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 Danish Bankers Association, Copenhagen, 3 December 2003.

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For twenty years the fixed-exchange-rate policy has been a cornerstone of economic policy in Denmark. It has won widespread acceptance from business, organisations, political players and the media.

At the beginning of the 1980s, the Danish economy was caught in a vicious circle with high inflation, frequent devaluations and long-term interest rates at around twenty per cent. We had to break this circle and did it by getting public finances into shape, abolishing the cost-of-living adjustment and implementing a consistent fixed-exchange-rate policy. Later in the 1980s, a tax reform was introduced to limit the interest-deduction entitlement.

These structural reforms were the basis for the stability-oriented economic policy pursued ever since. It has served Denmark well, and a virtuous circle has replaced the vicious circle.

Danes do not question the value of the fixed-exchange-rate policy, but analysts in other countries sometimes perceive it as old-fashioned. Fixed-exchange-rate regimes are often the target of criticism and warnings in reports from international organisations and not least in academic literature.

The general view in Denmark is that the fixed-exchange-rate regime has provided for very smooth sailing. Nevertheless, the two main points of criticism generally raised against fixed-exchange-rate regimes merit a closer look.

The first point of criticism is that as history has shown, a fixed-exchange-rate policy is difficult to maintain because of its vulnerability to speculative attacks. It may be especially difficult to resist speculation being built up in anticipation of a devaluation of a currency.

Globally, there are several examples of how speculative attacks have caused a fixed-exchange-rate regime to collapse. The most famous example is the withdrawal of sterling from the European Monetary System in September 1992. At the beginning of the 1990s Finland and Sweden were also forced to float their currencies and thus to abandon the fixed-exchange-rate policy. Finland, however, reverted to the fixed-exchange-rate policy in 1996 in preparation for introduction of the euro.

In the years since the early 1980s, Denmark has experienced a number of currency crises, but the fixed-exchange-rate policy has remained intact. The most recent speculation against the Danish krone took place more than five years ago, and Denmark’s fixed-exchange-rate policy today enjoys unique credibility in the market.

The present central rate vis-à-vis the euro represents a conversion of the exchange rate between the D-mark and Danish krone fixed in January 1987.

Why could we weather the storms despite all the arguments that the system is so vulnerable?

The short reply is that we have taken great pains to follow the “rules of the game”. First, we have used monetary policy solely to stabilise the exchange rate - whether or not the necessary interest rate was appropriate in relation to the domestic economic situation. Monetary policy has been earmarked for exchange-rate stabilisation.

Second, it is just as important that fiscal policy has “come through” - to use a modern expression. Fiscal policy has been responsible for ensuring stable and credible macroeconomic development in the medium term. Adjustments have been made primarily in connection with the annual Finance Acts. Nevertheless, in isolated cases specific measures were required. The latest example is the Whitsun package of economic measures in 1998.

The other main point of criticism of fixed-exchange-rate regimes is that a flexible exchange rate is necessary to shield the economy from external shocks. The same argument is used against participation in a monetary union.

The hypothesis is that a flexible exchange rate allows such external disruptions to be reflected in the exchange rate.

Following the EMS crises at the beginning of the 1990s, a number of those countries which had to give in to speculative pressure chose to let their currencies float. This enabled them to use monetary policy - i.e. the interest rate - to stabilise domestic demand and thus inflation.

A new inflation-management model was introduced in monetary policy, the so-called inflation targeting model. New Zealand and Canada had already applied this approach for some time. However, it was the Bank of England and Sveriges Riksbank that primarily developed the principles of this policy in close cooperation with academia.

Central banks applying inflation targeting aim at influencing the economy by solely using the interest rate to keep inflation two years ahead within a defined interval, typically 2 or 2½ per cent plus/minus 1 per cent.

The interest-rate decisions are taken by a committee based on economic projections, model calculations and personal assessments.

The ECB has a clear objective of price stability which is interpreted as an inflation rate below but close to two per cent. The ECB's interest-rate decision is also based on economic projections and on an analysis of key economic indicators. The decision-making process is, however, not formalised to the same extent as in Sweden and the UK, for example.

The Federal Reserve System has a broader economic objective where inflation not necessarily takes centre stage.

In 2001 Norway implemented an inflation-targeting regime. This happened gradually after the phasing out of the fixed-exchange-rate policy. Denmark is presently the only Nordic country to pursue a fixed-exchange-rate policy, as Finland now participates in the euro area.

It is worth examining whether this has led to more unstable inflation and growth in Denmark and Finland in recent years than in Sweden and Norway, which both have floating-exchange-rate regimes.

To this end Danmarks Nationalbank has compared the development in the four Nordic countries after 1996. The results are published in an article in our Monetary Review to be published on 4 December.

The comparison shows the course of inflation measured as the Harmonised Index of Consumer Prices, HICP, that is a general and comparable measure of price development. The message emerging from the comparison is that the variability in both inflation and output has clearly been lower in Denmark than in the other countries.

It shows that our fixed-exchange-rate policy has not been an obstacle to stable economic development. This is contrary to economic theory about this subject.

The article presents possible explanations of this apparent contradiction. One explanation is that in reality, stability is not jeopardised by external shocks, but rather by internal shocks in the form of inappropriate economic-policy changes.

History is rich in examples of how the wrong economic policy can lead to instability.

