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, 28 April 2005.

* * *

The global economy is generally in a period of strong growth – at a rate of 5.1 per cent in 2004. This may not completely match the picture painted by the media. The reason is that the figure conceals very strong variation between growth rates in various parts of the world.

After a slowdown in 2001 and the beginning of 2002, the USA has achieved annual growth of 3-4 per cent. This growth has been driven particularly by strong private consumption, stimulated by tax reductions and very low interest rates. However, the downside in the USA has been a high and growing current-account deficit and a considerable government finance deficit. Both of these deficits are often mentioned as the reason for the dollar's weakening against the euro. However, the USA has not faced difficulties in financing its current-account deficit and selling its government bonds. The demand for dollar assets is still high, especially from the Asian countries.

Even though financing has not presented problems for the USA, this does not change the fact that the USA is becoming increasingly indebted to the rest of the world. This course does not appear sustainable, but it is naturally hard to predict how long it can continue.

Asia, apart from Japan, has even higher annual growth rates, at 6-9 per cent. This reflects strong growth in exports to especially the USA, as well as growing domestic demand, including rising private consumption.

This American-Asian growth is driving the global economy.

Growth in the euro area, on the other hand, is currently very weak. Once again, private consumption is part of the explanation. Especially in Germany, households are reluctant to increase their consumption demand. More fundamentally, Germany has a clear need for structural reforms of its labour market and welfare system. The reforms are being addressed, but as long as the changes are still ongoing and even more are expected, general uncertainty will prevail. This contributes to the caution towards increasing private consumption.

Structural reforms are also needed elsewhere in the euro area. For the euro area overall, the weak development in consumption is a key factor behind the moderate growth.

In Denmark, however, we are good consumers! At least in the sense that we are currently spending a lot of money. Private consumption rose by more than 4 per cent in 2004, the largest increase in 10 years. The Danes have great faith in their own future finances, and they show no hesitance in taking advantage of recent years' tax cuts, lower interest rates and deferred-amortisation loans in what could almost be called a consumption bonanza.

As is the rule for such upswings, the impact on Danish employment has materialised with a certain time lag. Moreover, part of the consumption increase has naturally enough been directed at imported goods and services, including foreign travel. This does, of course, create jobs, but in other countries. This development in imports has contributed to reducing the current account surplus by almost kr. 10 billion, albeit from a very high level exceeding kr. 45 billion in 2003. It is important to note, however, that stronger growth in demand in Denmark than abroad traditionally has a strong impact on the trade figures.

Some of us are old enough to remember how in the 1970s and 1980s the balance of payments was the key problem in the Danish economy for a period of more than 20 years. We can certainly confirm that the Danes were also good consumers then.

Solving the sustained Danish current-account problem required a number of structural economic reforms in e.g. the labour-market and taxation areas. This entailed some difficult years of adjustment in the 1980s and 1990s. But these reforms made a vital contribution to the strength of the Danish economy from the late 1990s right up to the present day. Unlike then, we cannot say today that overall we are living beyond our means. Having said that, we should also remember that we currently have very substantial export revenues from oil and shipping, and these sectors are highly sensitive to cyclical developments.

In this perspective the current rising consumption does not pose balance problems for the economy. But in the slightly longer term the economic upswing ought to be more balanced so that overall production can keep up with growth in demand.

Unemployment has been falling during the past year and is now at the level of the spring of 1998 when the government of the day introduced the Whitsun package of economic measures in order to dampen consumption and increase the supply of labour. The Government Platform of February 2005 sets out a number of means to achieve a permanent increase in employment. Recent developments show the importance of immediate concrete initiatives to increase the supply of labour. Otherwise there is a risk of a situation with pressure on the labour market.

The traditional basis for Danish mortgage credit was that homeowners could borrow on capital-market terms. The bonds were callable, so that borrowers could take advantage of falling interest rates, but were not affected by interest-rate increases.

The terms offered by the various mortgage-credit institutes were virtually identical, and bonds issued by the various institutes were perceived as almost perfect substitutes, called "uniform bonds" or "enhedsobligationer".

The mortgage-credit market has also traditionally been closely regulated in terms of maturities, mortgageable limits and types of loans. The limitations on access to lending, designed to steer cyclical development, were gradually removed so that legislation was based solely on the security aspects. Up to the mid-1990s this system by and large reigned supreme.

But then the development of new mortgage-credit products began to take off.

Today there is a choice between not only fixed and adjustable interest rates, but also mixes such as adjustable interest rates with a ceiling and deferred amortisation for fixed periods, while commercial banks have also joined the market to offer mortgage loans. Loan conversions are the order of the day, and the average borrower keeps loans unchanged for a shorter period than was the case just a few years ago.

