

Danish Government's official report on EMU (Copenhagen, 27 November 1989)

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The Danish Government's official report on EMU

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REPORT ON ECONOMIC AND MONETARY UNION

SUMMARY IN ENGLISH

1. Chapter III describes the historical background for the plans for Economic and Monetary Union. An overview of the articles in the Treaty of Rome concerning economic policies is given. It is emphasized that the present plans for an Economic and Monetary Union should be seen in continuation of similar ideas from the beginning of the 1970's inspired by the Werner Report.

2. Chapter IV shows that the EMS has fulfilled the goal of creating a zone of increased monetary stability in Europe. This has to be seen against the background that monetary stability presupposes as well as contributes to convergence in economic performance. Thus, the EMS has served as the point of departure for the endeavours of participating countries to reduce inflation.

During the 10 years of the EMS the level of inflation as well as inflation differentials between countries have been markedly reduced. At the same time the EMS has been strengthened, especially through the Basle/Nyborg-agreement of 1987, but also with the accession of Spain in 1989. It is noted that the ECU continues to play only a modest role.

3. Chapter V describes the contents of the Delors Report with the proposed three phases leading to Economic and Monetary Union. At the European Council in Madrid in June 1989 it was decided that the first phase should start on July 1, 1990. On the same date the fourth directive on capital-liberalization enters into force, and accordingly restrictions on capital-movements within the EEC will remain in force only as an exception. The first phase of EMU implies, inter alia that all Community currencies join the EMS and that the same margin of fluctuation applies to all currencies. The chapter concludes that the implementation of the first phase of Economic and Monetary Union is in the interest of Denmark.

4. In chapter VI a number of factors of importance for the establishment of a Monetary Union are described. These include a considerable degree of agreement on priorities in economic policies as well as convergence in economic performance, particularly in cost developments. The size and composition of trade among the participating countries as well as the composition of their production also have to be taken into account. The more diversified the production composition, the more uniform the foreign trade pattern, and the more open economies are, the greater is the importance of stable currency conditions. The degree of labour and capital mobility also has to be considered.

It is concluded that the appropriateness of Economic and Monetary Union can only be assessed based on a total evaluation of all the above factors. Furthermore, a static analysis is not sufficient. Conditions have to be viewed in a dynamic context. It is stated that the implementation of the single market will contribute to fulfil the conditions of Economic and Monetary Union. Thus, Economic and Monetary Union is not a precondition for the single market, but lies in continuation hereof.

5. In chapter VII the consequences of economic and Monetary Union for the conduct of economic policy are discussed.

The EMS has implied considerable advantages, inter alia, through an important reduction of the rates of inflation and interest to relatively low levels. These developments have come about because of the greater importance which the fight against inflation has been given in an increasing number of EEC member states.

In an Economic and Monetary Union a common monetary and foreign exchange policy must be formulated. As a consequence of the EMS-membership and the ever increasing financial integration the room for manoeuvre for autonomous national monetary and foreign exchange policies is already considerably limited.

Decisions on monetary and foreign exchange policy in the Federal Republic of Germany in particular have dominated the EMS. Market forces have given the Deutsch-mark a central role because of the low rate of inflation in the Federal Republic as well as the economic weight of that country. For a number of countries, including Denmark, a common monetary policy based on joint decision-making, therefore, implies increased influence on monetary policy within the Community as well as on exchange rate policies in relation to third countries, in particular vis a vis the US dollar.

A common monetary policy will necessitate a common decision-making process and in practice require a new independent monetary institution in the EEC. This can be done with a basis in existing central banks in the form of a European System of Central Banks. Difficult political negotiations on the details of the system including the decision-making procedures can be foreseen.

Fixed exchange rates do not necessarily imply a common currency. For practical reasons, however, a common currency would be the most convenient.

6. Implementation of Economic and Monetary Union can be expected to follow the principle of subsidiarity. This principle implies decisions to be taken at Community level only to the extent they are necessary for effective decision-making. Accordingly, there will be only limited need for constraints on other economic policies. In this respect present plans for Economic and Monetary Union, including the Delors Report, deviate markedly from the Werner Report, which foresaw a greater degree of centralization.

