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Denmark is not Switzerland

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The Danish central bank, Nationalbanken, has over the past few weeks taken unprecedented action to defend the Danish fixed exchange rate policy. Since the Swiss National Bank (SNB) last week chose to let the franc float freely, a large amount of capital has flown into Denmark. The reasons are twofold.

First, Denmark is currently perceived as a safe haven by financial market players due to its solid public finances. Second, it is a more speculative test by the markets of the Danish central bank's willingness and ability to maintain its fixed exchange rate policy following the SNB move.

The significant capital inflows, which over the month probably amount to some DKK 90-100bn, put significant upward pressure on the Danish krone. This pressure has been countered by the central bank through a build-up of foreign exchange reserves and a lowering of the currently most important key refinancing rate, ie the CD rate (the rate of interest on certificates of deposit), by a total of 45 bp. The interest rate is now at -0.5%. Only in conjunction with the first rate cut on 19 January did the central bank also cut the lending rate, by 15 bp to 0.05% now.

The CD rate is the key policy rate of the Danish central bank at the moment because the commercial banks in Denmark run considerable deposit surpluses. In periods of funding gaps, the lending rate is the main monetary policy rate of the central bank.

Denmark is not Switzerland

It is important to understand the difference between the monetary policies pursued in Denmark and in Switzerland. Unlike Switzerland, Denmark has a long tradition of maintaining a fixed-exchange-rate policy. Switzerland introduced a temporary ceiling on the franc against the euro at 1.20 only in September 2011 after massive capital inflows had led to a significant overvaluation of the franc. This overvaluation of the Swiss currency threatened the economic

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upswing during a period when the world economy had only just started recovering from the global recession. It should be noted that the franc was not subject to a symmetrical fluctuation band and that Switzerland was alone in ensuring that the franc did not strengthen beyond 1.20 against the euro.

The Danish fixed exchange rate policy is fundamentally different. Denmark has a long tradition of maintaining a fixed rate policy towards its main trading partners and has since the collapse of the Bretton Woods system in 1971 been a member of the current European monetary cooperation. Since 1983, the fixed exchange rate policy has been a cornerstone of the economic policy pursued. This is a significant difference compared with for example Switzerland.

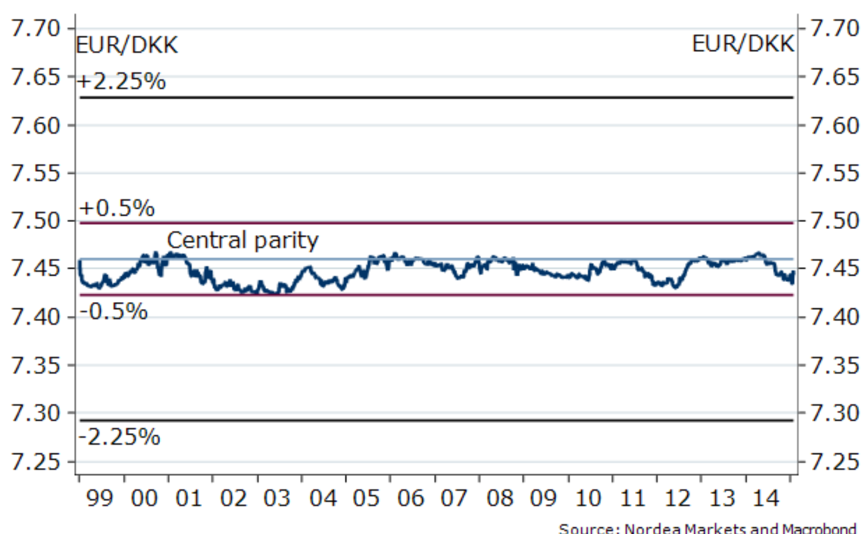
Denmark in ERM2

By referendum Denmark has decided not to join the euro, but it participates as the currently only member in ERM2, with a central parity rate of 7.46038 against the euro. The normal fluctuation band in ERM2 is +/- 15%, but Denmark has chosen a narrow band of +/- 2.25%. The ERM2 agreement includes a provision on unlimited intervention credit between the ECB and the participating central banks in connection with intervention at the fluctuation band limits – in the case of the Danish krone at 7.62824 and 7.29252 versus the euro.

This exchange rate regime provides a framework for low and stable inflation in Denmark. There is a clear distribution of responsibility for economic policy. In a fixed exchange rate regime such as Denmark's, monetary policy rates are reserved for managing the exchange rate and they cannot also be used for managing the business cycle. The Danish central bank's monetary policy purely aims at keeping the krone stable against the euro. The government conducts its fiscal policy and economic policy in general so as to achieve a stable economic development. A stability-oriented fiscal policy is also of paramount importance to the fixed exchange rate policy. Click here to read more about the Central Bank's monetary policy.

