DANMARKS NATIONALBANK

Speech by Governor Per Callesen at the ICMA Conference, 24 May 2013

CHECK AGAINST DELIVERY

Thank you for the invitation.

As this important event is held in Copenhagen, I expect you would appreciate reflections on some of our domestic issues and a few international issues seen from our perspective. I will try to cover:

- Our current economic situation and the experience of negative policy interest rates
- The state of our banking sector, now soon 5 years after the outbreak of the financial crisis
- Perspectives on the European banking union
- FTT

1. Current economic situation and negative interest rates

The fundamentals of the Danish economy are by and large at par with most other North-Western European economies. We have very large levels of private savings, large current account surplus, moderate public sector deficit, low inflation, moderate levels of unemployment and extremely low interest rates.

Growth is low for both structural and cyclical reasons. Structurally, the working age population is no longer increasing and productivity growth is weak. For a number of years even weaker than in many peer countries. Cyclically, we are still in the aftermath of a strong housing and construction bubble which led to overheating in 2006-07. Fiscal policy is over the years 2011-2013 moderately contractionary, tightening the structural balance by 0.5 per cent of GDP annually after major stimulus in 2009 and 2010.

High savings and low real investments imply that Denmark is increasingly becoming a creditor nation. That was not the case just going back 5 years. Now the international investment position is net assets of 35 per cent of GDP and net annual revenues from the return on assets are some 3-4 per cent of GDP.

This, together with moderate pressures from net capital inflows, has provided some currency challenges. We have successfully run a fixed exchange rate policy for 30 years, first against the Deutsche-mark, later against the euro. We were used to have moderate interest rate spreads and in

some cases had to raise policy rates more significantly to counter negative currency pressures, which tend to come in recessions, such as in 1993, 2000 and 2008. In recent years this has reversed. The challenge has been to avoid currency appreciation.

Our policy remedies are a combination of currency intervention and interest rate adjustments. In most cases we have simply shadowed decisions taken by the ECB. In late 2011 our policy spreads towards the ECB became negative. When the ECB cut its deposit rate even further in July 2012 we followed suit, this time taking our marginal deposit rate (for certificates of deposits which have a maturity of one week) to negative territory at -0.2 per cent. By January 2013 we increased the negative rate to -0.1 per cent following some reversal of the previous inflows.

Episodes of negative market interest rates are rare, but they happen. There are examples of negative rates for T-bills in Japan in the 1990s and recently for short term money market rates in Germany, Switzerland and Denmark. Episodes of negative policy rates are very rare. So what have we learned?

First, the transmission to market rates has worked well. Money-market rates fell and the currency weakened – as intended – probably because the remaining uncertainty about our readiness to introduce negative rates vanished. Subsequently, upwards currency pressure also faded due to improvements in the debt financing situation of vulnerable euro area countries. The volume of money market transactions has declined, but the money market still functions well. We were careful in preparing market participants well in advance that moving towards negative deposit rates was an option and explained how the system, if invoked, would work.

Second, spill over, if any, to the retail rates of private banks has been very limited. The annual costs associated with a negative policy rate of -0.1 per cent compares to 0,013 per cent of private bank lending volume, or in other words 1.3 basis-points. When private banks have positive net positions, deposits, at the central bank, lower policy rates will affect their earnings. The marginal impact is not stronger by moving into negative territory than reducing a positive rate to a level less positive.

Third, neither private banks themselves nor their customers have increased their cash holdings. For the former large amounts of cash holdings are probably too costly as compared to negative policy rates of such a low level. For customers, the incentive to hold more cash has not been present, since banks have not introduced negative deposit rates for customers.

Can our experience be copied? We do not take positions on the policy stance of other central banks and we are careful not to make parallels to very different situations. Our case is specific, a small open economy and a very explicit exchange rate target. Our concern was not to directly target inflation or spur lending to the real economy.

2. The current state of the banking sector

The Danish banking sector – like banking sectors in peer countries – found itself in 2008 with far too little capital and too much reliance on short term whole sale funding. We had, and to some extent still have, a long tail of smaller banks of which too many were weak, although we also have many well-run smaller banks.

May be surprisingly for some, the collapse of the housing bubble has not caused direct problems for financial stability. There is much international talk about high household debt in Denmark and some other Northern European – I would add the term creditor – countries. In our case, loan impairments in our mortgage institutions due to household exposures – and these institutions provides by far most of lending for housing - cumulates to less than 1 per cent of lending over the entire 5-6 years since the collapse of the housing bubble. Also for the banking sector itself, write down of household exposures have been very limited.

