

Bodil Nyboe Andersen: A common currency or separate currencies?

Speech by Mrs Bodil Nyboe Andersen, Governor of the National Bank of Denmark, at the Conference on the Economy in the Danish Commonwealth hosted by the North Atlantic Group of the Folketing (Parliament), Christiansborg, 25 May 2004

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The organisers have asked me to give a speech on “A common currency or separate currencies?” As agreed, my speech will mainly be a technical presentation of the various options. The decision on the actual regime is a political one. My aim is merely to lay out the alternatives and their implications.

My approach is solely economic. I will not look into national law issues or other legal issues. However, the legal issues would play a decisive role in a specific decision on change.

1. What is a currency?

Let us begin by looking at the characteristics of a currency. A specification of the basic criteria can be useful, although they are normally known in practice:

1. Banknotes and coins denominated in the currency must exist as legal tender.
2. There must be a central bank with the required net capital and foreign-exchange reserves, and the central bank must be responsible for the currency.
3. The banks in the currency area must be able to make deposits and raise collateralised loans at the central bank.
4. There must be access to an interbank payment system, possibly via the central bank.
5. In a liquidity crisis, solvent banks must be able to use the central bank as “lender of last resort”.

Decisive factors for an independent currency are thus that a central bank is responsible for the currency, and that the central bank is able to conduct monetary and foreign-exchange policy in the currency area in question.

One central bank cannot undertake the responsibility for two different currencies. Similarly, two central banks cannot undertake the responsibility for one currency.

2. Currencies in the North Atlantic region

According to these criteria Iceland evidently has its own currency, the Icelandic króna, and its own central bank, Sedlabanki Íslands. The currency is associated with the country of Iceland.

Denmark, the Faroe Islands and Greenland employ the same currency, the Danish krone. Danmarks Nationalbank is responsible for this currency. Let us look at the use of Danish kroner within the Danish Commonwealth in the light of the five criteria.

Re 1) Danish kroner are available as banknotes and coins and can be used in the entire area. I will go into the issue of the special Faroese banknotes a little later.

Re 2) Danmarks Nationalbank is responsible for the currency, which is the Danish krone. Danmarks Nationalbank has a considerable net capital and a large foreign-exchange reserve, which safeguard the stability and credibility of the currency.

Re 3) The private banks and credit institutions in Denmark, in Greenland and on the Faroe Islands may hold accounts at Danmarks Nationalbank and may make deposits or raise collateralised loans. Danmarks Nationalbank is “banker to the banks” in the entire Danish Commonwealth.

Re 4) The payment and clearing system can be used by Danish, Faroese and Greenlandic banks.

Re 5) Danmarks Nationalbank is the central bank to all banks in the Danish Commonwealth. It may thus provide liquidity support to a solvent bank with liquidity problems. This function is called “lender of last resort”. It is very rarely used, but it has happened.

The special Faroese banknotes

Act No. 248 of 12 April 1949 stipulates that The Faroe Islands shall have their own banknotes as legal tender on the Islands. These banknotes are printed and issued by Danmarks Nationalbank. The Faroese banknotes in circulation are included together with the Danish banknotes in circulation in the item "Banknotes" on the liabilities side on Danmarks Nationalbank's balance sheet. The Faroese banknotes can be exchanged for Danish banknotes on a 1:1 basis. Danmarks Nationalbank has cash depots on the Faroe Islands to supply banknotes to the local banks.

Although the special Faroese banknotes can be used for cash transactions on the Faroe Islands, contracts, bank deposits and financial transactions are conducted in Danish kroner. Banknotes in circulation consist of the special Faroese banknotes, but the money stock is otherwise made up of bank deposits in Danish kroner.

The international ISO currency code for Danish kroner is DKK. This currency code is also used on the Faroe Islands.

The Faroese banks use Danmarks Nationalbank's monetary-policy instruments and the Danish payment systems.

