Monetary Union and Obfuscated Protection in the European Union[1]

–first draft, comments most welcome –

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Abstract

In this paper, we analyze the effects of the Euro on trade and protection. To be more precise, we empirically test our theoretically developed argument that the increase of trade between the member states of currency unions should entail a rise in the demand for (industry-specific) protectionism. What is the rationale for this argument? With the advent of currency unions, import-competing producers find themselves in a more pronounced competition than before. Since the currency risk that used to be involved in buying goods from producers abroad disappears, the competitive position of national producers is weakened. To restore this position and to regain lost rents, national import-competing producers demand protection from the government as the main supplier of regulation. In turn, national governments, taking into account their political support functions, then decide upon the increase of protection within given bounds. In short, this seemingly counter-intuitive relation between currency unions and protection we hypothesize is the consequence of a shift from *natural* barriers to trade – such as exchange rate volatilities and transaction costs – to such *artificial* barriers as higher regulative standards, subsidies, or simply tariffs. With respect to Economic and Monetary Union in Europe, we econometricly analyze whether the single currency has to some extent only relocated and disguised the bumps instead of truly leveled the playing field for companies and businesses in Europe.

1. Introduction

Research on Economic and Monetary Union (EMU) as a natural experiment of a multi-country currency union has been plentiful within the last decade. Of the many outcomes of the introduction of the Euro as the European single currency, its impact on trade between EMU member states has been studied most extensively. The decision of European Union (EU) member states to form the EMU is usually seen as a step towards completion of the Single European Market and the long proposed level playing field for companies and businesses in Europe. Now, almost a decade on, we analyze the effects of the Euro on trade and protection. To be more precise, we empirically test our theoretically developed argument that the increase of trade between the member states of currency unions should entail a rise in the demand for and supply of (industry-specific) protection.

What is the rationale for this argument? With the advent of currency unions, import-competing producers find themselves in a more pronounced competition than before. Since the currency risk that used to be involved in buying goods from producers abroad disappears, the competitive position of national producers is weakened. To restore this position and to regain lost rents, national import-competing producers demand protection from the government as the main supplier of regulation. In turn, national governments, taking into account their political support functions, then decide upon the increase of protection within given bounds.

In short, this seemingly counter-intuitive relation between currency unions and protection that we hypothesize is the consequence of a shift from *natural* barriers to trade – such as

exchange rate volatilities and transaction costs – to such *artificial* barriers as higher regulative standards or subsidies. In our empirical analysis, we find some support for this theoretical claim. Controlling for other politico-institutional explanations brought forward in the literature on subsidies, we can show that being part of Euro land and higher import penetration does indeed go hand in hand with higher subsidies. However, the hypothesized positive interaction effect between imports and the Euro is not supported. In fact, we find a robust and negative conditional effect of import penetration on protection. In other words, EMU membership seems rather to decrease than increase the protectionist tendencies of European governments.

The paper is structured as follows. Following this introduction, we embed our argument in the broader literature on European Economic and Monetary Union in a *second* part, pointing out where we see our own contribution to this literature. In a *third* part, we develop our theoretical model, which leads us to the specification of two hypotheses about the interacted relation between exchange rate volatility/currency unions and trade on protectionist moves by governments. In our empirical *forth* part, we specify the indicators with whom we intend to measure our theoretical concepts before reporting the findings of some preliminary tests of our hypotheses in an IV framework. We conclude in a *fifth* and final part of this paper with a brief discussion of the results and their implications for currency unions, trade, and protection in general. In addition, we point to potential starting points for improvement on our empirical approach and future research.

