The Case of "EMU-Outsiders": Economic and Political Considerations

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Abstract

Our paper discusses the option of three EU countries – United Kingdom, Sweden and Denmark – of not joining the EMU and analyses whether besides their subjective option of staying out of the EMU there is also an economic reason behind this decision, based on existing literature in the field. The three "EMU-outsiders" are different in terms of economic power, financial market attributes, monetary policy rules employed and political decisions. In each case, the choice to remain outside EMU was based on economic reasons, as well as political and sometimes nationalist arguments. Of the three countries under scrutiny, Denmark is by far the one which has the best prospects of joining EMU, given its fixed exchange rate against the Euro, and United Kingdom the worst, particularly given the recent vote for Brexit. At the same time, the sovereign debt crisis that the EU and particularly the EMU had to confront between 2009 and 2011 has seriously threatened the eventual adoption of the common currency by these economies.

Keywords: European Monetary Union (EMU); Denmark; Sweden; United Kingdom; Brexit;

JEL Classification: F33; F36; F45;

1. Introduction

The creation of the Euro as the common currency in the European Union aimed at the increase of economic and financial integration among its member states. In order to be able to use the common currency, adopting countries have to conform to a set of macroeconomic criteria, with the purpose of demonstrating that they are able to maintain stability and ensure the development of the Union as one of the world's strong economies. Besides the European countries that embraced this idea and introduced the euro as soon as they fulfilled the required conditions[1], there are three outsiders - Denmark, Sweden and the United Kingdom (hereinafter UK) -, to which we will refer as the "outsiders" of the European Economic and Monetary Union (EMU)[2]. These countries

[1] These conditions or benchmarks, widely known as euro convergence criteria, refer to the following: (i) the inflation rate determined based on the Harmonized Index of Consumer Prices (HICP) cannot exceed the HICP reference value, calculated by the end of the last month with available data as the unweighted arithmetic average of the similar inflation rates in the three EU member states with the lowest inflation plus 1.5 percentage points; (ii) the ratio of the annual general government deficit relative to GDP must not exceed 3%; (iii) the ratio of gross government debt relative to GDP must not exceed 60%; (iv) exchange rate stability - countries should not have devalued the currency central rate against the euro during the previous two years and should have participated in the exchange-rate mechanism (ERM/ ERM II) under the European Monetary System (EMS) for two consecutive years; (v) long-term interest rates, calculated as average yields for 10-year government bonds in the past year) cannot be more than 2.0 percentage points higher than the unweighted arithmetic average of the similar yields in the three EU member states with the lowest HICP inflation.

[2] It should be mentioned that the euro convergence criteria were relaxed to a high extent at the end of 1998, in order to allow member states such as Germany, Greece, Austria and Italy to enter EMU – see De Grauwe (2009).

have been members of the European Union for a long time, but they are not members of the EMU yet and consequently, they cannot benefit from the advantages, as well as the disadvantages, offered by a common currency. These three countries make an interesting case because although they have in common the non-acceptance of the Euro despite their good economic development, they do have a different attitude towards the common currency. Out of the three satellites, Denmark and the UK had signed an opt-out clause from a common currency in the founding treaty of the EU. However, Denmark has joined the Exchange Rate Mechanism II which tied up its currency to the euro, while the UK maintained its scepticism. Sweden did not sign such a clause, but its denial to tide the krona to the Euro revealed no intention from its part either to adopt the common currency. Moreover, the recent vote of the British people in the favour of leaving the EU seems to have put UK at thousands of miles distances from adopting the common currency.

The purpose of this study is to analyse whether besides these countries' subjective option of staying out of the EMU there is also an economic reason behind this decision, taking into account the most recent developments in the rapports between them and the EU. The paper is structured as follows: Section 2 presents a number of general considerations regarding the EMU and the decision of the three countries to stay out of this structure, Sections 2 to 4 discuss each country's case for what concerns the main arguments for not adopting the common currency, and Section 5 concludes.

