Does a wait and see approach to European integration shelter the industrial base of small countries?

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Abstract

This paper compares the effect of economic integration on industry location for a small country that goes ahead with an integration process, such as the European, and a country adopting a wait and see strategy. Theoretical results, derived from a three-region new economic geography model, are compared to stylized facts on European manufacturing production. The result is that further integration could strengthen the industrial base of small countries that go ahead with integration.

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1 Introduction

Several European countries have chosen a wait and see approach towards the ongoing European integration. Norway and Switzerland have chosen to remain outside the EU, whereas the EU members Denmark, Sweden and the UK have chosen not to adopt the euro. Except the UK, these are all small countries in a European context.

One reason for hesitating to go ahead with integration is that politicians in small countries fear that industry will delocate towards larger markets in central Europe. This is underscored by a number of theoretical papers showing how economic integration may lead to an agglomeration of industry to large markets (Krugman 1991, Krugman and Venables 1995, Venables 1996, Fujita et. al. 2000, Baldwin et. al. 2003).

This paper uses a new economic geography model with three countries - two small and one large - to compare the effects of the ongoing European integration for a small country participating in the integration process, and a small country adopting a wait and see strategy,

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respectively. The theoretical results are compared to stylized facts on European manufacturing production.

The paper employs a modified version of a new economic geography model by Martin and Rogers (1995), the footloose capital (FC) model, which has the advantage of being analytically solvable in several of the experiments below. A dispersion force, which is independent of trade costs, is added to the model, which is important for the purpose of policy analysis. Agglomeration is driven by market access, but this factor becomes less important when trade costs are low. Other forces then tend to dominate location; for example decreasing returns, congestion, and comparative advantage could all lead to geographically dispersed production when agglomeration forces are unimportant (e.g. Krugman and Venables 1995, Fujita et. al. 2000, and Forslid et. al. 2002).

Many factors outside this model of industry location affect a county’s decision to go ahead with the European integration - some of them country specific. One often discussed concern is the problem of accommodating country-specific shocks in the EMU, once monetary policy is centralised to the ECB. This type of problem is associated with short-term fluctuations, however, while the focus here is solely on long-run effects.

The theoretical experiment in this paper is related to the analysis of the effects on industry location of preferential trade agreements. Puga and Venables (1997) numerically simulate the effects of preferential trade agreements as well as hub and spoke arrangements in a version of the Krugman-Venables (1995) model with three countries of equal size. Baldwin et. al. (2003), which analyses preferential trade agreements using the FC-model, is more closely related to this paper, where the theory section differs by the exact experiment performed, but also by the addition of a dispersion force, independent of trade costs.

The paper is organised as follows: Section 2 develops the model and section 3 analyses the effect of economic integration on the long-run equilibrium location of industry. Section 4 compares theory with stylised facts and finally, section 5 concludes.

2 The Model

This paper uses a multi-country version of the FC-model by Martin and Rogers (1995) and Baldwin et. al. (2003). The model is considerably simpler than the seminal new economic geography models by Krugman (1991), Venables (1996) and Krugman and Venables (1995), which show how the manufacturing sector, which consists of firms producing differentiated products under increasing returns to scale, may agglomerate in one region when trade costs are low. Agglomeration of the manufacturing sector is the result of demand and supply linkages. With the Chamberlinian large group assumption, firms set price as a constant mark-up on marginal cost which, in turn, implies operating profit to be a constant fraction of nominal sales. Suppose now that there are two markets of different size, separated by trade costs. Firms clearly prefer, ceteris paribus, to locate in the large market to minimise trade costs and maximise sales and operating profits. Consequently, there will be a proportionally larger equilibrium share of
manufacturing firms in a large market. This is the 'home-market' effect identified by Krugman (1980) and Helpman and Krugman (1985). Combining this effect with expenditure shifting creates a circular causality that can produce agglomeration, which is achieved in Krugman (1991) by having labour move with firms, and in Krugman and Venables (1995) and Venables (1996) by assuming that firms buy goods from each other as intermediate inputs. In the new economic geography literature, the home market effect and expenditure shifting are together named the demand link. The second agglomeration force is called the supply link. It stems from the fact that a region with many firms has a lower price index with CES preferences. The demand- and supply-link implies positive feedbacks creating possibilities of very non-linear dynamics.