It helps of course that debt servicing costs are very low and falling. It helps that our mortgage system has a very strong prudential framework. It helps that households also have very large financial assets. Whereas previous generations of owner occupied houses paid down debt almost entirely before retirement, current generations have large private pensions and can continue to serve debt. Note also that household debt is strongly correlated with income. The 20 per cent of households with the highest income owe more than 50 per cent of household debt. They are also those most likely to hold large financial assets in addition to the value of houses.

Neither was trouble for the banking sector caused by their investment or proprietary trading positions – structural separation of banks is not the issue in this country.

What caused the banking problem was, on the back of small capital and liquidity buffers, traditional lending – one could add reckless lending – to commercial real estate, some expansionary business developers and certain branches such as agriculture. Also, our largest bank had a branch in Ireland which suffered from very high losses. Domestically the housing bubble and its collapse indirectly reinforced these problems due to the large contributions to the bust of the real economy. Of course also the negative spill over from the weak international economy took its toll on the real economy and bank exposures.

In our assessment, Denmark has come a long way to clean up problems in the banking sector. Profitability is still low due to high levels of loan impairments related to the lending previous referred to. And some smaller banks still struggle. But overall the sector has become much better capitalized and prepared for the future. However, we are not done yet.

Recently, a government-appointed commission on systemically important financial institutions recommended, inter alia, a special capital surcharge for Danish SIFI's. The surcharge varies between 1 and 3.5 per cent of risk-weighted assets. We would expect the total capital charges for our SIFI's to be by and large at the level set in peer countries with similarly sized banking sectors. Our recommendation is therefore to implement the recommendations of this committee (in which we took part) and strengthen capital requirements without delay. To quickly clarify the regulatory requirement for SIFI's has strong merits.

Arguments, if any, for a mediocre capitalization of banks are weak and not persuasive.

As a point of departure, the risk of and return to assets of a bank are not related to the composition of liabilities. Higher capital should therefore not have much of an impact for its overall funding costs. To the extent this would not be the case, the main reason is likely to be that investors attribute a high probability of government intervention and bail-out in case a failure of a bank due to its low capital. Implicit government guarantees are not a good substitute for well capitalized banks. They would be distortive, expensive for tax payers and leads to too much risk-taking.

It is an investment worth taking even if funding costs and therefore lending costs would increase marginally due to higher capital requirements. Financial crisis are very costly and it has a strong payoff to reduce their frequency.

In the Danish case the larger banks has already come a long way by increasing their capital positions, in some cases beyond the stipulated future regulatory requirements. Benefits have also already materialized: As an example, the funding costs of Danish banks relative to competitors have come down substantially over the last 1-2 years in parallel with better capital positions

3. Banking Union

The European Banking Union is a major issue under discussion and development. We believe this makes a lot of sense. Just a few remarks to make clear where we stand:

Denmark is a strong supporter of a harmonized approach to resolution where comprehensive and rules-based bail-in of bank creditors comes first and in center of any resolution of a troubled financial institution. Of course a fiscal lending or capitalization backstop is needed and dealing with any SIFI in distress will have to manage the systemic concerns.

While there are euro area specificities related to banking, most issues of the banking union has a broad scope of caring for the internal market, ensuring efficient cross-border cooperation and breaking the link between sovereign

and banks, creating better mutual insurance. Thus, it is a matter for all EU countries.

The Central Bank has urged the government to engage actively in discussions of developments of the full the banking union, including potential participation in the Single Supervisory Mechanism. It is our impression that this is taken up well.

4. FTT

Finally, a few words on the Financial Transaction Tax, which I understand has been a focus area for ICMA. In short, we share the concerns raised about this. Banks are wrong if they complain about higher capital requirements. They are right if they complain about FTTs.

Some issues debated have been the difficulties of ensuring the global coverage of such a tax and the incidence of costs. The real and most important issue should, however, be how such a tax will affect the functioning of the detailed machinery of financial markets. A few observations:

We observed in the financial crisis that illiquidity is problematic and can trigger large difficulties. Bank regulation therefore calls for larger liquidity buffers. The FTT is effectually a tax on market liquidity and thus works counter to the intention of liquidity regulation.

As liquidity in secondary markets is intentionally reduced by introducing an FTT, one should expect higher investor premiums in primary markets. This will raise funding costs in many markets, including for government debt.

Very many transactions are undertaken by financial institutions on behalf of non-financial companies in order to mitigate risks of fluctuation of currencies, raw materials etc. Higher costs of such insurance would likely lead to less risk mitigation, or in other words more “speculative” exposures.

As regards volatility in financial markets it is doubtful that less liquid markets would reduce such volatility. Here the effects tend to move in different directions and the literature tends to be inconclusive. Markets for real products would probably be more volatile. If financial instruments can no longer serve the functioning of smoothing and shift the risk of exposures to those who can professionally bear it at smaller costs.

Overall an FTT does not fit well with current efforts to repair the financial system.

Thank you for the attention!