

Scientific Council for Government Policy

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**Bloc Formation, Fragmentation and
Stability in the World Economy**

J. Kol

The Hague, September 1995

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Note

Throughout this study the acronyms EC and EU have been used to indicate the European Economic Communities / European Community / European Union, institutions being operational consecutively during the period of investigation in this report. As a rule, the acronym EC is used in the analysis for the years up to 1990, the EU for the years thereafter.

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EXECUTIVE SUMMARY

Scope of Study

This report investigates tendencies towards integration and towards fragmentation in the world economy. This perspective has been chosen in view of the research programme of the Scientific Council for Government Policy to support decision making on a new design of foreign policy of the Netherlands.

The Scientific Council has underlined that international relations are increasingly dominated by economic factors and that this should be reflected in the recommendations regarding the Netherlands' foreign policy.

Within this framework the present study has been commissioned to report on major developments in the world economy. This study analyses in particular:

1. globalization of investment and production;
2. regionalization and bloc formation in world trade;
3. fragmentation of production processes and markets.

From the viewpoint of foreign policy, including security, the degree of stability in the world economy is of considerable importance. In this perspective the Scientific Council has chosen the analysis of integrating tendencies and fragmenting forces in the world economy as the guiding principle. This study reports on developments in the world economy from this perspective. The main findings are summarized below.

Globalization of Investment and Production

Globalization of investment and production represents the cross-border activities of firms in production, sourcing and marketing. *Empirical evidence on globalization* is that the outward stock of foreign direct investment (FDI) of the industrial countries rose from nearly 5 percent of their GDP in 1967 to over 8 percent recently. Furthermore, since 1986 the outflow of FDI from the industrial countries rose with 5 percent per annum, twice as fast as their *domestic* investment.

Globalization of investment and production proceeds with the extent of the market. Income growth and declining costs of transportation and communication expand the market. The expanding world market enables the fragmentation of production processes into separate parts, distributed across countries according to locational advantages. This type of international fragmentation is common in manufacturing and recently spreading into services.

Globalization of investment and production increases specialization and interdependence among national economies, and therefore represents a factor of integration in the world economy. In principle, the benefits of globalization extend to all countries involved. Evidence shows that increasing global competition and imports from low-wage countries are not important factors in the rise of unemployment in Western Europe. Indeed, unemployment cannot be addressed adequately by attempts to isolate the economy from international economic developments through protectionist and other measures.

Government policies are instrumental to the attractiveness as a host country for FDI. Political and economic stability, are of prime importance, next to infrastructural provisions in law, education, transport and communication. Trade related investment measures (TRIMs), such as local input requirements and export requirements and other policies may restrict inward FDI. From the perspective of international specialization and economic interdependence, it is a positive development that since the Uruguay Round TRIMs are dealt with multilaterally under GATT and WTO.

The Network of World Trade

In the period 1960-1992 the pattern of world trade changed considerably. The share of Japan in world trade rose from 3 to 8 percent, that of Asia and Oceania (except Japan) rose from 10 to 17 percent. The share of Central and Eastern Europe declined from 10 to 3 percent and of Africa from 4 to 2 percent. North America continued to hold a share of around 17 percent in world trade, while Western Europe continued to have by far the largest share (including intra-area trade) that even rose from 40 to 45 percent.

The network of trade relations in the world economy among the eight regions considered did not attain a substantially higher degree of cohesion in the period 1960-1992. In 1960 only 28 of the possible 63 trade relations attained a level of some importance with more than 0.5 percent of world trade, this figure having risen to 31 only by 1992. Throughout the period *Western Europe* entertained the maximum number of 14 important trade relations in the world network; *North America* has a second position with 9 such relations in 1992. For *Japan* this number increased from 4 in 1960 to 7 in 1992.

Foreign trade of *Africa* is concentrated on *Western Europe* for more than 50 percent, and after 1990 the same is true for *Central and Eastern Europe*. In contrast, by 1992 foreign trade of *Asia and Oceania* was evenly spread among *Western Europe*, *Japan* and *North America*. This is one of the main reasons why countries in *Asia and Oceania* favour an open multilateral trade system under GATT and WTO.

Bloc formation in world trade can be defined as the concentration of trade among countries bound by a formal agreement on economic cooperation.

With respect to the EU, the index measuring *bloc formation* in trade rose threefold in the period 1960-1992; for products related to the Common Agricultural Policy the index rose even twice as fast. For road vehicles the index doubled. In contrast, the corresponding figures for NAFTA were much lower and declining in the same period. The comparison between bloc formation in the EU and in NAFTA is made notwithstanding that the US-Canada free trade agreement is of much later date (1988) than the founding of the EC (1957). However, US-Canadian economic cooperation dates back from the previous century.

To evaluate these observed tendencies up to 1992, it is important to consider the policies designed and implemented by the potential trading blocs on economic relations in trade and investment with the outside world. In NAFTA and East Asia policy trends are towards liberalization and deregulation, internally but also externally. The same is true for the EU, where liberalization and deregulation are at the core of the

1992-programme. The supply of public utilities is opening up to competition, from within the EU and from outside.

In *conclusion*, the network of world trade has not decreased in cohesion. Bloc formation of trade with diminishing access from outside the bloc, is highly unlikely to develop in East Asia, is not born out by the evidence on NAFTA, and would contradict the rationale of the 1992-programme in the EU.

Globalization and Economic Coordination

Since the breakdown of the Bretton Woods system the International Monetary Fund has identified two other key structural changes in the international financial system:

1. the rapid expansion of *private* international financial markets; and
2. the removal of capital account restrictions in the industrial countries.

The *globalization of financial markets* has led to a more explicit international evaluation of the creditworthiness of individual countries. This in turn has led to an increased incentive for countries to adopt macro-economic and monetary policies appropriate from that perspective.

With respect to the EU the convergence of economic policies is strengthened furthermore by the conditions set for participating in the EMU.

At the same time, and in particular since the mid-1970s, specific developments in trade policy embody a tendency towards *fragmentation* of the world market. These developments include:

1. The use of *non-tariff barriers* (NTBs), such as quota, applied for instance against imports of textiles and clothing under the Multi Fibre Arrangements (MFAs). Quota and other NTBs, unlike tariffs, discontinue the functioning of the price system, and fragment the market.
2. The protection of the *agricultural sector*. The Common Agricultural Policy has led among others to increased self-sufficiency of the

EU in agricultural products. Similar developments elsewhere have led to an increased isolation of the agricultural sector from a world market.

3. *Bilateralism* in trade relations. This tendency is apparent from the excessive attention of the USA on its trade deficit with specific trade partners, especially Japan. The EU entertains a network of preferential trade agreements with specific countries and groups of countries, in the industrial world (with EFTA, succeeded by the European Economic Area), in Central and Eastern Europe (the Europe Agreements) and among developing countries (under Lomé Agreements, and with the Mashreq and the Maghreb). Bilateralism in trade relations undermines the multilateral trade system, based on the principle of non-discrimination, as embodied in GATT.
4. *Unilateralism* in trade relations. Section 301 of the 1974 US Trade Act and later provisions such as Super 301 and Special 301 allow the USA to take unilateral actions against policies of a particular country, deemed unfair or restrictive to US commerce. Thus, the rules for conducting foreign trade are decided upon unilaterally, leaving the system of multilaterally agreed rules weakened.

The above tendencies to fragmentation of the world market have been kept in check by the successful conclusions of the Uruguay Round in December 1993, or at least are given less leeway. Protection in the sectors of agriculture and of textiles and clothing are brought under GATT and its successor, the WTO. The agreement includes the tariffication of non-tariff barriers and the procedures for the settlement of disputes are strengthened.

Evaluation and Main Recommendations

Tendencies towards *integration* in the world economy are embodied in the activities of multinational firms, in the network of world trade and in economic cooperation among countries. Developments in direct foreign investment, the fragmentation of production processes across countries, and expanding trade relations all increase the interdependence among countries. Furthermore, the globalization of financial markets and

agreements on economic integration enhance the coordination of economic policies among nations.

Tendencies towards fragmentation in the world economy are represented by protection of the agricultural sector, by the use of non-tariff barriers to imports, by policies fending off direct foreign investment, and by undermining the multilateral system of world trade by focussing on bilateral trade and by setting rules unilaterally. Bloc formation in world trade with high protection against other blocs would represent another tendency to fragmentation. Such bloc formation was found unlikely to develop, given the policies of liberalization and deregulation underlying NAFTA and the 1992-programme of the EU. Furthermore, tendencies towards fragmentation will meet restrictions through the successful conclusion of the Uruguay Round.

On balance the tendencies towards integration in the world economy are found to outweigh the forces of fragmentation.

At present the Netherlands ranks eighth among countries in world trade and sixth in foreign direct investment. An open multilateral system of world trade and investment is of considerable importance for the Netherlands, as it is for the EU.

In this perspective, it is recommended, in general, that foreign policies of the Netherlands would support integration in the world economy and check tendencies towards fragmentation. More concretely, this can be achieved by supporting the GATT/WTO and its further development, strengthening the tendencies of liberalization and deregulation in the EU underlying the 1992-programme, and supporting the coordination of economic policies within the framework of the EU, the OECD and the UN.

LIST OF ABBREVIATIONS

AD	Anti-Dumping
AFR	Africa
AFTA	ASEAN Free-Trade Area
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of South-East Asian Nations
CAP	Common Agricultural Policy
CEE	Central and Eastern Europe
CEPT	Conference Européene des Postes et Télécommunications (European Conference of Postal and Telecommunications Administrations)
CER	Closer Economic Relations (between Australia and New Zealand)
CMEA	Council of Mutual Economic Assistance (COMECON)
CU	Customs Union
CVD	Countervailing Duties
DC	Developed Country
EC	European Community
EEA	European Economic Area
EEC	European Economic Communities
EFTA	European Free-Trade Agreement
EMU	European Monetary Union
EU	European Union
FDI	Foreign Direct Investment
FTA	Free-Trade Agreement/Area
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
GSP	Generalized System of Preferences
IMF	International Monetary Fund
ITU	International Telecommunication Union
JPN	Japan
LA	Latin America
LDC	Less Developed Country
MFA	Multi-Fibre Arrangement
MFN	Most-Favoured-Nation

MNE	Multinational Enterprise
NA	North America
NAFTA	North American Free-Trade Agreement
NIC	Newly Industrializing Country
NIE	Newly Industrializing Economy
NTM	Non-Tariff Measure
OECD	Organization for Economic Cooperation and Development
R&D	Research and Development
ROW	Rest of the World
RTA	Regional Trade Agreement
SITC	Standard International Trade Classification
TNC	Transnational Corporation
TRIM	Trade Related Investment Measure
TSC	Transnational Service Corporation
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
UPU	Universal Postal Union
US(A)	United States (of America)
USSR	Union of Socialist Soviet Republics
USTR	United States Trade Representative
VER	Voluntary Export Restraint
WE	Western Europe
WRR	Wetenschappelijke Raad voor het Regeringsbeleid (Scientific Council for Government Policy)
WTO	World Trade Organization

1. INTRODUCTION

1.1 Scope of Study

In 1995 the Government of the Netherlands is considering a new design of its foreign policy. To support decision making the Scientific Council for Government Policy (WRR) ¹ is engaged in the preparation of a number of studies; the entire project has been labelled 'Security and stability in Europe' ² and comprises three main areas:

1. defense and security;
2. foreign economic relations;
3. other areas of foreign policy.

The WRR underlines that international relations are increasingly dominated by economic factors and that this observation should be reflected in the recommendations for a reconsideration of foreign policy of the Netherlands.

Within this framework the present study has been commissioned to report on major developments in the world economy. This study analyses in particular:

1. Regionalization and bloc formation in the world economy;
2. Globalization of investment and production;
3. Fragmentation of production processes and markets;
4. Strategic trade policies;
5. The level of decision making.

Developments in the world economy can be interpreted from various perspectives. To illustrate, such perspectives may include:

- the activities of transnational corporations, including strategies for marketing and cooperation;
- international economic development, including intercountry differences in prosperity and economic growth;

¹ WRR stands for 'Wetenschappelijke Raad voor het Regeringsbeleid', the Scientific Council for Government Policy.

² WRR, *Veiligheid en stabiliteit in Europa*, Rapporten aan de Regering nr. 48, 's-Gravenhage, Sdu Uitgeverij, 1995.

- sustainability of economic development, including interrelationships between economic growth, the use of energy, and the preservation of the environment.

Given the variety of possible perspectives the WRR has chosen a particular perspective as a 'constituting principle', namely the presence and significance of 'fragmenting forces' and of 'integrating forces' in international relations. Obviously, this perspective has been chosen by the WRR in view of the process of reconsidering foreign policy of the Netherlands in general, that is including security as well as economic relations. A survey and an analysis of economic forces of integration and of fragmentation and their effects on the world economy, are particularly relevant from the viewpoint of international stability.

As a consequence the present study will analyze the five topics mentioned above from the same perspective, namely that of *integration and fragmentation in the world economy*. The next section will present more detail on the content of each of the five issues.

1.2 Content of the Study

Bloc formation in world trade is the subject of *Chapter 2*. In the 19th century the conclusion of a free-trade agreement became controversial as the preferential treatment involved would violate the principle of most-favoured-nation treatment, that was generally accepted as the main principle to govern international economic relations. It is reviewed briefly how this controversy was solved (section 2.1). Likewise, any agreement on economic integration with limited membership is a departure from the principle of non-discrimination, ruling international trade relations since the second World War, under GATT. An overview of GATT legislation and its interpretation is presented (section 2.2). More in general, there is a fear that regionalization of world trade poses a threat to the multilateral trade system. In this respect the successful conclusion of the Uruguay Round in December 1993 is of importance (section 2.3). The OECD has investigated bloc formation in world trade in the period 1961-1989 for the four main regional trade agreements in the OECD area (section 2.4). Recently various studies have been made regard-

ing the question whether a trading bloc in East Asia is emerging, of which the main findings are reviewed (section 2.5). Empirical investigations regarding regionalization in world trade benefit from a clear conceptual distinction between bloc formation, regionalization and polarization in international trade (section 2.6). As an introduction to the empirical analysis the network of world trade is investigated first, presenting an overview of the main trade flows in the world economy and their development over time since 1960 (section 2.7). Tendencies toward possible concentrations in world trade are investigated next, covering the period 1960-1992. Investigated are polarization in world trade (section 2.8), regionalization in world trade (section 2.9), and bloc formation in world trade (section 2.10). A policy evaluation of the main findings concludes the chapter (section 2.11).

The globalization of investment and production is the subject of *Chapter 3*. The phenomenon is approached from the perspective of Adam Smith's basic insight about the division of labour, which process is limited by the extent of the market (section 3.1). The extent of the market enabling the division of labour or specialization can be enhanced by a variety of factors; the role of technology in transportation and communication is dealt with in particular (section 3.2). One of the main vehicles of globalization is foreign direct investment (FDI), of which the general trends and characteristics are presented (section 3.3), its country distribution (section 3.4) and its sectoral composition (section 3.5). The major factors explaining international production are reviewed with specific attention to locational factors (section 3.6). The relationship between FDI and trade is another important aspect of the process of globalization. This relationship however is not straightforward but rather complicated, in which commercial policies and trade related investment measures play a role as well (section 3.7). The consequences of globalization for employment in the OECD and in Western Europe in particular are investigated next (section 3.8).

The recent concentration of international trade of the countries in Central and Eastern Europe on Western Europe renders this economic relationship of specific interest within the context of this study. In this perspective an overview is presented of recent economic developments

in Central and Eastern Europe (CEE), including international trade, investment and policies in these areas both in the CEE countries as well as in the EU (section 3.9).

Recently, also the financial markets have become more internationalized. Various aspects of this process of globalization of financial markets and its implications for economic policy coordination are presented (section 3.10).

The chapter concludes with a general description of the likely consequences of globalization on economic policies of the countries participating in this process (section 3.11).

Fragmentation in the world economy is the subject of *Chapter 4*. Two major aspects are considered: the fragmentation of production processes and the fragmentation of markets induced by recent measures of trade policies. An increasing extent of the market will also lead to increasing specialization among firms. This specialization may take different forms, one of which is the fragmentation of a particular production process into separate industrial operations, which may be distributed among countries allowing less compromise in the exploitation of locational advantages (section 4.1). Illustrations of this process are given for the industries of textiles and clothing, electronics, and services (section 4.2).

Recent trade policy measures tend to fragment the world market into bilateral trade relationships; examples are the rise of unilateralism in US legislation and anti-dumping procedures adopted by the EU in particular (section 4.3). Fragmentation of the world market may also rise from a tendency to bilateral balancing of a country's foreign trade; this phenomenon was studied in particular by the League of Nations in the 1930s (section 4.4).

Securing the production in high-technology sectors for the domestic economy by means of a strategic trade policy is the subject of *Chapter 5*. Traditional trade theories underlining the mutual benefits of international trade are briefly reviewed first (section 5.1). Including the elements of economies of scale and imperfect competition, the new

international economics provide a case for a strategic trade policy which is correct in theory, the implementation of which in practice, however, is beset with problems (section 5.2). In this context, the case of Airbus is analyzed in particular (section 5.3). In addition, the scope for a national strategic trade policy is greatly reduced from the viewpoint of economic integration (section 5.4).

