Nils Bernstein: The European debt crisis – from a Danish perspective

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the seminar "Europe in the times of crisis – are we looking for solutions or parachutes?", at Danske Bank, Copenhagen, 14 December 2011.

The slides can be found on the website of the National Bank of Denmark.

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Thank you for inviting me to speak here today. I will touch upon the European debt crisis from a Danish perspective.

The world economy has lost momentum since last spring and short-term outlook has worsened. The European economies, especially in the euro area, have seen the strongest slowdown. But there are considerable differences from country to country. Germany and France continued to enjoy solid growth in the 3rd quarter, whereas growth in the most indebted countries, the five GIIPS countries i.e. Greece, Italy, Ireland, Portugal and Spain, has been close to zero or even negative **(*slide 2 – real GDP*)**.

There is a clear division among the EU Member States: countries, with relatively sound public finances and external balances before the crisis, are performing better than countries with internal and external imbalances **(*slide 3 – General government balance*)**. But over the past couple of months even euro area Member States with sound economies have been affected by rising interest rates. There is considerable volatility, and three groups in the euro area seem to have been formed. The first group with the narrowest spreads to Germany includes Finland, the Netherlands, Austria and France. The second group consists, among others, of Belgium, Spain and Italy and the third group is Ireland, Portugal and Greece. Denmark stands out by having a negative yield spread of 15–20 basis points to Germany.

In the five GIIPS countries, a substantial share of government debt is held by foreign investors, and the short-term public debt issuance requirement is high. In combination with high current account deficits, resulting from lack of competitiveness, this leaves these countries especially vulnerable to changes of sentiment in the international capital markets **(*slide 4 – current account*)**.

Despite marked differences between the economies with high debt ratios in the euro area, they all saw a significant reduction in the risk premium – and thus the level of interest rates – following the introduction of the single currency in 1999 **(*slide 5 – yield spreads*)**. This immediately eased the financing burden on their very substantial government debt. But this advantage was not used to consolidate government finances, but rather to increase public spending. At the same time, high wage inflation led to an erosion of competitiveness. The rest is history. The economies are left with an even higher government debt burden and a private sector with lacking competitiveness. Most of the countries have an urgent need of broad-based structural reforms: in the labour market, the pension system, public enterprises and elsewhere. They are facing massive pressure from the markets and the EU to introduce such structural reforms. But any steps are met with fierce public opposition – and the political will also seems to be lacking in some of the countries.

To some extent, the introduction of the euro in 1999 eliminated the normal market reactions towards euro area Member States with high government debt. The markets regarded the euro as a safe haven and yield spreads narrowed significantly. Italy is a case in point – its government debt is high, but has been stable for a long period of time. There has been only a slight increase over the past decade. At the same time, Italy – as opposed to the other GIIPS countries – has a primary government budget surplus. In other words, the actual deficit can be attributed to legacy debt. Finally, Italy's growth has been stagnant for many years **(*slide 6 – general government debt*).**

Italy provides a good example of the change in the markets' assessment of sovereign debt risks, and it is fair to ask: Why did the markets not react sooner? The build-up of government debt is not mainly the result of the most recent financial crisis but has occurred gradually over the past 15–20 years.

In the current situation, policymakers are, to some extent, pointing the guns at the markets and rating agencies. This means shooting the messenger rather than addressing the underlying imbalances. In fact, it is positive that the market reaction forces policymakers to take action. In other words, the problem is not that the markets are reacting by demanding higher interest rates; the problem is that they did not react sooner – before the problems escalated to the current level.

We are caught in a dilemma. On the one hand, fiscal stimulus to the economy – by expanding government spending – seems reasonable. But market pressure makes this strategy untenable. The market demands fiscal consolidation, and that the states address the structural shortcomings of their economies. And there is no doubt as to which stance will prevail: that of the markets. But that is not necessarily a bad thing. If policymakers react properly, this can boost consumer, business and investor confidence – and the current crisis is, to a large extent, also a crisis of confidence. If, on the other hand, there is a lack of political action, the volatility will spread to more and more countries.

The decisions made at the EU and at the euro summits in October were important steps towards containing the crisis and preventing the occurrence of future crises. The key elements were the agreement on voluntary restructuring of Greece's sovereign debt, the recapitalisation of the banking sector and the barriers to prevent the sovereign debt crisis from spreading. A cause for concern is that since the details are still being debated at the EU level, implementation has remained uncertain for so long.

Despite the steps over the past year and a half to improve economic governance in the euro area and the adoption of new measures to contain the sovereign debt crisis, market tensions have increased. In order to address these tensions, steps were taken at the European Council meeting last week to move towards a stronger economic union. **(*slides 7+8 – European Council decisions*)**.

The plan contains two elements:

A new fiscal compact and stronger economic and political coordination. And the development of stabilisation tools to face short term challenges.

