SPEECH

Governor Lars Rohde's speech at the Distinguished Speakers Seminar convened by the European Economics and Financial Centre

DANMARKS NATIONALBANK

23 November 2021

CHECK AGAINST DELIVERY

OVERCOMING THE CHALLENGES OF THE PANDEMIC: PERSPECTIVES FROM DENMARK

Good afternoon. It is an honour to join the European Economics and Financial Centre once again. In my remarks today, I will share my thoughts on why the Danish economy has fared relatively well through the pandemic so far – with emphasis on "so far". As we speak covid-19 cases are rising and Europe is once again at the epicentre of the pandemic. Although, the greatest challenges for economic activity are most likely behind us, we are still experiencing quivers from the pandemic.

With that in mind, I will point out the key factors that shape the outlook for the coming years.

Then, I will spend some time on developments in the housing market. Like in many other countries, house prices in Denmark have surged during the pandemic. Highly unusual, considering how economic activity at the same time has been on a roller-coaster.

Finally, I will touch briefly upon the fixed exchange rate regime. The pandemic has been a reminder of how the violin of monetary policy plays in a peg, and what responsibilities this puts on other economic policies.

THE DANISH ECONOMY DURING THE PANDEMIC

The pandemic was a swift and massive shock. It hit economies all over the world simultaneously, and plunged the global economy into the deepest recession since the Second World War. Over the course of 18 months, we have seen severe contractions followed by rapid recoveries.

But despite a coinciding shock, economic developments have been uneven across countries – even across Europe. Why? The answer is not clear-cut. We have seen large differences between North and South European countries; between services and goods producers; between digitalised and non-digitalised economies; and not least between countries with high vaccination rates and low vaccination rates.

In Denmark, the economy has fared relatively well through this challenging time. The fall in activity last year was milder than what many of our peers experienced. Going into the summer of 2021, Denmark was one of few European countries with activity and employment levels already higher than before the pandemic.

It is natural to ask: Are there big lessons to be learned from this small country? If so, I believe there are three main takeaways.

First of all, at the outbreak of the pandemic, the virus was less widespread in Denmark than in some of the bigger European countries. Early and effective government measures limited the initial wave of infections. Danes – in all modesty – have behaved responsibly. In general, Danes have high confidence in and abide by the rules of society for instance measured by global governance indicators. This allowed for shorter and less restrictive lockdowns compared to many other European countries. For example, we did not impose curfews and we did not shut down factory productions during lockdowns.

Second, swift and comprehensive policy measures leaned against lurking recession prospects from early on. Globally, fiscal and monetary policy has been sufficiently accommodative. Domestically, relief packages and liquidity measures have mitigated the economic downturn enabling activity to return quickly as restrictions were eased and the population vaccinated.

Let me just briefly dwell on the Danish policy response. Widespread wage compensation allowed Danish firms to limit layoffs. This kept employees and employers tied together, limiting the loss of human capital.[1] At the same time, liquidity measures kept many firms afloat when lockdowns were imposed. Today, the exposure to government liquidity support is limited.[2] In an international context, this might reflect, among other

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1 See Mikkel Bess and Saman Darougheh, Three lessons from the Danish wage compensation scheme, *Danmarks Nationalbank Economic Memo*, No. 5, August 2021.

2 See Danmarks Nationalbank, Banks ready for expiry of government liquidity support, *Danmarks Nationalbank Analysis*, No. 10, May 2021.

things, that Danish firms had deleveraged quite substantially since the financial crisis 10 years earlier. They were simply more resilient.[3]

The third lesson to me, is that withstanding sudden shocks is often easier when your balance is right. The Danish economy was in good shape leading up to the pandemic. It was operating moderately above its potential but not overheating. Households had to a large extent deleveraged since the financial crisis. Macroprudential policies had been implemented to better safeguard home-owners and the macroeconomy from house price developments. Labour market reforms had facilitated an expansion of the labour force. Public debt was among the lowest in Europe after years of fiscal discipline. By way of explanation, the financial scope for dealing with the crisis was quite large in Denmark. Or to use the words of former Bank of England Governor Mark Carney, Denmark was not – contrary to the UK – reliant on the kindness of strangers to finance a large current account deficit.

I will also add that the situation with no substantial macroeconomic imbalances in Denmark stands in contrast to the years before the financial crisis.

