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, 24 April 2008.

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Thank you for the invitation to speak here today.

At last year's meeting of the Association of Danish Mortgage Banks I said the following about the economic situation in the USA: "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". I was not the only person to hold that view.

I have been reminded that economic predictions should always be taken with a grain of salt.

It is no exaggeration to say that things have developed somewhat contrary to the predictions. The economic forecasts for the USA and Europe have gradually been adjusted downwards over the last year or so. What started as problems for companies specialising in subprime mortgages has spread to other parts of the financial sector – also outside the USA – and is now dampening output and employment. This again has a negative impact on financial enterprises.

The current assessment is that the USA is heading for a recession that will not subside until the 2nd half of 2008 at the earliest. Then the situation – at best – will only slowly improve. It looks as if Europe will avoid actual recession, but must be prepared for modest growth rates of between 1 and 2 per cent in the coming years.

This development has taken most people by surprise, although the boom in the USA had peaked before the subprime crisis. It is positive that developing countries and emerging market economies have so far steered clear of the economic downturn. This has mitigated the slowdown in the global economy. At the same time, inflation has risen worldwide, driven by increasing energy and food prices. The price increases limit the scope for further expansion of economic policy. There is a risk that inflation expectations will be pushed upwards, triggering a wage and price spiral.

Needless to say, the impact of higher food prices is most severe in the poor countries, and the issue is rapidly climbing to the top of the international agenda.

Today, it is estimated that losses in the financial sector could be as high as 1,000 billion dollars, or three times Denmark's domestic product – without comparison, I should add. Both financial enterprises and others have suffered losses, primarily in the USA, but also in Europe. The greatest losses have been observed in some of the world's largest banks, and one bank has been on the brink of failure. These enterprises have had thousands of highly educated and highly paid employees and managers at their disposal in order to avoid precisely such losses.

The events have led to self-examination among financial enterprises and authorities who were too late to see the problems and take action. How could the situation get so much out of hand, and how can we prevent this from happening again?

Much has already been written about the background to the crisis. And I am sure that the course of events will be the subject of many learned papers in the coming years, relying on the advantages of hindsight.

Basically, financial business is all about forming a link between people who at a given time need to spend more than they own and earn and others who are in the opposite situation. This intermediation enables enterprises to invest in anticipation of future profits. It enables households to buy houses and flats with a down payment of only 20 per cent. And it enables governments to operate with budget deficits from time to time.

Financial intermediation – at its best – ensures that savers receive the optimum return with the chosen risk profile, and that the most profitable investments are sought. Intermediation takes place across national borders, and the financial sector is at the forefront of globalisation. The importance of a well-functioning financial sector to a modern economy cannot be overrated.

However, in recent years financial intermediation has expanded at an excessive pace, combined with sophisticated product development – and risk assessment systems and incentive structures have not been able to keep up in the competition for market shares.

Where this development led to an atmosphere of euphoria, greed and imprudence could prevail.

Some degree of caution is reintroduced when investors get too close to the fire and burn their fingers. However, other action is also required. It is a safe bet today that rules will be tightened.

As the tide is turning, it is a question of striking the right balance between tightening the rules and safeguarding the role of financial intermediation in society.

Last autumn, the G7 countries asked the Financial Stability Forum (FSF) – which includes the ministries of finance, central banks and financial supervisory authorities of major countries, among others – to analyse the factors and weaknesses that led to the crisis and propose solutions to boost the resilience of the financial markets and institutions. The results are interesting to read and ought to be compulsory for anyone involved in the financial sector.

FSF tabled 67 proposals under 5 main headings:

The first group of proposals concerns tighter requirements for the financial institutions' capital, liquidity and risk management. A larger buffer is required. The obvious obstacle is, of course, how to implement such requirements in a situation where they could make things go from bad to worse.

The second group of proposals aims at increasing transparency in the markets by publishing all relevant risks and ensuring more reliable valuations. Uncertainty has increased because the financial institutions have only partially declared their losses and because it has been difficult to state the value of assets no longer traded.

A third group of proposals addresses the role of rating agencies in financial intermediation. It is necessary to improve the quality of the rating process in order to avoid conflicts of interest, and to improve awareness of the results. Authorities should reconsider their use of rating agency services.

Fourthly, it is suggested that for all large cross-border banks worldwide a group of representatives from the relevant national supervisory authorities should be set up. This proposal reflects awareness that the authorities are currently inadequately equipped to handle potential crises in banks with subsidiaries and branches operating across national borders.

Finally, central banks are encouraged to be more flexible, including to expand their lending facilities. One of the lessons to be learned from the current crisis is that central banks' lending facilities have been inadequate in relation to banks experiencing a credit crunch.

As you can hear, we must all do our bit: private enterprises, governments, supervisory authorities and central banks. It is recommended that most of the proposals should be implemented this year. The rest in 2009.

And how will all this affect us in Denmark?

It may sound strange, but the international economic slowdown, as it is now predicted, comes at a rather convenient time for Denmark. The economy has been strong for a number of years, underpinned by low interest rates and expansionary fiscal policy. Employment is record high, and unemployment at the lowest level for a generation.

The current-account surplus has fallen substantially, but fortunately no financial imbalances have accumulated during the upswing. Overall, households are well-consolidated with sound financial buffers, although the housing market has been weak for 18 months.

However, the Danish economy has been close to its capacity limit for some time. The shortage of labour has intensified the pressure for higher wage increases, and the gap between growth in Danish and foreign wages has widened in recent years. Annual consumer price inflation reached 3.1 per cent in March, primarily driven by higher energy and food prices, as was also the case elsewhere. Consumers' expectations of price increases continue to rise.

The shortage of labour curbs economic growth in Denmark. In Danmarks Nationalbank's most recent forecast – from March – the central estimate is that the Danish economy will shift to markedly lower growth in the coming years. However, unemployment will not reach a level that is compatible with sustainable long-term development in wages until 2010.

Previously, financial turmoil usually went hand in hand with currency unrest in Europe. So far, there have only been few indications of this. It would be natural to give the credit to the fewer European currencies, brought about by the euro. It is an advantage to Denmark that the euro exists and has now been adopted by 15 EU member states.

Combined with the European Central Bank's supply of liquidity in response to the financial turmoil, this has mitigated the risk of major negative real-economic impacts.

The financial system in Denmark has not been unaffected by the financial turmoil. But fortunately the effect has been less significant than in several other countries. The reason is that Danish investors have only to a small extent invested in – and thus lost money on – subprime-related assets. We have our own good mortgage-credit products.

However, in Denmark we have also seen how the uncertainty has made banks more reluctant to grant each other uncollateralised loans in the money market, particularly for longer maturities. The result has been shorter maturities and higher financing costs. This mainly affects the banks that have built up considerable deposit deficits in recent years, based on the assumption that they would be able to raise inexpensive liquidity in the money market or by issuing bonds.

In the current situation, and in accordance with international recommendations, Danmarks Nationalbank, like other central banks, is reviewing its lending facilities. This is an ongoing process. However, we are of the opinion that well-run Danish banks should not find themselves in an unnecessary liquidity squeeze because of the international financial turmoil.

Thank you for your attention. I wish you a successful meeting.