DANMARKS
NATIONALBANK

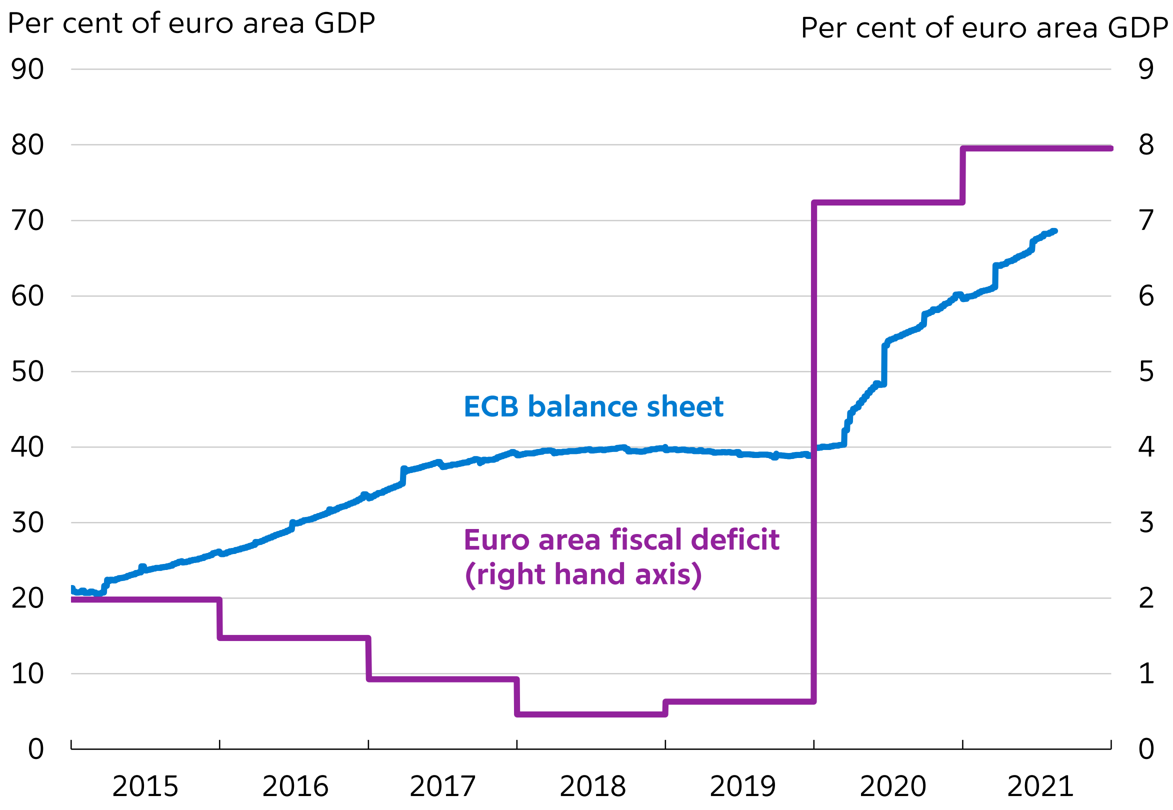
Central banking and dealing with the enduring impact of Covid-19

