

Bodil Nyboe Andersen: Monetary policy and financial market developments in Denmark

Speech by Mrs Bodil Nyboe Andersen, Governor of Danmarks Nationalbank, at the Annual Meeting of the Danish Bankers Association, held in Copenhagen on 6 December 2000.

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In 2000 monetary policy has been the focus of more attention than we are accustomed to. Monetary policy is normally a relatively anonymous exercise in Denmark – except in periods of foreign-exchange unrest.

But the debate leading up to the referendum on Denmark's adoption of the euro on 28 September brought monetary policy into the limelight in two respects. Considerable interest was shown in the structure and monetary policy of the European Central Bank, while Denmark's fixed-exchange-rate policy and its significance to monetary policy were also in focus.

The ECB's monetary policy naturally attracted interest because if Denmark had decided to adopt the euro, we would have participated in the single monetary policy, and participated fully in the work of the European Central Bank. Being outside the euro area, the ECB's monetary policy is also of interest to us since our fixed-exchange-rate policy entails that our monetary policy mirrors that of the euro area.

Up to the introduction of the euro and in the spring of 1999 the European economy was characterised by weak economic growth, with very low inflation expectations. This entailed reductions of the official interest rates. During most of 1999 the ECB's benchmark interest rate was only 2.5 per cent. However, as from autumn 1999 inflation prospects in Europe deteriorated and since November 1999 the ECB has successively raised its interest rate to almost twice that level, so that it is now just under 5 per cent.

In certain periods monetary policy also drew a lot of attention because of the great contrast between economic growth in the USA and Europe, and the strong inflow of capital to the USA. This caused the dollar to strengthen, despite a massive US balance-of-payments deficit. Notwithstanding the euro's recent strengthening, there is general agreement that the euro is still clearly undervalued in relation to the dollar.

However, it is not the task of the ECB to directly manage the euro/dollar rate by adjusting interest rates, nor is this the responsibility of the Federal Reserve. Both central banks must ensure internal stability as the central element of their monetary policy. Nevertheless, excessive fluctuations or movements in exchange rates may be countered by intervention, as we have seen on a few occasions this autumn.

The objective of the ECB is stated in the Treaty to be price stability. This has been defined as a rate of price increases of less than 2 per cent in the medium term. It follows that the ECB's central task is to ensure the stability of the euro – not in terms of the dollar rate, but in terms of the euro's purchasing power.

The current average rate of inflation in Europe is somewhat higher than 2 per cent, primarily due to the strong oil-price increases. But, as stated, the objective of the ECB's monetary policy is to influence inflation in the medium term. The decisive factor is thus not the current inflation rate, but expected inflation. Interest-rate decisions are forward-looking and must be based on an assessment of expected future inflation. The ECB recently announced its intention to publish its economic projection twice a year. Together with a number of other indicators of the economic and financial situation this projection forms the basis for discussions of interest-rate policy.

In view of Denmark's fixed-exchange-rate policy vis-à-vis the euro the ECB's monetary policy determines the development in the Nationalbank's interest rates. The benchmark short-term interest

rate, the Nationalbank's rate for lending and certificates of deposit, is thus determined on the basis of the euro interest rate, plus a spread reflecting Denmark's foreign-exchange situation.

At the beginning of the year this interest rate stood at 3.30 per cent, which was 30 basis points higher than the ECB's equivalent interest rate.

In view of the considerable outflow of capital the interest-rate differential widened during the spring and the summer. At the end of 1999 the foreign-exchange reserve amounted to kr. 165 billion. By the end of the 3rd quarter of this year it had fallen to kr. 108 billion. Therefore the interest-rate differential gradually widened from 30 basis points in January to 45 basis points in June, while at the same time the Nationalbank followed suit on the four occasions that the ECB raised its interest rates.

At the end of June the ECB adopted a new method of determining the interest rate for the main refinancing operations. A minimum bid rate is now fixed at meetings of the Governing Council. Liquidity is allocated every Tuesday under a tender procedure. In the tender procedure the actual lending rate tends to fluctuate a good deal, which affects the Danish interest-rate differential. The Nationalbank has chosen to mirror only the major changes. This means that we will not adjust our lending rate if the euro interest rates fluctuate by a few basis points in either direction.

Maintaining Denmark's monetary policy unchanged thus requires more frequent adjustments in the light of the ECB's new procedure for liquidity allocation, as a consequence of which the actual lending rate is subject to greater fluctuation.

Immediately after the referendum the Nationalbank raised the lending rate by 0.5 per cent, thereby widening the interest-rate differential to 95 basis points. The intention was to prevent uncertainty concerning the krone's exchange rate. Since then, it has been possible to narrow the interest-rate differential to around 60 basis points, in view of a certain reflow of foreign exchange. Nevertheless, the interest-rate differential is still twice as high as at the beginning of 2000.

