

Lars Rohde: Monetary policy, foreign exchange intervention and GDP growth seen rising

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Danish Mortgage Banks' Federation, Copenhagen, 25 March 2015.

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Let me first talk about monetary policy. This is an area where the beginning of the year was unusually eventful. The main background factor was the announcement by the Swiss National Bank on 15 January that it would no longer limit the strength of the Swiss franc against the euro. And one week later, on 22 January, the European Central Bank announced an expansion of its programme to purchase government bonds.

Already on the afternoon of the announcement from the Swiss National Bank we began to see a considerable inflow of capital into Denmark. The Swiss decision seems to have led some foreign investors to purchase Danish kroner. In that way they would make a substantial profit if the fixed exchange rate policy were abandoned and the krone appreciated.

However, nearly two thirds of the increased demand for kroner in January and February came from domestic market players, including insurance companies and pension funds. They have to some extent wished to insure themselves against losses in the event that the krone appreciated like the Swiss franc. This was done by way of hedging. You might say that the pension funds bought insurance policies of no value as abandoning the fixed exchange rate policy has never been on the agenda. Obviously it is entirely up to the pension funds and life insurance companies how they wish to place their funds. But nevertheless it is a shame if individual pension savers are forced to bear unnecessary costs.

In order to stem the capital inflow, Danmarks Nationalbank intervened in the foreign exchange market for very large amounts, and we also reduced our monetary policy interest rates on several occasions. The interest rate on certificates of deposit is now -0.75 per cent – a level not seen previously. The monetary policy interest rates were reduced in increments. This is because we initially did not know the width and depth of the capital inflows and hence we had to assess the situation on a current basis. In order to further halt the capital inflows, the Ministry of Finance also decided to suspend issuance of Danish government bonds on 30 January. This was done at the recommendation of Danmarks Nationalbank.

Since the most recent interest rate reduction, which took effect on 6 February, the krone has been kept stable purely via intervention in the foreign exchange market. And compared with previous episodes of pressure against the krone, intervention has played a greater role this time.

But it also makes a great difference whether there is upward or downward pressure on the krone. When there is upward pressure, Danmarks Nationalbank sells kroner. We have plenty of those. So in a situation with upward pressure on the krone, Danmarks Nationalbank can sell unlimited amounts of kroner. The possibility of unlimited intervention also means that assistance from the ECB is not relevant in the defence of the krone when the pressure is towards a strengthening.

Despite the unusual volume of intervention, Danmarks Nationalbank has applied a well-known reaction function by first intervening in the foreign exchange market and then adjusting interest rates in response to the capital inflows. It has been important for us to stick to this reaction function, one reason being that in a normal situation it is the banks that carry out “stabilising speculation”. When kroner are inexpensive, the banks build up stocks of kroner, and when kroner are expensive they do the opposite – they sell kroner and purchase foreign exchange.

When the situation is not normal, the banks' position is typically around zero, and Danmarks Nationalbank absorbs the net shocks in the foreign exchange market. So Danmarks Nationalbank has applied its usual reaction function. This gives the banks a basis for gradually resuming their self-stabilising speculation as the situation normalises. Since the second half of February, the foreign exchange market has been relatively calm.

The very low level of interest rates in Denmark means that Danmarks Nationalbank profits from the foreign exchange reserve: the amounts in euro included in the reserve accrue interest at a higher rate than that at which the banks' deposits in kroner are remunerated. So Danmarks Nationalbank is strongly positioned in a situation with upward pressure on the krone. Our patience knows no limits. At the same time, we make sure that it is costly for investors to speculate against the fixed exchange rate policy.

Denmark has posted current account surpluses for some years and has built up substantial net foreign assets. This makes it necessary to export private capital on a current basis. Viewed in isolation, this points to a lower yield spread to the euro area in future compared with what we have previously seen, but also to the possibility that situations with upward pressure on the krone can emerge. However, situations can easily arise in which capital flows out of Denmark and Danmarks Nationalbank must purchase kroner. In 2014, we intervened both in order to strengthen the krone and in order to weaken it. Intervention and interest rate adjustments will continue to reflect current developments in the exchange rate, as they have done until now.

