PERSPECTIVES OF NORTHERN EU INTEGRATION

Summary of the Finnish study:
“Pohjoisen EU-integraation näköalat”

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The Central Chamber of Commerce of Finland

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FOREWORD

At the onset of the 2010s, the European Union faces huge challenges. The financial crisis in 2008 triggered a chain of events that has threatened to cripple the public finances of many member governments. Greece's fiscal crisis is only the tip of the iceberg as many EU countries are plagued by chronic government deficits. The direction must now be reversed.

Crises have sparked reforms in the European Union before. That will happen this time, too. In the midst of difficulties decision-makers are forced to find solutions that foster the EU's fundamental objectives, but under significantly tighter constraints. Political actors will have to work very diligently to stabilize their economies. They must be particularly active in the debate with the society as a whole. This is the only way to foster enduring legitimacy needed for making tough decisions.

The Central Chamber of Commerce commissioned ETLA, the Research Institute of the Finnish Economy, to carry out the study "Northern Integration" in January 2010. The aim is to provoke a new debate in the Nordic and Baltic countries in order to foster closer cooperation. As the work proceeded, the theme proved to become more interesting than originally anticipated. This report updates estimates of the prospects for integration in neighbouring regions, and illuminates the key issues underlying EU economic policy from a wider perspective.

The Central Chamber of Commerce together with the 16,800 member companies of the local Finnish Chambers of Commerce see closer northern integration not only as a remedy for improving the key preconditions for doing business in neighbouring regions, but also as a means of giving a strong boost to the development of the EU as a whole.

In the Baltic Sea region, in addition to expanding the area of the single currency and new countries possibly joining the EU, of key significance is the substantial improvement of the efficiency of the EU's internal market. These developments could help the Baltic countries meet global economic competition and foster development of long-term growth factors in the region.

The project was carried out at ETLA by Research Director Markku Kotilainen, Research Adviser, Kari Alho and Researcher Nuutti Nikula. Director Jukka Kero was responsible for supervising the project at the Central Chamber of Commerce.

Helsinki, May 19, 2010

CENTRAL CHAMBER OF COMMERCE

Risto E. J. Penttilä

CEO

THE NORTH'S TIME HAS COME

Director Jukka Kero, The Central Chamber of Commerce of Finland

Europe needs to strengthen the foundation of its integration. Deeper integration would be of pivotal importance also for Finland and its neighbouring areas. The EU's northern members becoming new euro countries would bolster the euro area and the entire European Union.

Companies and residents of the eleven countries in the Baltic Sea region (broadly speaking), from Russian to Iceland, have to cope with ten different national currencies. The eight EU countries in this area have seven national currencies. The single currency is used only in Germany and Finland. Increasing and deepening integration would reduce the costs incurred by businesses and residents and foster business as trade barriers are reduced.

Businesses and citizens would benefit from closer EU integration in the north

Closer northern integration would provide more abundant and more efficient business opportunities for Finnish enterprises. Adoption of the euro is a key means of improving the business environment in the Baltic Sea region. Foreign currency transaction costs, administrative costs from currency exchange and currency risks arising from trade in the region would be reduced. Comparability between the countries would increase. This would create a more profitable and efficient business environment.

For residents of the single currency area expansion would mean increased transparency of prices and savings on foreign exchange costs. A northern expansion of the euro would strengthen the foundation for practicing economic policy, boost the credibility of the euro area and improve the predictability of the policy.

In its statement released in mid-May, the European Commission gave a green light to Estonia to join EMU. Estonia will probably join the euro area at the beginning of 2011.

As this report states, Denmark and Sweden can be eligible for the euro if they wish. The Swedish krona is floating for the time being, so Sweden's euro-zone entry will take some time. Denmark's opt-out clause with respect to the euro is also a reality. It would be in the long-term interest of these countries' businesses to adopt the euro. Estonia, Sweden and Denmark adopting the euro would be welcomed by Finnish companies.

Europe needs the stability of the north

Close integration of the northern European countries has become even more valuable in the midst of the turmoil currently plaguing the European Economic and Monetary Union. Finland must now do everything it can to foster the strengthening of the EU and expansion of the euro area with a fresh line-up of countries meeting the membership eligibility criteria both literally and in spirit.

The northern countries' good reputation and their tried and tested credibility is just what European integration as a whole needs right now. A greater role in decision making for the Nordic and Baltic countries would be in the interest of Finnish businesses, workers and citizens. In addition to new euro countries, the potential EU membership of Iceland and Norway would substantially augment the integration progress.