A major determinant of the balance between integrating and fragmenting forces in the world economy derives from the choice of the level of decision making. This is the subject of *Chapter 6*. The case for the choice of a proper level of decision making in accordance with the globalization of production is discussed first (section 6.1). The criteria for this choice also in connection with the discussion on subsidiarity in the EU are presented next (section 6.2). Some refinements are presented as well as the role of democratic control (section 6.3). The criteria are applied to the functioning of concrete institutions subsequently (section 6.4). An evaluation of the main findings concludes the chapter (section 6.5).

Chapter 7 gives an overview of the main findings of this study and, based on these, presents recommendations with respect to government policies.

2. REGIONALIZATION IN WORLD TRADE

2.1 The Customs Union Issue

Long before the beginning of the 19th century the principle of most-favoured-nation (MFN) treatment had been accepted as a general principle which should govern international economic relations (Viner, 1950). The MFN-principle stipulates that a country, A, that is obliged by treaty to give MFN-treatment to another country, B, must admit imports from B on as favourable terms as it admits similar imports from a third country, C.

As a consequence, in case country A had concluded a MFN-treaty with country B, a customs union between countries A and C, would violate the MFN-treaty between countries A and B. The 19th century is full of conflicts in international economic diplomacy on this issue³. For instance, upon the conclusion of a new constitution of the Zollverein among German states in 1867, the French emperor, Napoleon III, claimed on the basis of the MFN-clause in the French-Prussian commercial treaty of 1865 that French products should have free entry into Prussia. The French claim was denied however (Henderson, 1939).

The apparent incompatibility of the conclusion of a customs union with an existing MFN-treaty with a third country, was solved by the acceptance of customs unions provided they were complete, or in other words, would act as a single entity in their relations with outside states (Ito, 1930). The result was that customs unions were promoted where otherwise less complete forms of preferential arrangements would have been chosen.

In the 20th century, the League of Nations followed this point of view and urged repeatedly the general acceptance of compatibility between customs unions and MFN-obligations. In 1933 the Economic Committee of the League of Nations suggested a model for an MFN-clause by which the founding of a complete customs union was exempted⁴.

³ An overview is given in Chapter 2 of Viner (1950).

⁴ League of Nations (1933).

2.2 Economic Integration and the GATT

During the 20th century the principle of most-favoured-nation (MFN) obligation has been replaced by the more powerful principle of non-discrimination, in ruling international relations in trade. The principle of non-discrimination provides the main foundation on which the GATT construction is built ⁵.

By their nature, any form of economic integration among a select group of countries discriminates against external imports and thus violates, in principle, the GATT rule of non-discrimination.

The GATT has dealt with the issue of economic integration in the following way. The GATT permits departures from the non-discrimination principle for the formation of Customs Unions (CUs) and Free-Trade Areas (FTAs) and therefore sanctions preferential trade barrier reductions among a subset of GATT members as long as they eliminate barriers for 'substantially all trade'.

As described in Article XXIV, paragraph 8 and 9 (GATT, 1994b):

8. (a) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that:
- (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and
 - (ii) subject to the provisions of paragraph 9, substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union.

⁵ Contrary to popular belief, the GATT is foremost not on free trade but on non-discrimination in international economic relations. The reason is that only a multilateral setting of rules, rather than a bilateral or a unilateral setting of rules, would ensure the openness of the market among the contracting parties as far as possible, thus enhancing the prospects for specialization and its economic benefits.

(b) A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories.

9. The preferences referred to in paragraph 2 of Article I shall not be affected by the formation of a customs union or of a free-trade area but may be eliminated or adjusted by means of negotiations with contracting parties affected⁶. This procedure of negotiations with affected contracting parties shall, in particular, apply to the elimination of preferences required to conform with the provisions of paragraph 8(a)(i) and paragraph 8(b).

According to Bhagwati (1992b), the rationale for inclusion of Article XXIV in the GATT appears to be threefold:

- Full integration of trade among any subset of GATT members would have to be allowed since it created an important element of single-nation characteristics (such as virtual freedom of trade and factor movements) among these nations.
- The fact that the exception would be permitted only for the extremely difficult case where all trade barriers would need to come down, seemed to prevent the possibility that all kinds of preferential arrangements would come into existence.
- Article XXIV acknowledged that such arrangements could provide a complementary, practical route to universal free trade, which was seen as the ultimate goal. The general negotiations of the many Rounds would lead to a dismantling of trade barriers on a GATT-wide basis, while simultaneously a deeper integration would be achieved within those areas where politics permitted faster movement to free trade under a strategy of full and time-bound commitment.

The clear determination that only integration schemes with 100 percent preferences were compatible with multilateralism and non-discrimination, and the equally firm view that anything less was not, meant that when

⁶ It is understood that the provisions of Article I would require that, when a product which has been imported into the territory of a customs union or free-trade area at a preferential rate of duty is re-exported to the territory of another member of such union or area, the latter member should collect a duty equal to the difference between the duty already paid and any higher duty that would be payable if the product were being imported directly into its territory.

Article XXIV was drafted, its main objective was to close all possible loopholes by which it would degenerate into a justification for less than 100 percent preferential arrangements (Bhagwati, 1990).

In practice, the discipline of Article XXIV has fallen into disuse since the notification of the formation of the EC, which was not contested in large part due to US interest in fostering a stronger and more united Western Europe. With most GATT members involved in some form of preferential trading arrangement, members have tended to refrain from forcefully criticizing regional trading arrangements.

Actually, of the 70 regional trading arrangements (including amendments to existing arrangements) notified during 1948-1990 and examined by the GATT working parties, only four were deemed by consensus to be compatible with Article XXIV. These four cases were:

1. the South Africa-Rhodesia Customs Union (1948);
2. the Nicaragua-El Salvador Free-Trade Agreement (1951);
3. Nicaragua's participation in the Central American Common Market (1958); and
4. the Caribbean Common Market (1973).

However, none of the 70 agreements, such as the EC or the EFTA, notified to the GATT, has been formally declared incompatible with Article XXIV (de la Torre and Kelly, 1992).

Bhagwati (1990) demonstrates the weakened position of Article XXIV with two examples. First, the elimination of 'duties and other restrictive regulations of commerce' with respect to 'substantially all the trade between the constituent territories' was ambiguous. Issues as whether across the board cuts on all trade were required or whether substantial sectors could be left out altogether from the scope of the cuts were areas of discussions. With both interpretations possible, less than 100 percent preferential arrangements could not be effectively ruled out. The second ambiguity was the problem of the speed with which the 100 percent preferences should be implemented. Article XXIV states that a customs union or free-trade area should be fully consummated within a reasonable length of time, which left room for laxity in conception and execution of the CUs and FTAs under Article XXIV (Bhagwati, 1990).

The implementation of the provisions of Article XXIV was further weakened by the 1979 Enabling Clause. Under this clause, arrangements that were exclusively among developing countries could bypass Article XXIV altogether, unless the arrangements contemplate the selective removal of non-tariff barriers, in which case approval by other GATT members is required. The Enabling Clause is thus substantially less demanding than Article XXIV in terms of notification and consultation, 'substantially all trade' requirements, and the timeframe for implementation of intra-regional trade liberalization (de la Torre and Kelly, 1992).

2.3 Regionalism and the Multilateral Trade System

The impression is that regional economic integration is fragmenting the world economy into three internally coherent trading blocs: in the Americas, in Europe and around the Pacific. Empirical evidence however indicates that an increasing focus on internal trade is only a clear tendency in the EU, not so much in the NAFTA countries and certainly not in the Pacific area (Schott, 1991).

The threat to the multilateral trade system from regionalism would only arise if economic liberalization within the region would be complemented with increasing protectionism against the other trading blocs.

Of course the successful conclusion of the Uruguay Round in 1993 will not keep in check completely the tendencies towards bilateralism and regionalism, but certainly these tendencies would have had more leeway, had the Uruguay Round failed. In this respect the clarification, streamlining and strengthening of GATT rules and dispute settlements is of great importance. In addition, the agreement on the establishment of the new World Trade Organization (WTO) represents a commitment of all contracting parties to the multilateral setting of rules of conduct in international trade and investment.

2.4 Bloc Formation in Four Free-Trade Areas: 1961-1989

Lloyd (1992) investigated in particular whether a tendency towards bloc formation could be found among four important regional trade agreements (RTAs) in the world economy:

1. EC (the European Community) ⁷;
2. NAFTA (including Canada and the USA) ⁸;
3. EFTA;
4. CER (including Australia and New Zealand) ⁹.

The EC includes the original EC-6, the later EC-12 and the EC-ASAT, reflecting the group of countries 'as at' the time of investigation. The EFTA includes the EFTA-6 and the EFTA-ASAT, reflecting the group of countries 'as at' the time of investigation ¹⁰.

The measure of regional concentration of trade used (Lloyd, 1992) is the share of intra-group imports in total imports of the group in the commodities concerned. The intra-group share is the measure commonly used as an indicator of regionalization.

The intra-group shares of RTA group trade are reported in Figure 2.1. Consider first the EC, EFTA and CER as these three groups have experienced substantial intra-group trade liberalization over the whole period in the case of the EC and EFTA and since 1965 in the case of CER. The EC and EFTA have had changing membership over the period. For the EC, the most useful definition of the group here is *original* membership - referred to as EC-6 - as they have been in the group for the whole period. For EFTA, the most useful definition is the original eight (including

⁷ The period of investigation includes the years up to 1989; for this reason the acronym EC is retained.

⁸ The North American Free-Trade Agreement between Canada and the USA was formally concluded in 1987 and took effect on January 1, 1989. Earlier free-trade arrangements between these two countries existed. For ease of reference the various schemes of economic cooperation between Canada and the USA are referred to as NAFTA.

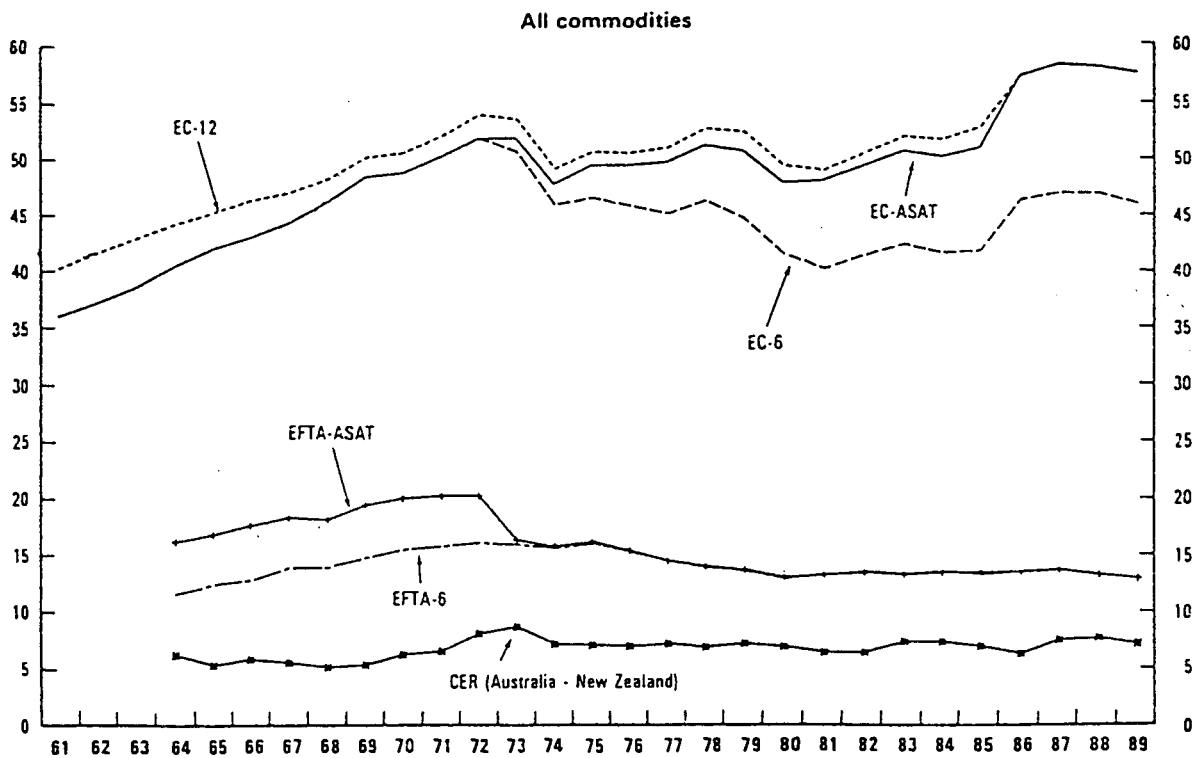
⁹ CER stands for Closer Economic Relations (between Australia and New Zealand).

¹⁰ EFTA-6 includes Austria, Finland, Iceland, Norway, Sweden and Switzerland.

Finland) plus Iceland less the United Kingdom, Denmark and Portugal which have joined the EC. This group will be called the EFTA-6.

For all merchandise commodities Figure 2.1 shows an upward trend in the intra-group share for the EC-6 in the 1960s and early 1970s following the Treaty of Rome, and in the CER. In EFTA-6 the trend is upward until the early 1970s and then downwards.

Figure 2.1 Intra-area imports as share of total group imports (EC, EFTA, CER)



Source: Lloyd (1992)

The peaking of EC-6 and EFTA-6 intra-group import shares around the time the United Kingdom and Denmark moved from EFTA to the EC could be the

result of the original formation of the EC and EFTA with the effect of the new members reducing the intra-EC-6 group. Alternatively, the decline in shares after the early 1970s could be the result of global freeing of trade and/or the declining competitiveness in some industries. To cancel the effects of the shift of members between EFTA and EC, the shares were also considered for the group of EC-12 throughout the period. This shows an upward trend for all commodities in the intra-EC-12 import shares but it is stronger in the period up to 1973, suggesting that both the change in membership of the EC and EFTA and the decline in competitiveness contributed to the later fall in these shares.

Lloyd (1992) concludes that there is only weak evidence that the intra-group shares of total group imports for the four RTAs considered have increased over the last 30 years, and that the increase applies in particular to the years immediately following the agreements.

An important factor that may explain the contradiction between the expected increase in intra-group import shares and the observed trends for the OECD RTAs is the countervailing influence of multilateral and unilateral reductions in trade barriers. This non-regional liberalization may be greater than commonly believed (Lloyd, 1992).

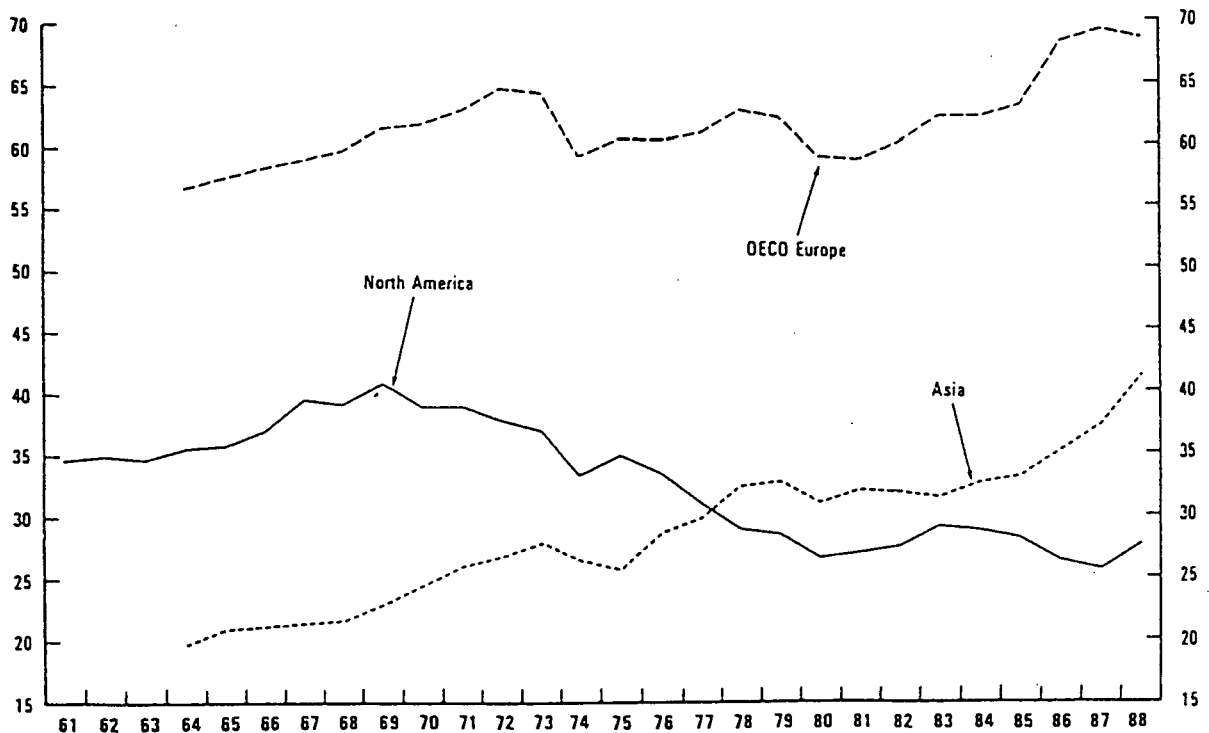
Lloyd (1992) continues his analysis by considering the question of a tripolar view of the world, with the USA, Japan and the EC representing the three poles.