Signe Krogstrup, Governor, Danmarks Nationalbank
27 September 2021

DANMARKS
NATIONALBANK

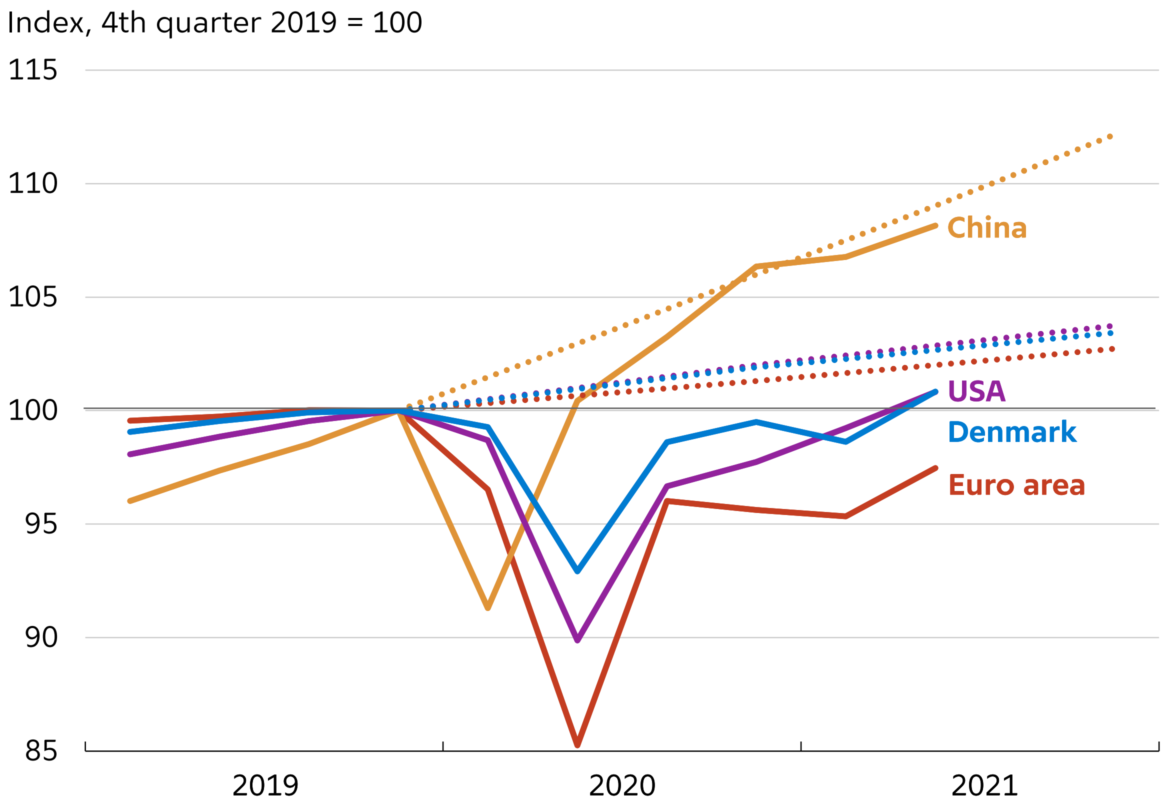
Forceful economic policy responses support the economy – strong recovery, but with bumps

