Nils Bernstein: Recent economic and financial developments in Denmark

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the Annual Meeting of the Danish Bankers Association, Copenhagen, 30 November 2005.

*   *   *

I appreciate the friendly welcome that I have been given by the banking industry and thank you for this invitation to speak today.

Let me start by stating that I intend to continue the line set by my predecessor in relation to monetary and foreign-exchange policy. This policy has served Denmark well.

I have been around for so long that I remember the time when we used exchange-rate adjustments actively to solve our structural problems. As we know, this led to double-digit inflation rates and interest rates exceeding 20 per cent. In the end, it became plain to all that this policy was not sustainable.

Today, there is only seldom focus on the fixed-exchange-rate policy. Outside Denmark, it is in a way viewed as outdated. Nevertheless, this policy has been important for Denmark. It has had broad political support and contributed to very low inflation; in practice so low that ordinary people hardly think about it any longer. In the last 15 years annual price increases have been kept at around 2 per cent on average, and retail prices have remained completely stable in recent years. This safeguard of real wages is to everyone's benefit each and every day.

For the corporate sector it is easier to plan ahead when the exchange rate vis-à-vis the euro is stable. The foundation for their investments does not suddenly change due to changes in the exchange rate . Companies know that it is primarily up to them to meet future demands by developing products and human resources.

The lower rate of inflation is not an isolated Danish phenomenon – it is seen worldwide. The increasing integration of Asian countries into the global economy dampens prices and wages in the rest of the world. This is also reflected in long-term yields. Since the global propensity to invest is lower than is normally the case, and since both central banks and pension funds are currently buying large portfolios of long-term bonds, long-term yields are at the lowest level in the post-war era. .

These effects will diminish at some point – we do not know when – but when that does happen, interest rates will rise.

*   *   *

Denmark's economic policy has had broad political support for a number of years. In fact, the Danish "model" is increasingly seen as a role model for other countries.

Our labour market is particularly interesting, and the way we make flexibility go hand in hand with social security. What we see now is the result of many years' development of the Danish model. This is a never-ending process. Good reforms require careful preparation and considerable time. Ideas need to mature to ensure support for the reforms. The process is important to achieving a good result.

The fixed-exchange-rate policy means that the level of Danish interest rates is generally determined abroad. This also implies that it does not always match Danish needs. In practice, this has not constituted a problem. Fiscal policy has been designed so as to avoid both overheating and high unemployment. A forward-looking and reform-oriented policy usually means that only minor adjustments are required in connection with the annual Finance Act. Therefore, it is important to keep sights on long-term objectives all the time.

In this context, experience from other countries can be useful. The Netherlands is currently struggling to get out of a recession that is self-inflicted. A favourable economic climate in the late 1990s led to large government surpluses. Some of the surplus was used to finance e.g. tax cuts, and the economy overheated. However, the consequences were not evident until a late stage. Wages soared, and so did unemployment, and suddenly government finances showed a large deficit. It was necessary to tighten policy in the throes of a recession that only now seems to be receding. The lesson is: do not spend the surplus when the economy is good – particularly if there is the slightest risk that competitiveness will suffer.

The Danish economy has developed favourably in recent years. This is naturally very satisfactory. Unemployment has declined and is now at a low level, private consumption is increasing by leaps and bounds, and yet we have a current-account surplus and cash is flowing into the government coffers. It is almost too good to be true – and there is indeed reason to exert some caution.

Demand is still strong – and perhaps a little too strong. We do not know for certain. But the day, we do know that things are going too fast, we will have some unpleasant years ahead. At that point it will be too late to make adjustments without considerable costs. The challenge we face today is to ensure a balance that will enable us to reduce unemployment even further. We need to bring more of the weakest in society permanently into the labour market – and that will not be possible if the economy overheats.

Speed limits should therefore not only be observed on the roads, but also in economic policy. Economic speeding has far more serious implications than an endorsement on a driving licence. Currently, this means that there is no scope for any relaxation on either the revenue or expenditure sides – on the contrary in fact. Central and local government must observe the expenditure targets, and the cyclical position does not warrant unfinanced tax cuts.

The lesson to be learned from the Netherlands is clear: in an upswing the economic policy must not contribute to further accelerating developments.

* * *

Many of the large euroarea member states are struggling with economic difficulties. Large-scale unemployment leads to uncertainty. There is increasing awareness of the need for greater labour market flexibily. Yet so far the reforms have been small.

A key problem in Italy, France and Germany is that companies are not investing sufficiently in their home countries, and since households are reluctant to spend, the only option is to wait for an export-driven upswing.

A consumption-driven upswing in Europe would be desirable. To this end households must be willing and able to spend more. However, in many member states the financial sector is not geared to financing the households' consumption or housing requirements. The banking structure is based on household savings financing corporate investments, not on lending to households.

In Denmark, lending by banks and mortgage-credit institutes to households matches the level of output. At the other extremity within the EU, Italian households have only borrowed one quarter via these market channels, but the figure is presumably higher if loans from relatives are included. Yet market channels are important if family relations are not to be the central factor when young people buy a home or a car, or spread consumption rationally over their lifetimes.

The very high level of borrowing by Danish households reflects especially that homeowners can borrow from the capital market via the mortgage credit system. This is an advantage, but also has its drawbacks. New loan types, also from the banks, have probably contributed to the very strong increases in house prices. However, most of the increases must be attributed to the low interest rates, growth in real incomes and the freeze on property taxes. This is therefore not an inexplicable price bubble, yet prices may fall when interest rates go up.

Times are good for the banks, and lending is growing. Good times are also when losses are seen as a thing of the past, and credit quality may deteriorate. Not in one's own bank, but among competitors.

The banks face the major task of incorporating the new international accounting standards and the forthcoming capital-adequacy rules – Basel II. This requires considerable resources. It is also an important task requiring each bank to assess its need for buffers against bad times. Other parts of the financial sector have also devoted many resources to new legislation and its implementation. The European Commission has now indicated that all major legislation is in place in the financial area. Now we need to make the single market for financial services work.

The IMF is assessing the entire financial system in Denmark as part of its Financial Sector Assessment Program – FSAP. Let us take this as a good opportunity for a service check. It is good to take a fresh look at whether we have an optimum structure in relation to international standards. The

IMF has just concluded a two-week visit to Denmark. I would like to thank the members of the Danish Bankers Association and a large number of the other players in the financial system for their efforts in connection with this visit. FSAP is a long process and there is still considerable work ahead in the coming months. The IMF's final assessment of Denmark and its recommendations are expected to be presented in mid-2006.

Bodil (Nyboe Andersen) has asked me to extent her gratitude for your fine cooperation – not only over the past year, but over many years. I hope this fine cooperation will continue in the years to come.