

Address given by Bodil Nyboe Andersen on the euro and Denmark (18 January 2000)

Caption: On 18 January 2000, Bodil Nyboe Andersen, Governor of the National Bank of Denmark, assesses the introduction of the euro in ten European Union Member States and argues in favour of Denmark's adoption of the single currency.

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The Euro and Denmark: Speech by Bodil Nyboe Andersen to the British Import Union on 18 January 2000

The background to the Economic and Monetary Union

On 1 January 1999, 11 EU member states introduced the euro as the single currency. The euro has thus been in force for one year now, but not yet as notes and coins.

The EU took many years to reach this stage. The idea of a single currency was fostered by the original idea of the Common Market, as it was called in 1957. The idea was quite simply to create a large domestic European market to enhance growth and progress in Europe.

First customs and trade restrictions between the participating countries were abolished. This in itself was an important step in post-war Europe.

In the 1980s it was the turn of the technical barriers to trade. The implementation of the single market spurred the harmonisation of the authorities' product requirements. Although these requirements were often founded on health or safety considerations they could in practice also constitute barriers to trade.

All that was still needed to complete a domestic European market, a "common market", was the introduction of a single currency.

The idea of a single currency, in a currency union, was already put forward in the 1970s, but never came about. However, the mid-1980s saw a more favourable political climate for the idea. The Delors Committee was established in 1988. Besides the Chairman, Jacques Delors, the Committee comprised a few experts, as well as all central-bank governors of the EC, as it was then.

The Committee prepared a draft structure for a European currency union. It can probably be credited to the central-bank governors that so much importance was attached to the issue of the independence of the common central bank from the political authorities, and that the ECB's objective to maintain price stability was set out with such clarity.

The ECB was modelled primarily on the German Bundesbank. The Bundesbank has always been independent of political influence, whereas the political authorities exerted considerable influence on monetary policy in many other countries in the 1980s, even the EU member states. Today, centralbank independence and price stability are widespread objectives all over the world.

The proposal of the Delors Committee of 1989 formed the basis for the provisions on economic and monetary union of the Maastricht Treaty.

The fact that it was the central-bank governors who designed the model is probably also of significance to the considerable loyalty to these plans demonstrated by the EU central banks during the 1990s.

A few years ago, not many people expected 11 EU member states to be ready to introduce the euro by 1999. That so many member states qualified for participation after making the necessary adjustments to their economic policies proves the strong political motivation to achieve this project.

The first year of the euro

One year has passed since the euro was introduced and how can its brief history be accounted for today?

First and foremost, the euro immediately took its place as one of the world's three major currencies, together with the dollar and the yen.

The single money market denominated in euro functioned well right from the start in January and the technical transition progressed without major problems. This was important in view of the very large scale

of the project and because market participants had to adjust to the new environment.

The currency market operates in euro, rather than the previous national currencies which were replaced by the euro.

The euro has also gained a strong foothold in the international capital market. It now competes with the dollar for the position of most frequently used currency for bond loans.

The single monetary policy of the 11 member states has now been in place for one year. The same short-term interest rate applies in all the participating member states, irrespective of their cyclical position in relation to the average of the euro area member states.

For many of the participants, i.e. the countries which by longstanding tradition have a fixed-exchange-rate policy based on the D-mark, this is business as usual. Like Denmark, France, the Benelux countries and Austria have for years pursued an interest-rate policy closely in line with Germany's. These countries are therefore accustomed to using other aspects of economic policy for domestic cyclical stabilisation. Their economic-policy situation after the introduction of the single currency and the single monetary policy has therefore not changed all that much, except that their central-bank governors now share influence on the fixing of interest rates.

The countries facing a new situation are particularly the southern European member states who by tradition have experienced a more inflationary economic course. These member states have become more stability-oriented.

With broadbased popular support, they have set out to participate in the currency union in order to create the framework for more stable economic development.

A central issue over the last 12 months has been whether the euro will be a strong or weak currency. However, it has not always been clearly defined what is actually meant by a strong currency.

The Maastricht Treaty emphasises that the euro must be a strong currency in the sense that it must be a low-inflation currency whose purchasing power is not undermined by inflation. The D-mark was a success during its 50-year history because prices were more stable in Germany than in most other countries, while at the same time Germany enjoyed strong economic growth. This led the D-mark to be perceived as a strong currency, which it was, regardless of whether the exchange rate was almost 3 D-marks to the dollar as in 1985, or only 1½ as in 1995.

The concept of the euro as a strong currency is drawn from experience with the D-mark. For an economic area as large as the euro area, the strength of the currency must be measured inwards to an even greater extent than for the D-mark. The ECB has therefore been given the task of maintaining price stability, which in practice has been interpreted to entail an inflation rate of less than 2 per cent.

On the other hand, the ECB is not to conduct monetary policy to influence the rate of the euro against the dollar, nor is the Federal Reserve to conduct monetary policy to steer the dollar's price against the euro.

Since economic trends in the various regions of the world differ the major currencies fluctuate considerably against each other. This has always been the case, and will also be so in the future. However, perhaps because the euro is a new currency, there has been unjustified focus on its price in relation to the dollar.

