Lars Rohde: Recent developments and outlook for the Danish economy

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Association of Danish Mortgage Banks 2013, Copenhagen, 26 September 2013.

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The global economy is recovering at a moderate pace. In the 2nd quarter, the euro area saw positive growth for the first time in 18 months, and looking ahead, the economy is expected to pick up further, albeit slowly. Activity in the US economy is also set to grow, although bond yields are beginning to rise. Growth is supported by extremely accommodative monetary policy, with the Fed funds target rate close to zero and current large-scale asset purchases.

Activity in the Danish economy remains below its potential level, but here, too, there are signs that the situation is beginning to improve. GDP grew by 0.5 per cent in the 2nd quarter. Private consumption was flat, as it has basically been since 2010. In Danmarks Nationalbank's assessment, macroeconomic balances have now more or less been adjusted following the years of overheating of the economy and the subsequent downturn, and the foundations for renewed growth are in place. Signals from abroad are also more encouraging. Danmarks Nationalbank projects growth at just over 1½ per cent in 2014 and 2015. That is higher than the average growth rate expected for the euro area, but in line with the outlook for Germany.

Over the last year, households have begun to take a more optimistic view of the housing market, and more people now expect prices to rise. But the recovery is unevenly distributed across the country. Prices of flats in Copenhagen have risen by more than 10 per cent over the last year.

With the most recent overheating of the Danish housing market in mind, we might now begin to ask whether things are moving a bit too fast in Copenhagen. However, the price increases should be seen in the light of the preceding strong fall in 2008–09 and the decline in 2011. An article in Danmarks Nationalbank's most recent Monetary Review compares price levels for flats in northern European capitals. While an average flat of 100 square metres costs kr. 2.3 million in Copenhagen, it would cost about twice as much in Stockholm and Oslo and three times as much in Paris. In Berlin, on the other hand, the price is kr. 1.9 million. Although these differences can hardly be used as indicators of national price developments, they are illustrative and show that the price level in Copenhagen is not particularly high in an international perspective. Judging by the economic fundamentals, prices are not likely to continue to rise at the pace seen over the last year, and nor should they. In Danmarks Nationalbank's assessment, prices of flats in Copenhagen are not far from their equilibrium – although the equilibrium level is difficult to identify precisely. The equilibrium price can be expected to increase by 2–3 per cent annually, but experience shows that there may be large deviations from this trend. As Danmarks Nationalbank has previously pointed out, the structure of housing taxes contributes to instability in the housing market.

The outlook that the Danish economy will begin to pick up steam highlights the issue of how much spare capacity we actually have, and when the economy will begin to experience capacity problems. Danmarks Nationalbank compiles the output gap at minus 2½ per cent of GDP. That is not tremendously large, and the economy is expected to approach its potential level in the coming years. It is estimated that employment can increase by around 55,000 without creating inflationary pressures in the economy. This is a snapshot. A couple of years down the line, the figure will be higher if structural unemployment falls and the structural labour force increases as expected. Most of the increase in employment is to be achieved via a higher participation rate, while it is estimated that there is room for unemployment to fall by approximately 15,000. Irrespective of the measure of unemployment applied, unemployment is low viewed over the last few decades. In fact, we are already seeing the first signs that labour is becoming scarcer. For example, there has been a small increase in the number of firms reporting a shortage of labour, and there has also been a higher influx of foreign labour into the Danish labour market in the last few years. This does not indicate that unemployment is far from its structural level.

The outlook for the Danish economy does not indicate that fiscal policy should be eased. The timing could prove to be bad, by which I mean that fiscal stimulation of demand might accelerate an upswing, with the risk that the economy rapidly experiences capacity problems.

The new fiscal policy framework does not leave scope for further easing. The budget deficit is close to 3 per cent of GDP this year and in both 2014 and 2015 if the expected extraordinary revenue from early taxation of capital pensions is disregarded, as it should be. When the bill was passed, it was a precondition that revenue from such taxation that had been moved forward should be used to reduce the government debt. This revenue is extraordinary and temporary, and will entail a shortfall at a later time. The structural budget balance will deteriorate in 2014 and is close to the Budget Act’s limit of minus 0.5 per cent of GDP. The conclusion is clear. There is neither a need for nor scope for fiscal easing.

Lending by banks and mortgage banks to the corporate sector has been virtually unchanged since 2008. But there has been a redistribution among the credit institutions, so that lending by mortgage banks has increased, while lending by banks has declined. This may reflect the need for some banks to consolidate after the financial crisis, encouraging customers – especially firms – to raise mortgage loans rather than bank loans. At the same time, some firms may have found mortgage loans more attractive. In addition, firms have increasingly sought alternative sources of funding, such as corporate bonds, sector loans and trade credits, export guarantees, etc.

The mortgage banks have been able to meet the demand for loans and have thereby contributed to a stable supply of credit in the crisis years. This applies not only in relation to corporate customers, but also in relation to households.

The number of families falling behind on their mortgage payments has been low since the mid-1990s. Even the financial crisis led to only a small increase in the arrears ratio for mortgage debt. The question is whether this is also likely to be the case in future. Danish households have far more debt relative to income than families in other countries. This has caused some concern among observers of the Danish economy as to whether the families will be able to service their debt, especially if the Danish economy were to be affected by another serious recession . Let me state this very clearly: Danmarks Nationalbank does not share the view that the high debt ratio among households is a problem in relation to financial stability. Even financially squeezed households typically service their mortgages and cut down on private consumption instead. This affects demand in the economy and hence the corporate sector. That has an impact on macroeconomic stability rather than financial stability, but indirectly the banks may also be affected.

