

3.3 Longer-term International Effects of EMU on Trade

In the longer term, if the launch of the euro as a single European currency is successful, and Member States other than those chosen as the "first wave" of countries decide to adopt the euro, then a critical mass of users may create significant "network externalities", so that significant growth in usage of the currency occurs outside the EU (see Reynolds (1993) for an interesting model which tries to capture these externalities, but specifically in the EU during the transition period). This scenario is only likely in certain circumstances, and although the sanguine assumptions necessary for such an outcome currently seem unlikely, if such a scenario did come to pass, it would profoundly affect the world economy and international macroeconomic policy coordination.

The "follow on" issue is dealt with by Ilzkovitz (1995), Hartmann (1996) and the Economist (1997). The issue is clearly difficult to anticipate, so most of the arguments are qualitative in nature. The share of world output of the EU is currently greater than that of the US, plus the share of world trade for the EU is also greater than that of the US, even when intra-EU trade is excluded. Thus, if most of the EU adopts the euro, then it is likely that a critical mass of usage will be attained over time, such that network externalities will exist, creating an environment where the euro could challenge the US dollar as the principal currency used in international trade invoicing. Clearly, the monetary policy of the ECB would have to be credible, and supportive of low and stable inflation. Also, as the ECB is a central bank, with complete independence of government (as no EU government currently exists), then political pressure would largely be absent, so it may be that the ECB's policy would generate a more stable currency than the US dollar.

But where, in regional terms would the euro challenge the US dollar as an international currency for trade invoicing? Hartmann (1996) points to Asia as a prime candidate for euro trade invoicing. The main planks of this argument rest on several observations about Asian trade. First, Japanese exporters, for strategic reasons, prefer to bear exchange risk themselves so as to maintain market share - their chosen international currency has usually been the US dollar. Second, although EU exports to Asia are less than US exports to Asia, the growth in EU exports is higher than that of US exports, so that within a decade, the share of EU exports and imports in Asia may exceed those of the US. At this point, so the argument goes, Asian exporters and importers may decide to denominate their international trade in euros rather than US dollars. Another fast-expanding market is the Eastern and Central European market. In these markets there has been a tendency to denominate trade with Western Europe in Deutschmarks, and outside of Europe in US dollars. Several Baltic states have exchange-rate policies that anchor the national currency to the Deutschmark (in the form of a currency board arrangement), so post-EMU if these countries decided to adopt the euro for exchange rate and monetary policy purposes, there would be a greater incentive to also adopt the euro as a trade-invoicing currency. Clearly, in both Asia and Eastern and Central European markets much depends on events in other markets such as the foreign exchange market and derivative markets, as trade financing in dollars is currently relatively easy to arrange because of the depth and liquidity of the US dollar markets. Thus any switchover into euros would have to be made with no loss of liquidity in the foreign exchange market and maintenance of equivalent levels of financing services that exporters and importers require.

If this scenario were to be realised, what would be the effect on Canada? Canadian trade is largely denominated in US dollars, because Canada's major trading partner is the US. Table 3.6 shows the breakdown of the destination of Canadian exports and origin of imports, and a possible scenario whereby roughly 20 percent, 35 percent and 50 percent of exports to non-EU and non-US destinations are denominated in euros.