THE THREE OUTSIDERS AND THE MONETARY UNION

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EMU at ten. Should Denmark, Sweden and the UK join?

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Before the start of monetary union in 1999, Denmark, Sweden and the UK decided that they did not want to participate. Denmark and the UK obtained opt-out clauses in the Maastricht Treaty, while Sweden has chosen to stay out unilaterally. In all three countries, the key reason for this decision was - and still is - a negative view among the electorate. The Danish and Swedish governments have been in favour of membership and have put the issue before the people in a referendum (in Denmark twice). In the UK, the government has been in favour in principle, but with caveats.

This chapter reviews the costs and benefits of being outside the monetary union for Denmark, Sweden and the UK in view of the evidence from the last ten years. Building on the discussion in the preceding chapters, we consider the effects in relation to monetary policy, fiscal policy, labour markets, trade, and financial markets. We also briefly discuss political issues - whether the outsiders have experienced reduced influence in the EU and whether the entry of new member states into the monetary union has had any significance for the three outsiders. We start, however, by reviewing the background for why Denmark, Sweden and the UK are not currently members of the monetary union.

Short background

In the negotiations leading up to the Maastricht Treaty in 1992, the UK was granted an opt-out clause, leaving it up to the UK to decide whether it wanted to join the monetary union. In 1997, the UK government committed itself to the principle of joining the single currency, but with a number of important caveats. Membership should be in the national interest, the case should be clear and unambiguous, and there should be popular consent. The government stated five economic tests in terms of (1) business cycle compatibility (convergence), (2) sufficient flexibility in case of problems, (3) conditions for investments into the UK, (4) competitiveness of the financial industry, and (5) overall effect on growth and stability. Furthermore, a decision by the government should be put to a referendum of the British people.

In 2003, an extensive review by the UK Treasury concluded that the investment and financial services tests were met, but not the convergence and flexibility tests. Thus, the Treasury's assessment was that “a clear and unambiguous case for UK membership of EMU has not at the present time been made and a decision to join now would not be in the national economic interest.”

In contrast, the Danish Government accepted the Maastricht Treaty. However, when the Treaty was presented in a referendum in 1992, it was rejected by a slight majority. Denmark then obtained four opt-out clauses, including exemption for transition to the third stage of EMU, the monetary union. In September 2000, a new referendum was conducted. Prior to the referendum, the Government emphasised the efficiency arguments in favour of adopting the euro, essentially “appealed to the purse of the Danes”.[1] However, largely for political reasons - to retain sovereignty - the Danes voted No with a majority of 53 percent.

Sweden is according to the Maastricht Treaty required to adopt the euro whenever it satisfies the entry conditions. The Swedish government has nevertheless maintained that the Swedish parliament will take the final decision on Swedish membership. Sweden does not qualify at present, since the country has not made the necessary changes to its central bank legislation and does not participate in the Exchange Rate Mechanism (ERM II) to meet the condition of a stable exchange rate. The issue of Sweden joining the monetary union is therefore – conveniently – not put to the test.

In 1995, a Swedish government commission of experts concluded that, at that time, the arguments against membership were stronger than the arguments in favour. The commission therefore recommended that Sweden should wait.[2] .

In September 2003, a referendum on Swedish membership in the monetary union was held and a majority of 56 percent voted No. Many of the sceptics argued that full monetary union membership would have negative consequences for Sweden’s sovereignty and be detrimental for democracy.[3]

The three outsiders differ with respect to their overall view on the EU. The Danes are generally much more positive than the Swedes and the British. In the October 2006 Eurobarometer, 74 percent of Danes say Yes to the question: “Taking everything into consideration, would you say that (your country) has on balance benefited or not from being a

[1] Marcussen (2005).
[2] Calmfors et al, (1996)
[3] Lindahl and Naurin (2005).

member of the European Union". This makes Denmark the third most positive among the EU members. In contrast, in Sweden 41 percent says Yes and in the UK 39 percent, making them the third most and the most negative of all EU members respectively.

Macroeconomic performance

At the overall economic level, the three outsiders have done well. Growth in real GDP has been considerably higher in Sweden and the UK than in the euro area, while it has been somewhat lower in Denmark. However, the EU average is pushed down by the weak situation in the bigger countries. The unweighted average growth rate of the euro area is comparable to the unweighted average of the outsiders. In terms of GDP per capita, all the three outsiders are well above the EU average. Employment growth has been higher in the euro area than among the outsiders, but this must be seen in light of the unemployment being much higher in the euro area at the outset. In 2008, unemployment was still markedly lower for all three outsiders than the euro average.

The outsiders have also done well in the area of monetary and fiscal policy. Inflation has been kept fairly close to the target of 2 percent, with the average annual deviation in the range 0.4 – 0.8 percent. However, the average annual inflation deviation from 2 percent has been low in many of the monetary union countries also, and the unweighted average over the euro countries is 0.8 percent. In terms of fiscal policy, two of the three outsiders, Denmark and Sweden, have had a positive fiscal balance on average compared to the negative balance of the euro countries, while the UK in recent years has run a fairly large deficit.

Overall, the performance of the outsiders is comparable to the more successful of the monetary union countries. But what lies behind this performance? Does it depend on the freedom of being outside the monetary union or is it caused by other factors? Let us look at parts of the economy that could or would be particularly influenced by monetary union membership.

