

Bodil Nyboe Andersen: Recent financial and 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 Bankers' Association, Copenhagen, 4 December 2002.

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Virtually every report and article on the international economic development nowadays starts by describing the unusually high degree of uncertainty. Not only has the expected upswing been deferred once again for another year, but it has also become more common to hear expressions of concern for the economy's course in both the USA and Europe.

The terms recession, depression and deflation make frequent appearances in the headlines, and are often used interchangeably to describe the fact that things are not going as well as we were accustomed to up to 2000.

Economists apply these three terms to describe different concepts:

- *Recession* is the least serious situation. A rule of thumb says that a drop in output for two quarters running is a "technical recession". In the USA, the National Bureau for Economic Research operates with a more sophisticated definition of recession, based on the development in a number of macroeconomic time series. According to this definition, the Bureau noted a year ago that the USA went into a recession in March 2001. Whether this recession is persistent or has now ceased will not be revealed until the figures have been revised and closely analysed, with a timelag of many months, and perhaps more than one year.
- *Depression* is a prolonged period of abnormally low growth and high unemployment. So this is a far more serious situation than recession. The term depression is used in particular to describe the persistent economic crisis in the 1930s.
- *Deflation* signifies a drop in the general price level, i.e. the opposite of inflation. A situation with falling prices is dangerous, since it tends to have a self-reinforcing tendency. If sustained price drops are expected, purchases and investments will be postponed, and this in itself will deepen the crisis.

The confusion regarding these terms is exacerbated by the fact that "deflationary" is sometimes used merely to describe a tendency for the economy to dampen.

Lower growth is not necessarily a major problem, however. After strong growth and pressure on the labour market, a calmer period can be healthy.

The challenge here is that not all countries have experienced strong growth with the related reduction of unemployment up to and around the millennium rollover.

For many years, Japan's economic development has been alarmingly poor, and its state is close to depression. Moreover, Japan also experiences deflation, i.e. falling prices. Japan's economic problems appear very hard to solve by applying the traditional economic-policy instruments.

In Europe, the German economic development in particular has given grounds for concern. Although remaining Europe's economic locomotive for many decades, since the mid-1990s Germany has experienced moderate growth and high unemployment. The international economic slowdown has further amplified these problems.

At the same time, Germany faces a situation where a large budget deficit impedes an active fiscal policy to counter this development. Even the automatic budget reaction in the face of a further dampening will create problems for Germany's compliance with the budgetary requirements.

What about Denmark? Do we have recession, depression or deflation? In fact we have none of them.

Denmark did not reach very high growth rates at the end of the 1990s. We experienced moderate economic growth, but our employment situation was extremely favourable; in fact the labour market was under pressure. This situation has not changed significantly.

The figures so far available indicate that Denmark's economic situation is robust, with some economic growth. The growth has been sufficient to stabilise unemployment at a level that is very low by European standards. Thus, so far the international economic slowdown has not presented noticeable problems for Denmark.

The economic slowdown has generated debate within the EU with regard to the Stability and Growth Pact. It is criticised for inflexibility in view of the maximum permitted budget deficit of 3 per cent of GDP. However, this limit is just one element of the Pact. In order to stay on the right side of 3 per cent, the member states are committed to respect the medium-term budgetary objective of positions close to balance or in surplus. In the years of favourable cyclical development, there must be a sound budget surplus. This lends flexibility, i.e. "leeway", when the business cycle weakens, and the automatic stabilisers come into play.

However, if the deficit in the good years is already high, there is no margin to draw on when the economy weakens. In this situation, the limit of 3 per cent is reached quickly.

The fundamental idea behind the Pact is therefore in the good years to create room for manoeuvre via a strong budgetary situation. In this case too, Denmark is actually a good example.

For a number of years, Denmark's fiscal policy has contributed to creating a robust situation for government finances. Both the previous and the present government have maintained a sound fiscal policy with a satisfactory budget surplus.

If Denmark's cyclical development also weakens, and unemployment rises, the budget will deteriorate when the automatic stabilisers set in. Lower fiscal revenues and higher expenditure on unemployment benefits are the classical examples of such budgetary reactions. Even if these effects are rather strong in Denmark, the underlying favourable budget situation will accommodate their impact.

It is important to maintain this room for manoeuvre, and therefore there is no scope for any fiscal-policy relaxation.

Danmarks Nationalbank has continuously emphasised the importance of a firm and consistent fiscal policy. This policy is vital to our credibility in maintaining the fixed-exchange-rate policy for which there is a broad consensus in Denmark.

Over the years, many countries have been forced to abandon the fixed-exchange-rate policy due to speculation against the currency. But in virtually every case this speculation has arisen due to the country's lack of the will or the ability to adhere to the "rules of the game" for a fixed-exchange-rate policy. These rules impose requirements on the design of not only monetary policy, but also fiscal policy.