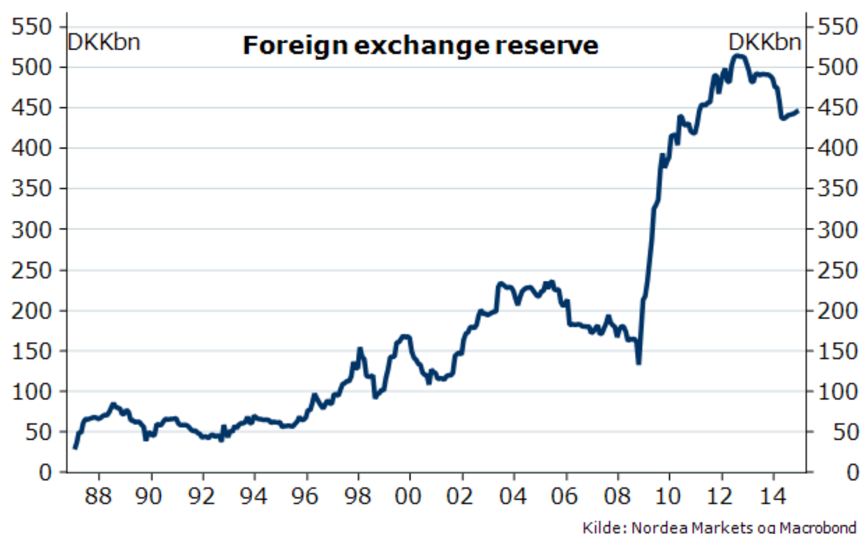
Since the late 1990s, the Danish central bank has kept the krone stable at a level close to the central parity rate. There seems to be a kind of informal fluctuation band of +/- 0.5%.

However, in periods where the krone tends to weaken the Bank has been even more aggressive in pursuing its peg policy, see chart.



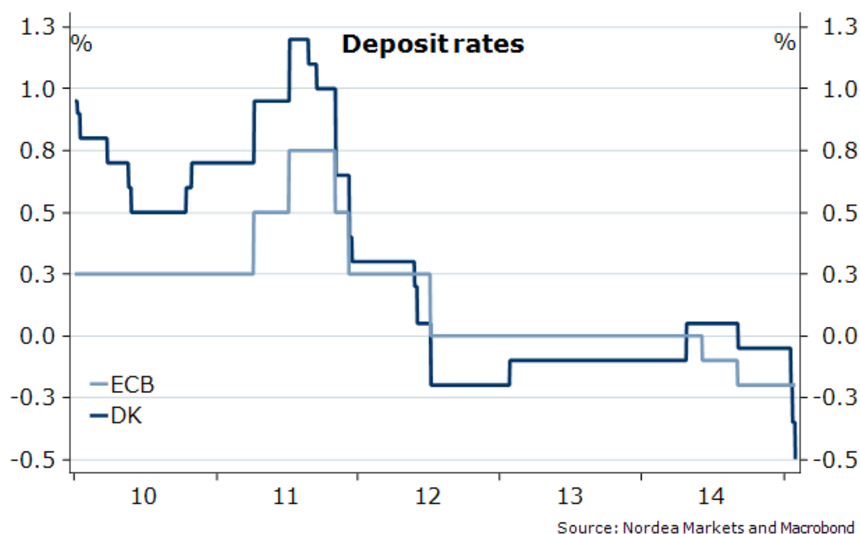
A fixed rate policy implies a need for sufficient foreign currency reserves at all times. In periods of capital inflows into Denmark, the central bank purchases foreign currency in the market and sells Danish kroner. The opposite is true during periods of capital outflows, as was the case in eg September 2008. See chart.

The Danish central bank has no set target for the foreign currency reserves, but the below chart shows that since the financial crisis the bank has preferred having relatively large reserves at hand in case of speculative pressure against the krone.



However, when the central bank believes that the flows of capital are too violent – typically a one-way flow of around DKK 15bn over a short period of time – the bank typically responds by shifting interest rates upwards or downwards.

Since the exchange rate is fixed against the euro, the ECB's key rate is the one by which the central bank sets its own key rate. If the Danish central bank wants a stronger DKK, the interest rate differential must be in favour of the DKK, ie higher than in the Euro zone. If the central bank wants a weaker DKK, the Danish rates have to be lower than the equivalent rates in the Euro zone. This is the case in the current situation, and to our mind there is no lower bound to the interest rate. The Danish central bank has over the past weeks demonstrated by its actions that the fixed exchange rate regime is carved in stone. In case the inflow continues, we would expect to see the bank cutting rates according to the above-mentioned rule of thumb.



Unconventional tools

On Friday, February 28 the conventional means were followed up with a surprising decision of a temporarily suspension of the issuance of Danish government bonds. The decision was taken by the Ministry of Finance upon the recommendation of the Danish central bank. The central government has a very large deposit on its account at the central bank, which can easily cover the financing requirement in 2015 and given the foreign currency situation, the Danish central bank does not find it appropriate to reduce the issuance of government bonds over several years.

The central bank has purchased foreign exchange in the market and reduced the monetary-policy interest rates and currently, the Danish short-term interest rates are lower than those of the euro area, while long-term rates however are higher. In a period of an underlying upward pressure on the krone, this gives an additional incentive for foreign investors to buy Danish bonds, which just leads to another increase in the pressure on the krone.

The exercise of the central bank is thus to curb capital inflows by forcing also the long end of the yield curve down through a reduction in the supply of government bonds. At the same time the bank strives to counter that capital will flow into the Denmark even more substantially when the ECB in March introduces its large-scale quantitative easing program, QE. This will force interest rates on government bonds in the euro area further down, and there is certainly a possibility

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that part of the amount can be placed in Denmark if the interest rate differential between Denmark and the euro area is sufficiently attractive. Since it is still uncertain whether the central bank will be able to curb the capital inflow by it's latest action we have to conclude that a possible future Danish QE programme cannot be excluded.

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