The backdrop of this economy, performing moderately above its potential, is a combination of distinct characteristics. Characteristics that also helped the economy keep its balance better than others. A few examples. The Danish business structure depends little on tourism and more on exports that are less cyclical. This dampened the fall in foreign demand when the pandemic hit. [4] This stands in contrast to countries in the south of Europe that rely more on tourism. The Danish labour market is characterised by its flexibility. This allowed labour to adapt to health restrictions.[5] This stands in contrast to some of the big European economies where labour markets are less flexible. And lastly, the Danish economy is highly digitalised. This was a crucial precondition for adapting to the pandemic.[6] This stands in contrast to some countries in Eastern Europe.

In particular, I believe that the degree of digitalisation is important.

These past 18 months have shown that highly digitalised economies have coped better with the pandemic. More digital economies have been able

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3 See Alexander Meldgaard Otte, Carina Moselund Jensen, Nastasija Loncar and Rasmus Mose Jensen, Lower borrowing needs in Danish corporations compared to European during COVID-19, *Danmarks Nationalbank Analysis,* No. 20, October 2020.

4 See Adrian Michael Bay Schmith and Helle Eis Christensen, Large drop in Danish exports but the composition might ease the fall, *Danmarks Nationalbank Economic Memo*, No. 8, June 2020.

5 See Mikkel Bess, Pernille Valentin Borgensgaard and Thea Thalia Iuel, The labour market is recovering after historically severe setback, *Danmarks Nationalbank Economic Memo,* No. 13, September 2020.

6 Amy Yuan Zhuang, Digitalised economies have performed better during the pandemic, *Danmarks Nationalbank Economic Memo,* No. 6, August 2021.

to ensure a higher degree of economic continuity by moving shopping online and maintaining work efforts from home offices. In this context, the digital infrastructure in Denmark is strong, and the digital skill level of the population high. This has helped us through the pandemic.

I admit that I am painting a bright picture of the Danish economy. Please remember that the pandemic has still had severe impact.

THE OUTLOOK FOR THE DANISH ECONOMY

This leads me to the current state of the economy and its outlook for the near future. The Danish economy is already now operating above its potential. Activity in the 3rd quarter was 4 per cent higher than before the pandemic. Over the coming years, we expect the economy to find a balanced trajectory around the same capacity as projected before the pandemic.

The road to get there is bumpy to be honest. Lockdowns and changed behaviour across the world have resulted in major shifts in global production and demand. The repercussions are still affecting the global economy today.

High demand for goods, together with production and transport disruptions, has led to increasing pressure in several places. Interruptions in supply chains are widespread in both the Danish and international economies. We are currently witnessing long delivery times, higher commodity prices and soaring freight rates across the world.

But let us first turn to the present circumstances of the Danish economy. The current expansion has taken place on the back of phasing out of restrictions related to the pandemic and reopening of society. It has been strengthened by a brightening outlook on export markets and confident consumers at home.

Private consumption has increased substantially. And consumption patterns of Danes have returned surprisingly quickly to their previous contours. A swift recovery and sudden regain of employment have put pressure on the labour market. The unemployment queue has shortened and business is increasingly flagging labour shortages as a challenge. This is despite the fact that the labour market participation rate is actually higher than before the pandemic in Denmark. It is fair to say that the Danish labour market is tight.

In many ways, the Danish economy seems to have caught a head start in the business cycle compared to many European countries.

Pressures are feeding through to prices. Consumer price inflation in Denmark has risen quite sharply lately, similar to many other countries.

Inflation has been subdued for a long time but picked up to 3.2 per cent in October, its second month in a row above 2 per cent.

I believe – and I will argue why – that the current pressures on the Danish economy are generally transitory. Although that must be followed by a word of caution. Navigating through this pandemic is uncertain and untried.

The scope of the current pressures is hard to predict. Pressures may very well persist longer than first anticipated, leaving a greater mark on economic activity and prices. To this point, I note that international institutions have repeatedly extended the prospects of these.

What are then the arguments for a transitory nature of pressures?

Let us begin with inflation. Inflation has been low for a long time. Recently, surging energy prices have pushed up consumer prices. In addition to this, Denmark has implemented higher taxes on tobacco currently boosting inflation.

These driving factors are expected to have a transitory effect on consumer price inflation. Forward rates suggest that energy prices are expected to come down next year.

