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HOW LONG IS THE DANISH ROAD TO THE EURO?

1. Introduction

In year 2002, the prospects for global economy were not promising. Neither the European nor the American economy experienced expected upswing. In 2003, consumer and business confidence were undermined by high uncertainty about the development of the situation in Iraq. In most of the European Union countries the signs of a global slowdown were strongly experienced. The rise in unemployment and fall in foreign investments affected to high extent some of the eurozone economies.

Nevertheless, the Danish economy remained robust and has been developing as fast as in the previous years. Keeping the economy on the track of growth was possible due to a successful combination of the fiscal and monetary policy. Denmark is one of the three countries, which kept some leeway in conducting the economic policy. As a member of the Exchange Rate Mechanism II (ERM II), Denmark may adjust the monetary policy with respect to the current state of the economy.

The Danish policy-mix is of interest in this paper. The goal of the paper is to show that staying within the ERM II for a longer time does not need to be a “bad necessity”. It proves that in case of Denmark the adoption of euro “as soon as possible”, which is considered for Poland after joining the European Union in May 2004, does not need to be the only good solution.

2. The beginnings of ERM II

Until the introduction of the euro on 1 January 1999 Denmark had been staying within the exchange rate mechanism, which assumed that krone rate would be stabilized against the core currencies of the European Monetary System (EMS): the D-mark, the Dutch guilder, the Belgian franc, the French franc and the Austrian schilling (Danmarks Nationalbank, 1999). Since that day, Denmark has participated in the exchange rate cooperation with the European Central Bank. The purpose of this agreement, which is called ERM II, is to retain the exchange rate within the agreed fluctuation band. The standard fluctuation band is +/- 15%. Nonetheless, due to the good condition of the economy, Denmark adopted a narrower band of +/- 2.25% around the central parity which was set to 7.46703 Danish krona for 1 euro. Such decision was justified by a high convergence of the Danish economy with the euro area (Andersen Nyboe B., 2001). In the Figure 1, the krone's exchange rate vis-à-vis euro since January 1999 was drawn. The horizontal lines show the upper and lower bounds of possible fluctuation of the krone's exchange rate from the central parity. It can be seen that on a monthly basis, the krone's exchange rate did not differ very much from the chosen central parity and a 2.25% deviation could be even considered too big.

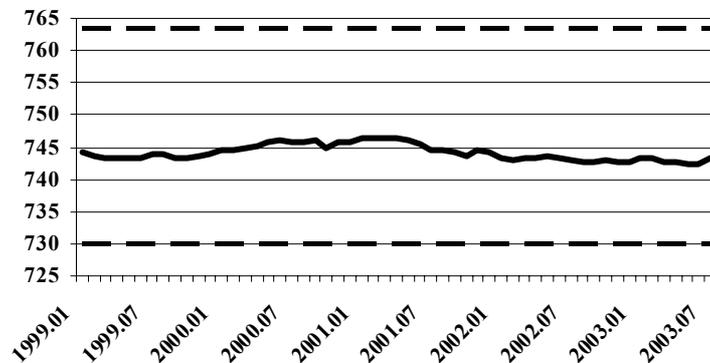


Figure 1: The exchange rate DKK/EURO.
Source: Danmarks Nationalbank

The ERM II was initially thought as a transition period before the adoption of euro and the withdrawal of a national currency from circulation. Nevertheless, in a referendum, which took place on 28 September 2000, majority of Danes rejected euro (Buch et al., 2002). As a matter of fact, only 12 countries introduced common currency into circulation in 2002.

The opponents of the euro in Denmark were indicating on the worsening of the standard of living, as a consequence of losing independence in deciding about the tax rates and the level of social services. The Socialdemocratic government, which was strongly supporting the campaign for the euro adoption, was indicating on the threat of a financial crisis, as a consequence of a more active behaviour of speculators. The dispute has not finished yet and the actual government of Fogh Rasmussen does not want to set a date of a new referendum, keeping in mind the reluctant attitude of the Danes three years ago.

The analysis of a functioning of the ERM II in Denmark needs to be done with respect to the past state of the economy, as it gives interesting insights into the current situation and helps to understand the decisions taken by the Danish government and Danish central bank (Danmarks Nationalbank).

