Currency Unions, Trade Flows, and Capital Flows

James Yetman
Hong Kong Institute for Monetary Research
The University of Hong Kong

September 2003

Summary

Trade within currency unions has been shown to be much larger than outside of currency unions, even after factoring in many relevant variables. The existing empirical evidence is based on reduced form models of trade, and therefore indicates that there exists a high correlation between currency union membership and trade, but does not indicate the causality, or the mechanism at work.

This paper argues that the balance of evidence points to a large and statistically significant causal relationship from currency unions to trade, and then considers two possible mechanisms behind this: (1) being a member of a currency union reduces trade resistance; and (2) being a member of a currency union reduces investment resistance. Based on a small theoretical model that incorporates both of these, we argue that both mechanisms are important in explaining the economic impact of currency union membership.