DIIS BRIEF

Executive summary

The 1st January 2009 marked the ten year anniversary of the Euro, but Denmark and Sweden are the only small, open EU economies not seeking to join in the immediate future. Paul Krugman, the Nobel Prize winner for economics, has argued that all small European economies should join the Euro. There are currently four main economic arguments put forwards by leading economists such as Krugman related to the global economics crisis and new evidence emerging from studying the past 10 years of the Euro: (1) that membership of the Euro provides protection from the worst effects of the global financial crisis, (2) that the positive trade effects are conclusive, (3) that Foreign Direct Investment (FDI) has been effected by the Euro and (4) that relative Euro-zone economic effects have been understated over the last 10 years.

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Small, open €uro economies

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INTRODUCTION

The 1st January 2009 marked the ten year anniversary of the Euro, but Denmark and Sweden are the only small, open EU economies not seeking to join in the immediate future. In an interview for the Swedish Sydsvenskan Paul Krugman, the Nobel Prize winner for economics, argued that all small European economies should join the Euro. Why are leading economists such as Krugman now advocating that small, open European economies should join the Euro? What are their arguments and why are they so certain?? And to what extent are these arguments important for Denmark and Sweden, particularly in the Öresund region???

> "I think the lesson of the crisis is that one should join the euro…. For good or evil should probably all the small European countries join."
>
> Paul Klugman, Nobel Prize for Economics, Sydsvenskan 16th November 2008.

There are currently four main economic arguments put forwards by leading economists such as Krugman related to the global economics crisis and new evidence emerging from studying the past 10 years of the Euro: (1) that membership of the Euro provides protection from the worst effects of the global financial crisis, (2) that the positive trade effects are conclusive, (3) that Foreign Direct Investment (FDI) has been effected by the Euro and (4) that relative Euro-zone economic performance has been understated over the last 10 years.

GLOBAL FINANCIAL CRISIS

Professor Claus Vastrup of Aarhus University, former chairman of the Danish Economic Council, has recently argued for Denmark membership of the Euro in order to benefit from risk sharing through the Eurozone financial markets. Denmark has a 25-year history of a fixed exchange rate policy with the D-mark/Euro and as a result currently has relatively higher interest rates. Professor Willem Buiter of the London School of Economics goes further to argue that European countries with exposed banking sectors, such as Iceland, Britain, Switzerland, Denmark and Sweden, should adopt the Euro to avoid a run on their banks. As leading economists, Krugman, Vastrup and Buiter reflect the general scientific opinion that membership of the Euro provides protection from the worst effects of the global financial crisis, particularly in small countries with exposed banking sectors.

> **Risk diversification**
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> "EMU has increased financial integration, which has the benefit of risk diversification among member countries and adaptation to a new long-term equilibrium after, for example, interest rate and inflation shocks in member countries."
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> *Economic Consequences of EMU*, Claus Vastrup, Institute for Economy, Aarhus University, December 2008.

Banking crisis

"Iceland's circumstances were extreme, but there are other countries suffering from milder versions of the same fundamentals – (1) a small country with (2) a large, internationally exposed banking sector, (3) its own currency and (4) limited fiscal spare capacity relative to the possible size of the banking sector solvency gap. Countries that come to mind are Switzerland, Denmark, and Sweden and even to some extent the UK".

The Icelandic banking crisis and what to do about it, Willem Buiter and Anne Sibert, Centre for Economic Policy Research, October 2008.

POSITIVE TRADE EFFECTS

The past 10 years of the Euro has now provided a large amount of concrete economic evidence of its effects on trade and FDI. The most famous economist in the field, Professor Andrew Rose of the University of California, Berkeley, has recently surveyed 26 studies of this evidence and concludes that EMU has raised trade inside the Eurozone by at least 8% and perhaps 23%. Professor Richard Baldwin of the Graduate Institute in Geneva argues that this boost in Eurozone trade is mainly caused by the increase in newly-traded goods, where existing firms export a wider rand of their products to the Eurozone. The most extensive analysis based on sector-data by Harry Flam (Stockholm University) and Håkan Nordström (Swedish Board of Trade) who compare 2002-2005 data with 1995-1998 data in order to conclude that the Euro has increased trade within the Eurozone by about 26% and trade between the Eurozone and outsiders by about 12% on average. Such extensive economic surveys demonstrate that the positive trade effects of the Euro over the past 10 years are conclusive.

EMU and Trade

"the newly-trade goods" hypothesis – the euro is stimulating the export of new products rather than simply increasing the volume of already-traded varieties."

Study on the Impact of the Euro on Trade and FDI, Richard Baldwin et al, Economic Papers, April 2008.

