Lars Rohde: Developments in the world economy, the Danish economy and in its mortgage credit system

Speech by Mr Lars Rohde, Governor of the National Bank of Denmark, at the annual meeting of the Danish Mortgage Banks' Federation, Copenhagen, 3 April 2014.

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The international economy is recovering. The upswing is gaining momentum in the USA, and euro area GDP has increased in the last three quarters. With the exception of Greece, southern Europe was also picking up at the end of 2013. On the other hand, growth has declined in the emerging economies, mainly as a result of weaker development in domestic demand.

The US economy is now so strong that the Federal Reserve in January began the previously announced tapering of its asset purchases. At the same time, some emerging economies – including Argentina, Brazil and Turkey – saw capital outflows and pronounced weakening of their currencies. This should also be viewed in the context of a deteriorated growth outlook and internal imbalances in these economies. But the countries affected represent only some 5 per cent of global trade, so the derived effects of this turmoil on the advanced economies are presumably limited. The same applies to the turmoil in Ukraine. So far, it has not led to large fluctuations in the international financial markets, except in Russia.

In the euro area, price inflation has decreased in the last couple of years, to 0.5 per cent in March. Core inflation has also declined. Besides subdued wage developments, the low rate of inflation is attributable to downward pressure on import prices, to some extent reflecting the appreciation of the euro. In addition, factors such as the freer movement of labour and stronger international competition exert sustained downward pressure on import prices and hence on the overall rate of wage and price increase.

In Denmark, economic activity is picking up, although the growth pattern has been somewhat uneven. There are positive signs in the labour market, with falling unemployment and a rise in the number of people in employment, especially in the private sector. But the number of part-time employees has grown. Private consumption has not recovered yet, although the foundation for increased consumption is in place. The level of private savings has been high for some years. Interest rates remain historically low, while real wages are set to rise, partly due to low – but nevertheless positive – price inflation. Add to this positive consumer expectations and rising net wealth. Although the households' average gross debt ratio remains high, and some households may have a wish for further consolidation, it is difficult to see how Danmarks Nationalbank could be criticised for forecasting higher private consumption in the coming years.

In its most recent projection, Danmarks Nationalbank forecasts growth in GDP at 1.4 per cent this year, rising to 1.7 per cent next year. This may not sound of much, but it is above the forecast potential, so the capacity situation will normalise towards 2016. If economic growth is to reach a higher level while remaining sustainable, productivity growth must increase. Reforms to boost productivity are on the government's agenda for the near future, and I welcome these initiatives. Denmark must stay on the path of economic policy reform. That is a precondition for future growth and prosperity.

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Now let me turn to the housing market. In general, prices have been showing a slight upward trend for the last 18 months. In January 2014, house prices were 6 per cent higher than in mid-2012, while prices for owner-occupied flats had risen by 14 per cent in the same period. Nevertheless, trading activity remains low, and the supply of homes for sale is still high – in a long-term perspective. But it has not risen any more over the last year.

In recent years, economic activity – and hence the housing market – has developed unevenly across Denmark. Economic growth is increasingly a city phenomenon. This has been the case for many years and the same pattern is seen in other countries, but the trend seems to have accelerated in Denmark in recent years. Since 2008, there has been a strong influx of mainly young people and people with jobs to the Capital Region, while pensioners and unemployed people have moved out. Especially young people aged 20–29 move to the cities in connection with education or training, and they increasingly stay there afterwards.

This demographic development can be seen in the housing market. House prices are considerably more cyclical in the cities than in the rest of Denmark. This is particularly true of the Capital Region and surrounding areas, which are typically also the “first movers”. In addition, house prices in urban areas have risen in real terms over time, reflecting factors such as underlying demographics, with still more people living in an area of a virtually given size. Since the price of building a house is almost the same throughout the country, it is mainly land prices that have risen.