The model in this paper is similar in structure to the core-periphery model. However, the mobile factor is physical capital rather than labour, and the return to capital is repatriated to immobile owners. This implies that the supply link is absent, since physical capital moves according to nominal returns and is therefore unaffected by the price index. Second, there is no expenditure shifting since the return to capital is repatriated, implying that there is no circular causality which, in turn, makes the dynamics much simpler. In particular, starting from a symmetric equilibrium, there will be no relocation of capital and industry as trade costs are reduced. However, when countries are of asymmetric size, the home-market effect will still gradually cause agglomeration, as trade costs are reduced.

2.1 Basics

There are $R$ countries, two sectors, and two factors. Physical capital, amounting to $K^W$ worldwide, can move between countries but capital owners do not. Workers can move freely between sectors, but are immobile between countries. Country $j$ is endowed with the share $s_j$ of the world endowment of labour $L^W$ and capital $K^W$, that is, countries may be of different size, but they have identical capital labour ratios. A homogeneous good is produced with a constant-returns technology only using labour, while differentiated manufactures are produced with increasing-returns technologies using both capital and labour. All individuals have the utility function

$$U = C_M^\mu C_A^{1-\mu},$$

where $\mu \in (0, 1)$ and $\gamma > 0$ are constants, and $C_A$ is consumption of the homogenous good. Manufactures enter the utility function through the index $C_M$, defined by

$$C_M = \left[ \int_0^N c_i^{(\sigma-1)/\sigma} \, di \right]^{\sigma/(\sigma-1)},$$

where $N$ is the mass of varieties consumed, $c_i$ the amount of variety $i$ consumed, and $\sigma > 1$ the elasticity of substitution.
Each consumer spends a share \( \mu \) of his income on manufactures, and demand for a domestically produced variety \( i \) in country \( j \) is therefore

\[
  x_i = \mu \cdot \frac{p_i^{1-\sigma}}{\int_{k=0}^{N} p_k^{1-\sigma} dk} \cdot Y_j,
\]

where \( p_i \) is the price of variety \( i \), and \( Y_j \) income in country \( j \).

The unit factor requirement of the homogeneous good is one unit of labour. This good is freely traded, and since it is chosen as the numeraire

\[
  p_A = w = 1,
\]

\( w \) being the wage of workers in all countries.

Ownership of capital is assumed to be fully internationally diversified, that is, if one region owns \( x \) percent of the world capital stock, the region will own \( x \) percent of the capital in each country. Income in country \( j \) is therefore given by

\[
  Y_j = s_j \left(L^W + \bar{\pi}K^W\right),
\]

where \( \bar{\pi} \) is the average return to capital determined by \( \bar{\pi}K^W = \sum_{j \in \mathbb{R}} s_j \pi_j, \mathbb{R} = \{1, 2...R\} \).

In the production of differentiated goods, the fixed cost consists of capital, whereas the variable cost consists of labour. The total cost of producing \( x_i \) units of manufactured commodity \( i \) in country \( j \) is

\[
  TC_j = \alpha \left( \frac{n_j}{s_j} \right)^\gamma \pi_j + \beta x_i,
\]

where \( \alpha \) is the fixed cost of capital, and \( \beta \) the requirement of unskilled labour per unit \( x \). Units of capital are chosen so that \( \alpha = 1 \), which implies that the world capital stock equals the world mass of firms, \( K^W = N^W \). The term \( \left( \frac{n_j}{s_j} \right)^\gamma \) in (6) represents the fact that concentration of the capital stock in one country is costly, and the parameter \( \gamma > 0 \) determines the strength of this effect. The term simply reflects any dispersion force, which is independent of trade costs. The particular specification here is algebraically convenient, but gives qualitatively the same effect as many other dispersion forces.\(^1\) For convenience, it will be called a congestion force.

Distance is represented by trading costs. Shipping the manufactured good involves a frictional trade cost of the “iceberg” form: for one unit of good from country \( j \) to arrive in country \( k \), \( \tau_{jk} > 1 \) units must be shipped. Trade costs are also assumed to be equal in both directions, so that \( \tau_{jk} = \tau_{kj} \).

