

Bodil Nyboe Andersen: Recent developments in the Danish economy

Speech by Mrs Bodil Nyboe Andersen, Governor of Danmarks Nationalbank, at the Annual Meeting of the Association of Danish Mortgage Banks, held in Copenhagen on 19 April 2001.

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Wherever economists currently meet, they discuss the development in the US economy and its significance to the rest of the world. Not only is the uncertainty regarding the future development considerably greater, but there is also great uncertainty about how serious the current situation actually is. Some of the key data on which assessments are based, such as stock prices and other financial data, can be monitored hour by hour, while other key figures are available only after several weeks or months have elapsed.

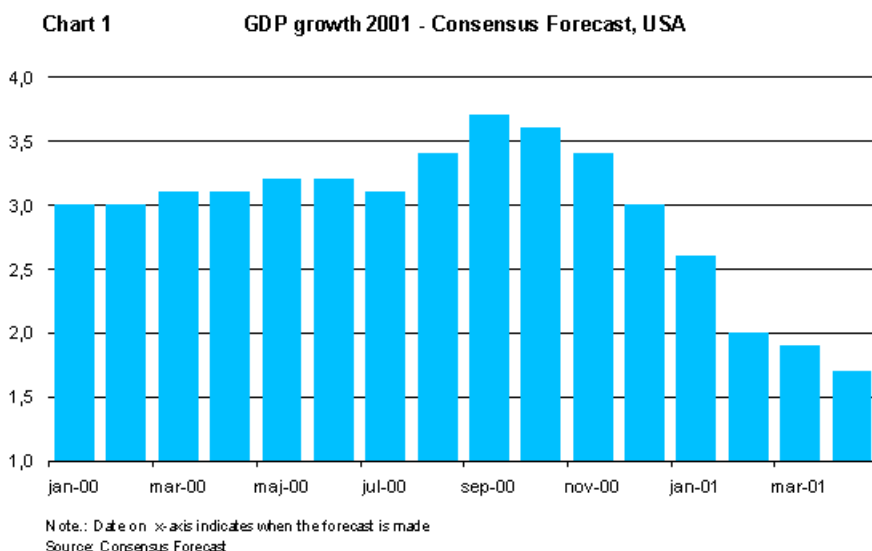
After many years of strong growth the US economy has slowed down. Most notably, stock prices have declined. One year ago, the general perception was that stock prices, especially for IT stocks, were excessively high. Nonetheless, the downturn has given rise to concern, since it impacts demand from both consumers and business enterprises.

Numerous economic forecasts are drawn up by national and international authorities, analysis institutes and financial institutions.

Experience shows that it is very difficult for economists to predict cyclical reversals. It is virtually always the case that forecasts are only adjusted on the brink of the turnaround.

On the basis of the forecasts a “consensus estimate” is drawn up. As the basis for assessing growth prospects for 2001 a number of forecasts are collated in order to aggregate the forecast data. In the following month new forecasts will have appeared, and a new set of aggregate figures is prepared.

Viewed over a period, a picture is gained of the expectations of growth in the USA in 2001 (Chart 1). In the first half of 2000, growth of just over 3 per cent was expected for 2001. The figure was even higher, at 3.7 per cent, when the forecasts available in September were assessed. Since then, the expected growth in the current year has been reduced month by month, and the expected growth rate is now 1.7 per cent, which is less than half the growth forecast for 2001 made in September 2000.



US growth prospects have thus been subject to extensive downward revision. However, it is important to bear in mind that it has long been considered necessary to achieve a “soft landing”, after the unusually strong boom over many years. Currently lower growth, but not negative growth, is expected in 2001. In view of the many years of growing accustomed to high growth, the current development is nonetheless still perceived as rather dramatic.

The Federal Reserve has reacted to this slowdown. In 2001 it has reduced its official interest rate in four stages by a total of 2 per cent to 4½ per cent.

By lowering its interest rates the Federal Reserve is seeking to revigorate the economy and create positive expectations of the future economic development. However, the very fact that the Federal Reserve found it necessary to lower interest rates so rapidly and dramatically emphasises that it considers the situation to be serious and that there is a reason for the negative expectations held in many quarters.

