Nils Bernstein: Recovering of the Danish economy and housing market developments

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the annual meeting of the Danish Mortgage Banks' Federation, Copenhagen, 24 March 2010.

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The global economy is on the mend. The upswing is fragile, and though the direction of economic indicators are not clear, the recovery seems slightly stronger than expected in the autumn. The recovery is strongest in the emerging and developing economies, while it remains slightly more subdued in Europe. The overall picture is that the economic setback has been most pronounced in regions where the financial sector has been particularly exposed to inflated asset values.

The development has not yet led to a reversal in labour markets in the USA and Europe.

The rebound in the international economy is primarily the result of many countries' still very expansionary fiscal and monetary policies. The extraordinary monetary policy measures are slowly being phased out. But few central banks have begun to raise interest rates.

Public finances have deteriorated across industrial countries. And most EU member states are expected to run budget deficits exceeding 3 per cent of GDP this year. This means that they hold prospects of being included in the excessive deficit procedure that focuses on consolidation and leaves little room for manoeuvre in supporting the economic upswing further, if it turns out not to be self-sustaining.

The situation in Greece is in a category of its own. Lack of confidence in Greece's ability to get its public finances on track unaided has boosted the premium on loans to the Greek government. Ireland and Latvia are examples that illustrate the scale of the measures needed to restore confidence.

The recovery of the Danish economy is also expected to be slow and hesitant. The road ahead is likely to be bumpy. This year's growth will be insufficient to halt the increase in unemployment. The corporate sector has considerable spare capacity, and unemployment is expected to rise for yet another year.

Denmark is a small open economy, and about one job in four is related to exports, directly or indirectly. Wage competitiveness therefore plays an important role in the Danish economy, and the crisis has resulted in weak export markets and hence weak selling opportunities.

Erosion of wage competitiveness has led to loss of market shares. The loss has been quite substantial relative to those of many comparable countries. There is a clear tendency that countries whose competitiveness has deteriorated the worst also fare worst in export markets.

Collective bargaining has been finalised in a climate of rising unemployment and considerable uncertainty about the economic development. There are prospects of lower wage inflation than in previous years. Which we welcome. But there are hardly prospects of a change in the competitive environment. Changing real wage expectations after a period with a strong labour market is an uphill struggle. And it also clearly highlights the problems arising when demand reaches unsustainably high levels.

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Financial conditions are very expansionary amid historically low short-term interest rates. Adjusted for tax and inflation, the real interest rate on an adjustable-rate mortgage is currently very low. This supports the housing market. In our judgement, the housing market is slowly recovering, and price adjustments are done at the current low interest rate level. Budding optimism is seen among potential buyers.

I usually refrain from official predictions of interest-rate developments. But today, I will make an exception. I am quite sure that rates on 1-year adjustable rate mortgages cannot be sustained at the current low level. I will not try to predict when it will rise. But I advise homeowners and others against stretching their budgets so tight that they can only make ends meet at the current very low interest rate level.

Normalisation of interest rates and rising unemployment may present a certain risk to the development. If the low growth continues in the euro area in the coming period, the normalisation of interest rates will be postponed. By contrast, stronger economic growth could cause interest rates to rise, but in that case, unemployment will stabilise and perhaps begin to fall.

Housing market developments and rising equity prices have caused household wealth to rise again. Combined with continued handsome growth in disposable incomes and more upbeat consumer expectations, this means that we take a more positive view on the outlook for private consumption.

The decline in consumption during the crisis has been sharper in Denmark than in most other countries. Despite a fairly good rise in incomes. The consumption ratio has thus dipped and now stands at a very low level. This, together with general stabilisation of the economic development and the slightly positive sentiment, paves the way for the return of confidence and for households to spend the increase in disposable incomes on consumption and residential investments. However, indications for the first months of the year do not suggest a strong reversal.

The low interest rates will gradually stimulate the economy over a number of years. Therefore, interest rates will have an underlying expansionary effect on the economy in the years ahead. This also applies to fiscal policy as the expansionary stance of the past years has not yet fully shown through. Initial fiscal consolidation is thus unlikely to change the picture of an economy on a slow recovery path.

