Lars Rohde: The most important recent economic developments in Denmark

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the Auditors' Day 2013, Copenhagen, 26 September 2013.

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In the turbulent period in the wake of the financial crisis and the subsequent government debt crisis, Denmark became known as a "safe haven" among international investors. The Danish government has maintained its triple-A rating, at times capital inflows into Denmark have been sizeable, and both interest rates and the yield spread to Germany reached historically low levels. In fact, the yield spread to Germany was even negative for a while. Presumably no-one could have imagined that before the crisis. And if Denmark's economic policy had not enjoyed a high degree of credibility, it would not have been possible. It now looks as if the situation is normalising, at least for long-term interest rates.

Today I would like to outline the most important economic developments leading to our current situation. Let me start with an international perspective.

With the introduction of the euro in 1999, a number of heavily indebted southern European countries such as Greece, Spain, Portugal and Italy, as well as Ireland – the "GIIPS countries" – saw their yield spreads to the core member state, Germany, narrow substantially. Many of the GIIPS countries had sustained government deficits, and the structural element of these deficits was incorrectly estimated. As a result, government debts were allowed to increase further from elevated levels. Productivity grew at a slow pace in these countries, while wage inflation was fairly high, which undermined competitiveness. Previously, that could have been addressed by devaluing the currency. With the euro, that was no longer an option. This was the situation in the GIIPS countries – to varying degrees.

The financial crisis was a wake-up call, and in 2011 the heavily indebted countries were hit by the sovereign debt crisis. Economic imbalances were large, and investors realised that a single currency does not automatically entail joint liability for sovereign debt. Yield spreads widened again. Retrospectively, we can see that the financial markets did not play the watchdog role, as they should have done. Given the unsustainable economic policies, risk premia on the government bonds of the debt-ridden countries should never have fallen to the German level after the introduction of the euro. The economies in question are now in an adjustment process, which is all the more difficult because action was not taken at an earlier stage. This shows what may happen if economic policy is not sufficiently responsible.

To a large extent, the description of the heavily indebted countries in the lead-up to the financial crisis also describes developments in Denmark – but with the opposite sign.

History shows that when it comes to fiscal policy, credibility or lack of credibility is what really separates the wheat from the chaff in terms of the countries seen as safe havens.

For many years, Denmark pursued fiscal policy that dampened cyclical fluctuations. But in the period before and during the most recent upswing, fiscal policy became procyclical. That was unfortunate, and it has contributed to prolonging the adjustment of the economy after the downturn.

Nevertheless, there were sizeable government surpluses and government debt was reduced in the years leading up to the financial crisis. So Denmark's point of departure was more favourable when the crisis hit. Unlike most other EU member states, Denmark had scope to let public finances cushion the impact of the strong setback without jeopardising basic confidence in the fiscal policy pursued.

In response to the lessons learned from the financial crisis, a set of framework conditions for responsible fiscal policy have been laid down. This has been done at EU level via the Fiscal

Compact, which forms the basis for the Danish Budget Act. From 2014, the Act lays down 4-year current spending ceilings for central, regional and local government. It is hoped that the Budget Act will help to ensure that the many years of systematic budget overruns are now a thing of the past. Even before the Act comes into force, discipline has been strengthened, in that spending has been within budget in recent years.

Pursing responsible fiscal policy requires a constant effort. In the current debate on the 2014 Finance Act, there have been proposals to ease fiscal policy more than the government plans to do. Danmarks Nationalbank takes a clear stand on that issue. There is neither a need for nor scope for further expansionary measures. Fiscal policy is already very close to the limits of the framework adopted.

Moreover, although we have a negative output gap – and consequently spare resources in the economy – the gap is not tremendously large, and Danmarks Nationalbank expects it to narrow gradually towards 2015. Unemployment is not far from its structural level and is actually 30,000 lower than when the Whitsun Package of austerity measures was introduced in 1998. Considerable savings have been built up in the economy, and at some point this will invariably lead to higher private consumption and investment. Fiscal easing at the current juncture could prove to be badly timed as it might boost an economy which is already on its way up, with a risk that the economy overheats again.

Besides sound fiscal policy, the transition from a country with large external debts to a creditor nation is important in relation to Denmark's status as a safe haven. A few decades back, the current-account deficit was a theme that dominated practically all economic discussions. Denmark had permanent deficits from the early 1960s until 1990. External debt accumulated and constituted 40 per cent of GDP when it peaked in 1986. That severely restricted Denmark's room for economic manoeuvre. Many of us remember Finance Minister Knud Heinesen's warning that Denmark was heading for an abyss. Today we are in the opposite situation. Denmark's net foreign assets now exceed 35 per cent of GDP and continue to grow. However, we expect them to fall this year due to rising long-term interest rates, which will entail capital losses on pension funds' hedging instruments in particular.

In recent years, Denmark has received the equivalent of 3 per cent of GDP in annual return on its net foreign assets; this increases consumption opportunities correspondingly.

The current account of the balance of payments reflects the difference between savings and investment in the economy overall. The positive trend since 1990 is attributable to a structural increase in the propensity to save rather than lower investment. True, the investment ratio is somewhat low at present, but in view of the current cyclical position it is not unusually low.

One of the reasons for the structural increase in the propensity to save in Denmark is that the tax deductibility of interest payments has been reduced steadily from 73 per cent in the mid-1980s. Undoubtedly, labour-market pensions also play a role as they are in the nature of compulsory savings for some people.