Large euro effects

"We estimate that the euro has increased trade within the eurozone by about 26 per-cent and trade between the eurozone and outsiders by about 12 percent for the years 2002-2005 on average as compared to 1995-1998."

Explaining large euro effects on trade: the extensive margin and vertical specialization, Harry Flam and Håkan Nordström, August 2007.

FOREIGN DIRECT INVESTMENT

FDI and Euro

"there is evidence of a small but sustained shift of major economies' FDI towards the Euro-12 from other destinations after EMU, if intra-zone FDI is excluded; this suggests that the euro is attracting modest inflows from outside the zone."

Foreign direct investment and the euro: the first five years, Christopher Taylor, January 2007.

Similar to trade, there is now increasing evidence that FDI has been positively affected by the last 10 years of the Euro. Christopher Taylor of the British National Institute of Economic and Social Research recently concluded on the basis of previously unpublished data from Eurostat, that there is evidence of a small but sustained shift of major economies' FDI towards the Eurozone from other destinations after EMU, if intra-zone FDI is excluded. Taylor suggests that the Euro is attracting modest inflows from outside the zone. In the most extensive survey of its kind, Richard Baldwin, Virginia Di Nino, Lionel Fontagné, Roberto De Santis and Daria Taglioni present evidence that both EU and Eurozone membership have had pro-FDI effects and that the Euro's pro-FDI effects were much larger for deals within sectors as opposed to across sectors. Again, 10 years of economic evidence demonstrate the pro-FDI effect of the introduction of the Euro.

The euro's pro-FDI effect

"The euro's pro-FDI effect was much larger in manufacturing versus services. The euro's pro-FDI effect was much larger for deals within sectors as opposed to across sectors. The euro fostered domestic and cross-border M&A activity by both large and small firms, but its effect on small firms was biased towards cross-border activity. The euro's adoption promoted FDI from outside the euro area, but this effect was only about half as strong as the impact within the area."

Study on the Impact of the Euro on Trade and FDI, Richard Baldwin et al, Economic Papers, April 2008.

UNDERLYING ECONOMIC PERFORMANCE

While all economic surveys of the last 10 years of the Euro pay attention its success in stimulating trade and investment, achieving low inflation rates and structurally lower interest rates, less attention has been paid to its underlying economic performance. During 2008 extensive surveys by the Brussels-based think tank Bruegel, the European Commission, the European Central Bank, the British House of Lords and Deutsche Bank Research have emphasised these positive trade, investment, inflation and interest rate effects. The 2008 survey by the Goldman Sachs European

European labour markets

"The Euro-zone's underlying economic per-formance is better than many portray. In the ten years since the start of EMU, Euro-zone GDP per capita growth has been the fastest within the G3. This outperfor-mance has been driven by the transformation of Euro-pean la-bour markets—a transformation brought about by rising female participation and later retire-ment.

The Euro at Ten, Goldman Sachs European Economics Group, June 2008.

Economics Group pays greater attention to underlying economic performance and argues that the Eurozone's understated success has been in terms of relative per-capita growth. The Goldman Sachs survey compares Eurozone gross domestic product (GDP) per-capita growth and argues that the Eurozone has outperformed both the USA and Japan.

The survey argues that previous comparisons with the USA tend to overlook the extent to which population growth inflates economic growth. In contrast, the survey sets out how Eurozone outperformance has been driven with the transformation of European labour markets – a transformation brought about by rising female participation and later retirement. It is increasingly clear from these 10th anniversary surveys that relative Euro-zone economic effects have been understated over the last 10 years.

Current Danish and Swedish opinion polls show that there are high levels of general support for the EU as a progressive force against the negative effects of globalisation, such as climate change and economic crisis. Danish and Swedish membership of EMU and the Eurogroup would help contribute to the role of the EU as protection against the worst excesses of globalisation and help build more sustainable global financial architecture. For the Öresund region these economic and political effects are important in encouraging confidence and stability for companies, commuters, and the wider society. Krugman's argument that small open economies should join the euro area is therefore of particular importance to Denmark and Sweden.

GDP per capita growth, 1998-2008

Average Annual Growth Rates, 1998-2008	Eurozone	USA	Japan
headline GDP Growth *equals changes in*	**2.2**	**2.6**	**1.3**
Population	0.4	1.0	0.1
plus **Productivity (GDP/hour)**	1.4	1.6	1.9
plus ***Labour utilisation***	0.4	-0.1	-0.7
underlying productivity growth in GDP per capita	**1.8**	**1.6**	**1.1**

Source: Goldman Sachs European Economics Group, *The Euro at Ten: Performance and Challenges for the Next Decade* (June 2008), table 2, page 45.

FURTHER READING

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