Denmark

Why Denmark Will Not Follow The SNB

- Despite large ongoing currency inflows, we believe there is little chance that the Danish National Bank (DNB) will follow the Swiss National Bank (SNB) and abandon its commitment to exchange rate stability (operated via the ERM system, with a central target of DKK7.46038/€ and fluctuation bands of +/-2.25% – i.e. between DKK 7.29252 and DKK 7.62824 per euro).

- The SNB's decision to end its currency peg likely reflected a mix of worries over potential losses on FX reserves if intervention had continued, a sense that the emergency which prompted the currency peg had faded, and a view that the economy has shown its ability to cope with FX appreciation. The position in Denmark, meanwhile, is very different; there is much greater support within the DNB and political establishment for the FX peg, less concern over the buildup of FX reserves, and greater worries about the economic damage if the peg is abandoned.

- In the face of large inflows, policy action by the DNB so far has included FX intervention, rate cuts and suspension of government bond issuance. If, as seems likely, inflows to DKK remains high, we reckon the DNB will be forced to continue intervening in the FX market and – perhaps very soon – to cut the CD-rate deeper into negative territory. The DNB also may allow the currency slightly greater flexibility within its ERM II band in order to produce two-sided FX risk. The DNB may also take advantage of additional unconventional measures, for example in the form of QE (buying government and mortgage bonds) or curtailing issuance of Treasury bills. Economic factors (sluggish economy and inflation near zero) give the DNB ample reason to avoid the tightening of monetary conditions that would be produced by an appreciating exchange rate. Or, put differently, negative interest rates are not in conflict with the DNB's domestic policy aims.

Tina Mortensen
+44-20-7986-3284
tina.mortensen@citi.com

Michael Saunders
+44-20-7986-3299
michael.saunders@citi.com

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Why Denmark Will Not Follow The SNB

Following the surprising Swiss National Bank (SNB) move in mid-January, when it abandoned its CHF1.20/€ currency cap, there has been speculation on whether the Danish National Bank (DNB) could choose to, or be forced to, exit its EUR/DKK peg too.

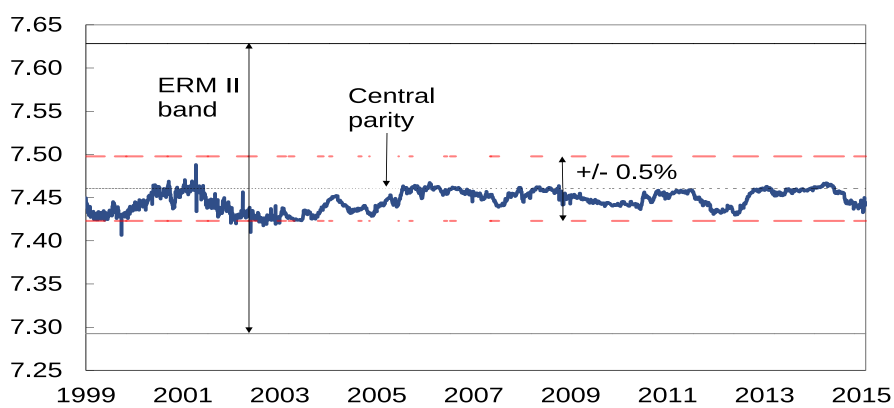
The SNB move, combined with the larger-than-expected bond purchase program from the ECB, has led to sharply stronger demand for Danish assets. Within a short period of time, this has forced the DNB to intervene in the FX market, cut interest rates more deeply into negative territory and to suspend government bond issuance in an attempt to halt krone appreciation. Despite these measures, the Danish currency remains strong.

However, we believe the chances of the DNB following the SNB are very low. The SNB's decision to end the currency peg appears to have reflected a mix of worries over potential losses on FX reserves if intervention had continued, a sense that the emergency which prompted the currency peg had faded, and a view that the economy has shown its ability to cope with FX appreciation. The position in Denmark is very different, in our view, with much greater support within the central bank and political establishment for the FX peg, less concern over the buildup of FX reserves if and when the FX cap ends, and greater worries about the economic damage if the peg is abandoned.

Deeper political support for the currency peg

Although both Switzerland and Denmark are relatively small open economies, the two countries have very different attitudes to the appropriate currency regime. The SNB has never been wedded to exchange rate targets and has overseen a long trend of FX appreciation over recent decades. The SNB operated various forms of monetary targeting in the 1970s, 1980s and 1990s, other than a brief interlude of an exchange rate target in 1978-79, and has had a formal inflation target since 2000. The SNB adopted the CHF1.20/€ currency cap in Sep-2011 as an emergency measure, arguing that *"The current massive overvaluation of the Swiss franc poses an acute threat to the Swiss economy and carries the risk of a deflationary development."* In practice, inflation has repeatedly undershot the SNB's forecasts since then, but real economic growth has been no worse than expected, and among the highest across advanced economies. In our view, the SNB chose the wrong time to end its currency cap. But, it was always a question of 'when' not 'if' the currency cap would end. For the SNB, the decision to end it marks a return to its comfort zone of a flexible exchange rate.