Table 1 Macroeconomic performance – the euro area and the outsiders

Period averages

	euro area (6)		Denmark		Sweden		UK		euro area unweighted	
	1989-98	1999-07	1989-98	1999-07	1989-98	1999-07	1989-98	1999-07	1989-98	1999-07
Real GDP growth (1)	2.3	2.2	2.2	2.0	1.5	3.2	2.1	2.7	2.9	3.0
Real GDP (2)	94.3	109.9	109.8	128.1	102.3	132.2	96.8	119.7	100.7	126.6
Employment growth	0.1	1.0	0.0	0.3	-1.2	0.4	-0.1	0.2	0.4	0.8
Unemployment (3)	9.6	8.3	7.1	4.6	5.8	4.9	8.3	5.2	8.2	6.9
Inflation	3.7	2.1	2.5	2.1	4.1	1.4	3.7	1.6	4.0	2.4
Inflation deviation (4)	2.0	0.6	0.7	0.4	3.0	0.8	1.8	0.6	2.4	0.8
Fiscal Balance (5)	-4.3	-1.8	-1.9	2.4	-3.4	1.4	-3.7	-1.3	-4.0	-0.8
Gross public debt (5)	80.2	71.8	69.7	31.8	82.5	46.9	53.4	47.5	73.3	56.8
Trade balance (5)	1.0	1.6	4.7	4.6	3.6	6.5	-1.1	-2.2	1.7	2.9

(1) annual rate; per capita
(2) per capita; OECD=100 in 2000
(3) % rate of labor force
(4) Absolute value of annual deviation from 2 percent
(5) % of GDP
(6) 12 countries weighted by population

Source: http://stats.oecd.org
Economic Outlook No. 83
OECD Factbook 2008

Monetary policy

The three outsiders have chosen different monetary policy regimes. While Sweden and the UK have adopted an inflation target, Denmark has maintained a fixed exchange rate towards the euro.

Members of the monetary union have no independent monetary policy. The monetary policy interest rate is set by the ECB Governing Council, taking the effects for the whole euro area into account. Given the size of the euro area, a single country - even the UK - will by itself have a small or negligible impact on the interest rate. Thus, the euro interest rate will only suit an individual member country to the extent that the cyclical situation in the country is close to the euro average. How do the outsiders stand on this count?

Figure 1a shows that there have been fairly large discrepancies when it comes to GDP-gaps between the outsiders and the euro area.[4] For example, the downturn in the early 1990's was much sharper and stronger in Sweden than in the euro area. However, the fluctuations in the GDP-gap seem to have become smaller over time, which would reduce the importance of the issue. Furthermore, there is also a tendency towards more synchronisation of business cycles. According to the study by the European Commission of monetary union after ten years, the UK economy is much more synchronised with the euro area now than it was in the 1990's.[5] Correspondingly, another study finds that Swedish business cycles have become more correlated with the euro area since the mid-1990s.[6]

In spite of more synchronisation, there are still sizeable differences. Notably, in 2004 the UK economy was above trend, with increasing inflation albeit from a low level, while the euro area was in a downturn. As can be seen from Figure 1d, the upshot was that the Bank of England set an interest rate which was 2-3 percent above the euro interest rate at the time. If the UK had been a member of the monetary union, the low euro interest rate would have stimulated the British economy further. While the UK inflation rate for several years was below its target, suggesting that the UK interest rate may have been too high, the subsequent evolution of the UK economy suggests otherwise in one respect. A lower interest rate would have stimulated the surge in property prices further, presumably making the recent fall in property prices sharper.

For Sweden, the difference in the cyclical position as compared to the euro area has been smaller, which is also reflected in the small difference in interest rates, cf. Figure 1c. This is consistent with an analysis of how well the ECB interest rate policy has fit the individual members of the monetary union.[7] The analysis finds that the euro interest rate would fit well for Sweden and less well for the UK. However, it also finds that the euro interest rate has been even less suitable for two monetary union members, Ireland and the Netherlands, than for the UK.

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[4] The GDP-gap is the difference between actual and the trend of GDP, positive in a boom when GDP is above trend and negative in a downturn.
[5] European Commission (2008).
[6] Söderström (2008).
[7] Calmfors et al (2007). Specifically, the study calculates the optimal interest rate for each country based on a stylized monetary policy rule, a forward-looking Taylor rule with the same weights for all countries.

By contrast, the same analysis finds that the euro interest rate has suited Denmark even better than Sweden. This suggests that Denmark has lost little in terms of monetary stabilization policy from keeping a fixed exchange rate with the euro, implying that the Danish interest rate parallels that of the euro cf. Figure 1b. However, in 2006-2007 GDP-growth was relatively high and a higher interest rate than in the euro area might have been more appropriate.