3. Overview of the Danish economy

Since the Second World War the Danish krone's exchange rate had been tied with the British pound and later with the American dollar. Until a collapse of the Bretton Woods system, Denmark had not conducted any active exchange rate policy. In 1972, it became a member of the "currency snake" with a fluctuation band of +/- 1.125%. At that time, although a mobility of the capital was restricted, the system was not completely stable. Moreover, in the seventies the economic policy in Denmark, which was based on the traditional Keynesian demand incentives, was not appropriate in the presence of the oil crises. As a consequence, the budget deficit and current account deficit forced devaluation of the Danish currency. The series of devaluations started in 1979, when the European Monetary System was created. The devaluations took place in September and November 1979, and later in October 1981. However, it did not prevent Denmark from falling into recession in year 1981. The next two devaluations in February and June 1982 were the announcement of the turning point in the macroeconomic policy. Denmark resigned from

using the exchange rate as a tool of the monetary policy and adopted the fixed-exchange-rate policy. As a consequence, the Danish krone appreciated and was overestimated from the end of the eighties until the middle of the nineties.

Despite the negative impact of the devaluations on the wage adjustments to the general costs of living, the government managed to keep the prices down. Gradually, the interest rates and inflation were falling down. It was possible due to the attempts towards deregulation, internationalisation and increased competition in the economy. As a result, the difference between the Danish and German long-term bond interest rates was diminished from 10.6 percentage points in 1982 to 0.3 percentage points in 2002 (Danmarks Nationalbank, 2002). Figure 2 presents how the interest rates have been changing over the last few years and shows a high convergence of the Danish and German long-term interest rates in this period. In general, the Danish interest rates were co-moving at the same pace as the German interest rates

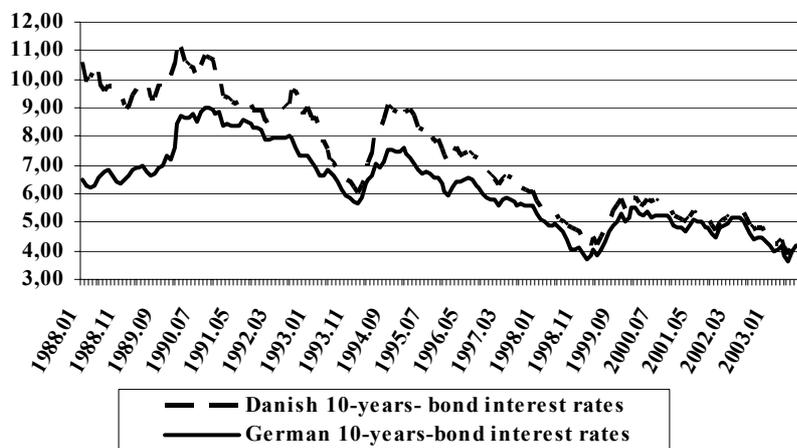


Figure 2: Long-term interest rates.
Source: Danmarks Nationalbank

As far as the inflation rate is concerned, it reached its highest level in 1974 and amounted to 15%. The oil crises, which occurred in the seventies, had an impact on the pace at which the rise in prices could be limited. As a result in 1980 the Consumer Price Index (CPI) was 12% and after that year it began to fall. Since the beginning of the nineties, it has remained at the low level of around 2%, which is believed to have positive impact on the growth of the economy as it creates a basis for an increased competition and allows for the adjustments in the real terms. The estimated inflation rate for year 2003 is 2.0% (Finansministeriet, 2003).

