



Managing of an ‘Out’

Camilla Andersen interviews

Bodil Nyboe Andersen,

Denmark’s central bank governor

WHILE THE corridors of the Danish central bank—located in a beautiful marble and glass building designed by internationally acclaimed architect Arne Jacobsen—are pretty quiet these days, it wasn’t always so. When Bodil Nyboe Andersen took over at the helm of the central bank in 1995, she probably had little inkling of the challenges that lay ahead. In 1997, she had to protect the krone (Denmark’s currency) from contagion stemming from the Asian crisis and then, a year later, the Russian crisis. And in 2000, she had to calm currency markets concerned about the Danes voting no—for the second time in less than a decade—to adopting the euro.

The decision not to join the European Union’s (EU’s) Economic and Monetary Union (EMU) has left Denmark on the periphery of the euro area and has entailed a loss of influence over economic policy. Having experienced what it means to be an “out” country, Andersen would like to see that decision reversed. “I am personally in favor of euro participation,” she tells *F&D*. “Adopting the euro would widen the scope of economic policy compared to a situation where a fixed exchange rate policy is pursued. We would gain a share of influence on Europe’s monetary policy and have a little more room for maneuver in fiscal policy.”

Andersen’s career before joining the central bank taught her valuable lessons about adapting to changing circumstances and also provided her with insight into the workings of private finance—two important qualities when you are in charge of managing a small currency in a country that has removed all capital controls. Before her appointment as governor, she moved effortlessly between academia, the private sector, and government—something which is still uncommon in a country where, unlike in the United States, people tend to choose one career path and then stay with it. After spending a few years as a lecturer at Copenhagen University, she became a private banker—a career that culminated in her appointment to the management board of Unibank, Denmark’s second largest bank, in

the Currency Country

1990. But after less than a year there, she moved to the board of governors of the Danish central bank, and five years later, she found herself in charge. “It might look like a career plan but it wasn’t,” Andersen says.

Andersen was ranked in 2004 as the most credible person in Denmark for the seventh year in a row by *Børsens Nyhedsmagasin*, Denmark’s leading business magazine. And as one of only a handful of women to hold the top job at a central bank, she was named by *Global Finance* magazine in 2000 as among the world’s 20 most powerful women in finance. For its part, the Danish economy was praised by the IMF’s Executive Board in 2004 for its ability to “combine a strong welfare state with high employment and growth.” With unemployment at only 6 percent (despite very high labor participation by EU standards; over 75 percent of all adults work), government debt at 43 percent of GDP (compared to the euro area average of over 70 percent), a strong and sustained budget surplus, and inflation below 2 percent, Denmark is the fifth most competitive economy in the world, according to the World Economic Forum’s 2004 growth competitiveness index.

Small country, large consequences

Andersen got a preview of the turbulence that would mark the first 10 years of her tenure at the central bank in June 1992, when the Danish government called a referendum to ratify the Maastricht Treaty, which contained the blueprint for EMU. The timing of the referendum could hardly have been worse. Resistance to abandoning national coins and banknotes was growing throughout the EU, and weak economic growth made it difficult for many countries to fulfill the preconditions for joining EMU. While lower interest rates would have helped, participants in the European Exchange Rate Mechanism (ERM) had no choice but to follow the policy of the Bundesbank, which was keeping rates high in a bid to control inflation after German reunification. Denmark’s “thanks, but no thanks” to a single currency added to the sense of impending gloom. Unrest gripped the currency markets, with countries having to repeatedly raise interest rates to defend their ERM parity. The unrest escalated into a full-blown crisis, which engulfed most of the currencies in the ERM—including the Danish krone. “The crisis was indeed terrible,” Andersen says. One country—the United Kingdom—left the ERM for good, while the other countries agreed to allow their

currencies to move within a wider band. Denmark, however, “came back within a few years to the former narrow band—with the old parity—without big problems.”

Although Denmark subsequently followed the United Kingdom and was granted an “opt-out” from adopting the euro (see box), the government decided in 2000 to hold another referendum on whether the country should join the euro area. But despite support from all the major political parties, the Danes again voted no. What did this renewed rejection of the euro mean for monetary policy? While the period leading up to the referendum must clearly have been nerve-racking, and while the outcome was a big disappointment to all those at the central bank who had helped prepare for Denmark’s entry into the euro area, Andersen responds laconically: “The outcome meant we could continue the monetary policy we had been running for many years.” Denmark’s long-standing tradition of using the exchange rate as a nominal anchor dates back to the original Bretton Woods system of fixed parities that was dismantled in 1973. According to Andersen, the policy worked successfully in some periods, and in other periods less successfully. “But since the early 1980s, a stable exchange rate policy has been the cornerstone of Denmark’s economic policy.”

Going against the trend

Maintaining the peg against the deutsche mark—and from 1999 onward, the euro—was not, however, universally viewed as the best way to go. Following financial crises in Mexico, Asia, Russia, Brazil, and Turkey that brought down one currency peg after another, the IMF’s position gravitated toward what became known as the “bipolar view.” Only very hard pegs or free floating currencies were likely to be sustainable in countries open to capital movements, and hard pegs could be maintained only if supported by policies that satisfied stringent requirements. Intermediate regimes were viewed as crisis-prone, at least for economies open to capital flows.