Danmarks Nationalbank's decisions relating to monetary and foreign-exchange policy - including interest-rate decisions - apply fully and directly to the Faroe Islands.

It must thus be concluded that the Danish krone is used as the currency of the Faroe Islands today. The Faroese banknotes should be regarded as banknotes issued by Danmarks Nationalbank with text in Faroese, even though this is not explicitly indicated on the banknotes. This corresponds to the situation in Scotland where special Scots banknotes are used, but the currency is the pound sterling, and the Bank of England is the central bank for all of the UK.

The Faroese banknotes are a special version of the currency Danish kroner. On no account - neither fully nor partially - do they constitute a separate currency, although in some places the wording of the Act of 1949 may indicate this.

The currency of the Danish Commonwealth

At present the Danish krone is thus the currency of Denmark, Greenland and the Faroe Islands. And Danmarks Nationalbank is the central bank for the entire Danish Commonwealth.

3. Are there any alternatives?

Besides a presentation of the current system the organisers also asked me to present alternatives. That means a situation where Denmark retains its currency, but the Faroe Islands and/or Greenland get their own currencies, abandoning the common currency.

For the sake of simplification I will describe alternative exchange-rate regimes for the Faroe Islands only. In principle, the same would apply to Greenland, however.

At the moment an independent currency for the Faroe Islands is not an issue since the political announcements are that monetary and foreign-exchange policy should still be conducted by the Danish national authorities.

Nevertheless, let us make the **theoretical assumption** that it is decided that monetary and foreign-exchange policy should be conducted by the home rule of the Faroe Islands. In that case there are three main options: a currency union with Denmark, a fixed-exchange-rate policy or a floating exchange rate. Let us look into these three options.

A currency union

If home rule is introduced in the field of monetary and foreign-exchange policy, Danmarks Nationalbank will not be able to continue its activities on the Faroe Islands. It will be an entirely new situation. If the Faroe Islands wish to continue with the Danish krone, an agreement must be concluded with Denmark on a currency union. This decision cannot be made unilaterally by the Faroese authorities. Continued use of Danish kroner in this situation would thus require an agreement to be approved by the Danish and Faroese Parliaments.

As mentioned, each currency area can have only one monetary-policy authority. Furthermore, elements of Denmark's monetary and foreign-exchange-policy competence are not likely to be delegated to the home rule of the Faroe Islands. A currency union would thus entail that the Faroese authorities acknowledge - formally and clearly - that the decision-making competence regarding monetary and foreign-exchange policy rests solely with the Danish national authorities, including Danmarks Nationalbank.

In a currency union the situation would, in practice, be unchanged. The currency would still be Danish kroner, and Danmarks Nationalbank would continue to conduct monetary policy. This means that the Faroese authorities would have no autonomy as regards monetary and interest-rate policy. This is unchanged from the current situation.

Thus, it appears that delegation of monetary and foreign-exchange policy to the home rule with simultaneous conclusion of a currency union with Denmark would be a complex way of maintaining status quo.

Separate currency - fixed-exchange-rate policy

If a decision is made for the Faroe Islands (or Greenland) to have their own currency, the options are the same as in other currency areas. However, the currency would be very small, and the narrow business structure would present a number of special challenges.

The "strongest" fixed-exchange-rate policy is a currency board, whereby the local currency is completely fixed vis-à-vis another currency. This regime is used today by e.g. Estonia, which applies a currency board with a fixed exchange rate vis-à-vis the euro.

An initial option for the Faroe Islands could be a currency board vis-à-vis the Danish krone in a ratio of 1:1.

A currency board entails the establishment of a central bank to set the monetary-policy interest rate and intervene in the foreign-exchange market to stabilise the exchange rate. However, the central bank's options are rather mechanical. These - often statutory - restrictions on the central bank are imposed to ensure credibility.

History shows examples of successful currency boards, e.g. Estonia, and total failures, e.g. the currency board in Argentina.