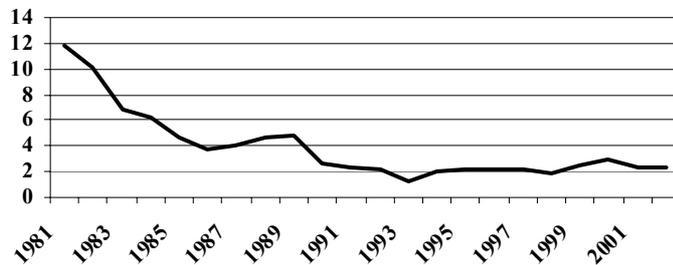


Figure 3: Consumer Price Index.
Source: Danmarks Statistik

It is worth noting that the Danish economic policy since the beginning of the sixties until the nineties was aimed at decreasing the unemployment rate, which in 1993 reached the level of 12.4%, at improving the balance of current account and the competitiveness of the economy. The structural changes were indispensable as the Danish economy had to undergo a transformation from an economy, in which almost 20% of all employed people worked in agriculture and fishing and 40% within manufacturing and construction, to a more modern model of economy. In 2002, these rates were less than 4% and 25% accordingly (International Monetary Fund, 2002). More jobs were created in the service sector. In 2002 the unemployment rate was 5.2% and the structure of employment changed. These figures prove that some positive effects of the labour market reforms could already be noticed. The figure below presents the rate of unemployment, which has been displaying some cyclicality over the last twenty years. In 1999 it declined and reached a bottom in 2001. If a cycle were to be repeated, one should forecast an increase. As a matter of fact, already in the first half of this year, 2003, there have been signals of a rise in the number of unemployed people in Denmark.

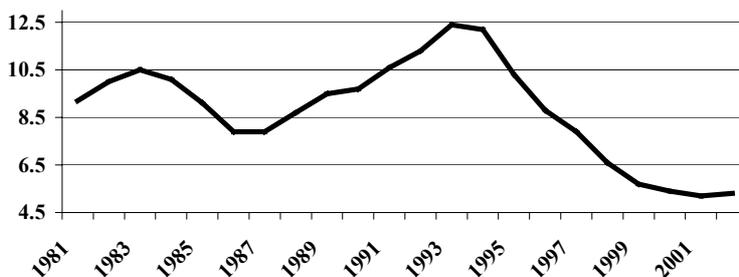


Figure 4: Unemployment rate.
Source: International Labour Organization

In a nutshell, in 1993 the strong economy recovery began. This year is usually called a “kick-start” of the Danish economy. Lowering the international interest rates, concurrently with converting the mortgage loans turned out to be a successful demand incentive. The gain in consumer confidence was noticed. Nonetheless, after 6 years of booming, Danish economy lost its momentum in 1999, which was due to a decrease in the

domestic demand. However, a situation on a current account was reversed and for the first time a surplus of around 10 billion krona was estimated.

The growth in GDP was positive and in 2000, it reached the highest level of 2.8%, after which it took a value of 1.4% and 1.6% in the following years. The estimate for year 2003 is 2.3% and had to be lowered due to a later than expected pickup in the global economy.

4. Monetary policy

The fixed-exchange-rate policy has been a cornerstone of Denmark's economic policy since the beginning of the eighties. The monetary and fiscal policies are pursued in compliance with the fixed-exchange-rate goal. In this view, monetary policy is designed to maintain a stable krone rate, whereas fiscal policy is in charge of stabilization in wages and prices development.

The objective of the monetary policy in Denmark is to stabilize the exchange rate of Danish krone against the euro, but not vis-à-vis any other currencies as for example American dollar or Polish zloty. The exchange rate of the Danish krone depends on the demand and supply of foreign currencies. The Nationalbank trades in the foreign exchange market. The operations of purchase or sale take place on a daily basis. Since the beginning of nineties the central bank has been more often buying the foreign currency than selling, which led to an increase in the foreign exchange reserves (Danmarks Nationalbank, 2002). The purchases were thought as to offset the surplus on the balance of payments which in year 2002 amounted to 39 billion krona. The foreign-exchange reserves increased to 193 billion krona.

The financial stability of the economy depends on the Danmarks Nationalbank's policy and its monetary-policy counterparties, which comprise all together 119 banks and mortgage-credit institutes that can participate in the weekly market operations in order to obtain a 14-day loan against collateral in securities or deposit liquidity for 14 days by purchasing certificates of deposit. The fluctuations in government payments and Danish central bank's purchases and sales of currency have an impact on the net positions (the certificates of deposit and current-account deposits less the loans from the central bank) of the financial institutions. In 1999, when Denmark became a participant of ERM II, in order to prevent the build-up of large current-account deposits that could be used for speculation in interest rate and/or exchange-rate fluctuations, there have been set limits of 20 billion krona in current-account deposits. If the ceiling is exceeded, then the current-account deposits in excess in particular banks or mortgage-credit institutes will be converted into certificates of deposit.