The hypothesis that the world is becoming more polarized in terms of trade flows is tested in the same manner as the RTA version of the regionalization view of the world was examined.

The intra-area import shares as a measure of the concentration of trade within these areas are reported in Figure 2.2. For OECD Europe, this measure has tended to increase throughout the period, from 56.4 percent in 1964 to a peak of 69 percent in 1987. For North America, this share is much lower and has fallen from a peak of 40.5 percent in 1969 to only 27.5 percent in 1988. For Asia, the intra-region share roughly doubled between 1964 and 1988 from 20 to 41 percent. However, this is primarily

due to the fact that the total (import) trade of countries in the region has grown faster than trade in other countries and not to regionally discriminatory trade policies as there has been much less trade discrimination in the Asian region than in Europe and North America. If there were no changes in trade policies and competitiveness, faster growth within a region would itself increase the share of intra-area trade, even if the shares of export markets were constant.

Figure 2.2 Intra-area imports as share of total imports (OECD Europe, North America, Asia)



Source: Lloyd (1992).

Thus, one may conclude from the evidence in Figure 2.2 that there is a tendency for world trade to become more regionalized in terms of broadly defined regions as Western Europe and Asia have tended to trade increasingly within their own area. However, the changes in the Asian region at least are not attributable to discriminatory trade policies.

One feature of the more broadly defined regions is the change in the definitions of the broad groups themselves. Since 1960 several major groupings have collapsed and disappeared. These include the Sterling Area countries, the system of British Imperial (later British Commonwealth) Preferences and most recently the CMEA. These collapses were associated with the decline of the polar power in the grouping, namely, the United Kingdom and the USSR, respectively. Similar, some RTA groupings in Africa and the Caribbean have collapsed or merged with others. This long-term instability in groupings reinforces the conclusion that there is no clear polarization of the world economy.

Lloyd (1992) concludes that the numbers of both RTAs and the countries which are members of them have been growing steadily. The extent of the intra-area liberalization of trade barriers has also increased for both tariffs and non-tariff measures alike. Some RTAs are now addressing non-border measures which distort intra-area production and trade and harmonizing other policies which affect trade. The second generation of RTAs among the OECD members (EC, CER and Canada-United States FTA) are evolving towards the achievement of single markets with completely free access and a greater degree of coordination of policies within the arrangements (Lloyd, 1992).

The question of regionalization is sometimes put in terms of the growing importance of more broadly defined regions. Currently this view is in terms of the groups around three poles, the United States, Japan and the EC. There has been a tendency for world trade to become more regionalized in the OECD Europe and Asian regions but in the case of Asia this cannot be attributable to discriminatory trade policies.

There is a current spate of new arrangements and a number of prospective candidates for future RTAs are being considered. There may, therefore, be a greater danger of regionalization in the future. The United States in particular has abandoned its historical opposition to new discriminatory arrangements. Many of these current proposals are defensive, showing a concern over the dangers of trade conflicts and seeking economic security from largeness. The attractiveness of regional arrangements will depend

significantly upon the outcome of the Uruguay Round and the future of the GATT-based system (Lloyd, 1992).

2.5 The Possibility of a Trading Bloc in East Asia

Recently several studies have been made investigating whether a trading bloc is emerging in East Asia.

Schott (1991) defines a trading bloc as an association of countries that reduces intra-regional barriers to trade in commodities. Regarding developments in East Asia, Schott (1991) observes that during the 1980s the region's total trade more than doubled; much of the growth was generated by sales to the North American market. Because of the strong growth in exports to third countries, East Asia has been the only region in which the relative share of intra-regional trade to total exports remained basically the same in the 1980s, fluctuating from 34 percent in 1980 to 28 percent in 1986 and back to 35 percent in 1989. Its focus has been primarily outward-oriented, particularly to the US market on which most of the countries in the region are highly dependent.

The concept of a potential East Asian trading bloc has been advanced in two somewhat related forms. Some see such a bloc emerging because the countries of the region seem to be coalescing around the region's dominant economy, Japan. Others regard the growing interest in Pacific Basin initiatives as the catalyst for a new trading bloc, with the United States and Japan at the core (so that the United States blocks Japanese economic dominance in the region). Prospects for each are discussed below.

Japanese trade and investment in East Asia has grown dramatically over the past decade, but so has Japanese trade and investment in North America and Europe. Japanese trade with North America has been larger, and grown faster, than trade with East Asian countries (excluding the People's Republic of China) during the 1980s. Japanese trade with East Asian countries rose from 25 to 29 percent of total Japanese trade during the 1980s; however, trade with North America rose from 24 to 32 percent (after peaking at 34.8 percent in 1987). In addition, the EC share of

total Japanese trade almost doubled to 17 percent during the same period (Schott, 1991).

Japanese foreign direct investment (FDI) in East Asia has shown similar growth in recent years, albeit from a relatively low base. Outward investment to that region quadrupled from 2 billion to 8.2 billion US dollars during the period 1985 through 1988, matching the growth rate of overall Japanese FDI in North America. However, more money was invested in Europe during this period, a cumulative total of 21.1 billion US dollars in Europe versus 19.8 billion US dollars in East Asia (including the People's Republic of China).

Unlike the trade flows, FDI in East Asia accounts for only a small share of cumulative Japanese FDI. As of 31 March 1989, the East Asian region (including the People's Republic of China) accounted for only 22.3 percent of cumulative Japanese FDI, compared to 40.3 percent for North America and 16.2 percent for Europe.

The trade and investment data point to a growing internationalization of the Japanese economy, but not with the East Asian region alone or with East Asia more than other regions. The United States remains the primary focus for Japanese trade and investment, and Europe - especially since the advent of the 1992 process - has become an increasingly important market. Japanese trade with the EC almost tripled from 1985 to 1989 (albeit from a lower base than trade with East Asia and North America), and more than half of Japan's cumulative 30 billion US dollars in FDI in Europe took place in 1987-88 (Schott, 1991).

Could the Asia Pacific Economic Cooperation (APEC) initiative lead over the medium term to the evolution of a regional trading bloc? A combination of economic and political factors argues to the contrary (Schott, 1991).

First, the countries in the Pacific Basin (as defined by the APEC membership) are widely dispersed geographically and have diverse levels of economic development. Distances between markets in the region are quite large, even if one excludes the North American countries. Per

capita incomes range from poor (Indonesia and the Philippines) to modern (Korea) to comfortable (Australia, Hong Kong, Singapore and New Zealand) to wealthy (United States, Canada and Japan). Integrating such a diverse and expansive region would pose enormous physical and adjustment problems.

Second, trade policies and regulatory regimes differ markedly from country to country, and there seems to be little political commitment to an evolving regional organization. For example, the ASEAN countries have long been wary of economic arrangements in the region to the extent that, after twenty years, they have not yet even established a free-trade area among themselves. It is unlikely that the ASEAN would be interested in the development of a regional trading bloc, as long as multilateralism remains a viable alternative.

Finally, the dependence of East Asian countries on the US market argues against the evolution of an East Asian bloc, for two reasons.

First, it is more important for the East Asian countries to maintain access to the US market - arrangements with the United States thus take precedence over regional trading initiatives (as evidenced by the strong interest of these countries in potential FTAs with the United States along the lines of the Canada-US FTA).

Second, and related to the first, these countries have a vested interest in the strengthening of GATT disciplines, which they believe provide the best safeguards against further encroachments on their access to the US and European markets.

Anderson (1991) corroborates this view. There is no doubt that, if given the opportunity, East Asia would continue to grow rapidly, providing both increasing export markets for the rest of the world as well as increasing import competition, particularly for traditional manufacturing industries. But it needs to be recognised that the extraordinary economic performance of first Japan's, then Asia's newly industrializing economies (NIEs) has been dependent on access to Western European and North American markets for manufactures.

Anderson (1991) considers also the implications of recent and prospective developments of economic cooperation in the region. Might the Asian-Pacific region, with or without North America, be inclined to form an FTA if the global multilateral trading system becomes less open? It seems unlikely, for the following reasons: first, the smaller Western Pacific countries would be unwilling to form a trade bloc with Japan for fear of Japanese domination in the absence of a North American counterweight. Second, even if North America were to be invited to join an Asian-Pacific FTA (partly as a counterweight to Japan, partly because of the importance of America to Western Pacific trade), it would be unlikely to do so. After all, political pressures have been such that most of the United States' manufacturing trade policies of the past decade or two have been aimed at *reducing* imports from East Asia, and a further fortressing of Europe against East Asian exports would, if anything, intensify that opposition to increasing import competition from Asia. Similarly, Northeast Asia would find it politically intolerable to remove their high barriers to agricultural imports from North America or even just from Australasia. In short, the high degree of complementarity between resource-rich and resource-poor Asian-Pacific economies works against the political feasibility of an FTA in that region. By contrast, the relative similarity of the economies of Western Europe allowed an FTA to be formed relatively easily, because the gains have been able to come mainly from intra-industry trade specialization which has not involved the wholesale shrinkage of large sub-sectors of each economy, as would follow the formation of an Asian-Pacific or Western Pacific FTA. Instead, the interests of Western Pacific countries will continue to be served best by a strong open, global trading system.

Recently, Panagariya (1994) observed that with the creation of trading blocs in North America and Europe, policy advisers are beginning to ask whether it would be time for East Asia to form such a bloc as well.

Panagariya (1994) considers first the two economic arguments favouring the implementation of a discriminatory trading bloc in East Asia.

First, an East Asian bloc may serve as a deterrent to the formation of closed trading blocs around the world. According to this argument, the

world is already dividing into blocs. To ensure that they do not become overly protective of and limit access to their own markets, East Asia should be united and in a position to retaliate. Unilateral actions such as those taken by the United States under its Super 301 provisions, for instance, would be harder to implement with a united East Asia.

Second, the formation of regional blocs could facilitate future rounds of the General Agreement on Tariffs and Trade (GATT). The Uruguay Round was protracted in part because of the large number of participants and the free rider problem such a number generates. One reason for the success of past GATT rounds was that the United States could deal with the EC as a single unit. This fact has led many to conclude that a small number of blocs could make future GATT negotiations more manageable.

However, Panagariya (1994) observes that a range of potential factors render the implementation of a discriminatory trading bloc in East Asia very unlikely.

First, the major players in the region have historically been political rivals.

Second, the East Asian countries have very different levels of protection and are at very different stages of development, suggesting that the distribution of gains from an FTA would be uneven.

Third, East Asia comprises a large number of countries, making negotiations for an FTA a daunting task. It has been difficult for the ASEAN countries to make progress with just six members.

Panagariya (1994) therefore concludes that a discriminatory bloc is not a very feasible proposition in light of the above arguments, but there is another regional approach - centred around GATT style, non-discriminatory liberalization - that could be considered.

Several arguments can be offered in favour of this approach. First, because trade liberalization would be non-discriminatory, there would be no trade diversion. One important objection to a discriminatory bloc

would be removed: countries with high initial tariffs would not feel threatened by liberalization, since the consumers inside these countries would be the winners.

Second, this type of regionalism would not face a serious challenge from the United States, for non-discriminatory liberalization would also improve US access to East Asian markets.

Third, because liberalization would take place simultaneously in all the major countries of the region, short-run adjustment costs would be minimized.

These long-term gains make non-discriminatory liberalization an attractive option. Unfortunately, the short- to medium-term economic effects of this approach are unfavourable, for several reasons.

First, because existing tariff levels, at least in Japan, are relatively low, potential gains from lowering this most transparent trade barrier are limited. Japan also gives extensive trade preferences to its East Asian trading partners under the Generalized System of Preferences (GSP). If Japan were to lower its tariffs in a non-discriminatory fashion, these developing countries would lose the tariff preferences they currently enjoy.

Second, because tariff levels across the other countries are highly variable, the scope for negotiating reduced barriers is limited.

Third, in any East Asian negotiations, Japan must assume the leadership role the United States played during the GATT negotiations. But with so few formal trade barriers, Japan may have difficulty.

In conclusion, Panagariya (1994) observes that given the importance of open markets to the region's economic growth, the case for an East Asian bloc should be evaluated primarily in terms of the impact such a bloc would have on the world trading system. The region's future interests will be best served by a strategy that promotes an open world trading system. A discriminatory bloc does not fit that bill.

2.6 Regionalization: Concepts

Regionalization, as a concept, may relate to various developments in world trade:

1. *Bloc formation*

Bloc formation relates to the relative concentration of international trade among countries that are members of a formal free-trade agreement or another formal agreement on economic integration.

2. *Regionalization*

Regionalization relates to relative concentration of international trade among countries that are part of a country group with an informal cohesion, for instance in terms of geographical proximity.

3. *Polarization*

Polarization can be regarded as a special case of regionalization, namely the case of a relative concentration of international trade among countries at different levels of development. More concretely, polarization refers to the relative concentration of trade from a group of developing countries on a group of industrialized nations with geographical proximity.

It is useful to distinguish between bloc formation, regionalization and polarization, because each may have different implications with respect to the functioning of the multilateral world trade system.

In the definitions given above, the aspect of measurement is described in terms of relative concentration of international trade. Apart from the aspect of development over time, various methods can be applied to establish the relative concentration of international trade at any particular point in time ¹¹.

¹¹ An overview of these methods is not presented in this report.

2.7 The Network of World Trade

Before investigating the empirical evidence on the various aspects of regionalization in world trade, this section presents a general overview of geographical developments in world trade from 1960 till recently.

To that end the network of world trade has been investigated, representing total exports and imports between 8 countries and country groups in the world economy ¹²:

1. WE : Western Europe,
2. JPN : Japan,
3. NA : North America,
4. CEE : Central and Eastern Europe,
5. AFR : Africa,
6. ASIA : Asia and Oceania (except Japan),
7. LA : Latin America,
8. ROW : Rest of World.

The eight regions and countries are represented as areas of origin and of destination of international trade in the Tables 2.1-2.5, displaying the network of world trade in the years 1960, 1970, 1980, 1990 and 1992.

In this period world trade in current prices rose from 128 billion dollars in 1960 to 3668 billion dollars in 1992, a nearly 30-fold increase. For ease of comparison however, the networks in the Tables 2.1-2.5 are in percentages. The share of *Western Europe* in world trade was already high in 1960 with 40 percent of world exports and 42 percent of world imports; by 1992 these percentages had risen to 46 and 45, respectively.

In 1960 *Japan* had a share of 3 percent in world trade, both in exports and in imports. By 1992 this percentage had doubled for imports and increased threefold for exports.

In the period 1960-1992 *North America* had a fairly constant share in world exports and imports around 17 percent.

¹² Annex 2.1 provides the details regarding country composition.

The *Central and Eastern European countries'* share in world trade declined considerably - if not dramatically - from 10 percent in 1960 to 3 percent in 1992.

A similar decline is registered for *Africa*, whose share of 4 percent in world trade was halved by 1992.

Asia (including *Oceania*, but excluding *Japan*) saw its share in world trade rising considerably, from 10 to 17 percent in the period 1960-1992.

Latin America also experienced a considerable decline in world trade, with an 8 percent share in world exports and imports in 1960 being halved by 1992.

In summary, in the 30 years since 1960 the most significant changes in the shares in world trade were registered for *Japan*, with a share that more than doubled, and for the *Central and Eastern European countries*, *Africa* and *Latin America*, of which the shares were halved at least.

Region of origin	Region of destination								World
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	
Western Europe	23	.	4	2	3	3	3	2	40
Japan	.	-	1	.	.	1	.	.	3
North America	7	1	5	.	.	2	3	1	20
Central/East Eur	2	.	.	6	.	1	.	.	10
Africa	3	.	.	.	.	.	.	.	4
Asia/Oceania	3	1	1	1	.	3	.	.	10
Latin America	3	.	3	.	.	.	1	.	8
Rest of World	2	.	.	.	.	.	.	.	4
World	42	3	16	10	5	11	8	4	100
Total world exports: 128 billion US dollars									
Source: own calculations from UN trade data base									
Note: . indicates trade flow is less than 0.5 percent of world exports									

The shares of various country groups in world trade were described above using the row and column totals in the Tables 2.1-2.5. The inner part of these tables describes the *network of trade* flows between the country groups; only trade flows are included that are above 0.5 percent of total world trade.

From the viewpoint of stability in the world economy the degree of trade inter-dependence between the various country groups would be an important element to consider. Since the tables include one country (Japan) and 7 country groups, there are 63 possible trade flows of which 7 represent intra-country group trade. Of these 63 possible trade flows, only 28 are above 0.5 percent of world trade in 1960, this number having increased only slightly to 31 in 1992. Only in 1980 this number was considerably higher, namely 36. This was mainly due to the high oil price, reflected in the oil exports from the rest of the world (ROW), that includes the oil producing countries in the Middle East, and the correspondingly high value of the imports into these countries. This led to 11 trade relations of the rest of the world above 0.5 percent of world trade, compared to 5 in 1970 and 7 in 1992.