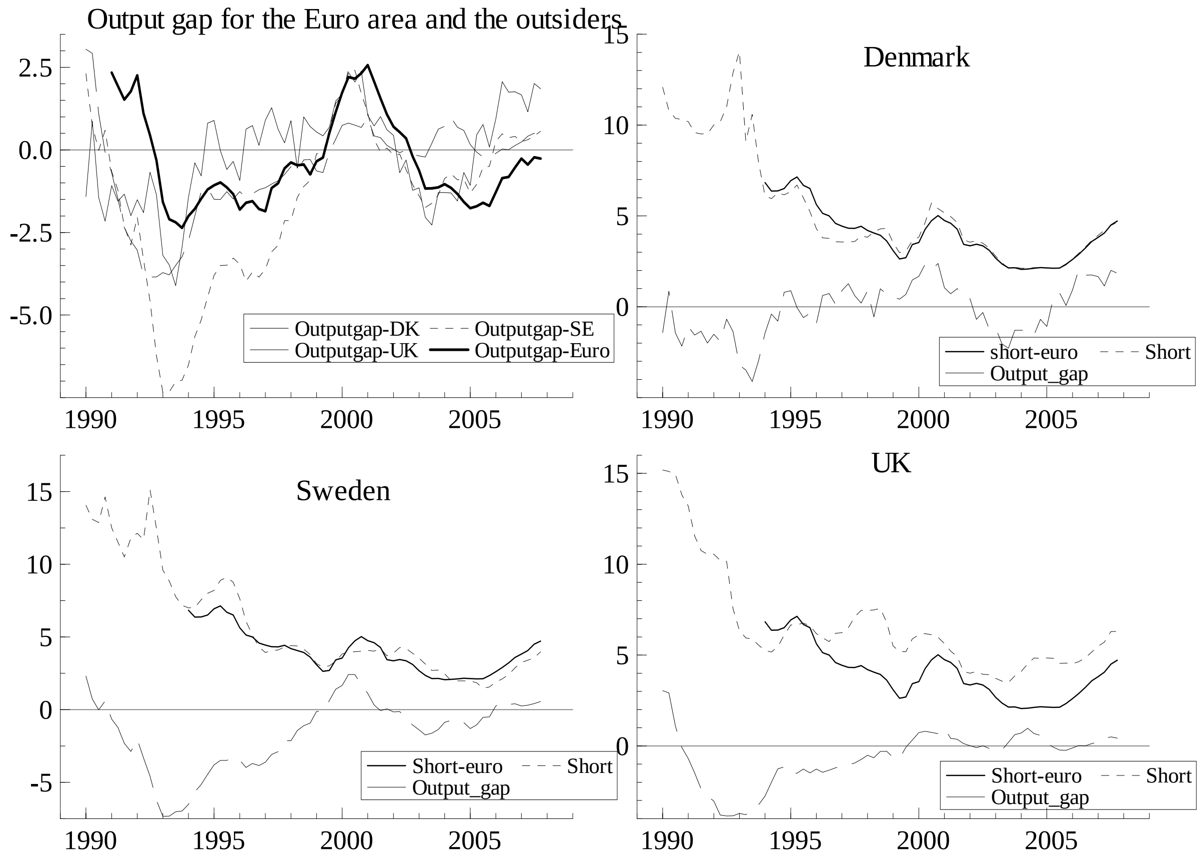

Figure 1: The upper left panel displays the GDP-gap for the euro area and for each of the three outsiders. The other three panels show the GDP-gap and the short run interest rate in the country, as compared to the euro interest rate.

Another side of monetary policy is the exchange rate. How would the outsiders have fared on this account if they had adopted the euro? The first years after the introduction of the euro in 1999, the British pound and the Swedish krona appreciated against the euro, to some extent following the strong U.S. dollar. See Figure 2. However, the krona has depreciated back to around the original level again, and the pound has depreciated even further.

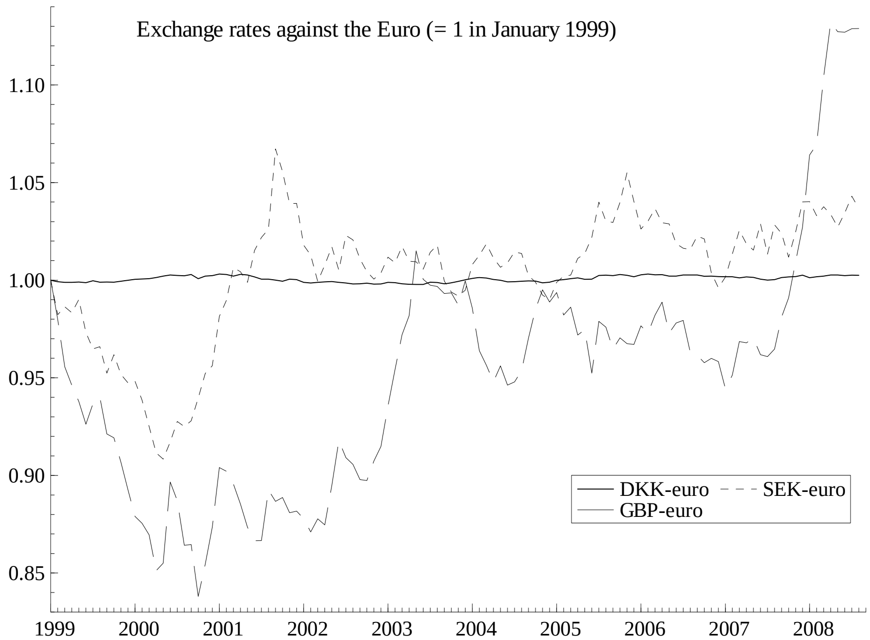

Figure 2. Exchange rates against the euro (lower value indicates stronger currency)

Figure 3a shows the nominal effective exchange rate for the outsiders. We notice considerable volatility for the Swedish krona in the early period, and more stability later on. For the pound, sizeable fluctuations have persisted. Figure 3b shows the nominal effective exchange rate in the hypothetical case that the currencies were linked to the euro, formed by multiplying the series in Figure 3a by the series in Figure 2. This implies neglecting any possible effect on the euro exchange rate and on the trading patterns of the countries. We observe that this would have led to a smoother evolution of the nominal effective exchange rate, to a large extent following the early depreciation of the euro and the subsequent appreciation. Thus, over this period, it seems that monetary union membership would have led to fewer short run fluctuations in the effective exchange rate, but also to more persistent changes.