Danmarks Nationalbank conducts monetary policy by determining the lending rate and the discount rate, which are of crucial importance for setting the short-term money-market rates. Since Denmark's monetary policy is aimed at keeping the krone stable vis-à-vis the euro (the exchange rate is stabilized even within a +/-1% range), Danmarks Nationalbank's interest rates usually shadow those of the ECB. If the tendency for the krone to strengthen or weaken is more prolonged Danmarks Nationalbank may unilaterally adjust the interest rates without an agreement from the European Central Bank. In year 2002, Danish central bank had cut the interest rates three times by a total of 0.15 percentage points until December 2002. The ECB had not lowered its interest rates until 5 December 2002, when a simultaneous reduction took place - the same day the ECB's and Danish interest rates were decreased by 0.5 percentage points. As a result, the Danish lending rate in 2002 was 2.95% and a discount rate 2.75%.

In general, the Danish 3-months deposit rates were significantly higher than the German interest rates in the late eighties and in the beginning of the nineties. The huge difference was noted during the ERM crisis, when the Danish interest rates were increased by nearly 6 percentage points. In the year 1998, before the ERM II, Danish deposit rates were higher than those in the EMS countries. In the graph below the deposit rates in Denmark and in Germany until January 1999, and later in the eurozone are drawn. In general, Danish interest rates were higher, however, in the last months one can observe a very high convergence of the interest rates. The last months show that Danmarks Nationalbank was continuously following steps taken by the European Central Bank, hoping to boost the economy.

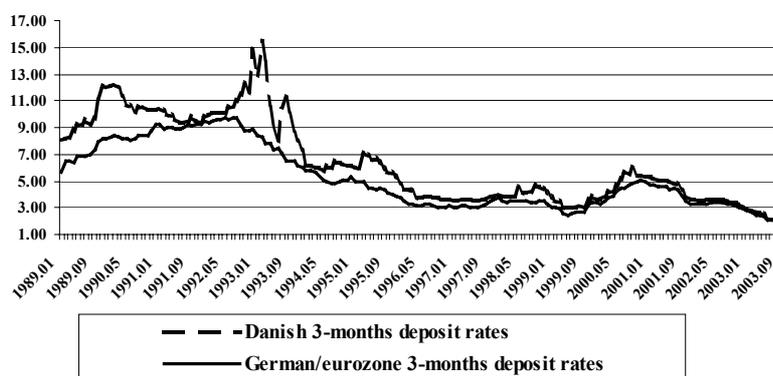


Figure 5: 3-months deposit rates.
Source: Danmarks Nationalbank

All in all, while Denmark does not share a single currency, its central bank has always tracked changes made by the ECB. Danmarks Nationalbank, although still an independent institution, is watching with vigilance every action taken by the ECB and will probably keep on emulating its actions until (and if) the euro is adopted in Denmark. Nevertheless, one has to be aware of the differences in the Danish and eurozone's monetary-policy instruments. In Denmark there is no access of the banks and mortgage-credit institutes to an overnight lending facility. Thus, they are obliged to trade liquidity among themselves instead of borrowing from Danmarks Nationalbank and it supports an efficient money market. Secondly, the Danish current-account-limit system is not compatible with a reserve-requirement system applied by the Eurosystem. The purpose of the reserve-requirement system is to stabilize the overnight interest rate in the eurozone and enhance the transmission of the monetary-policy interest rates to market interest rates. In Denmark the overnight interest rates do not have an impact on the money-market interest rates for longer maturities. Moreover, the symmetry in the conditions for loans and certificates of deposit makes the sign of the monetary-policy counterparties' net positions, which can shift as a result of the Danmarks Nationalbank's operations in the foreign-exchange market, insignificant. Thirdly, the Danish central bank does not call tenders when it is conducting the refinancing operations. Thereby, the American auction principle does not hold in Denmark, where Nationalbank determines a lending rate at which the counterparties can decide on the volume of monetary-policy loans and certificates of deposit, thus making it more transparent.