For budgetary policies it can be expected that monetary financing of budget deficits should not take place. This is in line with present practices in Denmark.

In chapter VII it is also discussed whether generally binding rules for budget deficits should be introduced, as recommended by the Delors Report (paragraph 30). On the one hand, it can be argued that such rules are not necessary as budget deficits in the future will be financed in the market. Changes in creditworthiness will automatically influence the terms of financing of budget deficits. On the other hand, against the background of the experiences from the debt crises of the developing countries it can be argued that the financial system does not sufficiently flexibly evaluate the ability of public authorities to service their debt. This may be due to expectations that other countries will bail out a country with a debt problem. On this background it is argued in this chapter that there may be need for binding rules against destabilizing budget imbalances.

All in all, it is concluded that there are reasons to adopt a sceptical attitude to the suggestions of the Delors Report on generally binding rules for the size of budget deficits as a precondition for Economic and Monetary Union. Coordination of fiscal policies can take place on a voluntary basis, while in special cases rules could be agreed concerning destabilizing budget imbalances. On the other hand, Denmark should support that monetary financing of budget deficits cannot take place.

7. As is the case with the single market an Economic and Monetary Union must be based on efficient markets. Therefore, a strengthening of EEC competition policies has to continue, including the respect for the rules on public subsidies. By respecting these rules individual member states can contribute to the necessary economic convergence prior to the subsequent phases of Economic and Monetary Union.

Economic and Monetary Union cannot be seen in and by itself to contribute to a deepening of regional disparities in the Community or in so-called peripheral areas. In so far as individual member states can control cost developments, economic integration will in itself imply better use of their relative advantages in production. Therefore, it must be expected over a period that to a certain extent the more labour intensive and low-technology productions will be relocated to the more competitive less prosperous EEC countries. It is in this way that these countries can build up their production potential, which is in the longer run the

precondition for a smoothing out of economic disparities within the Community.

The Community's structural funds will, therefore, also in EMU continue to be a supplement to the market mechanism. Irrespective of this, a political pressure can arise to increase transfers to less prosperous member states. In this connection, it should be recalled that it has already been decided to double the structural funds in the period up to 1993.

8. Concerning parallelism in economic policies it is stated in chapter VII that harmonious economic developments presuppose a certain degree of economic policy coordination. Already during the first phase of EMU procedures for economic policy coordination will be introduced in the form of multilateral surveillance. To what extent it may become necessary to revise these procedures in parallel with the integration of monetary policies has to be evaluated, inter alia, against developments in the first phase.

9. Chapter VIII discusses the constitutional aspects in Denmark of Economic and Monetary Union. It is stated that EMU presupposes an institutional change in the monetary field. It, therefore, automatically follows from the new article 102 A in the Treaty of Rome, which was inserted at the time of the Single Act that it will be necessary with a change of the Treaty. This chapter builds on contributions from The Ministry of Justice and The Ministry of Foreign Affairs. The conclusion is that Danish participation in Economic and Monetary Union as described in the Delors Report can take place according to article 19 of the Danish constitution, which implies a simple majority in the Danish Parliament (Folketinget). This evaluation rests in particular on the assumption that a monetary institution in the EEC will not get executive power with binding effects for citizens, as well as the fact that the Treaty of Rome already contains ample authority to make decisions concerning economic policies.

10. Chapter IX deals with the economic consequences of EMU. A common European monetary policy implies that the difference between Danish and German interest rate levels will be considerably narrowed or disappear all together. The latter can be assumed to take place in particular in the short end of the market. Based on actual relationships this could imply a reduction of the Danish interest rate level on short term claims of about three percentage points. Interest rate differentials on longer term claims will also be narrowed considerably, but whether a complete elimination of differentials will take place will depend, inter alia, on the underlying supply and demand conditions as well as institutional differences between member states.