2. General Considerations on EMU and Euro Adoption

The European and Monetary Union (EMU) is a major step forward for the economic integration of countries of the European Union, which involves the coordination of macroeconomic policies of member states, a common monetary policy and last, but not least, a common currency – the euro. The year 1992 represents the starting point of the EMU, by the signing of the Maastricht Treaty, which introduces the euro as the common currency of countries participating in EMU and imposes required benchmarks on a number of macroeconomic variables – see above - for the countries wishing to be part of the EMU. In the same year, the British pound and the Italian lira are withdrawn from the Exchange Rate Mechanism that supported the creation of EMU, and in 1997 the members of the EU adopt the "Stability and Growth Pact" with the aim of strengthening the surveillance and coordination of national fiscal and economic policies. The euro is introduced in January 1999 as an accounting currency and is adopted by eleven countries – Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain, and in 2002 the euro notes and coins are also introduced. At present, a number of 19 countries are EMU members, to the ones joining EMU in 1999 being added Cyprus, Greece, Estonia, Latvia, Lithuania, Malta, Slovakia and Slovenia. Table 1 shows the participation of EU countries in the ERM II, as well as the revaluations of some of the currencies (Danish kroner and Slovak koruna) and the dates of euro adoption, except for Denmark.

Table 1. EU currencies included in ERM II

Currency	Joined ERM II	Rate and fluctuation band	Devaluations/ Revaluations	Adopted Euro
Danish kroner	1 Jan 1999	7.46038; ±2.25	-	NO
Greek drahma	1 Jan 1999	353.109; ±15%	17 Jan 2000: revalued to 340.750	YES; 1 Jan 2001
Estonian kroon	28 June 2004	15.6466; ±15%	-	YES; 1 Jan 2011
Lithuanian litas	28 June 2004	3.45280; ±15%	-	YES; 1 Jan 2015
Slovenian tolar	28 June 2004	239.640; ±15%	-	YES; 1 Jan 2007
Cypriot pound	2 May 2005	0.585274; ±15%	-	YES; 1 Jan 2008
Latvian lats	2 May 2005	0.702804; ±15% (in reality, ±1%)	-	YES, 1 Jan 2014
Maltese lira	2 May 2005	0.429300; ±15%	-	YES; 1 Jan 2008
Slovak koruna	28 November 2005	38.4550; ±15%	19 March 2007: revalued to 35.4424 29 May 2008: revalued to 30.1260	YES; 1 Jan 2009

Source: Author's organisation, based on data from European Commission – The Directorate for Economic and Financial Affairs, http://ec.europa.eu/economy_finance/euro/adoption/erm2/index_en.htm

Clear benefits of the EMU have been pointed out by researchers in the field. For instance, Alogosfoukis and Portes (1990), Artis (1991), Minford (2002), or Tideman and Giuliodori (2010) – to name just a few studies - pointed out several advantages that would result for a country from EMU membership, such as the reduction in transactions cost of changing currency, the decline in the currency risk, thus leading to greater trade and foreign investment flows with the rest of Europe and to a lower risk-premium, and increased transparency in price comparison. Despite these acclaimed benefits, there are still three countries that have opted out of the Eurozone, namely Denmark, Sweden and the UK. This issue has driven the attention of researchers, who studies their level of financial integration with the Eurozone countries and find the reasons behind their refusal to give up their own currencies. Friedman's (1953) hypothesis on monetary independence may provide an explanation, stating that flexible exchange rates allow countries to pursue independent monetary policies and to adjust easily so as to eliminate imbalances and to offset changes in their international competitiveness. If this could explain to a certain extent Sweden's and Britain's non-membership, for Denmark this is no longer a reason for staying out of the EMU as long as it has a fixed exchange regime with the euro.