It is very satisfying to note that the fixed-exchange-rate policy has not encountered any serious difficulties during this year. Although money-market interest rates were rather high for a period up to the referendum there was no actual foreign-exchange unrest at any time. There was a tendency for an outflow of capital, which was countered by the Nationalbank's sale of foreign exchange and the widening of the interest-rate differential, so that a very stable krone rate could be held against the euro in 2000 so far. This could only be achieved on the basis of the strong confidence in the fixed-exchange-rate policy.

Together with the effects of the Whitsun package of economic measures the development in exchange rates has contributed to a strong improvement in the balance of payments over the last two years. However, even with a favourable balance-of-payments situation and a stable exchange rate a fiscal-policy tightening may be necessary, if the low unemployment rate exerts greater pressure on prices and wages. On several occasions the government has announced that it will not hesitate to tighten the economy if the fixed-exchange-rate policy so requires.

The fiscal-policy agreement does not represent a tightening of fiscal policy. Even in the light of a considerable government budget surplus in 2001 the Finance Act agreement must be characterised as rather expansionary. Moreover, it does not entail the type of structural improvements in the labour market which Denmark has implemented successfully in recent years.

It is to be hoped that other factors will counteract the expansionary fiscal policy in the coming year. In any case it is important that fiscal policy is not weakened further during the year, and that the objective is to return to a tight fiscal policy in the following years.

We are very proud of Denmark's economic development in current years, but we must not forget the old saying that the seeds of future problems are sown in the good years. This applies to the macroeconomic balance, but also to the financial sector.

That is why politicians and the Nationalbank alike have often on occasions like this warned the banks against being too bold when the going is good. The old saying is still as valid as ever. It is now that the banks must prepare themselves for future losses.

It is therefore surprising to note that the Finance Act agreement includes a reduction of the liquidity advantage on the provisions of banks and mortgage-credit institutes. The Nationalbank will not comment on the issue of whether it is fair to increase the taxation of the financial institutions to counteract the reduction of the corporation tax. Nevertheless, we find the choice of a method which reduces the incentive to make provisions to be unfortunate.

Experience shows that a prudent provisions policy, together with ample own funds, is vital to the ability of financial institutions to weather periods of recession.

The financial sector has seen many mergers during the past decades. The mortgage-credit sector accounted for most mergers in the 1970s and the 1980s, while the period around 1990 saw major mergers in the commercial bank and savings bank sector. Later on, the special focus has been on cross-border mergers, with the transgression of both sectoral and geographical borders.

This has resulted in larger, but also more complex, institutions which make new demands not only of boards and management, but also of the authorities. A particular problem is that legislation is based on financial institutions with a clear national foundation, even though they have extensive international operations.

This has, for example, led to agreement on intensified cooperation between the supervisory authorities of the Nordic countries. The Nordic central banks have also set themselves the task of evaluating the role of the central banks in relation to the cross-border financial groups.

The functioning of the financial markets is affected by the restructuring into fewer and larger institutions.

The money market especially is characterised by the reduction in the number of participants. The money market is an inter-bank market for trading liquidity between banks. An active market and efficient price formation require a suitable number of major market players. The mergers reduce the number of participants, however, so that liquidity flows are internalised within the individual institutions.

Prohibitions or regulations cannot change this, since the very objective of the money market is to distribute liquidity among the individual financial institutions. The fewer and the larger the banks, the less need for redistribution. However, several smaller banks still depend on the money market and on efficient price formation. We expect the large banks to continue to safeguard this structure. Otherwise, the Nationalbank will occasionally have to play a more active role on the money market than before.

The foreign-exchange market is characterised by a small number of active Danish participants and also a number of foreign participants trading kroner against foreign currencies.

Another important factor is that as an element of internationalisation major capital transactions are made to and from Denmark in connection with the acquisition and sale of companies and portfolio investments.

These transactions sometimes have a significant impact on the foreign-exchange market, emphasising that the Danish krone is a small currency in international terms.

The third financial market, the capital market, may also be affected by the decrease in the number of financial institutions. However, efficient price formation for bonds depends especially on investor behaviour. The restructuring of the tax system from real-interest tax to return-on-capital tax has eliminated the former locking effects on the capital market. The new rules on the taxation of the return on capital of institutional investors are neutral in relation to portfolio restructuring within the sector.

The cooperation between Danmarks Nationalbank and the Danish Bankers Association and its members covers a wide range of topics. These years have seen a number of major projects calling for the development of new types of cooperation. The payment systems have been modernised and significant innovations are being introduced in the statistics area. At the beginning of 2001 we will commence the publication of balance-sheet statistics for financial institutions in a new format. All of these projects require a major effort on the part of the banks, and not least their IT departments.

On behalf of the Nationalbank I would like to thank all of our cooperation partners who are part of the Danish Bankers Association.