

The spoken version is the final version

Annual meeting of the Danish Mortgage Banks' Federation 2009

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Thank you for inviting me to speak here today.

The economic outlook is still deteriorating. Global output is now expected to decline by more than ½ per cent this year. That may not sound so bad. But, in comparison, global growth was 5 per cent in the boom years. In Denmark, a decline in the range of 1½ per cent is expected for the second year running. International growth estimates are regularly adjusted downwards. There is a high degree of uncertainty, and it is impossible to say when the tide will turn. A few very recent indicators, mainly for the USA, are slightly more positive than they have been for some time, but it is still too early to talk of an economic spring.

All over the world, economic policies have been eased significantly. Policy interest rates are historically low in many countries, and fiscal policies are highly expansionary. This is also the case in Denmark.

The fiscal-policy initiatives taken in Denmark amount to kr. 20 billion in both 2009 and 2010. Relative to the size of the economy they are in line with those taken by many other OECD countries, but do not forget that unemployment in Denmark is one third of the OECD average. Government finances in Denmark are also more sensitive to cyclical fluctuations than they are in other countries, so that public expenditure and revenue automatically stimulate the economy more in a recession.

Nevertheless, unemployment is expected to rise for some time yet. Initially it is a question of restoring financial market confidence. That will have a positive effect on the real economy, including consumption, and then unemployment figures will probably begin to go down. We do not believe that unemployment will peak until early 2011. The economy must grow by 1-2 per cent to prevent a further increase.

The government balance showed a surplus of kr. 50 billion last year. Next year, a deficit of the same magnitude is expected. This is equivalent to a reversal of 5½ per cent of GDP. Just over half of the deterioration is attributable to the automatic stabilisers, while the rest is the result of the

decisions made. The government budget deficit means that there will, once again, be a need for net issuance of government bonds, following a period of debt reduction.

The expansionary economic policy is reflected in household finances. For those who do not lose their jobs, real disposable incomes will grow considerably in the current and coming year thanks to sizeable wage increases and tax cuts in 2009 and, particularly, in 2010. In addition, consumer prices are rising at a moderate pace, interest rates are receding, especially at the short end of the curve, and this year Special Pension savings will be released at a reduced tax rate.

Falling cash prices, rising disposable incomes and lower interest rates all ease the financial burden of buying a home. At the national level, the price of an average house as a percentage of disposable income has been falling over the past 18 months. This development will accelerate in 2009, and by year-end housing costs as a ratio of disposable income is estimated to be some 3-6 per cent lower than in 2008. The largest falls will be seen in the Copenhagen area and for short-term financing.

Under normal circumstances, rising income and falling interest rates exert upward pressure on housing prices. But the current situation is not "normal". The housing market has almost frozen with many homes for sale, slow sales and business volumes at a long-time low. The market is driven by negative expectations that overshadow the positive trend in the private finances of most Danes.

Expectations that cash prices will fall further can be self-fulfilling if people are hesitant to buy, and this pattern that can be difficult to break. Especially if unemployment is rising.

Those initially affected are people whose social circumstances change due to unemployment, illness, divorce or similar. Such events are often at the root of the observed rise in enforced sales. Nevertheless, the level remains low. Although the number of enforced sales can be expected to rise further in the near future, the current outlook for household finances does not point to an increase to the level seen in the early 1990s.

Combined with falling stock indices, lower housing prices have led to a reversal of the prolonged upward trend in household wealth, and a fall was seen last year. All the same, household wealth is still strong. The value of both assets and liabilities has increased over time, but what matters when it comes to the soundness of household finances is the difference between the two.

Last year, total wealth – i.e. the value of all assets, including pension savings, less the value of all liabilities – was 3½ times the disposable income. That is kr. 1.2 million per household on average, which is high in a

long-term perspective and higher than before 2003, when the most recent upswing began. Owner-occupied housing accounts for approximately half of all household wealth, while shares make up an estimated 15-20 per cent, including shares owned indirectly by way of pension savings.

Overall, the finances of Danish households are therefore still sound, not only because of the capital gains reaped during the upswing, but also because net savings have been positive for a long time – in the range of 5-10 per cent of annual disposable incomes. This prudence pays off now that the economy is moving in the opposite direction.

But the fact remains that some people may find themselves in a fix. The fall in housing prices means that an estimated 110,000 Danes have debt-to-value ratios exceeding 100 per cent – they are "technically insolvent" and thus at risk if incomes go down or they are otherwise forced to sell their homes.

Let me now turn to the financial markets.

