THE EURO AT TEN: ITS EFFECT ON INTRA-EUROZONE TRADE

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On the 1st of January 1999, the euro was introduced in eleven EU states, as part of a wider aim to promote economic integration, growth and stability within the EU. In this essay, Mark Havel looks at its effect on trade within the Eurozone. Despite high expectations from some quarters, the currency has not led to dramatic increases in intra-Eurozone trade. Notwithstanding this, it can still be seen as a successful monetary policy endeavour, and even more so when considering the current economic climate.

Introduction: the genesis of the single currency

The euro is now ten years old. After a decade, what has been the effect of the euro on trade between the Eurozone countries? The Treaty of Rome laid down only minor provisions for monetary cooperation. The establishment of the internal market led the Community to revive the objective of monetary union. The Hanover European Council in 1988 stated that 'in adopting the Single Act, the Member States of the Community confirmed the objective of progressive realisation of economic and monetary union'. In April 1989, a report by the Delors Committee envisaged the achievement of European Monetary Union (EMU) in three stages: the first stage, between June 1990 and January 1992, was to step up cooperation between central banks; the second stage was the establishment of a European System of Central Banks (ESCB) and the progressive transfer of decision-making on monetary policy to supranational institutions; and in the final stage, the national currencies would have their exchange rates irrevocably fixed and would be replaced by the European single currency. At the Madrid European Council in 1989, the Delors Plan was adopted as a basis for moving toward monetary union. With minor alterations made, this plan went ahead, and on the 1st of January 1999, eleven countries joined the EMU. Greece subsequently joined in 2001, and in 2002 the euro currency came into circulation in twelve countries (European Parliament Fact Sheet, 2001).

Effect of the euro on intra-Eurozone trade

Before looking at the euro's effect on intra-Eurozone trade, it should be noted that the euro was introduced mainly to achieve a higher level of economic integration within the common market and promote economic growth and stability. The anticipated trade effects were small.

Some early work by Andrew Rose (2000) predicted that having a common currency would have a large effect on trade between participating countries, increasing trade by a factor of three. His calculations were made using the gravity model, which states that the flow of trade between a pair of countries is proportional to their economic mass and inversely proportional to the distance between them. He showed that even after taking into account other factors such as output, size, distance between other countries and other controls, two countries that share the same currency trade substantially more than countries with their own separate currencies. The reasons for such a large increase may be due to the effect of ‘home bias’ in trade. McCallum (1995) quantifies the size of this ‘home bias’ at more than twenty to one. Part of this home bias may come from the fact that a single currency is used domestically, a circumstance the monetary union hopes to recreate.

Yet the general consensus is that trade among Eurozone members has increased by far less than had been estimated by Rose. Bun and Klaassen (2002) estimate a total cumulative increase in intra-EMU exports of 3.9% in 1999, 6.9% in 2000, 9.6% in 2001 and 37.8% in the long run. These effects are significant and show that from an economic point of view the euro has a positive impact on trade. This may be relevant in the policy debates on whether to join the euro in Denmark, Sweden and the U.K., and for the negotiations on the accession of central and eastern European countries to the EU and EMU. The evidence shows that in the ten years that the euro has been in use, the increase in trade has been 10-15%, much less than the tripling effect estimated by Rose. What are the reasons that trade did not increase by a factor of three?

One of the reasons may be language. Evidence has shown that sharing a land border, a language, or a regional trade agreement increases trade by economically and statistically significant amounts. While the euro area has two of these traits, it does not have a common language, which might act to restrict trade between Eurozone nations.

Another reason is time. At ten years old, the euro is still a new currency and there could be a time lag between its introduction and full effects. Other important aspects, other than a common currency, that exist within nations but not between nations that affect trade are: common cultural norms, a common legal system, and a common history. Because these have not been harmonised to the degree that the financial markets have, they could impede the euro’s full effects.

One of the criticisms of the euro’s effect on trade is that its benefits have not just been to those who joined the single currency. Through the EU single market, euro ‘outsiders’ are able to participate in the gains of the euro, especially if they sustain stable exchange rates with the euro (Dyson, 2008). This acts as an incentive to stay out of the euro, as a country can realise the gains from the single currency while still having control over monetary policy.

