

Bodil Nyboe Andersen: Recent economic developments in Denmark

Speech by Mrs Bodil Nyboe Andersen, Governor of the National Bank of Denmark, at the Annual Meeting of the Association of Danish Mortgage Banks, Copenhagen, 30 April 2003.

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We live at a time when the global economy is hard to get going. Growth is low, stock prices have fallen by 40-50 per cent in three years, and interest rates are at a historically low level.

In recent months, the “geopolitical situation”, a euphemism for the conflict in Iraq, has been used to explain the extraordinary uncertainty currently affecting all economic forecasts.

Now that the military situation has been clarified, focus is returning to the structural problems affecting the large economies of the USA, Japan and the euro area.

Japan's structural problems have been discussed for 10-15 years without getting any closer to an actual solution, i.e. economic and political reforms. The expectation is rather that, as time passes, the cyclical downturn will have reached a point where the economy sooner or later recovers by itself.

The structural problems faced by the euro area are especially related to the rigidity of the labour market, and to very high and rising unemployment, especially in the two largest euro area member states. These countries also typically have the largest budget deficits. So there is no scope to stimulate demand via fiscal policy. This would be in conflict with the requirements of the Stability and Growth Pact, and would entail even larger structural budget deficits.

When the economy was stronger, these euro member states failed to improve the underlying fiscal position, and in several countries it was even weakened. Therefore we now face a situation with large structural budget deficits, and have forfeited the flexibility which the Stability and Growth Pact is intended to give.

For a number of years the USA has been the locomotive driving global growth, and the end of the 1990s saw an exceptionally strong boom in the USA. During those years, the USA built up a large current-account deficit. Many other countries would have faced considerable problems with financing a current-account deficit that expanded from around 1½ per cent to 4 per cent of GDP in three years. But at the same time the rest of the world wanted to increase investments in the USA, especially equity investments. Therefore the large deficits were easy to finance, and the dollar in fact rose in those years.

Now that the economy is growing less strongly, the USA still faces large current-account deficits of up to 5 per cent of GDP.

By definition the counterpart of a current-account deficit is a savings deficit. The interesting aspect in the USA's case is that since 2000 the federal budget has swung from a surplus to a deficit of around 3½ per cent of GDP, so that the savings deficit no longer relates to the private sector, but primarily derives from the public sector. This is reminiscent of the situation that in the 1980s was termed “The Twin Deficits”: the current-account deficit is “twinned” by a large government deficit.

Especially international organisations and European economists have begun to describe these deficits as a structural problem for not only the USA, but also for the global economy. The Americans apparently do not consider this to be a fundamental problem.

From a European viewpoint, a particular concern is that if this development continues the dollar may fall substantially, thereby hampering European exports and making a further contribution to the slowdown in Europe.

Higher savings in the USA will create other problems, however. The classical solution to this deficit problem is, as in Denmark's case in the second half of the 1980s, a strong tightening of economic policy and thereby a reduction of domestic demand. However, if the USA were to follow this course today, this would exacerbate the international problem of excessively weak demand, and thereby growth.

How is demand to be stimulated? Neither Japan nor Europe are making any significant contributions to growth in current years. The development in Asia, which seemed so promising in 2002, is now subject to uncertainty because nobody really knows whether SARS will cause growth to be seriously

undermined. All over the world, people are hoping that the economic upswing will come from the USA. To paraphrase a central-banking term, the USA has the role of the world's "Spender of last resort".

The Danish economy is not particularly "European" in current years, in terms of the situation in the euro area.

From 1994 to 2000, Denmark's economic development was sound, unemployment was reduced, and a favourable current-account surplus was achieved. Concurrently, the development in prices was moderate. Growth has been a little weaker in recent years, however. Nonetheless, the reduction of unemployment achieved in the second half of the 1990s has not been jeopardised. Public finances and the balance of payments continue to show sound surpluses.

Danmarks Nationalbank has therefore characterised the Danish economy as "robust". This can be interpreted in two ways, and both are of relevance to the current situation. Robust can either be used to describe an overall favourable macroeconomic balance. It can also mean that the Danish economy is not particularly sensitive to the international development. But this is not to say that we are not affected at all.

Unemployment has risen during the past half-year, but the level is still low compared to other countries in Europe and compared to the situation in the 1990s.

Some economic indicators, e.g. car sales and unemployment, show signs of slowing down, while other statistics, e.g. retail turnover and wage and price increases, point to the opposite. The economic picture is thus not completely clear at the moment. Therefore, Danmarks Nationalbank does not find any grounds to discuss any adjustments to fiscal policy in the current situation.

The picture was completely different in 1993, when fiscal policy was relaxed, popularly described as a kick-start of the economy. In 1993 Denmark had undergone 7 years with by and large zero growth in GDP. This stagnation was necessary to correct the imbalances of the economy, especially the current account deficit, in the mid-1980s. During this restoration period unemployment had risen to 12 per cent by 1993, i.e. more than twice today's level. Danish wage increases in 1993 were furthermore lower than among our trading partners.