Region of origin	Region of destination								World
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	
Western Europe	29	1	4	2	2	2	2	3	44
Japan	1	-	2	.	.	2	.	.	6
North America	5	2	6	.	.	2	2	1	19
Central/East Eur	2	.	.	6	.	.	.	1	10
Africa	3	.	.	.	.	.	.	.	4
Asia/Oceania	2	1	1	.	.	2	.	.	7
Latin America	2	.	2	.	.	.	1	.	6
Rest of World	2	1	.	.	.	.	.	.	5
World	45	5	16	9	4	9	6	6	100

Total world exports: 312 billion US dollars
Source: own calculations from UN trade data base
Note: . indicates trade flow is less than 0.5 percent of world exports

The observation that the number of considerable trade flows only rose from 28 to 31 out of the possible 63 from 1960 to 1992 leads to the conclusion that during this period *the network of trade relations in the world economy* did not arrive at a substantially higher degree of cohesion. There are however, considerable differences in this respect between the various country groups and important changes over time.

Throughout the period *Western Europe* had the highest number of important trade relations in the network; excluding intra-Western European trade this number was 12 in 1960 and 14 in 1992. Second in this respect is *North America* with 9 such relations (again excluding intra-North American trade). A third position in the network is taken by *Asia and Oceania* with 8 important trade relations almost throughout the period. The fourth position is taken by *Japan* with 7 important trade relations in 1992, up from 4 such relations in 1960. The fifth position is taken by the rest of the world (ROW, including the oil producing countries in the Middle East), where since 1970 the number of important trade relations doubled to reach 6 in 1992 (again excluding intra-group trade).

Region of origin	Region of destination								World
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	
Western Europe	27	.	2	2	2	2	1	3	40
Japan	1	-	2	.	.	2	.	1	6
North America	4	1	4	.	.	2	2	1	14
Central/East Eur	2	.	.	4	.	.	.	1	8
Africa	2	.	1	.	.	.	.	.	5
Asia/Oceania	2	2	2	.	.	3	.	1	10
Latin America	1	.	2	.	.	.	1	.	5
Rest of World	5	2	1	.	.	2	1	1	12
World	44	6	15	7	4	10	6	8	100

Total world exports: 2001 billion US dollars
Source: own calculations from UN trade data base
Note: . indicates trade flow is less than 0.5 percent of world exports

Latin America had 4 to 5 important trade relations throughout the period (excluding intra-group trade). The number of important trade relations of the *Central and Eastern European* countries declined substantially from 4 in 1960 (excluding intra-group trade) to 2 in 1992. *Africa* throughout the period only had 2 important trade relations, representing exports and imports both with *Western Europe*.

Looking at the magnitude of individual trade relations in the Tables 2.1-2.5 intra-Western European trade is by far the most important, increasing

moreover from 23 percent of world trade in 1960 to 33 percent in 1992¹³. Among the three regions Western Europe, Japan and North

Region of origin	Region of destination								World
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	
Western Europe	33	1	4	1	1	2	1	3	47
Japan	2	-	3	.	.	3	.	.	8
North America	3	2	5	.	.	2	2	1	15
Central/East Eur	2	.	.	2	.	.	.	.	5
Africa	1	.	.	.	.	.	.	.	2
Asia/Oceania	3	2	3	.	.	5	.	1	15
Latin America	1	.	1	.	.	.	1	1	4
Rest of World	2	1	.	.	.	1	.	1	4
World	46	6	17	4	2	14	4	6	100

Total world exports: 3392 billion US dollars
Source: own calculations from UN trade data base
Note: . indicates trade flow is less than 0.5 percent of world exports

America, the trade relations account for 51 percent of world trade in 1992, up from 41 percent in 1960. Trade relations between Western Europe and North America declined in importance from 11 to 6 percent of world trade, but these still dominate the trade relations between Japan and North America representing 4 percent of world trade, and those between Japan and Western Europe accounting for 3 percent of world trade.

Outside these three areas, the main trade relations are held by Asia/Oceania with 7 percent of world trade within that group in 1992. In 1960 intra-group trade of the Central and Eastern European countries represented still 6 percent of world trade, but has vanished by 1992.

¹³ Considering Western Europe as one country would represent a still hypothetical case resembling the factual situation of the USA. This would of course reduce the figure for intra-Western European trade to zero, increasing the others with a certain factor, which for 1992 would equal 1.5 (i.e. $100/(100-33)$). Such an approach has not been followed here, since the countries in Western Europe are still independent states.

Region of origin	Region of destination								World
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	
Western Europe	33	1	3	1	1	3	1	3	46
Japan	2	-	3	.	.	3	.	.	9
North America	3	1	5	.	.	2	2	1	15
Central/East Eur	1	.	.	.	.	.	.	.	3
Africa	1	.	.	.	.	.	.	.	2
Asia/Oceania	3	2	4	.	.	7	.	1	17
Latin America	1	.	1	.	.	.	1	.	4
Rest of World	1	1	.	.	.	1	.	1	4
World	45	6	17	3	2	16	5	5	100
Total world exports: 3668 billion US dollars									
Source: own calculations from UN trade data base									
Note: . indicates trade flow is less than 0.5 percent of world exports									

2.8 Polarization in World Trade

In section 2.7 it was already observed that the trade relations of Africa are exclusively concentrated on Western Europe. To explore this phenomenon further the Figures 2.3.1 to 2.9.2 display the percentage distribution of total trade of 7 of the country groups analyzed in the preceding section among each other ¹⁴:

- | | | | |
|----|------|------------------------------|-----------------------|
| 1. | WE | : Western Europe | Figures 2.3.1 - 2.3.2 |
| 2. | JPN | : Japan | Figures 2.8.1 - 2.8.2 |
| 3. | NA | : North America | Figures 2.6.1 - 2.6.2 |
| 4. | CEE | : Central and Eastern Europe | Figures 2.5.1 - 2.5.2 |
| 5. | AFR | : Africa | Figures 2.4.1 - 2.4.2 |
| 6. | ASIA | : Asia/Oceania | Figures 2.9.1 - 2.9.2 |
| 7. | LA | : Latin America | Figures 2.7.1 - 2.7.2 |

¹⁴ Polarization of trade of the Rest of the World (ROW) is not included in this section. The listing of countries according to country groups is given in Annex 2.1.

For each of the country groups, two figures display the percentage distribution of total trade for the years 1960 and 1992 ¹⁵.

The pattern of trade relations of *Western Europe* is fairly stable over the period 1960-1992. The intra-group trade remained of prime importance, increasing its share from 55 percent of total Western European trade in 1960 to 71 percent in 1992. The trade relations with the other country groups are all of significance and show a fairly even spread. The importance of the trade relations with North America and with Latin America declined over time, it increased for Japan.

There is a striking resemblance between the pattern of trade relations of *Africa* and that of *Western Europe*. In the case of *Africa*, this means that *Africa's* trade relations are highly concentrated on *Western Europe*; the opposite is not true: for *Western Europe* the trade relation with *Africa* is of only minor importance, representing only 7 percent of total *Western European* trade in 1960 and even less (3 percent) in 1992. In that year *Africa's* trade with *Western Europe* comprised 56 percent of *Africa's* total trade. This figure had been higher in 1960 however, being 67 percent, gradually decreasing thereafter. Trade relations of *Africa* with *North America* and with *Asia/Oceania* increased somewhat in importance over the years.

The figures for *Central and Eastern Europe* show the collapse of intra-group trade of these countries, comprising 62 percent of their total trade in 1960 and only 18 percent in 1992. This decline has been compensated by a considerably increased concentration on *Western Europe*, having a share of 54 percent of total *Central and Eastern European* trade in 1992 up from 17 percent in 1960.

¹⁵ In section 2.8 only figures for the years 1960 and 1992 are presented. In Annex 2.2 the numerical values of the polarization of international trade are given for each of the 5 years under consideration: 1960, 1970, 1980, 1990 and 1992.

Figure 2.3.1 Polarization of international trade - Western Europe, 1960
(percentage distribution of total trade)

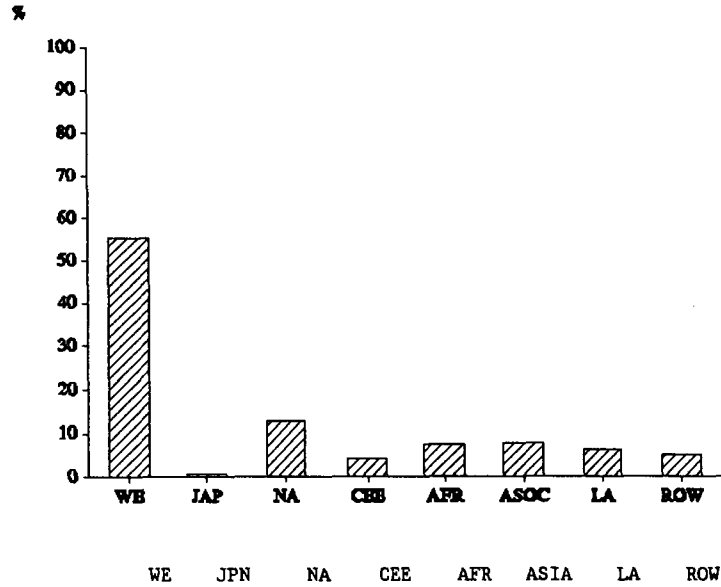
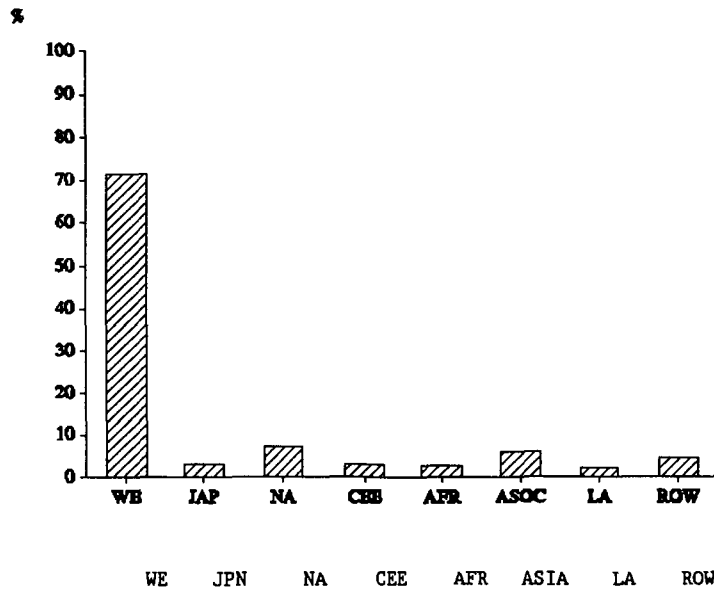


Figure 2.3.2 Polarization of international trade - Western Europe, 1992
(percentage distribution of total trade)



Source: own calculations from UN trade data base
Note: total trade is represented by the sum of exports and imports.

Figure 2.4.1 Polarization of international trade - Africa, 1960
(percentage distribution of total trade)

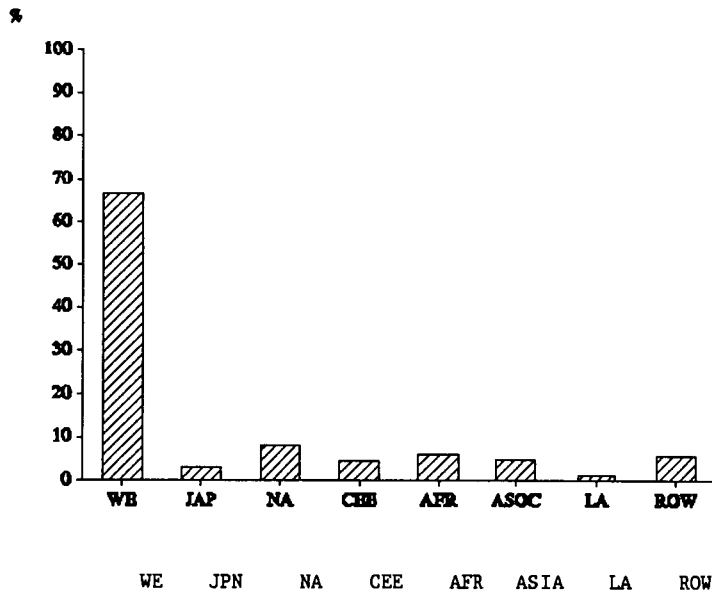
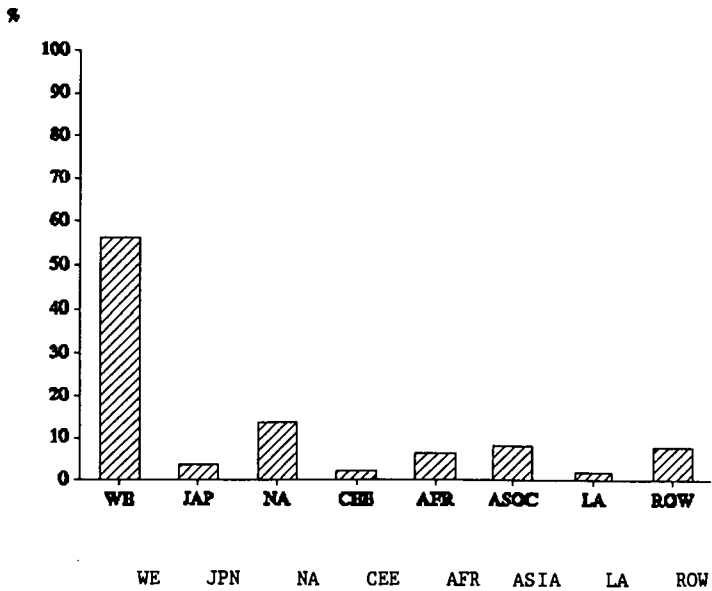


Figure 2.4.2 Polarization of international trade - Africa, 1992
(percentage distribution of total trade)



Source: own calculations from UN trade data base

Note: total trade is represented by the sum of exports and imports.

Figure 2.5.1 Polarization of international trade - Central/Eastern Europe, 1960
(percentage distribution of total trade)

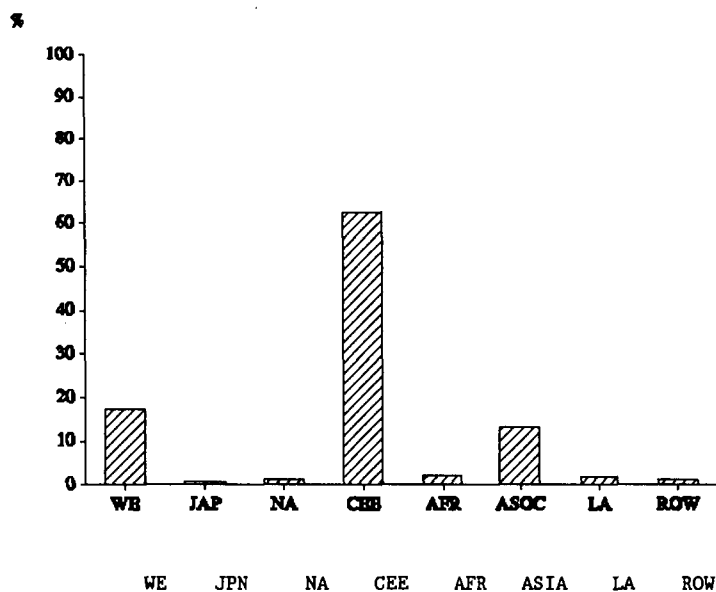
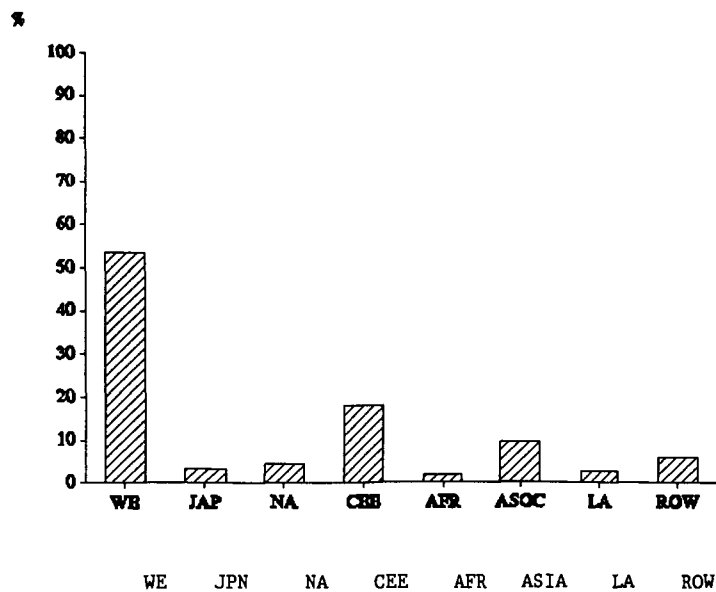


Figure 2.5.2 Polarization of international trade - Central/Eastern Europe, 1992
(percentage distribution of total trade)



Source: own calculations from UN trade data base
Note: total trade is represented by the sum of exports and imports.

Trade relations of *North America* are far less concentrated on the own region than in *Western Europe*. The own group share in total trade was only 30 percent in 1960 and rose only to 32 percent in 1992. Trade relations with Western Europe declined in importance from 30 percent of North American trade in 1960 to 20 percent in 1992. Trade relations of North America with Japan and Asia/Oceania increased in importance, doubling their shares in North American total trade since 1960.

Trade relations of *Latin America* show a substantial concentration on North America, representing 42 percent of total Latin American trade in 1960, dropping only slightly to 40 percent in 1992, far higher percentages than those indicating the importance of the reverse relationship, namely the share of Latin America in North American trade. Another interesting phenomenon of Latin American trade relations is the declining importance of Western Europe, having a 33 percent share in total Latin American trade in 1960 declining to 23 percent in 1992. Trade relations of Latin America with Japan and Asia/Oceania increased in importance during the years 1960-1992.