Figure 1. Denmark – EUR/DKK Exchange Rate (Daily Observations), 1999-4 Feb 2015

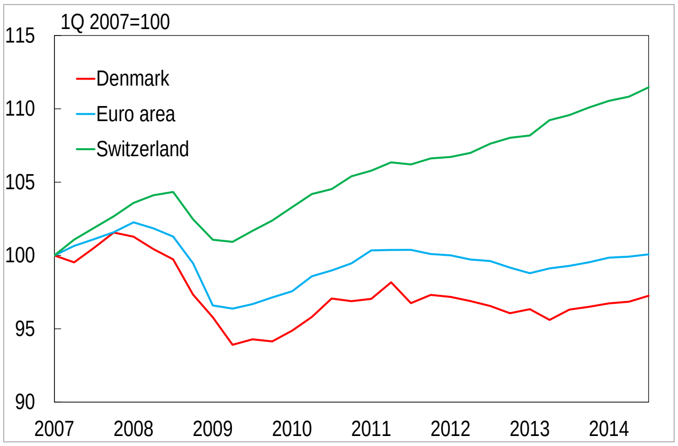


Sources: Ecowin and Citi Research

By contrast, support for a fixed exchange rate is deeply rooted at the DNB and in the Danish political and business establishment, with a long-standing tradition for basing monetary policy on an exchange rate target. In the latter half of the 1930s, the Danish krone was pegged to sterling. Later, Denmark participated in the dollar-based fixed exchange rate system, the Bretton Woods system, established under the auspices of the IMF in the post-war years. This system broke down in the early 1970s. Subsequently, the krone was linked to various European exchange rate systems, initially the 'Snake' and, from 1979, the Exchange Rate Mechanisms (ERM I and II). Since the late-1990s, the Danish peg has been governed very tightly. The Danish peg has survived the EMS crisis in the early 1990s, the financial crisis in 2008/09 and the European debt crisis in 2010-12. The DNB does not have an inflation target; its mandate is to keep the krone within a band around its central parity of 7.46038 per euro. Under the ERM II system, the krone is permitted to fluctuate by +/-2.25% (or between DKK 7.29252 and DKK 7.62824 per euro) around that parity, though in practice the Central Bank keeps an even tighter range (+/-0.5%).

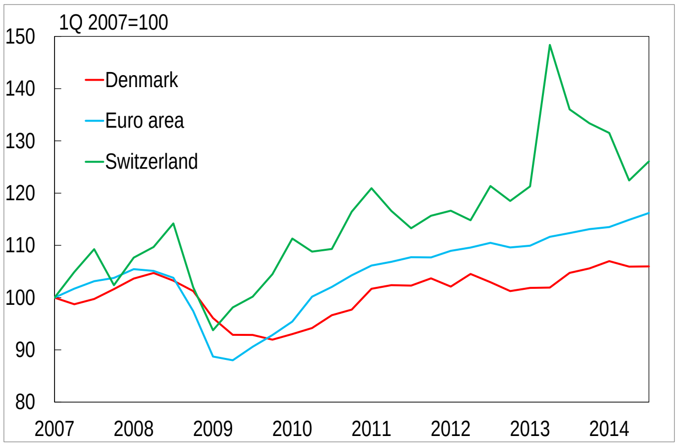
The exchange rate policy in Denmark is not decided solely by the DNB, but is laid down by the Danish government in consultation with the Central Bank. There is widespread support for the peg within the political system; both the current Social Democratic-led government and the opposition support the peg, hence we do not expect the general elections later this year (by September the latest) to change this. We also note that there is broad support across political party lines for the principle that Denmark should eventually join the euro area, although – with a clear-cut vote against euro area membership in the 2000 referendum and opinion polls showing strong public opposition to euro area membership – there is little chance of another referendum any time soon.

Figure 2. Selected Countries – Real GDP (Index: 1Q 2007=100), 2007-3Q 2014



Sources: Haver and Citi Research

Figure 3. Selected Countries – Goods and Services Export Volumes (Index: 1Q 2007=100), 2007-3Q 2014



Sources: Haver and Citi Research

Concern over scale of FX reserve build-up

In theory, a central bank that is intervening to prevent FX appreciation can accumulate reserves without limit, especially if deflationary domestic pressures limit concerns at any potential spillovers from such intervention to domestic liquidity and asset prices (especially if such intervention is not fully sterilised). But, in practice, worries over potential future losses on these FX reserves probably did play a large role with the SNB. This factor is unlikely to carry as much weight with the DNB.