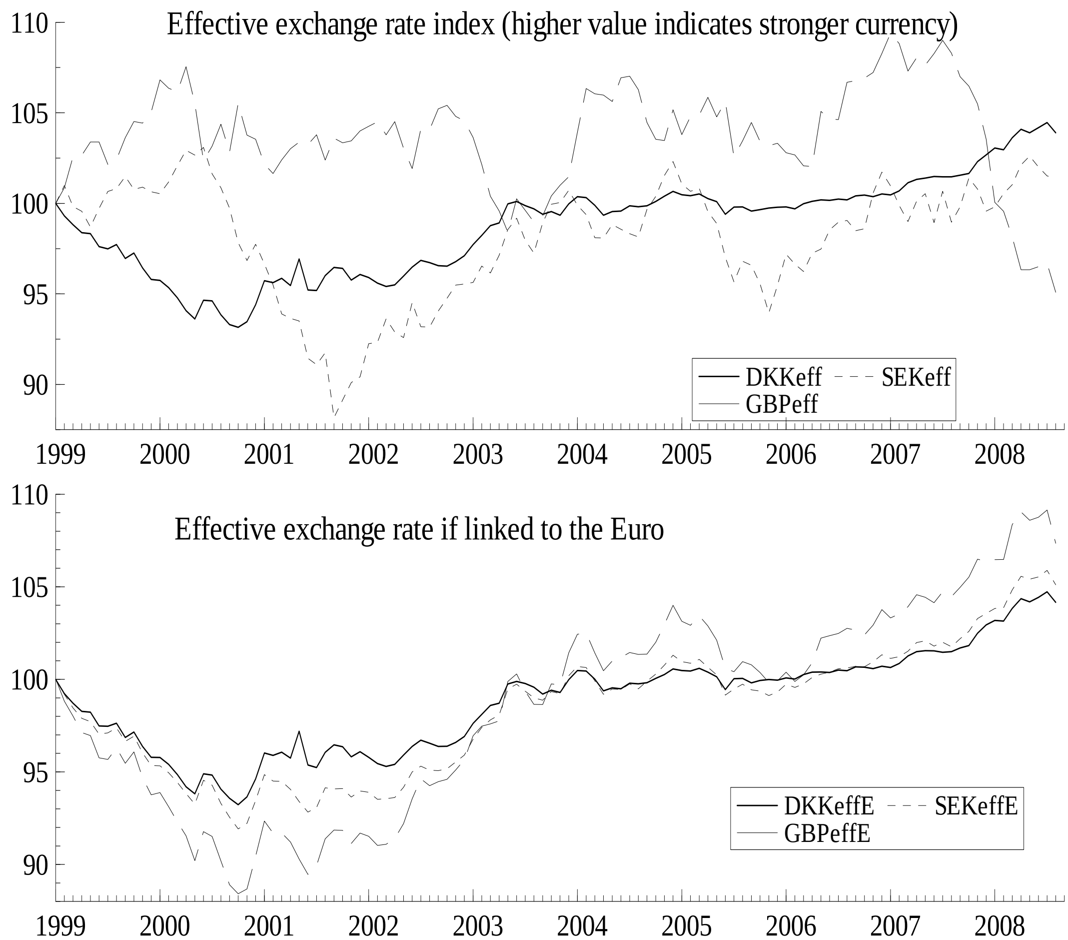

Figure 3. a) Upper panel, the effective exchange rate, BIS, broad index, time-varying trade based weights, geometric averages of bilateral exchange rates; b) Lower panel; effective exchange rate if linked to the euro.

What would have been the effect of a smoother evolution of the exchange rate? The bulk of empirical research suggests that short-run fluctuations in the exchange rate may occur for reasons that are disconnected from the economic fundamentals, such as GDP and interest rates.[8] This means that nominal exchange rate fluctuations in general are costly to the economy. However, exchange rate fluctuations may in some cases have a stabilising effect. A study of the consequences of a Swedish membership in the monetary union within an estimated model of the Swedish economy finds that, since 1993, exchange rate movements

[8] See e.g. the recent survey by Rigobon (2008).

have helped to stabilize the economy after disturbances in other sectors, but they have also to some extent acted to destabilise the economy by introducing additional volatility.[9]

Another issue is the risk of more persistent imbalances in the real exchange rate or competitiveness. The experience of the European monetary union is that excessive inflation in a given country may be very persistent. One reason is that with the nominal interest determined in the euro area as a whole, higher inflation will reduce real interest rates in the country, which in turn will stimulate the economy and fuel inflation further (this is often referred to as the Walters' critique of monetary union). Greece, Ireland, Portugal and Spain have experienced persistent high wage and price growth as compared to productivity growth, leading to a considerable loss in international competitiveness relative to other euro area countries.[10] When wages are rigid downwards in nominal terms, it may be difficult to restore competitiveness for a country that is member of a monetary union.[11] By contrast, a country with independent monetary policy can to a greater extent prevent excessive inflation from appearing, and thus avoiding a loss of competitiveness.

In the debate about monetary union membership, one concern for the outsiders was to maintain the credibility of monetary policy outside the monetary union. All the outsiders had a fairly recent history of high inflation, and monetary union membership was seen as a way of reducing the risk of repeating this history to a minimum. Indeed, the Swedish monetary union commission argued that unless the Riksbank were given increased independence, it would be a strong argument for entering the monetary union.[12] However, the Riksbank reform was carried through, and all the three countries have achieved credibility for their respective monetary regimes.