As I have already mentioned, Denmark's net foreign assets provide a sound annual return. Investment income from abroad increases domestic demand. That leads to upward pressure on wages in Denmark, which in turn weakens competitiveness. In other words, an internal revaluation process takes place. In countries with floating exchange rates, the currency would appreciate. This is a kind of balancing mechanism, and part of the deterioration of Denmark's competitiveness by 20 per cent since 2000 should be viewed in that light.

The fall in competitiveness was particularly strong in connection with the overheating of the Danish economy in 2006–08, but a large part of the excess wage increase has been made up for in recent years, as wage inflation has been lower here than in competitor countries. In fact, Denmark's industrial production, which is to a large extent driven by exports, has risen more strongly than Sweden's since it dived in response to the financial crisis in the autumn of 2008. The reason why growth in GDP has, nevertheless, been lower than in Sweden is weaker domestic demand as a result of the strong downturn in the Danish housing market after the overheating, with a resultant loss of wealth and negative implications for private consumption.

In general, it does not make sense to speak of “structurally weak competitiveness”. Weak competitiveness is temporary, not permanent. After a while it will strengthen as a result of developments in wages and exchange rates. With the fixed-exchange-rate policy, Denmark has deselected the latter option.

Over a period of time, extensive structural reforms have been introduced in Denmark. These include reforms of pensions, taxation and unemployment benefits, to mention but a few examples. The reforms help to secure the future foundations of the Danish economy and are also an element of credible economic policy. But in the short term they may initially have increased uncertainty in the population, thereby extending the recession slightly. However, this is not an argument for not taking action.

Obviously, we cannot talk about credible economic policy without mentioning the fixed-exchange-rate policy. Over the last 30 years, considerable credibility has been built up around this policy and no-one seriously questions it.

When the financial crisis peaked in the autumn of 2008, the krone – like other small currencies – came under very strong pressure. Combined with a number of crisis measures, the high degree of credibility helped to ensure that Denmark weathered the crisis.

Thanks to the favourable balances and strong confidence in the Danish economy, we have benefitted from the historically low interest rates in the wake of the financial crisis. This has buoyed up private-sector demand and hence also production and employment in recent years. Both short- and long-term interest rates have fallen considerably since end-2008. This is a concrete example of “credibility counts”, which is the theme of the Auditors’ Day 2013.

On 6 July 2012, Danmarks Nationalbank reduced the rate of interest on certificates of deposit to minus 0.2 per. In other words, banks and mortgage banks must pay to hold liquidity at Danmarks Nationalbank; a situation that is unique in both a historical and an international context. Subsequently the rate of interest on certificates of deposit has been raised to the current level of minus 0.1 per cent. In recent years, pressure on the krone has entailed preventing it from strengthening. That is, undeniably, more pleasant than having to support a weakening currency.

In the last few months, long-term interest rates in particular have begun to rise again, and the Danish yield spread to the euro area is no longer negative. We have known all along that interest rates would normalise at some point, but as long as this simply means that our neighbouring economies are recovering, it is not a problem.

I have talked about the importance of credible economic policy. This crisis has emphasised the need for credibility – at both macro and micro level. In Denmark, several banks had managements who were over-optimistic when it came to calculating the need for loan impairment charges. Roskilde Bank and Tønder Bank are sad examples. Both of these banks are history now.

I realise that the concept of credibility is not unknown to auditors. The whole purpose of audits is to ensure confidence in the information provided in the financial statements, so that investors and other stakeholders may trust the information – and make informed decisions. The auditors perform an important task as the trusted representatives of society. This task is also of significance to the macroeconomy as it helps to reduce uncertainty about the figures, thereby facilitating capital and credit flows.

But trust in auditors has also been shaken a little by the financial crisis. Several legal investigations of the banks that have been wound up question the quality of the audits performed. And in several cases the government-owned winding-up company, the Financial Stability Company, has raised claims against the external auditors for non-compliance with good audit practice. I am not going to anticipate the outcome of these cases, but – even if they relate to only a few black sheep – they have a negative impact on the general reputation and credibility of auditors. As a result, confidence in the financial statements may be eroded.

As always, the authorities respond by introducing more regulation. In Denmark, there are proposals for a special certification scheme for auditors of financial enterprises in addition to the approved degrees in accountancy. And at the European level, the Commission has tabled a number of proposals to strengthen the independence of auditors – including compulsory rotation between accounting firms – and proposals to coordinate supervision of auditors in the individual member states. I also know that your organisation, FSR – Danish Auditors, has initiated a project to enhance transparency and quality within the sector in Denmark.

Such initiatives are important and relevant. They can help to create a framework for confidence and credibility. But ultimately, credibility is the responsibility of the individual auditor, who must ensure that he or she has the necessary competences and asks critical questions at the right time. And that the management of the reporting firm is able to provide satisfactory answers to these questions. It is important that you, as auditors, dare to challenge the statements and answers provided by management. It is not enough to focus on ticking boxes and observing formal requirements.

I have also noted that the market mechanism does seem to be functioning to some extent – in Denmark and internationally. Accounting firms connected with financial enterprises that have collapsed after the revelation of major accounting irregularities have lost reputation and customers. That helps to ensure self-discipline.

As with the credibility of economic policy, confidence must be built up over time. On the other hand, it can evaporate in no time if the expectations of society are not met. So it is important that you as a profession work to reduce the “expectations gap” – that is, the gap between what the general public expects from auditors and what legislation requires. I think the key words in this context are communication and openness. That will promote both confidence and credibility.

Thank you for inviting me to speak.