7. Other Scenario-Dependent Potential Effects

There are several other effects that could potentially have an impact on Canadian trade and investment, but each of these effects is dependent either on how EMU is implemented or on the configuration of insiders and outsiders as EMU progresses. A non-exhaustive list of these items might be classified as follows:-

- changing trade patterns due to the insider-outsider configuration;
- exchange rate volatility effects;
- a one-time discrete jump in exchange rates at the beginning of stage three;
- internal EU competitiveness effects; and
- third country competitiveness effects;

Each of the above effects is addressed below.

7.1 Insider-Outsider Effects

The issue of the insider-outsider configuration has recently arisen in the academic literature (see Ghironi and Giavazzi (1997). The adoption of a small core grouping of Member States that decide to adopt the euro, may foster further trade creation, and given that the future monetary and exchange rate policy link between those Member States that decide to stay out, and those that decide to join, is currently vague, this may exacerbate the level of convergence between the so-called "ins" and "outs". Another issue that has not been addressed in the literature is the possibility that Member States and countries outside the EU might decide to unilaterally adopt the euro, thereby enlarging the single currency zone and the extent of trade creation. Although it is widely acknowledged within the EU that qualification for adopting the single currency entails satisfaction of the Maastricht criteria, what would stop a country that did not sign Maastricht from adopting the euro as legal tender?[6] Clearly, the Baltic states and Central European countries are the most likely to consider this, but this, in turn, may create two different sets of countries in terms of economic versus monetary union, with unforeseeable results.

7.2 Exchange Rate Volatility Effects

EMU is equivalent, in economic terms, to fixing participating Member State exchange rates against each other, with infinite foreign exchange reserves to defend the fixed rates, thereby eliminating exchange rate volatility. Hence, if exchange rate volatility has deleterious effects on trade and investment, then EMU could be growth enhancing, as it could produce a one-time increase in trade and investment.

Exchange rate volatility effects have also recently been the subject of a considerable amount of economic research (see Friberg and Vreden (1996), Smith (1996), Arize (1995), Frankel and Wei (1995) and Gagnon (1993)). If exchange rate volatility is to affect trade, then it will do so via the costs of uncertainty, which relate to the invoicing currency used for trade. On a macroeconomic level, there is no strong evidence of a link between exchange rate variability and the level of international trade, although weak evidence of an effect does exist, according to some economists (see Frankel and Wei (1995)). Smith (1996) claims that commodity price volatility has been much larger in magnitude than exchange rate volatility, and for many commodities, exchange rate volatility tends to offset commodity price volatility to create a hedge in overall price risk faced by domestic firms. But this will not affect the vast majority of traded merchandise goods, as either exchange rate volatility will add to commodity price

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[6] The fact that Cuba uses the US dollar for most economic and financial transactions is not politically desirable as far as the US is concerned, but there is little that the US can do about it.