The relaxation of fiscal policy achieved in 1993 had an effect concurrently with a considerable stimulus to demand as a consequence of the extensive wave of mortgage conversions. The strong decline in international interest rates in 1993 also had an impact on Denmark, and from mid-1993 to the beginning of 1995 mortgage-credit loans for approximately kr. 300 billion were converted. The fact that the conversion wave was so extensive was not only due to the drop in interest rates, but was also a consequence of adjustments to the Mortgage Credit Act and to tax acts, underpinning the new conversion opportunities.

At Danmarks Nationalbank we have sought to assess the effects of both the expansionary fiscal policy and the conversion wave from 1993. Calculations show that the contribution to growth from the drop in interest rates was at least as strong as the contribution attributable to the fiscal-policy relaxation.

The calculations also indicate an upswing in consumption, which statistically cannot be attributed to either the conversions or to fiscal policy. It seems that the expectations became more positive, and that this change of mood among consumers also helps to explain the upswing in 1994.

As stated, Denmark's economic situation today is significantly better than in 1993. If the slowdown becomes more pronounced in the near future, public finances, via the automatic stabilisers, will themselves help to stimulate the economy.

The automatic stabilisers in the Danish economy are rather strong compared to many other countries, and when they come into play in a downturn, the surplus on government finances will diminish. However, since the starting point is the strong budget balance that Denmark has built up in recent years there is also scope to allow this to take effect when the economy dampens.

Finally, there is one similarity between 1993 and the situation today in that the low interest rate stimulates the economy. This will not only affect business investments since the current wave of conversions will help to reduce homeowners' interest expenditure, as was the case in 1993. This will stimulate the households' consumption and their maintenance and modernisation of owner-occupied homes.

In view of Denmark's fixed-exchange-rate policy Danish interest rates closely match European interest rates. As the euro area's cyclical position is weak, the monetary-policy interest rates are very low, and therefore the financial conditions are more relaxed than Danish factors alone would indicate.

Four years ago, Danmarks Nationalbank made a number of adjustments to the monetary-policy instruments. This e.g. entailed that mortgage-credit bonds, like government bonds, can be pledged as collateral for Danmarks Nationalbank's monetary-policy lending.

On the same occasion, without any relation to the adjustment of the lending basis, the mortgage-credit institutes also became monetary-policy counterparties on an equal footing with the banks.

In my speech at the Annual Meeting of the Association of Danish Mortgage Banks in 1999, I stated the following:

“Danmarks Nationalbank expects that the mortgage-credit institutes will not only use this access to accommodate their own liquidity requirements, but will also actively contribute to broadening and revitalising an already well-functioning money market.”

I would like to take this opportunity to remind the mortgage-credit institutes of this. In the view of Danmarks Nationalbank, the mortgage-credit institutes could be rather more active participants in the money market, and also utilise the related earnings potential. It will be in all parties' interest to have more players in this market, and that these are participants with a different liquidity profile, i.e. the mortgage-credit institutes.

At a time when many new financial products are being developed, boundaries between different sectors are being eroded, and financial conglomerates are emerging, while the financial markets are globalising, it is remarkable to note the strength of the traditional mortgage-credit product.

The new Mortgage Credit Act currently being considered by the Folketing (Parliament) still maintains the foundation stones on which the mortgage-credit system is based. Innovations are being made that give borrowers more choice, e.g. the opportunity for repayment-free loans for a long period, i.e. up to 10 years.

However, the basis is still the balance principle, which requires a high degree of accordance between the terms of lending and the issued bonds.

Over the years, the mortgage-credit sector has often suggested that the balance principle be removed, or at any rate softened considerably.

Danmarks Nationalbank has always advised against a more than marginal relaxation. The balance principle is important to maintaining the blue-chip status of the bonds and has a great deal of the credit for the very high rating enjoyed by Danish mortgage-credit bonds. The balance principle is fundamentally a very simple way of managing risk.

The mortgage-credit product may not be very exciting, but it is a good, simple and inexpensive product that gives even small borrowers the opportunity to finance homes and businesses on financial-market terms.

These are characteristics that are also needed in other countries, and currently distant Mexico is in the process of establishing a mortgage-credit system that borrows a number of fundamental characteristics from the Danish system.

The US Treasury and a firm of consultants have acted as intermediaries in this process and have pointed out the uniqueness of the Danish model in terms of efficiency, transparency, security and protection of the interests of both borrowers and investors.

Representatives of the Mexican authorities have visited Denmark on several occasions, seeking technical assistance in building up a mortgage-credit system step by step.

This international recognition reinforces our pride in Denmark's mortgage-credit system.