In fact, if we look through tax changes and price developments for energy and food products, the underlying price pressure remains subdued. Core inflation is at 1.2 per cent.

Meanwhile, disruptions to supply chains have increased producer prices during the pandemic. In Europe, there has only been a limited spillover to underlying consumer prices. However, over the coming year, producer price inflation will most likely offset some of the drag from energy prices. Still, for more lasting effects on inflation, the pressure must be reflected in inflation expectations and wage formation[7]. And so far, we are yet to see this.

Let us then turn to bottlenecks in global production. The transitory nature of disruptions to global value chains are hard to predict. In line with most international organisations, we expect disruptions to fade, but leaving traces well into 2022. Business will in time work its way through backlogs of delayed deliveries as demand patterns across economies approach pre-pandemic contours. We have seen such normalisation of

[7] The wage growth rate in the private sector stood at 3.2 per cent year-on-year in the 3rd quarter of 2021. Even though wage increases in the 2nd and 3rd quarter of 2021 were at their highest since the late 2000’s, they have still not been markedly above the collective wage agreements for the private sector that were agreed before the pandemic

demand patterns in Denmark already, and there are signs that this will follow in the rest of Europe and the USA in the coming time.

Finally, to the labour market. Current labour shortages are likely to reflect that many firms need to re-employ in the wake of reopening society. In the main scenario of our projection for the Danish economy, we expect recruitment challenges to ease as positions are filled, and testing and vaccination efforts are scaled down. At the same time, there are still people outside the workforce who can step in. In the short term, the influx of foreign labour will help to alleviate pressure. In the longer term, labour market reforms continue to increase the labour force.

Worker flows and job-to-job mobility are high in Denmark – also across economic sectors. This flexibility has served the Danish economy well for decades. And it will also help alleviate pressure on the labour market going forward. However, I will repeat that emerging from the pandemic is uncertain and untried. As we speak, testing efforts in Denmark are being upscaled once again. This may sustain the labour market pressure for longer.

It is not all transitory though. Activity in the manufacturing industry and in construction has been high during most of the pandemic. Labour shortages here are widespread too, and recruitment challenges could increase the wage pressure over time. In this context, wage increases sound like a bad thing. But let me just add that wage pressure is at the core of the mechanism in a market economy. It ensures that less competitive firms exit and that new more competitive ones enter.

During the pandemic, the risks to economic outlooks have generally been much more pronounced than usual.

The future course of the pandemic remains decisive for the outlook of any economy. Vaccination rates differ quite substantially across countries, and new variants of the virus can quickly worsen prospects – the current surge in covid-19 cases across Europe serves as a dim reminder. This balances the distribution of risks to the outlook for the global economy.

For the Danish economy, we assess the distribution of risks to be tilted to the upside. This reflects that there are preconditions present for overheating of the economy.

Household savings and wealth have risen significantly during the pandemic, as both home equity and stock prices have increased markedly. The accumulation of wealth enables households to raise consumption substantially. Our main concern is a scenario where households tap in to equity, leveraging themselves to increase consumption, which in turn is likely to lead to overheating of the economy.

Yet, several conditions make us believe, that accumulated wealth will be consumed gradually, and not overshoot initially. First of all, large parts of wealth increases are tied to home equity and pension funds. These are less liquid asset classes. Second, academic literature suggests that service consumption does not catch up on foregone spending after demand driven recessions.[8] In its most simple terms, haircuts do simply not double as an expansion sets in.

I will argue, that the conditions described above justify a main scenario with a balanced upswing. But we are following developments closely, and are very aware of the upside risk. Later in my remarks, I will touch upon the ability of the economy to adapt to an output trajectory that implies more persistent pressure than our main scenario.

GAUGING DEVELOPMENTS IN THE HOUSING MARKET

I will focus my next remarks on the housing market. The pandemic has brought with it many surprises in terms of economic developments. The housing market has been one of the biggest.

The pandemic fuelled the broadest global house price boom in decades. As the economy deep-dived into waters of uncertainty, and economic activity fell at unprecedented speed, house prices in almost every major economy accelerated. Going into this summer, prices in Denmark had increased 17 per cent year-on-year on average.