All the measures taken by Danmarks Nationalbank, its set of instruments and unconditional willingness to keep the exchange rate stable, make the speculation in the Danish currency less probable and ensure stability on the foreign-exchange market.

5. Fiscal policy

As already mentioned, after the introduction of the euro, the eurozone member states are subject to the single monetary policy. The other economic policies are pursued at the national level with respect to some provisions stipulated by the EU Treaty.

Of the utmost importance is the Stability and Growth Pact, which lately has been broadly criticized. It was adopted in January 1999 and it obliges all EU member states to seek to ensure a medium-term budgetary position close to balance or in surplus. The EU countries need to prepare and publish stability programs and state how they are going to fulfil them. However, no sanctions can be put on the non-euro area countries, such as Denmark.

Solid public finances are indispensable for the proper functioning of the economy. Therefore, EU initiated deficit targets and convergence programs which create the formal framework for the fiscal policies in the member countries. According to the Maastricht criterion the debt-to-GDP ratio should not exceed 60%. The Treaty states that the individual countries ought to avoid government budget deficits which should not exceed 3% of GDP. Some countries set more restrictive limits.

In 1997 Denmark was facing problems with fulfilling the fiscal criteria. The debt-to-GDP ratio amounted to 65.1%. Thus, the government announced a plan "Denmark 2005", in which it set an explicit objective of reducing the 2005 debt-to-GDP ratio to 40% (International Monetary Fund, 2002). One year later this figure was 59.5%. Already in year 2001, the planning horizon was extended. Plan "Denmark 2010" was assuming a debt-to-GDP ratio of 35% by 2005 and 20-25% by 2010. Year 2010 is considered to be an important date. It is estimated that by this year, there will be significant demographic changes. Thus, necessary changes in the fiscal policy need to be done before that date and with respect to the future possible threats for stabilization of the public finances.

Danish fiscal policy, as the policies in all the industrialized countries, is pursued with respect to the changes in the population structure. The government needs to take into account the ageing of the society, which means less active people in the labour market and more pensioners. It is estimated that now there are 4 persons of working age for every person aged 65, and in year 2040 this figure will decline to 2.5. That is why the long-term effects of the today's decisions need to be carefully investigated.

Denmark is considered to be well ahead in preparing for the fiscal strains from the ageing of the population as the erosion of the tax base should be anticipated. However, the success will depend on structural reforms and better expenditure control. Until now, Danish government has been successful in implementing the tax reforms, which took place in 1987, 1994 and 1999. They were focused mainly on personal income taxation. What is worth noting is that in Denmark most of the tasks are delegated to the local authorities. The deeper local government autonomy has its beginnings in 1970, when the Municipal Reform was implemented. Today, 16 counties and 275 municipalities provide around 80% of public services. They can determine income tax rates and decide about the social benefit schemes, subject to a limited set of restrictions.

The delegation of the responsibilities to the local level makes the economic policy less subject to the cyclical events, such as elections or temporary imbalances in the economy. It proves to have been successful in the last years, since Denmark is the country with the lowest unemployment rate in the EU and at the same time with a very high level

of public services.

6. Why (or why not) euro in Denmark?

The Danish economy is less open (as measured by total trade-to-GDP ratio) than most other small Member States and has a relatively high price level, which is partly due to a lack of competition in a number of sectors, although a progress has been made in liberalising telecommunication and electricity markets (European Commission, 2002).

In real terms Danish exports and imports account for 46% and 41% of GDP respectively. The current account has been in surplus since 1998 and in 2002 amounted to 2.8% of GDP. The main trade partners of Denmark are those from the European Union countries. The EU accounts for 72% of imports and 65% of exports. High trade exchange with the EU countries could mean cutting the transaction costs if Denmark introduced euro. Although, one can argue whether these benefits would be really that significant. The other advantage could be an increase in the trade with the eurozone economies.