A second criticism of the euro is that it did not boost the growth rates of the Eurozone to economically or historically high levels. While trade between the Eurozone countries did increase, the growth rates of the Eurozone, seen in the table below, lagged behind the US and non-Eurozone EU members.

Macroeconomic performance indicators

		Period averages					
		Euro area		Denmark, Sweden, UK		United States	
		1989-1998	1999-2008	1989-1998	1999-2008	1989-1998	1999-2008
Real GDP	% rate of change	2,2	2,1	2,0	2,7	3,0	2,6
Real GDP per capita	% rate of change	1,9	1,6	1,7	2,2	1,8	1,6
Real GDP per capita	index, US = 100	73	72	74	76	100	100
Employment	% rate of change	0,6	1,3	0,1	0,9	1,5	1,0
Labour productivity	% rate of change	1,6	0,8	1,9	1,8	1,5	1,6
Unemployment	% of labour force	9,3	8,3	7,9	5,2	5,8	5,0
Inflation	%	3,3	2,2	3,4	1,7	3,3	2,8
Fiscal balance	% of GDP	-4,3	-1,7	-3,6	-0,9	-3,3	-2,5
Gross public debt	% of GDP	68,6	68,6	48,7	43,0	67,8	60,7
Long term interest rate	%	8,1	4,4	8,6	4,9	7,1	4,6
Real long term interest rate	%	4,7	2,4	4,2	3,3	4,3	2,4

Source : European Commission, OECD

Figure 1

Another criticism is that the trade effects, at least the beneficial trade effects, are greatest at the 'core'. The 'core' refers to Germany, France, Austria, Belgium and the Netherlands. These countries were, and are, the most synchronised, meaning they had the most to gain and the least to lose when embarking on a monetary union. Countries on the periphery that were less synchronised had less to gain. Future entrants could gain more from membership of the currency union than existing members, for example the Czech Republic is more synchronised to Germany and the core than an outlier like Ireland. As the graph below shows, Germany's trade surplus has risen a great deal since the launch of the euro; this strengthens the claim that the main beneficiaries of the monetary union are the 'core' countries.