It is to be hoped that the lower interest rates together with other initiatives will ensure that the slowdown in the USA is short-lived. Many American forecasts are quite optimistic in this respect, and expect a return to stronger growth by the end of year. The reasons given are that this is considered to be a brief period of adjustment due to excessive stockpiling and expansion of the capital stock. Other forecasts are less optimistic, however, and expect a prolonged cyclical slowdown.

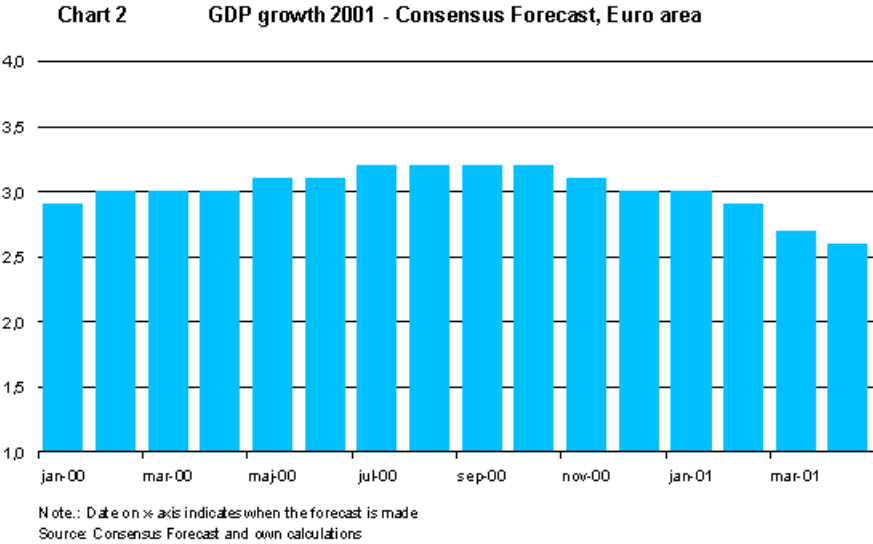
Not only the development in the USA is subject to uncertainty: there is also great uncertainty of the extent to which it will affect Europe.

The traditional source of influence is foreign trade. However, as a major market with a single currency, the euro area has become less dependent on trade with the USA.

There can also be an impact via the financial markets, where movements in bond and stock prices are homogenous across national borders. However, European consumption is significantly less sensitive to the development in stock prices than US consumption.

Finally, it is clear that the strong media focus on trends in the USA in itself can contribute to affecting expectations in Europe too. In view of the tax-relief measures already adopted by many European countries the situation is more robust than in the USA, however. But it may be hazardous for Europe to allow itself to be infected by US expectations and make things out to be worse than they are.

However, it is a fact that growth expectations for Europe in 2001 have also been adjusted downwards. The curve (Chart 2) showing consensus estimates for euro-area growth in 2001 has thus been revised downwards. In August-September the forecast average was 3.2 per cent, and now it is 2.6 per cent. The downward adjustment is not as strong as in the USA, and both the OECD and the European Central Bank still expect solid economic growth in Europe in 2001. Against this background the ECB has maintained its benchmark interest rate, the minimum bid rate, at 4.75 per cent.



However, the ECB has also stated that the inflation risk is diminishing. Overall the ECB’s position regarding interest-rate adjustments can be characterised as “neutral”, or “wait and see”.

Denmark’s unemployment rate is currently very low compared to rates in most European countries. This has led to pressure on the labour market, so that development in prices and wages has been slightly higher than the average for the euro area. The tight labour market imposes limits on the level of growth which is possible without jeopardising balance in the economy.

A few years ago, we discussed the need to brake the economy, a “soft landing”, and this is what we have in fact experienced. So for the time being a lower growth rate in Denmark should not be considered a problem.

Consumption has risen slowly, and growth has been driven by investments and exports in particular. This has also benefited the balance of payments, and the deficit seen in 1998 has been replaced by sound surpluses.

Should Europe suffer a serious economic downturn, Denmark will naturally also be affected. However, there is reason to believe that the reaction will be more subdued in Denmark. Many companies are close to their capacity limit and will not encounter any major problems in the face of more subdued growth in demand.

Moreover, government finances show a favourable surplus, allowing the automatic stabilisers to counter any tendency for a downturn.

As a consequence of the fixed-exchange-rate policy Denmark's monetary policy is closely linked to the monetary policy of the euro area. Danmarks Nationalbank therefore matches the ECB's interest-rate policy and since October 2000 has held the discount rate at 4.75 per cent.

