Jens Thomsen: How does the individual member state design an appropriate stabilisation policy in a monetary union?

Panel statement by Mr Jens Thomsen, Member of the Board of Governors of the National Bank of Denmark, at the 3rd ECB Central Banking Conference, Frankfurt, 22 October 2004.

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Having pursued a fixed-exchange-rate policy for many years, Denmark has gained extensive experience in this area. The present central rate was fixed in January 1987. Some of this experience is also relevant in relation to the new EU member states' participation in ERM II. In my contribution, I will focus not only on ERM II, but also on the broader question: how does the individual member state design an appropriate stabilisation policy in a monetary union? This means that the conclusions drawn will be applicable to both new and old EU member states.

In EMU, there is obviously no national monetary policy. The national stabilisation policy must therefore be based on alternative instruments.

ERM II is an integral part of the EMU process. For as long as the broad fluctuation band is utilised, monetary policy may still form part of a country's stabilisation policy. However, it cannot stand alone. As I will describe, its impact will diminish as the date of EMU entry approaches. All new EU member states have stated that they want to be in ERM II for as short a period as possible.

This means that fiscal and structural policies - the only national policy instruments in EMU - should already be appropriately designed within ERM II. This will ensure, among other things, that the terms of the Stability and Growth Pact are met or are, at least, immediately in sight. This is a simple but important point to always keep in mind.

Denmark has decided to stabilise its exchange rate close to the central rate. On account of the high degree of convergence, the stability of the Danish krone in the market, and the sustained stability-oriented economic policy, Denmark participates in ERM II with a narrow fluctuation band of +/–2.25 per cent. This band is, however, far from utilised. In other words, fiscal and structural policies are the only stabilisation-policy instruments available to Denmark - as will also be the case in EMU.

This means that the exchange rate - and the exchange rate alone - determines the interest-rate spread. Intervention in the foreign-exchange market is also an option, for brief periods of time, to counter adverse exchange-rate movements. Intervention cannot stand alone, however.

Organisationally, this also implies that we must be able to adjust our interest rates when required, without being tied down by the meeting schedule of a monetary-policy committee. This is a well-known fact in the market and thus highly transparent. Alternatively, one could say that our monetary-policy committee convenes every day and as required.

Central bank independence is a prerequisite in this respect. Without it, the implementation of necessary measures can be endangered.

We have a clear division of work regarding intra-marginal interventions. The Board of Governors, in collaboration with Market Operations, establishes a strategy based on current market conditions. The Board of Governors has access to real-time information on any interventions, but is not consulted in advance. Interventions within one day are never capped, but subject to ongoing assessment in order to establish whether strategy adjustments are called for. The ECB is kept informed on an ongoing basis.

In principle, one might ask whether the design of our stabilisation policy is appropriate?

Theoretically, there are two arguments for acting as we do.

Firstly, the institutions are designed to be in compliance with EMU participation and thus also with the provisions of the Treaty. At some future point in time we expect Denmark to enter EMU, and when it does, we will not have to alter our fiscal policy, since it is already based on government finances in surplus or close to balance. There is strong political support for this rule-bound division of labour in economic policy. The awarding of this year's Nobel Prize in Economic Science demonstrates that the design of institutions is also considered to be of great theoretical importance.

Secondly, we know from the "impossible trinity" that in a world of free capital movements, it is not possible to set interest and exchange rates independently of one other. The central bank has one instrument, and one instrument only, at its disposal: the short-term rate. Any attempts to stabilise the exchange rate while at the same time meeting other targets, are thus futile in theory. In practice, they spawn a number of problems which are aggravated the closer one seeks to stabilise the exchange rate.

A number of central banks, including several from new EU member states, currently base their monetary policy on inflation targeting. In principle, the central bank seeks to approximately meet not only one, but two targets, an inflation target and an output-gap target, using just one instrument: the short-term rate. The reason that this is viable is that usually the targets work together. The problem in supplementing these targets with an exchange-rate target is that the need for internal stabilisation may easily conflict with the exchange-rate target.

Spain formally continued its inflation targeting up to its EMU entry. This was, however, also a period in which the interest-rate spread to Germany progressively narrowed, and never widened, while fiscal policy was put in place. Meeting the convergence criteria was the central aim of the overall economic policy - irrespective of how monetary policy was classified.

Theoretically, inflation targeting in ERM II presents an additional complication in that the impact of the national interest rate diminishes relative to domestic activity and future inflation rates as the date of EMU accession approaches.

If the country is expected to enter EMU in, say, one year, the national interest rate will exist for only one year. The closer the date of entry, the greater the interest-rate changes needed to influence activity.

If the inflation-targeting country is expected to enter EMU with a specific exchange rate, there is, on the other hand, a risk of wide exchange-rate movements in the run up. With a known entry rate, the spot rate has to move in order to fulfil the interest-rate parity.

This issue, trivial as it may seem, is rarely mentioned in the literature.

This means that, in practice, new EMU members need to abandon inflation targeting well before EMU entry and rely on fiscal and structural policies.

In Denmark's experience, this is no hindrance to appropriate economic performance.

Monetary policy is reserved for keeping the exchange rate stable and close to the central rate within ERM II. In conjunction with sound public finances, this has ensured an anchoring of inflationary expectations in line with the ECB's definition of price stability.

We have used structural improvements and symmetric fiscal policy, in compliance with the requirements of the Stability and Growth Pact, to achieve sound public finances. Our clear medium-term objective is to reduce the government debt.

The fiscal policy stance is determined annually in connection with the Finance Bill for the coming year and allowing for the expected cyclical development. Discretionary fiscal policy measures are rarely used in the course of the year and have typically included structural improvements.

In the long term, the structural policy is most important. As the world keeps turning, structural reforms in principle never end. The most appropriate speed and sequence of reforms e.g. depend on whether the output gap is positive or negative. This makes it difficult to draw a clear distinction between structural and fiscal policy.

In international terms, including countries that apply best practice inflation targeting, Denmark has seen very moderate volatility in inflation as well as output in recent years. We attribute this, in large measure, to the use of stabilisation policy as described above. In the 1970s and early 1980s, a very activist fiscal policy was pursued, as opposed to the current situation. Our government debt rose steeply and the exchange-rate policy was anything but consistent. In those years, Danish volatility was high by international standards.

Danish experience thus speaks against fiscal as well as monetary fine-tuning of the economy. Efforts to stabilise the economy often end up rocking the boat. Our experience, in the main, corroborates the focus on structural economic factors theoretically established by Kydland and Prescott.

I want to make one final point:

It is appropriate that drivers practise and qualify for a driver’s licence before getting behind the wheel.

Similarly, it is appropriate that a country documents that it is ready for EMU prior to entry. Part of this documentation is ERM II membership