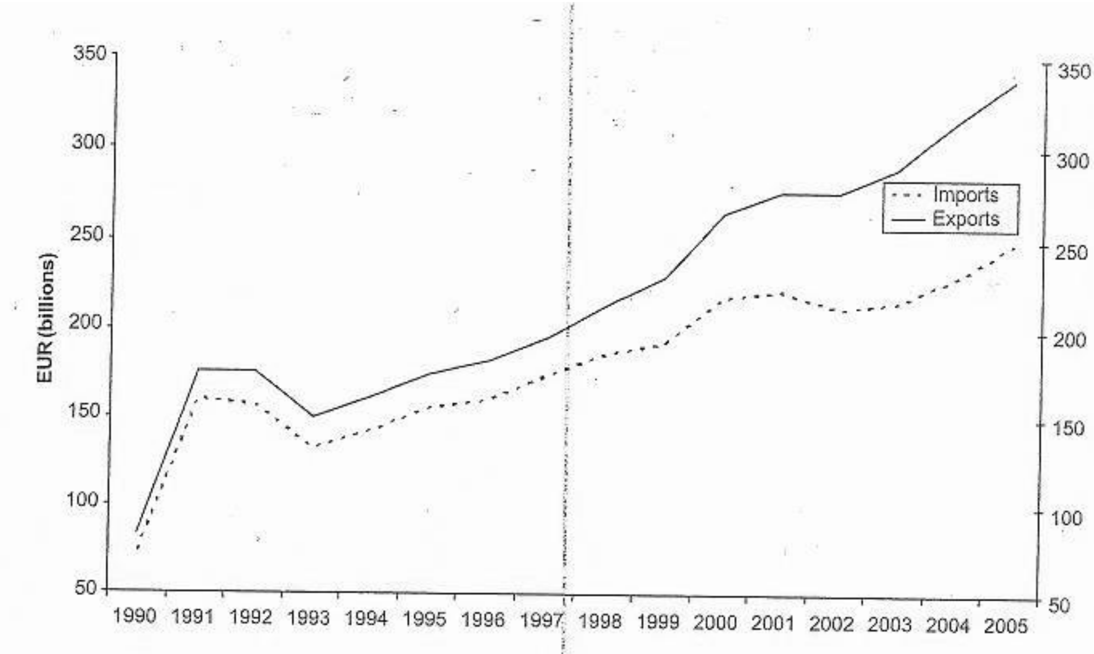
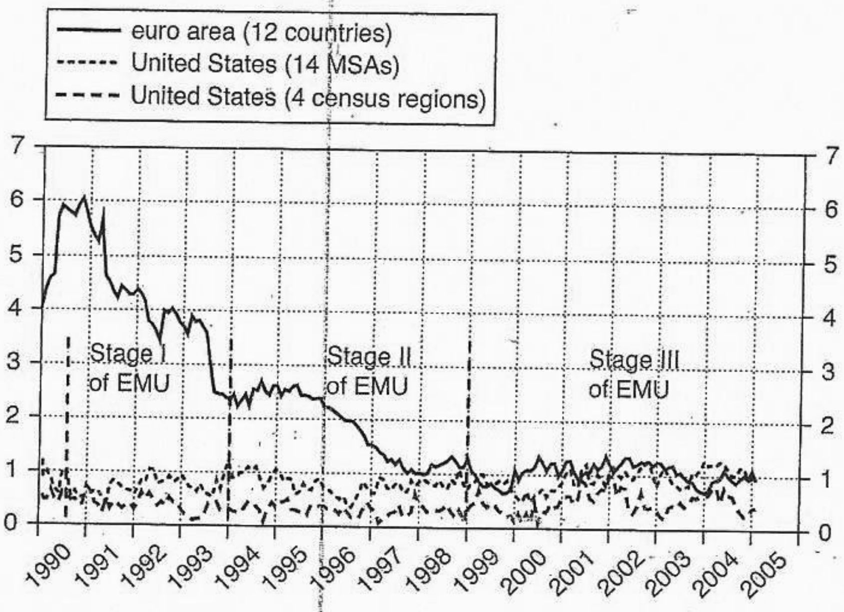


Figure 1.9 Germany pushing Euroland apart *(Germany's soaring trade imbalance with its Euroland partners)*

Source: Reuters.

Figure 2

It should be noted though that the ‘core’ has had positive effects on the other members too. Or, rather, Germany has had positive effects on other members, lowering interest rates to German levels, lowering the cost of capital to German levels, and, as in the graph below, lowering inflation levels to the German level. In this sense, it could be worthwhile for countries to join the monetary union in order to import lower German inflation levels.



Sources: Eurostat, US Bureau of Labor Statistics and ECB calculations.
[1] Data up to February 2005.

Figure 17 Dispersion of annual inflation in the euro area, fourteen US metropolitan statistical areas (MSAs) and the four US census regions[1]

Figure 3

Although the gains of a trebling in trade did not materialise, the euro should not be seen as a failure. The gains in trade that occur are noteworthy on their own accord. If Andrew Rose had predicted gains of 15%, as has occurred, the euro would be hailed as a success. Intra-area trade flows now account for one third of the area's GDP, up from one quarter ten years ago. The euro also had the effect of reducing the capital costs to firms by lowering interest rates toward the German level. The gains in trade that have occurred can be attributed to a few variables. The removal of exchange rate risk is one such variable, although its effect was probably minimal. Lower transaction costs is another, as currencies no longer had to be changed, for which there is a cost, and insurance against exchange rate risk no longer had to be taken out. Price and cost transparency as a result of a single currency can also be credited with increasing trade.

Although the euro has been criticised for not exclusively favouring Eurozone members in terms of trade, the graph below shows that intra-Eurozone trade has increased and trade with EU non-euro users has declined since the euro’s inception.

