Why Denmark should either abandon its peg to the euro or join the single currency

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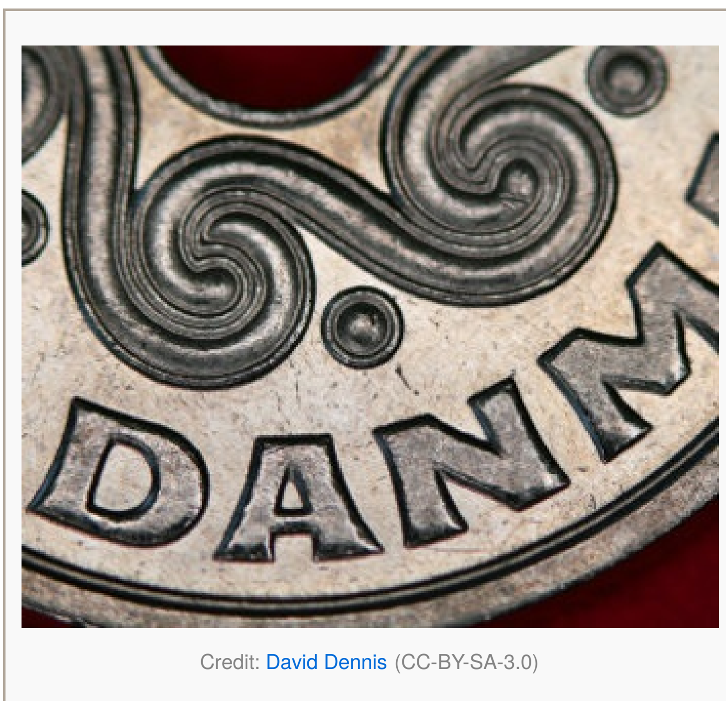
Following Switzerland's announcement in January that it would no longer hold the Swiss franc at a fixed exchange rate with the euro, Denmark has faced mounting speculation that it will follow suit and abandon its euro peg. **Lorenzo Codogno** *and* **Paul De Grauwe** *write that there is a paradox in the approach of Denmark to the issue: the Danish central bank has made it clear that it will never change its parity with the euro, but if this is true then there is no reason for the country to avoid joining the single currency. They argue that while there are still instruments available to resist the immediate pressure from financial markets, ultimately the costs of any adjustment in policy will be lower if action is pursued now.*

Being a central banker in Denmark is no fun. In normal times you just cut and paste the decision made in Frankfurt by the European Central Bank (ECB), without having a say on it. If the currency peg is under pressure you can only act in ways that may be perceived to have negative implications for your economy and citizens. In fact, policy options include currency intervention first and then either higher or lower interest rates depending on whether there is upward or downward pressure on the currency. And finally you do not even have a mandate on the ultimate decision, i.e. abandoning the peg in favour of a more flexible regime or joining the euro.



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Danmarks Nationalbank cut its deposit facility rates to a record low of -0.75 per cent on 5 February. It was forced to buy a record DKK 275 billion (EUR 37 billion) worth of foreign currency in January-February in an attempt to counter the upward pressure on the Danish krone and preserve the peg, thereby driving up foreign reserves to about DKK 737 billion (EUR 100 billion). The size of the central bank balance sheet is not huge but it has already exceeded 30 per cent of GDP.

Denmark is bound by a Treaty agreement to comply with a fluctuation band within the framework of the European Exchange Rate Mechanism (ERM II). Since January 1999 the fluctuation band has been +/-2.25 per cent with respect to the central parity of 7.4604, i.e. 7.29252-7.62824. Effectively, the band has been maintained within an even narrower 1 per cent fluctuation. According to the ERM II, the ECB is contractually obliged to intervene together with the central bank of the country when the currency reaches one of the band limits.

The peg has been the backbone of economic policy in Denmark and according to the recent IMF's Article IV, "it has served Denmark well. It has anchored inflation and interest rates and facilitated trade with the neighbouring euro-area countries".

All that is true but here is the paradox of the choice made by Denmark to peg to the euro. The Danish central bank

has made it clear that it will never, never change the parity with the euro. But if it is serious about this, it makes no sense to keep Danish krone. The Danes could as well take over the euro. This is in fact the only choice that makes it fully credible that the parity will never be changed. All the benefits that the forever fixed rate can generate ("anchoring inflation and interest rates, facilitation of trade with neighbours" in the IMF parlance) can also be had when joining the euro. In addition in that case the Governor of the Danmarks Nationalbank would sit around the ECB table in Frankfurt to co-decide about monetary policies, while today he has to wait close to the telephone for news from Frankfurt to learn what he should do.

