Bodil Nyboe Andersen: The role of monetary policy in Denmark

Speech by Mrs Bodil Nyboe Andersen, Governor of Danmarks National Bank, at the Annual Conference of Danish Industries, held in Copenhagen, on 26 September 2000.

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Thank you for the invitation to speak on the role of monetary policy. Traditionally, this topic has not drawn much attention in Denmark. Some might claim that this is because Denmark does not in fact pursue a monetary policy as such. In normal times we just shadow the euro area, and before that, Germany. However, in conjunction with the debate on whether Denmark should adopt the euro the design of monetary policy has attracted greater interest.

Price stability

In all countries the primary task of monetary policy is to contribute to price stability. The approach is either direct inflation targeting or more indirect control by maintaining a stable exchange rate against another currency which is characterised by price stability. Price stability is defined as very low inflation, preferably below 2%.

The prevailing view in the postwar period was that a certain element of inflation helped the economy to function more smoothly. In recent decades there has been growing recognition that this is not the case.

Instead of an inflation rate of 10-12%, low, stable inflation at no more than 2-3% has proved to be a better way of ensuring sound and steady economic growth. Even moderate inflation increases the uncertainty of long-term economic decisions and entails inappropriate redistribution of resources in society.

In the years around 1980 Denmark had high inflation and high interest rates and the krone was devalued on every possible occasion. This course was stopped in 1982 and from that time inflation was reduced significantly by means of a consistent fixed exchange rate policy. This strategy was supported by the trade union movement, which during the 1980s came to realise that inflation did not benefit its members. Some very different groups in society were the real winners of the inflation game.

But moving from high to low inflation had its price. Most of us can remember a lot of problems in the years around 1990. They were the result of far too many inappropriate economic decisions during the inflation years.

As stated, during the 1980s the benefits of low inflation were generally acknowledged in Europe. Germany became the role model. Although this was probably the result of many different factors in Germany, the prevailing view became that the low inflation rate was especially attributable to the Bundesbank's successful monetary policy, of which the main objective was keeping down inflation.

A basic assumption of the negotiations prior to the Maastricht Treaty was that a single European currency and a single monetary policy should be based on the objective of price stability. This objective was therefore incorporated in the Treaty.

Independent central banks

It was also decided to make the European Central Bank independent of the political system in order to assure this objective the greatest possible credibility. Since the 1980s central bank independence has been a global trend. It is stipulated in the Treaty that all EU central banks must be independent of the political system. This meant that Sweden, for example, had to amend the Act on Sveriges Riksbank, even though Sweden is outside EMU. The United Kingdom is subject to a special exemption from the

Treaty requirements, but it has nevertheless been decided to give the Bank of England operational independence.

The Danish central bank is independent by long-standing tradition, as set out in the Danmarks Nationalbank Act of 1936. In view of this statutory provision, no amendment was necessary as in Sweden's case. However, legislation will have to be amended should Denmark decide to adopt the euro, since a number of provisions would have to be adjusted to be in line with our participation in the single monetary policy.

Subject to the shared objective of price stability, there is great variation in the structure of monetary policy in respectively a floating and a fixed exchange rate regime. I would first like to point out certain characteristics of monetary policy in a floating exchange rate regime and then proceed to the fixed exchange rate policy and Denmark's experience.

Inflation management

In a floating exchange rate regime monetary policy is used as an instrument to influence inflation via the impact of interest rates on economic activity and on expectations.

The effect of interest rates on the economy - what the economists call the transmission mechanism - is not immediate, but takes place over time. It is therefore not the inflation rate here and now that is managed. Inflation in the medium term, typically two years, is the anchor of monetary policy.

Moreover, economists by no means agree on how effectively monetary policy can influence the economy's course.

Central banks which have an inflation target can choose between various monetary policy approaches. However, irrespective of the approach, it is the same economic fundamentals that are considered.

An estimate of inflation two years ahead can be made on the basis of various economic indicators, including money supply, market interest rates, consumer expectations, raw materials prices, etc. This estimate takes the current monetary policy as its starting point.

Should future inflation calculated in this way be outside the central bank's target range, it should also be calculated how monetary policy should be adjusted to achieve a successful result two years ahead.

Inflation forecasts

Some central banks have published their forecasts and then explained their decisions based on the forecast results. The United Kingdom and Sweden have opted for this approach. This is not yet the approach of the European Central Bank, but its President, Wim Duisenberg, has officially stated that the ECB plans to publish its forecasts.

In its first years the ECB has faced the specific problem that it is difficult to construct a reliable model based on statistics and trends from the period before the introduction of the single currency. This adds to the challenges faced by the model designers and is probably the reason that the ECB prefers to try out various models before a model-based forecast that can be released to the general public is chosen.

Presentation of a model-based forecast has obvious benefits since it summarises a number of the factors influencing inflation. This gives a better overview of the process - to outsiders - but does not disguise the fact that even the best model cannot provide precise mechanical answers on what action to take. It must be supplemented with assessments. The "human factor" will therefore always be in strong demand - irrespective of the model-based results.