The Baltic Sea region now needs a substantial effort to increase economic cooperation, transport and improve safety. These issues are also essential elements of the EU Baltic Sea Strategy. Finland should take a strong leadership role on this matter, too, since otherwise the project threatens to stay merely on a rhetorical level.

We must now look far into the future unbiased by the current crisis mentality. In the short term the EU must make its integration decisions after careful deliberation and using discretion in certain cases. The lessons of the Greek debt crisis now shaking the foundation of the economic and monetary union must be taken into serious consideration when making and preparing future decisions. Common lessons must nevertheless be learned from the setbacks now experienced, so that ultimately the EU will be stronger and function more effectively.

SUMMARY AND CONCLUSIONS

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The term northern EU integration as used in this study to denote the economic integration of the Nordic and Baltic countries with Europe, especially the EU countries. The mutual relationships between these countries are examined via their EU ties, as closer integration can take place only within the framework of the EU. The attention will primarily be focused on still unrealized forms of integration and assessing their impact and likelihood.

The study evaluates the prerequisites for EU membership by Norway and Iceland and the EMU memberships of Sweden, Denmark, the Baltic countries and at a later stage, possibly Iceland and Norway. Finnish indicators are included in the study's comparative data. The effects of closer integration in the north are interpreted in particular from the Finnish and European companies' point of view - not forgetting the fact that macroeconomic stability is a key prerequisite for the successful operation of the businesses.

Denmark and Estonia fulfil EMU criteria, others still have some barrier to membership

Sweden's GDP declined by 4.5 per cent in 2009. According to forecasts, its production will start to expand in 2010 and the rate growth will accelerate in 2011-2012. The rate of increase in consumer prices accelerated in 2008 to around 3 per cent, but it has now subsided to a couple of per cent. Long-term interest rates have fallen accordingly. The general government deficit will reach its lowest point in 2010, at about one per cent relative to GDP. The public debt is hovering around 40 per cent of the total production. Sweden therefore meets the EMU criteria except for the exchange rate. In early 2009 the krona depreciated against the euro by as much as a quarter. In the spring of 2010, however, the exchange rate nevertheless returned close to the level from which it began to depreciate in the second half of 2008. Formally, the Swedish krona should join the ERM2 and remain within its fluctuation bands for at least one year. It is nonetheless possible that the stability of the currency against the euro could be interpreted as sufficient even without ERM2 membership. The problems for EMU stability spawned by Greece's economic crisis may, however, lead to tighter interpretation of criteria.

Norway's total production fell by slightly less than two per cent in 2009. Growth in 2010 is expected to about one per cent. Boosted by the international economic upswing and rising cost of raw materials, consumer prices climbed by 4 per cent in 2008, but inflation has subsequently fallen to around two per cent. Interest rates have likewise fallen. The general government surplus fell significantly in 2009, but it was still 9 per cent relative to GDP thanks to abundant oil revenues. The gross general government debt is slightly less than 60 per cent relative to GDP. In recent times the Norwegian krone exchange rate has fluctuated roughly in parallel line with movements of the Swedish krona. Norway therefore does not meet the exchange rate criterion for EMU membership. Norway's large oil sector and its impact on the economy as a whole is one of the factors dampening Norwegians' desire for EMU membership in the long run.

Denmark's GDP contracted by around 4.5 per cent in 2009 from the previous year - i.e., as much as Sweden's GDP. Denmark's short- and medium-term economic prospects are good thanks to the favourable point of departure for its public finances. The gross general government debt is below 40 per cent relative to GDP. Danish public finances were running a significant surplus before the current economic crisis, and even at its weakest point the deficit remained less than 4 per cent in 2010. Inflation and thus its long-term interest rates meet the EMU criteria. By participating in the ERM2 mechanism with its ± 2.25 per cent fluctuation range, Demark also fulfils the EMU criteria for exchange rate stability.

In the long term, however, Denmark needs to boost its productivity and to innovate new products. Danish exports have done well with respect to fairly traditional products, but their growth potential is limited. Like other European countries, Denmark suffers from a shrinking labour supply stemming from the aging of its population. This reduces potential growth in total production.

