

Trade effects of monetary agreements: Evidence for OECD countries

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Abstract

This paper analyses the effects of monetary agreements on trade flows using a sample of 25 OECD countries over the period 1950–2004. We find that these agreements have boosted intra-bloc trade. This result especially applies to the case of the euro. More importantly, in contrast to regional trade agreements, all monetary agreements analysed show evidence of trade-creating effects with third countries. Finally, only the euro shows a symmetric impact for the trade-creating effect with non-members, that is, using the euro promotes both the Eurozone's exports and its imports to non-Eurozone markets to a similar extent.

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1. Introduction

The adverse consequences of the discriminatory trade practices in the 1930s convinced policy-makers that international monetary stability was necessary in order to promote trade. The Bretton Woods (BWs) system was created in 1944 to this end. Since the early

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1950s, there has been a special concern in Europe firstly for ensuring international payments and later about the potentially negative impact of exchange rate volatility on international trade. As a result, Western European countries have been involved in a variety of Monetary Agreements (henceforth MAs). In particular, the European Payments Union (EPU) was established under the auspices of the Marshall Plan to overcome problems of convertibility.¹ The collapse of the BW era in the early 1970s led European countries to create the European Monetary Snake (Snake), a regional version of the BW system designed to limit intra-European exchange rate fluctuations. As a result of the inability to maintain the Snake agreement, the European Monetary System (EMS) was launched in 1979 in another attempt to create a stable exchange-rate area. Finally, in 1999 the Economic and Monetary Union (EMU) came into force.

The steady steps followed by Western European countries over the past decades towards their monetary integration provide us with a unique opportunity to analyse the effects of different kinds of MAs on international trade. The aim of this paper is to investigate the impact of European monetary agreements on bilateral trade flows not only between member countries but also between members and non-members.

The effect of exchange rate volatility on trade has attracted extensive attention from international economic researchers. Empirical studies on the volatility-trade link have multiplied since the breakdown of the BW system. A related strand of literature investigates the impact of exchange rate regimes on trade. Additionally, much work in recent years has examined the relationship between currency unions and trade since Rose's path-breaking study in 2000, in which a common currency dummy was added to a gravity model of bilateral trade, as well as a variable for exchange rate volatility. Several papers on this issue have investigated the effect of the formation of EMU.²

Rose alone, or with his co-authors (see, e.g., [Rose and van Wincoop, 2001](#) or [Glick and Rose, 2002](#)), has found that currency unions strongly stimulate trade. Moreover, [Klein and Shambaugh \(2006\)](#) (henceforth KS) and [Lee and Shin \(2004\)](#) find that fixed exchange rate regimes also have a strong effect on trade, although smaller than that of currency unions. These studies, like many others, exploit large data sets including both developing as well as industrial countries and lump many MAs all together in a dummy. As a result, studies using a large set of highly heterogeneous countries and combining distinct currency unions or fixed exchange rate regimes may produce distorted results and mask specific impacts.³

In this paper we use a sample of 25 OECD countries. All countries in our sample have long been members of the two main international institutions, IMF and GATT/WTO, which look out for the best national and international practices for freeing trade. Moreover, some of them have also promoted regional agreements among a number of countries belonging to a particular region.⁴ Using a sample of OECD countries has two main advantages. First, as [Persson \(2001\)](#) and [Baldwin \(2006\)](#) point out, when estimating

¹After the World War II, trade among European nations was generally conducted on the basis of bilateral agreements, often involving barter. The EPU was a mechanism for multi-lateralizing bilateral agreements. The EPU was dissolved at the end of 1958 when EPU currencies were declared convertible.

²See Section 2 for a review of the literature about the trade effects of exchange rate volatility and currency unions.

³In fact, studies that have investigated the impact of the euro on trade also use smaller samples of industrial countries.

⁴A great number of studies have investigated whether regional agreements create or divert trade. Empirical evidence shows that regional trading agreements have usually been trade creating, especially in a world of "open

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