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 volatility, or else foreign price volatility will not be as great, as would be expected with semi-manufactured and manufactured goods. Nevertheless, all the literature cited above, with the exception of Arize (1995), points to negligible or small and insignificant exchange rate volatility effects on trade volumes. As Eichengreen and Ghironi (1995) point out though, just because economic studies have not managed to identify significant trade volume effects from exchange rate volatility does not mean that such effects may not exist. Certainly all anecdotal evidence (and the evidence provided by the survey which accompanies this study) suggests that exchange rate volatility does affect trade - but it may be that exporters and importers do not let short term exchange rate losses (or profits) influence their longer term decision regarding their prospects for gaining or consolidating market share. Or, as Wihlborg (1996) notes, if exporters and importers do not hedge, they may decide to incorporate

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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.