

DANMARKS NATIONALBANK

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Comparison of four periods of pressure on the Danish krone

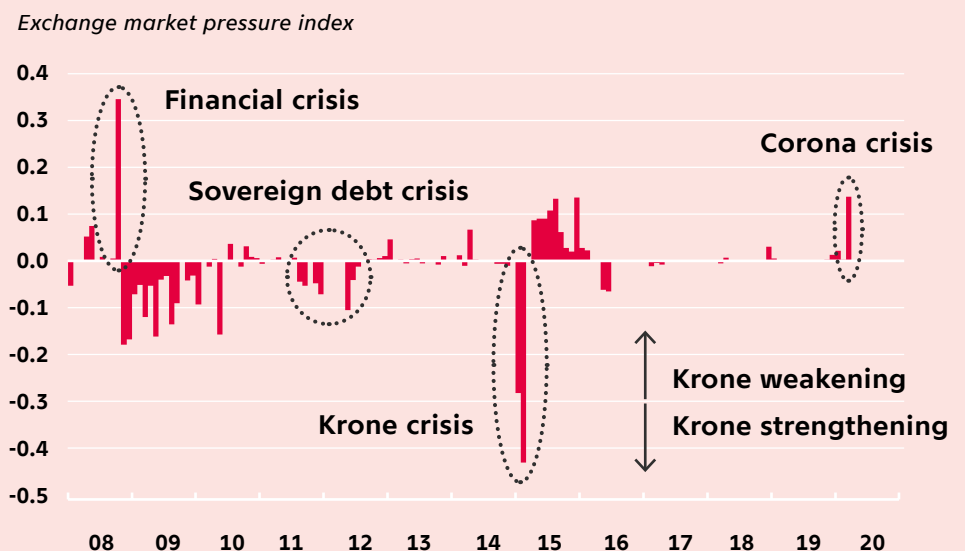
Losses on dollar assets contributed to pressure on the Danish krone

A new publication by Danmarks Nationalbank compares the pressure on the krone during the corona crisis with three earlier periods of krone pressure over the past 12 years. The pressure on the krone in March this year was unusual because it was not impacted by for example speculation about the Danish fixed exchange rate policy. Rather, it was caused by Danish institutional investors selling kroner in response to a decline in the value of their foreign assets.

Danish pension companies and other investors holding assets in, for instance, US dollars, hedge against losses from a weakening dollar through foreign exchange forward contracts in which investors sell dollars against kroner. That way, they hedge their dollar exposure. As the value of their dollar assets dropped sharply in March, so did their need for dollar hedging. Consequently, they chose to buy back some of the dollars sold via forward contracts by selling kroner. In March, the insurance and pension sector's

Strongest pressure towards a weakening of the krone since the financial crisis

Source: Asger Munch Grønlund and Lars Risbjerg, Pressure on the Danish krone in times of crisis, Danmarks Nationalbank Economic Memo, no. 11, July 2020.



reduction of dollar hedging resulted in krone sales totalling kr. 61 billion.¹

So, this time around, the pressure on the Danish krone was not caused by a change in behaviour or perception of the krone by some market participants; instead, it was the result of their response to external factors in order to maintain the hedge ratio of, for instance, their dollar exposure.

This is a major difference from previous episodes of pressure on the krone. Previous episodes of pressure have been affected by market speculation about whether the fixed exchange rate policy could be maintained, or whether the euro area would break up. This appears from a new Economic Memo, prepared by Asger Munch Grønlund and Lars Risbjerg, Danmarks Nationalbank. The Economic Memo can be found here ([link](#)).

For close to four decades, Denmark has been pursuing a fixed exchange rate policy – initially against the German D-mark and then against the euro. Under this policy, Danmarks Nationalbank maintains the exchange rate of the krone against the euro through intervention in the foreign exchange market, buying or selling foreign exchange or, if this does not suffice, by changing interest rates to make it more or less attractive to hold kroner.

The fixed exchange rate policy entails that the krone/euro exchange rate is not the only indicator of pressure on the krone. An overall indicator of the pressure on the krone, which can be used to compare the pressure across time periods and countries, is the Exchange Market Pressure (EMP) index. The EMP weights exchange rate changes, foreign exchange interventions and interest rate changes. Based on the EMP, the pressure on the krone in March 2020 was the strongest pressure towards a weakening of the krone since the financial crisis, see the chart.

The corona crisis, like the financial crisis in 2008, is a global economic crisis. There are several commonalities between market developments during the corona crisis and the financial crisis, such as plummeting stock market prices and high market volatility. Financial market uncertainty indicators reached the same levels during the two crises.

During the pressure on the krone caused by the corona crisis, Danmarks Nationalbank intervened in the foreign exchange market by selling foreign exchange totalling kr. 65 billion in March 2020 and raised the certificate of deposit rate by 0.15 percentage points to -0.60 per cent p.a. During the financial crisis, interventions were of a similar magnitude, while the certificate of deposit rate was raised by 0.90 percentage points. This coincided with the European Central Bank (ECB) cutting its rate.

As equity markets have stabilised since March, the pressure on a weakening krone has vanished. There are no indications that foreign investors have pulled out of kroner during the corona crisis. Foreign investors have also continued to purchase Danish mortgage bonds during the corona crisis, which is also in contrast to the financial crisis.

Economic Memos are a new type of publication from Danmarks Nationalbank, a cross between Analysis and Working Paper. An Economic Memo often presents the ongoing analysis work of the authors and is targeted primarily at professionals. You can find Danmarks Nationalbank's Economic Memo series here ([link](#)).

1 For an elaboration, see, for instance, Box 3 in Danmarks Nationalbank's analysis Monetary and Financial Trends, published 17 June 2020.

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