All European markets for mortgage bonds were affected by the financial turmoil after Lehman Brothers had filed for Chapter 11 in September last year. Attention suddenly focused on the credit risk on mortgage bonds. The yield spread between mortgage and government bonds widened in Denmark and in comparable countries.

The initiatives taken to support the Danish pension sector at the end of October curbed the widening of the yield spread between mortgage and government bonds, which returned to the level just before the Lehman Brothers episode.

Adjustable-rate loans account for a large part of the Danish mortgage market. For the lion's share of these loans, the rate of interest is fixed in December. The financial turmoil in the autumn demonstrated all too clearly that there is a considerable risk for both borrowers and issuers if interest rates are fixed only once a year. Danmarks Nationalbank is in favour of spreading issuance of adjustable-rate loans to other months than December.

Developments in September and October 2008 showed that at times it is necessary to intervene to support the krone. In such situations, the foreign-exchange reserve serves as a buffer that allows Danmarks Nationalbank to maintain a fixed exchange rate against the euro.

In addition to intervening in the foreign-exchange market, Danmarks Nationalbank raised its policy interest rates. At the time, risk aversion in the markets was high, so a given increase in interest rates had a smaller impact than it would normally have.

On the basis of the lessons learned from the crisis we believe that we will need to maintain a larger foreign-exchange reserve than in recent years.

Nevertheless, it should be borne in mind that our target is to keep the exchange rate stable. The foreign-exchange reserve is one of the tools for observing this target, and its size depends very much on its buffer function.

The foreign-exchange reserve has to some extent been increased by raising sovereign loans in foreign currency, but market conditions have also allowed Danmarks Nationalbank to buy foreign exchange.

Later this year, the legislation on covered bonds – or SDOs, as we call them in Danish – will be reviewed on the basis of the experience gained. It is important to take into account what the financial crisis has taught us and to perform a thorough analysis. It is still too early to draw any firm conclusions as regards potential amendments.

In this context, it may be useful to outline some of the preliminary observations from the financial crisis that seem to be particularly relevant.

Firstly, access to capital may be limited when the need is greatest.

Secondly, house prices may fluctuate strongly and have to some extent been driven by innovation in the mortgage market.

Thirdly, if the problems reach a systemic level, they no longer affect only lenders and borrowers, but become problems to society as a whole.

In its 2007 consultation response concerning SDO legislation, Danmarks Nationalbank indicated that it preferred a robust and simple model and that the upper loan-to-value limit for residential properties was set at 70 per cent at the time that the loan was granted and not subsequently raised. Since the loan-to-value ratio may not exceed 80 per cent, a substantial buffer is required. Experience with a scarce supply of capital when the need is greatest, combined with the drop in property prices, may warrant an even greater margin.

The launch of covered bonds means that credit institutions must restore the underlying collateral if house prices fall. This has introduced a risk in the Danish mortgage system that did not exist previously – a risk that has been accentuated by the financial crisis. Danmarks Nationalbank finds it important to consider this aspect carefully when reviewing SDO legislation. After all, government guarantees do not last forever.

Late in the SDO legislation process a deal was struck whereby SDO loans can be redeemed at par. This provision has limited the scope for product development, and as such it is worth preserving. Under the traditional Danish mortgage system, mortgage loans are redeemable at around par. This

is a good arrangement, which safeguards consumers against unpleasant surprises. A sound mortgage system must have a high degree of consumer protection. It is good to know that Danish consumers have not been offered loans with an artificially low initial rate of interest and a correspondingly higher rate later on.

The fact that capital may be most difficult to obtain when you really need it is something that the financial sector should keep in mind now that the government is offering a supply of risk capital. It would be wise to have extra large buffers against losses and to employ the capital received in a sufficiently flexible manner. The financial sector should remember that society has now lent it a hand twice. The reason is that this sector is not just another business sector, it also fulfils an important role in society. This role should be at the core of any decisions on capital injections in the near future. The way the sector has acted – both before and during the financial crisis – must naturally be a key consideration when the new regulatory regime is laid down.

We are living in turbulent times. We have yet to reap the benefits of the financial sector rescue packages launched all over the world, and the real economic prospects are bleak. Nevertheless, I think we can say that the Danish system for financing real property has steered through the crisis fairly well when we look at the situation in other countries. Throughout the rough period it has been possible to obtain mortgage loans. True, conditions have been tightened, but the mortgage system has risen to the challenge. There are many good reasons for this, but I will not go further into that.

Thank you for your attention.