

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, 26 April 2007.

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Thank you for the invitation to speak here today.

There is still high growth in the global economy. Growth has slackened off a little in the USA, but the upswing in Europe and many other parts of the world has become more apparent. The significant global imbalances – especially the large current-account deficit in the USA, which is counterbalanced by substantial surpluses in, for example, China and the OPEC countries – have diminished a little, and the risk of abrupt adjustments is decreasing, but has not been eliminated.

The lower US growth reflects, among other things, that the housing market is adjusting after some years of strong price increases, but the adjustment seems to be moderate and gradual. There is no sign either that the problems faced by companies specialising in mortgage loans to less creditworthy households will spread to other areas of the financial markets.

Concern that the European upswing might be suppressed by Germany's VAT increase has lifted, and the German economic dynamo is powering up.

The overall prospects for Danish exports are favourable, and there will be no lack of demand in the immediate future. On the contrary, exports may be affected by a shortage of production capacity. The Danish economy is at its capacity limit, and many companies find it difficult to recruit the manpower they require.

In more positive terms, employment in Denmark has never been higher, and the unemployment rate is the lowest since the start of the 1970s, and also among the lowest in the world. This also leaves little scope for economic growth in the immediate future. With the prospect of sustained growth in domestic demand, the pressure on capacity will continue unabated.

It will to a high degree be up to us here in Denmark to ensure that we can benefit from the sustained international boom.

The housing market has dampened in recent years after a period of very strong growth in cash prices, in fact so strong that it has also attracted international attention.

Most recently, the big question in Denmark has been whether house prices are about to slump. A certain downward price adjustment in the areas with the largest price increases cannot be excluded. In view of the strong Danish economy it is unlikely, however, that we are on the brink of dramatic general price decreases. In itself it is an advantage that expectations of the future development in prices of owner-occupied homes have dampened, so that property is not bought chiefly to achieve a capital gain.

The change of mood seems to have been most pronounced in the Greater Copenhagen area, and it is also in Copenhagen that house prices have recently fallen, especially for owner-occupied flats. This reflects that prices per square metre have reached a very high level, and that the supply of newly-built homes has augmented. Construction always reacts to rising house prices with a certain time lag. Economic growth in Greater Copenhagen is still strong, however, and prices will be underpinned by the influx of new residents from the rest of the country.

Three quarters of Denmark's owner-occupied homes are located outside Greater Copenhagen. In most areas, prices have risen more slowly, and price falls are less likely.

The higher prices per square metre in recent years have strongly augmented housing wealth, which has increased by kr. 670 billion since the start of 2005. Borrowing has also risen, but not by any means to the same extent. Home equity has grown by an estimated kr. 550 billion over two years. This ensures that there is a significant buffer against any future price drops.

Rising house prices are first and foremost to the benefit of those of us that already own a home. The majority of the population are homeowners and this is probably one of the reasons that the high price increases have not provoked strong protests.

Stagnating and perhaps falling house prices will be to the benefit of first-time home buyers. For those who bought their homes when prices peaked any price drops will naturally be less welcome. However, only a small proportion of the owner-occupied homes changed hands at the very high prices. Around 5 per cent of one-family houses in Denmark are sold each year, so that for most homeowners a small price drop will just mean that a small part of the capital gain that emerged so quickly will disappear. The increase in interest rates moreover diminishes the market value of the outstanding debt, unless the home is financed at variable interest rates.

Danmarks Nationalbank assesses that in the short term the slowdown in the housing market will have only a limited effect on the economy in general. Once the construction backlog has been eliminated, new construction and conversion activity will probably dampen, but that is still far off, and furthermore, business construction is increasing. In addition, private consumption has only been affected by the increasing housing wealth to a small degree. Since 2004 the propensity to consume has shown an increase equivalent to approximately kr. 15 billion, while housing wealth has risen by kr. 670 billion. It is true that the capital gains have been further mortgaged, but the proceeds have mainly been used for home improvements or pension contributions, or invested in other financial assets.

