Nils Bernstein: Global recovery and the Danish economic outlook

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the annual meeting of the Association of Danish Mortgage Banks, Copenhagen, 22 April 2010.

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The global economy is on the mend. The latest indicators point to a faster recovery than previously expected. There is considerable regional variation, and it is likely to be a bumpy ride.

The emerging and developing economies show the strongest growth. Countries like China, India and Brazil are now less affected by the economic crisis, while growth is more subdued in the old OECD countries, especially Europe.

Global GDP contracted by 0.6 per cent in 2009, the strongest fall in output since World War II. For comparison, global growth peaked at more than 5 per cent before the slowdown set in.

The crisis originated in the USA, but Europe experienced the most severe setback. Indeed, the recovery now seems to be stronger in the USA than in Europe. The US business sector has once again demonstrated its adaptability.

However, the main driver of the global economic recovery is the very accommodative economic policy. Many countries have historically low monetary-policy interest rates and very high budget deficits. Budget deficits of such magnitude may only exist for a relatively short period of a few years. Most countries are facing a consolidation challenge in the coming years, and some have to start already this year. Optimism about the global economy is only moderate because it is still uncertain whether the recovery will be self-sustaining. This means whether private demand will be able to take over when fiscal policies are tightened again.

The global recovery is illustrated by the rebound in world trade after the strong drop. Before the crisis, the limelight was on international imbalances, especially the large US current-account deficit and China's equally large surplus. The crisis has not eliminated these imbalances, and the discussion of the exchange rate of the Chinese currency should be viewed against that backdrop.

The market focus has shifted to fiscal imbalances – sovereign risk has taken centre stage. The IMF expects the government debt of the old OECD countries taken as one to reach 110 per cent of GDP by 2014. This is an alarming figure, but it covers considerable variation across countries. Greece is an example of how slippery the slope can be if a country is too complacent for too long. But Greece's tribulations have also highlighted the Eurosystem's limited scope for remedying an escalating situation when a member state is struggling to get through.

Most EU member states now have budget deficits exceeding the limit of 3 per cent of GDP under the Stability and Growth Pact. As a result, the Commission has ordered or will order these member states to reduce their deficits to below 3 per cent of GDP within a short span of years. The Stability and Growth Pact is at the heart of the EU's fiscal surveillance. It is no exaggeration to say that this surveillance has not been satisfactory when it comes to Greece. The outcome remains to be seen.

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It is encouraging to see that the normalisation of the international financial markets has made great headway. Since the autumn, the spread between collateralised and uncollateralised yields, reflecting uncertainty in the money markets, has been back at pre-crisis levels. US long-term yields have risen since the beginning of 2009 in the light of improved growth prospects – and so have leading international stock indices.

The euro has weakened against the dollar due to the widening yield spread in favour of the USA, exacerbated from January this year by uncertainty about the Greek economy and concerns about a possible ripple effect in other euro area member states. But these fluctuations are still within normal range. The current euro/dollar rate is close to the level before the onset of the financial crisis in the summer of 2007.

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In Denmark, the crisis caused output to drop by more than 7 per cent. Since last summer, growth has been back in positive territory, albeit moderate. It will remain so in the coming years. We will probably have to wait until 2013 to see Danish output return to the level observed immediately before the crisis.

Private consumption in Denmark is recovering slowly. Disposable incomes are showing good growth this year, reflecting income-tax cuts and other factors. At the same time, household wealth is beginning to pick up again. The prospects for the housing market are also brightening, at least at the current level of interest rates. Moreover, consumer confidence has seen a marked increase over the past year. Nevertheless, the purse strings are still relatively tight, probably due to higher unemployment. But the overall finances of the household sector are quite robust. It is understandable that households are consolidating their finances. At the same time, there is scope for private consumption to contribute to the expected rebound in growth in the near term.

Denmark's export growth is lagging behind that of other countries. Industrial production remains low. The deterioration in Denmark's wage competitiveness over a relatively long period gives cause for concern. This could prevent Danish companies from making the most of the budding international recovery.

