Bodil Nyboe Andersen: Recent economic developments in Denmark

Speech by Mrs Bodil Nyboe Andersen, Governor of the National Bank of Denmark, at the Annual Meeting of the Association of Danish Mortgage Banks, Copenhagen, 11 April 2002.

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In its Annual Accounts for the year 1886-87 Danmarks Nationalbank for the first time presented not only financial data, but also a brief report on the past year. The report commenced as follows:

"Danmarks Nationalbank's activities during the past banking year have been affected to a significant degree by the prevailing slackness of business in important areas of commerce. Throughout the banking year money has been in ample supply both at home and abroad, and the interest rate extremely low. In Denmark, both the discount rate for bills of exchange and the lending rate were lower than in any previous year, and the demand for money was in both cases unusually low."

This was all that Danmarks Nationalbank wrote about the economy's development in this first report.

However, a noteworthy statement in this paragraph is that "the demand for money ... (is) unusually low". In the terminology of our day this means that there was no demand for credit, and it was no consolation that "the lending rate ... (was) lower than in any previous year".

This could be construed to mean that Danmarks Nationalbank wanted to say that nothing more could be achieved by relaxing monetary policy.

This discussion has appeared time and time again in the history of monetary policy. Best known is Keynes' demonstration of situations where the liquidity trap prevents any stimulation by means of monetary policy. His response was that fiscal policy had to be used instead. In our day we see this monetary-policy dilemma in the case of Japan, but here fiscal policy apparently has no effect either.

On the other hand, the USA has used both monetary and fiscal policy to stimulate economic activity in recent years, apparently with success.

The Federal Reserve has a rather broad objective for its monetary policy, and interest-rate decisions are based on arguments related to an overall assessment of the cyclical position. This has led to a very expansionary monetary policy in the USA in 2001. However, the USA's experience cannot be applied directly to Europe, since the USA's economic structure is radically different, e.g. its labour market.

During the last 10-15 years Europe's division of work between monetary and fiscal policy has become clearer. European experience shows that the best contribution monetary policy can make to balanced growth and development in the longer term is to safeguard price stability. Price stability provides a fixed framework for the long-term strategies of both business enterprises and consumers. In practice, price stability means very low inflation in the range of 2 per cent.

For this reason, the Maastricht Treaty makes price stability a direct objective of the European Central Bank. The same applies to a number of central banks in non-European countries as well as the UK, Sweden and Norway.

The fact that the central bank's objective is price stability does not prevent short-term aspects of the significance of the interest rate to employment from being taken into account, but only in situations where this does not conflict with the objective of price stability.

As will be known, Danish monetary policy is related closely to that of the euro area. In a more indirect way, our objective is also price stability, since in order to maintain a stable exchange rate our inflation must not deviate significantly from inflation in the euro area.

Since World War II, Denmark has pursued a fixed-exchange-rate policy in various guises, with varying degrees of firmness.

Denmark reaped favourable experience from its consistent fixed-exchange-rate policy in the 1980s and 1990s. In fact, Denmark is a good example of how for a number of years it has been possible to reconcile high employment, rising real wages, low inflation and a favourable balance of payments with the help of an economic policy based predominantly on structural changes, and not on short-term cyclical policies .

As a consequence, when the euro was introduced, Denmark decided to continue its fixed-exchange-rate policy with a narrow linking of the krone to the euro. The official Danish interest rate is therefore earmarked to influence the exchange-rate development.

Fortunately, Denmark's economy has proved to be so robust in recent years that confidence in the krone's stability has increased significantly. The foreign-exchange market is thus currently extremely stable.

Formerly, the mortgage-credit market was dominated completely by fixed-rate loans. Once a loan had been raised, private home owners were not affected by increasing interest rates. So when a home changed hands, the focus was on the mortgage payments for the first year.

An alternative from the end of the 1990s has been adjustable-rate mortgage loans. Since then, this area has been subject to extensive product development and marketing. It is very positive to note the trend to offer borrowers a selection of different financing models, including the opportunity to combine fixed- and adjustable-rate loans.

Adjustable-rate mortgage loans are popular with good reason, since the mortgage payment for the first year is currently considerably lower than for a traditional fixed-rate mortgage loan. On the other hand, the interest rate can fluctuate. This is an important part of the explanation for the normally lower level of short-term interest rates than long-term rates.

The risk scenario is therefore entirely different to that for traditional mortgage financing.