2. Literature

What are the effects of currency unions on trade and protection? This research question of our paper can be placed within the context of two broader areas of research. *First*, ever since the ceremonious signing of the Maastricht Treaty on European Union (TEU) in 1992 and the successful launch of the single currency in 11 EU member states in 1999, scholars in international and comparative political science and economics have pondered upon the question which political and/or economic forces lead to the formation of the European currency union. This paper argues that, although political issues as well as economic reasoning cannot be fully neglected, the political economy perspective – in which special interests are key to understanding the decisions of policy makers – offers a theoretically and empirically crucial surplus. *Second*, and more innovative, our paper contributes to the research area, which links currency unions to increases in trade between their member states, by proposing that protectionist interests can hollow out the economic gains from the introduction of a single currency, even in the EU context. We employ a standard political economy model of protection (Grossman and Helpman 1994) and argue that current research on the trade effect of EMU does not adequately incorporate the topic of 'hidden' or 'obfuscated' protectionism.[2]

The following section provides a short overview over the research, which has been done so far in the two research areas mentioned above, before we introduce our own argument about the surge of rather subtle and artificial protection in Europe following the launch of the Euro.

[2] See Kono 2006 for a discussion of obfuscation in the context of trade policies.

2.1 The Causes of EMU

At least since the early to mid-1990s, numerous scholars in the fields of political science and economics have tried to uncover the mechanisms that would lead member states of the EU to give up their own currency and (formal) monetary policy autonomy to create the European Economic and Monetary Union. Various driving forces behind this decision have been analyzed, and several causes for this significant commitment to a common monetary policy have been hypothesized, tested, and confirmed or rejected by numerous studies.

In political science, arguments about functionalist spill-overs running from the Single European Market, the European Monetary System, and the liberalization of capital markets to the EMU are put forward (cf. Padoa-Schioppa 1994) alongside arguments about Franco-German *realpolitik* linking German reunification with the desire of the French government to further monetary integration. This latter perspective argues that the German decision to join the monetary union project and thereby giving up its own very strong position in the determination of European monetary policy was not made out of economic reasoning, but merely on political grounds (Garrett 1994, Woolley 1994). However, by exclusively focusing on political processes in the realm of inter-governmental decision-making, these approaches paint an incomplete picture of EMU formation.

Within the wider field of economics, there exist three lines of argumentation explaining European currency politics. The first argument centers on the optimum currency area (OCA) theory (Mundell 1961, McKinnon 1967). An OCA supposedly maximizes economic efficiency of the countries involved. In order for this to happen, the economies of a region in question for a currency union are supposed to be closely linked by trade in goods and

services and factor mobility. For most observers (Krugman and Obstfeld 2003, Eichengreen 1990, Wyplosz 2006), it is mostly the low labor mobility between European countries and the differences in manufacturing structures, which make the Euro zone not an OCA. However, now that OCA considerations in the formation of EMU have been largely refuted by empirical reality, disciples of OCA theory pose the question of whether the EMU area has slowly evolved since its initiation or will be transformed into an optimal currency area over time. Another line of argumentation – complementing the political *realpolitik* claims described above – stipulates that European governments wanted to credibly commit themselves to low inflation by permanently pegging their currencies to the DM. In other words, they wanted to 'import' German anti-inflationary credibility (Frieden 2002). Claims by Martin (2000) and Oatley (1997) go even a step further. They relate the steps towards EMU to efforts by European policy makers to get rid of myopic policies pushed by interest groups. Whether policy makers actually believed that they could overcome interest group pressure and had intentions to get rid of myopic policies by forming a currency union or not, we definitely challenge theoretically and empirically the idea that European monetary integration has or could have helped them achieve such a fatuous objective. In this paper, we strongly support the view presented in the next paragraph about the importance of interest groups for the decision-making of European governments on the EMU.

This third argument considers the *real* – as opposed to monetary – effects of currency unions on cross-border investment and trade (Frieden 2002). In this view, policy makers have to take political economy factors into account when deciding between exchange rate flexibility and stability. Policy makers have to consider the real distributional consequences and welfare effects of their decisions and weight them with the relative importance of those groups in

society that gain or lose from these decisions (Frieden 2002). This argument combines inter-governmental decision-making over macro-political outcomes with the influence and preferences of interest groups. Thus, we build on it when developing our own argument in the third part of this paper.