The situation is exactly the opposite in the areas of Denmark where people are moving away. Here, demand for housing is declining, while the supply is more or less unchanged. This results in decoupling of house prices and construction prices, which are normally indicative of the level of prices in the long term. The housing surplus means that some properties are falling into disrepair and are, in effect, worthless.

The question is whether this development is cyclical, or whether it is a more structural tendency. Causality between population growth and regional economic growth can go both ways, and a cyclical recovery may stem the tide. At some point, the regional differences between house prices may become so large that the gain from moving out halts the migration towards the cities, but presumably this will affect only the immediate surrounding areas. Beyond commuting distance, the development seems to be more structural. This is a problem that neither can nor should be solved by the financial system. The Danish mortgage-credit system is based on value behind the loans. If the value of a property is eroded completely, there is no longer a foundation for providing a mortgage loan.

During the most recent boom, borrowing by households surged, rising more sharply than ever before. The surge went hand in hand with an even stronger rise in housing wealth, which enhanced homeowners’ opportunities to raise loans against the home as collateral. Previous analyses have shown that Danish households would still be able to service their debts, even during an economic downturn, and the high gross debts do not pose a serious threat to financial stability. One of the reasons is that the households also have considerable financial assets. But high loan-to-value ratios amplify cyclical fluctuations in the Danish economy. This highlights the importance of restoring the link between property values and taxation.

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While increased stabilisation of house prices via housing taxes is not immediately on the cards, the Folketing – the Danish parliament – on 11 March passed a legislative amendment to introduce contingent maturity extension of mortgage bonds if the underlying loans are not pre-financed. This is a very important amendment, and a good way of dealing with various tail risks in the Danish mortgage-credit model. I appreciate the positive contribution of the sector to this process – from the presentation of the first proposal to the adoption of the final legislation. Input from the sector and other market participants was taken into account, but the purpose of the amendment has remained unchanged from day one. Firstly, a robust solution for addressing the mortgage banks’ refinancing risk has now been found. Secondly, a credible resolution model for mortgage banks is re-established.

I am also pleased to note that the credit rating agencies’ reception of this amendment is predominantly positive. Although this solution is not a silver bullet, Moody’s concludes that the new legislation removes the refinancing risk on Danish mortgage bonds. This eliminates a major source of credit risk, thereby supporting a high credit rating.

It is essential for the mortgage banks to maintain sound credit policies, also after the legislative amendment. Investor confidence in the long-term credit quality is all-important – irrespective of how the housing market develops. Against that background, Danmarks Nationalbank recommends reducing the upper limit for deferred-amortisation loans – as a percentage of the value of the home at the time of mortgaging. This should apply to deferred-amortisation loans underlying covered bonds, covered mortgage bonds or mortgage bonds issued by banks and mortgage banks. In this way, borrowers will gradually move away from the maximum loan-to-value ratio over time. This will further underpin the high degree of security in the mortgage-credit system, even if house prices plummet, and contribute to macroeconomic stability.

Experience shows that general changes in the amortisation profile, particularly the first-year payments, also have an initial effect on the price of housing, and hence on the macroeconomy. So the timing and dosage of restrictions on deferred amortisation should be considered carefully.

In contrast, banks should not be restricted further from providing deferred-amortisation loans if such loans are financed in other ways than by issuance of covered bonds. Mortgage lending is a particularly secure business model that differs fundamentally from banking and that is subject to special regulation. While mortgage banks finance their lending purely through issuance of mortgage bonds that match the loans, banks finance their lending via various sources of funding, such as deposits, issuance of covered bonds and issuance of senior debt. As a main rule, mortgage banks can take on credit risk only – and even this risk is contained through regulation of loan limits and redemption profiles. If a mortgage bank wants to have the same opportunities as a bank, it must obtain a banking licence.

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Now I will turn my attention to Europe. Here, the banking union is moving away from the design phase and becoming a cornerstone of the financial architecture. Some people primarily see the banking union as part of the strengthening of the euro. But from Danmarks Nationalbank's point of view, the key element is that the banking union will contribute to a well-functioning single market for financial services.