Figure 2.6.1 Polarization of international trade - North America, 1960
(percentage distribution of total trade)

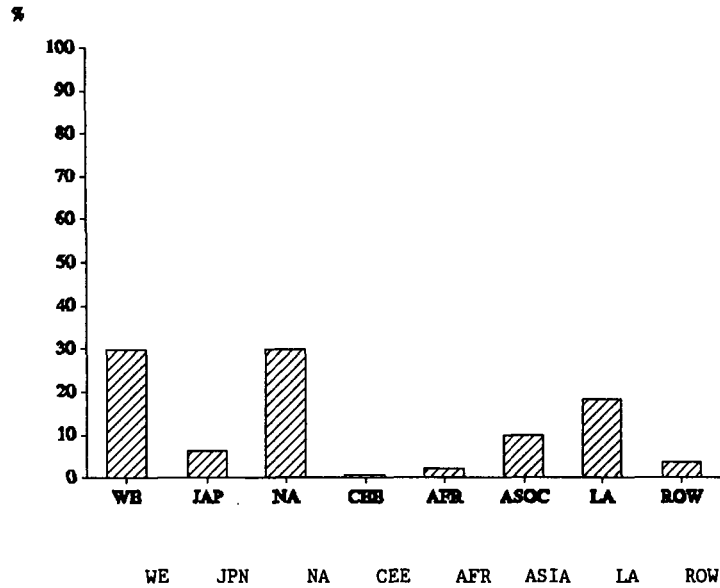
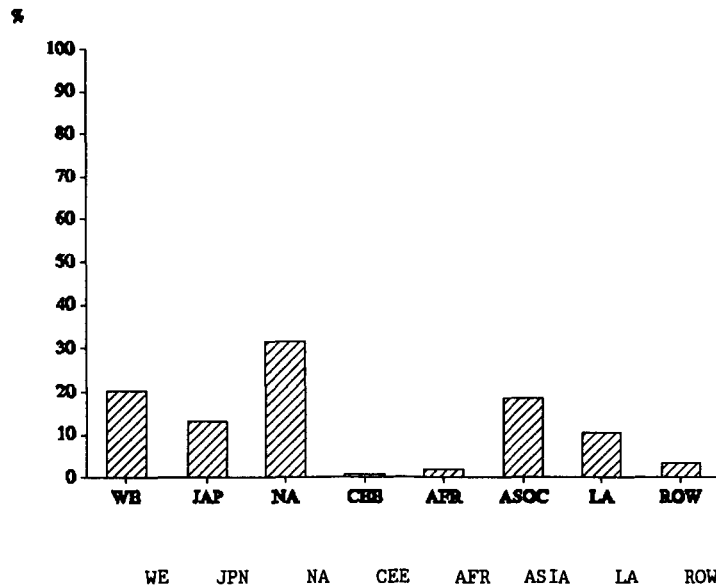


Figure 2.6.2 Polarization of international trade - North America, 1992
(percentage distribution of total trade)



Source: own calculations from UN trade data base
 Note: total trade is represented by the sum of exports and imports.

Figure 2.7.1 Polarization of international trade - Latin America, 1960
(percentage distribution of total trade)

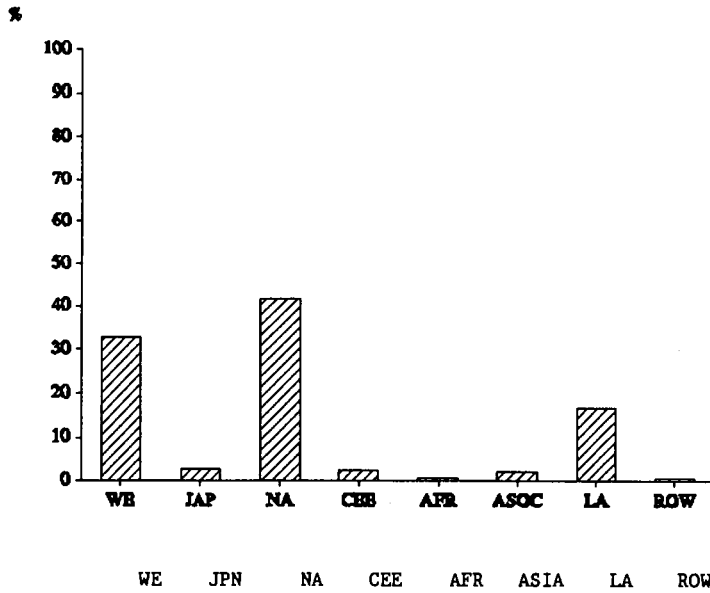
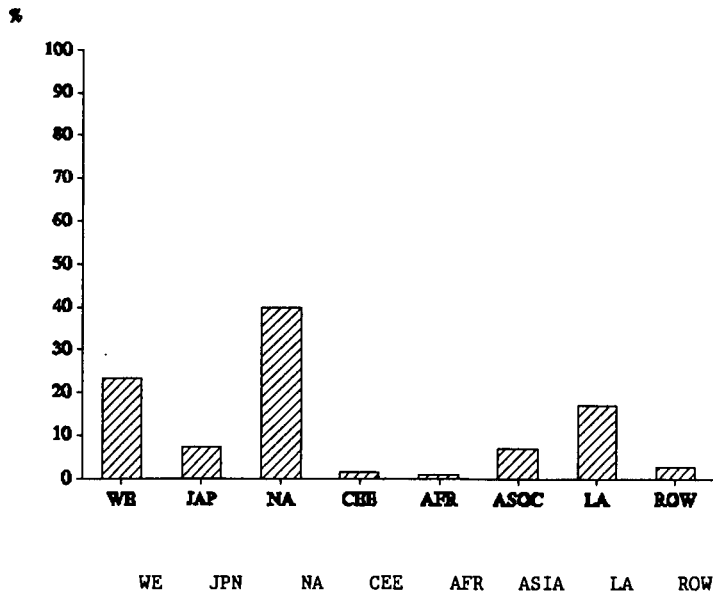


Figure 2.7.2 Polarization of international trade - Latin America, 1992
(percentage distribution of total trade)



Source: own calculations from UN trade data base
 Note: total trade is represented by the sum of exports and imports.

Throughout the period 1960-1992 trade relations of Japan were concentrated on North America and on Asia/Oceania. The share of North America in Japan's trade declined from 36 percent in 1960 to 28 percent in 1992; the share of Asia/Oceania increased from 33 to 38 percent in the same period. Western Europe has a less important share in Japan's trade, but it rose considerably from 11 to 19 percent in the period 1960-1992.

Characteristically, in 1960 trade relations of Asia and Oceania were concentrated on Western Europe, with a share of 30 percent of Asia/Oceania's total trade. This share has gradually decreased; by 1992 trade relations of Asia/Oceania were evenly spread, with Western Europe, North America and Japan accounting for 16, 17 and 18 percent of Asia/Oceania's trade respectively. The intra-group trade of Asia/Oceania rose considerably from a share of already 24 percent of total trade in 1960 to 41 percent in 1992.

In conclusion then, trade relations of Africa turn out to be highly concentrated on Western Europe, although seen from the perspective of Western Europe trade relations with Africa are only of minor and even diminishing importance. The similar is true for trade relations between Latin America and North America. A different pattern of trade relations applies to Asia/Oceania; trade shares are evenly spread over Western Europe, North America and Japan, while intra-group trade has the most important role in Asia/Oceania.

Figure 2.8.1 Polarization of international trade - Japan, 1960
(percentage distribution of total trade)

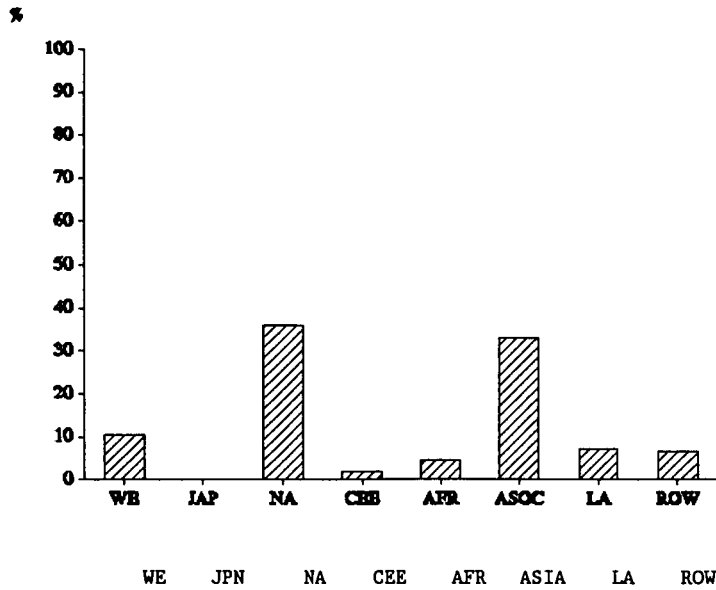
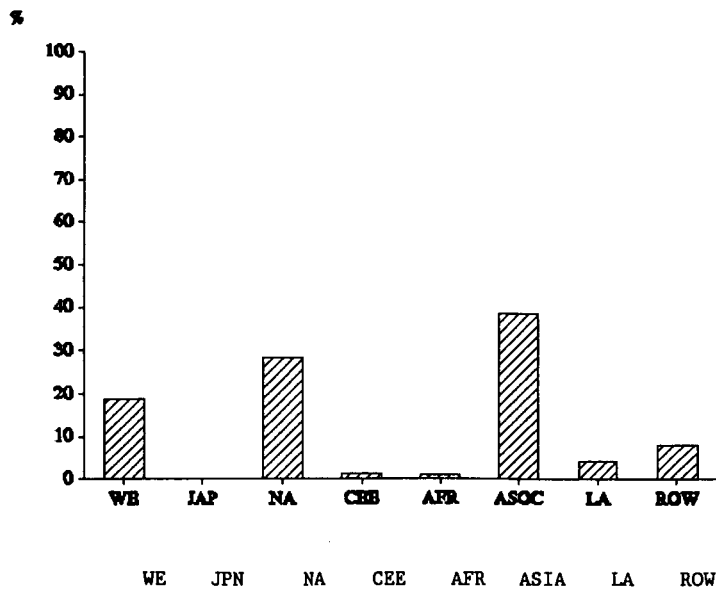


Figure 2.8.2 Polarization of international trade - Japan, 1992
(percentage distribution of total trade)



Source: own calculations from UN trade data base
Note: total trade is represented by the sum of exports and imports.

Figure 2.9.1 Polarization of international trade - Asia/Oceania, 1960
(percentage distribution of total trade)

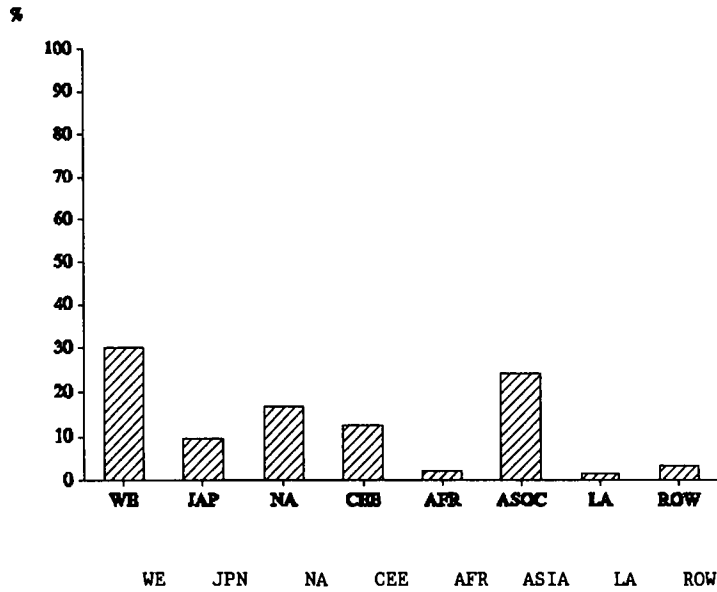
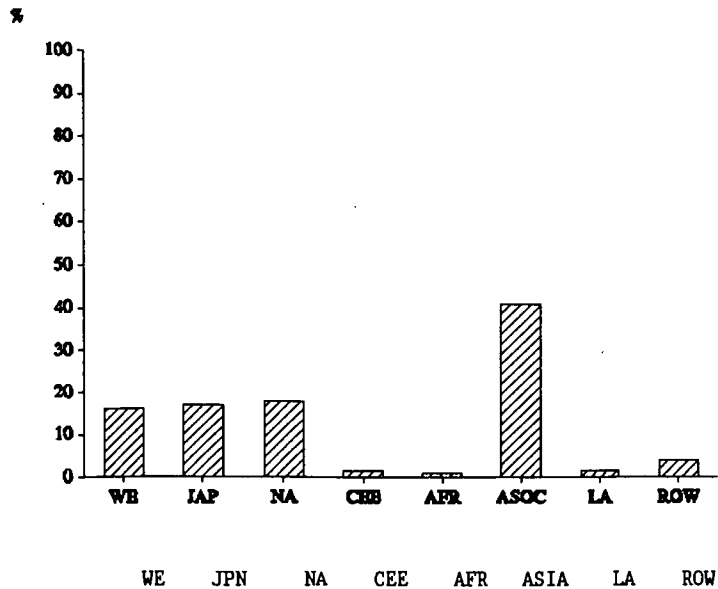


Figure 2.9.2 Polarization of international trade - Asia/Oceania, 1992
(percentage distribution of total trade)



Source: own calculations from UN trade data base
 Note: total trade is represented by the sum of exports and imports.

2.9 Regionalization in World Trade

Regionalization in world trade is the subject of this section. It has been defined previously (in section 2.6) as the concentration of international trade among countries that are part of a country group with an informal cohesion.

To investigate possible tendencies towards regionalization a variety of methods can be applied. The approach taken in this study has been developed by Sautter (1974).

In Sautter's approach, for each of the country groups i considered the share of their total exports ($X_{i\bullet}$) in total world exports ($X_{\bullet\bullet}$) is calculated ($y_{i\bullet}$). Next, again for all country groups, now labelled j , their share in world imports is calculated ($y_{\bullet j}$)¹⁶. Regarding exports from country group i to country group j a hypothetical value of this trade flow is calculated as:

$$\bar{X}_{ij} = y_{i\bullet} \cdot y_{\bullet j} \cdot X_{\bullet\bullet} \quad (2.1)$$

That is, the hypothetical value of exports from country group i to country group j would correspond to the respective shares that these country groups hold in world exports and world imports. More precisely, the values of \bar{X}_{ij} would represent a situation in which the distribution of exports over importing country group j would be identical irrespective of where these exports would originate: from any country group i or from the world at large; and, the distribution of imports over country groups of origin would be identical regardless of the destination of the imports, be it any country group j or the world at large.

¹⁶ In Sautter (1974) trade figures used include reported exports only, implying equality of world exports and world imports.

It is easy to show that the thus derived hypothetical trade flows add up to total world trade observed ¹⁷, that is:

$$\sum_i \sum_j \bar{X}_{ij} = X_{..} \quad (2.2)$$

Comparing the hypothetical value \bar{X}_{ij} in (2.1) with the exports from country group i to country group j observed in reality, X_{ij} , a coefficient k_{ij} can be calculated:

$$k_{ij} = X_{ij} / \bar{X}_{ij} \quad (2.3)$$

The value of k_{ij} ranges from 0 to $X_{..}$; it equals one when the observed and hypothetical values of the trade flow considered are identical. According to Sautter (1974), values of $k_{ij} > 1$ are considered as an expression of intensive trade relationships between the country groups i and j . Strictly speaking the reciprocal relationship only holds if besides $k_{ij} > 1$ also $k_{ji} > 1$, that is, the observed trade flows between country groups i and j should be larger than the hypothetical values in both directions.

The approach in Sautter (1974) is based on Savage and Deutsch (1960) and Goodman (1963). Alternative measures regarding regionalization are the Gini-Hirschman coefficient as applied in Hirschman (1945) and Michaely (1962, 1984), and the gravitation index as applied in Linnemann (1966). In the latter approach hypothetical trade flows are constructed depending on the trade partners geographical distance and national product. These hypothetical values are then compared with the actual trade flows to arrive at an impression of regionalization. The gravitation model is therefore similar to the approach in Sautter (1974). Considering however the long term scope of the present study, in which also the development of the national product may vary considerably among countries, the

¹⁷ When $i = j$ for individual country groups obviously \bar{X}_{ij} should be zero; this however will not held in view of relation (2.1) because $y_{i.}$ and $y_{.j}$ will both be larger than zero. It follows, that a correction procedure is required which arrives at $\bar{X}_{ij} = 0$ for individual country groups. Sautter (1974) provides the details.

approach in Sautter (1974) provides hypothetical values that are in the context of the present study to be considered as more neutral than those provided by the gravitation model.