2.2 The Consequences of EMU… on Trade

Since the Euro has been launched on January 1, 1999, the scholarly debate has not so much been centered on the question of what lead to the Euro or whether the Euro could work for Europe, but instead on how well it has worked so far and what has happened to macroeconomic indicators, such as trade, investment, and inflation, in the wake of its introduction. Well then, did the Euro increase trade between member states by eliminating exchange rate volatility? From a theoretical point of view, exchange rate volatility introduces risk. Therefore, risk-averse ordinary traders reduce trade volumes if there are unexpected fluctuations in the exchange rate (Cheong et al. 2006). A currency union removes barriers to trade, thereby lowering the transaction costs of trade. In turn, this should lead to increases in trading activity between the member states of a currency union.

Previous empirical research on the effect of currency unions on trade has been dominated by Andrew Rose's (2000) finding that pairs of countries that are part of a monetary union have trade flows among themselves that are – on average – 100 % higher than those among pairs of countries that are not part of a monetary union. A large number of econometric studies has tried to replicate and expand on Rose's finding. Some of these studies confirmed those strong effects (Engel and Rose 2000, Frankel and Rose 2002, Alesina et al. 2002, Tenreyro

and Barro 2002).[3] However, other well-designed econometric studies searching for a trade effect of EMU have found much smaller (Micco et al. 2003, de Nardis and Vicarelli 2003) or no (Nitsch and Berger 2005) trade effects at all. Tenreyro and Barro (2003) were the first to elegantly solve the problem of endogeneity by specifying the probability of two countries pegging their exchange rate to the same anchor, and they still find a large, positive and significant effect of common currencies on trade. Taking these findings into account, we agree with the assumption that the establishment of a monetary union does come with an increase in trade, but wonder whether this effect may be temporal and short-lived or at least less pronounced when looking at the medium term (Mancini-Griffoli and Pauwels 2006). In fact, we argue that governments within the EMU member states have faced strong incentives to gradually, but still remarkably, increase the use of artificial methods to shield their non-competitive national producers from foreign competition since the introduction of the Euro, thereby lowering the initial beneficial effect of an increase in trade.

3. New Protectionism in €uro Land

Drawing on politico-economic research on redistributive politics, we assume that general policy decisions – such as the level of protection – are centralized in the hands of a survival-maximizing government that can be influenced by organized interest groups (Olson 1965, Persson and Tabellini 2002). Assuming that governments seek to maximize political support and following the pioneering work of George Stigler (1971), we argue that, first, the welfare that interest groups derive from a policy and, second, the deadweight loss that is imposed on society at large by this very policy are the crucial arguments entering incumbents political support function (Grossman and Helpman 2002).

3 See Rose 2003 for a survey of 19 studies on currency unions and trade.

To succeed in upcoming elections, politicians depend on campaign contributions, e.g. in the form of money. Organized interest groups can provide these political contributions, and this ability gives them a favored position in the eyes of governments (Grossman and Helpman 1994). In exchange for contributions, governments act as the suppliers of protection. Within the literature on the politico-economic determinants of trade policies, Grossman and Helpman's *protection-for-sale* model has gained prominence. It derives much of its beauty from the "relatively simple structure that yields clear-cut empirical predictions, and has been applied in a number of subsequent theoretical analyses" (Goldberg and Maggi 1997: 2).

We argue that two different contexts for lobbying or gaining political influence have been present *before* and *after* the start of Economic and Monetary Union. These differences are interconnected and have led to the distinct outcomes we expect to observe. And although we are mostly interested in explaining increased protectionism between the member countries of EMU after its initiation in this paper, in order to give a full explanation of the dynamics leading to this outcome, we have to begin with the formation of the union.

3.1 The Formation of EMU

Arguing along the lines of Frieden (2002) and Eichengreen (1993), we assume that politico-economic concerns of European decision-makers have played an important role. Looking at the *real* implication of monetary union on trade and investment ties, politicians weighted the costs and benefits for the society as a whole and were also exposed to lobbying from national producers. But, how do lobbying groups and governments interact within the

process of decision-making on such policy issues as fixed exchange rates and full monetary union?