Central bank and fiscal response in euro area



Source: Macrobond

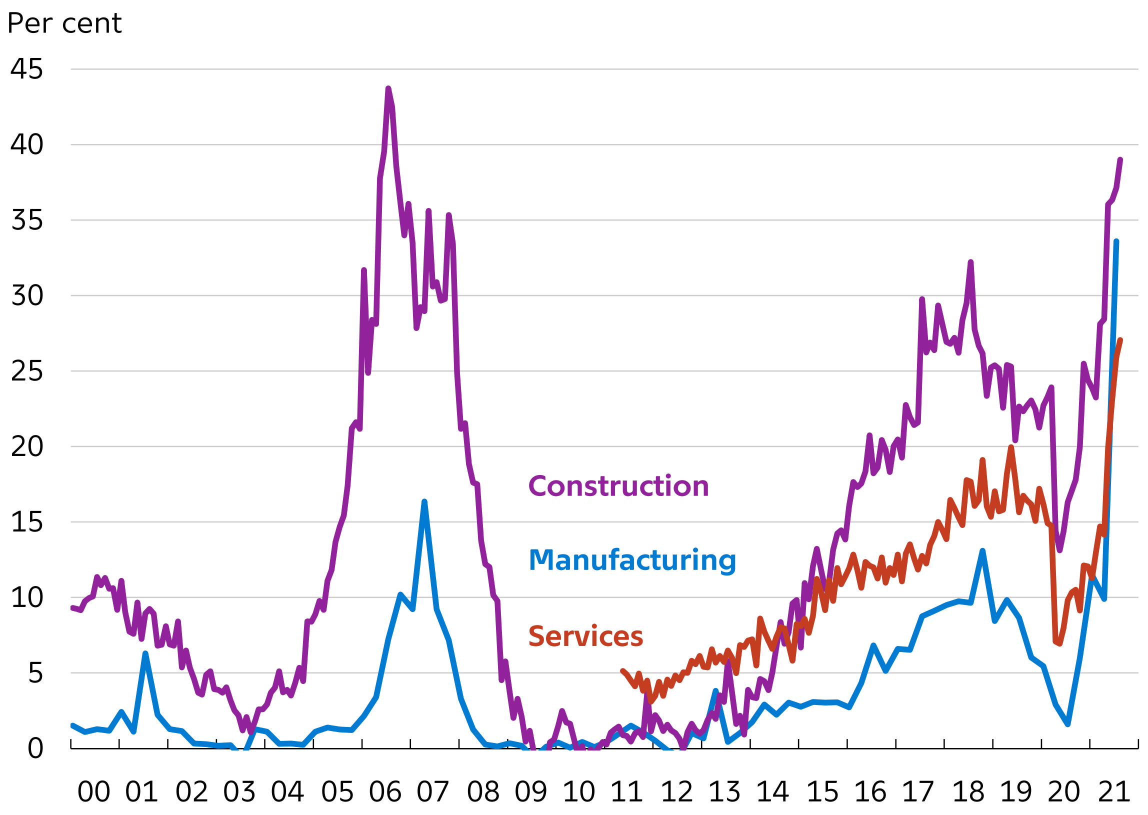
Quarterly development in GDP



Note; The dotted lines indicate the IMF's forecast from January 2020 before the coronavirus outbreak.
Source: Macrobond, IMF and own calculations.

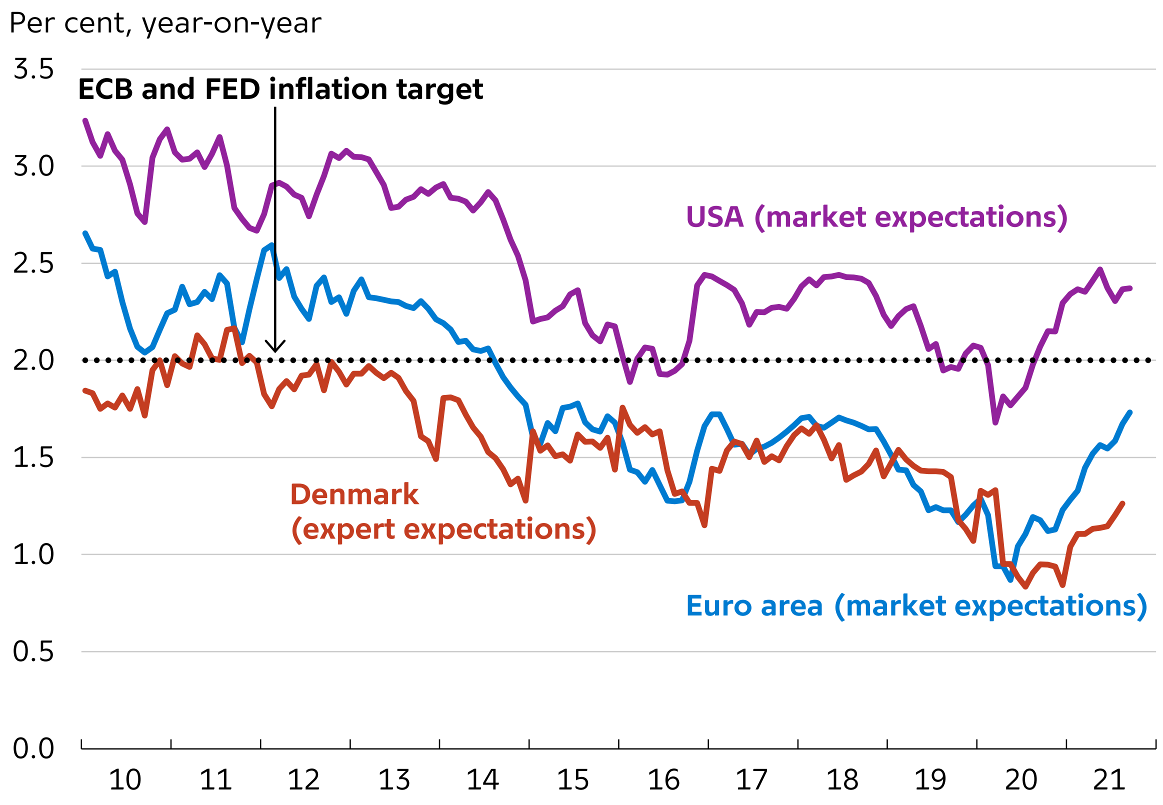
Inflation – will the labour market recovery and bottlenecks entail price pressures?

Labour shortages in Denmark



Source: Statistics Denmark and own calculations.