For many years, Denmark's observation of these ground rules has been firmly agreed between the government and Danmarks Nationalbank. Today, the fixed-exchange-rate policy is so much embedded in our economic policy that it is actually no longer a basis for discussion. There is broad agreement that this policy has served us well, and after the rather chaotic foreign-exchange policy of the 1970s we have experienced many years of firm and stable economic development.

Up to 1 January 1999, Denmark was part of the EMS, together with a large number of the EU member states. Our monetary and foreign-exchange policy adhered to the European standard, so to speak. However, all the other member states that were part of the old EMS have now introduced the euro, and we are the only one of the out-countries to participate in ERM II.

Even though our policy is unchanged from the late 1990s, this is no longer an internationally well-known model. Therefore we have to do more ourselves to provide information on the goals and means of our monetary and foreign-exchange policy. We cannot just refer to the model.

In principle, the fixed-exchange-rate policy is easy to explain. Currencies are traded twenty four hours a day, anybody can see at any time whether the exchange rate matches the target set, and no econometric models are needed to see whether things are on track.

Danmarks Nationalbank's aim is to ensure that the krone's rate against the euro is stabilised close to the central rate within ERM II, and the exchange rate is the sole basis for our monetary-policy deliberations.

Among market players there is a degree of uncertainty concerning the exact size of the decimals that Danmarks Nationalbank considers to be acceptable fluctuation. The banks often demand precise details. However, this is not something we are prepared to give. An exact description down to the final

decimal place would eliminate the basis for the currency market in kroner against euro functioning as a real market, with the opportunity of profits and the risk of losses. In that case, Danmarks Nationalbank would quite simply take over the market's function.

Our efforts are designed to ensure that the fluctuations are so moderate that for most ordinary business enterprises - in contrast to foreign-exchange dealers - they no longer even need to be considered.

Our instruments are also well-known: intervention in the currency market and adjustments to Danmarks Nationalbank's interest rates. Although the market itself to a great extent stabilises the exchange rate Danmarks Nationalbank intervenes in the currency market when necessary, and on these occasions often for considerable amounts.

Danmarks Nationalbank's interest-rate policy is fundamentally that we "shadow" the interest rate of the European Central Bank. This means that we raise or lower the discount and lending rates in line with the ECB. In addition, we adjust the interest-rate spread to the ECB in the light of the foreign-exchange situation. We take account of the krone's position vis-à-vis the euro, and whether there has been any sustained inflow or outflow of foreign exchange. These adjustments can take place concurrently with adjustments to the ECB's interest rate, or at other times. However, the actual decisions are taken on the basis of all of the information available concerning the currency market at that particular time. There is never an automatic reaction.

During the past year, there has been great interest in placing funds in kroner, and we have mostly purchased currency. The foreign-exchange reserve has therefore increased by around kr. 50 billion. It has also been possible to reduce the interest-rate spread in relation to the euro interest rate, and this is now as low as 20 basis points.

When capital flows are reversed at some point in the future, we are of course also prepared to sell currency. Those who are familiar with our operations will be in no doubt that Danmarks Nationalbank's currency defence will be extremely resolute in terms of both intervention and widening of the interest-rate differential.

Danmarks Nationalbank must continually monitor the krone's position in the market, and the decision-making structure must be designed for decisions on intervention or adjustment of interest rates to be taken at any time. Danmarks Nationalbank has the flexibility required to be able to act immediately.

In recent years, many central banks have introduced fixed published dates for monetary-policy decisions, but the fixed-exchange-rate policy is not compatible with such fixed decision-making dates. A central aspect is that measures can be taken immediately to halt any inappropriate exchange-rate movement in order to prevent a crisis from emerging.

The situation in the currency market can quickly change. When conducting a fixed-exchange-rate policy, it is therefore not advisable to prepare the market for forthcoming changes in the interest-rate differential, as practised by many central banks with other monetary-policy objectives.

Furthermore, we take the view that all parties in the market must have access to the same information, at the same time, from Danmarks Nationalbank. Danmarks Nationalbank's monetary-policy announcements are thus published with great precision via several channels simultaneously. No hints are given to certain groups capable of interpreting such messages. Danmarks Nationalbank therefore never comments on forthcoming changes, even though we frequently are asked questions in this respect.

At the more technical level, we have ensured that the market participants receive information on the expected development in liquidity. On a monthly basis, Danmarks Nationalbank publishes estimates of expected day-to-day movements in the banks' overall liquidity, and at the same time releases information on the expected dates of Danmarks Nationalbank's sale or purchase of certificates of deposit.

Additional information on the development in liquidity is published on a daily basis, giving market participants a good opportunity to prepare their positions, and to subsequently analyse developments. On this basis, there is normally no great uncertainty concerning the scale of Danmarks Nationalbank's interventions in the foreign-exchange market.

Openness and transparency are generally given high priority in our modern society. For monetary policy these are also the means to achieve the credibility which is so essential for a central bank to

implement the chosen policy. However, this must not be allowed to overshadow the fact that the safest path to credibility is over a long period to fulfil the promises one makes, or to put it bluntly: to practise what is preached.