Decision forum

Once the basis for decision is in place, decisions are most often made by a group of people - a board of governors or a monetary policy committee.

In many cases it used to be committees of directors of central banks comprising a majority of political representatives. With certain exceptions this model has now been abandoned in favour of a council of independent representatives. These may be governors or part-time members of the council, ie individuals with a “neutral job”.

The idea of a group as the decision-making forum is a natural consequence of the fact that the outcome cannot be calculated. It must be supplemented with evaluations. There is reason to assume that these evaluations will be more exhaustive when made by a group of people with various backgrounds, but all with the required professional expertise.

Presentation of decisions

How decisions, and the basis for decision, are communicated to the general public varies considerably, however. This variation is often taken to reflect differences in content and ways of thinking, but this is not necessarily the case.

One model is the well-known Bundesbank approach, which is also applied by the European Central Bank. It is also the practice in Norway. According to this model a press conference is held where the chairman of the council, the central bank governor, presents the decision with a detailed explanation of the background to the decision. In certain cases a press release is issued instead of the verbal presentation at a press conference. This is then supplemented, typically on a quarterly or monthly basis, with the central bank’s evaluation of the economic development, with special emphasis on the financial situation.

The other members of the decision-making council may make statements in various fora, at lectures and in interviews, but the chairman makes the official presentation of the collective decision. As a result the chairman is very much in the spotlight, and sometimes people may wrongly believe that he more or less makes the decisions alone.

The other model is used in such countries as the United Kingdom and Sweden. The views of the individual members are emphasised, since edited minutes of the decision-making meetings are published, subject to a certain time lag. This can lead to excessive interest in each member’s views, and particularly in whether they change their minds. Since the whole idea of discussion in a group forum is that you can learn from listening to the arguments of the other members it should be perfectly all right to change your mind.

The Federal Reserve also publishes minutes of the meetings of the Federal Open Market Committee. This has been the Federal Reserve’s practice for years, although it has not prevented the widespread misunderstanding that Alan Greenspan alone makes the monetary policy decisions.

Fiscal policy

Although the central bank is responsible for managing inflation, this does not imply unlimited scope to design fiscal policy. An inappropriate fiscal policy - eg a very expansionary policy in a situation with full capacity utilisation - can be a serious obstacle to the work of the central bank. This is taken into account in the structure of EMU, since the provisions of the Stability and Growth Pact ensure that a sound fiscal policy is pursued. This not only applies to the euro area, but to all EU member states, including Denmark.

In countries with no formal restrictions it is nevertheless essential that politicians understand the need for a prudent fiscal policy. Otherwise the financial markets may respond with rising interest rates, showing in this way how they feel about the fiscal policy.

It is therefore no coincidence that in speeches and articles central bank governors often emphasise an appropriately balanced fiscal policy as the background to the central bank’s price stability task.

Fixed or variable exchange rates

If a central bank's task is to manage price development via its monetary policy the latter cannot be used to manage the exchange rate. This is the lesson learned by the British business community in recent years. The Bank of England has pursued a tight monetary policy in order to contain inflation. But in certain periods this led to a strengthening of sterling, which presented problems for the export sectors.

The European Central Bank has witnessed how the markets have strongly traded down the euro, which is found to be out of line with the economic fundamentals. Last week the European Central Bank took the initiative with the USA, Japan, the United Kingdom and Canada to intervene in the currency market in support of the euro. The authorities of these countries shared a concern about the potential implications of recent movements in the euro exchange rate for the world economy.

Just as it was not the Bundesbank's task to design monetary policy for management of the D-mark's rate against the dollar, it is not the European Central Bank's responsibility to manage the euro/dollar rate via its interest rate policy. The European Central Bank has to react by raising interest rates only if price stability is threatened by the exchange rate's development. In view of the size of the euro area, most of its trade is internal. This considerably reduces the significance of the exchange rate to price trends compared to smaller countries with extensive foreign trade.

If the purpose of monetary policy is to ensure low inflation it cannot also be used to manage the exchange rate. On the other hand, if a fixed exchange rate policy is pursued, the monetary policy must be designed accordingly. This rules out a further objective to adjust interest rates to domestic economic trends.

Fixed exchange rate policy

A fixed exchange rate regime entails a political decision to maintain a stable exchange rate vis-à-vis another - typically major - currency. This decision is made in order to create stable exchange rate conditions for the business community. The currency chosen is therefore usually one which is of great significance to the country's foreign trade.

However, a further consequence is that the country in question indirectly pursues a policy of price stability, since the fixed exchange rate policy is only sustainable if the country's inflation is generally equivalent to that of the country whose currency it shadows.

Denmark's fixed exchange rate policy dates back to 1982. It is widely agreed that this policy has served Denmark well and has promoted understanding of the necessity of the stability-oriented economic policy, ie a policy which keeps the economy on track. It is also clear that Denmark's fixed exchange rate policy has achieved a high degree of credibility.

