

NEWS FROM NATIONALBANKEN

TIGHTER ECONOMIC POLICY SHOULD KEEP THE UPSWING ON TRACK

Private sector growth is now so strong that it is time to rein in the public economy. That will reduce the risk of overheating.

That is the assessment of Danmarks Nationalbank in its projection of how the Danish economy will develop in the coming years. At the same time, Danmarks Nationalbank recommends continued focus on reforms to increase the labour force, as the unemployment benefit and retirement reforms have done.

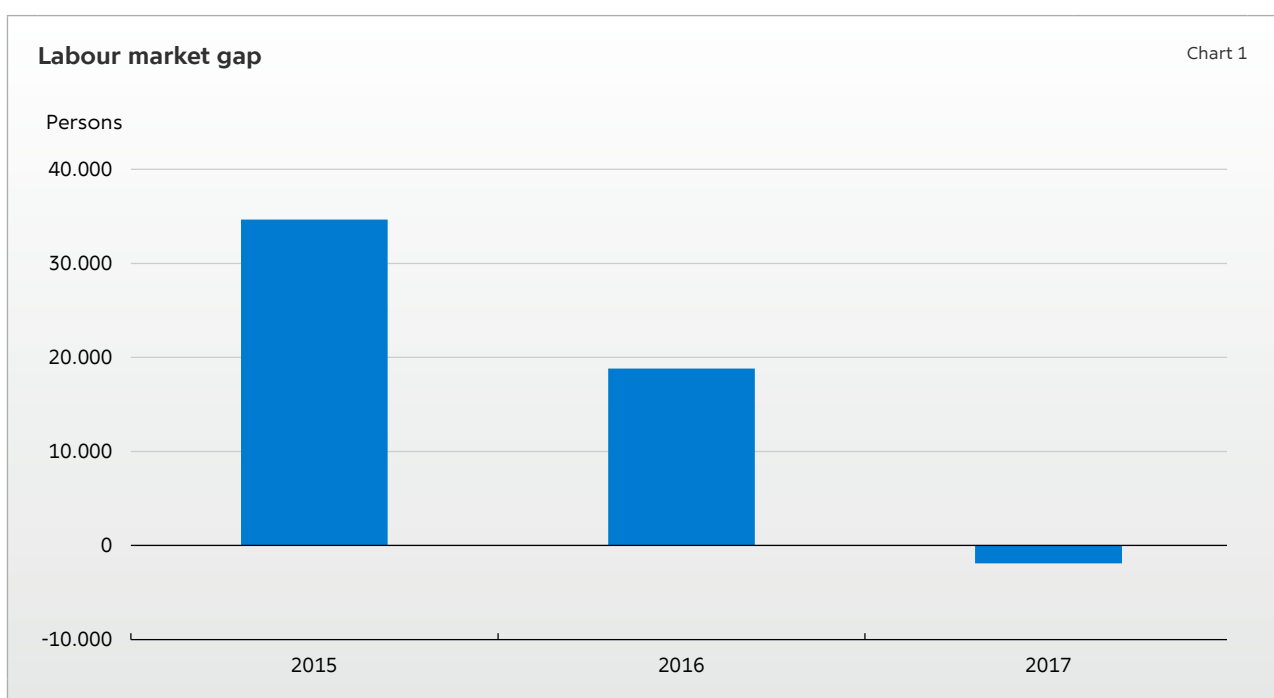
In recent years, fiscal policy, in the form of e.g. investment and lower taxes, has supported

activity in the Danish economy. However, private sector growth is now so strong that it entails a risk if public finances are used to stimulate the economy.

In Danmarks Nationalbank's opinion due caution should therefore be exerted by tightening

Chart 1

Spare resources in the labour market are decreasing and hence it is time for fiscal tightening.



fiscal policy so that public spending and revenue are brought in balance by 2017.

It may be necessary to tighten further if the economy grows at a faster and stronger pace than expected. Such rapid and powerful upswings have been seen on several previous occasions, e.g. in the 1980s, in the 1990s and after the millennium rollover. As such, an upswing is positive, but if it is too strong, there is a considerable risk that it will be followed by an equally strong slowdown.

This was seen in the mid-2000s, and the lesson learned from then is that the costs are high if the warning signs of overheating are disregarded.

Tightening can be effected either by reducing public investment and spending or by raising direct and indirect taxes. All types of tightening involve challenges, but it is important to have a full toolbox of economic instruments and not to make a firm decision beforehand as to whether to reduce expenditure or increase revenue in order to rein in the economy.