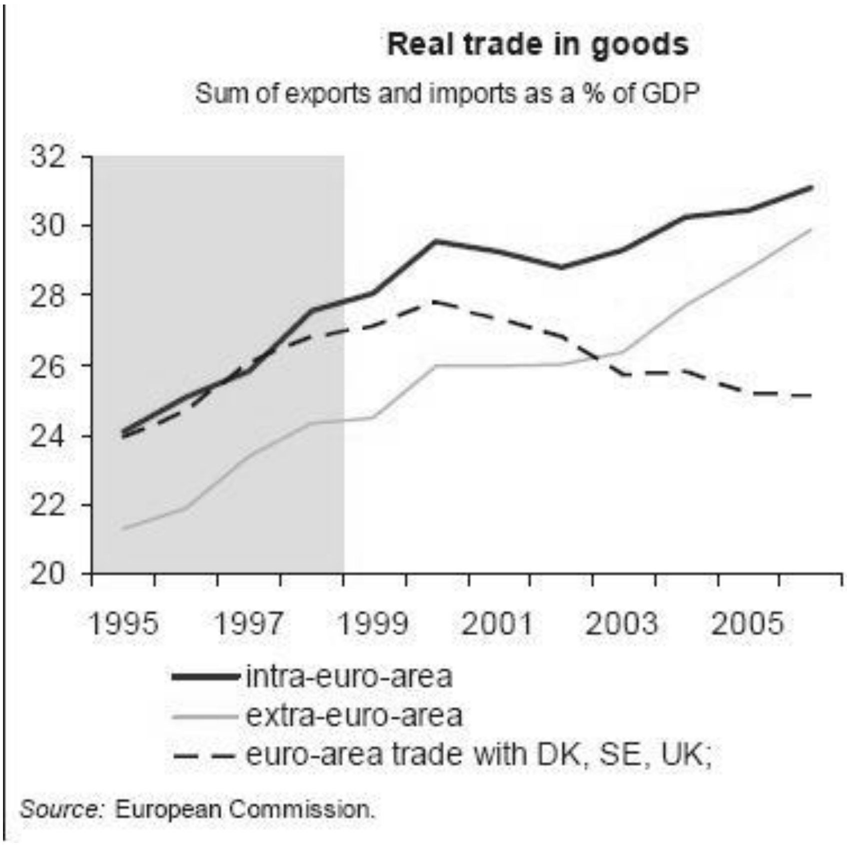
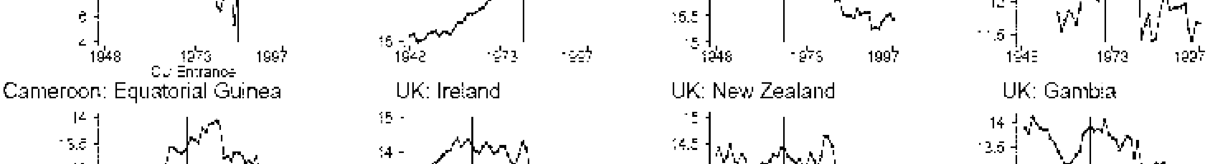


Figure 4

Extra-Eurozone trade in goods has risen faster than intra-Eurozone trade, but this is because of the rapidly emerging economies of China and India, from which there has been an increased demand for European exports. Importantly, the increase in trade flows between Eurozone countries has not been at the expense of trade with non-Eurozone countries, pointing to a genuine trade creation effect, which is supported by the findings of Nitsch and Pisu (2008).

Did the euro cause trade growth?

Another problem is whether the trade growth can actually be attributable to the single currency, or whether it would it have occurred regardless. Berger and Nitsch (2008) argue that the increase in trade within the Eurozone is simply a continuation of a long-run trend, probably linked to a broader set of EU economic integration policies. Of course, it is impossible to know for sure what the correct answer is. However, it is feasible to view the effects of leaving a currency union, and this can be used as a measure against which we can view the success of the monetary union. The following graphs from Glick and Rose show the impact of leaving a currency union on trade.



It is evident that in all but a few cases that leaving a currency union has a negative effect on trade with the former partner. Work done by Thom and Walsh (2002) focused on the dissolution of the currency union between Ireland and the UK in 1979, their results show that leaving the currency union had little effect on trade, explaining the initial dip as part of a business cycle. But from the other evidence compiled by Glick and Rose it seems obvious that the conclusions of Thom and Walsh cannot be generalised beyond the Irish–British case. Glick and Rose found that the exiting of a currency union has a bigger effect on trade than entering into one, so the graphs above do not offer a perfect counter factual to monetary union, but can be interpreted to show that when in a currency union, countries do trade more with each other. Although it should be noted that in the countries used for the study, all were small, poor, or both, so restraint should be used when applying the results to the EMU.