By some accounts, maintaining credibility has been most impressive for the Danish fixed exchange rate regime. In a world of highly internationally mobile capital, it has been increasingly difficult to maintain a fixed exchange rate, and many European countries failed to do so in the 1990's. Denmark's fixed exchange rate, however, has remained perfectly credible, at least until the recent financial crisis. The high credibility of the Danish fixed exchange rate regime has reflected the high correlation of the business cycles, implying that

[9] Söderström (2008)
[10] European Commission (2008), 58-60.
[11] See evidence in Dickens et al, (2007) and Holden and Wulfsberg (2008).
[12] Calmfors et al (1997).

the strain for the Danish economy from adopting the euro interest rate has generally been small. It has also reflected the substantial gain from maintaining a fixed exchange rate , as almost half of Denmark's exports are directed at the euro area. Third, Denmark has an intervention agreement with the ECB, allowing for unlimited intervention by the ECB if such is necessary to maintain the parity, conditional on not being a threat to price stability in the ECB.[13] In the current financial crisis the interest rate differential, however, has increased to over one percent.

Fiscal policy

Membership in the monetary union would have two main implications for fiscal policy. First, the Stability and Growth Pact sets a more binding ceiling on the budget deficit and the public debt for members than it does for outsiders. Second, an increased burden is placed on fiscal policy to stabilize the economy.

Table 1 suggests that in recent years Denmark and Sweden have done considerably better than the euro countries in terms of fiscal sustainability, with a sizeable fiscal surplus on average and consequently a much reduced public debt. The UK, on the other hand, has run a fairly big deficit in recent years - close to the Stability and Growth Pact limit of 3 percent - but has a public debt that is lower than the average among the euro countries.

However, as pointed out in Chapter 3, some of the euro area members have also done well in this context by maintaining a fiscal surplus and being able to reduce public debt substantially. Thus, one cannot conclude that monetary union membership in itself has made a big differenceas regards fiscal discipline since 1999, but it did force several countries to improve their fiscal balances as they were struggling to meet the entry conditions before 1999.

The slight effect of monetary union membership on the fiscal balance may reflect that the incentives facing members and non-members are rather similar. Monetary union members are restricted by the Stability and Growth Pact, and they also have an incentive to obtain a fiscal surplus in a normal cyclical situation so as to be able to conduct an active stabilisation policy in a downturn. However, maintaining a sustainable fiscal policy is as important outside the monetary union, in part because bad fiscal discipline may easily undermine the credibility of

[13] See http://europa.eu/scadplus/leg/en/lvb/l25082.htm.

monetary policy. Furthermore, Denmark and Sweden seem to have learned from their experience of high public debt in the early 1990's and have pursued a sound fiscal policy since.

Turning from fiscal sustainability to the increased role for fiscal policy for stabilization as a result of being a member of the monetary union, the evidence in Chapter 3 shows that most EU countries, including the three outsiders, have fairly large and effective automatic stabilisers. However, there has been no consistent countercyclical discretionary fiscal policy in the EU countries over the last decade, in contrast to the clear countercyclical fiscal policy in the US.

The sound fiscal position of Denmark and Sweden should make it possible for them to use fiscal policy to stabilise fluctuations in the economy, even under the rules of the Stability and Growth Pact. In Denmark, politicians have been well aware that maintaining a fixed exchange rate visávis the euro requires that the fiscal policy is used to stabilise the economy.[14] In Sweden, the recent introduction of a fiscal council -- a government agency with the task of providing an independent evaluation of Swedish fiscal policy-indicates an impressive political willingness to maintain a sound fiscal policy. Thus, on this account Denmark and Sweden would be well suited for monetary union membership. For the UK, the current larger fiscal deficit would suggest that more time would be needed to be prepared for the fiscal rules of the Stability and Growth Pact.

Even if fiscal policy can and should be used to stabilise the economy, one should remember that it cannot fully substitute for the lack of an independent monetary policy. There are well known limitations, including that it takes more time to implement, is harder to use in a timely fashion and that frequent changes in tax rates and public purchases may have adverse effects on the efficiency of the economy. Fiscal policy is also often influenced by political considerations that may run contrary to the demands of stabilisation. Hence, fiscal policy is less potent as a measure to restore imbalances in the real exchange rate caused by excessive wage growth, as pointed out earlier.

[14] See Andersen and Chiriaeva (2007)

Labour market and wage setting

The lack of independent monetary policy within a monetary union raises the demand for labour market flexibility to avoid that cyclical fluctuations lead to volatile employment levels and persistent unemployment. The outsiders seem well prepared for membership in the monetary union, having higher employment and lower unemployment rates than most of the monetary union members. Over the last ten years, they have also undertaken more extensive labour market reforms to increase labour market flexibility than the bulk of the monetary union members.[15] In contrast, many monetary union members carried out more reforms before becoming members and less when membership was secured.

Employment growth, on the other hand, has been higher in the monetary union, which partly reflects the very low employment rate in some monetary union countries in the mid-1990's.

In spite of the UK labour market being among the most flexible in Europe, the 1993 Treasury Assessment based on the monetary union studies mentioned above concluded that "we cannot be confident that UK flexibility, while improved, is sufficient." Underlying this conclusion was scepticism as to whether flexibility would be sufficient within the monetary union. It was argued that "The less progress on flexibility that is achieved in the EU, the greater the premium on a high level of flexibility in the UK economy".

A key aspect of the labour market is wage setting. As pointed out in recent research, a strict inflation target may induce wage moderation in countries with centralised wage setting .[16] The idea is that high wage growth will be met by a sharp rise in interest rates, which in turn will amplify the adverse effect on employment. This should induce wage moderation and consequently a permanently lower equilibrium level of unemployment.