HOUSING TAXES SHOULD SUPPORT STABILITY

Housing taxes also need to be adjusted so that they support a stable economic development. In previous upswings, the housing market has been a source of macroeconomic instability and overheating of the economy. To counter this development and contribute to stabilising the housing market, it is necessary as quickly as possible to establish a system whereby the value of houses is taxed at a fixed rate so that the tax payable

increases when house prices rise and decreases when house prices fall.

A STRONG PRIVATE SECTOR

According to Danmarks Nationalbank's projection, which covers the period up to and including 2017, the coming years will bring further growth, rising employment and falling unemployment.

As regards growth, Danmarks Nationalbank forecasts GDP growth of 2.0 per cent in 2015, 2.1 per cent in 2016, and 1.8 per cent in 2017. This is identical to Danmarks Nationalbank's forecast from the 1st quarter of this year.

Danmarks Nationalbank expects employment to have grown by just over 100,000 persons by the end of 2017. Practically all of this increase will come from the private sector. The underlying factors are higher demand – from rising private consumption, higher exports and increased business investment – and a larger supply of labour due to net immigration of people of working age while more people also remain on the labour market.

One of the reasons for the latter is that the retirement reform is gradually postponing the early retirement age these years. It is a precondition for a sustained upswing in the Danish economy that the reforms are not rolled back.

For further information, see the article 'Current Economic and Monetary Trends' in the Monetary Review, 2nd Quarter 2015.

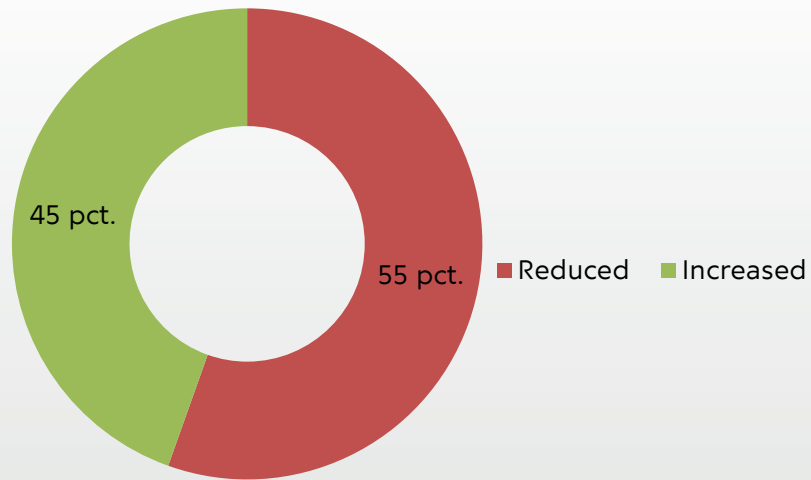
THE PENSION SECTOR WENT AGAINST THE KRONE – BUT WITH CONSIDERABLE VARIATION BETWEEN THE COMPANIES

Overall, the Danish insurance and pension (I&P) companies accounted for the greatest volume of krone purchases in the first months of the year, but behaviour varied considerably from company

to company. Measured as a percentage of the balance sheet, 55 per cent of the pension sector reduced its exchange rate risk in euro from December to April – mainly by purchasing kroner

Pension funds' changes in euro risk in connection with the pressure on the krone

Chart 1



forward – thereby contributing to the pressure on the krone. Conversely, 45 per cent increased the exchange rate risk in euro.

This can be seen from a compilation by Danmarks Nationalbank of purchases and sales of Danish kroner in the first four months of 2015.

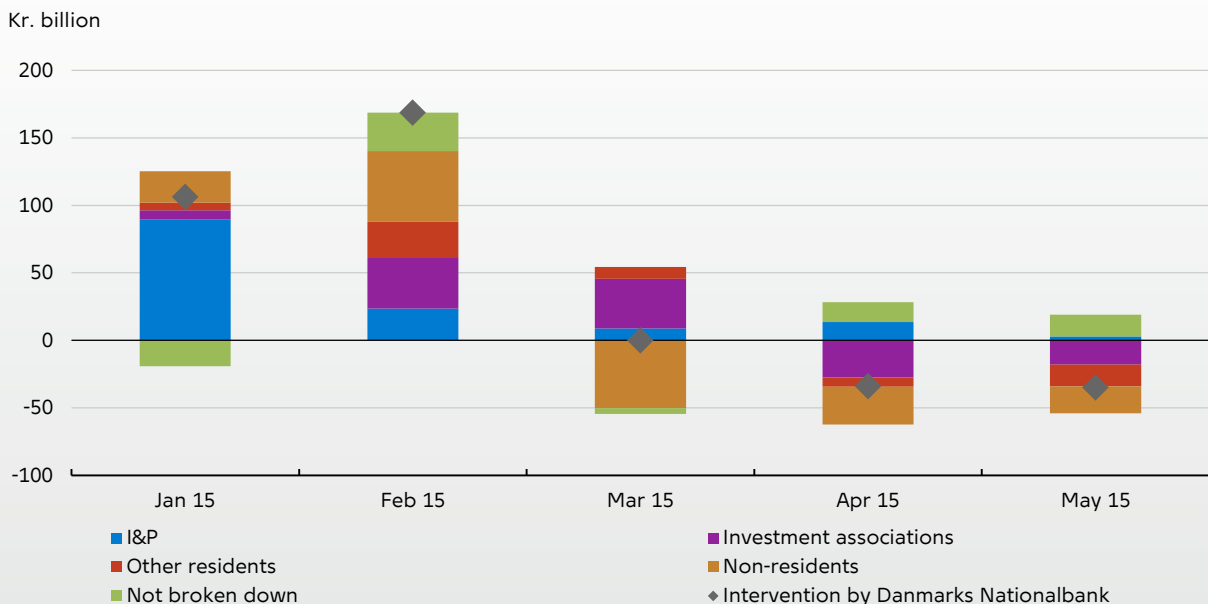
The sector's commitments – to insurance customers and people receiving pension disbursements – are in kroner. Hence investments in