Newspaper comment often highlights the fact that the euro is not yet used extensively. This is correct with regard to accounts, price lists, invoices, etc. where amounts are stated only in euro. We are still in a transition phase where the old national currencies are still the usual means of payment.

During this period people naturally also prefer to use the old national currencies instead of the euro for money transfers and price fixing.

The euro and the old national currencies are in fact the same currency – it is just a matter of multiplying by a constant. There is no exchange rate between the French franc and euro, or between the Dutch guilder and D-mark, but rather a conversion rate between various denominations of the same currency, the euro.

People do not change their behaviour overnight, especially if the real outcome is of little importance, so many show that old habits die hard by continuing to state amounts in the old currencies. But when the euro-denominated notes and coins are introduced in two years' time the old national currencies will lose their importance and the euro will take over completely. For a certain period thereafter prices in euro will probably be supplemented with information on prices in the old currencies.

I have already mentioned that from its birth the euro was perceived as one of the world's three major currencies. It is not a main goal for the ECB to make the euro an international currency used all over the world, like the dollar. However, due to the euro area's economic significance there is no doubt that gradually this will happen. A large number of international bond issues are in euro, and the euro is part of the foreign-exchange reserves of many countries. In Denmark it is the dominating reserve currency, although many central banks by tradition mainly hold dollars. There will probably be a gradual trend towards using the euro as a reserve currency.

The dollar dominates as the currency used on international commodities exchanges and the euro is hardly likely to gain a footing in this area for some time.

The European Central Bank

The first year of the euro has really drawn the media's attention to the European Central Bank. It has become quite clear that the ECB's independence is an issue to be championed, and most politicians appear to accept this independence.

The vital aspect is that no attempt is made to exert political pressure on the ECB or the members of its Governing Council, nor should attempts be made to reach agreements on the overall economic policy which also involve monetary policy. A politician who puts forward an opinion on a suitable level of interest or exchange rates is hardly infringing the central bank's independence. Indeed, the central banks also make pronouncements on areas of economic policy for which they are not responsible.

The ECB has been criticised for a lack of openness and I find this criticism to be unfounded. In its Monthly Bulletin the ECB publishes very detailed analyses of economic and monetary trends and also presents the detailed background to its interest-rate decisions immediately after its meetings. Unfortunately, the general public has seemed to be more interested in hearing who said what, even though the decisions should be judged on the basis of the arguments put forward, rather than the people behind them.

Denmark and the euro

Denmark has decided not to join the currency union, but to retain the krone. This decision was taken in 1992-1993, but nonetheless Denmark has endeavoured to fulfil the access requirements or convergence criteria. This is not in order to become a member, but because Denmark considers this to be an endorsement of a sound economic policy, and since this is a condition for maintaining our chosen exchange-rate policy in the longer term.

Denmark has chosen to continue to conduct a fixed-exchange-rate policy, as has been the case since 1982. There is broad-based political agreement that this policy has contributed to ensuring a favourable and stable course for the economy. We have therefore joined ERMII, which replaced the EMS after the introduction of the euro. The ERMII system operates with a normal fluctuation band of ± 15 per cent against the central parity. However, in view of its favourable convergence position Denmark opted for, and gained, a special agreement on a narrower band of $\pm 2\frac{1}{4}$ per cent.

The Danish situation can best be described as shadowing the euro with regard to economic policy and exchange rate. Even though via ERMII we have an agreement on marginal intervention with the ECB, this support is only short-term. It is Denmark's responsibility alone to pursue an economic policy which ensures that we can maintain a stable krone rate vis-à-vis the euro.

Our economic policy must be designed to ensure that our course does not deviate excessively from that of the euro area member states. Our monetary policy can be used solely to stabilise the exchange rate. This entails that when the currency markets are stable Denmark's Nationalbank fixes a short-term interest rate slightly above the euro interest rate, so that our interest rate is adjusted in step with the ECB's. In times of currency unrest Denmark's Nationalbank has to raise the short-term interest rates in order to make placements in Danish kroner more attractive. This was most recently the case almost 1½ years ago during the currency unrest in September 1998.

Long-term yields are formed in the market. The yield differential fluctuates considerably over time and is also affected by periods of currency unrest. The Danish 10-year government-bond yield is currently around 1/3 per cent above the equivalent German yield.

Consequences of opting out

This yield differential is often used uncritically as a measure of the costs of remaining outside the euro. But this is incorrect. Even if we joined the euro area, the spread between Danish and German government-bond yields would not be eliminated. German government bonds are issued in very large series. These benchmark bonds are more attractive for international investors than Danish government bonds could ever be. It can also be seen that e.g. Dutch government bonds command a yield premium of around 15 basis points compared to German yields. So even though membership would reduce the Danish yield differential from today's level, it will hardly disappear entirely.

On the other hand, today's yield differential is to a great extent affected by the expectation that Denmark will adopt the euro within a few years. If this takes longer, or if the euro is rejected by referendum, there is no doubt that the yield differential will widen from the present level.

So it is not possible to state exactly what the interest cost margin between a "yes" and a "no" vote would be.