Empirical findings

To establish tendencies towards regionalization in world trade the approach used by Sautter (1974) has been applied to trade flows within and among the eight country groups distinguished earlier in this study; the results have been calculated for the years 1960, 1970, 1980, 1990 and 1992 and are displayed in the Tables 2.6-2.10. In these tables the numbers on the head diagonals represent the tendency to *regional concentration within the country group* concerned. It can be seen that between 1960 and 1992 the concentration of trade within Western Europe increased somewhat from 1.3 to 1.6, but by 1992 was lower than in any of the other country groups considered. In North America the index reached a value of 2.0 in 1992, up from 1.7 in 1960. In Central and Eastern Europe the trade intensity index was 6.8 in 1992, only a bit higher than in 1960. Also for internal trade in Africa, Asia/Oceania and Latin America the indices for trade intensity in 1992 are 3.0, 2.4 and 4.1 respectively, higher values than for Western Europe; the developments over the period 1960-1992 show furthermore that the intensity of internal trade has increased in Africa and in Latin America, and has remained stable in Asia/Oceania.

The off-diagonal elements in the Tables 2.6-2.10 represent the intensity of trade relations between country groups.

Regarding the *trade relations of Western Europe* the figures show a fairly constant value of the concentration index for trade with Africa, while for trade with Central and Eastern Europe a recent tendency towards concentration can be observed.

The figures for trade intensity between Western Europe and Central and Eastern Europe were 1.1 and 1.2 for exports and imports of Western Europe, respectively, up from both 0.4 in 1960. Internal trade concentration within the Central and Eastern European countries amounted to a much higher figure, being 6.2 in 1960 and 6.8 in 1992. At first sight this result seems to be at odds with the results reached on the polarization

of trade of Central and Eastern European countries (section 2.8), where it was concluded that in the period 1960-1992, the concentration of trade shifted away from within Central and Eastern Europe towards trade with Western Europe. It was however also concluded that trade relations between Central and Eastern Europe and Western Europe are far more important seen from the viewpoint of Central and Eastern Europe than for Western Europe. Both tendencies are reflected in the values of the index of trade concentration. The values of the concentration index for internal Latin American trade and for the trade relations between Latin America and North America are to be interpreted likewise.

The figures for *Asia/Oceania* show a concentration of trade with Japan that decreased recently however, and to a small degree a concentration of trade with North America that remained fairly constant however in the years 1960-1992.

According to the values of the concentration index the concentration of trade between *Western Europe and North America* has been weak throughout the period, and between *Western Europe and Japan* has continued to be even weaker. Trade relations between *Japan and North America* have shown some degree of concentration, that has remained fairly stable over the years 1960-1992.

	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW
Western Europe	1.3	0.2	0.6	0.4	1.6	0.7	0.8	1.2
Japan	0.3	-	1.9	0.2	1.4	3.2	1.0	1.1
North America	0.8	2.1	1.7	0.1	0.4	1.0	2.0	0.9
Central/East Europe	0.4	0.2	0.0	6.2	0.4	1.1	0.2	0.5
Africa	1.6	0.5	0.5	0.6	1.3	0.5	0.1	1.0
Asia/Oceania	0.7	3.0	0.8	1.4	0.4	2.3	0.3	0.8
Latin America	0.8	0.9	2.7	0.3	0.2	0.1	2.1	0.2
Rest of World	1.2	2.1	0.7	0.1	1.6	0.8	0.2	2.7

Source: own calculations from UN trade data base
Note: for explanation of Sautter index see section 2.9.

	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW
Western Europe	1.5	0.2	0.6	0.4	1.2	0.5	0.7	1.2
Japan	0.3	-	2.1	0.3	1.5	3.5	1.0	1.2
North America	0.6	1.8	2.0	0.1	0.5	1.1	2.0	0.8
Central/East Europe	0.4	0.3	0.1	6.6	0.9	0.6	0.5	1.0
Africa	1.5	0.8	0.4	0.7	1.5	0.4	0.3	0.5
Asia/Oceania	0.5	3.6	1.2	0.7	0.8	2.9	0.3	0.7
Latin America	0.7	1.1	2.2	0.6	0.2	0.2	2.9	0.2
Rest of World	1.0	3.5	0.3	0.6	1.3	1.0	0.3	1.8

Source: own calculations from UN trade data base
Note: for explanation of Sautter index see section 2.9.

	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW
Western Europe	1.5	0.2	0.4	0.5	1.5	0.4	0.5	1.1
Japan	0.4	-	1.8	0.4	1.1	3.1	1.0	1.5
North America	0.6	1.4	1.8	0.3	0.6	1.3	2.3	0.8
Central/East Europe	0.6	0.2	0.1	7.1	0.7	0.5	0.5	1.4
Africa	1.1	0.3	2.2	0.4	0.7	0.2	1.0	0.5
Asia/Oceania	0.4	3.3	1.3	0.6	0.7	2.7	0.4	0.9
Latin America	0.6	0.7	2.4	0.9	0.5	0.2	3.4	0.6
Rest of World	0.9	3.0	0.8	0.4	0.6	1.3	0.8	0.9

Source: own calculations from UN trade data base
Note: for explanation of Sautter index see section 2.9.

	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW
Western Europe	1.5	0.4	0.5	0.6	1.2	0.4	0.5	1.0
Japan	0.5	-	2.0	0.3	0.6	2.4	0.9	0.7
North America	0.5	1.8	2.0	0.3	0.6	1.1	2.8	0.6
Central/East Europe	0.8	0.3	0.1	9.0	0.9	0.6	1.2	1.6
Africa	1.3	0.4	1.1	0.8	2.4	0.2	0.3	0.9
Asia/Oceania	0.4	2.6	1.3	0.6	0.6	2.5	0.4	0.7
Latin America	0.5	0.9	2.0	1.2	0.6	0.4	3.5	2.3
Rest of World	0.7	2.7	0.6	1.3	2.2	1.0	0.5	2.0

Source: own calculations from UN trade data base
Note: for explanation of Sautter index see section 2.9.

	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW
Western Europe	1.6	0.3	0.4	1.1	1.2	0.3	0.5	1.1
Japan	0.5	-	1.8	0.4	0.5	2.2	1.0	0.9
North America	0.5	1.6	2.0	0.4	0.6	1.0	2.8	0.8
Central/East Europe	1.2	0.6	0.1	6.8	0.8	0.5	0.3	1.5
Africa	1.3	0.4	1.1	1.0	3.0	0.2	0.3	0.9
Asia/Oceania	0.4	2.4	1.2	0.6	0.7	2.4	0.5	0.7
Latin America	0.6	0.9	2.1	1.0	0.5	0.3	4.1	0.7
Rest of World	0.7	3.1	0.6	1.1	2.4	1.0	0.5	2.3

Source: own calculations from UN trade data base
Note: for explanation of Sautter index see section 2.9.

2.10 Bloc Formation in World Trade

Bloc formation was defined earlier (section 2.6) as the relative concentration of international trade among countries that are members of a formal agreement on economic integration.

Given the scope of this study and the relatively long and successful process of economic integration the EC, founded in 1957, is the obvious candidate for exploring any tendency towards bloc formation. The analysis is carried out for the period 1960-1992. In this period the EC expanded

in membership from 6 to 12 participating countries. For each of the benchmark years 1960, 1970, 1980, 1990 and 1992 the composition of the EC has been taken as it was at that particular point in time.

The criterion for judging the tendency towards bloc formation is the ratio of intra-EC trade over extra-EC trade. If this ratio rises with time, this would represent a tendency towards higher self-sufficiency of the EC market; if the ratio would go down, this would imply an increased openness towards the outside world.

Obviously, one would expect a tendency of the ratio intra-EC trade/extra-EC trade to rise over the period 1960-1992, the process of economic integration having just started by 1960 and being intensified thereafter, this being given an extra impetus with the single market programme launched in 1985.

As a matter of interpretation, it is therefore to be expected the ratio of intra/extra-EC trade to rise in the period considered as the EC market gradually became liberalized internally, whereas the EC commercial policy retained a certain degree of protection around the EC market.

The expectation that the ratio of intra-EC trade over extra-EC trade would be rising during the period of intensified economic integration, has to take into account the effects of new membership. If a new member enters the EC, which has a ratio of trade with EC members over that with non-EC members that is different from the present EC average, this would, upon entrance, lead to a change in this ratio, without any change in policy towards bloc formation having taken place. To take this factor into account some of the calculations represent more continuity in the composition of the EC than representing the actual EC-membership at the time.

The ratio chosen to investigate possible tendencies towards bloc formation comprises total internal EC trade in relation to total external EC trade. Trade includes imports as well as exports as both represent factors in a country's economic relations with the outside world. In the denominator only external EC trade and not total (that is both internal

and external) EC trade has been chosen as the former would in combination with internal EC trade in the numerator reflect possible tendencies towards bloc formation more acutely.

Finally, the tendency towards bloc formation has been investigated for all commodity trade as well as for trade in particular product groups. This has been done to allow for differences in EC trade policies with respect to different product groups.

The results for *all-commodity trade* are represented in Table 2.11. The ratio intra-EC trade/extra-EC trade was 55 in 1960, indicating that internal EC trade had a value of only 55 percent of external EC trade at that time. This figure had risen to 159 by 1992, indicating a 3 times as high ratio of internal over external EC trade.

Table 2.11 Bloc formation in international trade of the EC, 1960-1992 (intra-EC trade as percentage of extra-EC trade)									
Year/EC	Total trade	Primary products	Manu- fac- tured pro- ducts	Food pro- ducts	Mineral fuels	Machinery and transport equipment	Telecom equip- ment	Road vehi- cles	Textiles and clothing
SITC	0-9	0-4	5-8	0,1, 22,4	3	7	76	78	26,65,85
1960/EC6	55	-	-	41	59	55	-	-	-
1970/EC6	99	-	-	100	47	97	95	145	-
1970/EC9	103	-	-	101	51	110	-	-	-
1970/EC10	106	76	125	102	53	113	-	-	155
1980/EC9	-	-	-	-	49	-	73	164	130
1980/EC12	116	81	144	151	47	130	-	-	164
1990/EC12	155	136	165	237	63	160	-	-	163
1992/EC12	159	146	167	252	68	161	87	292	162

Source: own calculations from UN trade data base

The figures in Table 2.11 also indicate that *primary products* starting with a ratio of 76 in 1970 had almost doubled its value by 1992, an increase much faster than for *manufactures* where in the same period the value increased from 125 to 167.

To investigate more in detail the developments for *primary products* in relation to the *Common Agricultural Policy* Table 2.11 gives the results

for the combined product group *food products*¹⁸. In this case the ratio increased 6-fold from 41 in 1960 to 252 in 1992.

On the other hand, for the product group *machinery and transportation equipment* (SITC 7), which includes the modern technology sectors, such as computers and telecommunications, the development of the ratio follows the EC average for all commodities, reported above, and implies therefore a much slower tendency towards bloc formation than for the primary products. Regarding *telecommunications equipment* (SITC 76) and *road vehicles* (SITC 78) Table 2.11 presents some details. The internal EC trade of *telecommunications equipment* has been lower than the external EC trade in this product group with a ratio of around 90 in the period 1970-1992. For *road vehicles* the ratio doubled from an already high figure of 145 in 1970 to 292 in 1992.

Regarding *mineral fuels* (SITC 3) the ratio is throughout the period well below 100, indicating a continued dependence on foreign supply; the ratio was 59 in 1960 decreased to around 50 in the 1970s and continued to rise thereafter to 68 in 1992.

For *textiles and clothing* (SITC 26, 65 and 84) internal EC trade has continued to be more important than external EC trade; the ratio has been almost constant at a level of around 160 since 1970.

The North American Free-Trade Agreement (NAFTA) started with the US-Canada Free-Trade Agreement signed in 1988 and being effective from 1989. It is therefore of a very recent date, but economic cooperation agreements between the USA and Canada have been concluded already earlier and in fact date back from the previous century, with a Reciprocal Free-Trade Agreement being concluded in 1854 (Morici, 1989).

For these reasons the ratio of intra-US-Canada trade over extra-US-Canada trade has been calculated for the period 1970-1992 to provide a comparison with developments in the EC. The results are recorded in Table 2.12,

¹⁸ Represented by the SITC categories 0, 1, 22 and 4.

and will be referred to as the outcome for NAFTA. There are some marked differences between the figures for NAFTA and the EC.

For *all-commodity trade* the ratio is much lower for NAFTA than for the EC and moreover declining in the period considered from 55 to 42, whereas the ratio for the EC rose from 99 to 159 in the same period. Of course the figures for 1980 and 1992, being 37 and 42 respectively, show an increase, which may be testifying to an increasing bloc formation upon the founding of NAFTA (representing the US-Canada agreement) in 1989.

For *textiles and clothing* the ratio for NAFTA is 10 times lower than for the EC, and declining, where the figures for the EC show a more stable outcome. The ratio for *telecommunications equipment* is also lower for NAFTA than for the EC, with a factor 5 in 1992, with again a decline recorded for NAFTA and a more stable pattern for the EC. The results for *road vehicles* show an opposite development for NAFTA compared with the EC: the ratio started with a value of 237 in 1970 and halved to 125 in 1992 (though up from 111 in 1980), whereas for the EC it doubled from 145 in 1970 to 292 in 1992.

Table 2.12 Bloc formation in international trade of NAFTA, 1970-1992 (intra-NAFTA trade as percentage of extra-NAFTA trade)					
Year	Total trade	Mineral fuels	Telecom equipment	Road vehicles	Textiles and clothing
1970	55	61	30	237	15
1980	37	22	18	111	12
1992	42	42	16	125	11

Source: own calculations from UN trade data base
 Note: for SITC classification of product groups see Table 2.11

2.11 Policy Evaluation

Tendencies towards regionalization and bloc formation in the world economy cannot be judged on the basis of an analysis of trade flows alone. This is already apparent from the discussion in section 2.2 about the relation between preferential treatment inherent in an agreement on

economic integration and the multilateral GATT framework of rules for international trade based on non-discrimination. For the evaluation of bloc formation and regionalization it is of importance what policies are designed and implemented regarding trade relations with countries and country groups that are outside the region or bloc considered, or more in general, policies regarding the openness of the bloc or region concerned.

In this perspective, Pelkmans (1993) observes that in the three regions the EU, NAFTA and East Asia there are strong undercurrents of deregulation, privatization and liberalization. This is abundantly clear in the case of '1992' which boils down to a massive programme of deregulation, regulatory flexibility, regulatory competition and internal liberalization. Deregulation is impressive in services sectors such as telecom, air transport and banking, insurance and securities trade. The way market participants in these sectors think and act today places them in a totally different class than the same players (if they have not merged or split up) less than a decade ago. Regulatory flexibility is clearest in the 'new approach' to technical barriers. EU regulatory activity remains limited to a broad formulation of the health and safety objectives (the 'essential requirements'), with a reference to European standards fulfilling these requirements; great flexibility and hence room for innovation or alternative solutions is achieved because (1) EU and non-EU suppliers alike can get around the standard, subject to certification, (2) the standards are not design but performance oriented which tends to lead to fewer restrictions of commercial freedom. Regulatory competition in services (beyond a jointly agreed minimum of harmonized rules) and fiscal competition (again, within jointly agreed limits for indirect taxation, but neither such limits nor an agreed minimum rate is applied for corporate taxation, let alone income taxation) are themselves a recognition by the EU member states that a new competitive climate may also apply to the activities of the state. This is even more true for the notion of 'mutual recognition' in the case of unjustified technical barriers within the Community (when Art. 36 does not apply or the essential requirements are 'equivalent'). Liberalization is found in '1992' in the opening up of supplies to utilities, telecom networks and public transport to competitive procurement; in the removal of national quotas especially in consumer electronics, footwear, cars and textiles

and clothing; and in the removal of all exchange and capital controls. The password of '1992' is therefore (greater) competition, engendered by whatever is the most suitable means given the nature of the sector and regulatory starting position. The pervasiveness of this drive for greater competition and 'more market' should be well understood by outsiders (and indeed this has markedly improved since three years ago). Rather than being governed by fears one should attempt to grasp '1992' in terms of opportunities (Pelkmans, 1993).

But there are reasons to be positive as well about the other two instances of 'regionalism'. It is quite clear that Mexico is firm in fitting NAFTA into its overall liberalization strategy, internal and external. Mexico has staged an impressive programme of trade liberalization, in addition to having become a GATT member. It is often suggested, without justification, that the true significance of 'regionalism' for Mexico is to enhance confidence for foreign direct investors. Also the US/Canada FTA is generally pro-competitive. Indeed, for a while there were fears about its political feasibility in Canada precisely because the FTA tends to weaken the regulatory powers of the provinces. To a degree the intra-Canadian market fragmentation (e.g. for beer) may be overcome via the agreement with its large neighbour. It is also useful to put the US/Canada agreement in a proper perspective: Canada and the US were already one another's largest trade partners for decades, when there was no FTA (except for a special arrangement for cars since 1965); moreover, US ownership of Canadian industry is very high; for several Canadian provinces it is quite appropriate to say that *de facto* they are more integrated with the US economy (called North-South trade in Canada) than with the Canadian economy (East-West trade). The FTA will liberalize trade in some difficult sectors, as well as in services (to some extent only, however) and it will help to tame the US application of trade remedy laws to Canada in exchange for less government intervention (subsidies) in Canada (Pelkmans, 1993).

