Trade Areas Versus Currency Agreements: Which Causes What to Economies?*

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The economics literature on the effects of currency agreements has recently documented extremely large effects of currency unions on bilateral trade intensity. On the other hand, the effect of currency agreements on the co-movement of price and output shocks is far from conclusive. This literature has taken into account the endogeneity of the currency union criteria while controlling for the presence of regional trade agreements. This paper argues that it is important to control for the endogeneity of currency *and* trade agreements simultaneously for two reasons: first, trade agreements can impact trade flows as well as price and output co-movements; second, the determinants of country participation in the trade and currency agreements may be related. This paper estimates the impact of currency and trade agreements in a new cross-country dataset, while fully taking into account the endogeneity of each indicator. In addition to the endogeneity issue, our paper differs from the literature in two other important ways: we use information only on relatively large economies, constituting the overwhelming fraction of world trade and output; we take a long-term view by computing all variables of interest as decade averages, from the 1970s to the 1990s. Our results show that instrumenting for currency or trade agreement indicators in isolation shows that either leads to larger bilateral trade flows, less export dissimilarity, and closer co-movement of output and real exchange rates. However, in specifications where *both* currency and trade agreements are instrumented for, currency agreements have an effect only on real exchange rate variability while trade agreements increase bilateral trade and the co-movement of output while decreasing export dissimilarity.

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