Homeowners are bombarded with offers of loan conversion, and the products offered are becoming ever more complex. Institutions compete intensely to be the first to introduce new products in order to win market shares. The only parameter that does not seem to be subject to competition is the contribution fees for loans for owner-occupied homes and summer cottages.

The mortgage-credit sector should perhaps consider whether the many new products will lead to bond series that are so small that they adversely affect the very favourable interest terms traditionally characterising Danish mortgage-credit bonds.

The rising indebtedness, greater use of adjustable interest rates and the opportunity for deferred-amortisation loans have brought up the issue of the vulnerability of households in the event of a significant increase in interest rates.

On the basis of data made available by Nykredit, Danmarks Nationalbank has analysed the sensitivity of homeowners to changes in interest rates. The analysis will be published in our annual publication "Financial stability", which will be issued on 12 May. The analysis exclusively considers effects on interest costs without incorporating the mortgageable values.

The higher the homeowners' incomes, the lower their interest burden, i.e. interest expenses as a ratio of gross income. On the other hand, the groups with the highest incomes have a larger proportion of adjustable-rate loans.

Despite the variations in the debt composition of the different groups, the calculations show that the interest-rate exposure is more or less identical for all income groups. Interest-rate exposure indicates the increase in the average interest burden on the group on an increase in the short-term interest rate. The latter is expressed as the interest rate on an adjustable-rate loan, irrespective of maturity.

The analysis shows that if the short-term interest rate increases by 1 percentage point, homeowners' interest expenses will on average increase by approximately 1 per cent of their gross income. Note that this is an average consideration. There is considerable variation in the figures both within the individual groups and with regard to other criteria, e.g. geographical location. For example, households in Greater Copenhagen and Århus have a higher mortgage debt than in the rest of the country.

Is this a large or small degree of vulnerability? This cannot be assessed from a single partial analysis of the debt composition.

Firstly, as mentioned, the figures are subject to considerable variation. Even if the average homeowner does not face considerable difficulties in paying a higher interest rate, there is a significant group of households that are far more vulnerable because their interest-rate exposure is more than twice as high.

Secondly, vulnerability depends on whether the household has other loans at adjustable interest rates, whether it has a buffer to meet any higher interest expenses and whether it can easily reduce its consumption in the event of an interest-rate increase. Unfortunately, the analysis does not include data that would shed light on this aspect. Considerations of this nature should be central elements of the advice provided when loans are raised.

Analysing homeowners' vulnerability is naturally relevant because for many years development has been in one particular direction. House prices have risen and risen while the interest rate has been very low and it has become easier to borrow. The option of deferred-amortisation loans has been taken up more than most people had expected. Therefore the question is now being raised of whether there is a property-market bubble, and if there is, when the bubble will burst. Nobody can give a clear answer to that.

Bubbles are extremely interesting for economists to analyse, but unfortunately experience shows that bubbles can neither be predicted nor identified when they exist. Bubbles are only apparent in hindsight.

In mortgage-credit circles – and in the media in general – falling interest rates and low interest rates are considered to be positive while high interest rates have a negative image. This is the typical viewpoint of the borrower.

However, there is also a creditor side to the story, even though it plays a far smaller role in the debate. Perhaps this is because many people's assets are mainly placed collectively in pension schemes, so that the relationship between interest-rate level and yield is less apparent to the individual.

We nonetheless see increasing focus on yields and concern about the low bond yield. Many investors still remember the far higher bond yield ten years ago, and the low interest rate has undoubtedly stimulated interest in shares and real assets.

Today a 10-year government bond yields 3.5 per cent interest. With inflation below 1.5 per cent this is still a positive real rate of return. But for tax-liable investors the real bond yield after tax will seem very low.

Almost 25 years in the financial sector have taught me that it is vital to emphasise the relationship between yield and risk. Apart from utilising asymmetrical tax rules, a borrower or financial investor does not have much opportunity to make a profit without assuming a risk. Nobody knows how exchange rates, share prices, interest rates or even house prices will develop. But many do have a firm opinion on this.

So we currently see a growing interest in various more exotic investment products with yields based on exchange rates, share prices, etc. We have had products of these types for many years, but the new aspect is that they are now also marketed to private individuals with relatively modest investment portfolios and no particular financial insight.

Investors may naturally speculate if they wish to, but it is important that they are aware that this is what they are doing.

From time to time tales of disaster in the financial press serve to demonstrate that investors have not always understood that in today's markets an annual yield of 10-12 per cent is unattainable without taking on a large risk.

It is therefore essential that professional advisers take great pains to point out the risks and the opportunities to diversify risk by not putting all one's eggs in the same basket.