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## Economics focus

### The euro and trade

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#### The supposed benefits of monetary union are cut down to size

IN THE continuing controversies about Europe's bold experiment in monetary union, there has at least been some agreement about where the costs and benefits lie. The costs are macroeconomic, caused by forgoing the right to set interest rates to suit the specific economic conditions of a member state. The benefits are microeconomic, consisting of potential gains in trade and growth as the costs of changing currencies and exchange-rate uncertainty are removed.



In 2003, for example, Britain's Treasury ruled out membership because the country's economy had not yet converged sufficiently with that of the euro area to be able to live with interest rates set in Frankfurt. But it tossed a juicy bone to disappointed euro-enthusiasts with some salivating figures for possible gains in trade and growth from joining the club. In rather than out, Britain could enjoy a rise in trade with the euro area over 30 years of up to 50%, which would boost living standards by up to 9%.

A new study\* by Richard Baldwin, a trade economist at the Graduate Institute of International Studies in Geneva, scythes through these and earlier, even higher, estimates. He works out that the boost to trade within the euro area from the single currency is much smaller: between 5% and 15%, with a best estimate of 9%. Furthermore, the gain does not build up over time but has already occurred. And the three European Union countries that stayed out—Britain, Sweden and Denmark—have gained almost as much as founder members, since the single currency has raised their exports to the euro zone by 7%.

Interest in the potential trade gains from the euro was primed six years ago by a startling result from research into previous currency unions. In 2000 Andrew Rose, an economist at the University of California, Berkeley, reported that sharing a currency boosts trade by 235%. Such a number looked too big to be true. It clashed with earlier research that found exchange-rate volatility reduced trade only marginally. The dissolution in 1979 of the currency union between the Irish Republic and Britain seemed to have had no significant effect on their bilateral trade.

Despite such worries, researchers continued to find large trade effects from currency unions. Mr Baldwin explains why these estimates are unreliable. The main problem is that most of the countries involved are an odd bunch of small, poor economies that are in unions because of former colonial arrangements. Such is their diversity that it is impossible to model the full range of possible influences on their trade. But if some of the omitted factors are correlated with membership of a monetary union, the estimate of its impact on trade is exaggerated. And causality is also likely to run the other way: small, open economies, which would in any case trade heavily, are especially likely to share a currency. Much of the trade effect of monetary unions comes from a collapse in exports and imports when they dissolve. However, this can be caused by the imposition of tariffs by newly independent countries, civil disruption or war.

## A new theory is planted

The intractable difficulties in working out the trade effect from previous currency unions means that previous estimates are fatally flawed. But the euro has now been in existence since the start of 1999, with notes and coins circulating since January 2002, so there is an increasing body of evidence based on its experience. That has certainly highlighted the macroeconomic disadvantages for its 12 member states. The loss of monetary sovereignty has hobbled first Germany and, more recently, Italy.

Despite these drawbacks, some studies have pointed to a substantial increase in trade within the euro area arising from monetary union, for example by 20-25% in the first four years. As with the previous currency unions, however, many other explanatory influences might have come into play. Fortunately, unlike those earlier unions, there is a "control" group: the three countries that stayed out. This is particularly useful because they have shared other relevant aspects of membership of the EU, such as trade policy. It is on the basis of this that Mr Baldwin reaches his best estimate of a 9% increase in trade within the euro area because of monetary union.

As important, he establishes that the boost to trade did not occur, as expected, by lowering the transaction costs for trade within the euro area. Had it done so, the stimulus would have been a fall in the prices of goods traded between euro-zone members relative to those traded with countries outside the currency union. However, Mr Baldwin fails to find either this expected relative decline or the trade diversion it would have generated from the three countries that stayed out. He argues that another mechanism was at work. The introduction of the euro has in effect brought down the fixed cost of trading in the euro area. This has made it possible for companies selling products to just a few of the 12 member states to expand their market across more or all of them. This explains why the boost to trade has essentially been a one-off adjustment; and why countries that stayed out have benefited almost as much as those that joined.

The case for Britain adopting the euro is thus even weaker than was once thought. But there is also an important lesson for the 12 members of the euro area. Even if their economies were insufficiently aligned to be best suited for a currency union, one hope has been that the euro would make them converge as they trade much more intensively with one another. The message from Mr Baldwin's report is that this is too optimistic. Countries in the euro area will have to undertake more reforms, such as making their labour markets more flexible, if they are to make the best of life with a single monetary policy.

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\*"In or Out: Does it Matter? An Evidence-based Analysis of the Trade Effects of the Euro", Centre for Economic Policy Research.