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 Association of Danish Mortgage Banks, Copenhagen, 27 April 2006.

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The Danish economy is doing well. This is the result of a dedicated effort over many years and probably first and foremost agreement across the political spectrum on the fundamental economic framework. One need not look far beyond Denmark to find examples of the opposite.

In the short term the major challenge is to make the good times last, while preventing the economy from overheating. In the long term the challenge is to maintain a healthy balance between the labour force and the rest of the population.

To a high degree the large government surpluses relate to the strong growth, but also to extraordinarily high revenue from taxation of pension yields and corporate tax, including from the North Sea. This type of revenue cannot finance permanently higher expenditure or tax cuts. The sound economy must be maintained, which could prove to be a challenge, knowing that the number of 25-60 year-olds, who are the core of today's labour force, will decline by almost 20,000 per year over the next ten years.

Let me continue by repeating that Denmark pursues a fixed-exchange-rate policy vis-à-vis the euro. This means that we are part of the euro area's efforts to maintain inflation close to, but not above, 2 per cent. The fixed-exchange-rate policy has been one of the means to achieve and maintain the sound Danish economy. It has ensured a steady increase in real incomes for wage earners and pensioners alike and facilitated Danish business enterprises' long-term planning.

As we all know, it is impossible to have your cake and eat it. Consequently, under the fixed-exchange-rate policy Danmarks Nationalbank's lending-rate decisions cannot take any account of homeowners' interest expenses, or housing prices for that matter, or the overall economic situation. The spread between the Danish lending rate and the benchmark interest rate of the euro area is determined solely by the foreign-exchange conditions. If there is a persistent tendency for foreign-exchange outflows we raise the lending rate without considering the day of the week or the time of day. This is explained clearly in descriptions of Danish monetary policy over the years. Nevertheless, Danmarks Nationalbank's raising of the lending rate by 10 basis points in mid-February came as a surprise to some market players. The interest-rate increase was Danmarks Nationalbank's reaction to considerable outflows of foreign exchange and brought the foreign-exchange flows back into balance. This tool will also be wielded in future when made necessary by the foreign-exchange conditions.

The mortgage-credit institutes and the rest of the financial sector are in good and profitable shape. This is among other things the result of strong activity in the housing market where low interest rates and other factors have pushed up prices and stimulated new construction. The prices of single-family houses have risen by 24 per cent in recent years. Apartments have seen even larger price increases. Greater Copenhagen and the major provincial towns have accounted for the strongest price increases, implying an uneven distribution across the country.

Are the strong price increases signs of a price bubble about to burst? In overall terms that is hardly the case. The outlook of a continued high employment rate gives no reasons to expect housing prices to plummet. Besides the favourable development in employment and real incomes, other factors explaining the price increases so far are low interest rates, new loan types, including deferred-amortisation and adjustable-rate loans, and a strong preference for certain areas where the supply of housing is limited. A further factor is the freezing of property taxes, which has affected prices in particularly attractive areas where the progressive property tax has or would have an impact.

Despite the most recent increase, interest rates remain very low in both nominal and real terms. In view of the stronger economic outlook for Europe and continued high energy prices the financial market generally expects interest rates to rise further in the near future. This will lead to lower housing prices than would otherwise be the case, perhaps even slightly decreasing housing prices, but for as long as the favourable economic development continues, there are no prospects of considerable large-scale price drops.

As in so many other respects, this is by no means an open and shut case. A combination of considerably higher interest rates and unemployment could cause housing prices to fall more dramatically. At present this is not the most likely scenario, however.

The very strong price increases for real property have generated substantial capital gains. If a major proportion of these gains is translated into consumption, there is an increased risk of the economy overheating. The possibility is there. In 2005 the housing wealth of the households rose by approximately kr. 500 billion. In comparison, private consumption totalled approximately kr. 750 billion. The real property of many households thus appreciated by a good deal more than their earned income after tax. Fortunately, the households have generally managed the rising property values prudently. The increased housing wealth can probably only explain "additional consumption" of kr. 7-8 billion.

Instead, the price increases have increased net worth. 2005 saw an increase in net worth – even when housing wealth is excluded. Substantial borrowing, e.g. from mortgage-credit institutes, was the order of the day, but to a great extent the loans were used to acquire financial claims, including for pension saving purposes.

The households have quickly adopted the new loan types. All in all, the use of the new loan types gives no grounds for concern. An interest-rate increase by 1 percentage point for adjustable-rate loans would on average lead to an increase in the households' interest expenditure on mortgage-credit loans by 1.2 per cent of gross income. This corresponds to an annual increase of kr. 6,000 before tax for a household income of kr. 500,000. There will always be some exposed groups, who will have bitten off more than they can chew. But the extent of this does not by a long way pose a threat to financial stability. However, in the present situation there is every reason to think carefully about ones personal finances, to avoid ending up in the exposed category.

History has proven the Danish mortgage-credit system to be a good system that has facilitated considerable product development. The annual meeting of the Association of Danish Mortgage Banks is a good occasion for listing some of the qualities of the Danish system. Thanks to the legal framework, including loan limits and the balance principle, it is a very safe system. This plays an important role for the rating agencies. The system has also created a large and liquid bond market. A particularly important aspect is that the system offers individuals access to highly transparent home financing based on the market yield for the issued bonds plus administration fees.

There is no doubt that new home-financing products will continue to be developed. The coming year will probably see some innovation in the bond area. Denmark will have to adapt its legal framework to gilt-edged or covered bonds. The special collateral requirements could make covered bonds particularly attractive to investors and could thus also benefit borrowers. Initially it will be easier for the banks to accommodate the special collateral requirements under EU legislation, while it will be considerably more difficult for the mortgage-credit institutes, unless they reduce the loan limits.

It goes without saying that this may shift the competitive balance between the banks and the mortgage-credit institutes.

Danmarks Nationalbank believes that any price advantages related to covered bonds should accrue to the borrowers. This can best be achieved by implementing legislation that allows both banks and mortgage-credit institutes to issue covered bonds – to ensure a large number of home-financing intermediaries, including major players – and by enabling the product development to take place within a framework that continues to ensure safe and transparent home financing at wholesale market rates. This calls for a thorough review of the future regulations, including their implications, to establish a legal basis for covered bonds that provides a safe and secure home-financing system based on gilt-edged bonds.

Competition is a good thing. The development of new products in the financial system is clearly subject to fierce competition. Success stories about price competition emerge from time to time. Fees for electronic share trading are a case in point where it became easier for the users to assess the market and vote with their feet. In view of the level of profitability in the financial system, I am sure that there is ample room for more success stories of this type.

After this kindly meant encouragement I would like to conclude by acknowledging the excellent cooperation between the Association of Danish Mortgage Banks, the sector's business enterprises, and Danmarks Nationalbank.