This view spilled over into the IMF’s dialogue with Denmark during its biannual consultations. According to Andersen, missions would arrive in Copenhagen expressing skepticism about the central bank’s approach to pegging and probing the case for either more flexibility or full EMU membership. Each time, however, she and her staff made it clear that “we were willing to follow the rules of the game and make the necessary sacrifices.” After what were sometimes lengthy discussions, mutual understanding was reached, and the IMF’s reports during the 1990s all ended up concluding that the level of the peg was sustainable as long as the Danish government kept supportive policies in place.

Today, things are different, Andersen emphasizes. The IMF has a more nuanced view of pegs and the success of Denmark’s economic and monetary policies speaks for itself.

Denmark's special relationship with the EU

When Denmark voted against the Maastricht Treaty in 1992, it almost derailed the implementation of the treaty throughout the EU, as all member states must approve any changes to the EU's constitutional framework. In an effort to win over euro-skeptic Danes, the government quickly held a new referendum—this time promising four opt-outs from the Maastricht Treaty. These included:

- **Economic and monetary union.** Denmark is not required to adopt the euro. The only other country with this opt-out is the United Kingdom, which negotiated its special status in 1991, before the first Danish referendum.
- **Union citizenship.** An opt-out in this area has become obsolete.
- **Common defense.** Denmark is not required to participate in actions that have implications for defense, including EU peacekeeping missions.
- **Justice and home affairs.** Denmark does not participate in certain areas of EU judicial cooperation, including decisions that involve immigration and asylum policies.

The krone has remained stable against the euro since the introduction of the common currency in 1999 and is trading within an extremely narrow band in ERM2—the exchange rate mechanism that replaced the ERM when the euro was launched. In its most recent assessment of the Danish economy, the IMF praised the fixed exchange rate for being a central pillar of the macroeconomic stability strategy and said the low spreads in interest rates vis-à-vis the euro area attested to the credibility of the peg. As Andersen puts it, “we are seen by the markets as being as stable as the euro.”

Does Andersen attribute at least part of this success to the fact that the markets and the public believe what she has to say? After all, credibility is seen as critical to the job of central bank governor. Andersen does not deny that, but she scoffs at the notion that the krone's stability is somehow the result of her communication skills. “Our credibility has come not from me being governor, but from the central bank and the government delivering what has been promised. Delivering year after year and not diverging from the path is what creates credibility.”

This philosophy is aided by the fact that an exchange rate regime based on a hard peg is very transparent and does not require much explaining once credibility has been established. And in contrast to the previously fashionable policy of targeting money supply, having the exchange rate as a nominal anchor means success or failure is easy to see: all markets have to do is look at the daily exchange rate between the krone and the euro. In contrast, inflation targeting requires a lot more external communication because it is based on projections of future inflation. As Andersen explains, an exchange-rate based policy “is a very easy regime once you have credibility because, when the markets foresee that there could be movements, they carry out so-called ‘stabilizing speculation’ instead of the central bank.”

Keeping the fiscal house in order

When a country forgoes flexibility in monetary and exchange rate policy as Denmark has—every rate move by the European Central Bank (ECB) is followed by a similar move in Denmark within hours—it has no choice but to run a very responsible fiscal policy lest the markets lose trust in the central bank's ability to sustain the currency at its current level.

Denmark is no exception to this rule. A sound fiscal policy has been central to the krone's stability, and the country has been running a budget surplus since 1997. This has allowed the government to reduce its debt from a high of almost 80 percent of GDP in 1993 to the current low of 43 percent. Andersen credits this commitment to fiscal prudence to a fiscal crisis in the late 1970s, during which “Denmark was headed for the abyss, albeit in first class.” From this crisis, a strong political consensus emerged in favor of fiscal consolidation. In 1997, the EU adopted the Stability and Growth Pact (SGP), which requires EMU members to limit their annual fiscal deficits to 3 percent of GDP and aim for fiscal balance over the medium term, and specifies sanctions if those requirements are not met. While only EMU members can be sanctioned, all EU countries are bound by the goals set out in the SGP. Today, while as many as half of all EMU members are in breach of the SGP, Denmark enjoys a comfortable 1–2 percent surplus on its state finances, putting it well within the requirements of the pact, and helping it prepare for an aging society and a shrinking workforce.

Asked whether the requirements of maintaining a stable exchange rate against the euro have been driving fiscal consolidation, Andersen says it is difficult to say which came first. “It can't just be said that the exchange rate policy helped foster fiscal discipline. Fiscal discipline helped make the exchange rate policy possible. That, and other bold policy initiatives taken in the 1980s, were all part of the package that transformed Denmark's macroeconomic framework,” she says.

Given Denmark's success in fiscal stabilization and the key role it has played in maintaining a stable exchange rate, it is perhaps not surprising that the Danish central bank has adopted a hawkish stance in the current debate on whether to relax the requirements of the SGP. Andersen and her central bank colleagues have on many occasions stressed they are against changes that will relax the budget constraints. “It's not the rules that are bad,” she says, “it's adherence to the rules that hasn't been perfect.”