Chart 2

The chart shows the sectors that have purchased and sold Danish kroner in the first five months of 2015. It is seen that non-resident investors purchased kroner in January and February, but sold them again in March, April and May.

Purchase and sale of kroner broken down by sector

Chart 2



other currencies entail a risk. However, this does not apply to investments in euro due to the fixed exchange rate of the krone vis-à-vis the euro. Of the sector's total assets of more than kr. 3,000 billion, just over 2/3 are invested in Danish kroner. This is either because they are invested in Danish assets, or because the exchange rate at which a foreign investment is to be settled at some future date has been agreed beforehand – hedged via derivatives.

The investments not hedged are mainly in euro. Only a small share of these assets in euro were hedged in the spring and contributed to the pressure on the krone. In total, the companies have purchased kroner for around kr. 140 billion this year. However, some of these purchases relate to reduction of the risk in other currencies, e.g. dollars. Interest in the Danish krone was triggered by the Swiss National Bank's decision to abandon its fixed exchange rate policy in January. The Danish pension sector is large compared with those of other OECD countries, and consequently the companies' foreign exchange transactions have a major impact on the exchange rate of the krone.

CAPITAL FLOWS HAVE REVERSED

By the end of February, non-resident investors had realised that Danmarks Nationalbank and the Danish government were firmly resolved to keep the krone stable against the euro. So they lost interest and sold all the kroner purchased in the first two months of the year – and more. Since then, most Danish investors have followed suit. The pension companies are an exception. They have purchased kroner every month since the beginning of the year.

The pressure on the krone after the turn of the year was the reason why Danmarks Nationalbank reduced its rate of interest to -0.75 per cent and also – together with the Ministry of Finance – suspended sales of government bonds for the time being.

For further information, see the article 'Current Economic and Monetary Trends' in the Monetary Review, 2nd Quarter 2015.

BETTER REGULATION MAKES THE DANISH BANKING SECTOR MORE ROBUST

After the financial crisis, a number of new requirements have been imposed on the banks, including requirements for more and better equity, which is the banks' protection against losses on their exposures. Bank equity is important because a robust banking sector with large buffers is the precondition for financial stability and a hence stable economic development.

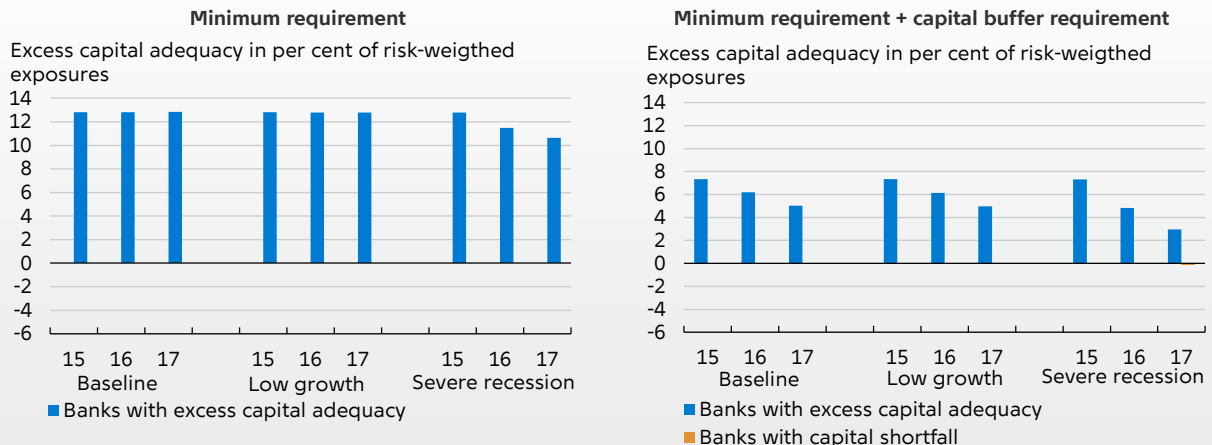
Strengthened regulation is the new reality for banks. The regulation that is being phased in entails a gradual increase of the capital requirement for banks over the next four years. And although the largest banks easily meet the current requirements, some of them will have only a small margin

