CEPS COMMENTARY

Thinking ahead for Europe

Danish currency wobbles: A positive unintended side effect of the ECB's QE?

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Small European currencies are back in vogue. Following the Swiss float, the Danish krone—which is pegged to the euro— has come under increasing appreciation pressure, forcing the Danish central bank to suck up an unprecedented amount of euros in January. The foreign exchange reserve went up by 23% to around 564 billion DKK (almost €76 billion at the current exchange rate), which is 30% of GDP. In Denmark this is no small issue. Thirty years of fixed exchange rate policy (first pegged to the D-mark and since 1999 to the euro) is under threat. Making it even more delicate is the fact that the fixed-exchange-rate regime is considered synonymous with a stable macroeconomic policy environment. In fact, the adoption of the currency peg ended a period of periodic devaluations and inflation – a period that shaped Danish macroeconomic psychology in ways similar to the effect that hyperinflation had on German psychology in the early 1920s.

The official line is that Denmark is determined to maintain the peg whatever it takes ('Denmark is not Switzerland'). The country has historically maintained an even narrower peg (a bandwidth of +/- 0.5% around the central rate) than is called for under ERM II, which stipulates a +/- 2.25% band. The latter may be important. Under ERM II rules, the ECB is obliged to intervene in support of the krone if it starts to test the 2.25% band. However, abandoning the narrower informal band in place for 15 years, only to proclaim a determination to stay firm at the 2.25% limit (with the official help of the ECB) may strengthen investors' resolve. In principle, the ECB can – in agreement with the Danish central bank – intervene to strengthen the Danish krone already at this stage. It is not clear whether this is actually being done.

How low can you go?

It is uncertain how long the current situation can be sustained. As the foreign exchange reserve continues to grow, so does the loss that must be borne if the peg is abandoned. Meanwhile, having lowered the overnight deposit rates (the certificates of deposit rate)) four times in little more than two weeks (it currently stands at -0.75%), the Danes have been testing the lower

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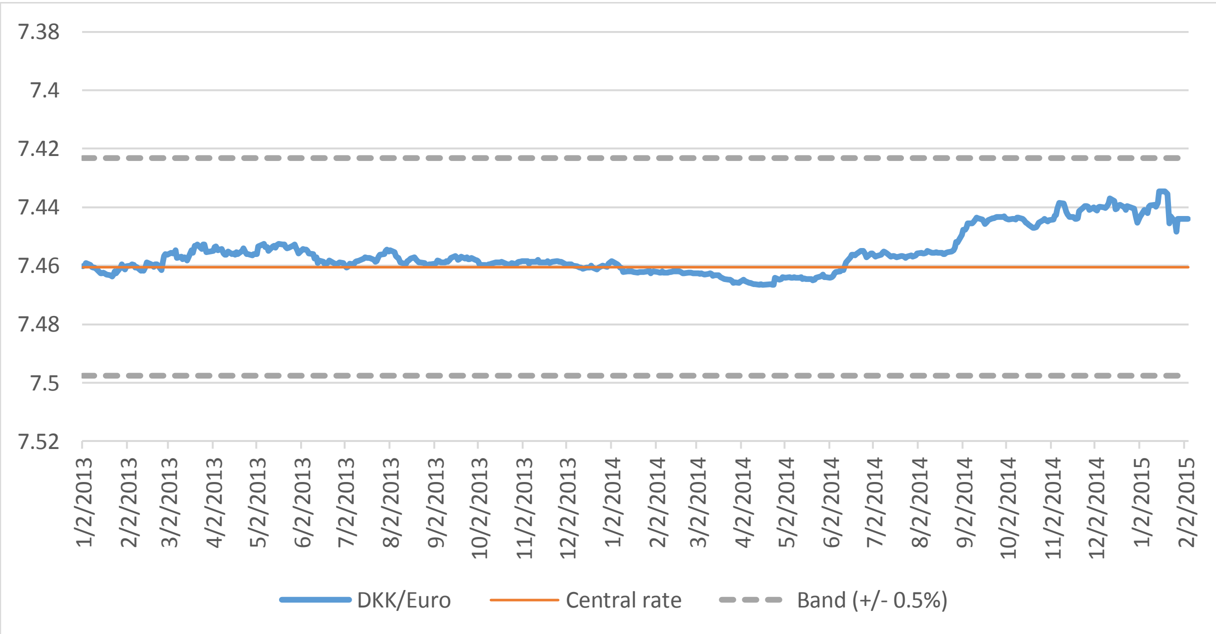
limit of policy interest rates. In principle, the policy rate can be reduced some further notches down, but the risk of asset price bubbles is looming large. On February 4th, the CEO of the country's largest bank warned of bubbles in house and stock prices. The interest rate on 30-year fixed-rate mortgage bonds is approaching 1.75% and rates on some adjustable-rate mortgages are now negative. Naturally, a change in currency regime would upset financial institutions operating in DKK and create major balance-sheet shocks. At stake are particularly potential losses for large pension funds with substantial investments abroad. As a consequence, the public debate in Denmark as to the value and feasibility of maintaining the peg is heating up.

Speculation, QE and eurozone malaise

The likely driver of the krone's current troubles is the inflow of speculative money. Investors have been bolstered by the successful attack on the Swiss Franc as well as the limited downside should the peg be maintained. Part of the current pressure is due to further quantitative easing by the ECB and the eurozone's continued malaise, not least the added uncertainty from the Greek election and the subsequent stance of the country's government (Alcidi & Giovannini, 2015). However, what goes mostly unnoticed is the fact that the DKK/euro exchange rate has been strong for months (see Figure 1). While intervention has been limited up until January, it nevertheless made the kroner vulnerable to recent events.

Figure 1. DKK/euro exchange rate and de facto exchange rate bands



Source: ECB.

Fundamentals may also be at play here. The DK has experienced an uninterrupted current account surplus since the current central rate of 7.46 DKK/euro was instated in 1999, and it has been more than 5% of GDP since 2010 (around 7% in 2014, which is half the value of the Swiss current account surplus). While the large current account surplus in Denmark and other northern European countries is part of the imbalances in the EU (Gros, 2013), Denmark has actually run a current account deficit vis-à-vis the eurozone countries.

Not bad for the eurozone

Should DK eventually be forced to abandon the peg – either by floating the currency or by lowering the central exchange rate – this will be no bad thing for the eurozone. It may move Denmark further away from the euro, but in any case, there is currently no appetite among the Danes for joining the euro (and Denmark has secured an opt-out from the Monetary Union in the Maastricht Treaty).

On the positive side, an appreciation of the Danish krone would contribute to increasing the competitiveness of southern European countries vis-à-vis Denmark. Albeit small, this would not be a negligible benefit. Imports from eurozone countries amounted to more than €40 billion in 2013; close to one-half the value for Switzerland (Gros, 2015); and surely, peripheral European countries should welcome all improvements in competitiveness. While this is not an explicit target of the ECB's monetary policy, it is not an unwelcome side effect from the eurozone's point of view.

References

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