We assume that the objective of politicians lies in the maximization of total political contributions from lobby groups and aggregate social welfare. Following Grossman and Helpman (1994), lobbying can be seen as a two-stage process. First, each organized interest group confronts the government with a contribution schedule, which translates each policy the government might chose (tariffs, subsidies, and other non-tariff barriers to trade) into a level of contribution given to the government. On the basis of these contribution schedules or 'menus', the government decides on a policy vector and collects the contributions from each lobby group accordingly. An equilibrium of such a common agency problem[4] (Bernheim and Winston 1986) is "a set of contribution schedules such that each lobby's schedule maximizes the aggregate utility of the lobby's members, taking as given the schedules of the other lobby groups" (Grossman and Helpman 1994: 836). Herein, the lobbies are aware that politicians ultimately set the policy according to their own welfare concerns. The protection-for-sale framework (Grossman and Helpman 1994) serves as a background on how we presume that the decision on monetary union was shaped by interest groups.[5]

[4] A common agency problem describes a situation in which "several principals simultaneously and independently attempt to influence a common agent" (Bernheim and Whinston 1986: 923).

[5] Here we consider only national level lobbying and decision-making. We are aware of the fact that a multitude of influences on the supranational and international level were also present. However, such a simplification serves our purposes in this paper and therefore we refrain from introducing a further, European level of the decision-making.

Given the outcome we have observed ex-post (i.e. Economic and Monetary Union) and assuming the above-mentioned influence of producers on policy-making, we would suppose that a majority of lobbying groups were in favor of EMU. Furthermore, we presume that rational forward-looking agents at the time of decision-making used the available information about these policies and the collective choice processes, which generated them, to forecast outcomes. However, considerable uncertainty about future policies is involved in such forward-looking decisions. The relation between policy formation and policy outcomes may thus be quite complex. So, when "information is incomplete […] dynamic feedbacks due to political uncertainty about the future significantly complicate the effects of current policy on outcomes" (Drazen 2000: 39).

In sum, the context in which decisions were made was one of great uncertainty about future outcomes. Repercussions on individual welfare and the distributional effects of EMU were not fully predictable. As the context changed and the effects of EMU kicked in, new lobbying coalitions were formed and – due to a situation of lock-in – other policies were asked for.

3.2 Counterintuitive Reactions to the Change in the Rules of the Game

Since 1999, Economic and Monetary Union has been a *fait accompli*. It has emerged as a new institution governing the monetary policies for the Euro area and, thereby, exerts a great influence on economic variables such as cross-border trade and investment. Along the lines of Grossman and Helpman (1994: 834), we argue that such a change in the "international rules of the game […] would affect government's willingness and ability to protect particular sectoral interests, but would not affect politicians' weighting of campaign contributions

relative to general voter dissatisfaction." We set out to investigate this institutional change (onset of monetary union) more closely in order to see how it influences equilibrium policies.

As briefly mentioned above, we assume further that special interest in favor of currency union no longer have to make their voices heard on this issue, since the participation of their countries in the EMU can essentially be considered as locked in. Leaving the Euro zone is supposed to be associated with high political and economic cost, and office-seeking governments will refrain from such costly action as long as possible.[6] Therefore, the groups that seek governments' support in this changed situation are those groups that have experienced a loss of competitiveness due to the new institutional arrangements.

Who are these groups? Who loses out from monetary union? According to theory, import-competing producers will feel the tougher winds of competition in particular. Therefore, they will be the ones demanding new forms of protection from increases in free trade (Anderson and Baldwin 1987). These assumptions about the demand for protection are also in line with empirical findings about the supply. For instance, Marvel and Ray (1983) find that protection is usually given to politically important industries and industries that are penetrated by imports. By contrast, healthy, competitive, and politically less relevant industries receive less protection.

[6] Although, time and again, there has been talk about the possibility that member states (especially Italy) might be forced to leave the European currency union (Economist 2006, Centre for European Reform 2006).