Looking at the trade-offs between joining the EMU and keeping control over national currency, the Mundell-Fleming theory (1962-1963) is worth mentioning. Also called the "Impossible Trinity", the theory states that in an international economic environment it is impossible for a country to simultaneously achieve the following three goals, as they are mutually exclusive two by two: a fixed exchange rate regime, capital market integration and monetary policy independence. Major *et al.* (2005) explained the validity of this theory: if a country wishes to achieve capital market integration and a stable exchange rate regime, domestic interest rates will depend on international ones and the country cannot maintain its monetary independence; if capital markets are still integrated but the country wants to achieve monetary independence instead, authorities can decide over domestic interest rates, but they will have to accept any exchange rate that the market dictates, so exchange rates will be volatile; if a country tries to stabilize its exchange rate and maintain its monetary independence, then capital market integration can no longer be achieved. On the sceptics' side to this theory we can mention Rose (1996), whose findings prove to be more optimistic about the simultaneous existence of the three conditions. At that time he was among the first researchers to contest this “Holy Trinity”, as he calls it. Surprisingly, the incompatibility between the three goals did not prove to be very statistically significant. He concludes that the effect on capital mobility and exchange rate can be negligible. Moreover, the economic and statistical significance of the monetary divergence on exchange rate volatility was actually small according to his results. Nevertheless, he draws the attention upon the fact that some results may be misleading, due to the inconveniencies met in measuring monetary independence and capital mobility.

Meanwhile, Holden (2009) considers that the decision of Denmark, Sweden and the UK to join the EMU is mostly explained by the overall performance of these countries in six important sectors:

(i) First, in terms of monetary policy there are two indicators we must look after, namely the exchange rate and the interest rate. From the three countries, Denmark has the closest relationship with the euro through its fixed exchange rate, while Sweden and UK chose inflation targeting as their monetary policy rule. As for the exchange rate, we would expect short-run fluctuations to diminish in case of an EMU membership, but at the same time, the changes may be more persistent. Independent monetary policy can better prevent the occurrence of hyperinflation and loss in competitiveness. To exemplify this situation, he brings into discussion the case of Greece, Spain, Portugal and Ireland, who have pushed inflation through high wages and price growth without a productivity increase. In this case, staying out of EMU seems the best way to maintain a country’s competitiveness. Nevertheless, Denmark’s fixed exchange rate to the euro has proved to be beneficial, as half of its exports are directed to the euro area. The interest rate is related to the business cycles. The higher the correlation of business cycles with the euro area, the more suitable would be the euro interest rate for that country; accordingly, it seems that the euro interest rate better fits Sweden and even Denmark than the UK, showing that there was no substantial loss for Denmark in terms of monetary stabilization from maintaining a fixed exchange rate to the Euro.

(ii) By taking a view to the fiscal policy, Sweden and Denmark are more prepared for EMU membership than the UK. As we know, all Eurozone countries have adopted the Stability and Growth Pact, which involves more binding ceilings for public deficit and public debt (the values are linked to the euro convergence criteria previously mentioned). Surprisingly, both Denmark and Sweden had been left behind the euro countries with a considerable fiscal surplus and lower public debt. The UK’s public debt was also under the average of the EMU countries, although unlike the other two countries, it has a public deficit that is still little under the Pact’s 3% limit. Even though fiscal policy should normally stabilize the economy, it cannot fully substitute monetary policy independence.

(iii) The situation for labour market and wage setting proved to be a plausible possible reason for the lack of interest for EMU membership. The outsiders have a relatively more flexible labour market in comparison with most Eurozone countries. Moreover, a fixed inflation target may cause wage moderation in countries with a centralized wage system. The outsiders have both better performance in terms of unemployment rate than most EMU countries and have introduced reforms to increase labour market flexibility.

(iv) Next, at the trade and foreign direct investment level, EMU membership would be a favourable environment for an increase of cross-country flows. On one side, Denmark's high credibility due to the fixed exchange rate against the Euro has led to a higher increase in trade with the Euro area than the average increase for the Eurozone countries themselves. On the other side, this increase was smaller for Sweden and the UK, meaning that EMU membership would bring clear benefits. As for the foreign direct investments, the Euro's positive effect may be noticeable in the increase of investments from countries outside the Euro area rather than within the Euro area.

