Nils Bernstein: Developments in the world economy, the Danish economy and in its mortgage credit system

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the annual meeting of the Danish Mortgage Banks, Copenhagen, 26 September 2012.

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Growth in the world economy was weaker than expected in the 1st half of 2012 and declined further over the summer. It now looks as if global growth this year and next year will be lower than expected in the spring. Not only the European economies have slowed down, but also major emerging economies such as Brazil, China and India – which have until now been surprisingly resilient to the crisis.

This development is reflected in world trade, which has flattened out since the turn of the year. According to the press, the WTO assesses annual growth in world trade at only 2–3 per cent at the moment. This is a clear indication that things are not going too well.

The problems in southern Europe still constitute the greatest uncertainty factor.

The debt crisis has been weighing down the world economy since early 2010. Many initiatives have been taken – by the member states in question, by the euro area as such and by the IMF. But it has proved to be difficult to come up with effective solutions.

The good years of the last decade were only to a limited extent used to build up buffers. So when the crisis erupted, many countries had little resilience, and the need for consolidation soon became evident. Uncertainty about US fiscal policy is another risk factor.

At a time with weak domestic demand and low confidence in the private sector, many countries are compelled to pursue tight fiscal policies due to large government deficits and debts. These countries are to a large extent paying for the sins of the past. On the other hand, it should also be emphasised that consolidation is underway, especially in many European economies, and medium-term strategies to ensure fiscal sustainability are in place. Combined with the most recent initiatives from the European Central Bank, this should help to bring down interest rates, and hence funding costs, to a manageable level in debt-ridden EU member states such as Spain and Italy. Among the member states subject to IMF programmes, Ireland has made the most progress towards economic recovery and is now, once again, able to borrow in the international financial markets at affordable interest rates.

Neither the USA nor Japan has adopted a medium-term fiscal plan – that is, a plan for reducing the growing debt in the long term.

The weak economy pushes up unemployment in many countries. Total euro area unemployment now exceeds 11 per cent of the labour force. But there are wide variations, from 5 per cent and falling in Germany to 25 per cent and rising in Spain. Weak activity and anchored inflation expectations mean that underlying inflationary pressures are low in most member states.

I am pleased to note that the European debt crisis is being addressed through a combination of national measures and support from the community. After all, the many summits and ministerial meetings show that the relevant member states are not left to fend for themselves, taking initiatives that could be detrimental to others.

Furthermore, we should not underestimate the highly developed cooperation between central banks and supervisory authorities worldwide – ranging from specific, coordinated measures to the development of rules and exchange of experience. This provides useful transparency as a basis for our own decisions.

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Obviously, Denmark is not unaffected by events in the rest of the world. There is a direct impact via trade, as well as an indirect impact via expectations for the future.

Economic activity in Denmark has stagnated over the last 18 months. The reason is that consumers and firms still keep a tight rein on spending. The consumption ratio is low and the investment ratio even lower, while the savings surplus is unusually high. This should be viewed against the backdrop of considerable loss of wealth in the wake of the financial crisis, which has by no means been restored. Add to this a subdued trend in disposable income and, not least, low consumer and investor confidence. The high household savings entail a large consumption potential, which can be unleashed when confidence returns. Exactly when this will happen is difficult to predict.

In our most recent forecast, we assume that private consumption will pick up a little over the coming year. On the basis of a very weak 1st half, we estimate output growth at only 0.3 per cent this year, rising to just over 1.5 per cent p.a. in 2013 and 2014. But this will all depend on when confidence is restored and the private sector begins to convert some of its savings into consumption and investment. Presumably the situation in the housing market will have to improve first.

Since Statistics Denmark began to publish monthly statistics of house prices last autumn, the figures initially published have consistently been a little lower than the final figures. With this in mind, we have seen a stabilisation of prices over the last six months – and the first tentative signs of improvement. The supply of homes for sale has decreased considerably in the last nine months, and although this does not reflect higher turnover, it may well help to stabilise prices. In our forecast, we assume that the tide will turn in the 2nd half of the year, and prices will begin to rise moderately. Prices are estimated to be slightly below their equilibrium level, based on the current low interest rates. The future development in prices is subject to much uncertainty.