The advantage for the consumers would be a better transparency of the markets. The Danish tourists, travelling around Europe, would not need to pay commissions for exchanging money. Moreover, the prices would become more comparable, if expressed in the same currency. It could enhance a competition in these sectors of the Danish economy, in which it is still inadequate. Moreover, as the level of prices in Denmark is higher than in most of the EMU countries, it could force the producers to decrease the prices with the benefit to the Danish consumers.

Of the utmost importance would be the indispensable decrease in the Danish interest rates. Those are still higher than in the eurozone countries. Banks do not feel obliged to lower the prices of the credit. The banks average lending rate amounted to 8.2% p.a. in 2001. The interest rates were much higher for the households, which had to pay 10.2% for a loan, and a little bit lower for the business which had to pay 6.4%. At the same time the deposit rate was much lower and amounted to 3.3%. Again the difference between the interest rates for the companies and households was significant as the interest rates took a value of 3.8% and 2.9% accordingly (Danmarks Nationalbank, Statistics).

On the other hand, there are drawbacks and risks of the EMU, which mostly relate to the challenge of maintaining discipline in a number of policy areas in the face of the country-specific shocks. The loss of sovereignty in monetary and exchange rate policy can become hard to accept, especially that it burdens policy makers in two other areas: fiscal policy and labour market reforms. The commitment for substantial advances in these areas is of the utmost importance for the future of EMU.

The exchange rate is no longer a tool which will help the country to absorb adverse and asymmetric shocks in the union. The adoption of a common currency deprives a country from having to disposal monetary tools in order to respond to the dampening of the economy. In case of the eurozone, it is the European Central Bank, which takes the decisions on the basis of the results in all the economies. It can be successful if there is a correlation of the business cycles in these countries, which sometimes may not be the case.

The theory of the optimum currency areas (introduced by Mundell) assumes that countries will create such an area, if a number of prerequisites are fulfilled. Three of them require a high convergence of the economies in the nominal terms (low inflation rate, high level of financial integration, small changes in the real exchange rate) and they are perfectly fulfilled by Denmark. The other three indicate on the necessity of labour market flexibility, openness of the economies and diversification of a production.

Denmark is a small open economy, which according to the European Commission, is currently operating at a level close to its potential. It needs to enhance its production potential by focusing on easing labour supply constraints and improving efficiency in the public sector. Apart from that, the wage rate flexibility is low because of the generous systems of benefits and minimum wage regulations. It means that in a few years Denmark, as well as other EU countries, may face serious problems concerning labour rigidities. The importance of the issue is further underscored by the absence of labour-related convergence criteria and also by the existence of high structural unemployment in the EU. The problem of labour immobility should also be taken into consideration in the face of the language and cultural barriers within Europe as well as the ageing of the population in most of the EU countries.

If Denmark decides to introduce euro into circulation, it has to be aware of the future problems which may affect the EU countries. Shrinking labour supply, future tax competition as the only tool to attract investors, and necessary tax cuts aimed at boosting labour supply, which is getting older and older - these are only some of the arising issues. The EU countries need to make a move towards solving these problems. Otherwise, Europe may find itself with a single currency, the euro, and lots of convergence criteria, but one step behind other developing economies. Although the European countries are members of a union, they are different because of their history, cultural traditions or natural and human resources. That is what makes them unique, and putting the same criteria on every country could in the future make these economies less competitive on the global scene.

7. Conclusions

The aim of this paper was to raise an issue of a possibility, for a country being a EU member state, of staying outside the currency union. The case of Denmark was discussed, since it is interesting from Poland's point of view. Poland does not have a "no euro" option but closer look at the situation in Denmark may be helpful in deciding about the length of the transition period before launching the euro in our country.

Although majority of Danes in the public opinion poll conducted in January 2003 was in favour of the euro (55%) and opponents constituted 34% of the surveyed people, no one can say yet how long the Danish road to the euro will still be (C2D, 2003).

Denmark's road to euro is being prolonged but it is difficult to imagine this country steering clear of the common currency in the long term. Although Sweden's "no" for the euro will certainly not accelerate the process of monetary integration in Denmark. From the economic point of view Denmark is ready to join the common currency area. Of crucial importance should be the enlargement of the EU, which will take place in May 2004. The new members and discussions on their membership in the currency union, may induce the Danish society to review (and maybe change) its opinion on the euro.

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