It is sometimes emphasised that the borrower can convert to a fixed-rate loan at a later time, if the short-term interest rate increases. However, this does not cover the risk at all, since one cannot count on the long-term interest rate remaining constant if short-term rates have increased substantially.

Together with his or her advisers the borrower must therefore evaluate closely which risks he or she is exposed to. The borrower needs answers to a number of questions such as: "What will happen to my mortgage costs if ...?". This "if" can be related to family matters and external economic events, including interest-rate increases. It is like the way many investors set up various "stress scenarios" before an investment decision is taken in order to assess the potential effect of the investment on their economic position.

It is vital that borrowers do not just focus on the mortgage payment for the first year and see adjustable-rate loans as a less expensive version of the traditional fixed-rate mortgage-credit loans.

In 1997, Danmarks Nationalbank found it appropriate to point out that the ongoing adjustments to mortgage financing arrangements would not lead to any changes in monetary policy. The fixed-exchange rate policy implies that Danmarks Nationalbank raises the lending rate if the Danish krone comes under significant pressure due to speculation. This remark was intended to be an item of "consumer information" to mortgage-credit customers. It was naturally also influenced by the fact that on several occasions during the 1990s we had to counter speculative attacks on the krone by significantly raising the monetary-policy interest rates.

This statement has been considered and debated in the media on numerous occasions during the last five years. So this risk is hardly likely to be overlooked by many home buyers. Some have perhaps even misunderstood and believe that this is the only risk presented by adjustable-rate mortgage loans denominated in kroner. However, it is first and foremost the case that these loans will become more expensive if the interest rate is generally rising.

The market perception is that interest rates have bottomed out. Only time can tell whether this is true, and nobody can say anything definite about the level of interest rates in five or ten years' time. However, if the international upswing really gets under way, inflation prospects can be affected, making interest-rate increases like those already seen in Sweden necessary.

If the European Central Bank sees this development as a threat to price stability and raises interest rates, Denmark will follow suit. As a result, adjustable-rate loans in both euro and krone will become more expensive.

What is the explanation for the growing popularity of loans at variable rather than fixed interest rates at the end of the 1990s? Why did this take place at a time when the level of interest rates was historically low?

In retrospect, one can see that borrowers should have taken loans at variable rates when interest rates were very high, e.g. in the early 1980s. At that time mortgages were financed predominantly with fixed-rate loans because the economic situation was perceived as far more uncertain. Inflation was high and fluctuating, and interest rates had risen significantly.

In an uncertain economic world borrowers' primary need was to be certain of the level of their future mortgage costs. If the first few years were manageable, experience showed that there was no reason to be concerned for the long term.

The situation today is entirely different. The economy has been stable since the end of the 1980s and there is a general faith that reasonably low inflation and equivalently low interest rates will dominate for years to come. Many borrowers therefore now opt to benefit from the fact that the short-term interest rate is normally lower than the long-term rate. The risk of rising interest rates must be assessed on a par with the risk of other events that can affect private finances.

Foreign exchange has flowed into Denmark during the last 15 months. This inflow is partly due to the current-account surplus of kr. 34 billion in 2001. The foreign-exchange reserve rose by almost as much, implying that other capital flows were close to zero in net terms in that year.

Cross-border trading of bonds and shares, corporate acquisitions and other direct investments lead to major capital movements and thereby to the demand for and supply of foreign exchange. In some periods the demand for foreign exchange will exceed supply – and in other periods the opposite will apply.

If our exchange rate were allowed to float, the result would be exchange-rate fluctuations. Denmark's fixed-exchange-rate policy entails that such imbalances must not be allowed to affect the krone more than marginally. This is why Danmarks Nationalbank intervenes in these situations. It does this by buying or selling currency, which is the purpose of having foreign-exchange reserves. Danmarks Nationalbank can also intervene by adjusting its lending rate, thereby affecting capital flows. In recent years there have been a number of minor interest-rate reductions in response to capital inflows.

The current interest rate spread to the euro is approximately 25-30 basis points, depending on which short-term interest rates are considered. There are many opinions on what a "normal spread" should be, but it cannot be pinpointed. If there is a strong outflow of foreign exchange, or fears thereof, Danish interest rates must be raised in order to widen this spread.

On a substantial inflow of foreign exchange, as in 2001, the spread narrows. In recent years such adjustments have typically been by 0.05 or 0.10 per cent at a time.

There is therefore no such thing as a "normal interest rate spread", since its size depends on the situation in the foreign-exchange market.