With the advent of EMU, import-competing producers in EMU member states have seen themselves in a more pronounced competition than before. As, for consumers, there is no longer a currency risk involved in buying the same goods and services from producers in a different Euro country, the competitive position of national producers is weakened. To restore this position and the lost rents, national producers are hypothesized to demand protection from the government as the supplier of regulation. National governments, in view of their political support functions, then may decide upon the level of protection within certain bounds. We therefore arrive at the following hypothesis:

Hypothesis 1: Governments of countries that face more intense import-competition provide – *ceteris paribus* – more protection.

The governments of EU member state cannot use standard tariff and non-tariff barriers (NTBs) to protect their import-competing industries, but exchange rate volatility has still effectively functioned as a stumbling block to free trade in Europe. With the introduction of the Euro, this stumbling block has been removed at least between the EMU members. Therefore, in the context of the EMU, there are two different starting points left to conceptualize ways to (successful) lobbying for and provision of protection.[7]

One way is to think of governments as bargain within the institutions of the European Union to 'legally' protect national import-competing companies through non-tariff barriers,

[7] A third way of successful lobbying would go directly through EU institutions. Although we are fully aware of the increased lobbying that takes place on the EU level (cf. Journal of European Public Policy special issue on lobbying in the EU, April 2007), for our theoretical argument the domestic arena still predominates as far as lobbying efforts of national producers are concerned.

such as the increase in regulative standards, which only their national producers meet. A second possibility is that governments use the little scope they dispose of to unilaterally protect national industries, e.g. via the provision of subsidies. In our paper, we shed some light on this second proposition, notwithstanding the relevance of the first. We, therefore, focus our second hypothesis on the provision of subsidies as a means to protection:

Hypothesis 2: The governments of the Euro area, which can no longer rely on natural barriers to trade for protection, revert to the provision of subsidies as an artificial and somewhat hidden means to achieve their protectionist objectives.

To rephrase this second hypothesis in other words, while we can expect all EMU members and import-competing countries to provide slightly higher state aid to their producers, we expect a particularly strong subsidies-increasing effect of import penetration for countries that are no longer protected by currency risk and the transaction costs that come with cross-boarder economic activity between countries with different currencies. Conditional on EMU membership, higher import-competition comes with higher subsidies.

The seemingly counter-intuitive relationship between EMU and protection is supposed to work through a shift from *natural* barriers to trade, such as exchange rate volatilities and transaction costs, to *artificial* barriers to trade, such as subsidies and also higher product standards. We thus claim that the Euro has only relocated and disguised the bumps instead of truly leveled the playing field for businesses in the EU. Before EU membership and the European currency union, national governments had different instruments to shield non-competitive producers from competition from abroad, e.g. by tariffs, quotas, and other

NTBs. Now, being part of the Single European Market and moving from quasi-flexible exchange rates to full monetary union make rigidities in domestic factor mobility, wages, and price behavior even more costly (Willett 2001), and, without the monetary policy instruments at their or their national central banks' disposal, decision-makers in non-competitive economies have to make their choice between painful structural reforms or support of the non-competitive parts of their economies.

In line with the standard political economy, we presume that politicians are interested in winning the next elections and are less worried about repercussions later on in their careers (Alesina and Tabellini 2004). Even if structural reform represents the avenue down which there is long-term competitiveness, if no visible improvement can be achieved in the short-term, myopic politicians are supposed to opt for alternatives that are effective in the short-term, but less effective in view of long-term goals. One such short-term instrument is the granting of subsidies to ailing producers, which are thereby protected from European market forces. Therefore, and repeating what we wrote above, we expect an increase in subsidies following EMU, conditional on the severity of the import penetration of national economies.