(v) A close look is given to financial markets, based on the assumption that EMU membership would not have a significant influence on the financial integration of the outsiders. First, the money and public debt markets were integrated almost immediately after the launch of the Euro. Second, since the launch of the Euro, the three countries seemed to converge in terms of corporate bond interest rates, the slight differences being explained by the differences in the interest rates used by central banks. While Denmark and Sweden recorded closer values to the Euro area, the UK is again left behind. Third, the integration in equity and credit markets is still incomplete, mainly for the UK and Sweden, which have chosen an inflation targeting policy, but this difference can be explained again by the interest rates of the countries' central banks. Forth, there is still a concern about the financial stability of the three countries. EMU membership would enable better assistance during crisis times through a better regulation and supervision. Bank loans are still the most important source of financing debt in European corporations and an easier access to external banking would be an advantage for Eurozone countries. Nevertheless, one of the concerns that the three countries may bring is that a loss in central banks' independence would mean that they will no longer be able to address domestic specific problems, such as additional credit in case of a liquidity problem;

(vi) Political issues are also subject to the EMU membership trade-offs. By staying out of the EMU, the outsiders lose their right of membership in the Governing Council of the European Central Bank and their participation to the regular meetings of the finance ministers of the Euro area, which translates into a loss of influence in the decision-making process. However, their performance (as for example the "best-in-class" strategy of Denmark and Sweden by overachieving the Pact's conditions) does not make them negligible partners, instead a clear majority in the EU decided that this should not be an elimination criterion, and they still benefit of important positions in the European Parliament or in the European Commission. The conclusion Holden reaches are that while for Denmark the benefits of joining are more clear (as it has already a fixed exchange rate and thus less of a monetary independence), for Sweden and the UK the decision is connected to their willingness to give up the control over their monetary policy in favour of gains from a reduction in exchange rate fluctuations and asymmetric shocks, and an increase in trade.

Turning to macroeconomic analysis, Moser *et al.* (2004) provide a study of GDP growth in these three countries between 1999 and 2003, along with the contribution of national economic policies and cyclical fluctuations to this growth. Not being part of the euro area yet did not deprive neither Denmark nor Sweden or the UK to maintain a close relationship with the member countries. In fact, the results of the study indicate that all three countries account for almost a quarter of the total export market of the euro area in 2003, out of which 18% was UK's contribution. There are several determinants of potential growth in these countries: high spending on research and development is a common drive, but it mostly privileged Sweden, which achieved a dominant position in information and communication technology. Denmark's spending on active labour market was higher than in any other EU member state. The UK's strategy was to direct its forces towards improvements in education and public sector investments. When analysing the business cycles, the authors differentiate between the roles of several factors that may have influenced these countries' economies. The global economic environment refers mainly to global shocks, such as restrictive monetary policies in many countries (2000), geopolitical uncertainties, a severe oil price shock and the ICT bubble burst resulting in a price collapse on world's major stock market (2001), the start of global economic recovery (2002-2003). Country specific factors and economic policy is another grouping criterion, which stands mostly for individual strategies in terms of monetary and fiscal policies. The overall results show that at that time (2003) joining the EMU was not recommended for the UK, as it had not achieved yet a long-term convergence of business cycles. Moreover, the GDP growth was higher in Sweden and UK than in the euro area, but lower for Denmark compared to the same group of countries. Finally, the convergence between the three countries and the euro area seemed to have increased with the emergence of EMU.

