

**Speech by Governor Nils Bernstein,
Danmarks Nationalbank,
at the Annual Meeting of the Danish Bankers Association,
Monday 30 November 2009**

Check against delivery

The recession in the world economy seems to be over. Most OECD countries are returning to positive growth rates. World trade is slowly beginning to pick up again after its sharp downturn.

Turning to Denmark, we currently only have an overview of developments in the first half of the year. We still don't have a full picture of how things have evolved since the early summer, but in the assessment of Danmarks Nationalbank, Denmark is also gradually beginning to move out of the recession that set in around the turn of the year 2008.

It looks as if our aggregate output bottomed out in mid-2009 at a level of 7 per cent below the most recent peak in 2007.

Most forecasts show that the recovery will be slow, and in our assessment we will not be back at the 2007 output level until some time in 2013 at the earliest. The business sector has considerable spare capacity, and unemployment is therefore set to rise for another year or so.

Crucial factors will be consumer spending and the contribution from exports to growth. Right now the extensive stimulus packages launched in Denmark and abroad, as well as inventory adjustments, are the main factors that have halted the slowdown and are once again driving the economy forward. It remains to be seen whether this momentum will be self-sustaining once the stimulus packages and expansionary fiscal and monetary policies are phased out. The outlook for the coming years is particularly uncertain – much can go wrong – but we believe that the economy will gradually recover.

One of the current challenges is how to finance the large government deficits resulting from the expansionary fiscal policies in Denmark and abroad. If these policies are rolled back too late, fear of a debt spiral and inflation may push up interest rates. On the other hand, if they are rolled back too early, the financial markets may, once again, come under strong pressure. Further stimulus packages may be required.

This balancing act is very much about ensuring investor confidence in the sustainability of the future economic policy. Lack of confidence will cause interest rates to rise, which in turn could trigger a downward spiral of increasing budget deficits and interest costs. This risk could dampen growth, so we need to have a sustainable fiscal consolidation

plan. And a sustainable and credible plan requires agreement – not only on the objectives, but also on how to achieve them.

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Now that the financial crisis is receding, it makes sense to put the course of events into perspective – and to draw some lessons from these events. This has been the most serious financial crisis since the 1930s, and its causes will be the subject of many thick, academic volumes of economic literature.

At this point I can only say that a strong economic upswing in the USA, initially boosted by tax cuts and highly accommodative monetary policy, spread to the rest of the world. At the same time, the Chinese economy gained a more prominent role.

The US economy rode on a wave of optimism and a strong propensity for consumers to buy, while the Chinese economy gained strength thanks to impressive export growth and massive business investment. A very substantial US current-account deficit was to a large extent financed by surpluses in China and in the oil-producing countries, which profited from the strong growth in the world economy. The global financial system had access to ample and inexpensive liquidity. The hunt for profit took on many shapes, and risk appetite was strong.

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This also affected us here in Denmark. Being a small, open economy, we benefited from the international upswing. The ample supplies of liquidity in the international capital markets enabled banks to supplement traditional deposits with foreign loans for financing strong growth in lending. In addition to traditional corporate financing, this period was characterised by a boom in construction activity and refurbishment – not least in the housing sector. The favourable economic conditions also meant that transactions in the financial sector increasingly took on an international dimension, with acquisitions of banks to an extent not previously seen.

The mounting foreign debt burdens of many banks made the sector dependent on continued access to international liquidity.

The ample and inexpensive borrowing opportunities helped to fuel the upswing. The Danish upswing was driven by exports, private consumption and investment, while government spending also had a procyclical effect. The Danish economy reached its capacity limit towards the end of 2007, independently of the emerging financial crisis, and was already reversing when Lehmann Brothers collapsed in September 2008, sending shockwaves through the financial markets and triggering the economic crisis. The decisive financial blow came from abroad, but we had put ourselves in a vulnerable situation when the crisis struck. We cannot prevent new crises, but we can, and must, learn from experience.

Looking back over the last decade or so, it is evident that developments in the Danish property market amplified the economic fluctuations in both directions, thereby contributing to the difficulties we are now facing.

Danish house prices showed an almost constant upward trend from 1993 to 2007, particularly in 2005 and 2006. Until 2005, growth in property prices during the most recent upswing was to a large extent attributable to low interest rates – especially at the short end of the curve – deferred-amortisation loans, higher disposable incomes, falling unemployment and the tax freeze.