The recently concluded collective agreements for the private sector entail a lower rate of wage increase than what has been observed for some time. But wage inflation is also declining in our competitor countries. Denmark's wage competitiveness has been eroded over a relatively long period by excessive wage increases and weak productivity development. It is a Herculean task to reverse this trend. And the results will, at best, be slow to emerge. But we have to make an extra effort in light of the increasing challenges in the international environment.

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Employment has dived. The loss of 170,000 jobs since the peak in the 1st quarter of 2008 has almost swallowed up the entire increase in employment observed during the boom.

Many people have lost their jobs, but registered unemployment has "only" increased by 70,000.

The flattening of the unemployment curve in recent months is partly due to the seasonal adjustment methods.

What it boils down to is that the increase in unemployment is far smaller than the drop in employment. This pattern is different from previous periods of economic slowdowns, where around one third of the drop in employment was offset by a reduction in the labour force, while two thirds were offset by rising unemployment. This time, it is almost the other way around.

The question is whether the lower-than-expected increase in unemployment reflects stronger cyclical development than otherwise envisaged. Regrettably, I do not think that this is so. It is more likely to be the result of a stronger-than-expected reduction of the labour force and continued weak productivity development.

The private sector has borne the brunt of the fall in employment. In the public sector, some of the jobs that were difficult to fill during the boom have now been filled. Employment in the public sector taken as one has risen by 10,000 since the 1st quarter of 2008.

And the people who have left the labour force, where have they gone? The number of people receiving student grants or under adult education or educational activation has risen somewhat, reflecting that some people choose to embark on an education or finish their education later. On the other hand, the number of people receiving permanent benefits has not risen to any significant extent. This indicates that many of those who have left the labour force are self-supporting, such as unemployed who are not members of an unemployment fund and who do not receive cash benefits. Others have left the country, for instance some of the migrant workers who came to Denmark from Eastern Europe during the boom. In addition, the number of commuters, especially from Germany and Sweden, has fallen.

On the positive side, there is a well-founded hope of spare capacity in the labour market to use when economic growth gains real momentum. Moreover, it is encouraging to see that the number of people on permanent benefits has not shown any significant increase.

There are indications that the supply of labour is now reacting more strongly than previously to economic developments. This is a positive feature in so far as it reflects greater flexibility in the labour market. It is important that the current cyclical reduction in the labour force does not lead to a rise in the number of people on benefit schemes. This could produce a knock-on effect in the form of a more permanent increase in the number of people on transfer payments, and Denmark is already at the upper end of that scale.

This development could mean that it may take longer before registered unemployment is reduced to any significant degree. Companies have not yet adapted fully to the drop in output. This means that they can increase production without hiring more people. And there are more to be hired outside the registered unemployment category.

It is interesting to observe how much these unemployed people outside the registered unemployment category will contribute to dampening wage inflation. If the contribution is substantial, our previous estimate of registered structural unemployment may be on the high side, but it is still too early to draw any conclusions.

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Normally, consumer issues are outside the scope of Danmarks Nationalbank's tasks, important and interesting as they may be. Today, however, I would like to comment on the latest development in the market for financing of cooperative housing. Some cooperative housing associations seem to have resorted to very risky sources of finance in recent years. I'm thinking of uncallable fixed-rate loans subject to rising interest rates during the term of the loan. Technically, these loans are structured as adjustable-rate loans combined with an interest-rate swap.

These loans do not accord with Danmarks Nationalbank's opinion on the par rule that provides for redemption of a loan at a price close to 100. In addition, the loans seem to be a far cry from the mortgage sector's declared objective of protecting the borrower. So far, it has been good practice to provide housing loans on terms that give the borrowers a chance to get rid of their loans without being tied down by increasing debt. This is ensured by the right to redeem at par, and it was also a key aspect of the rules on covered bonds adopted almost three years ago. Adjustable-interest loans cannot be redeemed at par, but these loans are typically financed by short-term bonds, limiting the risk on the outstanding debt.

Several institutes offer cooperative housing associations loans at a low initial interest rate, which then increases over the term of the loan. In Denmark, these are known as "stepped loans", but they are the same as the teaser loans that dominated the US subprime market just before the financial crisis.