First, the scale of reserve buildup – although large – is less dramatic than for the SNB. At end-Dec 2014, Denmark's FX reserves stood at DKK 450bn (about 24% of GDP), surging to DKK 564bn (about 30% of GDP) in January 2015. Nevertheless, the rise in reserves remains quite modest by comparison with that in Switzerland, where the SNB's reserves (including gold) escalated from 24% of GDP at end-2009 to 84% of GDP at end-2014. Second, the issue of central bank losses is far more politicised in Switzerland. The SNB pays a dividend (of up to 6% of its share capital), of which one-third goes to central government and two-thirds goes to the Cantons (i.e. local government). In recent years, this distribution has been CHF1bn per year. This represents 0.2% of nominal GDP but for the Cantons this dividend represents roughly 1% of their income – and hence if this is cut then pressure on the Cantons to cut spending creates an immediate grass roots political backlash. In early 2014, the SNB dividend was suspended as a result of SNB losses in 2013 and, while the CHF1bn SNB dividend was reinstated in early 2015 (after large FX profits in 2014), the prior year's experience probably led to pressure from its shareholders to limit potential future losses[1]. By contrast, the DNB is wholly a branch of central government, and any losses or profits on the FX reserves are absorbed within the broad pool of finances – and do not affect actual general government spending.

Ability to withstand FX appreciation

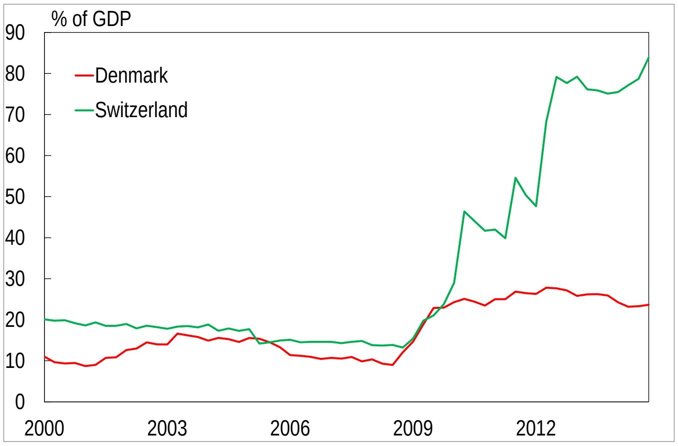
The Swiss economy has over time shown much greater ability than Denmark to cope with currency appreciation, with faster export growth despite a greater trend of FX appreciation. This resilience may well reflect the relatively high share of financial services and high-tech manufacturing in Switzerland's total exports, sectors that are relatively insensitive to currency appreciation. For example, Switzerland's nominal GDP is roughly twice that of Denmark, but Switzerland's market share in global exports of pharmaceuticals, aerospace and computers is more than four times that of Denmark. Conversely, 34% of Denmark's exports of manufactured goods are in low-tech sectors, compared to 23% of Swiss exports[2]. In turn, this disparity heightens the Danish authorities' commitment to FX stability and their fear of the economic disruption that might follow if the ERM II band is abandoned.

The sluggish economy gives the DNB ample reason to avoid the tightening of monetary conditions that would be produced by an appreciating exchange rate. The Danish economy has been recovering only slowly and unevenly from the unwinding of the massive domestic property boom, plus the global crisis that erupted in 2007-08. The recovery has been very sluggish and this has come alongside widespread worries over banking sector health. The level of GDP in Denmark is 4% below the pre-recession peak and no higher than it was in 2005. According to calculations by the DNB, the economy has a significant output gap (about 2.0% of potential GDP in 4Q 2014). GDP in Denmark probably rose by only 0.9% Y/Y in 2014, and we only expect a minor acceleration this year (1.4% Y/Y) and next (1.7% Y/Y). Households and non-financial corporations continue to consolidate, with high household debt and the savings ratio above their long-term averages.

[1] After the end of the FX cap, the SNB dividend was subsequently raised, as a one-off, to CHF2bn on 30 January.