A country opting for a currency board has to defend its own currency. In case of speculation against the currency no help should be expected from the country to whose currency the currency in question is pegged. Speculation may therefore require dramatic interest-rate increases.

Elimination of the risk of collapse in the event of speculation requires a guarantee agreement with a highly credible external party. For the Faroe Islands, this could e.g. mean a guarantee from the Danish central government that the exchange rate vis-à-vis the Danish krone could be maintained. This unlimited guarantee in terms of amount and time would make the regime more credible, unless there was speculation against abolishment of the government guarantee.

However, the Danish central government cannot be expected to furnish such an unlimited guarantee without gaining some insight into or control over other economic-policy measures implemented under the currency board or by the Faroese authorities. In addition, the monetary-policy interest rate would be determined entirely by interest rates in Denmark.

In practice this scheme would not give the Faroe Islands any more economic-policy autonomy than the current direct use of the Danish krone as their currency. It must be emphasised here that the existence of special Faroese banknotes is no indication that the Faroe Islands today apply a currency board.

It would be very difficult for the Faroe Islands to pursue a conventional fixed-exchange-rate policy since the economy is small and catch volumes and fish prices may fluctuate substantially. In several periods the fixed-exchange-rate policy has been problematic even for Iceland, a much larger economy. On several occasions the Icelandic króna was devalued considerably. Today Iceland has abandoned the fixed-exchange-rate policy.

A conventional fixed-exchange-rate policy where the authorities seek to stabilise the exchange rate by means of intervention and through interest rates sometimes requires extremely harsh economic measures to safeguard its credibility. Denmark's fixed-exchange-rate policy vis-à-vis the euro and previously vis-à-vis the D-mark today enjoys a high degree of credibility. This credibility is founded on

Denmark's success in maintaining a fixed exchange rate for more than 20 years and willingness to tighten monetary as well as fiscal policy if required to protect the currency against speculative attacks.

Floating exchange rate

A freely floating Faroese currency could be subject to very strong fluctuation, again due to the narrow business structure and the fact that the currency would be a small one. Like Sweden and Norway, Iceland has opted for a floating-exchange-rate regime where monetary policy is anchored in an inflation target. This model would be difficult for the Faroe Islands to apply since only a small proportion of the consumer goods are manufactured locally. The direct effect of interest rates on inflation would therefore be limited. Interest rates will mainly impact on the economy via the effect on the exchange rate.

In an international context, floating exchange rates have generally yielded poor results for small economies. If the exchange rate fluctuates too much, private individuals and companies are tempted to use one or more foreign currencies instead in order to achieve greater stability.

In recent years the problems encountered by small currencies have led to growing interest in currency unions and common currencies, most notably reflected by the introduction of the euro.

4. Conclusion

In conclusion I would like to point out that a decision for the Faroe Islands and/or Greenland to have their own currency can obviously be made. Nevertheless, to protect such an independent currency from speculation and very strong fluctuation it must be strongly attached to another currency - the Danish krone in these examples. As a consequence of this attachment the economic scope would not be greater than in the current situation where the Danish krone is used as the currency of the entire Danish Commonwealth.

I would like to end by emphasising that the financial markets are very sensitive to expectations of change.

If a debate on the introduction of an independent currency is initiated on the Faroe Islands or in Greenland, there is a risk that the debate itself would generate speculative movements. This could lead to a "run" on the local banks to transfer deposits to Danish banks. It could also lead to extensive exchange of Faroese banknotes for Danish ones. The latter is a harmless phenomenon, but extensive transfer of deposits from local banks could entail considerable difficulties for the business community.

Monetary and foreign-exchange issues should therefore be approached with caution by the authorities. If a change is to be made, there must be an exact plan for the whole process and for how the currency will be anchored, that means how the value of the money will be protected under the new regime. The financial markets hate uncertainty, and money can be moved in an instant if uncertainty arises.