Profit maximisation by manufacturing firms leads to price

\[
  p_j = \frac{\sigma}{\sigma - 1} \beta,
\]

\(^1\) An obvious alternative would be decreasing returns in the \( A \)-sector, which is less tidy but gives the same qualitative outcome.
of each differentiated commodity; choosing units of $x$ so that $\beta \equiv (\sigma - 1)/\sigma$ gives $p_j = 1$.

With a fixed capital stock and free entry, the reward to capital will be bid up until the entire operating surplus goes to capital, where the congestion cost associated with capital is taken into account; that is

$$(1 - \beta)x_j = \left(\frac{n_j}{s_j}\right)^\gamma \pi_j,$$

implying that

$$x_j = \sigma\left(\frac{n_j}{s_j}\right)^\gamma \pi_j.$$

### 2.2 Short-run equilibrium

In the short run, the allocation of $N^W$ is taken to be fixed. The model is closed by the M-sector market-clearing condition, where the left-hand side (supply) is derived from (9) and the right-hand side follows from the demand functions in (3), exploiting that all varieties have producer price 1,

$$\sigma\left(\frac{n_j}{s_j}\right)^\gamma \pi_j = \frac{\mu Y_j}{P_j^{1-\sigma}} + \sum_{l \in \mathbb{R}, l \neq j} \frac{\phi_{jl} \mu Y_l}{P_l^{1-\sigma}},$$

where $\mathbb{R} = \{1, 2...R\}$ and

$$P_j^{1-\sigma} = n_j + \sum_{l \in \mathbb{R}, l \neq j} \phi_{jl} n_l,$$

and where $n_j$ is the mass of varieties produced in country $j$. The object $\phi_{jl} = \tau_{jl}^{1-\sigma}$, ranging between 0 and 1, stands for ”freeness” of trade between $j$ and $l$ (0 is autarchy and 1 is zero trade costs).

Solutions where the homogenous sector becomes inactive in a country are ruled out. A sufficient condition for this is that the sector is active in any country $j$ hosting the entire manufacturing base. The amount of unskilled labour in manufacturing in country $j$ equals $n_j \beta x_j$. Substituting $x$ from (9) gives $n_j \beta x_j = n_j \beta \sigma\left(\frac{n_j}{s_j}\right)^\gamma \pi_j$. For country $j$, hosting the entire industry, world operating profit equals the congestion adjusted return to the fixed factor $n_j\left(\frac{n_j}{s_j}\right)^\gamma \pi_j$. The world operating profit is given by $\mu E^W/\sigma$. World expenditure, in turn, equals world factor income $E^W = L^W + \mu E^W/\sigma$, which gives $E^W = \frac{L^W}{1 - \mu/\sigma}$. The condition ensuring that the agricultural sector is active in any country $j$ is therefore given by $s_j L^W > n_j \beta x_j = n_j \beta \sigma\left(\frac{n_j}{s_j}\right)^\gamma \pi_j = (\sigma - 1) \frac{\mu L^W}{\sigma - \mu}$, or simply $s_j > (\sigma - 1) \frac{\mu}{\sigma - \mu}$.²

### 2.3 Long-run equilibrium

In the long run, capital is fully mobile between countries and responsive to the incentives provided by the relative returns that can be attained in the three countries. Interior equilibria are characterised by the allocation of some capital in each region and an equal return to capital in all countries:

²Clearly, by allowing $\sigma$ close to one, this condition will also hold for very small countries.
\[ \pi_j = \pi_l = \pi, \quad j, l \in \mathbb{R}. \quad (12) \]

Corner solution type of equilibria entails one or two countries without capital, since capital would enjoy a lower return in that location. Contrary to most new economic geography models, the model in this paper does not display circular causality and accordingly, does not display multiple equilibria or bifurcations. The reason is that the usual demand and supply links are absent, since return to capital is repatriated and capital moves according to nominal return, which cuts the price index effect. However, due to the 'home market effect', the model still produces agglomeration when countries are of different size.

3 Economic Integration

We now turn to the analysis of the effects of economic integration. The analysis proceeds in steps of increased complexity.