The fixed exchange rate policy is a cornerstone of Danish economic policy. Over the past 30 years, it has been the basis for stable economic development in Denmark – although we have had to navigate through choppy waters at times. The fixed exchange rate policy means that monetary policy is reserved for keeping the krone stable against the euro.

Therefore monetary policy does not take factors such as growth, employment and house prices into account. These considerations are addressed by other economic policies – not least fiscal policy, which plays an important role in relation to ensuring stable growth.

The reductions of monetary policy interest rates and the suspension of sales of government bonds have led to negative market rates, even for longer maturities. This is not the first time we see negative interest rates in Denmark. But this time around the interest rate on certificates of deposit is even lower, and so are market rates.

Apart from certain technical difficulties, negative interest rates are, basically, not so different for the financial sector to handle than persistent low interest rates.

The debate has focused on the direct effect on monetary policy counterparties of the negative interest rate on certificates of deposit; the fact that they must pay to deposit money at Danmarks Nationalbank. However, it is rarely the credit institutions that ultimately foot the bill. The demand for kroner has this time often been triggered by a forward transaction in which the bank's income matches the negative interest rate on certificates of deposit. At the same time, the current environment of low or even negative interest rates seems to have led to a wave of remortgaging. That will also help to fill the credit institutions' coffers.

Negative interest rates must be considered as something extraordinary, not a new permanent state of affairs. In other words, there is no foundation for easing credit standards, not even if competition intensifies. Special caution should be exercised when granting loans at variable rates of interest. The assessment of the finances of each borrower should be based on good practice and take into account whether the borrower would be able to service a 30-year fixed rate loan with amortisation. But if the assessment is based on a fixed long-term rate of 2 per cent, it does not constitute much of a stress test. A variable rate of interest could soon rise above that level. Either the credit institution should apply a more severe stress test, or it should actually grant a fixed rate mortgage loan.

The Danish economy is in an upswing. Growth has not been impressive, but it has been clearly visible if we adopt a slightly broader perspective than merely GDP growth. Employment is picking up, house prices are rising and there is solid growth in real GDP net of oil extraction and in the gross national product, which includes the net return on external assets.

We are seeing growth because the foundations are in place. Denmark is competitive, so exports can begin to fuel the economy. And household finances have become more balanced after the housing bubble in the 2000s.

In addition, three other factors are boosting growth strongly.

Firstly, interest rates have fallen by more than we had expected. At the current very low level of interest rates, monetary policy provides a strong growth impulse – globally and in Denmark.

Secondly, the effective krone rate has weakened since the autumn in step with the weakening of the euro against the dollar. Combined with the prospect of stronger growth abroad, this provides good opportunities for increasing exports.

Thirdly, the low oil prices entail large cost savings for firms and households. This will further stimulate growth, both in Denmark and among our major trading partners.

The fall in oil prices has pushed inflation down towards zero. But many prices are still rising, wage growth is accelerating and the lower effective krone rate will exert upward pressure on import prices, so we are not heading towards deflation. The oil price fall is in fact good for the economy.

Against that background, Danmarks Nationalbank's new projection operates with growth at a higher level this year and in the coming years. GDP growth is expected to rise from 1 per cent last year to around 2 per cent this year and the next couple of years.

With this growth outlook, all spare resources in the economy will have been absorbed within a few years. If we are not to face capacity problems, both the labour market and fiscal policy must be geared for this development.

Firstly, fiscal policy should take into account the strong expansionary forces currently at work. In this situation it is not expedient to continue to conduct fiscal policy very close to the limits, as has been the case in the weak economic climate in recent years. Fiscal policy must be restored to a neutral level. This means that the structural government balance must be brought close to balance over the next couple of years.

Secondly, it is essential that recent years' reforms of e.g. the unemployment benefit and pension systems boost the supply of labour sufficiently. If not, there could soon be a shortage of labour. So far there are only few indications of this, but the strength of the predicted recovery could soon change that.