3. The Case of the United Kingdom

Individual studies have also been carried out for the three countries taken into discussion, the highest number of contributions being directed toward the United Kingdom's non-membership. Layard *et al.* (2002) emphasizes the "for" and "against" reasons for Britain's membership in the EMU, proving in the end to be more in favour of Britain's total integration. As for the case of joining, four arguments seemed to weigh more in his analysis: (i) First, in order to address the need of a large unified market that would contribute to higher standards of living, a single currency is needed, and Britain's best option would be the Euro, as Europe is by far UK's largest market; (ii) Second, EMU membership offers clear benefits in terms of influence over economic and political issues, for enabling ECB and Euro-club representation (although Holden (2009) shows that UK still has access to important positions in European institutions); (iii) Third, adopting the euro would eliminate the floating exchange rate problem, which may produce shocks in the economy and discourage trade; (iv) Forth, the single currency would diminish transaction costs. On the same line, Buiter (2008) concludes that staying outside the Eurozone, Britain has all the premises to become more vulnerable to a triple financial crisis: banking, currency and sovereign debt crisis. The UK is a small country, whose banking sector is largely exposed to global shocks, but who has a currency that is not a global reserve currency like the dollar or the Euro, and disposes of a limited fiscal capacity relative to the possible size of the banking sector solvency gap. EMU membership would eliminate mainly the third problem, through adopting a global reserve currency, which would have a major impact on the other three remaining. Coming back to the research of Layard *et al.* (2002), even though it brings into discussion also the counter arguments of joining the euro area, the authors seem to find explanations that would (partially) offset the negative influence of Euro adoption. Britain's belief that "one size does not fit all" in terms of interest rates convergence comes from their desire to control their own budgetary policy instead of being limited to certain ceiling values by the Stability and Growth Pact (although a fluctuating currency has a quite important risk of failure in case of shocks), and to maintain Britain's supremacy in Europe as an oil-producing economy (which in fact does not represent a noteworthy share of the country's GDP). Their second assumption that "Europe is a failing economy" is unjustified according to the authors, as long as productivity per hour is higher in France, Germany, Belgium, Luxemburg, the Netherlands and Northern Italy that in the UK. Furthermore, the productivity growth rate is higher in Europe than in the US, and continental Europe benefits from the biggest share of prosperity produced. Nevertheless, one of their fears is that each country's problem in terms of unemployment is transmitted to the EU level EU and if UK accepts the total integration unemployment would rise. Next, the tax harmonization danger has nothing to do with the euro adoption - it is just a misleading belief. Other counter arguments claim UK's dissimilar financial system or the fear of Euro's failure. At the time, the conclusion of the research is that postponing the EMU membership on behalf of waiting for responses (in a better business cycle convergence, flexibility, investment, employment, growth) will only increase the delay costs and there is no evidence that more information that could be gained meanwhile would bring substantial benefits.

To enforce the above-mentioned authors' results claiming that the UK would gain more than it would loose from becoming a member of the Economic and Monetary Union, Yang *et al.* (2003) conclude that Britain was left behind in terms of financial market integration among other European countries. Their perspective is based on the size of the stock markets of the analysed countries, examining long-run, short-run and contemporaneous integration for ten EMU countries plus the UK and the US, and finding that as a general trend, stock market integration among EU countries has increased as a result of the emergence of the EMU. As for the UK, Yang *et al.* (2003) find out that there is a delay in its stock market integration with the rest of the countries. A similar output is obtained by Hardouvelis *et al.* (2006), whose findings are rather extreme regarding UK's non-membership. Using proxies for nominal convergence (gradual convergence of inflation and long term interest rates toward German levels – in the risk free rates) and for real convergence (better balanced fiscal budgets, increased synchronization of business cycles), the authors study the influence of EU-wide risk factors and currency risk over country specific risk factors on required rates of return. They conclude that by choosing to stay out the EMU, the UK showed no signs of integration with EU stock markets.

The recent vote in UK in favour of leaving the European Union, known as Brexit[3], has considerably changed any opinions on the country adopting the euro. Now, the discussion in the literature has moved from pondering arguments regarding euro adoption to arguments regarding remaining or leaving the EU. At the same time, there are many unknowns about what UK will do about removing itself from the EU (including the timetable), about the most likely outcomes of this decision and, in the end, about the implications for the European integration. Begg (2016) makes reference to a study published by HM Treasury that describes three scenarios of the UK-EU post-Brexit

[3] The referendum took place on June 23, 2016 and it resulted in 51.9% of the participants to vote for Brexit. The results were split between the constituent countries of the United Kingdom: England and Wales voted to leave, while Scotland, Northern Ireland and the British Overseas Territory of Gibraltar voted to remain in the EU.