Building on this effect, some researchers have pointed out that entry into the monetary union may remove such wage moderation for a country with centralised wage setting and a national inflation target since there would no longer be a clear link between national wage setting and the common interest rate in the euro area.[17] This argument suggests that membership in the monetary union would increase equilibrium unemployment in Sweden by reducing the

[15] See European Commission (2008), 80-82
[16] Bratsiotis and Martin (1999) and Soskice and Iversen (2000).
[17] Soskice and Iversen (1998) and Cukierman and Lippi (2001).

discipline imposed by the Riksbank on the power of unions. (The UK has decentralised wage setting and Denmark has a fixed exchange rate, so this effect would not be relevant for them.)

However, one can also argue that precisely because a national inflation target may discipline wage setters, it also weakens their incentives to coordinate on wage restraint.[18] Thus, the stronger incentives for coordinated wage restraint within the monetary union, or with a fixed exchange rate as in Denmark, may imply coordination leading to lower equilibrium unemployment. Indeed, Finnish observers claim that monetary union membership has "reinforced demands for centrally agreed wage solutions".[19] Other researchers find that wage restraint has increased not only in many euro area countries after the introduction of the euro, but also in Sweden and the UK.[20] In other words, they find no support for any relationship between wage restraint and monetary regime. However, this analysis does not check a host of other variables that are also likely to affect wage setting, such as institutional variables and labour market tightness, which reduces the value of this finding.

Trade and foreign direct investment

As noted in chapter 5, one would expect a monetary union to have a positive effect on trade within the union. Currency exchange costs and exchange rate uncertainty are reduced. Prices become more transparent, which should increase competition. As noted in Chapter 5, most studies find evidence of increased trade, but the size of the estimated effect varies. On balance, the evidence indicates that monetary union membership has a fairly large positive effect on trade, raising trade both with the euro area and trade with other countries. This last effect could be because monetary union membership makes a country more attractive as a trade partner for countries outside the monetary union, and because euro area exporters become more competitive.

For the three outsiders in question, the analysis in chapter 5 in fact finds that the increase in trade with the euro area has been greater for Denmark than the average increase for the euro area countries themselves. Denmark's performance may reflect the high credibility of the fixed exchange rate against the euro. For Sweden, the increase in trade with the euro area was

[18] Holden (2005).
[19] Tiilikainen (2005).
[20] Posen and Popov Gould (2006).

somewhat smaller for Sweden and for the UK much smaller, than the average for all euro area countries.

Thus, from the evidence in Chapter 5 we would expect that the three outsiders, in particular Sweden and the UK, would have a clear benefit from increased trade by becoming members of the monetary union, both from trade within the euro area and increased trade with countries outside the monetary union and the EU. Moreover, increased trade with the euro area as a consequence of joining the monetary union may in itself lead to greater synchronization of business cycles with the euro area countries. This would reduce the loss from not having a national monetary policy.[21]

The effects of a monetary union on foreign direct investment are less clear than those on trade. As discussed in Chapter 5, there would be opposing effects at work. On the one hand, horizontal direct investment, such as establishing production in another country for sales there and to neighbouring countries, tends to be a substitute for trade. Thus, reducing the costs associated with trade may actually lead to less need for horizontal direct investment. On the other hand, the monetary union has also made it more attractive for firms from outside the monetary union to establish production within the union. As one might expect from opposing effects, the empirical studies surveyed in Chapter 5 show varying results. However, as argued in Chapter 5, the studies that find positive effects have not controlled adequately for the positive effect of the Inner Market. Overall, the conclusion in Chapter 5 is that the euro has had little or no effect on foreign direct investment within the euro area, but it may have had positive effects by attracting investment from countries outside.

Financial markets

The creation of monetary union led to the swift integration of some financial markets. As shown in Chapter 4, Figures 1 and 2, the money and public debt markets integrated almost immediately after the euro was launched, and integration in the corporate bond market is very high. However, the interest rates for these assets in Denmark and Sweden have also almost converged with the interest rates in the euro area, and the slight remaining differences probably reflect the difference in central bank interest rates. For the UK, the differences are somewhat larger, reflecting the difference in central bank rates.

[21] Frankel and Rose (1998).

Chapter 4 also shows that some integration has occurred in equity and credit markets, but this is still incomplete, particularly in the credit markets. For example, there is still considerable dispersion in mortgage rates within the monetary union, as shown by Figure 3 in Chapter 4. The dispersion for the two outsiders with inflation targeting Sweden and the UK is still greater, but much of this can be explained by the difference in central bank interest rates. Overall, this comparison would suggest that membership in the monetary union would have limited effects on financial integration for the outsiders.

An important additional concern is connected with financial stability. Bank credit is the major source of debt financing for non-financial corporations in Europe. Cross-border banking is increasing, and many European banks have become large in relation to the size of their home country. This increases the need for common, supranational bank regulation and supervision, which became evident during the financial crisis. Being a member of the euro area may be an advantage in a financial crisis, since it gives some influence in crisis management and possibly access to assistance that outsiders do not have.

One may also argue that having an independent national central bank gives more scope for adapting measures to the local circumstances. For example, if domestic economic problems mean that domestic banks face a tighter liquidity squeeze than banks in other countries, a national central bank may supply additional credit by accepting a wider range of collateral. Within a monetary union, it might be difficult to address country-specific problems in such a way.

On balance, issues of financial stability seem not to present any clear arguments for or against joining the monetary union. The current financial crisis is a tough test for the system , however, and may yet produce such arguments.

