

Do Currency Unions Solve the Border Effect Puzzle? Evidence from the CFA Franc Zone

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Abstract

This paper deals with two controversial issues in international economics. The first one concerns the relationship between trade and monetary unions and is highlighted by Andrew Rose (2000). He shows that a fixed exchange rate has a negligible impact on trade, while a monetary union enhances trade by a factor of three. The second controversial issue relates to the so-called border effect puzzle, emphasized by McCallum (1995), who shows that a Canadian province trades about 20 times more with another province than with an American state of comparable size and distance. A potential explanation of the border effect puzzle stems from the existence of various currencies. Since a nation is by definition a monetary union, crossing borders implies the use of different currencies, entailing transaction costs and therefore impeding international trade.

In this paper, we try to answer two essential questions. First, does a common currency have an impact on trade? Second, does the existence of separate currencies explain part of the border effect?

To address these issues, we use the theoretical gravity equation derived by Anderson and van Wincoop (2003) and redefine the trade cost factor. Using bilateral trade data on 25 African and European countries from 1980 through 1999, we empirically test the relationship between currency unions and the border effect. The choice of West and Central Africa is relevant for our purpose, since it is the most long-lasting currency union experience and since there has been very little literature estimating the border effect for this particular zone. We find a positive impact of currency unions on trade, but the national border effect remains large even after controlling for the currency union effect.

Keywords : Currency Union, Gravity Equation, Border Effect
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