There were of course fundamental forces stimulating house price growth. Interest rates had been low and falling up to the pandemic. Household incomes had been supported during the pandemic by various relief packages. Still, house price increases were substantially higher than what these factors could explain according to macroeconomic models.[9]

If we have to offer an explanation, we would point to a general increase in preferences for housing during the pandemic. This goes both for the Danish experience and when looking across developed economies. A range of factors pointed that way. First of all, Danish households have had relatively large consumption of housing-related goods and services during the pandemic. Restrictions made a range of services inaccessible, leaving consumption suppressed. This may have directed consumption to

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8 See, for example, M. Beraja and C. Wolf, Demand Composition and the Strength of Recoveries, Massachusetts Institute of Technology, mimeo, 2021, and N. G. Mankiw, 1982, Hall's Consumption Hypothesis and Durable Goods, Journal of Monetary Economics (10), pp. 417-425, 2021

9 See Adrian Michael Bay Schmith, Jesper Pedersen, Simon Juul Hviid and Simon Thinggaard Hetland, Housing market robustness should be strengthened, *Danmarks Nationalbank Analysis*, No. 16, June 2021.

housing. Second, frontier academic literature suggested that working from home in itself increased homeowners' preference for their homes.[10]

The course of house prices going forward is naturally still affected by interest rates and incomes. But the increased preference for housing will be equally important for house price developments in the years to come. Not surprisingly, there is significant uncertainty about preferences. We simply do not have an adequate experience base.

Assessing the vulnerability of the housing market has made Danmarks Nationalbank call for action. Let me reflect on why.

Our call for action is not related to the recent surge in prices as such, but to the general structures and in Denmark, some politically decided structures weigh on the robustness of the housing market. These structures have stimulated price increases before and during the pandemic, instead of stabilising them. This leaves the economy vulnerable to spillovers from the housing market. Let me just emphasise that most of the severe economic setbacks has originated from problems in the housing market. The main risk runs through a collateral channel, as household spending tends to be affected by home equity shocks.[11] The bigger the shocks, the bigger the spending effect, which in turn affects household leveraging.

In particular, we have conveyed three recommendations to improve structures.

First and foremost, the current housing taxation in Denmark contributes to reinforcing housing market fluctuations. A tax reform has already been passed in Parliament but its implementation has been deferred to 2024. It is key that it is not postponed further. The proposed reform will re-enact housing taxes as an automatic stabiliser, and strengthen robustness.

Second, interest-only mortgages in Denmark are widespread and we have seen a significant movement further in this direction, with interest-only mortgages making up more than 50 per cent of new loans in the 2nd quarter of 2021. An amortisation requirement for the most indebted homeowners will generally reduce the vulnerability of the Danish economy to large housing market fluctuations.

And third, the current level of tax deductions for households' interest expenditures in Denmark incentivises homeowners to take on debt.

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[10] See Morris A. Davis and Andra C. Ghent, The Work-from-Home Technology Boon and its Consequences, NBER Working paper, April 2021.

[11] See Henrik Yde Andersen and Søren Leth-Petersen, Housing wealth or collateral: How home value shocks drive home equity extraction and spending, Journal of European Economic Association, February 2021, or Simon Juul Hviid and Alesssia De Stefani, Housing collateral and home-equity extraction, Danmarks Nationalbank Working Paper, No. 135, February 2019.

Bringing down deductions will reduce the risk of building up large imbalances and increase the robustness to housing market fluctuations.

Unfortunately, the rule of thumb politically seems to be that it is never the right time to fix housing market structures. Nevertheless, I have made my opinion on this topic very clear.

THE PANDEMIC AND THE PEG

My final remarks will centre on a story of a new acquaintance and an old friend of mine – the pandemic and the peg.

Next year, we will celebrate the 40^{th} anniversary of Denmark's fixed exchange rate regime. The peg against the deutsche mark – which later became the peg against the euro – was introduced on the backdrop of an unsustainable macroeconomic situation in Denmark. The unemployment rate, the government deficit and the foreign debt were all scoring double digits. With competitiveness struggling, repeated devaluations made for quick but short-sighted solutions during the 1970s and early 1980s. But all they brought was higher inflation and higher interest rates.

In September of 1982, a joint statement from the incoming government and the central bank turned a page in bringing this policy of repeated devaluation to an end. Back then, it did not receive much attention. But looking back, that one-page statement marked the beginning of a fixed exchange rate policy that we have been pursuing ever since.