Taking a different approach, Nitsch and Pisu (2008) examined the trading activities of Belgian firms, to find out what effect the euro has had at the micro level. They found that the euro has raised the propensity of firms to export to countries in the euro area. Also, they found that the euro has increased the number of products that exporters ship to the euro area. This shows that the euro has resulted in trade creation rather than trade deflection.

Another area, in which far less work has been done, is the effect of the euro on trade in financial assets. The euro’s impact on trade in financial assets should be of interest because the euro may more directly affect transaction costs on financial markets than on goods markets, as it can be considered a direct engine of financial integration. Also, financial integration should generate gains in terms of allocation efficiency and risk diversification (Coeurdacier and Martin, 2007). The latter point is all the more important in the Eurozone where asymmetric shocks cannot be tackled using monetary policy. Coeurdacier and Martin (2007) estimate that the transaction costs to buy assets from the Eurozone are lower by around 17% for equity and 14% for bonds. This applies to countries that are in and outside of the Eurozone. In addition to these effects, the countries inside the Eurozone benefit by an extra 10% for equities and 17% for bonds. So for a country inside the Eurozone, the transaction cost for the cross-border purchase of a stock is lower by 27% and by 31% for a bond. The share of equity held by Eurozone members in other Eurozone countries has risen from 20% in 1999 to 40% in 2008.

The euro during the recession

The advantages of euro membership became obvious when the current economic crisis increased in intensity. Capital drained from currencies that investors saw as risky. That included countries such as Iceland, with bloated financial industries, as well as some eastern European states with current account deficits, large public borrowing or both. Euro area currencies with similar faults have been spared the currency crisis that plagued others. Ireland's guarantee of bank deposits and debt would seem unrealistic if it still managed its own currency.

Outside the Eurozone things don't look as good. Some people even have doubts about the wisdom of holding the British pound. Britain can be viewed as Ireland on a larger scale, but without Ireland's lifeline: its membership of a large and liquid currency pool. Denmark had to raise interest rates last October to keep its currency peg with the euro. Raising interest rates at this time is not a desirable option. The lessons of the crisis have not been lost on European countries that have yet to join. Even though joining can be a lengthy process, countries are aware that the next recession is only a boom away, and euro membership could prove worthwhile.

There are downsides in being in the Eurozone during a recession. When a country's wage costs rise too quickly, it can no longer recover competitiveness through a lower exchange rate. This is a concern for some countries because wages have become dangerously inflated. Portugal had a 27% increase in unit labour costs between 1999 and 2007, Greece a 28% increase, and Ireland a 33% increase; these are all well above the euro area average of 14% (OECD, 2008). The old remedy of a lower exchange rate is no longer available. In 1992, the last time there was a currency market crisis in Europe, both Britain and Italy were forced to devalue their currencies against other EU nations. Such an option is not available today, at least not to Italy. Nor is it an option to leave the euro, default on your euro debt and devalue. As soon as a Eurozone country started preparations for leaving the euro, a bank run would ensue, as people would seek to make an arbitrage gain once devaluation occurs. Borrowing costs would surely rise as well, as is the case for countries that have in the past defaulted.

2008 saw the Eurozone hit by an asymmetric shock, as different countries in the zone experienced different problems, but the monetary union emerged intact. 2009 is likely to see a symmetric shock, as Eurozone countries all deal with the same problems of GDP contraction and rising unemployment. This means that the ECB will react in a manner that is likely to suit all Eurozone countries, namely, cutting interest rates. Given that the euro survived the asymmetric shocks of 2008 its immediate future seems secure.

Conclusion

The euro is a one-of-a-kind concept. Never before has a currency changeover like it taken place. Therefore there is no yardstick against which to measure its success. The fact that the euro has survived its first ten years should be enough to deem it a success. And while not fully conclusive, most commentators believe it to have had a positive impact on intra-Eurozone trade. Trade between Eurozone members has increased 10-15% since its inception, and at least some of this must be attributed to the monetary union.

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