In *East Asia* the unambiguous trend is trade liberalization. This is true for Japan itself, as indeed recognised by the EU. For Indonesia, Malaysia and Korea trade liberalization has led to a significant opening up of their markets. In all three countries this has been accompanied by

(domestic) deregulations in financial services, for instance. With Hong Kong and Singapore being already free traders, and Thailand and Taiwan embarking on external liberalization as well, the old and new NIEs in East Asia seem to be driven by the same urge to spread the reach of competition to areas and sectors sheltered thus far (Pelkmans, 1993).

In this more realistic perspective the relevant question becomes: does the recent trend, if any, of greater regionalism negatively affect market access? This question can be split into two sub-questions: first, does the formation of the formal arrangement affect market access negatively?; second, will new stronger blocs raise new trade barriers? Before addressing these two sub-questions, it should be noted that market access ought to be distinguished from the *effect* of bloc formation or bloc strengthening on trade flows.

The answer to the first question hinges essentially on the type of regional arrangement sought. The EU's move from a customs-union-plus to a 'completed' common market is so unique that no GATT or other worldwide rules apply for the large majority of '1992' decisions. One therefore has to engage in the tedious exercise of checking such decisions one by one, spread over many different fields, often not comparable to product trade (Pelkmans, 1990, 1991). On the whole, market access improves or remains unaffected (dependent on the case), and not a single instance could be identified where market access actually worsens. One important qualification might be thought to consist in a number of reciprocity clauses (e.g. financial services and public procurement in the 'excluded sectors'). This is certainly not correct for the Utilities Directive: as the Cecchini report shows, (foreign) EC and non-EC suppliers alike were excluded from these national markets, sealed off as they were - hence, the 50 percent clause is an unambiguous improvement in access and can be effectively exploited with, say, a local partner. The reciprocity clause in the three financial services is harder to evaluate since it is far from clear how to define *ex ante* market access. To begin with, Art. 58 (EEC) applied national treatment to subsidiaries. This shifts any question about access back to that of (first) establishment; once in, they are EC firms. Authorization policies for establishment of financial services companies (from third countries) differed widely among the EC

member states before the 1992 process began. So, effective access differed. Moreover, access to what? As the regulation, product scope and internationalization of the national financial services markets diverged greatly, it is arbitrary to push the access issue too far now that a single market for financial services with different rules emerges. Finally, the grace period in the Second Banking Directive, the exceptions (for developing countries) and the link with the Uruguay Round impart a liberal slant, to say the least. (Pelkmans, 1993).

The question cannot be answered for the East Asian bloc as there is none in any formal sense. The Singapore Summit of January 1992 decided to establish an ASEAN free-trade area (AFTA) over a period of 15 years. It will be a classical free-trade area in the end, hence lacking a common external access policy. Origin rules are likely to be liberal for outsiders so as to take the high imported value-added of local production of multinationals into account. ASEAN is eager to practice what is denoted as 'open regionalism'. Surprisingly, however there is a strong current among decision makers not to notify under Art. 24 (GATT procedures), but under Chapter IV (arrangements for developing countries) (Pelkmans, 1993).

This leaves the US/Canada FTA. It is a classical FTA, supplemented by some specific sectoral provisions (e.g. energy, wine, cars), national treatment for services companies (with exceptions and 'grandfathering') and for investors (again with 'grandfathering'), including a prohibition on performance requirements (called TRIMs in the Uruguay Round). A very special instance of preferential treatment is the dispute settlement about anti-dumping and countervailing duties (AD-CVD), in the form of a binding review of a binational panel. Surely Canada, in obtaining the latter, is better off than all other trading partners which would no doubt wish to subject US AD-CVD practices to bilateral or multilateral surveillance. But in and by itself it does not worsen the access of outsiders to the two countries. The entire FTA appears not to impact on market access for outsiders. Whether this can be maintained once NAFTA is formed with Mexico remains to be seen but, as free-trade areas do not engage in a common trade policy, this would appear possible. The only case of doubt might be in origin rules of NAFTA.

The answer to the second sub-question - new barriers? - is straightforward if one studies the US/Canadian FTA and '1992': no new barriers are proposed or implemented. In a difficult sectoral EU case - cars - access is improved over an 8 years transition period, after which free trade is established. The Commission proposed the 1992 solution for textiles and clothing as the total removal of national quotas, with the retention of existing EU quotas. The details are not yet on table, however, and in the case of textiles and clothing there is always some devil in the detail. Of course, the EU supports MFA abolition so that the EU quotas will grow and eventually disappear. The Council has politically accepted the principle (Pelkmans, 1993).

The Common Agricultural Policy, restrictive regulation or interventionism, represent the exact opposite of what '1992' is all about: competition. This is not to say that EU trade policy cannot be drastically improved as the GATT (1991) report has amply demonstrated. At the same time it is hard if not impossible to discover any relation between '1992' and the reporting on VERs and anti-dumping cases in the GATT report. There is no trend in the number of dumping cases and the sectoral composition would appear to be unrelated with the sectoral emphasis in '1992'. Most of the reported VERs predate the 1992 process. There is only one clear '1992' case amongst those VERs and that is footwear (VERs with Korea and Taiwan); it is part of the transition to free trade in footwear which is now almost completed (Pelkmans, 1993).

3. GLOBALIZATION OF PRODUCTION

3.1 The Division of Labour

One of the most important insights in economics dates from Adam Smith (1776) and is represented in his analysis of the division of labour. In his well-known example of a small pin-factory he observed that 'a workman, not educated in this business, nor acquainted with the use of machinery employed in it, could scarce make one pin a day. (But that when) making a pin is divided into about eighteen distinct operations (... carried out by ten men), those ten persons could make among them upwards of 48,000 pins a day.' This would equal the manufacture of 4,800 pins a day per worker, an improvement with nearly 480,000 percent compared with the situation without division of labour and the use of specialized machinery. Smith (1776) shows furthermore that the invention and application of specialized machinery to save time and to increase efficiency is induced by the division of labour as well, concentration on a specific task leading to a specific focus on efficiency improvements.

Having demonstrated in this way the powerful force of a division of labour behind economic growth Smith (1776) deals with the question why then the division of labour is not instantaneous or evolving at a much quicker pace than economic history has shown this to be the case. The well-known answer by Smith is, that the division of labour is limited by the extent of the market. If society needed only 10 pins per day, it would not be economic to have a factory set up with 10 workers applying a division of labour in 18 tasks, let alone the employment of specialized machinery.

3.2 Globalization and Technology

The extent of the market has been identified in the previous section as the main element enabling the division of labour, while at the same time limiting it. In general the extent of the market is determined by two main factors:

1. the amount of buying power;
2. the costs of transportation and of communication.

The first factor, the amount of buying power, by definition consists of the size of the population and income per capita. The extent of the market is determined in the second place by the costs of transportation per unit weight of cargo transported. Costs of communication play a role as well. Among these elements raising the costs of bridging geographical distances should also be mentioned the measures of protection. Tariffs raise the price of traded goods; the effects of non-tariff barriers are more harmful to the extent of the market, since they fragment the latter.

In this perspective Dicken (1992) analyses the role of technological development in transportation and communication.

A fundamental prerequisite of the evolution of international production and of the transnational corporation is the development of technologies which overcome the frictions of space and time. The most important of such *enabling* technologies - and the most obvious - are the technologies of transport and communications. Neither of these technologies can be regarded as the cause of international production or of the Transnational Corporation (TNC); rather, they make such phenomena feasible. But without them, today's complex global economic system simply could not exist.

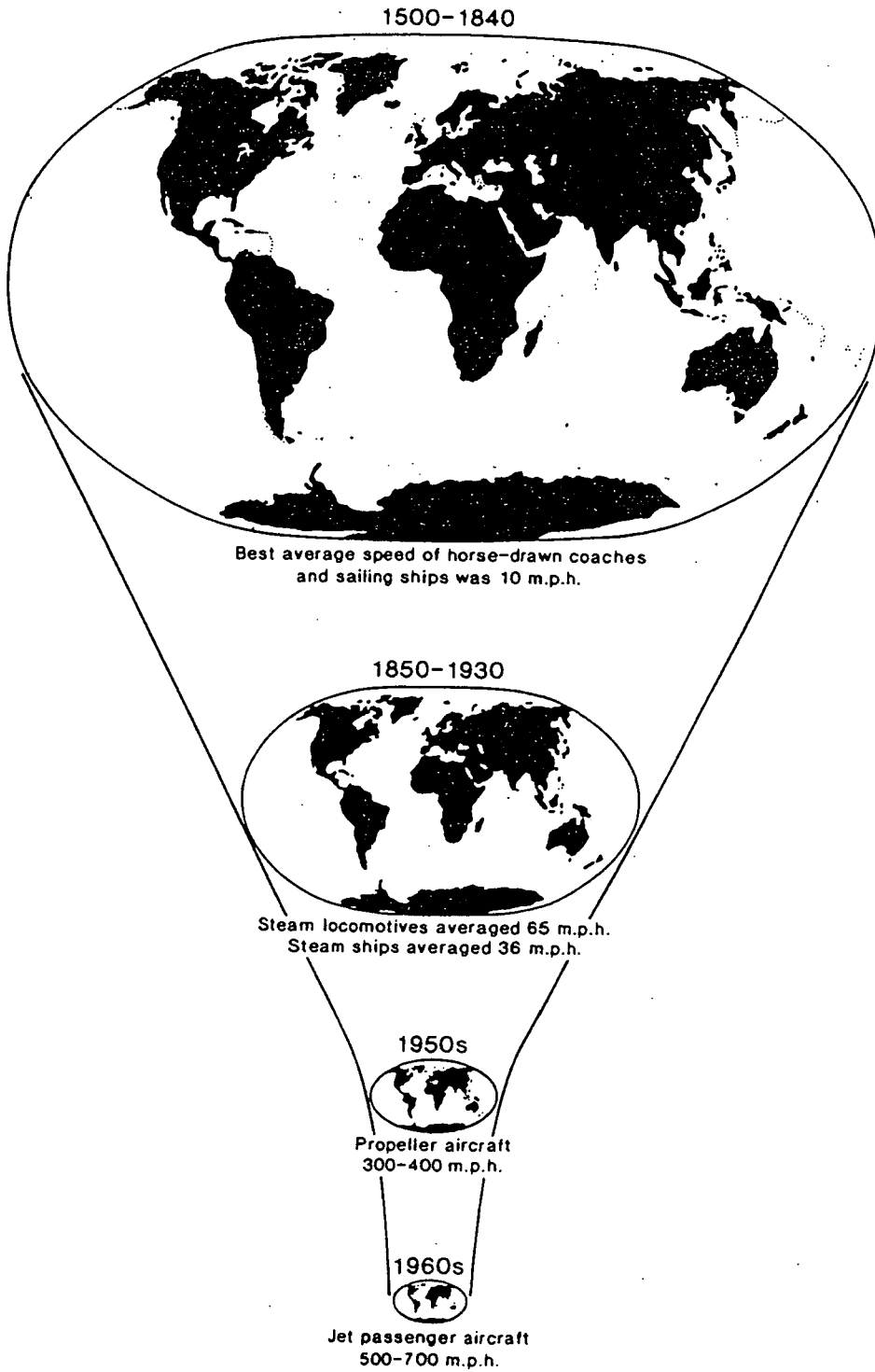
In terms of the time it takes to get from one part of the world to another there is no doubt that the world has 'shrunk' dramatically (Figure 3.1). For most of human history, the speed and efficiency of transport were low and the costs of overcoming the friction of distance high. Movement over land was especially slow and difficult before the development of the railways. Indeed, even as late as the early nineteenth century, the means of transport were not really very different from those prevailing in biblical times. The major breakthrough came with two closely associated innovations: the application of steam power as a means of propulsion and the use of iron and steel for trains and railway tracks and for ocean-going vessels. These, coupled with the linking together of overland and ocean transport and the cutting of the canals at Suez and Panama, greatly telescoped geographical distance at a global scale. The railway and the steamship introduced a new, and much enlarged, scale of human activity. The flow of materials and products was enormously enhanced and the possibilities of geographical specialization were

greatly stimulated. Such innovations were a major factor in the massive expansion in the global economic system during the nineteenth century.

The twentieth century, and especially the past few decades, has seen an acceleration of this process of global shrinkage. In economic terms, the most important developments have been the introduction of commercial jet aircraft, the development of much larger ocean-going vessels (super-freighters) and the introduction of containerization, which greatly simplifies transshipment from one mode of transport to another and increases the security of shipments. Of these, it is the jet aircraft which has had the most pervasive influence, particularly in the development of the TNC. It is no coincidence that the take-off of TNC growth and the take-off of commercial jets both occurred during the 1950s. As a consequence, in terms of time, New York is now closer to Tokyo than it was to Philadelphia in the days of the thirteen colonies.

The far more complex global transport system of the present day depends fundamentally on telecommunications technology. Indeed, communications technologies should now be regarded as the key technology transforming relationships at the global scale. Global communications systems have been transformed radically during the past twenty or thirty years through a whole cluster of significant innovations in information technology. Probably the most important catalyst to enhanced global communications has been the development of satellite technology.

Figure 3.1 Global shrinkage: the effect of changing transport technologies on 'real' distance



Source: Dicken (1992).

Satellite technology, together with a whole host of other communications technologies, is making possible quite remarkable levels of global communication of conventional messages and also the transmission of data. In this respect, the key element is the linking together of computer technologies with information-transmission technologies over vast distances. It has become possible for a message to be transmitted in one location and received in another on the other side of the world virtually simultaneously.

Not only are transmission costs by satellite insensitive to distance but also the user costs have fallen dramatically. In the 1960s the annual cost of an Intelsat telephone circuit, giving a connection from one point on the earth's surface to any other, was more than 60,000 dollar. In the late 1980s the same facility costs only 9,000 dollar. Satellite communications are now being challenged by a new technology: optical fibre cables. Optical fibre systems have a very large carrying capacity, and transmit information at very high speed and with a high signal strength.

3.3 Foreign Direct Investment: General Trends and Characteristics

One of the important aspects of the globalization of production is, of course, the development in foreign direct investment (FDI). This can be illustrated by the growth of FDI relative to other economic phenomena. Table 3.1 presents growth rates of FDI in the 1980s relative to the growth in GDP, trade and domestic investment. Quite clearly, after 1986 growth rates of the phenomena mentioned increased considerably with FDI growing at least twice as fast as GDP, trade and domestic investment. Especially the differential growth rates of FDI and domestic investment testify to an increasing globalization ¹⁹.

¹⁹ In 1990 FDI of all countries was 225 billion dollars, or 5 percent of gross domestic investment.

Table 3.1 Foreign direct investment and selected economic indicators (Growth rates for 1981-1985 and 1986-1990)		
Indicator	Growth rates (percentages)	
	1981-1985	1986-1990
All countries		
FDI outflows	4	24
GDP at market prices	2	9
Gross domestic investment	0.5	10
Exports	-0.2	12
Royalty and fees receipts	0.1	19
Developed countries		
FDI outflows	3	24
GDP at market prices	3	10
Gross domestic investment	2	11
Exports	2	12
Royalty and fees receipts	0.2	19

Source: United Nations (1993b).

As a share of GDP the outward stock of FDI of the industrial countries rose from nearly 5 percent in 1967 to 8 percent in 1988 (Dunning, 1993a).

The link between FDI, trade and technology flows implies that the growth of FDI is increasingly related to the growth of the other two types of flows. For example, it is estimated that intra-firm transactions in royalties and licence fees (which include mostly receipts for the use of trademarks, processes, techniques, copyrights and patents) between firms related by ownership account for over 80 percent of the total value of these transactions. Intra-firm trade between TNCs is also substantial, accounting for an estimated 25 percent of world-wide trade, although it is substantially higher for individual countries. To a certain extent, therefore, the growth of royalties and licence fees and trade is associated with the growth of FDI (UN, 1993a).

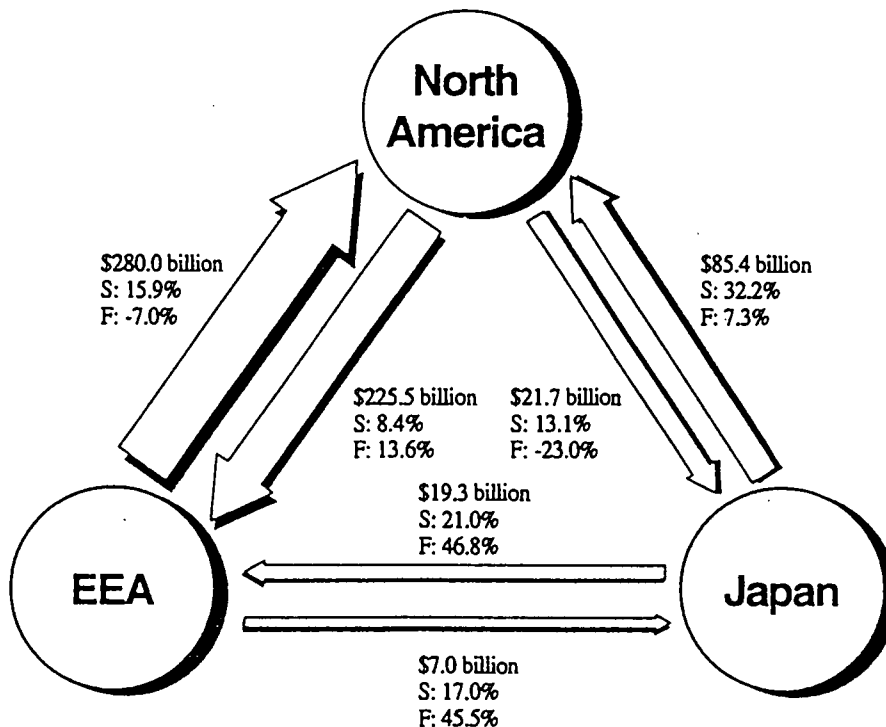
While global FDI outflows, receipts of royalties and fees and exports grew at similar rates throughout the early and mid-1970s, those rates of growth began to diverge during the 1980s. Since 1986, FDI outflows grew about 1.3 times faster than receipts of royalties and fees and about 2

times faster than exports. To a certain extent, the growth of receipts of royalties and fees reflected the rapid growth of FDI flows. The divergence between the rates of growth of FDI and exports, in spite of the link between FDI and trade, suggests the possible existence of time lags or the influence of exchange rates on exports (UN, 1993a).