relationship, as follows: the first scenario points towards an arrangement similar to Norway, which guarantees UK the same market access; the second scenario indicates a "Canadian model", similar to the configuration of the CETA agreement (under negotiation); and the third scenario would see UK in the "WTO model" in which the country benefits only from the "most favoured nation" status against the EU, as in the case of other countries. The study concludes that any of these alternative scenarios would leave UK poorer compared to the actual status as EU member. Campos and Macchiarelli (2016) consider that the most important area of the "new agreement" between UK and EU is represented by the relationship between the EMU members and the EU countries that are not EU members. As such, they show that after the introduction of the euro, the business cycles in UK and the Eurozone increased their synchronisation, which consequently might significantly increase the costs of the Brexit. Besides the costs for UK, the Brexit might trigger other effects, some of them not necessarily pleasant for the existing EU configuration. Patomäki (2016) goes rather far by suggesting that the current EU policies, principles and institutions generate counterproductive political and economic effects and suffer from problems of legitimation, which give rise to tendencies towards disintegration. In such a framework, it is more than obvious that a discussion on whether UK will adopt the euro becomes obsolete.

4. The Case of Sweden

Sweden joined the EU in 1995, after the adoption of the Maastricht Treaty, which means that Sweden was obliged to adopt the euro at some point in future, but the timing of euro adoption was not set in 1995. The Calmfors Report (1997), issued by a special commission named by the Swedish Parliament, concluded that the gains of joining EMU would be small (reduced transaction costs and exchange rate uncertainty and greater competition) in comparison with the loss of monetary policy and, consequently, the reasons for not adopting the euro in 1999 were stronger that the ones in favour of euro adoption. At the same time, it is worth mentioning the fact that the Swedish economy was then recovering from its toughest recession since 1930s, which made the prospects of the country joining an "avant-garde political project" and facing possible asymmetric shocks not very well perceived by the Swedes (Czech, 2015). Still, the Calmfors Report outlined many disadvantages related to staying outside the EMU, such as exposure to unfavourable currency fluctuations, higher transaction costs and political marginalization. In the fall of 2003, 55.9% of the Swedes decided, however, through a referendum, that they were against euro adoption, while only 42.0% were in favour of the common currency. Regarding this referendum, Ahfeldt *et al.* (2016) analyse the voting results in the 21 Swedish counties or regions, by putting a special focus on the role of the regional industrial mix. They show, quite interestingly, that voters in regions with interest-sensitive industries decided against the EMU, as they did not expect to gain from the adoption of the common currency. Since then, the Swedish politicians no longer made pressures for euro adoption and even stated that the euro issue "is not even in the cards"[4].

The literature for Sweden's case is less consistent, but Reade and Volz (2009) clearly pointed out that the overall benefits would offset the possible disadvantages of joining the

[4] This is part of a debate that took place in May 2014 between the then Prime Minister Fredrik Reinfeldt and the opposition leader Stefan Löfven who became PM in the fall of 2014 after the elections (Czech, 2015).

EMU. The authors claim that losing monetary independence is widely perceived as the main cost of entering a monetary union, and that might also be the underlying reason of Sweden's decision to stay out of the EMU. Unlike Denmark and the UK, Sweden has not signed an opt-out clause, but by denying its membership in the Exchange Rate Mechanism II it practically decided that it is not time to give up its own currency.

Buiter (2008) concludes that Sweden's situation is not very different from UK (both being characterized by the "inconsistent quartet") and, consequently, Sweden would be better off if it had a global reserve currency, due to the fact that it is a small open economy with a sizeable and internationally exposed financial system, and additional maintenance costs would occur in case of shocks that would affect the national currency.