In this theoretical part of our paper, we have argued that Economic and Monetary Union might not have truly leveled the playing field for companies and businesses in the European Union, but led to other sorts of 'protectionism in disguise'. We claim that these erosions diminish the benefits from the European currency union as governments revert to short-term subsidies and state aid instead of allowing for full-scale structural reform where it is most dearly needed. Similar arguments about canceling out one barrier of trade for another

have been made before (e.g. Kono 2006, Lee and Swagel 1997). In their 1985 study about tariff- and NTB-levels in the United States, Canada, Japan, and the European Community, Ray and Marvel find that although tariff rates were low, NTBs were used to compensate industries affected by reduced tariffs (Lee and Swagel 1997: 373). Furthermore, Kono (2006) argues that the variation in complexity of trade policy instruments leads to differences in policy transparency, which then determine politicians' incentives to employ different forms of protection in democracies and non-democracies. Optimal obfuscation or protection in disguise (Kono 2006) within democracies leads to the empirically observable result that more democratic countries have lower tariffs, but higher quality barriers to trade, such as subsidies and product standards. A central implication for the understanding of trade policy, which derives from this finding, is that other determinants of trade policy can have asymmetric effects on different policy instruments, just like democracy. In line with this implication, we also argue that institutions – in our case the EMU – affect trade policy by "changing politicians' relative responsiveness to mass public and interest-group pressures" (Kono 2006: 382).

4. Analysis

Having made claims about the interaction of EMU and trade with respect to protection in Europe above, we now take our hypotheses to a first, rough, and preliminary empirical test. For this we use a panel data set on the EU 15 member states, except for Luxembourg, and the 16 years from 1990 to 2005. From these 14 European Union member states, Austria, Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, and Spain launched the Euro in 1999 and were joined by Greece in 2001, just in time for the introduction of the Euro coins and notes in 2002. Denmark, the United Kingdom, and

Sweden have resisted the temptation to become full members of EMU so far. The restriction of our analysis to those 14 EU member states is not only due to issues of data availability, but also because they form the least likely group of countries to implement any sort of protectionist measures. Not only are all custom duties and "charges having equivalent effects" (Article 23, Treaty Establishing the European Community) strictly prohibited on trade between the member states, but the same holds true for the main object of our analysis. Subsidies are prohibited if they, in any form whatsoever, distort or only threaten to distort competition in the EU by favoring certain undertakings (Article 87, Treaty Establishing the European Community). Therefore, if we find that the creation of the European currency union has indeed lead to an increase in the provision of state aid in countries affected by disproportionately high import penetration, we can be almost certain that we would find similar or even stronger backlashes to free trade in the rest of the world.

The restriction to the time period 1990-2005 is due to the lack of reliable data on our dependent variable before the 1990s. It measures all manufacturing subsidies or state aid, as they are known in the EU context, provided by a government to all sectors, except for subsidies to railroads, in any given year as a percentage of gross domestic product (GDP).

Our main covariates are a Euro dummy and a variable measuring yearly imports as a percentage of GDP plus the interaction effect between the two. To deal with the obvious problem of endogeneity with respect to imports, we instrument the yearly imports and the interaction variable with the excluded instruments GDP in constant 2000 million US$ and GDP per capita in constant 2000 US$. All these data come from the World Bank's World Development Indicators. In addition, we employ a time trend and three political control

variables (cf. Zahariadis 2002). These are the proportion of left government members, the number of veto players from Henisz's Political Constraints dataset, and a general election counter.

To test our hypothesis we estimated an IV or two-stage least square model. The regression results were generated using the statistics software package Intercooled Stata 9.2. We tested for first- and higher order serial correlation. None was found. Problems of heteroscedasticity were counteracted by the use of robust (Hubert/White) standard errors. As to unobserved heterogeneity, we decided against the use of fixed effects (cf. Plümper, Manow, and Tröger 2005).

