing lower growth. The international organisations all predict that the world economy will pick up only gradually in 2013, and growth estimates have generally been adjusted downwards, particularly for the euro area.

Although the USA seems to be faring a little better, its unsustainable budget deficit presents serious challenges. So far, political disagreement between the President and Congress has stood in the way of finding an effective solution to the problem. The risk is that the financial markets at some point begin to respond, as seen in other highly indebted countries. The USA is unique in a number of respects, such as the size of the economy, but all the same, the economic fundamentals still apply. The development in the USA will have a knock-on effect on the rest of the world.

In the summer of 2011, when the US debt ceiling was raised, a compromise was reached between the Democrats and Republicans, meaning that a number of summary budget reductions will be introduced at the turn of the year, and at the same time a number of tax cuts will expire.

The potential tightening accounts for 4 per cent of GDP and, if effected, it will plunge the US economy into a recession.

Negotiations to avoid this “fiscal cliff” are underway. It is scarcely possible to find a solution without addressing the long-term problems linked mainly to demographic change. The financial markets constantly reflect the changing prospects of reaching a compromise.

In some of the most heavily indebted countries, unemployment has reached alarming levels. Public opinion often ascribes this to the consolidation of public finances. But actually, there is no real alternative to consolidation. Sustainable public finances are a condition for reducing the rate of interest on government debt to an acceptable level. Sovereign default is not an attractive alternative. And it will certainly not lower unemployment – on the contrary. The solution is the “long haul”, to coin a phrase. The problems were caused by the imprudent economic policies pursued by these countries in the 10–15 years leading up to the crisis. They cannot be solved overnight. Ireland is an example of how resolute action to address budget and competitiveness problems can shorten the path back to tolerable conditions.

The ECB continues its efforts to contain the crisis. The Outright Monetary Transactions programme announced in September entails that the ECB may buy short-term government bonds from debt-ridden EU member states in the secondary market under certain conditions – for example that the EU member state accepts a programme to seriously address its structural problems. Following the announcement, 2-year yields immediately fell in e.g. Spain and Italy, while they rose in Germany. Activation of the programme requires an official request from the member state in question. Spain has been mentioned as a candidate.

Turning to Greece, we hope that last week’s agreement between the euro area finance ministers can restore calm for a while. But the Greek debt will be a recurring theme for many years to come.

The Danish economy is well-balanced, but growth is on a slow track. The current-account surplus is large, and we hold considerable external assets. Inflation is moderate, and so is unemployment. In fact, if we disregard the most recent period of overheating, culminating in 2008, we have to go back to the first half of the 1970s, when things also went wrong, to find a lower number of unemployed people than today. Experience from the period of overheating has to some extent distorted our concept of normality. But the level of unemployment in that period was not normal, so it cannot be used as a yardstick. If we do that, things will go wrong again.

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The private sector is consolidating in the wake of the financial crisis. That is understandable, but obviously it is curbing consumption and investment. This trend will cease when savings have reached the desired level – time will show when – and the economy will begin to pick up. The shift could come suddenly – but that is not a promise – especially if the signals from the rest of Europe become more positive.

The most recent national accounts figures for Denmark point to negative growth this year. We estimate that the economy will grow by 1–1½ per cent next year compared with this year.

Exports have buoyed up growth in Denmark. The reason is that some of our largest export markets, such as Germany and Sweden, have not been so severely affected by the crisis until now. In the short term this somewhat cushions the impact of a deterioration of around 20 per cent in Denmark's competitiveness over the last decade, measured by relative unit labour costs. We have lost and are still losing manufacturing jobs in the competitive sectors. If we want to boost employment in these areas, we must improve competitiveness – there are no other options.

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There are – tentative – signs that the housing market is recovering. Price falls have slowed down and the curve has flattened somewhat during the year, both for owner-occupied flats and for single-family houses. In the Copenhagen area, which typically feels the winds of change first, both turnover and prices have risen.

The low level of interest rates is supporting the market. Moreover, the number of homes for sale has dropped sharply over the last year, which helps to stabilise prices. As regards mortgages, we are seeing a shift from very short-term variable-rate loans to variable-rate loans with longer rate fixation periods, as well as a shift from lending by banks to lending by mortgage banks.

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The agreed Finance Bill 2013 is in keeping with the 2020 plan for public finances, which allows public spending to grow by 0.8 per cent of GDP. But this year consumption growth will be considerably lower, presumably below 1/4 per cent. However, it is essential not only to set narrow limits on growth in public spending, but also to observe these limits. In that respect we have seen a change in recent years – unlike previously, local and regional governments are not overspending. When the new Budget Act with a tougher sanction regime comes into force, starting with the budgets for 2014 to 2017, there is a greater chance that this will also be the case in future. Prudent management of public finances is a precondition if the Danish government is to maintain its high credit rating and be able to borrow at low interest rates.