Since Denmark keeps its own currency and exchange rate with the euro it signals that it is keeping an option, i.e. the possibility to change the parity in the future. If it does not want to signal this, it can simply take over the euro. The very existence of the option indicates that Denmark prefers to keep the door open to devalue (or to revalue). This choice makes perfect sense. Denmark may in the future be subject to a large shock that will be absorbed with lesser cost if the currency is devalued (or revalued, depending on the nature of the shock). In fact keeping the krone only makes sense if one wants to keep this option open.

The problem with this option is that it can easily trigger destabilising speculative movements that in the end will force the central bank to change the parity even if it does not want to do so.

Put differently, the currency peg is like an option with a negative present value that the Danish perceive is worth paying. If you strongly believe in the peg and in the commitment that it will not be changed for the time being, then it would be much better to simply join the euro. If instead you believe this option is worth having it is undermining your own commitment to the peg. The peg would look like the "Emperor's New Clothes", which happens to be a novel by a Danish author, Hans Christian Andersen. At some point, financial markets will dare to say the Emperor isn't wearing anything at all given that the very existence of the peg undermines the commitment. And, guess what, this would force you to exercise your option.

It is sometimes said that this problem only arises when the currency is subject to downward pressure. With the current upward pressure on the Danish krone, allowing reserves to increase and interest rates to go deeply negative appears a much easier course of action. There is no need to ask the ECB to come to the rescue. "We have an unlimited supply of our own currency, the krone. And we are going to do whatever it takes to defend the peg" said Lars Rohde, Denmark's central bank governor. At least in theory, there is no limit to the size of reserves you can build up by printing money and interest rates can be crashed well below zero, thereby enjoying a nice positive carry.

But it is a fallacy. If not fully sterilised, it may come at the cost of flooding the economy with liquidity, which inevitably causes bubbles in asset prices, strain on the financial industry and other disequilibria in the economy. Close-to-zero interest rates on short-term mortgages may have contributed to an inflation of mortgage lending which stands at about 300 per cent of disposable income. With monetary policy focused on the peg, any other objectives, including fighting inflation when the peg is not enough, would fall under fiscal policy, which may not be best suited to deal with them.

Denmark's fixed exchange rate implies that the nominal interest rate remains fixed after a shift in the fiscal stance and effects are absorbed by foreign trade due to the high degree of openness of the Danish economy. However, if the economy does not run fully in lockstep with the Eurozone's, or Germany's for that matter, managing the currency, aggregate demand and inflation at the same time may turn out very difficult. Bottom line: the peg makes sense only as a transition to the single European currency, as in the spirit of ERM II.

Unfortunately, de-pegging may happen even if there is nothing wrong with your own economy. Despite "whatever it takes" commitments by policy makers, financial markets may come to believe that there is a non-negligible risk of euro break-up and that Denmark will side with the German bloc. Then the krone would immediately experience huge inflows of capital that would make the peg unsustainable. The "safe haven effect" has materialised on several occasions since the start of the sovereign debt crisis and even very recently.

No currency peg can last forever and the krone peg to the euro has already lasted more than fifteen years. Taking into account the former peg to the Deutschmark that dates back to 1982, there is more than a 30-year association with fixed exchange rates (with the last adjustment in central parity decided in 1986). The Swiss National Bank learned it the hard way: the longer you wait the harder may be the landing and, despite the benefits enjoyed in the past, it may lead the economy into a painful adjustment.

There is one major difference versus Switzerland, however. The Swiss decision was fully within the remit of the Swiss National Bank. The Danish central bank cannot convene its board over a long weekend and decide on the peg as it acts on a political mandate. And politics, by definition, is a messy and slow process. Economy Minister Ostergaard said recently that the policy was not in doubt and that “no serious politician” would propose leaving the peg.

But it would not be just up to Danish politicians. The ERM II provisions dictate that any decisions on central rates and fluctuation bands would require agreement between euro area ministers, the ECB and the ministers and central bank governors of the non-euro area Member States participating in ERM II. Moreover, it would be a co-decision in which the European Commission would also participate. In a nutshell, difficulties of exiting the peg do not make the peg any more credible but rather more vulnerable to financial market tensions.

So what’s the way out? In the near term there are still plenty of instruments the Danish Central Bank or the Ministry of Finance can use to resist any pressure. One example is the recent suspension of the issuance of long-dated government bonds. But how long can it last?

Admittedly, it does not sound an easy option given current Eurozone problems and poor economic performance. But if Danish policymakers believe that the economy is prepared to make the necessary adjustments to be irrevocably linked to the Eurozone, then why not join the euro?

If not, then you are left with one option: let financial markets do it for you. Sadly the poor Danish central bankers would not have a say even this time. But allowing capitulation to happen earlier on would prevent a more sizeable and painful adjustment at a later stage. Switzerland docet.

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