Inflation expectations



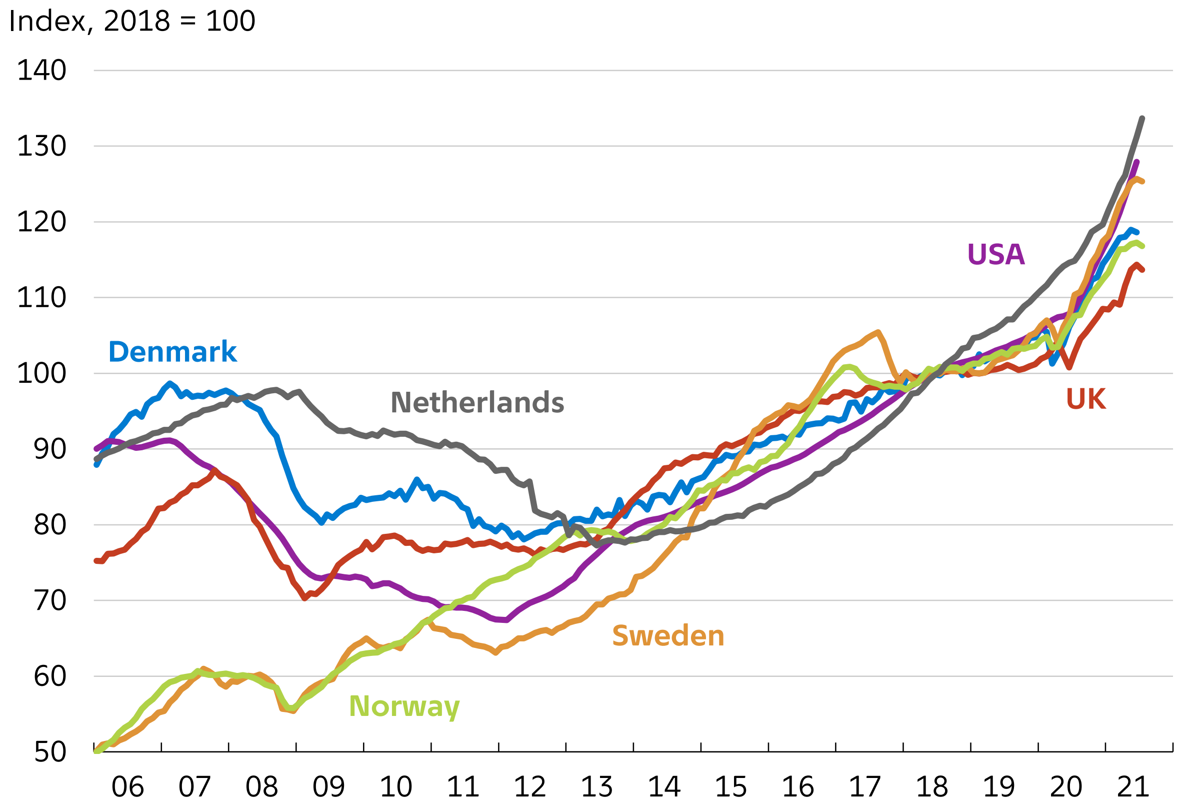
Note: Expert expectations is consumer price growth in the next calendar year from consensus. Market expectations is 5y-5y.

Source: Consensus, Thomson Reuters and own calculations.