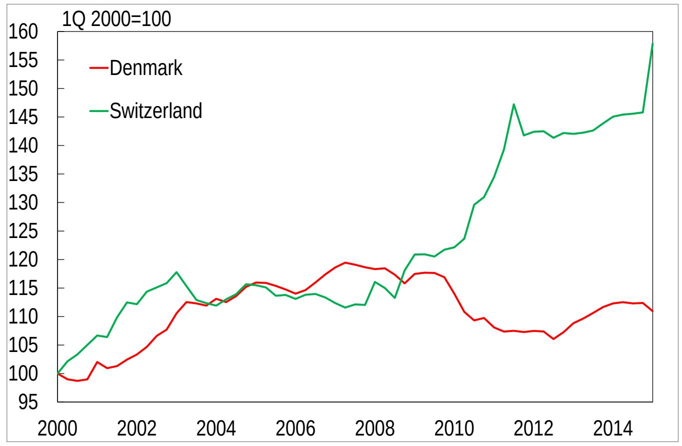
[2] Source: OECD.

Figure 4. Denmark and Switzerland – FX Currency Reserves (Pct of GDP), 1995-2014



Sources: Ecowin, Datastream and Citi Research

Figure 5. Denmark and Switzerland – ULC-Based Real Effective Exchange Rate (Index: 1Q 2000=100), 1994-Jan 2015



Note: The data is measured in local currency. Sources: Datastream and Citi Research

Options to cap DKK

History and recent actions show a strong commitment from Denmark's side to maintaining its peg, and we believe the probability that Denmark will follow the SNB is low. Moreover, although the DNB has already gone a long way, it still has several ways it can address the current situation and limit the strong appreciation of the DKK, in our view:

1. **Additional rate cuts.** DNB's most important weapon in fighting pressures on the krone is to trim the CD-rate as this determines money market rates at the very short end. Although the CD-rate is already at an all-time low of -0.5%, the Bank can still reduce the rate deeper into negative territory (levels below -1.00% are a possibility, in our view). In fact, the DNB emphasized last week that it has scope to cut rates further and sell more kroner: *"Those instruments remain in the toolbox to be used,"* head of communications, Karsten Biltoft said.

2. **Virtually unlimited build-up in foreign currency reserves.** DNB FX reserves currently amount to DKK 564bn (30% of GDP), and the DNB could allow them to rise to DKK 1,600bn before it reaches the current SNB level as a share of GDP. This is well in line with indications from the DNB, which after the release of January currency reserve data, stated that it has an *"unlimited supply of kroner"* and that there is *"no limit to how high FX reserves can go"*. In other words, the DNB will continue to use its standard intervention tool going forward if the appreciation pressure continues. So far, it also appears that the DNB has largely sterilized its FX intervention via CD issuance, with the monetary base relatively stable. Hence, the Bank can a) continue with sterilized interventions or b) implement unsterilized intervention.

3. **Intervene in the FX forward market** to complement intervention in the FX spot market.

4. **Quantitative easing.** Like other central banks, the DNB might well take advantage of additional unconventional measures such as an actual purchase program of government and/or mortgage bonds.

5. **Further halt to government bond issuance.** Late last week, the DNB announced that the Ministry of Finance had, upon its recommendation, decided to suspend the issuance of government bonds in order to reduce interest-rate spreads in the longer maturity segments. Since then, both the 10Y and 30Y yields have dropped significantly, in line with the Bank's aim. As a build-on measure, the DNB could recommend that the government stops the issuance of Treasury bills as well.

6. **Use of entire ERM II trading band.** In recent years, the DNB has only allowed the DKK to trade in a very narrow band versus the euro (+/-0.5%). With still a long way down to the lower ERM II floor of 7.29, DNB may thus for a period allow a slightly stronger krone versus the euro. This would create genuine two-sided risk for the currency, because DNB would be quite happy to tolerate significant depreciation within the wider band.

7. **Set a wider ERM II band** and allow it to appreciate to the lower end, hence, creating even more downside risk than option 6. The normal fluctuation band is +/- 15%, but since Denmark has shown an excellent degree of convergence to the euro area, a more narrow fluctuation band was negotiated (i.e. +/- 2.25%). A return to the +/-15% band (used briefly in the early 1990s) would create significant two-sided FX risk that might discourage FX inflows.

8. **Other measures to discourage capital inflows.** Possible options could be some form of capital controls or taxes on bank deposits (and perhaps other financial assets), in order to set effective interest rates more clearly negative.

From the above list, it appears that the DNB (and the government) retain substantial resources to keep the exchange rate regime intact. In line with indications from the DNB, we expect the Bank initially to make use of options 1-3 if pressure on the krone continues. If this proves insufficient, other unconventional measures may also be introduced (as per the list). One should never say 'never'. But, we still find it hard to come to any conclusion other than that the Danish peg will ride out the present storm – as it has done during previous storms (EMS crisis, the 2008/09 financial crisis and the European debt crisis in 2011/12).

Appendix A-1

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