3.1 The case of symmetric trade costs and no congestion costs \((\gamma = 0)\)

When trade costs are symmetric and congestion costs are absent, the model becomes analytically solvable in the general \(R\)-region case (Baldwin et. al. 2003). Using (5), (10), (11), and (12) to solve the model for interior equilibria gives

\[
n_j = \frac{1}{R} + \left( s_j - \frac{1}{R} \right) \frac{(R - 1)\phi + 1}{1 - \phi}. \quad (13)\]

Thus, the mass of firms in a region depends on its size and the level of trade costs. Note that the only parameters determining location are \(\phi\) and \(s_j\); \(\mu\) is absent since only relative market size is of importance.

The agglomeration effect is easily seen from (13). Differentiating \(n_j\) with respect to \(s_j\) gives:

\[
\frac{dn_j}{ds_j} = \frac{(R - 1)\phi + 1}{1 - \phi}, \quad (14)
\]

which shows that \(n_j\) increases more than proportionate to \(s_j\) for \(\phi > 0\). The effect increases in trade freeness, and becomes arbitrarily large as trade costs approach zero. This implies that even if we start out with one region just slightly larger than the others, that region will obtain the entire M-industry if trade costs are sufficiently low. To establish which region obtains the industry in a different way, note that the derivative

\[
\frac{dn_j}{d\phi} = \left( s_j - \frac{1}{R} \right) \frac{R}{(1 - \phi)^2}, \quad (15)
\]

is positive whenever \(s_j > 1/R\); that is, a region with larger than average endowments will always gain industry as trade costs fall, as long as these costs are symmetric. This result is useful for understanding the basic mechanism of the model, and will be kept in mind. However, rather
than a uniform increase in \( \phi \), I am here primarily interested in the effects of lower trade costs among a subset of countries and I next turn to this case.

### 3.2 Wait and see versus go ahead (no congestion costs)

Even absent congestion costs, the algebra of the R-country model quickly becomes cumbersome, when asymmetric trade costs are introduced. Therefore, consider a 3-country case, where congestion costs are absent \((\gamma = 0)\) for the time being. I compare two countries of equal size, countries 1 and 2. Country 1 decides to adopt a wait and see approach towards further integration whereas country 2 goes ahead and integrates with country 3. The experiment is supposed to mimic two European countries choosing different strategies for further integration with the rest of EU, as is represented by country 3.\(^3\)

Let \( \phi \) represent the trade costs between the outside country and the two integrating states, and \( \tilde{\phi} \) the trade cost between countries 2 and 3. Deeper integration between countries 2 and 3 implies a lower \( \phi_{23} \equiv \tilde{\phi} \). The effect on country 2 is given by

\[
\frac{dn_2}{d\tilde{\phi}} = \left( \frac{s_2 - \frac{s_2 + s_3}{2}}{\Delta} \right) \varsigma + \frac{s_1 \phi}{(1 + \phi - 2\phi)^2},
\]

where, for \( 0 < \phi, \tilde{\phi} < 1 \), \( \Delta \equiv \left[ 2\phi \left( 1 - \tilde{\phi} \right) - 1 + \tilde{\phi}^2 \right]^2 > 0 \), and

\[
\varsigma \equiv \left[ \left( 1 + \tilde{\phi} \right)^2 - 4\phi (1 - \phi) \left( \phi - \tilde{\phi} \right) - \phi \left( 1 - \tilde{\phi} \right)^2 \right] \geq 0.\]

The second term in (16), which is positive, illustrates that the inside country 2 will always gain industry from the outside country 1. However, as shown by the first term, the inside country may gain or lose inside the integrating bloc, depending on its relative size.\(^5\)

The effect on the outside country 1, which loses industry to both inside countries, is given by

\[
\frac{dn_1}{d\tilde{\phi}} = -\frac{2s_1 \phi}{(1 + \tilde{\phi} - 2\phi)^2}.
\]

Comparing the effects for the two countries 1 and 2, it is clear that if country 2 is large so that the first term in (16) becomes positive, the go ahead seems attractive since it leads to an influx of industry, as compared to an outflow for the outside country 1. However, if the integrating country is small, it will lose industry to the integrating partner (first term in 16 negative), which may outweigh the gain from outside (the second term). It might even be the

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\(^3\)A complication is that country 3, representing the rest of the EU, in reality consists of many countries. However, from (15) we know that it is the average size that is of importance. The size of country 3 can thus represent the average country size within the EU.

\(^4\)The easiest way of establishing the second inequality is simply by 3d-plotting.