DANMARKS NATIONALBANK

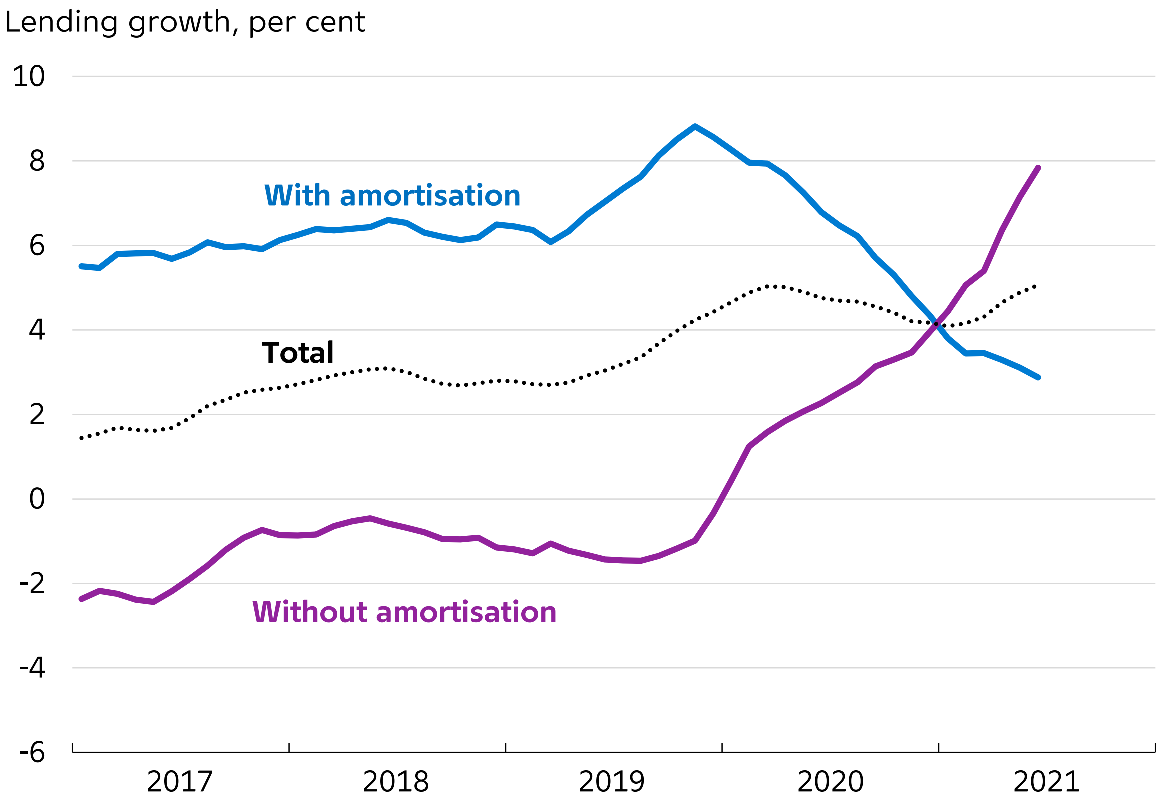
Asset prices – need for macroprudential policies to mitigate risks to financial stability?

Surge in house prices in Denmark and other countries



Note: Nominal housing prices, seasonally corrected.
Source: Macrobond and own calculations.

Growth in mortgages without amortisation in Denmark is a risk to financial stability



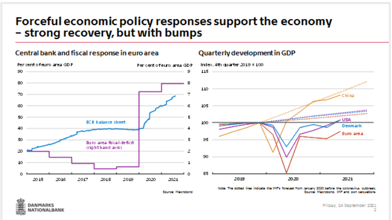
Note: Mortgages on owner-occupied dwellings and summer cottages of Danish households.
Source: Danmarks Nationalbank

Thank you

BACKGROUND

NOTES FOR GOVERNOR SIGNE KROGSTRUPS PANEL SPEECH AT BANGKO SENTRAL NG PILIPINAS AND REINVENTING BRETTON WOODS COMMITTEE (BSP-RBWC) INTERNATIONAL RESEARCH CONFERENCE ON "SHIFTING GEARS, CHANGING LANES: CENTRAL BANKING IN A POST-COVID ECONOMIC WORLD", 27 SEPTEMBER 2021

CHECK AGAINST DELIVERY



Slide 2

Forceful policy response supported the economy

- Both central banks and governments acted forcefully to counter the negative impact on the economies from covid-19.
- Significant fiscal policy stimulus across advanced economies.
  - Both automatic stabilisers and discretionary spending.

For central banks, policy responses aimed to reduce tail risks and secure market functioning in distressed times

- An important tool was asset purchases since monetary policy rates were already low or negative.
- Focus has now shifted to steering broader financial conditions.

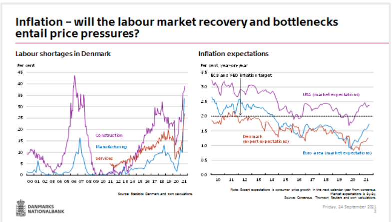
Monetary policy in Denmark

- A special case due to our fixed exchange rate regime.
  - Monetary policy is solely aimed at securing the stable exchange rate in a tight band to the euro.
  - Increased interest rate by 15 bps during the financial turmoil to counter selling pressure on the Danish krone.