At the meeting there was a wish to include the fiscal compact, in the Treaty. As will be known, the UK was against this. On this background the head of states or governments of the euro area decided to make a separate international agreement in order to implement the new fiscal compact. A number of non-euro countries have indicated that they will consider participate in the process after consultation with their respective parliaments.

The Danish government has stated that it will be decisive for an eventual Danish participation that it does not conflict with our euro opt-out, which can only be changed by means of a referendum.

I will not at this junction speculate over possible legal and pure political aspects but only comment on the aspects concerning the economic policy.

If the euro Member States decide between themselves a stronger and more binding framework for the economic policy, including fiscal policy, then Denmark as a small open economy with a fixed exchange rate regime vis-a-vis the euro has no other option than either to take part in as much of the agreement as we can, respecting our euro opt-out, or place us as close as possible at the new euro compact without formal participation.

In other words, a stronger discipline in the economic policy in the euro Member States should result in just as tough conditions for Denmark irrespective of whether or not we decide to participate in the new agreement. In reality we will hardly get a higher degree of manoeuvrebility in the economic policy by staying outside – quite the contrary.

If we decide to stay outside, we have to make sure that it is not mistakenly seen as a signal of less commitment to sustainable economic policy.

With respect to financial resources for the short term crisis fighting, the ceiling of the EFSF/ESM will be reassessed in March 2012 and the financial resources to the IMF will be increased substantially through bilateral loans. The commitment is up to 200 billion euro. The Danish part will be up to 40 billion Danish kroner which will be taken from the foreign exchange reserves.

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For close to 30 years, the fixed-exchange-rate policy **(*slide 9 – the krone rate*)** has been a cornerstone of Danish economic policy – and has served Denmark well. Inflation and interest rates are in line with those of the best-performing euro area Member States, and the Danish level of prosperity matches that of our neighbouring countries.

Prior to the pegging of the Danish krone to the D-mark, the situation in Denmark was similar to that of the problem economies in the euro area today. Denmark had been through a period of slow growth and large imbalances as regards government budgets, the current account and the labour market, which was affected by high unemployment throughout the 1970s in the wake of the oil crises. In 1982, inflation reached 12 per cent and interest rates 22 per cent. The government yield spread to Germany peaked at 12 percentage points **(*slide 10 – long-term yields*)**. This level of interest rates would be devastating to any economy.

The pegging of the Danish krone to the D-mark in 1982 marked the beginning of a long period in which structural imbalances in the economy and fiscal inadequacies were gradually addressed politically. But this was not without setbacks.

The Danish economy has performed relatively well – also after the introduction of the euro in 1999. This can be attributed to a stability-oriented economic policy with a medium-term focus, and to the implementation of structural reforms in the labour market and elsewhere during the 1990s. It is also a fact that, in practice, the economic policy pursued outside the euro area must be at least as tight as that pursued in the euro area in order to safeguard the credibility of the fixed-exchange-rate policy. The conclusion is clear. The credibility of the economic policy pursued is more important than the choice of exchange-rate regime. This also applies if fixed-exchange-rate policy is introduced in the form of participation in a monetary union.

Thanks to our relatively solid starting point, Denmark has been less affected by the debt crisis than many other countries. The most important real economic issue is that Danish economic growth is low partly due to poor consumer and business confidence. The steady stream of negative stories from the euro area is no doubt a contributing factor, but is far from the only reason. The Danish economy was severely overheated from 2006 to 2008, with very strong credit growth and a housing bubble. We are now struggling with the repercussions of the overheating. The situation was aggravated by the financial and debt crises, but these are far from the only reasons for the lack of consumer and investor confidence that is currently hampering economic growth.

In addition to a negative impact on confidence, weak growth in our key export markets obviously has an impact on Danish growth. Denmark is a small, open economy that is heavily dependent on foreign trade. Close to 50 per cent of Danish exports go to the euro member states.

Thanks to market participants' confidence in Danish economy in general and monetary and exchange-rate policies in particular, Denmark has not been affected by the increase in interest rates, seen in many euro area Member States. Danish government bonds are AAA-rated. This benefits the Danish market for mortgage bonds, which is one of the largest and most liquid in the world due to our mortgage credit system. This is greatly to the advantage of Danish home buyers at the moment, as a home purchase may be financed at short-term interest rates below 1½ per cent. This level of interest rates helps to protect the economy in the current highly uncertain climate.

Many euro area Member States fear that the sovereign debt crisis will turn into a banking crisis, as the banking sector holds a large percentage of the government bonds of the highly indebted countries. Again, Denmark is not severely affected. The exposure of Danish banks to the most debt-ridden euro area Member States is limited and even major write-downs of sovereign debt would be manageable.

In addition to the aspects already mentioned, I will draw attention to a third area where the crisis is leaving its mark: the management of economic policy. I believe that Danish politicians as a whole have been well and truly scared by the turn of events in Europe. They have seen the implications of excessive indebtedness and irresponsible fiscal policy. This has suddenly become very tangible. It remains to be seen how long this experience will remain in our minds.

Thank you for your attention.