to the buffer requirements that will apply in four years.

Other countries have gone further in terms of requirements for banks. In countries such as Sweden, the UK and Switzerland, which will not be joining the banking union, it has already been decided to impose higher capital requirements on the largest banks. This may lead to market expectations for the Danish banks to be better capitalised as long as Denmark also remains outside the banking union. In Danmarks Nationalbank's assessment, it is important that the banks are aware of a new market standard with higher capital requirements. And this makes it even more

The largest banks are resilient to severe shocks

Chart 1



Note: The capital buffer requirement comprises the capital conservation buffer, the SIFI capital buffer and the Pillar II add-on.
Source: Danish Financial Supervisory Authority and own calculations.

Chart 1

Even in a severe recession, the largest Danish banks have sufficient capital, but a few only just meet the aggregate capital requirement.

important that the improved regulation already introduced is not rolled back.

THE LARGEST BANKS ARE RESILIENT TO SEVERE SHOCKS

The enhanced capital requirements for banks have had an impact. This can be seen from Danmarks Nationalbank's semi-annual stress tests, which give an indication of the sector's preparedness for the future. The most recent stress test was based on the banks' financial statements for 2014. Specifically, calculations were performed to see how the large banks will fare until the end of 2017.

Obviously, the outcome depends on how the economy in general is expected to develop in Denmark and in the rest of the world. Consequently, the stress test operates with three potential scenarios for the future. The first scenario reflects Danmarks Nationalbank's actual expectations for the coming years, e.g. stable GDP growth of around 2 per cent p.a. The second scenario eliminates growth in the economy in the coming years. The third – very negative – scenario is a

Why Danmarks Nationalbank Stress Tests the Sector

Box 1

Danmarks Nationalbank must contribute to financial stability in Denmark. In this connection, semi-annual stress tests are performed to determine the robustness of the largest Danish banks. The tests are based on the financial figures published by the banks and their reporting to the Danish Financial Supervisory Authority, combined with theoretical stress scenarios with low growth and a severe recession.

Danmarks Nationalbank publishes information about any problems registered, but leaves potential action to other authorities.

The scenarios are prepared in collaboration with the Danish Financial Supervisory Authority.

In addition, stress tests of the largest banks, including the largest Danish banks, are performed at the EU level.

shock to the economy with a severe recession in the form of a sudden decrease in GDP of 4 per cent next year.

In all three projections, the stress test focuses on whether the banks have sufficient capital in relation to the risks incurred. Expected losses are at the core of the test, i.e. the money the banks stand to lose due to customers who are unable to fulfil their original loan agreements. The worse the economy fares, the more unemployment rises and output falls, the larger the losses will be.

The question is whether the largest banks have the financial buffers to meet these losses without

becoming distressed and triggering financial instability. The stress test shows that they do, even in the most severe scenario, in which GDP suddenly shrinks by 4 per cent. A decline of that size has been seen only once in Denmark – in the wake of the financial crisis in 2008.

A LARGE BUFFER IS IMPORTANT

The stress test examines the banks' excess capital adequacy, not only in relation to the minimum requirements, but also in relation to the so-called capital buffer requirements. Capital buffer requirements are excess capital that the banks must hold in addition to the minimum requirement it must fulfil for being licensed to operate as a bank. The idea is that the banks should hold sufficient capital to withstand a severe crisis without having any difficulties in meeting the minimum requirements.

In the most severe stress test scenario, some of the largest banks will require slightly more capital in 2017. Since the shortfall arises in the most severe scenario, and since there is still substantial excess capital adequacy relative to the minimum requirements, Danmarks Nationalbank's does not see this capital shortfall as a threat to financial stability. It can be expected that the banks which only just meet the 2019 requirements today will gradually increase their capitalisation in the coming years so that they will have a margin to the capital buffer requirements.

For further information see the article 'Assessment and Recommendations' in the Financial Stability, 1st Half 2015.