The Single Supervisory Mechanism, SSM, has already been adopted and is being implemented. On 4 November 2014, the ECB will take over supervision of the largest euro area banks. To ensure that the ECB takes over supervision of healthy, viable banks only, an asset quality review of the 130 largest banks is well underway. Besides its own resources, the ECB has employed an independent consultancy firm for this task, and in the summer a follow-up stress test will be performed. Banks that fail the stress test will be met with a demand for recapitalisation or resolution. All in all, the work to ensure that the corners of the house which the ECB will be responsible for are neither rotting nor crumbling looks very promising and ambitious.

Another core element of the banking union is the Single Resolution Mechanism, including a Single Bank Resolution Fund. The European Parliament, the Commission and the Council have just negotiated an agreement on this. The rules are expected to be adopted this month.

When your neighbours build a new house, you invariably look at your own house in a new perspective. The banking union is a fact and will have a substantial impact on Denmark – whether or not we choose to participate in this new financial architecture. In Danmarks Nationalbank's opinion, Denmark's interests are best served by participating in the banking union. The standard of supervision set by the SSM under the ECB can be expected to be the benchmark for the member states participating, but also for those opting out. If Denmark participates, it will be easier to adapt the standards to Danish conditions and experience. Presumably, the SSM will be perceived as a quality stamp, as more eyes, including external eyes, will be focused on the supervision of banks and the key supervisory decisions. Other things being equal, this will give the banks in question a competitive edge over the banks of "outsider" member states – even if they have credible national supervisory authorities as in

Denmark's case. If Denmark does opt out, this may require tighter supervisory practices. In addition, investors can be expected to require more ambitious levels of excess capital and liquidity than for banks within the union.

It is also in the clear interests of Denmark that a shared practice is established for crisis management of banks. The Single Resolution Mechanism will make it easier to perform crisis management of cross-border banks. When fully phased-in, the Single Supervisory and Resolution Mechanisms will act as an insurance scheme for financial enterprises and provide a better guarantee of equal treatment of the creditors of distressed banks across the EU.

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New international liquidity standards are another area that due to our special Danish financial architecture has attracted considerable attention. Since the Basel Committee's first consultation paper on new international liquidity standards was published in 2009, both the authorities and the sector have had a very special interest in the liquidity of Danish mortgage bonds. On the basis of a detailed data set compiled by the Danish Financial Supervisory Authority for all transactions in Danish government and mortgage bonds, Danmarks Nationalbank has analysed liquidity in these two markets before, during and after the financial crisis. In this connection, we have worked closely with experts from the Copenhagen Business School and from the BIS. Our results, which we published in 2010 and 2012, show unequivocally that highly liquid Danish mortgage bonds were by and large as liquid as government bonds during the crisis.

At the EU level, the European Banking Authority in 2013 performed a similar empirical analysis with virtually the same outcome. Now we are awaiting the European Commission's decision.

Seen from Danmarks Nationalbank's point of view, a liquidity buffer should be well-diversified, and it should be empirically well-documented what such a buffer may include. In that context, the treatment of government bonds in the financial regulation is a bit of a paradox. Government bonds from all EU member states may freely be included, without being risk-weighted and without any diversification requirement. This is puzzling, given that the EU Treaty prohibits the public sector from gaining privileged access to financial institutions.

In Danmarks Nationalbank's opinion, thorough empirical analyses with high credibility provide a basis for determining that liquid Danish mortgage bonds should be classified as extremely high quality liquid assets. Mortgage bonds can contribute to giving financial enterprises a well-diversified portfolio of liquid assets. We will maintain this point of view, irrespective of the EU outcome.

On the other hand, no true horror scenario can be conjured up for Denmark if the EU – despite solid empirical evidence to the contrary – chooses not to classify mortgage bonds as extremely high quality liquid assets. Yes, there will be a price to pay. But no, it will not bring about the downfall of mortgage banks, banks or homeowners. The Danish mortgage-credit system is far too stable for that.

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Thank you for your attention.