Interest rates on home loans are presumably lower in Denmark than anywhere else at the moment. The low interest rates generally help to buoy up the housing market. For buyers this means that with a fixed-rate loan the "housing burden" is now below its long-term average. If they opt for a variable-rate loan instead, the housing burden is very low at present. This is likely to attract more buyers.

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If we take a bird's eye view of the Danish economy and compare ourselves with other countries, we can see, on the one hand, that we are not among those most severely affected by the crisis. On the other hand, we too need to fix a few problems.

Our financial sector is undergoing an adaptation process in response to the financial crisis. New rules have been introduced, and the defences have

been strengthened. Structural developments are affecting the sector and will do so for some time to come. As I see it, a serious and targeted effort is being made, and the sector will emerge from this process strengthened – so that it will take more to shake its foundations next time a crisis hits us. But we have some way to go. Bad loans still dampen earnings.

Danish firms are challenged by weak demand, a high level of costs and a trend in productivity which is on the low side in an international comparison. If the output gap, i.e. the excess capacity in the Danish economy, is to be closed, these issues must be addressed. This cannot be achieved overnight. The business sector focuses much on what others can do, including on borrowing options. I am fully aware that some firms have difficulty in convincing their banks that it makes sense to lend them more money. But in general, firms are saving up and do not see finances as an impediment to production.

I would also like to make it clear that, in Danmarks Nationalbank's opinion, the framework conditions for funding the corporate sector should be based on market solutions. Such solutions do not include government-guaranteed corporate bonds. The government guarantee given to the banks was a very extraordinary measure aimed at preventing the collapse of the financial sector following the failure of Lehman Brothers.

The public sector has also been affected by the slowdown after the financial crisis. Reforms that will not only balance the government budget in the short term, but also ensure the sustainability of our finances in the slightly longer term, are underway. It is not surprising that politicians are facing increasing challenges at a time when unemployment has risen. But it is important to stay the course. We have already made much progress along the path of reform in Denmark. The best way to help our weakest citizens is by laying the foundations for long-term job creation.

Turning to the households, we can see that debt as a ratio of income has declined in recent years as a result of consolidation. All the same, it is a well-known fact that the Danish households' gross debt is high in relation to their income – both in a historical perspective and by international standards.

To examine whether the households' large gross debt is a problem for the economy, Danmarks Nationalbank and the Ministry of Business and Growth have collected an extensive and detailed data set that makes it possible to analyse the housing market, and especially home financing, at family level.

I take this opportunity to thank the sector for its contribution to this unique data set. The analyses have not been completed, but various patterns are emerging.

If families are grouped by income after tax, the 20 per cent with the highest incomes account for more than half of the families' aggregate gross debt. The 50 per cent with the lowest incomes account for only 14 per cent of the gross debt. So the overall impression is that in general the families with debt also have incomes to service it. Furthermore, households with debt are usually also those that hold the most assets besides their homes, i.e. financial assets and pension savings.

Basically, this is reassuring, but new preliminary analyses represent a dark cloud on the horizon.

We have examined whether families that have opted for deferred-amortisation loans use the lower monthly payments to reduce other – often more expensive – debts, as we have often heard from those assembled here today. Some of the families do, but unfortunately they are a small minority.

In addition, more than half of the families with deferred-amortisation loans exceed the loan-to-value threshold of 80 per cent of the property value. So in many cases young families who already have limited liquidity at their disposal will have to start repaying their loans when the current period of deferred amortisation expires. Are they aware of that, I wonder?

The data shows that the widespread use of mortgage loans with 100 per cent deferred amortisation has been a very bad idea – since the system only operates smoothly if house prices continue to rise.

Finally, our preliminary analyses show that households with deferred amortisation have higher gross debt, both in nominal terms and relative to income, than households opting for loans with amortisation. And there is a tendency for these families also to have more debt before they take out the deferred-amortisation loans.

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In recent years, I have raised a few concerns about the continued stability of the mortgage-credit sector in view of the major changes that have taken place within the last

10 years. I know you are also aware of these issues and are addressing them, but nevertheless, we still have a long way to go in some respects.

