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Back to markets

The outbreak of the covid-19 pandemic has caused significant declines in economic activity. As opposed to the financial crisis, banks have not been part of the cause of the crisis, and have so far not been substantially affected. Suspension of dividend payments and release of capital buffers have increased capital levels, and banks have made provisions expecting a large deterioration in asset quality with lower profitability as a result. Large losses are, however, yet to materialize.

This is not least due to extraordinary support measures from governments and the EU. Crisis-related discretionary fiscal support measures in 2020 amounted to close to 4 per cent of GDP, automatic stabilizers added a lot to this and liquidity support is close to 20 per cent of GDP. The support measures have helped prevent a wave of bankruptcies. Bankruptcy levels in 2020 were in fact below the previous year. Administrative delays, temporary relaxations of bankruptcy regulations and loan repayment moratoria in some instances have contributed to this. Bankruptcies can be expected to increase once the support measures are lifted, with higher NPLs in the banking sector as a result. This raises the question of how to best phase out support measures.

Support measures have been warranted for firms which have been prevented from doing business as a result of the lockdowns. Once restrictions are lifted, direct support measures towards firms should be phased out as well, and firms should go back to doing business on market terms. Business dynamics have been hampered by the lockdowns, and some unviable firms have been kept alive by support measures. Large reductions in revenue are not an unusual event for firms. A Danish study shows that, even in the best of times, 6 percent of firms experience a year-to-year drop in turnover of 30 percent or more. That has been the national threshold to qualify for government compensation for fixed costs.

Furthermore, the pandemic may lead to structural changes and a shift in consumer preferences. Some firms may experience decreased demand and ultimately default, and banks will experience losses. This is a natural part of the workings of a market economy. Firms default and new firms enter. We must not hamper this dynamic. Once restrictions are lifted, firms should do business on market terms – without government aid. As always, existing labour market policies etc. can assist transition.

Once bankruptcy levels start to increase, banks will inevitably experience increasing NPL levels. The strong fiscal and monetary measures, temporary macroprudential and supervisory relief, dividend restraint and prudent bank behavior imply that this is manageable by viable banks and should not act as a squeeze on lending capacities.

In the long period in between the GFC and the pandemic, we have improved the financial sector a lot. Risk levels in the EU banking sector have been reduced, capital levels have increased and we have the system and institutions to resolve non-viable banks. The BRRD made great strides to ensure that orderly resolution can be applied without costly government funds, which would distort competition, break the link between facing risk and earning risk premia, invoke moral hazard and revoke the bank-sovereign nexus. Some cases might test the resolve of governments to apply the BRRD. Yet, the role of the financial sector during and post COVID-19 should be seen as an opportunity to demonstrate how we have built a financial sector which is part of the solution and which can adjust dynamically to changing environments, on market conditions. Harvesting this opportunity will be important for years to come.