The fiscal challenges are now so daunting that consolidation is necessary in the coming years if we are to avoid an untenable increase in government debt. There is no avoiding it – even if there is still a great deal of spare capacity in the economy.

Add to this the erosion of wage competitiveness, strong pressures on expenditure, a heavy tax burden, low productivity increases and a limited job supply. The Danish economy is facing serious challenges far beyond cyclical factors.

And now over to mortgage credit.

The international financial crisis has demonstrated that there is a need for financial institutions having bigger capital buffers and larger and more stable liquidity reserves. Events deemed very unlikely by risk management models did actually occur.

International work is going on in order to formulate and agree on new rules addressing the problems unveiled by the crisis.

It is important to reach agreement across national borders and continents, so that the conditions for financial business are largely the same irrespective of the location.

For Denmark, it seems that our unique mortgage credit system can be facing challenges that we will have to deal with more or less on our own. It is therefore important that we carefully consider where to concentrate our efforts to have the new rules adjusted to our special conditions.

Here I will focus on the most essential aspects as we see them today.

The liquidity regulation proposals include a classification of assets based on how liquid they are. Government bonds and claims on central banks, international organisations etc. are considered fully liquid, while corporate bonds and mortgage-credit bonds can only be included up to a maximum of 50 per cent. Finally, there are some assets that cannot be included.

Denmark will seek to have mortgage-credit bonds included in the stock of fully liquid assets, provided their liquidity is comparable with that of government bonds. Liquidity – also in stressful situations – should be the crucial point.

We believe that we can prove that Danish mortgage-credit bonds are highly comparable with government bonds. And that's what we intend to do.

Another aspect concerns adjustable-rate mortgages specifically. During the financial crisis, financial institutions generally saw their funding sources in the market drying up. This was the reason why many governments found it necessary to issue state guarantees to financial institutions.

The rules now on the drawing board therefore pose requirements on stable funding. The definition of stable funding implies that Danish mortgage-credit bonds with a remaining term to maturity of less than one year cannot be included. Moreover, lending with a maturity of more than one year must be covered by stable funding.

Such a rule highlights the risk associated with Danish adjustable-rate mortgages. These are 30-year loans funded via short-term bonds, primarily with maturities of one year. Every year the issuing institute will have to refinance the loan.

At first, the risk can be passed on to borrowers, if they can bear it. If not, it will invariably return to the lender. We cannot ignore that there is a real risk inherent in the design of the Danish adjustable-rate mortgages. A design that implies that loans worth more than kr. 500 billion must be refinanced every year to finance 30-year loans.

I will not today try to guess whether the final formulation of the Basel rules will make it impossible to maintain the adjustable-rate mortgages as we know them today.

In such a situation, I find that it will be constructive if the sector itself seeks other solutions more in line with traditional mortgage-credit lending.

Finally, I will make a few remarks on the Danish discussions.

I understand that work is going on to ease the requirements for Danish covered bonds, if the loan exceeds 80 per cent of the property value due to declines in property prices. The so-called LTV rule. Today, the rule is that if the value of the property declines, and the covered bond loan then exceeds 80 per cent of the property value, the issuing mortgage-credit institute has to find additional collateral for the mortgage. I see little likelihood that it will be possible to requirement. And I doubt that it would benefit Danish mortgage credit in the longer run.

We should not introduce the slightest doubt about the quality of Danish covered bonds.

The legislation on covered bonds has provided the banks with the possibility of allowing investors in covered bonds to be secured creditors in respect of a number of assets in the banks' balance sheets. This arrangement makes covered bonds a much safer asset than senior debt issued by a bank. The banks can therefore use covered bonds for long-term funding without this becoming prohibitively expensive. The banks can use covered bonds as a tool for better matching maturities on the asset and the liability side and thus reduce their liquidity risk. Covered bonds are therefore a funding tool, which can for example help banks comply with future liquidity regulation. Against this background, Danmarks Nationalbank does not support the idea of abolishing this possibility.

On behalf of Danmarks Nationalbank, I hereby thank the Danish Mortgage Banks' Federation for our successful cooperation during the past year.

Thank you for your attention.