This year the government deficit is expected to be just over 4 per cent of GDP. This is to a large extent attributable to the extraordinary disbursements of early retirement contributions; many people said yes when this option was offered. Disbursements total some kr. 25 billion, corresponding to 1½ per cent of GDP.

The estimate of next year's deficit is subject to much uncertainty due to the new rules on taxation of capital pensions. The option to pay pension taxes in advance at a reduced rate will provide considerable one-off revenue for the government. How large this revenue will be I cannot say. But it should be used to reduce government debt.

The government has not yet introduced all the reforms – envisaged in the 2020 plan – required to ensure the sustainability of public finances. So keeping to the path of reform should be a main priority in the near term.

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Bank lending rates and the banks' willingness to grant loans have been relatively high on the public agenda since the financial crisis. Since 2008, Danmarks Nationalbank has reduced its interest rates on a number of occasions. But individual bank customers have, perhaps, experienced a different reality. The banks have not reduced their lending rates by nearly as much as Danmarks Nationalbank has, and within the last six months many have announced higher interest rates, while the monetary-policy rates have continued to fall. There are several reasons for this.

The unusually low level of interest rates has made it difficult – not to say impossible – for banks to reduce deposit rates further. To avoid undermining their earnings, the banks are compelled to keep their lending rates unchanged.

At the same time, the banks have been met with tougher earnings requirements. While higher earnings must compensate for higher credit risk under less favourable business conditions, new and more stringent capital-adequacy rules mean increased capital requirements. Irrespective of whether a bank chooses to build up capital buffers by retaining profits or by raising capital from investors, this requires sound earnings. Many banks have taken major steps to reduce costs, sometimes at the expense of employees.

Credit policies have generally been tightened since 2008. This is reflected in lending rates, but also in the perception of the access to borrow. Overall, firms are saving up, and when asked they generally say that they do not see finances as an impediment to production.

With a view to increasing funding options for small and medium-sized enterprises, the opportunities to expand the use of corporate bonds are currently being explored. Danmarks Nationalbank welcomes this initiative, provided that it takes place on market terms.

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It has attracted considerable international attention, most recently from the European Commission, that Danish households have far more gross debt relative to income than households in other countries. The low rate of interest on variable-rate mortgage loans has often been identified as the reason why the finances of the households are, nevertheless, generally sound. This raises the question of how robust household finances are to rising interest rates, and whether an increase could jeopardise financial stability. Today we are able to provide a fairly detailed answer to these questions. The main conclusion of an extensive study of household finances is that the threat to financial stability from household debt and its composition is limited. The assessment is based on the share of the debt held by families with particularly tight budgets.

Most families have robust finances and are resilient to negative events such as a strong increase in interest rates or a protracted period of unemployment if they reduce consumption or savings, although this may entail considerable lifestyle changes. And this assessment does not even take into account that a continuous rise in interest rates is very likely to go hand in hand with an economic recovery and hence better employment opportunities.

Obviously this assessment of the risk to financial stability does not rule out the possibility that higher interest rates could have rather unpleasant implications for families with very tight finances.

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Before I step down, it might be appropriate to reflect on some of the experience I have gained during my seven years as Governor of Danmarks Nationalbank. Naturally, it will only be a brief summary.

Without doubt, the financial crisis is the single event that has had the strongest impact on the financial sector during my tenure.

How prepared were we? How did we tackle the crisis itself? Which follow-up steps should we take? These are important questions.

Regardless of our actions, Denmark is a small, open economy and we would have been hit by the international financial crisis which from the autumn of 2008 caused international trade to contract by 20 per cent and later led to a European debt crisis that has descended like a fog of uncertainty on the European economies.

The key question is whether we in Denmark had made ourselves vulnerable to the severe shock that hit us from abroad. The answer is an unqualified “yes”. Even without a financial crisis, the Danish economy would have been under pressure.

In this country, the preceding international boom with ample liquidity and low interest rates was allowed to develop into an unusual overheating of the economy, which was already slowing down when the shock hit us. The tax freeze, tax cuts, growth in public spending and new mortgage types were the domestic factors behind the overheating. The banks’ lending growth, skyrocketing property prices and unsustainably low unemployment were manifestations of the overheating. Cause and effect worked both ways.

It has been discussed whether Danmarks Nationalbank issued sufficient warnings against this overheating. The truth is that the Danish government in the autumn of 2006 ignored a clear encouragement to tighten fiscal policy by kr. 8 billion; in fact, it even eased fiscal policy in 2007. And the opposition wanted to spend even more.

Admittedly, such tightening measures should preferably have been introduced at an earlier stage, but even in the autumn of 2006 Danmarks Nationalbank could not find support for its view.