\(^5\)These two forces have been named the two-tier home-market effect (Baldwin et. al 2003).
case that the loss to the integrating partner is larger than the inevitable loss from being outside. In exact terms, this will happen when $\frac{d(n_2 - n_1)}{d\phi} > 0$, or

$$-(s_3 - s_2) \left[ (1 + 2\phi)(\bar{\phi} - \phi)^2 + (1 - \phi)2(\bar{\phi} - \phi) + (1 + \phi^2) - 2\phi \left(1 - (1 + \phi)^2\right) \right] + \phi(1 + \bar{\phi})^2 \ 
\frac{(1 - \bar{\phi})^2(2\phi - 1 - \bar{\phi})^2}{(1 - \bar{\phi})^2(2\phi - 1 - \bar{\phi})^2} > 0.$$  
\tag{18}

Three factors are, from (18), important when judging the relative merits of being in or out. The first is the size difference between the integrating countries ($s_3 - s_2$). The smaller country is relative to the other core country, the more likely it is preferable for it to stay out. Second, the deeper the integration between the core countries relative to other countries ($\bar{\phi} - \phi$ large), the more likely is country 2 to lose industry relative to country 1. Finally, a higher general level of trade freeness makes integration more attractive for a small country. Starting from symmetric trade costs, this can more easily be seen by asking when a marginal step towards integration between the core countries will be beneficial for a joining small country. The condition is

$$\frac{d(n_2 - n_1)}{d\phi} \bigg|_{\phi = \bar{\phi}} = \left. \frac{\bar{\phi} - (s_3 - s_2)(1 + 2\bar{\phi})}{(1 - \bar{\phi})^2} \right) > 0,$$
\tag{19}

which can be written as

$$s_3 - s_2 < \frac{1}{2 + \frac{1}{\bar{\phi}}}. \tag{20}$$

The inequality shows the minimal size difference allowed between the core countries for the smaller one to be better off inside than outside. Clearly, starting at autarchy ($\bar{\phi} = 0$), the small country would never want to go ahead integrating. However, as trade freeness increases, it becomes more and more likely that a small step towards integration is beneficial.

The effect of deeper integration between countries 2 and 3 (higher $\bar{\phi}$) is conveniently illustrated by plotting $n_1$ and $n_2$ against $\phi$. Figure 1 ($s_1 = 0.3, s_2 = 0.3, s_3 = 0.4, \mu = 0.3, \sigma = 4, \phi = 0.3$) shows a numerical example when condition (20) holds. The figure also shows that once the integration proceeds far enough ($\bar{\phi} - \phi$ large enough), the inside country will lose as compared to the outside. This is always the case, as can be seen e.g. by substituting $\bar{\phi} = 1$ and $\phi = 0$, the maximal value of ($\bar{\phi} - \phi$), into (18).
Figure 1: Integration between countries 2 and 3 without congestion costs

Thus, the analysis so far indicates that it may be safer for a small country to wait until general trade costs are very low before going ahead with deeper integration. This gives one possible rationale for the wait and see strategy towards European integration adopted by several small countries. However, as we will see next, the conclusion is modified once congestion costs are added.

3.3 Wait and see versus go ahead with agglomeration costs

Once congestion costs are introduced, we must proceed by numerical simulation. Agglomeration forces are driven by market access and therefore, become relatively unimportant when trade frictions are low. Instead, congestion costs, which are independent of trade costs, will come to dominate at this point.

Figure 2 ($s_1 = 0.3, s_2 = 0.3, s_3 = 0.4, \mu = 0.3, \sigma = 4, \phi = 0.3, g = 0.05$) shows the same experiment as in Figure 1, but with congestion forces added. The locational pattern is essentially the same as in Figure 1 at the initial stages of integration ($\tilde{\phi}$ just slightly above $\phi$). However, there is a marked difference at a deeper level of integration. As trade costs between the integrating countries become low, congestion forces start to push industry back to country 2, which magnifies its gains relative to the outside country 1.
A different case arises when condition (20) does not hold. Country 2 will now lose industry at the initial stages of integration because of the low initial degree of integration. This is illustrated in Figure 3 ($s_1 = 0.3, s_2 = 0.3, s_3 = 0.4, \mu = 0.3, \sigma = 4, \phi = 0.1$ and $\gamma = 0.05$). However, the pattern is reversed at deeper levels of integration due to congestion forces. The initial losses to the integrating partner are reversed, whereas the gains from the outside are maintained.
In sum, when comparing the go ahead and the wait and see option, the conclusions concerning country size and the general level of trade costs still hold when a dispersion force, such as congestion, is introduced. The difference lies in the effect of very deep integration between the integrating countries, which is now to the benefit of a small country.