Finally, we are increasingly concerned about developments in the housing market. Parts of the market are moving fast at the moment. This applies especially to owner-occupied flats in the Copenhagen area, for which supply, turnover, time on market and real prices are approaching the levels seen in 2004–05, just before the most recent housing bubble. We want to avoid a situation where a sustained period of very low interest rates sparks an unhealthy development with self-reinforcing price rises for owner-occupied dwellings, as seen in the period 2005–07.

The absence of sufficient automatic stabilisers – or brakes – in the housing market is a problem. In their present form, housing taxes are procyclical and amplify fluctuations in the housing market. The most effective way to strengthen macroeconomic stability is by restoring the link between property value and property taxation which existed before 2002. This cannot wait until 2020. I would like to make it clear that Danmarks Nationalbank has no position on

the overall level of housing taxes, but it would contribute to economic and financial stability if taxation is not destabilising.

Denmark has a long tradition of stability-oriented economic policy, and now is the time for action if we are not to see a runaway upswing. In relation to stability-oriented economic policy, it is just as important to tighten during an expansion as to ease during a slowdown. In other words, financial easing should be rolled back when the economy begins to pick up again.

Now I will turn to the new rules on crisis management of credit institutions. These rules are expected to enter into force in Denmark on 1 June 2015. Basically, we will have the same rules throughout the EU, which will enable crisis management of all credit institutions, irrespective of size, without the use of public funds and without substantial negative implications for financial stability. I see the new rules as one of the most important foundation stones in the construction of a bulwark against a new financial crisis.

The rules cover both possible recovery measures when a bank is ailing and resolution measures when it is actually failing. In the latter situation, steps will be taken to ensure that the bank's critical functions – for its customers and for the financial system – can be continued so that the effects on the economy are not unnecessarily adverse. And all this will be effected without the use of taxpayer money. The banks will, as it were, be tidying up after themselves. Basically, the principles for crisis management of banks are similar to those we already know in Denmark; those who have invested in the bank – i.e. owners and investors – will bear the losses. It will be a bail-in, not a bailout.

It is essential that a failing bank has the capacity to absorb losses so that a bail-in can actually be carried out to the extent that this is necessary in order to restructure the bank. So in future EU credit institutions must meet an individual requirement to hold sufficient eligible liabilities.

An equally important aspect is the preventive element of the new rules. I am thinking of the credit institutions' own recovery plans and the authorities' resolution plans. The task of preparing recovery and resolution plans should not be limited to an exercise in "ticking" the formal requirements. Well-prepared and realistic plans are not only a contingency measure, they will also have a strong impact on the activities and the organization of each institution in normal times.

The Danish mortgage banks are fully comprised by the new rules, except that they need not comply with the requirement to hold eligible liabilities. Consequently, bail-in cannot be applied to a failing mortgage bank. This means that when handling mortgage banks, the resolution authorities do not have the same tools at their disposal as when handling banks.

Instead, the bill presented includes a national requirement for mortgage banks to hold a "debt buffer" corresponding to 2 per cent of their lending. So the Danish mortgage credit model will have yet another element that is not in conformity with the EU, and at the same time the buffer requirement seems to be on the low side. It might be a challenge to explain this to the outside world.

In Denmark's Nationalbank's view, Denmark has hereby missed a golden opportunity for the mortgage credit sector to benefit from developments in international standards. Credit institutions in the rest of Europe must sell uniform debt instruments that qualify as eligible liabilities, while Danish mortgage banks must sell another variant for a special Danish debt buffer. It would have been preferable if the mortgage banks would have had to use eligible liabilities in the same way as other credit institutions in Europe. This would also have eliminated the need to use Junior Covered Bonds for financing top-up collateral in the event of future house price falls.

Finally, if anyone is waiting for me to talk about the Banking Union, let me reveal that Danmarks Nationalbank still believes that the interests of Danish households and firms, as well as the Danish mortgage credit system, will be best served if we join soon. We look forward to the forthcoming debate about this issue.

Thank you.