Firstly, the Danish authorities, ie the government and the Nationalbank, have stated on every possible occasion that devaluation is out of the question and that this instrument is not even considered as an option. Over time this view has gained the widespread support of the general public and among the political parties.

Secondly, for many years Denmark has shown the willingness and the ability to adhere to the rules and conventions of the fixed exchange rate policy.

Monetary policy shadows anchor currency

In "normal" times monetary policy must be designed to match the monetary policy of the country whose currency is shadowed. For Denmark, until 1998 this country was Germany. As from 1999 Denmark has pursued a fixed exchange rate policy vis-à-vis the euro. This means that when the European Central Bank adjusts interest rates, Danmarks Nationalbank follows suit. However, Denmark's level of interest rates is slightly higher than the euro area level, as it was previously vis-à-vis D-mark interest rates. The greater the credibility of our fixed exchange rate policy over the years, the narrower Denmark's interest rate differential to the anchor currency.

A sudden event may upset this state of affairs - and not necessarily an event in Denmark. When the international financial crisis arose in September 1998 many investors preferred to move their assets to bigger currencies such as the dollar and the currencies which were then about to become part of the euro.

Such a situation can exert pressure on the Danish krone. In the first instance, in order to maintain a relatively stable exchange rate, the Nationalbank has to support the krone by selling foreign exchange from its reserve. If intervention is extensive it can be necessary to raise interest rates. In September 1998 the discount rate was thus raised by ½% and the Nationalbank's lending rate by 1%. Bond yields also rose.

The Nationalbank's monetary policy is thus completely bound by the development in the exchange rate, even though formally we pursue a separate monetary policy. In a stable exchange rate environment we pursue exactly the same monetary policy as the European Central Bank, but with slightly higher interest rates. In the event of exchange rate unrest we have to raise interest rates, only to normalise them as the markets return to stability.

This monetary policy stance also makes it very clear that special Danish requirements of higher or lower interest rates due to employment or price trends cannot be accommodated.

In reality these are the same terms as apply to the euro area member states: neither Finland nor Ireland is free to adjust its interest rates to fit the country's own economic situation.

Requirements of fiscal policy

A fixed exchange rate policy also imposes the requirement that fiscal policy be designed to ensure the balance in the economy which is a precondition for maintaining the credibility of the fixed exchange rate policy. Inflation may not significantly exceed inflation in the euro area, and excessive current account deficits must be avoided. It will therefore be necessary to dampen excessive economic growth.

The two best-known examples of fiscal policy measures to stabilise the exchange rate are the October 1986 package of economic measures, the "potato-diet" and the Whitsun 1998 package of economic measures. These examples are only the best-known of many as consideration of the requirements set by the fixed exchange rate policy is always an element of fiscal policy planning.

Even if Denmark adopts the euro, fiscal policy will still be used to stabilise the domestic economy. However, the special consideration of the balance of payments and the foreign exchange market, which today are basic conditions, will no longer apply.

Euro participation or fixed exchange rate policy

Adopting the euro would widen the scope of economic policy compared to the situation where a fixed exchange rate policy is pursued. We would gain a share of influence on Europe's monetary policy and we would have a little more room for manoeuvre in fiscal policy.

There is widespread agreement in the euro debate that Denmark must chose between a fixed exchange rate policy and adoption of the euro. Changeover to the euro would be a natural continuation of the fixed exchange rate policy which is so well established in Denmark.

Under the fixed exchange rate policy first the D-mark and then the euro has been a fixed element of business enterprises' foreign exchange transactions. The euro is by far the most important currency to Denmark's foreign trade and Danish business enterprises have learned to handle the fluctuations against other currencies.

I do not think anybody seriously wants Denmark to reintroduce a devaluation policy since this had such negative consequences in the 1970s and the early 1980s.

It is important to emphasise that one-off devaluation of the Danish krone would not be in our best interests now or at a later time. Damage to the credibility of our fixed exchange rate policy would take many years to repair. Nobody would believe our assurances that such a devaluation was a one-off measure, never to be used again.

A variable exchange rate is the natural choice for large countries and currency areas, but in small countries with extensive foreign trade a floating exchange rate exposes the business community to greater uncertainty.

Experience shows that many small and medium-sized countries that today have floating exchange rates were forced to let their currency float because their fixed exchange rate regime was destroyed by speculation. Such a shift was often associated with considerable costs. We are therefore naïve if we believe that Denmark easily and painlessly would be able to switch to a floating exchange rate. This would eliminate the fixed currency foundation for the planning of the business community, which they have been accustomed to for almost the last 20 years.

In conclusion I would therefore like to emphasise very strongly that there must be no doubt whatsoever that the fixed exchange rate policy will not falter should Denmark decide not to adopt the euro. In that situation we must not embark on any monetary or exchange rate policy experimentation.

If Denmark chooses to adopt the euro most of the strategies for economic policy will be well known from Denmark's many years with a fixed exchange rate policy.