For more than 200 years we have had a secure mortgage financing system with a large, standardised mortgage-credit bond market that has given borrowers access on equal terms to finance real property at long-term interest rates in the capital market. However, in recent times the mortgage-credit system has undergone many changes:

Mortgage credit no longer comprises associations of borrowers, with members holding joint and several liability that join forces to gain access to a less developed capital market. Today, the players are profit-maximising limited-liability companies in an economy with well-developed capital markets.

Mortgage-credit institutes and banks have become more closely connected in different ways. Credit institutions from other EU member states can compete freely in Denmark, and Danish credit institutions have become active in financing real property abroad.

Finally, there has been considerable development of new products – for example adjustable-rate loans, capped adjustable-rate loans and deferred-amortisation loans. In this way, mortgage credit has become a product like other commercial financial products in an open economy with a mature financial system.

This dynamic has not changed Danmarks Nationalbank's fundamental perception of the mortgage-credit system. Danmarks Nationalbank has always found it to be a secure system, beneficial for borrowers, lenders, the capital market, and financial stability.

Now a new type of covered bonds enters the market, called SDOs. At the last Annual Meeting I called for a thorough review of the future regulations for use of SDOs. I would like to acknowledge that this review has been undertaken, and there is now political agreement on a new act on SDOs.

Overall, I believe this to be a good result. The bill also makes it possible for the mortgage-credit institutes to provide mortgage credit financed by issuing bonds in exactly the same way as today. Danmarks Nationalbank has considered this to be important.

For some years the banks have competed with the mortgage-credit institutes to offer mortgage credit, among other things by introducing their mortgage loans. In addition, they also increasingly compete with foreign credit institutions – both in Denmark and abroad.

Now the banks will have the opportunity to obtain financing by issuing SDOs against mortgage loans as collateral. This sharpens competition and also gives the banks a new and stable source of financing to counter the growing deposit shortfall, to the benefit of financial stability.

I don't want to deny that at Danmarks Nationalbank we believe that the current mortgage-credit legislation, of which one cornerstone is a tight balance principle, has functioned well.

The purpose of a balance principle is to limit the issuers risk to credit risk. Both the present and the proposed new balance principle fundamentally entail the rule that no interest-rate risks, option risks or exchange-rate risks may be taken.

Today, risks are mainly covered by selling bonds that exactly match the mortgage loans, and this will naturally still be possible under the new balance principle, if wished for. However, the new balance principle also makes it possible to cover the risks using modern financial instruments to a greater extent.

The new legislation on SDOs also comprises a tightening of mortgage-credit legislation, required by EU-legislation, namely that throughout the duration of the loan no mortgage loan may have a value that exceeds 80 per cent of the value of the home that is mortgaged. Today, this only applies at the point in time when the loan is raised, as you will know.

If house prices fall, the credit institutions must to the extent necessary, re-establish the collateral behind the issued SDOs, e.g. by raising loans and buying government securities to use as collateral. This means that the new SDOs will always be backed with sound collateral, and this will limit the refinancing risk.

Overall, Danmarks Nationalbank assesses that the regulation on SDOs provides a basis for a mortgage financing system that is just as safe as today's mortgage-credit system. Now it remains to be seen how the market will receive the new bonds.

In principle, the introduction of a new mortgage financing instrument that can also be used by banks must be expected to increase competition. This is by no means detrimental, but it does require consumers to be active and capable of understanding the opportunities made available to them. The extensive work of devising methods to ensure transparency still remains to be undertaken.

The cross-border integration of the financial markets is one of the more striking phenomena of the last 30 years. This integration makes high demands of the underlying infrastructure. Cross-border securities trading still entails considerable costs.

On this basis, the European Central Bank, ECB, has taken the initiative to improve the cross-border trading of securities within the EU. Target2-Securities is the name of a new common European system for settlement of securities denominated first and foremost in euro, but later also for settlement in other currencies.

The objective of the project is to make it just as simple, inexpensive and efficient to settle securities trades across national borders within the EU as it is to settle domestic trades.

At the beginning of 2008 the ECB is expected to take the final decision on whether to develop the system.

The user requirements of the system will be determined in the near future. Danmarks Nationalbank and VP Securities Services have commenced the collection and coordination of the Danish input to the user requirements.

I would like to conclude by on behalf of Danmarks Nationalbank acknowledging the excellent cooperation with both the Association of Danish Mortgage Banks and its members over the past year.