Under present circumstances the higher level of interest rates in Denmark can be regarded as a price to be paid for having the possibility of adjusting the exchange rate within the EMS - a possibility which still more member states to an increasing degree do not want to take advantage of anyway.

The economic advantages of EMU accrue to both companies and households. For enterprises the more advantageous financial terms have already been mentioned. In addition, exchange rate uncertainty and costs of exchange connected with transactions with the other EEC countries will disappear. Increased exchange rate certainty is of particular importance for investments and foreign trade of small and medium sized enterprises. The costs of exchange for households are in the order of magnitude of 2 to 5 per cent. A smaller advantage can arise to the extent European currencies will be used as an international reserve currency. This will increase certainty for those transactions that are denominated in EEC currencies rather than in US dollars.

On the other hand, the EMU will not in itself imply any easing of Denmark's debt position. EMU will not change the imbalances lying behind the indebtedness and the current external deficit. Debt service will have to continue as at present, be it debt to other Community countries or to third countries. This means that demands for economic adjustment, which has to create better balance between production, consumption and investment, will remain almost the same compared to a situation where Denmark would not participate in EMU.

11. Chapter X discusses the preconditions for advancing between individual phases of EMU. The necessary convergence in economic performance is of fundamental importance. Usually, Denmark has adopted a

positive and pragmatic attitude in discussing further developments of the EMS. In evaluating the appropriate duration of the first phase of the EMU, experience from the first phase must be taken into account as well as the fact that the implementation of EMU in itself must be considered to be in the interest of Denmark as long as EMU is implemented under the appropriate conditions and economic circumstances.

In addition, the chapter contains a summary of the British memorandum on EMU. In reality this memorandum represents a suggestion for strengthening the role of the Deutsch-mark and possibly for strengthening the present EMS in which Great Britain has not yet participated in the exchange rate mechanism. Thus, in this chapter the view is expressed, that the British memorandum does not constitute a proposal for an alternative way of accomplishing EMU.

12. Chapter XI discusses a situation in which EMU at the outset would not necessarily include all EEC member states. Such a situation can arise because some less prosperous member states do not find that economic conditions are in place in the short run. However, these countries support the idea of EMU. The United Kingdom is sceptical for economic and political reasons.

The chapter also outlines how EMU might be shaped in a situation where all EEC member states would not necessarily participate.

Furthermore, the interest of Denmark in full participation in EMU is discussed. EMU will - *de facto* and probably also *de jure* replace the EMS. As a member of the EMS and the exchange rate mechanism Denmark fundamentally has different interests than, for instance, the United Kingdom. It is argued that the Danish economic experiences with the fixed exchange rate policy as framework for confidence in the Danish Krone and for the reduction of inflation and interest rates dictate full participation in EMU. To this must be added the increased advantages of enterprises and households as mentioned above. In this connection it must be recalled that Denmark benefits from EMU particularly because of our industrial structure with many small and medium sized enterprises as well as our large agricultural exports.

13. Finally, chapter XII deals with the importance of EMU for the relationship of the Community vis a vis third countries. Over and above the possibility for a reserve currency status for EEC-currencies, EMU will make the Community a more equal partner vis a vis the USA and Japan. This will increase the possibilities for a globally mutually satisfactory economic policy cooperation. At the European level, EMU must be expected to contribute to reconsiderations of foreign exchange regimes in non-EEC countries, including the Scandinavian countries. This would of course be in the interest of Denmark as this, *inter alia* could increase the share of Danish foreign trade covered by greater exchange rate stability.

14. From an economic point of view the overall conclusion of the report is that the same stability-oriented considerations which under the EMS led to the choice of the fixed exchange rate strategy, will contribute to an interest for Denmark in full participation in EMU. A Danish isolation outside the EMU will moreover contribute to great uncertainty concerning future economic developments and economic policies. Through full participation in EMU, Denmark will participate in shaping the framework for our economic policy and other economic actions. Such participation can take place at the same time as Denmark's *de facto* room for manoeuvre in economic policy-making is affected to a limited extent only.