But the trend became self-fuelling. In the expectation that prices would continue to rise, new homes were purchased before the old ones were sold. Property became an object of speculative investment. Driven by expectations, combined with the economic upswing, prices of single-family and terraced houses soared by almost 25 per cent within one year from early 2005. The increase was even stronger in the Copenhagen area. A hike of that magnitude cannot merely be explained by the underlying economic conditions. Expectations also played a role.

The rising property prices added fuel to the upswing. Home equity increased, and consumers gained extra purchasing power. We witnessed a strong expansion in construction activities, with clear signs of overheating.

And last, but not least, lending growth was particularly strong for banks with large-scale commitments to the property sector.

It is characteristic that in the shadow of property-market developments activities took place that are now being investigated by the Danish fraud squad.

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The rollback of these imbalances has amplified the impact of the international recession. Declining property prices have not only affected the building and construction sector, but have also exacerbated the fall in consumption when compared with other countries. As regards the financial sector, it is worth noting that the ailing banks are primarily found among those that previously displayed the most aggressive lending policies in the property market.

What does this tell us?

In a market economy, crises can never be avoided. We must accept economic downturns from time to time. As a small, open economy we cannot guard ourselves against a sudden drop in external demand, reducing exports by almost 20 per cent in six months, as we have witnessed.

But we can seek to conduct economic policy that does not in itself amplify economic fluctuations.

We have not been good at that. During the upswing, our economic policy was procyclical, contributing to the upward trend.

Too little was done to curb it. You might say that we put the economy into a higher gear in a situation when it was already running at a high speed, thanks to factors such as a low level of international interest rates. And, overall, we gave the housing market in Denmark too much leeway.

It is the imbalances created in Denmark and abroad during the boom that have brought on the current situation.

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As you know, the government guarantee on all deposits with and loans to banks in Denmark will expire in just under one year. This scheme is the most extensive and necessary step taken in Denmark when the financial crisis really hit us in autumn 2008. Guarantees of this size must inherently be short-lived, and we must now prepare for the time after its expiry. Don't count on an extension of the scheme. It will be replaced by an increased deposit guarantee of kr. 750,000, and until the end of next year it will be possible to subscribe to guarantees for individual loans applying until the end of 2013. This deposit guarantee of kr. 750,000 will cover the vast majority of all private individuals making bank deposits.

The temporary guarantee scheme for individual issuances is essentially mainly available to large banks. Danmarks Nationalbank is aware that the sector is working on umbrella schemes that will enable several smaller banks to make joint issues based on government guarantees. Danmarks Nationalbank takes a positive approach to these initiatives and the possibility of accepting them as part of our collateral basis.

As far as we can see, larger deposits and other financing have to some extent made their way to some banks under cover of the general government guarantee. Some degree of adaptation must be expected when this guarantee expires. For the credit extension system overall, it is, however, important that the relevant financial institutions take timely action to procure financing elsewhere or reduce their lending surplus. The larger banks must take their share of responsibility for restoring the smooth operation of the money market. The financial crisis has clearly demonstrated that banking is not just another sector of the economy. In return for the extensive bank rescue packages I expect the banks to face up to their social responsibility and role and to contribute actively to the functioning of the markets without government guarantees.

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The future financial architecture in Denmark also involves the expiry of the legislation allowing "the Financial Stability Company" to acquire banks when the general government guarantee expires. As far as I can see, the government's acquisition of ailing banks has had the desired effect, i.e. banking transactions with traditional customers have, as far as possible, continued although share capital and other liable capital has been lost.

The Financial Stability Company should still be empowered to make acquisitions – but without any other guarantee than the statutory deposit guarantee. If the financial system is to function without excessive assumption of risk, not only owners of liable capital should potentially be exposed to losses – but also large investors and other unsecured creditors. What matters is not whether a bank will survive, but whether its activities will be continued. In future the Financial Stability Company should, in a specific situation, be able to carry out appropriate restructuring, taking the above aspects into

consideration. In future the sector should make regular contributions to the deposit guarantee scheme by way of insurance, and in such a manner that the bill for aggressive financial behaviour is footed by those responsible. Action should be taken in this area, with a view to introducing new legislation before the summer holiday so that the scheme can take effect when the current legislation expires next autumn.

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Finally, I would like to thank the retiring chairman and the Danish Bankers Association for good cooperation based on mutual trust in a difficult situation. I would also like to say welcome back to the newly appointed chairman. I look forward to continuing our fruitful cooperation.