The foreign-exchange market has been stable since the euro referendum. Danmarks Nationalbank could therefore reduce the interest-rate spread vis-à-vis the ECB's minimum bid rate to 55 bp.

In 2000 Danmarks Nationalbank played a very active role in the foreign-exchange market in order to stabilise the krone and avoid any unrest in the period up to and just after the referendum. In recent months the market has become better at matching demand and supply itself. For some periods this has entailed slightly wider day-to-day price variations, but overall there is good balance in the foreign-exchange market.

Currently, the concept of “benchmarking” is very popular in management literature. The Ministry of Finance evaluates public institutions and ministries by benchmarking. Shareholders and boards of directors ask companies to draw up key figures as a basis for peer comparisons. Benchmarking is considered to be good management practice.

This concept is also applied to assessment of a country's economic policy. The convergence requirements of euro-area participants include absolute benchmarks such as the well-known 3-per cent maximum budget deficit, and relative benchmarks such as the inflation criterion.

The financial markets are no exception. The results achieved by a portfolio manager in an insurance company or another financial investor will be compared with those of others in the same sector. When investment funds publish their results, they are compared with benchmark portfolios.

This implies a tendency for all investors to do more or less the same. This herd-like behaviour is used to explain the often very substantial fluctuations in prices for stocks, and to a smaller degree for bonds, as well as the exchange rates between the major currencies.

It can sometimes be difficult to explain major fluctuations by underlying economic fundamentals and in such cases more psychological reasons are given such as expectations or herd-like behaviour.

Portfolio managers tend to buy and sell the same securities as all the others. They know that they are measured against the others, and there is good reason not to go against the flow. If things go badly, they can always point out that others are in the same boat, and blame it on the market. On the other hand, if they have taken an alternative strategy and things go badly, their reputation will be seriously undermined.

As so often before, we have to conclude that what goes around comes around. In 1936 Keynes wrote: “... it is better for reputation to fail conventionally than to succeed unconventionally”.

During the last decade the mortgage-credit sector has experienced several waves of conversion, utilising fluctuations in short-term interest rates. A change in rules and the strong decline in interest rates at the beginning of the 1990s made conversion an attractive option. In the following years fluctuations in the level of interest rates were used in order to convert mortgage loans. Today, borrowers have become more aware of the opportunities available. When a loan is raised, the future conversion potential will be one of the underlying considerations.

Moreover, mortgage-credit institutes and banks publish information material on conversion opportunities as soon as interest-rate conditions approach a situation where this might be favourable.

Bond purchasers are naturally aware of the conversion risk and therefore a higher interest rate is required for these bonds.

This higher interest rate has to be paid by both minor and major borrowers. Typically major borrowers will benefit most from the conversions, since in relative terms they are subject to the lowest costs.

Investors would be willing to accept a lower yield on uncallable bonds. However, experience shows that the borrowers are not interested. They are willing to pay for the conversion right.

The mortgage-credit institutes must not grant callable loans financed by uncallable bonds, since this would be in conflict with the balance principle which is a cornerstone of the mortgage-credit system. The balance principle has been subject to minor adjustments on other grounds, however.

The fundamental requirement of a high degree of accordance between the terms for loans and the issued bonds has been maintained. In Danmarks Nationalbank's view this is of great significance if the traditional status of mortgage-credit bonds as gilt-edged securities is to be maintained. This structure was one of the key reasons for Moody's recent upgrading of Danish mortgage-credit bonds.

I would like to take this opportunity to congratulate the mortgage-credit institutes on this upgrading. This emphasises once again that the Danish mortgage-credit system is fundamentally sound at a time when financial innovation is the name of the game.

Cooperation between Danmarks Nationalbank and the mortgage-credit sector concerns many different topics. During the past year, special focus has been on the new balance-sheet statistics, called the MFI statistics. This has brought us a good step forward towards more detailed and comparable statistics for both banks and mortgage-credit institutes.

On behalf of Danmarks Nationalbank I would like to thank the Association of Danish Mortgage Banks and its members for the excellent spirit of cooperation that has prevailed during the past year, both at management level and in the committee on the balance principle, and in committees on other financial topics as well as issues of a more technical nature.