Can the Danes teach the other EU countries—in particular the 10 new member states—any lessons in macroeconomic management? A few of these newcomers—including the two small Baltic republics, Estonia and Lithuania, with whom Denmark enjoys close ties—have already joined ERM2, with the intention of adopting the euro once they have proved they can keep their currencies stable for a minimum of two years. More countries (including Latvia, the third Baltic republic) plan to join soon.

Despite Denmark's success, Andersen is careful about promoting her country as a model for others to follow. She points to the many differences between Denmark and the new member states, including the fact that the krone is mov-

ing within a much narrower band than the new ERM2 currencies. But where the new member states can successfully emulate Denmark, she says, is in making sure that fiscal policy underpins the exchange rate regime. “They can’t run a regime relying on monetary policy and inflation targeting to stabilize the economy and leave fiscal policy to do other jobs—that’s not possible,” she warns. “This is the whole idea of ERM2—before giving up all monetary sovereignty by having a common currency, they must show that the other parts of their economic policy can be stable.”

Not a risk-free strategy

What might happen if the new participants in ERM2 do not heed this advice and precipitate a crisis? Will the krone be forced off its peg, as happened in 1993, by the forces of contagion? In a recent paper, Willem Buiter, chief economist at the European Bank for Reconstruction and Development, suggests that any attempt by a member state to use ERM2 to cover for weak domestic policies risks a multiple currency blowout like the one in the early 1990s. Without new rules for euro membership, he argues, a country that is not ready for the euro but joins ERM2 could do harm to other EU countries.

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Andersen certainly does not dismiss the risk of crisis and contagion. “One should never say never,” she notes, but adds, “I don’t think it’s a big issue for us.” She points to the large reserves of the central bank and to the fact that ERM2 is structured differently than the ERM, which linked all currencies together in a grid. The new “hub-and-spokes approach” means currencies are no longer directly linked to each other, but only to the euro, something that reduces the likelihood of contagion. Does she have a plan in her drawer just in case? Andersen says simply: “You should never be careless.”

Insofar as the Danes have an exit strategy, it is adoption of the euro. But before that can happen, a third referendum must take place. For her part, Andersen believes adopting the euro will not only provide more flexibility in economic policy, but also give Denmark the opportunity to have its voice heard when decisions are made at the ECB’s headquarters in Frankfurt.

The cost of being an ‘out’ country

Of course, there is an inherent paradox in Denmark’s decision to stay outside EMU. Those who voted no did so because they did not want to surrender more sovereignty to Brussels. Yet the result is that Denmark can now do little else but follow the ECB’s every move—without being able to influence it in any way. Andersen and her colleagues use personal networks to stay involved in—or at least informed of—important policy developments. “Luckily, there are a number of people in senior

positions at the central bank who have been around for many years, and we therefore have a big network,” she says.

When you come from a small country, networking is key not only at the European level, but also internationally. For this reason, Andersen applies the same principles to cooperation with the IMF, where she is a member of the Board of Governors, the IMF’s highest decision-making body. “We are very aware of the fact that we are a small country and this is an international organization, so how much we can influence things is limited,” she says. Denmark is a member of the Nordic-Baltic constituency—which comprises Finland, Iceland, Norway, and Sweden, as well as Estonia, Latvia, and Lithuania—and has a total voting power of only 3.52 percent.

Fortunately, IMF decisions are typically shaped through debate in the Executive Board and an informal search for consensus among countries, rather than through formal voting, and the Nordic countries do carry a certain moral authority. Not only are four of the six most competitive economies in the world located in Scandinavia, the Nordic countries are also the world’s most generous providers of overseas development aid in relative terms. Discussions flow freely—and occasionally heatedly—within the constituency, Andersen says, and positions taken by the Executive Director are decided jointly by the capitals. “It’s not like those constituencies where you have one country dominating.”

Quietly successful

Andersen has always welcomed change, and part of her success as an economist seems to have been her adaptability. “You learn all your life,” she says. When she retires in October this year at the age of 65, she intends to spend at least some time cultivating her earlier professional interests—she was recently appointed chair of the board at the University of Copenhagen where she first began her career in the early 1970s. But most of all, she says, “I’m looking forward to having more time for myself and for my grandchildren.”

While Andersen is getting ready for retirement, others will be busy picking her successor. She will be a hard act to follow. During her tenure, Andersen has been quietly successful in ensuring the stability of the krone through turbulent times, thus helping Denmark achieve more than 10 years of strong economic performance. While fiscal policy and structural reforms certainly have played a key role, the central bank made an important contribution. By enhancing the credibility of the peg, Andersen also firmly established the Danish central bank as a credible player in the European System of Central Banks, thereby maintaining its relevance despite its position on the periphery of the euro area. Of course, those charged with looking for Andersen’s successor will need to be mindful that the world does not stay the same. They will thus be looking for someone who can match Andersen’s combination of resoluteness and intellectual capacity to adapt to new challenges. ■

Camilla Andersen is on the staff of Finance & Development. She is not related to Bodil Nyboe Andersen.