A recent example is the Netherlands. For a long time the country seemed to perform extremely well and was praised for its strong economy. From the end of the 1990s until two years ago, the Netherlands experienced very high growth, which drove up inflation.

As a consequence, government budgets tended to improve, of course. But the Netherlands did not let this trend prevail so that the automatic stabilisers of fiscal policy could work freely. Instead, they introduced a set of "ground rules" whereby savings on the expenditure side were used for payment of other, new expenses, while half the revenue improvement could be used to reduce taxes. At first sight these rules looked convincing, but they were clearly procyclical.

When the reversal came, performance declined rapidly. This year, negative growth of 3/4 per cent is expected. At the same time the Netherlands has tightened fiscal policy considerably, including significant expenditure cuts. This also reflects a procyclical approach, but the Dutch want to keep the budget deficit below three per cent in compliance with the Stability and Growth Pact. If only all euro area member states were as determined as the Netherlands.

This example shows how succumbing to relaxation of fiscal policy in good times can lead to highly unstable development. The consequences of activist fiscal policy may be entirely different from what was expected.

In Denmark, changing governments have been well aware of the risk that economic policy could go off course - precisely because of the potential vulnerability of the fixed-exchange-rate policy.

Therefore, in Denmark more than in most other countries, the watchword has been "stability-oriented economic policy". And everyone has accepted that monetary policy in itself could not contribute to domestic stabilisation, as it was earmarked for stabilisation of the exchange rate. As mentioned, this increases the responsibility imposed on fiscal policy. Fiscal-policy "activism" has been avoided, and a largely neutral fiscal policy has been pursued. The shocks of frequent fiscal-policy changes have thus been avoided.

The internationalisation of the financial sector and the EU's single market for financial services have been key issues for many years. Many rules and regulations have been made to facilitate this development. The primary purpose has been to create a level playing field. Another purpose has been to facilitate cross-border activities. All this has contributed to making the financial markets more open and competitive and giving customers the advantages of a large market.

In reality, large financial corporations have a national affiliation even if they have foreign ownership. They are mainly in contact with national authorities such as a country's financial supervisory authority, central bank, deposit guarantee scheme and ministries.

However, developments in the Nordic banking market in recent years indicate that we may be headed for integration of a magnitude that will significantly change the national relations.

This will make it more difficult for the authorities to observe the traditional national borders. One very specific field where this will be evident in practice is statistics, as it applies the concepts "domestic" and "foreign".

If a financial group operating in several countries brings together certain activities in one country, it may cause strange shifts in the statistical information, which by no means indicate underlying changes in the transactions conducted. The statistics may no longer present an accurate picture. Such restructuring within cross-border groups will require a new approach from the statistical authorities.

It will also pose a new problem to the supervisory authorities if one or more of the largest financial institutions become branches of foreign banks.

The deposit guarantee schemes, too, are fundamentally national and thus difficult to adapt to comprehensive cross-border activities.

And what is the role of the central bank if a branch of a foreign bank is so large that it has systemic importance and perhaps even is the largest retail bank?

In Financial Stability, published by Danmarks Nationalbank in the spring, we summarised the problem as follows:

"Where a branch is as large as or larger than the home-country entity, or a branch in an individual host country is so large that it has systemic importance and could affect the financial stability of the host country, very close collaboration should be established between the authorities across national borders, irrespective of the home-country supervision".

These issues are discussed intensively by the authorities of the Nordic countries. In Danmarks Nationalbank's analyses of financial stability we have focused increasingly on the Nordic groups.

In practical terms, the Nordic central banks have prepared a Memorandum of Understanding, which is available on our website. It describes the arrangements for cooperation in case of a financial crisis in a Nordic banking group with subsidiaries in several Nordic countries.

Financial integration has advanced further in the Nordic countries than in the rest of the EU. Some of the features currently observed in the Nordic countries are beginning to show in the EU as well, and they will tend to strengthen after the enlargement of the EU with ten new member states.

Therefore, the Nordic countries are spurring discussion of these issues at EU level. And the other countries are indeed very interested in learning more about the Nordic experience.

Internationalisation also has other aspects. So far, Danmarks Nationalbank has issued government bonds via the Copenhagen Stock Exchange, but trading in government bonds is no longer a predominantly national matter. Danish government bonds are sold in large numbers to international investors.

In recent years, the international trading platform MTS has become the standard for trading in European government bonds. MTS is now used by 12 EU member states, and the international investment banks are using the system.

To obtain the best possible prices on Danish government bonds we have chosen to move issuance to MTS, whereby more international investment banks have become primary dealers and active players in the market for Danish government bonds.

This has intensified competition and at the same time modernised the market for government bonds.

In the 1980s, Denmark was one of the first countries to introduce the option of electronic stock-exchange trading. Nevertheless, government bonds were traded mainly over the phone up to the introduction of MTS in November.

The trading platform is now electronic, and the quality of price information available during the day has increased considerably.

To consider the interests of small investors, Danmarks Nationalbank has concluded a special agreement with a number of Danish banks on quoting prices for small trades on the Copenhagen Stock Exchange. This agreement entered into force recently and has given small investors the possibility to have their trades in government bonds executed directly on the Stock Exchange.

As mentioned, the EU has for many years facilitated progress towards financial integration in order to create a single market for financial services.

Recent years have shown that this development is well underway. However, the EU cannot plan such a development. Financial integration is driven by the markets. It is up to the authorities to respond to this development and if necessary adapt the rules to facilitate it.