Iceland's GDP contracted in 2009 by about 7 per cent. The country's economy is still in a dire situation because of the rapid growth of debt. The public sector deficit in 2009 was about 15 per cent of GDP. Furthermore, inflation is high as a consequence of the devaluation of Iceland's currency. In the future as well the exchange rate will remain under pressure, which may trigger further depreciation when restrictions on capital movements implemented during the crisis are removed. Iceland will not fulfil the EMU criteria in the next few years.

Estonia's gross domestic product contracted in 2008 by nearly 4 per cent and by as much as 15 per cent in 2009. This had been preceded by a clear economic overheating, reflected in both output growth and the rate of consumer price increases peaking at 10 per cent. The fiscal deficit was around 5 per cent in 2008, but it was eliminated already in 2009 via austerity measures. The gross government debt is around 10 per cent relative to GDP. The exchange rate has been stable within the ERM2. Thus, at this point it appears that Estonia fulfils the formal criteria for EMU. Inflation has been its economy's weak point. In 2009, inflation fell to around zero as a result of the recession and active economic policies.

Latvia's GDP plunged in 2009 by about 18 per cent. Also the Latvian economy overheated during the years preceding the recession. Inflation picked up to as much as 15 per cent. Consumer prices are expected to decrease in 2010 due to economic recession. The general government fiscal deficit will be around 9 per cent relative to GDP and the gross public debt will rise to about 60 per cent relative to GDP in 2011. The exchange rate has been kept stable within the ERM2, but the credibility of the exchange rate has been subject to far more pressure than in Estonia. Latvia does not currently meet the EMU criteria and its economic prospects for the medium and long-term are uncertain.

Lithuania's gross domestic product growth slowed in 2008 and in 2009 production dropped by almost 19 per cent. Previous rapid growth was spurred by domestic demand and the overheating of the real estate market. The Lithuanian general government fiscal balance was fairly sound in the early 2000s. After the recession the deficit widened to around 8 per cent relative to GDP in 2009. The public debt-to-GDP ratio is forecast to rise from the 20 per cent prevailing at the beginning of the millennium to more than 40 per cent in 2011, but this is still well below the EMU criteria's 60 per cent threshold. Inflation in 2008 climbed above 10 per cent, but consumer prices are expected to fall in 2010. Lithuania belongs to the ERM2, which keeps its exchange rate relatively stable against the euro. From the standpoint of the EMU criteria, the main problem is the general government deficit, which will take at least a few years to bring under the EMU criteria.

Denmark is the most similar to euro area average, Iceland and Norway are the most different

The study examines how well the northern countries meet the so-called optimal currency area criteria. The fundamental idea behind the criteria is that the more similar a country is in relation to the EMU average, the better prerequisites it has for EMU membership. The European Central Bank's interest rate policy and the exchange rate prevailing in the region are then well suited for such countries. The criteria evaluated are the correlation between fluctuations in production as well as the similarity of production and foreign trade. A few indicators are also used to determine what kinds of microeconomic benefits the countries could achieve with a common currency. The stability and performance of the EMU area are also assessed.

On the basis of the indicators it is found that in Finland fluctuations in total production during EMU membership and increasing globalization have become more similar to those in the euro area and the EU as a whole. The correlation of GDP growth with that in the euro area during the period 1996-2009 was highest among the northern countries. EMU membership has endogenously contributed to the increased similarity of fluctuations. In Sweden and Denmark outside the euro area, the correlation of the variation in total production is the next highest. Iceland, Latvia and Estonia rank in the middle according to this indicator. The lowest correlations were found in Norway and Lithuania.

In terms of the similarity of the production structure, Denmark, Iceland, Sweden, Finland and Estonia are more similar to the EU27. The most different are Norway, Lithuania and Latvia. Similarity is augmented by countries' domestic production, e.g. the public sector and private services. The similarity has increased especially in Iceland and Estonia, but it has decreased in Latvia.

The similarity of the open sector can be measured by the export structure. According to this indicator Sweden and Denmark are closest to the EU-27 average. The next group includes Estonia, Finland and Latvia. These countries have also witnessed a clear convergence in the last 10 years. In Finland this development is attributable to the decline in the export shares of forestry and the electronics industry and the increase in the export share of the engineering industry. This development has meant a reduction in the significance of trade based on comparative advantage and a shift towards intra-industry trade. Growth in intra-industry trade is often seen as improving the conditions for a common currency. In this case, each country must be able to safeguard the competitiveness of its production. Similar competitiveness of exports may weaken owing to an increase in costs or a deterioration of the real competitiveness of product quality.