Political issues

What do the outsiders lose in terms of influence by not being members of the monetary union? First, of course, the outsiders do not have a say in the Governing Council of the ECB. However, given that the outsiders - even the UK- are small relative to the total size of the euro area, the influence on the monetary policy of the ECB would in any case be small. Rather it would instead seem to be more important if being outside the monetary union means less influence on other EU policies that are of specific importance to the outsiders. Such a loss of influence could arise from not being allowed to participate in decision-making bodies, from being less attractive as a partner in the give-and-take of EU politics, or simply from reduced reputation.

Countries outside the monetary union do not participate in the regular informal meetings of the finance ministers of the euro area - the Eurogroup – that take place every month the day before the ECOFIN Council meetings. The Eurogroup is not mentioned in the Treaty and does not have any formal decision-making competence. It has nevertheless assumed more importance over time as a forum for discussion and the formation of consensus.

A number of studies have been undertaken to evaluate the loss of influence for the countries that have opted out of parts of the EU cooperation, including staying outside the monetary union. One study based on 33 in-depth interviews with Danish and British officials and 20 with representatives from EU bodies and other member states, all conducted between December 2005 and January 2008, finds that many of the Danish representatives described their opt-outs as a constraint on their ability to promote Danish interests. Besides the effect from being outside the decision-making in the areas involved, representatives may amplify the negative effect by self-censorship and by deliberately abstaining from seeking influence in order to avoid domestic or international criticism. However, the outsiders were found to compensate by other strategies, for example by being “best-in-class” (as when Denmark and Sweden “overfulfill” the Stability and Growth Pact criteria), by helping other member countries and by suggesting compromises. Some British representatives, on the other hand, argued that opt-outs in some situations could be used positively to further national interests. In the monetary union case, the study indicates that UK representatives are comfortable with being outside the euro area and also happy to contribute to the EU on the question of how good monetary policy should be conducted.[22]

Another study finds similarly that Sweden and Denmark improve their position by trying to be “best in class” and to maintain the best implementation record of EU directives.[23] ~~.~~They also practise the strategy of seeking bilateral cooperation with other member countries.

[22] Adler-Nissen (2008). This is consistent with the findings of Miles and Doherty (2005)
[23] Lindahl and Naurin (2005)

Several studies indicate that the three outsiders are not less influential than other EU countries, in spite of being outside the monetary union. In a study of 131 representatives in Council of Minister working groups from all EU member states undertaken in 2003, the three outsiders were ranked high as cooperation partners . The UK representatives were ranked top, followed by representatives from two other large countries, France and Germany, with Sweden and Denmark in fourth and seventh place. A clear majority, 102 of 129, said No when being asked whether the decision to stay outside the euro area was a factor to be considered when choosing cooperation partners (9 said Yes and 8 said Yes regarding euro issues only).[24]

The euro-outsiders are not treated unfavourable when it comes to important positions in the Parliament or for jobs in the Commission. While Swedes were underrepresented in the highest positions in the Commission, Denmark and the UK were overrepresented. In the distribution of rapporteurs in the Parliament, the Danes were lightly underrepresented, the British had average representation and the Swedes were clearly overrepresented.[25]

Interviews conducted in September 2007 with Danish eurostakeholders, representatives from trade unions and employers' organisations, the government, the central bank and other institutions, show that none of these groups have any immediate problems from Denmark remaining outside the monetary union. It is argued that solutions and practices have been found to deal with the situation. The Danish role as a "model country" has also put Denmark in a favourable position in Europe.[26]

Enlargement of the monetary union

In principle, accession of new member states into the monetary union has opposing effects on the question of joining for the three outsiders. On the one hand, a larger monetary union would increase the benefits from lower trading costs. It may also make it even more difficult for outsiders to exert any influence from the outside. On the other hand, more countries within the monetary union would also reduce each member state's influence within the union. Overall, one would expect that the effects are positive, but presumably small in light of the relatively small economic importance of the newcomers.

[24] Lindahl and Naurin (2003).
[25] Grönberg (2003).
[26] Marcussen (2007)

It will take more time than originally anticipated for all the new member states to join the monetary union. Slovenia joined in 2007, Malta and Cyprus in 2008, and Slovakia at the beginning of 2009, but the other new member states are still far away from membership. The slow progress on enlargement of the monetary union strengthens the conclusion that this is unlikely to have much effect on Denmark's, Sweden's and the UK's decision to join for many years.

Conclusions

The principal macroeconomic argument against joining the monetary union is that a national monetary policy tends to be better tailored to the state of the economy, and can therefore contribute to the stabilisation of output, employment and inflation. To the extent that asymmetric shocks imply that the common monetary policy diverges from what would be best for the individual national economy, stabilisation is left to national fiscal policy.

Fiscal policy can play an important role in stabilising the economy. First, as discussed in Chapter 3, most EU countries have fairly large and strong automatic stabilisers. When the automatic stabilisers are allowed to work, fluctuations in the economy are mitigated. Second, it is possible to stabilise the economy further with the help of countercyclical discretionary fiscal policy. However, in practice there are many limitations that make fiscal policy an imperfect substitute for monetary policy. Discretionary changes in fiscal policy are harder to use in a timely fashion and may involve changes in tax rates and public purchases that have an adverse effect on the efficiency of the economy. Furthermore, fiscal policy is often influenced by political considerations which may run counter to the demands of stabilization. In fact, the experience in the euro area is that discretionary fiscal policy tends to be procyclical rather than countercyclical.

A specific problem for the exercise of fiscal policy in the monetary union is posed by the restrictions laid down in the Stability and Growth Pact. It sets a limit on the size of the public budget deficit. It also sets a limit on the size of the public debt, which further limits budget deficits when the debt exceeds the limit.