4 Stylized facts

Here, it is investigated how the model’s predictions compare with stylised facts using OECD data on manufacturing production. Figure 4 shows yearly percentage changes in manufacturing production for three groups of European countries: the EMU bloc, EU countries outside EMU (Sweden, Denmark and the UK) and finally, countries outside the EU (Norway and Switzerland). Unweighted means are used to mitigate country-specific variation. The general picture is that the EMU-countries have been doing considerably better starting from the second half of the 1990s. Comparing the two outside groups is more difficult, but it is noteworthy that the countries outside the EU seem to be doing very poorly in the last two years of the sample.
Figure 4

However, the theoretical experiment consisted of a comparison between small countries inside and outside an integrating bloc. Figure 5 compares small European countries having chosen to stay outside various phases of the European integration process and small EMU members. Once more, unweighted means are applied. The figure shows that small integrating countries have been doing considerably better than small outside countries since the mid 1990s. Any specific effect related to the introduction of the euro in 2000 is, however, difficult to see.
Figure 5

Relating Figure 5 to theory, it is possible to observe the small inside country gaining industry relative to the outside country in two cases. First, it may be that congestion costs are unimportant but that size differences and trade costs are such that condition (20) holds. Further integration, in this case, risks leading to delocation of industry from the small inside countries à la Figure 1. A second possibility is that Europe is in a situation where integration in the EMU-bloc is so deep that congestion forces are starting to push industry back to smaller countries. In this case, further integration would unambiguously benefit small inside countries. The two cases can be distinguished by what happens within the integrating bloc. If congestion costs were becoming important, we would observe industry relocating from large to smaller countries within the bloc. Figure 6 shows production growth for small and large EMU-countries (unweighted means). The small inside countries have been gaining production relative to the large ones every single year since 1992, the starting year of the single market. Thus, stylized facts are consistent with Europe being integrated to a point where dispersion forces such as congestion become important.
In sum, the stylized facts show that integrating countries gain industry relative to outsiders. Second, small inside countries gain both relative to small outside countries and to large inside countries. This indicates that integration in Europe has reached a depth where market access is becoming a less important factor in determining the location of industry within Europe.

Naturally, some caveats are in order: Even though stylised facts are quite clear cut, it important to note that they rest on a limited number of observations. Country-specific factors may influence the results. There is also the usual problem of endogeneity; possibly the integrating countries have chosen this route exactly because they are countries that would gain from doing so.

5 Conclusion

Many European countries face the option of waiting or going ahead now with deeper integration. In particular, small countries hesitate to take the latest step, namely, to enter the EMU. This paper theoretically compares the two options with respect to the effects on industry location. It is first illustrated how lower trade costs in general make it more attractive to go ahead with deeper integration, which gives a certain rationale for the wait and see argument. However, when, in a realistic manner, forces resisting agglomeration independently of trade costs are added to the model, the tendency to lose industry to larger partner countries becomes hump-shaped in trade costs. As a consequence, the go ahead option will be attractive if integration within the integrating bloc is deep enough.
Using stylised facts on European manufacturing production, it is illustrated how small inside countries are doing very well. Moreover, regarding the critical factor - performance vis-à-vis large integrating countries - small countries are once more doing well; that is, the average manufacturing production growth has been higher every single year since 1992 as compared to large integrating countries. An interpretation of this is that integration in Europe is now sufficiently deep that small countries should not fear large-scale delocation of industry to large integrating countries. It should be noted, though, that stylized facts rest on a limited number of observations. Moreover, there is the usual problem of endogeneity regarding the selection of EMU members. Finally, short-run adjustment problems associated with giving up an independent monetary policy must naturally still be weighed in when the go ahead option is considered.

The main message of this paper, however, is that the fear of the long-run consequence of an EMU membership being that the industrial base of small EMU countries decamps to the large EMU members may be exaggerated.
References