On the basis of the above-mentioned indicators of similarity between the economies, Sweden and Denmark would clearly have the best chances for joining the euro area. They are deemed stable and diversified economies also according to other indicators. In terms of its production and export structure, the Estonian economy is relatively close in similarity to the euro area and the EU average. The problem with Iceland and Norway, in particular, is the one-sided export structures that differ from those of other countries. In Iceland the relative importance of fish products and aluminium exports as well as shipping is high. In Norway, large-scale oil production affects the entire economy.

All the countries would stand to gain microeconomic benefits from membership in the EMU. These arise from the elimination of foreign exchange transaction and hedging costs. Of the countries included in this study, the greatest foreign exchange costs prevail in the Baltic countries. They are the smallest between the Danish krone and the euro. The elimination of foreign exchange costs would benefit the businesses and residents of the countries in question as well as those of other countries.

Stability in the euro area requires fiscal discipline of member states

When analyzing the stability of the euro area attention has recently been drawn to problems stemming from the high public sector debt. This has been the main reason for the market's mistrust of Greece, in particular, but also of Portugal, Ireland, Spain and Italy. The ultimate question, however, is how will the euro-zone countries be able to maintain competitiveness in world markets. This concerns both the quality of the products and their price. Distrust is reflected in high interest rates, which is a first indication that the markets react to over-indebtedness. The problem has been that the euro countries encountering difficulties have not been able to adjust the level of their costs and spending in time. The single currency requires discipline in expenditure and costs and the ability to adapt them if the external economic environment changes.

European Central Bank (ECB) should be able to manage the euro area effectively as a whole. In addition, it should be able to ensure that imbalances in competitiveness prevailing between countries in the area - which is one factor behind the crisis that originated in Greece - are eliminated over time. In contrast, the ECB is not able to prevent the over-indebtedness of the public sectors in euro-zone countries, but rather highly indebted countries are required to practice fiscal restraint. The ECB's monetary policy can support the deflationary adjustment process - in fact, this support is very essential. In cases like Greece, the country should very soon, in already a few years, start running budgets surpluses measured in terms of their primary balance (expenditure excluding interest payments) which would be a major accomplishment. This should be done in order to reverse the trend of the continually rising public sector debt by mid-decade.

Estonia likely to join EMU, Denmark's and Sweden's fate depends on their own political will

Estonia has set a goal of EMU membership at the beginning of 2011. This seems to be a realistic goal, because the country has long maintained a fixed exchange rate, first unilaterally with its currency board and nowadays within the ERM2. During the current downturn, Estonia has also shown its ability to carry out painful cuts in costs and wages. One of Estonia's advantages is also its international labour mobility, especially in Finland's direction. This reduces the Estonian unemployment during a recession. On the other hand, easy mobility may raise wage levels in Estonia, if both Estonia and Finland are experiencing a boom at the same time.

The economic situation in Latvia and Lithuania is still weak in the medium term. Their eligibility for EMU, however, cannot be regarded as hopeless. They also have the advantage of economic flexibility and the ability to make adjustments in their wages. Like Estonia, their problem is the small size of their countries and the resulting one-sidedness and vulnerability of their economies.

Denmark and Sweden are eligible for EMU measured both in terms of the short-run EMU criteria as well as the similarity of their production and performance. The Swedish exchange rate can be stabilized to meet the EMU criteria if Sweden so desires. Until now, however, they have wanted to smoothen out their economic development with a flexible exchange rate. Denmark does not benefit macroeconomically from being outside the euro area, because its currency is closely tied to the euro. Danes nevertheless have to pay foreign exchange transaction costs and hedging costs. The solution must be seen as purely political. It wants to preserve its own political sovereignty. It is also largely a question of national identity. Denmark has negotiated its own opt-out clause, which allows it to remain outside EMU. Sweden should in principle join the monetary union, but in practice it cannot be forced nor is there any desire to do so.

Sweden has been able to pursue disciplined economic policies also outside EMU. It has succeeded in keeping its public sector deficit and inflation under control. Sweden is therefore not paying appreciably higher interest rates than the EMU countries. The floating exchange rate, however, has meant foreign exchange transaction costs and hedging costs for Swedish companies and households.