The rest is history. Today, the peg is viewed as a cornerstone of the Danish economy. It has served the Danish economy well and it has proven to be resilient – even during economic and financial crises along the way.

The fixed exchange rate policy aims at keeping the krone stable against the euro. The main objective of monetary policy in the euro area is to keep inflation close to 2 per cent. So, in this light, pegging the krone to the euro provides a framework for low and stable inflation in Denmark.

Our reaction function is consistent and concise. If the exchange rate tends to deviate from the central parity, we initially intervene in the FX market by either buying or selling kroner against foreign currency. If this is not sufficient, and pressure on the krone persists, the next step is to change policy rates.

The peg to the euro implies that Denmark mirrors the monetary policy of the euro area. That is why you would often argue that the success of a peg depends on a high degree of business cycle synchronisation. And that is – to a large extent – the case for Denmark and the euro area.

However, even if that was not the case, literature[12] suggests that the monetary policy regime might actually not be that important for stabilisation of business cycle fluctuations. This is due to a high degree of financial and economic globalisation. The existence of a global financial cycle makes it hard – no matter the regime – to conduct independent monetary policy, because we will import a global interest rate set by large central banks such as the US Federal Reserve Bank.

In any case, as independent monetary policy is set aside, other economic policies must take on responsibilities. To the extent necessary, the need to stabilise the business cycle in Denmark must then go through fiscal policy or other economic policies. Fiscal policy must provide economic stability at all times – preventing both overheating and deep recessions.

During times of pressure in the FX market, such as that brought by the pandemic, we are reminded of the mechanics of a fixed exchange rate regime. The sole focus on the peg implies that Danish monetary policy risks are procyclical. For instance, we increased interest rates in March 2020 at the outbreak of the pandemic. And then we lowered rates two months ago with the economy heading back towards a boom. To be honest, I understand why outside commentators might raise their eyebrows looking at this policy response.

As mentioned earlier, the Danish economy is already now operating above potential. We are seeing considerable pressure in the labour market. Still, our policy recommendation for fiscal policy is that the government should stand ready to tighten its economic policy by more than already planned. There is still room for the economy to absorb greater capacity pressure. For a number of years, the Danish economy has been characterised by large savings surpluses. Both households and firms on aggregate have large wealth.

The Danish economy is fundamentally sound, and competitiveness is strong. That is why – in our view – the economy can cope with a period of higher capacity pressures. That is, even though it weakens competitiveness moderately – with wage increases being higher in Denmark than abroad – and thereby reduces the large current account surplus.

Since the 1990s, the current account of Denmark's balance of payments has shown a surplus. We have in fact gone from being a net debtor nation to a net creditor nation – with net foreign assets increasing from -35 per cent of GDP to +80 per cent of GDP. In some sense, the economic situation today seems to be the contrary to that of 1982 – back when the

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[12] See Hélène Rey, Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence, *CEPR Discussion Papers*, No. 10591, 2013.

peg was introduced. The Danish current account surplus today is 8 per cent of GDP. To put that number into perspective, UK would be able to invest in 160 of the 2007-renovations of Wembley Arena – every year.

Please do not mistake my point, when I say there is room for some capacity pressure and a reduction of the current account surplus. We have no target for how large – or small – the current account surplus should be. It merely reflects the sum of all households', firms' and the public sector's savings and investment decisions.

CONCLUDING REMARKS

So, to conclude. The Danish economy has fared relatively well during the pandemic for a number of reasons. The health crisis has been milder than in many other countries. Policy measures have been swift and sufficient. And the Danish economy was in good shape when the pandemic hit.

The economy has recovered at high speed, and output is now above its potential. Denmark seems to have caught a head start in the business cycle, as pressures appear in several places of the economy. The labour market is tight, production is limited by supply constraints and prices are increasing.

We acknowledge the immense uncertainty about future developments. The storm of the pandemic has stirred economic waters, and although the sea might be calmer, swells from the storm persist.

We believe that the acute pressures in the economy are partly transitory, but for instance that the labour market is likely to be tighter than pre-pandemic for some time. Our main scenario is that the Danish economy will steer clear on a balanced trajectory above potential. Still, we appreciate the risk of an overheated economy and have our eyes set on developments to come.

Thank you for your attention.