

Trade diversion

Trade diversion is usually discussed in the context of customs unions - a structure which Europe has already achieved - but has also been raised in the context of EMU. It is difficult to come up with any quantitative measure of the trade diversion potential of EMU. The 0.4% of GDP cost saving identified by the European Commission is not large compared to other factors influencing competitiveness, and will most likely be centred in the smaller value and retail transactions within Europe, which are less exposed to international trade from outside the EU. There may be a small impact from the elimination of intra-EU currency volatility, but the empirical evidence for currency volatility effects on trade is not strong and, in any case, the revealed cost of currency volatility as measured by bid-offer spreads on currency hedges is small. There may be second-round effects if EMU encourages EU wide standards and regulation, which will facilitate more intra-EU trade.¹² In summary, the trade diversion potential of EMU is not large compared to the trade diversion engendered by the formation of Europe's customs union itself, and the subsequent elimination of barriers to trade within the EU.

Trade Protectionism

While some feel that EMU (combined with deregulation in Europe) will foster growth, investment and a more dynamic economy, there is a dark side scenario. A number of policy elements could conspire to result in a stagnant European economy after EMU:

- The inability of national monetary policies to address differing regional economic situations;
- inaction on the hoped-for deregulation of labour and product markets;
- a tight monetary policy protective of the external exchange value of the euro;
- the constraining effect of the Stability Pact on fiscal policy.

The resulting economic stagnation could lead to calls for trade protectionism and could colour Europe's attitude to multilateral trade and investment arrangements.

Euro-Markets and Canadian Financing

Canadian borrowers, including the federal government and crown corporations, make regular use of the London-based eurobond and euro-loan markets. While much of this activity is in US dollars, a considerable part is denominated in those currencies for which the euro will be the successor. In fact, if EMU goes ahead, those Canadian borrowers who have issued securities maturing beyond 2002 in EMU participating currencies will be paying interest and

¹²While we tend to think of the EU's common market as a "done deal", there are still many areas where regulation inhibits intra-EU trade. For example, the EU still does not have common standards for household electrical appliances. Financial sector regulation is also still done on a national basis.