Danmarks Nationalbank’s most recent Monetary Review evaluates a number of stress scenarios in which interest rates and unemployment soar and house and equity prices dive. While the selected stress scenarios would led to loan impairment charges for the financial sector overall, the calculations do not point to the mortgage banks being particularly severely affected. This is because the mortgage loan is nearly always the last item of debt that a family with a tight budget defaults on. For most families, even considerable worsening of their finances would lead to only a small increase in the probability of falling behind with mortgage payments.

The Danish economy has stabilised. That is also true of the financial sector. For the first time since the collapse of Roskilde Bank in the early summer of 2008, the summer has been quiet – and even sunny. But there are, nevertheless, a couple of financial summer stories to tell.

The first one is about F1 loans, i.e. mortgage loans with annual refinancing. The current debate was triggered by a word of warning from S&P. But the debate on the robustness of the construction behind the F1 loans is much older. Particularly after the auction in December 2008, people began to say, “suppose that...”. Suppose that the bonds had not been sold. At that time it was more the rule than the exception that markets froze. Liquidity typically dried up if doubts arose as to the credit risk.

Households’ long-term loans with annual refinancing are based on bonds with much shorter maturities. This has given mortgage banks qualities resembling those of ordinary banks, in that there may be “runs” on them. That risk did not exist under the old mortgage credit model since all loans were “prefinanced”.

So the question is, what would happen in practice if a mortgage bank finds itself in a situation – due to uncertainty about the credit risk, perhaps – in which it cannot sell short-term bonds in connection with refinancing.

The brief answer is that Danmarks Nationalbank will act as the lender of last resort – as it does for other banks – if the mortgage bank is solvent and can pledge adequate collateral. In practice, the latter would presumably be all the bonds not sold in the market.

Mortgage bonds, also bonds issued by the mortgage banks themselves, are now part of Danmarks Nationalbank’s collateral basis, i.e. they may be pledged to Danmarks Nationalbank as collateral. This option will limit the impact of a scenario in which bonds are difficult to sell. So the response to S&P and others is that this is not an immediate threat to financial stability in Denmark.

BUT this does not mean that a business model based on Danmarks Nationalbank as the backstop is expedient for private-sector financial institutions. That is not a sustainable solution.
One of the strengths of the Danish mortgage credit model should be that it is, inherently, so robust that no subsidisation whatsoever is required. That is exactly what the balance principle aims at. To the extent that it is possible, the mortgage bank should take on credit risk, but no other types of risk.

Investor confidence in the creditworthiness and liquidity of mortgage bonds is at the core of the Danish mortgage credit system. I have on other occasions argued that, in order to maintain this confidence, the mortgage banks should take a cautious approach and not go too near the statutory limits. The more resilient the mortgage banks are to losses, the greater is the probability that they can meet their obligations to investors. And all other things being equal, it will take a greater shock to trigger a “run” on the mortgage banks.

I would like to take this opportunity to acknowledge the initiatives already taken with a view to addressing this issue. Auctions are now spread over the year, business models and product ranges are being adjusted, and pricing structures are being changed in order to give borrowers incentives to choose products with lower refinancing risk. All these initiatives make positive contributions to the sustainability of Danish mortgage credit. But the system still involves considerable refinancing risk. In 2014, bonds linked to adjustable-rate loans totalling more than kr. 750 billion are currently set to fall due, and the auctions towards the end of the year will be of more or less the same size – just over kr. 400 billion – as the auctions in December 2008.

The Danish mortgage credit system has served us well for many years and proved its worth during the financial crisis. All the same – and for good reasons – it remains a subject of debate. I do not believe that we can or should return to the old mortgage credit model. But it is important that you find long-term solutions.

The second summer topic has been regulation of the financial sector in the wake of the financial crisis. Both at the international and national level, politicians have taken action during the crisis. A wide range of measures have been introduced: increased capital and liquidity requirements, enhanced governance requirements for financial institutions, a new crisis management regime, to mention but a few. In addition, the Danish Financial Supervisory Authority has been given additional resources and powers. The crisis revealed various weaknesses, and they have been addressed. But as we have seen previously, pressures to ease the rules will emerge at some point.

Personally, I am rather surprised to see what is happening in Denmark. The Bank Rescue Packages enjoyed broad political support and until recently they had a clear aim: a financial crisis – never again! The time had come to tidy up and tighten the rules. However, winds of change seem to be sweeping across the political landscape. Has the Danish Financial Supervisory Authority now been given too much power, and have the requirements imposed on mortgage banks become too tight? It is as if the financial crisis has already been forgotten. But I would be surprised if our collective political memory is that short. If so, it would be shorter than in other European countries.

So I would like to remind you that in Denmark we provided massive support during the financial crisis, and the government took on huge risks on behalf of the tax-payers. Under Bank Rescue Package 1, the government provided guarantees for an astronomical kr. 4,200 billion. With Bank Rescue Package 2, the government gave the financial sector a capital injection of kr. 46 billion in order to prevent a potential credit crunch, and it guaranteed debt issuances of kr. 194 billion. On the fifth anniversary of the introduction of the general government guarantee, the government has still injected capital totalling kr. 31 billion into the sector. So far, the government has not had any direct costs that have not been covered by the sector's payments for this support, but the risk has been enormous.

In that perspective there can be no doubt that there was a need for tightening. Yes, we have come a long way in terms of tidying up, but it would be unfortunate if the pendulum has already begun to swing back.

Thank you for inviting me to speak.