Table 1: Imports, the Euro, and Subsidies

	Expected signs:	*Actual coefficients:*
Euro (lagged)	+	2.761** (1.31)
Imports in % of GDP (lagged)	+	0.0364* (0.020)
Euro * Imports in % of GDP (lagged)	+	-0.0687** (0.033)
Time trend	-	-0.0391** (0.020)
Political control variables:		
Left government members in % (lagged)	+	-0.00256* (0.0014)
Veto players (lagged)	+/-	-1.334 (1.06)
General election counter (lagged)	-	-0.0537 (0.043)
Constant		0.756 (0.51)
Observations		172
R-squared		.4154

Dependent variable is subsidies in % of GDP. IV regressions with two-tailed t-tests. Robust (Hubert/White) standard errors in parentheses. *** = p 0.01, ** = p < 0.05, * = p < 0.1.

Taking a look at our preliminary empirical findings in table 1, three things become obvious. First, and most importantly, even though the unconditional effects of the Euro and imports on subsidies are positive and significant, the interaction effect between the two independent variables has a negative sign. So, instead of providing significantly more state aid, EMU member states faced by tough import competition do in fact reduce their state aid to all sectors of the economy. Second, the negative and significant time trend coefficient attests that the overall level of subsidies has decreased over the last one and a half decades in Europe. Despite the protectionist activities of some of its member states, the EU has set a process towards a more open and more competitive Europe in motion. It might not have achieved its aim of a single market without any distortions to competition yet, but it is definitely on the right track. Last, but not least, the partisanship of the government seems to matter, when it comes to the provision of subsidies – however, other than expected, with governments dominated by left-wing parties actually being less generous in the distribution of their state aid. Veto players and approaching general elections, on the other hand, do not affect subsidies.

5. Conclusion and Outlook

Albeit with a different focus, our paper wants to contribute to the understanding of politico-economic processes that can distort the benefits from economically efficient institutions or policies. In this paper, we have argued that the creation of Economic and Monetary Union might not have leveled the playing field for companies and businesses in Europe, but created incentives for governments to compensate the losers from monetary integration, i.e. import-competing producers that are no longer protected from foreign competition by currency risk, with subsidies that function as new and artificial barriers to trade. Putting these claims

to the empirical test, we find mixed support for the argument. While import penetration and Euro area membership seem to go hand in hand with higher subsidies, the hypothesized positive conditional effect of monetary integration and imports is not supported by the data. In fact, we find a negative relation. Higher imports to GDP rather reduce than increase the provision of state aid in the Euro countries.

Given these mixed findings, it is not perfectly clear what the implications of our analysis are. We cannot go as far as to argue that currency unions lead to higher protective walls among their members, but it is also clear that creating a single currency is not a quick cure for the negative effects of rent-seeking interest groups, myopic policies, and office-seeking politicians that have short time horizons. Monetary integration does not suspend the domestic policy process, but it is an institutional change that affects "equilibrium policies *by endogenously changing the shape of the political-support function*" (Grossman and Helpman 1994: 834, emphasis in the original).

With respect to future research, especially the empirical part of our paper leaves us with a lot of room for improvement. We could look at sector specific data to identify exactly those sectors that are most severely hit by foreign competition and analyze whether they succeed in their lobbying for compensation from the government. This could be done both quantitative and qualitatively. In addition and in the EU context, we could go beyond subsidies and have a closer look at the bargaining and decision-making that goes on at the supranational level. Do some member states essentially protect their domestic producers by 'uploading' strict regulative standards from the national to the European level? Our analysis could also be taken to the rest of the world. What is the experience with currency unions or

dollarization and the demand for protection outside Europe? Also, what happens if we substitute our Euro dummy for more fine grained indicators of exchange rate volatility, and how is this volatility strategically used as a barrier to trade? Going beyond the EU would also allow us to concentrate on more traditional, i.e. tariffs and non-tariff barriers, but also alternative subtle protectionist measures in the WTO world. Last but not least, by looking at dyadic trade relations instead of country aggregates, we could also gain a finer grained picture of trade and protection. From this very brief discussion it should be obvious that there are several avenues for future research. Taking one of these paths, however, is not an empirical end in itself. Rather, it is the interestingness of the theoretical research question and the practical implications that should motivate us to further analyze the protectionist side effects of currency unions around the globe.

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