An inherent property of monetary union is that differences in inflation rates between countries or regions give rise to differences in real interest rates since nominal interest rates are more or less equal. A country with higher than average inflation will have a lower real interest rate. This will provide additional fuel for inflation and may undermine the competitiveness of its tradable sector if it does not compensate by a higher rate of productivity increase. Greece, Ireland, Portugal and Spain are examples. The evidence from the euro area shows that it is difficult to correct prices and wages to restore competitiveness and that this can take several years. The weak macroeconomic performance of Germany after 1999 can to some extent be explained by too high a exchange rate to begin with.

The principal macroeconomic argument for joining a monetary union is that nominal exchange rate fluctuations towards the other countries in the union are removed. Nominal exchange rates may vary considerably in the short run with little or no relation to changes in fundamentals such as GDP and interest rates. Nominal exchange rate changes lead to real exchange rate changes in the short run since prices and wages are sticky. Such changes are costly for the economy. While membership in a monetary union could result in more volatility in the exchange rate towards countries outside the union, the three outsiders have almost half of their trade with the euro area. Adoption of the euro is therefore likely to lead to a reduction in nominal and real exchange rate fluctuations which would be beneficial for Sweden and the UK (but not for Denmark since this country already has a fixed exchange rate against the euro).

The most important gain from the removal of exchange rate fluctuations – indeed from adopting the same currency – is the increase in trade. The evidence in Chapter 5 indicates that monetary union membership has led to a substantial increase in trade, not only between members of the currency union, but also between insiders and outsiders. In addition, a single currency will increase price transparency and should therefore serve to promote competition in goods and service markets.

In view of the arguments for and against joining the monetary union outlined here, what can be said about the performance of Denmark, Sweden and the United Kingdom if they had become members of the monetary union in 1999?

Denmark has pegged its exchange rate to the euro and is not reaping the benefits of a national monetary policy. Its monetary policy interest rate has closely followed the ECB rate, except during the recent financial crisis, and its average inflation rate has been the same as that of the euro area. From this we must conclude that Denmark's macroeconomic performance would have been essentially the same if the country had been a member of the monetary union. As for the effect on trade, Denmark has already reaped some gains from its stable exchange rate with the euro, but would probably gain more if it joined.

Sweden has an independent monetary policy with inflation-targeting. The difference between the monetary policy rates of Sweden and the ECB has been fairly small since 1999. This is to be expected since the GDP-gap of Sweden and the euro area have followed a similar pattern and have been of a similar magnitude. Thus, it seems likely that Sweden's macroeconomic performance as a member of the monetary union would have been quite similar to its actual performance.[27] However, the evidence in Chapter 5 trade suggests that foreign trade would have been considerably higher, in particular with the euro area, but probably also with countries outside the monetary union.

The UK economy has become more synchronized with the euro area economy than before, but there are still sizeable differences in the cyclical position at times. This has led to periods with fairly large differences between the UK and the euro monetary policy interest rate, with the UK rate consistently above. For several years, UK inflation was below its target and a lower interest rate would have pushed up inflation, presumably reducing the deviation from target. On the other hand, a lower interest rate might also have stimulated the surge in property prices, most likely making the recent fall in property prices sharper. Overall, the effect of monetary union membership on the macroeconomic performance of the UK would not have been large. As above, the evidence in Chapter 5 suggests that foreign trade would have been considerably higher, in particular with the euro area, but probably also with countries outside the monetary union.

In summary, we conclude that macroeconomic performance would not have been substantially different for Denmark, Sweden and the UK if they had been members of the monetary union from its start. Foreign trade would have increased, however in particular for Sweden and the UK.

[27] This is supported by Söderström (2008) which studies the way of how the Swedish economy would have performed with the euro. Söderström finds that GDP growth would have been higher and more volatile and inflation higher. The differences are estimated to be quite small.

The political influence of Denmark, Sweden and the UK would probably not be much affected, since the loss of political influence due to staying outside seems to have been small. Furthermore, the enlargement of the monetary union would not have much effect on being an outsider.

What can this say about the effects if these countries were to join today? The evidence above indicates that trade would increase, in particular for Sweden and the UK. The effects on macroeconomic performance would depend on the extent of asymmetric shocks in the future and on the ability to handle such shocks. Steadily increasing economic integration between the outsiders and the insiders is likely to further reduce the extent of asymmetric shocks, thereby reducing the loss from giving up a national monetary policy. It is of course hard to predict what kind of shocks that will occur in the future. Moreover, it remains to be seen how the competitiveness problems in the monetary union will be resolved, and what the consequences will be for the countries affected.

As for the ability to handle shocks, the outsiders seem well equipped. At present, Denmark and Sweden are well positioned to use fiscal policy as a substitute – albeit imperfect – for an independent monetary policy, since their public debts are low and they have run public budget surpluses. Above all, they have a good framework for fiscal policy-making. The UK also has a relatively low public debt but a less favourable budget balance position. Furthermore, relative to most countries in the euro area, the outsiders have relatively flexible labour markets, which makes for easier adjustment when necessary.

Should Denmark, Sweden and the U.K. join? With a fixed exchange rate, Denmark has no monetary autonomy. While Denmark retains the option of devaluing its currency in the face of a large negative shock, it also runs the risk of speculation against the krone if the market loses confidence in the regime. Furthermore, trade is likely to increase. Denmark is therefore likely to gain economically by joining the monetary union.

Whether joining the monetary union is economically beneficial for Sweden and the UK depends on what weight is given to the loss of an independent monetary policy in the face of asymmetric shocks on the one hand, and to the likely gain from reduced nominal and real exchange rate fluctuations and increased trade on the other.

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