The single currency boosted foreign trade according to the findings also presented in this study. The study assessed, in particular, the foreign trade impact of Sweden's EMU membership. The framework used takes into account that the reduction of trade barriers brought by EMU membership has a direct effect on external trade. In addition, it affects price formation, because trade barriers are reflected in the pricing on export markets. A change in the price level in turn leads to changes in price competitiveness. The analysis sought to take all these effects into consideration.

As is usually the case in European integration, the benefits from closer northern integration are greatest for small countries. For the EMU area as a whole, the impact of expansion is nevertheless modest. It is significant, however, that the effects on the current euro-zone countries as a whole are positive, so this is no reason to refrain from expansion of the EMU. The benefits for Finland in close interaction with Sweden and Estonia may be larger than average.

The benefits from having its own currency and own monetary policy were estimated in Sweden's "official" study on EMU membership to be greater than the above-mentioned microeconomic benefits. Sweden's membership was rejected in 2003 in the national referendum. Recently, more positive views have been expressed publicly about membership. The situation is still so politically sensitive and uncertain that new efforts to initiate the application process have not been launched.

Iceland is applying for EU membership, Norway has no active debate on membership

Norway and Iceland are not even members of the EU. Norway has applied for membership on three occasions, in the years 1963, 1972 and 1994. The first application was blocked by France because of opposition against the EU expansion. The two other attempts were rejected in referendums held in 1972 and 1994. Iceland's membership aspirations have been put on hold in its Parliament. Both countries are, however, engaged in close cooperation with the EU via EFTA in the framework of the European Economic Area (EEA). They also participate in various EU programs, such as research programs. Compared to membership, the main shortcoming is that these countries are obliged to adopt the EU's internal market legislation without any possibility to influence decisions.

Iceland has applied for membership and the Commission has made its study of Iceland's membership. Iceland meets well the political criteria for membership and most of the economic criteria. Its main problems are related to fishing rights, agriculture, political independence of the judicial system and possible conflicts of interest for some of Iceland's public figures. The Commission paid particular attention to the political elite and business relationships. The Commission believes that Iceland must establish mechanisms to avoid conflicts of interest.

Norway's EU membership has not been a topical issue. The country has become accustomed to the current situation. The aspirations for membership are dampened, among other things, by the strong economy supported by oil. It has not needed to apply for membership to enhance the credibility of its economic policy, as Iceland has done in the aftermath of the financial crisis that began in 2007. In Norway, rejecting membership is a question both of political sovereignty and strong national identity.

Sweden's, Denmark's and Estonia's EMU membership would also be Finland's interest

Swedish and Danish meet the EMU criteria and are unlikely to cause problems for the stability of the euro area in the future. Sweden's membership would be particularly important from the perspective of stabilizing Finnish companies' competitiveness. During the recession triggered by the financial crisis it was observed that the devaluation of the krona led to competitive problems in many sectors, e.g. forest, metal and food industries. This also complicated production decisions in companies operating in different countries, even if in the short term the exchange rate diversified the risk. For many companies the Nordic countries and increasingly also the Baltic countries are domestic markets, which is why a common currency represents a significant cost savings and facilitates day-to-day business. Similar benefits are generated for travellers.

The Swedish krona is still undervalued. It would be wise for possible membership in EMU to take place at a somewhat stronger rate. This is of pivotal importance for Finnish companies. Sweden should not be allowed to gain a permanent competitive advantage, which would be the case if the exchange rate of the krona vis-à-vis the euro were weak.

When deciding about EMU membership we should not forget the problems that businesses may face if monetary economic integration is carried out too hastily and macroeconomic realities are ignored. This is evidenced by the problems experienced by the Greeks and some other southern EMU countries. In this regard, the EMU applications of Latvia, Lithuania and Iceland should proceed with caution. A single currency will only work if the economic realities are widely recognized in society and if the economies are sufficiently strong and flexible.

The EU membership of Iceland and Norway to would be in the interest of Finland and its business sector. Although the EEA membership already now links these countries to the EU internal market, the Northern Dimension would be strengthened by their EU memberships also in decision-making.

The euro area has in 2010 plunged into the most serious crisis of its existence. It is mainly the result of the irresponsible fiscal mismanagement by Greece and to a lesser extent, Portugal, Spain, Italy and Ireland. The funding packages decided upon during the spring of 2010 have defused the acute situation. Structural reforms nevertheless need to be implemented in order to strengthen the euro area and address the current problems. The resources and responsible economic policies of the Northern EU countries, notably Denmark and Sweden, would strengthen the entire euro area in this reform work.

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