7.4 EU Competitiveness Effects

It is now well known that exporters in large economies pursue policies of price discrimination. The empirical evidence suggests that firms in this position can "price to market" (that is, price exports in fixed terms for the importing country's currency). But is it always desirable to "price to market"? Because of real exchange rate changes, this will not always be the case, as increases in aggregate demand abroad will cause exporters to want to raise export prices in relation to the domestic market. Thus relative export prices will rise.

But "pricing to market" will depend not only on real exchange rates (because of price discrimination), but also on nominal rigidities in the domestic price level. See Giovannini (1988) for a more detailed discussion.

In international economics, the role of exchange rate "pass-through" is also closely related to "pricing to market". "Pass-through" refers to the effect on import prices from changes in exchange rates. If exporters "price to market" and fix prices in terms of the importer's currency, the degree of "pass-through" will theoretically be zero, as exchange rate fluctuations will only affect the exporter's mark-up. Clearly, though, the role of competition is important here, as if the exporter decides to price and invoice in the importer's currency, then the exporter is essentially carrying all the exchange rate risk (note here that pricing and invoicing do not necessarily occur in the same currency). The greater the degree of competition, the more likely it is that the exporter will be forced to "price to market", and therefore the lower the degree of exchange rate "pass-through" to the importing country. As Friberg and Vredin (1996) note, the degree of "pass through" to the importer's currency price decreases with the degree of market concentration, and increases with the extent of substitutability between goods and with the market share of foreign firms relative to local competitors. Thus it is clear that "pass through" should be high for imports from a country with a large market share.

Applying these theoretical results to the Canada-EU situation implies that Canadian imports from the EU should, as trade invoicing is higher for Canadian imports, and the EU clearly has a larger market share in many goods and services than Canada does, result in a non-negligible level of "pass through". Canadian exporters, on the other hand, will likely have to increasingly adopt "price to market" tactics, if Canadian exports are to remain competitive in the EU, thus increasing the level of risk for Canadian exporters and increasing the amount of euro trade invoicing in the future. These are the direct effects on competitiveness, but there may also be effects emanating from competitors in third countries. If these third countries are outside the EU, then the only differentiating factor in terms of exchange rates would be the level of volatility in the domestic currency versus the euro. The links between market share and pass-through suggest that the role of the location of Canadian export competitors is important in assessing the competitiveness effects of EMU on Canada in this area.

If the Canadian export competition comes from the EU, then this may have a deleterious effect on Canadian exporters, as they will be forced to carry the exchange rate risk in order to compete with EU companies, and also the degree of competition will increase as agglomeration effects occur (discussed above). The extent of this exchange rate risk effect will clearly depend in the degree of exchange rate volatility between the euro and the Canadian dollar, as this would represent the single largest disadvantage for Canadian exporters. There could also be costs in terms of trade financing for Canadian importers, particularly if they had only limited access to financial institutions that were willing to finance in euros. On the other hand, European companies that now practice price discrimination between different EU markets, will no longer be able to do so as easily, given a single currency, which would immediately eliminate excess profits.

Despite the non-quantitative nature of invoicing practices (such as "pricing to market") there