Speaking in terms of the late financial crisis, if they would have had the euro instead of the krona, the recovery process would have been smoother. On the other hand, Sweden had already managed to keep inflation rate at a reasonably low level, maintaining a credible monetary policy, and thus entering the EMU would not necessarily bring many additional benefits. Furthermore, the krona fluctuations against the euro had been relatively low. These arguments prove that in terms of interest rate and exchange rate, Sweden has been aligned to the Eurozone for a long period of time. In the same vein, Söderström (2008) shows that the Swedish business cycle has been well correlated with the EMU economies, but, at the same time, country-specific shocks have been also important for the Swedish economy, thus the EMU membership might be costly for Sweden. For what concerns the exchange rate, the author stresses the high costs of an independent monetary policy of the country combined with a floating exchange rate, thus indicating that euro adoption would represent a stabilising factor for the Swedish economy. Regarding the presence of shocks, Suni and Vihriälä (2014) undertake a simulation exercise on the economies of Sweden and Finland based on the effects of exchange rate regime choice under a hypothetical euro adoption by Sweden in 1999. The results of this exercise indicate that the choice of an independent monetary regime by Sweden reduced the impact of the global financial crisis shock on the country, but, at the same time, it cannot explain the gap in economic growth between the two countries since 2012. Continuing the research on exchange rates and interest rates with the aim of supporting the Sweden's option to stay out of the EMU, a thorough analysis of several international parity conditions – specifically, the covered and uncovered interest rate parities[5] and the forward rate unbiasedness hypothesis[6] – is conducted by Ruthberg and Zhao (2014). The authors reach the conclusion that Sweden's entry into EMU would not be a motivated decision, given the rejection of the uncovered interest rate parity and of the forward rate unbiasedness condition, which point towards a lack of monetary integration between the country and EMU. All in all, there are no clear disadvantages of not joining, but there are some important benefits of becoming a full-rights member, mainly covered by Buiter (2008).

[5] The covered interest rate parity (or the forward rate parity) is an equilibrium relationship in international finance which states that the forward premium or discount (the difference between the forward and the spot exchange rates) should be equal to the interest rate differential between the two currencies; is the relationship does not hold, arbitrage in free markets will restore it. On the other hand, the uncovered interest rate parity links the interest rate differential to the expected change in the spot rate; if the expected change in the spot exchange rate does not equal the interest differential, one can take advantage of his expectations through speculation in the foreign exchange and money markets.

[6] This parity condition states that the forward exchange rate should be an unbiased predictor of the future spot rate; i.e. the forward rate should not systematically undervalue of overvalue the future spot rate.

5. The Case of Denmark

Denmark caused upset in Europe by rejecting the Maastricht Treaty in 1992, which resulted in four opt-out clauses applicable only to the country – these are known as the Edinburgh Agreements, adopted after another referendum held in 1993. Denmark decided to stay out in four areas, as follows: (1) The Common Security and Defence Policy; (2) The supranational part of the Justice and Home Affairs; (3) The European Union citizenship; and (4) the third phase of the EMU (Hassing Nielsen, 2015). As a result, the country maintained its currency, the Crown, and the opt-outs mentioned above are still in place today, despite the evolutions in the European Union in the past decades. Nevertheless, recent research – see Marcussen (2009) – has debated on whether Denmark should eliminate these four clauses and enter the “EU enterprise”.

By having its currency already tied to the euro, Denmark did not present much interest for researchers in terms of financial integration with the Eurozone. The history of currency peg for Denmark started in 1982, when the country decided to adopt a fixed exchange rate of the crown against the German Deutschemark, the currency of its biggest trading partner. The decision meant that Denmark was favouring a stable currency in return for monetary independence. In time, with the advent of Exchange Rate Mechanism II, the fixed exchange rate against the mark was replaced by a peg against the euro. Lars Rhode, the Danish Central bank governor, strongly defends the crown-euro rate, stating that “*it is the cornerstone for all economic policy in Denmark, with broad support from all corners of politics*” (Jolly, 2015). In 2012, during one of the peaks of the sovereign debt crisis in Europe, as speculators were betting on the Danish Central bank inability to maintain the peg against the euro, Denmark resorted to negative interest rates in order to stimulate inflation and to drive away speculators (Campbell and Levring, 2016). As the European debt crisis reached one of its periodic crescendos in 2012, investors seeking a safe haven piled cash into Denmark, threatening to push the krone out of its trading band. The benchmark deposit rate was already at 0.05 percent, leaving nowhere to go but down to reduce the country’s appeal to hot money. Denmark thus resorted to negative rates not to spur inflation—as Japan is trying to do, unsuccessfully—but to drive away speculators. At the same time, the central bank intervened heavily in the currency market by selling $15.39 billion dollars (106.3 billion Danish crown) in January 2012, followed by a further purchase of 168.7 billion crowns in February 2012. In this context, it is noteworthy the statement of Lars Rhode: “*We will do whatever it takes to defend the peg; that is our mandate, the sole mandate*” (Jolly, 2015).

