

be macroeconomic effects, and these effects will depend on the degree of price and wage rigidity in each individual Member State. For instance, if prices were perfectly flexible then the discrete change in exchange rates would act like a tax on holders of balances of the depreciating currencies. If, however, prices were not perfectly flexible (due, say, to long-term contracts and adjustment costs) then the exchange rate change would affect the relative valuation of goods and services whose prices do not move freely. The macroeconomic effects would be in terms of the wealth and substitution effects of the changes in the real stock of money, which would give rise to a decrease in spending, a fall in output and the relative price of non-traded goods and an increase in output of traded goods and a trade surplus. The opposite effects would occur in countries whose currencies underwent an appreciation. The point here is that if expectations of economic agents are altered by the changeover, because of long-term contracts and adjustment costs, then it may not be in the interest of the private sector to adopt the official conversion rate, as this would change real payments as contracts are specified in nominal terms. In this sense mandating a changeover at a specified point in time acts like an incomes policy.

In order to eliminate any adverse economic effects of devaluing the currencies of Member States, Giovannini advocates the marking-to-market of contracts at the conversion date and the choice of a conversion rate that induces exactly the same exchange rate depreciation that was expected by wage and price setters (and so gave rise to any relative price distortions in the first place). In reality, this is unlikely to happen, as the calculations involved in such an exercise would be extremely difficult to extract from the economic data available. Nevertheless, it should be acknowledged that certain Member States might seek a discrete jump in exchange rates so as to effectively give them a "final devaluation" as EMU begins. It should also be noted that both Germany and the Netherlands will vigorously resist such a strategy, as it implies a discrete "revaluation" in their currencies, which would have adverse effects on their export sectors.

What would be the effect of this on Canadian exporters? Canadian exporters will effectively face a discrete jump in exchange rates for their exports to these Member States, and this will likely either make exports less price competitive compared with domestic producers, or shrink profit margins. The opposite would occur for Member States whose currencies revalued. This scenario, although it appears possible, is one which Germany appears most resolutely opposed to, so the likelihood of a significant jump in exchange rates is not high.

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