Our current situation entails a number of other consequences besides the yield differential.

First and foremost, the vulnerability which is a consequence of having a small currency which shadows a larger currency. Even if we take great care to fulfil at least the same economic-policy requirements as the euro area member states, the krone can become subject to speculative pressure. Even though we ourselves may consider it unreasonable and unfounded, these are the rules of the game for our participation in international trade and in financial markets.

So – even with a sound economy – we might be obliged to raise interest rates substantially should the currency come under attack. We might even be forced to go further and introduce other measures to tighten economic policy in the event of sustained pressure against the krone.

Once a certain period of time has elapsed after a currency crisis there is a tendency to forget that this vulnerability is a basic condition in a situation where a fixed exchange rate is to be maintained, while still leaving a formal back door open for realignment. This is not because there is any question of using this back door to devalue, but simply because the definition of an independent currency is that the exchange rate can be adjusted.

This issue is not only of relevance to Denmark. All over the world, exchange rate policy is discussed. It is widely suggested that the alternative to even small currencies having floating exchange rates is that the major currencies become even more dominant. The formation of the euro is one example of this.

Another example is the concept of "dollarisation" which is gaining strength in the debate. This term was formerly used to designate the extensive use of the dollar as an alternative to the official currency in countries burdened by high inflation. Today, "dollarisation" is also used to describe the phenomenon of a country to ensure stability giving up its own currency in favour of the dollar, but without gaining any influence on the monetary policy of the USA.

Perhaps at some time in the future we will see "eurorisation", i.e. certain European countries officially deciding to use the euro without gaining influence, i.e. without becoming members of the currency union. This idea was recently discussed in Estonia.

The final issue is the political marginalisation within the EU experienced by Denmark after the introduction of the euro. This gains in significance the longer we remain outside. It is not just a question of voting rights at certain meetings, but is also related to receiving information on international trends and the plans for international cooperation. To a great degree, this is also a question of influencing the course of events by participating in committees and working groups and other fora which prepare the formal decisions. But it is even more difficult to quantify these effects.

Besides the three aforementioned factors: yield differential, vulnerability and marginalisation, the consequences of membership for the business community must also be considered. It is sought to minimise the disadvantages of opting out via the fixed-exchange-rate policy. However, even though the exchange rate between euro and krone is very stable, the euro is not the domestic currency of Danish companies, as is the case for their European competitors, who gain a share of the major domestic European market.

It cannot be excluded either that companies within the euro area will prefer to trade with other companies within the area, since this will require less administration than trading with companies in e.g. Denmark. Within the euro area the costs of exchange-rate hedging and conversion can be saved and companies and private citizens alike can compare prices more easily.

Many small companies in particular will prefer to focus on their customers and products and not have to worry about exchange-rate issues.

These factors are very different. This makes it even more difficult to make an overall estimate of the "cost of opting out", a much-debated issue. It cannot be calculated in terms of money or jobs. However, today there is a price, and if we decide to opt out permanently it can only go up. However, weighing the various arguments is a political, rather than an economic decision.

The viewpoint of Danmarks Nationalbank

The central banks of the euro area member states are without any doubt the institutions which are most affected by the transition to the euro. If Denmark decides to join, this will also result in major changes for Danmarks Nationalbank. This has led some people to believe that the bank's management is sceptical, or even negative towards possible Danish adoption of the euro. It has been stated that we would probably not be in favour of losing influence and becoming "branch managers". However, this is not our view.

We will not consider Denmark's adoption of the single currency to be a reduction, but rather an expansion of our opportunities to gain information and influence. Except during currency crises, when we have to raise interest rates in order to stabilise the krone and then gradually bring interest rates back to normal, in the present situation we do not conduct a separate monetary policy.

By participating in the ECB Danmarks Nationalbank's management and employees will gain a share of influence not only on monetary policy, but also on many other decisions concerning the financial markets of Europe. At the same time we will continue our ordinary cooperation with Danish banks and other financial institutions and remain in contact with Danish authorities and the media. We will also still have to manufacture and issue notes and coins, even though their appearance will be different.

We therefore do not feel that Danmarks Nationalbank will lose influence if Denmark adopts the euro, quite the contrary in fact. Within the ECB all participating countries' representatives are equal and all votes have the same weight.

The key argument in favour of Denmark adopting the euro within the not too distant future is, however, not the issue of the Nationalbank's role and influence. The Nationalbank's management considers this step to be important, since in our view it will provide the most stable external framework for the economic policy which Denmark embarked on in the 1980s, a policy which Danmarks Nationalbank has always supported. Especially in the 1990s this policy formed the basis for strong and well-balanced economic growth.

The Danish economy has benefited from our abandoning the devaluation policy at the beginning of the 1980s and from the fact that the fixed-exchange-rate policy has been maintained, despite a change in the external framework. But we must also recognise that minor currencies are becoming more and more vulnerable in a world characterised by greater internationalisation and more rapid dissemination of information.

So Danmarks Nationalbank considers that Denmark's adoption of the euro will be a natural continuation of the economic-policy stance introduced almost two decades ago – a policy which in our view has served Denmark well.