Given these evolutions, most researchers believe that for Denmark, the issue of joining the euro comes mainly from people’s nationalism, in order to preserve their identity, although Denmark plays a key role in EU politics (Gotsi *et al.*, 2006). However, comments of EU politicians highly recommend that Denmark rethinks its option to stay out, taking into consideration the context of the recent financial crisis, when one of the main costs for the Danish Central Bank was the imminence of raising its interest rates: “*The financial crisis has made it visible that there is a clear cost of staying outside the euro zone*” (Danish Prime Minister Rasmussen, 2008).[7] He also emphasizes the losses that Layard *et al.* (2002) and Holden (2009) pointed out in terms of political influence in the decision making process: “*The decisions taken by the Eurogroup have a direct effect on Denmark, without Denmark having a seat at the table*”. Certainly, Denmark was

[7] http://www.icenews.is/2008/11/06/denmark-considering-joining-the-eurozone/#axzz4So6INQue

indirectly influenced by the European crisis in 2009-2011, specifically due to the fixed exchange rate policy of the krone against the euro.

However, the decision must be validated by the Danes' vote through referendum as usual. Nielsen (2015) argues that the Danish support for EU membership was stable and consistent even during the 2009-2011 EU sovereign crisis, but the Danes have rejected twice further integration. Besides the 1992 referendum mentioned above, the government held a new referendum on euro adoption in 2000, which was defeated (46.8% voted yes and 53.2% voted no). As a result, it seems that Danish politicians fear organising another referendum – for example, in 2007, the newly re-elected Danish government declared its intention to organize a new referendum for euro adoption by 2011, but these plans were thwarted by the new government that came to power in September 2011, which outlined that a new referendum on this issue would not be held during its four-year mandate.

Given the recent Eurozone crisis, as well as the fear of Danish politicians to organise a new referendum on EU further integration, including the adoption of the common currency, it is unlikely that the Danish opt-outs will be subjected to debate, let alone referendums, in the years to come (Nielsen, 2015). The Danish EU membership has proven to be a pragmatic endeavour, based on economic considerations and political reluctance, and this pattern does not have any reasonable chances of being reversed in the years to come.

6. Conclusions

European economic integration is a topic which is currently widely debated by researchers and decision-makers at national, regional and international level. The benefits and disadvantages of monetary unions and, in particular, of euro adoption, have been extensively presented in the existing literature. Our research aimed at discussing the option of three EU countries – United Kingdom, Sweden and Denmark – of not joining the EMU and at analysing whether besides their subjective option of staying out of the EMU there are also economic arguments behind this decision.

Obviously, the three "outsiders" of the EMU are different in terms of economic power, financial market attributes, monetary policy rules employed and political decisions. In each case, the choice to remain outside EMU was based on economic reasons, as well as political and sometimes nationalist arguments. Of the three countries under scrutiny, Denmark is by far the one which has the best prospects of joining EMU, given its fixed exchange rate against the Euro, and United Kingdom the worst, particularly given the recent vote for Brexit. At the same time, the sovereign debt crisis that the EU and particularly the EMU had to confront between 2009 and 2011 has seriously threatened the eventual adoption of the common currency by these economies.

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