This goes to show how difficult it is to conduct countercyclical economic policy. Often there is lack of ability and willingness to acknowledge problems in time and take action. So stabilisation policy should first and foremost be achieved by introducing automatic stabilisers in the economy, observing sustainable medium-term spending targets and aiming for structurally balanced government budgets. Labour market structures should be designed to promote growth and employment.

When the crisis really hit the financial sector in September 2008, a large majority in the Danish parliament – the Folketing – implemented the first of a series of bank rescue packages which have softened the worst blows against the financial sector. It has been a great strength that these initiatives have received broad political support.

The bank rescue packages were introduced as crisis measures. An actual revision of the rules on banking activities, based on the lessons learned from the financial crisis, is now underway and is to a large extent taking place at the international level. For Denmark, this will initially result in EU regulation, subsequently in Danish rules to fill in the EU framework.

A large financial legislation package is currently being submitted to the Folketing. I have the draft with me here. It weighs 1.37 kg. (Although I should add that the weight can be halved by printing on both sides of the paper.) And we will see much more in the coming years.

It is understandable that the rules are being tightened after the excesses of the financial crisis, and Denmark has very little scope for independent action. All the same, it is worth considering whether the growing volume of legislation and the increasing complexity of the rules will provide better assurance against future crises.

Professor and Doctor of Law Linda Nielsen, who works with banking law and investment, recently made a noteworthy contribution to the debate in the daily Politiken. Everyone working with these issues should read it. Her main point is that the number of rules aimed at regulating the financial sector's activities is overwhelming – and more are to come – and often the contents are so detailed and complex to read that even a person with a doctorate in law finds them very difficult to understand. There is a multitude of different rules with different structures, exemptions and levels of detail. It is completely overwhelming.

What does this mean to banks, their boards and their customers, and how about the legislators? Are we constructing a vehicle where the person in the driver's seat with a firm grip on the steering wheel believes to be steering it, while the car is in fact following its own path with considerable backlash? There is no simple answer to this question, which is not unique to financial regulation. As I have already said, individual countries have little room for manoeuvre as these activities take place at the international level. However, it is important to make the rules as clear and simple as possible. That will make them easier to observe and control. Keep it simple.

Let me try to illustrate this. Since 2004, Danmarks Nationalbank has prepared so-called outlier memos, i.e. identified outlier banks. On the basis of – mainly – published financial statements for a large group of banks, we have been able to point out those that achieved the lowest scores for selected key ratios, such as excess capital adequacy, high lending growth, large exposures and earnings capacity. Using this simple method, we sought to identify potentially vulnerable banks. Subsequently, we have concluded that virtually all of the banks within this group that have actually become distressed had been identified beforehand using this relatively simple method. The Danish Financial Supervisory Authority was aware of this and included it in its supervisory activities. With the "Supervisory Diamond", the Danish Financial Supervisory Authority has taken a step in the right direction, with focus on observing a few key ratios – and now with sanctions for non-observance. And others can also monitor these key ratios.

Another interesting observation is that among the 10 banks identified before the crisis as having the highest exposures to the property sector, 8–9 have subsequently become distressed.

So the conclusion is that relatively simple key ratios can be used to identify the banks that could be at risk.

Aggressive lending growth combined with property speculation is the single factor with the greatest impact on the banks that have folded.

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Seen in a broader perspective, Denmark has navigated the financial crisis fairly well so far. The weeding out of unsound banks has almost been completed, and after all less than 6 per cent of the banks became distressed – measured by balance-sheet total. Despite the large house price falls, the number of enforced sales is limited – especially when compared with the housing crisis in the early 1990s. If we disregard periods of unsustainable overheating and subsequent adjustment, unemployment has not been lower for the last 40 years. Denmark has sound economic ratios and internationally it is among the countries with the highest credit ratings. The reason why we have not been more severely hit is that we had the necessary buffers. All in all, this is no bad point of departure for meeting the challenges of the coming years.

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In my seven years as Governor of Danmarks Nationalbank, 1/3 of Denmark's banks have disappeared – in numeric terms. The decline has been steady over this period and is in keeping with a trend that goes far back – crisis or no crisis. Danmarks Nationalbank will gladly assist you in calculating when you will be able to hold your annual meeting at a decent-sized dining table – if this trend continues. As I see it, the most significant factor is the increasing complexity of banking. So if I may offer a piece of sound advice to a Director of the Danish Bankers Association (chief lobbyist) who wishes to continue to have a large number of paying members, I suggest that you give priority to clear and simple rules – especially for small banks. Regardless of the path you take, I would like to thank the Danish Bankers Association, its members, its employees and its Director for our good and constructive cooperation through seven years.

Thank you for your attention.