- To reduce risks to the financial system and thus the broader economy
  - Offered liquidity to the banking sector in both dollars, euro and a special 3-month lending facility in Danish kroner.

Activity and labour markets have recovered (surprisingly) rapidly in Denmark and other advanced economies

- The crisis was a "true" exogenous shock.
  - Not due to unravelling of imbalances in the economy.
  - No resulting financial distress (also prevented through the policy response).
- Large uncertainties and risks of bumps.
  - The economic development after the pandemic is uncertain; there is no precedent.
  - The virus is still here and supply obstacles remain.
  - Large private savings can fuel an overheating of some economies.



Slide 3

Are we looking into a longer period of higher inflation? Not clear

- Increased pressure on labour markets.
- Supply chain bottlenecks.
- Increases in commodity and production prices.
- Headline inflation rates have picked up.
  - Largely due to temporary conditions so far.
    - E.g. fluctuations in energy prices and changes in taxes and duties.

The underlying price pressures remain subdued

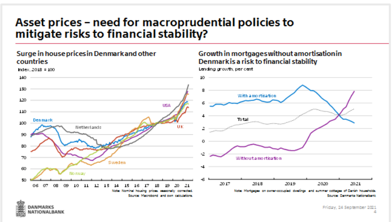
- Core inflation with constant taxes remains subdued in Denmark.
- External factors such as higher prices for raw materials and freight have mainly had a temporary impact on Danish price developments.
- Greater effect on wage formation needed for larger and persistent impact on core inflation.
- Well-anchored medium-term inflation expectations reduce risk of second-round effects.

The picture is broadly similar in the euro area

- Moderate underlying price pressures in the euro area.
- More prevalent price pressures in the USA, but the Fed expects these to be temporary.
    - However, risk that more policy stimulus and tighter capacity constraints may create more sustained inflationary pressure in the USA.

Likely that interest rates will remain low in Europe in the foreseeable future

- While there are currently risks to the upside, inflation rates are likely to remain low.
- Real interest rates will likely remain low.
    - The virus has not changed many of the structural drivers of low real interests rates.
    - For example the savings implications of aging populations and inequality.



Slide 4

Supportive macroeconomic policies, accommodative financial conditions and corona-related restrictions on consumption all contribute to propping up asset markets

- Equity prices have risen in advanced economies and in Denmark.
    - The equity risk premium has been falling the last couple of years, but is still higher than before the global financial crisis.
- Particularly strong real estate price growth during the pandemic across developed countries.
    - Shift in preferences for housing during the pandemic: lockdowns and restrictions have meant that households have spent significantly more time in their own homes.
    - Growth rates have slowed down lately in some countries, but – at least in Denmark – levels of trading activity are high and the housing supply remains low.

In Denmark, housing market fluctuations play a key role in amplifying business cycle fluctuations

- E.g. a build-up of vulnerabilities in mortgage credits prior to the global financial crisis – notably due to widespread use of interest-only loans – amplified a boom-bust episode.
- Currently, persistent low interest rates allow homeowners to take on very high levels of debt compared to their income.
- Partial tax deductibility of interest expenses related to mortgages further amplifies incentives to take on debt.
- While rules that limit LTVs and access to interest-only loans have been put in place, loans without amortisation are still widespread and increasing among the most indebted households.
- Historical experience as well as empirical evidence suggests that widespread use of loans without amortisation may result in negative externalities at the macro level – and thus systemic risks.

With low interest rates, macroprudential policy measures can prove useful in some circumstances to guard against tail risks

- Is the timing right? We believe the currently strong economic developments make for good timing when it comes to strengthening the robustness of economies to financial fluctuations.
    - It is better for both the economy and individual households to build up resilience during an upswing than during a downturn.
- We see two measures as appropriate for strengthening the resilience of the Danish economy vis-à-vis housing market fluctuations:
    - A restriction of Danish homeowners' access to new mortgage loans without amortisation if the loan-to-value (LTV) ratio of their home exceeds 60 per cent.
        - A key purpose is to increase the resilience of homeowners – and the Danish economy – to falling house prices, increasing interest rates and other negative economic shocks that may impact the individual homeowner or the Danish economy more generally.
    - A reduction of the tax deductibility of interest payments on mortgages.
        - To reduce incentives for household balance sheet expansion and associated vulnerabilities to house price fluctuations.