Firstly, deferred amortisation has made it possible for people to borrow more without having to pay more per month. This has contributed to large house prices rises and increased the vulnerability of borrowers and mortgage banks.

Against this background, I welcome the initiative by the Minister for Business and Growth to introduce a code of good practice, so that consumers are offered variable-rate or deferred-amortisation mortgage loans only if they would be able to service a fixed-rate loan with amortisation. But the question is whether this will be a binding restriction, since I am told that you have previously introduced a similar rule yourselves. Time will show.

I am also pleased to note that the Danish Financial Supervisory Authority has decided to set up an expert group to look into the possibilities of dampening strong house price fluctuations. This will be a foretaste of the macroprudential work to be carried out by the new Systemic Risk Council. In connection with the study of the Danish housing market, Danmarks Nationalbank pointed out that the strong impact of house price fluctuations on the economy is inexpedient. At the time, Danmarks Nationalbank indicated a need to dampen future fluctuations by restoring the link between property value tax and current house prices and by phasing out access to deferred-amortisation mortgage loans for owner-occupied dwellings. I think you know what I mean.

Secondly, the need to pledge top-up collateral for covered bonds when property prices fall has given mortgage banks an extra obligation. This can be a challenge if new loans have been granted right up to the 80-per-cent threshold, especially if these loans are with deferred amortisation. At the same time, the rating agencies are imposing extra collateral requirements on the mortgage banks.

The working group on top-up collateral under the auspices of the Ministry of Business and Growth was established after Danmarks Nationalbank had pointed out the risks related to the need for top-up collateral. This group is to explore the opportunities for handling this requirement in an appropriate way. In this connection it is positive that the mortgage banks have taken specific initiatives and proposed solutions.

My third concern is the surge in adjustable-rate loans. I am not referring to the fact that the rate of interest may vary over the term of the loan, but to the way these loans are structured. This has created a refinancing risk because 30-year mortgage loans are based on short-term, often 1-year, bonds.

If a short rate fixation period is desired, the best option would be to discontinue the 1-year bonds in favour of, say, genuine variable-rate loans with longer maturities. Alternatively, if the auctions of the underlying bonds are spread, the refinancing risk becomes less concentrated.

We have called attention to this issue several times. In 2009, Danmarks Nationalbank concluded an agreement with the mortgage-credit sector to spread the refinancing auctions over the year. A number of initiatives have been taken in the three years since then. For example, new adjustable-rate loans are no longer offered with refinancing in December, and some mortgage banks have offered their borrowers to reschedule their refinancing free of charge. However, the figures show that several mortgage banks have in fact made little progress. The volume of refinancing in December is still far too high. That is not satisfactory.

So let me take this opportunity to encourage the mortgage banks to exploit the options available. These might include drawing attention to loan types that are less vulnerable to refinancing, or introducing differentiated administration margins to give borrowers the right incentives.

I suggest that we make a shared commitment to reduce the volume of deferred-amortisation loans and adjustable-rate loans with very frequent refinancing – and especially loans combining the two – within a few years. And we should also seek to spread refinancing of the remaining short-term bonds evenly over at least three annual dates.

Danmarks Nationalbank is of the opinion that the Danish mortgage-credit sector is systemically important. You are already subject to special legislation aimed at underpinning confidence in the mortgage-credit system at all times. The committee on systemically important financial institutions will be presenting its final report at the end of the year. I find that the SIFI committee provides a good opportunity to perform a service check to see whether this legislation ultimately contributes sufficiently and adequately to protecting mortgage bonds, also in connection with the new loan types.

This is the last time I have the privilege of addressing this assembly. So I would like to give you some advice – free of charge – or should we say without any fees?

For generations, Danish mortgage credit has been characterised by safety and predictability, often the same services – year after year – no surprises – a bit boring, in fact!

I think you would be doing yourselves and your customers a service if you strove once again to make mortgage credit a bit more boring – it should not be all that difficult.

Thank you for your attention and thank you to the Association of Danish Mortgage Banks for our smooth cooperation.