This combination of long-term uncallable loans at a rising interest rate over the term of the loan is not suitable for housing financing. Stepped loans may entice borrowers to raise larger loans than they would otherwise have done, reinforcing the negative effects of non-redemption at par.

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And now over to mortgage credit and its legal basis. The proposals from the Basel Committee and the European Commission are well-known in this forum. I mentioned them at the annual meeting of the Danish Mortgage Banks' Federation a few weeks ago, and I have nothing to add. The Danish Financial Supervisory Authority and Danmarks Nationalbank have jointly sent letters to Basel and Brussels pointing out a number of problems in relation to the Danish mortgage-credit sector. One particular problem is that liquid mortgage-credit securities are not fully included as liquid assets. The proposals will impact on the adjustable-rate loans currently offered by the mortgage-credit institutes, but it must be admitted that the current structure has inherent risks.

Mortgage-credit institutes have recently held auctions of fixed bullets. I am pleased to see a more even distribution of the auctions over the year. I welcome this, while encouraging you to continue the process.

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In Denmark, both the authorities and financial enterprises are tuned in to 1 October 2010. This date marks the end of the general government guarantee of deposits and other unsecured claims in banks. It will be an important milestone in the process that will bring the financial sector back on its feet.

In order to smooth the transition, Danmarks Nationalbank has prolonged the credit facilities for banks and mortgage-credit institutes until 26 February 2011. The temporary extension of the collateral base has also been prolonged.

In Denmark, the most important initiative on the drawing board is the government's bill on a winding-up solution for banks, which is to replace the general government guarantee. Experience from the financial crisis and the management of ailing banks has shown that it is necessary to establish a permanent scheme to provide for controlled winding up of a bank's activities. Danmarks Nationalbank has previously emphasised that the key issue is not the survival of the individual bank, but smooth continuation of its healthy activities.

The bill will establish a winding-up scheme. The Financial Stability Company will be able to take over ailing banks. The guaranteed cover for unsecured creditors does not exceed the statutory deposit guarantee of kr. 750,000. Unsecured creditors can suffer losses on exposures with banks as is the case for creditors in other business enterprises.

This will give unsecured creditors an incentive to get out quickly if a bank shows signs of trouble. Firstly, this entails a potential pressure that can contribute to the smooth functioning of the financial system of its own accord without excessive risk. It will also entail market pressure on the individual banks to have sufficient buffers.

Secondly, it will require the authorities to react sooner and more consistently when a bank is on a slippery slope. The financial system and financial stability should not be left in doubt for prolonged periods of a bank's ability to continue in business.

If we want quicker action, we have to accept that the basis for the action will not be 100 per cent certain. It is not conducive to fast decision-making if the FSA is constantly at risk of being subject to retrospective investigations of its decisions. The FSA must have a certain margin for action.

The bill requires each bank to provide the necessary information on account structures, etc. within 24 hours to pave the way for quick crisis management. A quick solution ensuring continuity in payment systems also requires a well-planned process for changing account structures, etc. Danmarks Nationalbank will engage in close dialogue with other authorities and owners of settlement systems to ensure this once the bill has been adopted.

Controlled winding up using the proposed model increases the certainty of the assets maintaining their value, compared with a traditional winding-up procedure. And the bank's customers will not suddenly discover that their Dankort is not working or that deposits in a salary account have been swallowed up by a car loan. There is no obligation for the individual bank to use this model. I understand that such obligation would require further legislation so as not to contravene the Constitutional requirement that expropriation shall be subject to statutory provisions.

The financial crisis has taught us that no bank can turn a blind eye on the issue and say that this could never happen to it. All institutions have to accept that it could happen to them. And they must have an emergency action plan. That will enable the customers to navigate safely!

Consequently, we find it important that the institutions be obliged, by a prior general meeting, to decide whether to join the scheme now. I hereby welcome the Minister's consent.

Furthermore, it would be appropriate for the Danish Bankers Association to encourage its members to join the scheme.

I hereby thank the Association of Danish Mortgage Banks for our successful cooperation during the past year.

Thank you for your attention.