3.4 The Country Distribution of FDI

Figure 3.2 displays the flows of FDI among the European Economic Area (EEA), Japan and North America as these have taken place in 1990 ²⁰.

Figure 3.2 Intra-triad foreign direct investment, 1990



Note: Dollar figures show estimated values of stock of FDI based on data on inward and outward investment from North America and the European Economic Area (EEA), excluding Iceland and Liechtenstein. Intra-North American investment and intra-EEA investment have been netted out. Percentages show average annual growth rates for stocks (1980-1990) and flows (1985-1991). North America includes Canada and the United States. The European Economic Area includes the European Community (EC) and the European Free Trade Association, excluding Iceland and Liechtenstein.

Source: UN (1993b).

²⁰ The European Economic Area (EEA) includes the member states of the European Union (EU) and of EFTA. The data in Figure 3.2 exclude those for Iceland and Liechtenstein.

By far the largest flows of FDI are between the EEA and North America. The total amount of FDI between these two regions was 505 billion dollar in 1990, far more than between Japan and North America with 107 billion dollar and between the EEA and Japan with 26 billion dollar. However, the growth of FDI flows between the EEA and Japan was very high with more than 45 percent per annum in the years 1985-1991 in both directions. The growth of FDI flows from North America to the EEA was much lower in these years with 14 percent per annum and even negative in the opposite direction, with minus 7 percent per annum. From Japan to North America the flow of FDI increased with only 7 percent per annum in the same period but decreased sharply in the opposite direction with minus 23 percent per annum.

The outflows of FDI originate almost completely in the *developed market economies*. The figures in Table 3.2 indicate that in the 1980s only 2 to 3 percent of FDI outflows originated in the *developing countries*, with 97 to 98 percent originating in the developed countries. On the other hand the developing countries accounted for some 25 percent of the inflow of total FDI.

	1987	1988	1989	1990	1991	1992 ^a	1981-1985	1986-1990	1991	1992	1981-1985	1986-1990	1991	1992
	Billions of dollars						Share in total (percentage)				Growth rate (percentage)			
Developed countries														
Inflows	109	132	167	172	108	86	74	83	74	68	0.2	24	-37	-20
Outflows	132	162	203	225	177	145	98	97	97	97	3	24	-21	-18
Developing economies														
Inflows	25	30	29	31	39	40	26	17	26	32	-4	14	21	3
Outflows	2	6	10	9	5	5	2	3	3	3	33	45	-39	0
All countries														
Inflows	135	162	196	203	149	126	100	100	100	100	-0.9	22	-27	-15
Outflows	135	168	213	234	183	150	100	100	100	100	4	24	-22	-18

a) based on preliminary estimates

Source: UN (1993b).

Within the group of developed market economies some important changes in the relative position of *individual countries* regarding FDI have taken

place during the last decades. Table 3.3 indicates that in 1967 the USA accounted for 50 percent of the *total stock of outward FDI*; this percentage had dropped to 30 by 1988. This decline in the US position was counterbalanced by the rise in the position of Japan and Germany whose shares in world stock of outward FDI increased from 1 and 3 percent in 1967 to 10 and 9 percent respectively in 1988. *The Netherlands* continue to have an important position in outward FDI, having a share of 10 percent in 1967 - representing a third place among countries - and a share of 7 percent in 1988 - representing a fifth place. Throughout the period 1967-1988 the developing countries accounted for a mere 3 percent in the total stock of outward FDI.

Table 3.3 Outward stock of foreign direct investment by major home countries and regions, 1967-1988

Countries/regions	1967			1973			1980			1988		
	Value (bn \$)	% of total	% of GDP	Value (bn \$)	% of total	% of GDP	Value (bn \$)	% of total	% of GDP	Value (bn \$)	% of total	% of GDP
Developed market economies	109.3	97.3	4.8	205.0	97.1	5.1	535.7	97.2	6.2	1108.8	97.2	8.0
United States	56.6	50.4	7.1	101.3	48.0	7.7	220.3	40.0	8.2	345.4	30.5	7.1
United Kingdom	15.8	14.1	14.5	15.8	7.5	9.1	81.4	14.8	15.2	183.6	16.2	26.1
Japan	1.5	1.3	0.9	10.3	4.9	2.5	36.5	6.6	3.4	110.8	9.8	3.9
Germany (FDR)	3.0	2.7	1.6	11.9	5.6	3.4	43.1	7.8	5.3	103.4	9.1	8.6
Switzerland	2.5	2.2	10.0	7.1	3.4	16.2	38.5	7.0	37.9	44.1	3.9	23.9
Netherlands	11.0	9.8	33.1	15.8	7.5	25.8	41.9	7.6	24.7	77.5	6.8	34.0
Canada	3.7	3.3	5.3	7.8	3.7	6.1	21.6	3.9	8.2	50.7	4.4	11.6
France	6.0	5.3	7.0	8.8	4.2	3.8	3.8	3.8	3.2	56.2	5.0	5.9
Italy	2.1	1.9	2.8	3.2	1.5	2.4	7.0	1.3	1.8	39.9	3.5	4.8
Sweden	1.7	1.5	5.7	3.0	1.4	6.1	7.2	1.3	5.8	26.2	2.3	16.4
Other ¹	5.4	4.8	0.8	20.0	9.5	1.7	17.4	3.2	1.9	64.0	5.6	4.7
Developing countries	3.0	2.7	0.6	6.1	2.9	0.6	15.3	2.8	0.7	31.7	2.8	1.1
Total ²	112.3	100.0	4.0	211.1	100.0	4.2	551.0	100.0	4.9	1140.5	100.0	6.7

¹ Australia, Austria, Belgium, Denmark, Finland, Greece, Ireland, New Zealand, Norway, Portugal, South Africa and Spain.

² Including a small amount of outward FDI by centrally planned economies, especially in 1980 and 1988.

Source: Dunning (1993a)

To a large extent, the relative decline in the US's position as an international direct investor was inevitable. It primarily reflects the reinstatement of the continental European countries as leading outward investors and the emergence of Japan as a major global player. In 1988,

the four main European investors (the UK, Western Germany, the Netherlands and France) and Japan accounted for 46.9 percent of the accumulated stock of foreign direct investment compared with only 26.3 percent in 1960. More particularly, between 1980 and 1988, the net increase in the foreign capital stake of the UK, Western Germany and Japan rose by 125 billion dollar (Dunning, 1993a).

In general, over the past 25 years, there has been a gradual convergence between the share of outward direct capital stake of the leading industrial countries and their share of the exports of manufactured goods and services. In 1960, for example, the ratio between the US's share of the world stock of FDI and that of her export of goods and services was 2.74. The corresponding ratios for the UK, France, West Germany and Japan were 2.01, 0.99, 0.12 and 0.20. By 1988, the ratios were 1.92, 2.54, 0.79, 1.05 and 1.57 respectively (Dunning, 1993a).

With respect to the period 1967-1988 Table 3.4 displays the developments in the *total stock of inward FDI*. It appears that the USA increased its share threefold during these years, with a share of 9 percent of the total stock of inward FDI in 1967, and of 27 percent in 1988. Two decades after World War II *Western Europe* accounted for 30 percent of the total stock of inward FDI, a share that had risen to 37 percent by 1988. *Germany* doubled its share from 3.4 to 6.8 percent, the share of *Japan* remained very small, never exceeding 1 percent.

The developed market economies as a whole have attracted 70 percent of the total stock of inward FDI in 1967, a share that had risen to nearly 80 percent by 1988. Consequently the share of *developing countries* in the total stock of inward FDI dropped from 30 to 20 percent in the same period. However, the experiences of various groups of developing countries have been diverse. Of the total stock of inward FDI the share of Africa halved from 5 percent in 1967 to 2.5 percent in 1988, that of Latin America nearly halved from nearly 18 to somewhat more than 9 percent, while Asia grew somewhat from 8 to 9 percent. In the five leading industrializing countries in South-East Asia, that is Hong Kong, Malaysia, Singapore, South Korea and Taiwan, the inward foreign direct

investments increased 4.2 times between 1980 and 1988, almost double the 2.2 times rise in GDP.

Countries/regions	1967			1973			1980			1988		
	Value (bn \$)	% of total	% of GDP	Value (bn \$)	% of total	% of GDP	Value (bn \$)	% of total	% of GDP	Value (bn \$)	% of total	% of GDP
Developed market economies	73.2	69.4	3.2	153.7	73.9	3.8	403.4	78.5	4.7	959.5	78.7	6.9
Western Europe	31.4	29.8	4.2	73.8	35.5	5.6	186.9	36.4	4.2	444.5	36.5	8.4
UK	7.9	7.5	7.2	24.1	11.6	13.9	63.0	12.3	12.0	119.6	9.8	17.0
Germany	3.6	3.4	1.9	13.1	6.3	3.8	47.9	9.3	5.8	83.5	6.8	6.9
Switzerland	2.1	2.0	8.4	4.3	2.1	9.8	14.3	2.8	14.1	23.2	1.9	12.6
United States	9.9	9.4	1.2	20.6	9.9	1.6	83.0	16.2	3.2	328.9	27.0	6.8
Other ¹	31.9	30.2	4.2	59.3	28.5	4.2	133.5	26.0	8.7	175.7	14.4	4.8
Japan	0.6	0.6	0.3	1.6	0.8	0.4	3.3	0.6	0.3	10.4	0.9	0.4
Developing countries	32.3	30.6	6.4	54.7	26.3	5.4	110.3	21.5	5.4	259.8	21.3	9.0
Africa	5.6	5.3	9.0	10.2	4.9	8.7	13.1	2.6	4.1	30.9	2.5	9.7
Asia	8.3	7.9	3.9	15.3	7.4	3.6	34.9	6.8	5.0	114.0	9.3	8.9
Latin America	18.5	17.5	15.8	28.9	13.9	12.3	62.3	12.1	8.4	114.9	9.4	14.2
Other ²	na	na	na	0.3	0.1	0.1	na	na	na	na	na	na
Total	105.5	100	3.8	208.1	100	4.1	513.7	100	4.8	1219.3	100	7.2

¹ Australia, Canada, Japan, New Zealand, South Africa.

² Fiji, Papua New Guinea, Saudi Arabia, Turkey, Yugoslavia, Kuwait and United Arab Emirates.

na not available

Source: Dunning (1993a).

The figures in Tables 3.3 and 3.4 can be combined to calculate the rates of outward to inward foreign capital formation. The results are represented in Table 3.5. The figures for the USA indicate that its position has changed considerably from a mainly outward oriented investor country to a country where outward and inward foreign investment balances. In Western Europe the figures for the UK show a similar though less outspoken pattern. Germany has a ratio of 0.56 in 1960 indicating that inward investment was almost twice as large as outward investment. The ratio reached its highest value of 1.67 in 1985, being somewhat lower in 1988. The ratio for Japan rose from 3.7 in 1960 to nearly 15 in 1988 indicating a continuing and increasing strong outward orientation. The UN (1993b) mentions four main reasons for the strong outward orientation in

foreign investment of Japan. Historically, the Government of Japan has had a sustained preference for licensing over FDI for technology acquisition in Japan. Secondly, the liberalization of inward FDI policies started in 1967, still excluded some industry groups - agriculture, oil exploration and leather and leather products. Also, as a third factor, merger and acquisition activities were institutionally difficult until 1990, as prior notification was required. Finally, anti-competitive and exclusive business practices decrease the transparency of business transactions and would place foreign firms in a disadvantageous position.

However, FDI into Japan is increasing. Inflows in the first half of 1992 were almost double those of the same period in 1991. Moreover, the Government of Japan has recently committed itself to stimulate inward foreign investment (UN, 1993b). Finally, the strong position of the Yen and protection against exports from Japan have provided important stimulants for outward FDI of Japan.

However, it should be realized that it is not necessarily better for a country to be a net outward investor than to be a net inward receiver of FDI. There are benefits from FDI both for the home country and for the host country ²¹.

²¹ An analysis of the issues involved can be found in Dunning (1993a).

	1960	1967	1975	1985	1988
Developed countries					
North America					
USA	4.61	5.72	4.48	1.36	0.95 ⁶
Canada	0.19	0.10	0.28	0.60	0.65 ⁵
Western Europe					
France	na	na	1.16	1.06	1.35
Italy	na	na	0.36	0.86	1.02
Netherlands	na	na	2.14	1.98	1.60
Sweden	na	4.55	3.28	2.47 ⁴	3.40
Switzerland	na	1.19	5.50	1.95	1.96 ⁶
UK	2.16 ¹	2.00	1.58 ²	1.73	1.59 ⁵
Germany (FDR)	0.56	0.83	1.04 ³	1.67	1.24
Asia and the Pacific					
Japan	3.68	2.50	10.60	13.70	14.57
Australia	0.11	na	0.13	0.23	0.46
Developing countries					
Latin America					
Brazil	na	na	na	0.08	0.06
Chile	na	na	na	0.07	na
Columbia	na	na	0.04	0.13	na
Asia and the Pacific					
Singapore	na	na	na	0.11	0.09
South Korea	0.0	0.0	0.10	0.26	0.28
Taiwan	na	na	na	0.04	0.14

¹ 1962, ² 1974, ³ 1976, ⁴ 1984, ⁵ 1987, ⁶ 1989

na not available
Source: Dunning (1993a).

3.5 The Sectoral Composition of FDI

Even in the relatively short period of time of two decades (1970-1990) the stock of FDI underwent important changes with respect to the sectoral composition. Table 3.6 indicates the *outward stock of FDI* in the primary sector (agriculture and mining) halved its share from 23 to 11 percent between 1970 and 1990. In the same period the share of the secondary

sector (manufacturing) decreased from 45 to 39 percent. As a result the share of the tertiary sector (services) increased considerably from 31 to 50 percent. Therefore, the services sector by 1990 accounted for not less than half of the outward stock of FDI. Since the figures relate to the *stock of FDI*, the changes recorded would be even more considerably when expressed in *FDI flows*.

As the developed economies absorb three-quarters of outward FDI, the sectoral composition of the stock of inward FDI in developed economies follow the general pattern of the stock of outward FDI set out above; the figures are represented in Table 3.6.

The figures in Table 3.6 reveal also that the sectoral composition of the stock of inward FDI has followed a different pattern in the developing countries. Here the primary sector held its share of some 20 percent in the whole period 1970-1990, with the secondary sector declining in share from 56 to 49 percent and the tertiary sector increasing its share from 24 to 30 percent, far less than in the developed economies.

Group of countries and sector	1970	1975	1980	1985	1990	1971-1975	1976-1980	1981-1985	1986-1990	1981-1990	1970	1975	1980	1985	1990
	Billions of dollars					Average annual growth rate (in percent)					Share (in percent)				
A. Outward stock															
<u>Developed countries</u> ^a	29	58	88	115	160	14.0	8.7	5.5	6.8	6.2	22.7	25.3	18.5	18.5	11.2
Primary	58	103	208	240	556	11.7	15.1	2.9	18.3	10.3	45.2	45.0	43.8	38.7	38.7
Secondary	41	68	179	265	720	10.4	21.4	8.2	22.1	14.9	31.4	27.7	37.7	42.8	50.1
Tertiary	129	229	475	620	1436	11.7	15.7	5.5	18.3	11.7	100.0	100.0	100.0	100.0	100.0
Total															
B. Inward stock															
<u>Developed countries</u> ^b	12	17	18	39	94	4.7	5.9	16.7	19.2	18.0	16.2	12.1	6.7	9.2	9.1
Primary	44	79	148	195	439	10.7	13.4	5.7	17.6	11.5	60.2	56.5	55.2	46.2	42.5
Secondary	17	44	102	188	499	16.5	18.3	13.0	21.6	17.2	23.7	31.4	38.1	44.5	48.4
Tertiary	73	140	268	422	1032	11.3	13.9	9.5	19.6	14.4	100.0	100.0	100.0	100.0	100.0
Total															
<u>Developing countries</u> ^c	..	7	17	31	46	..	19.4	12.8	8.2	10.5	..	20.6	22.7	24.0	21.9
Primary	..	19	41	64	102	..	16.6	9.3	9.8	9.5	..	55.9	54.6	49.6	48.6
Secondary	..	8	17	34	62	..	16.3	14.9	12.8	13.8	..	23.5	22.7	26.4	29.5
Tertiary	..	34	75	129	210	..	17.1	11.4	10.2	10.8	..	100.0	100.0	100.0	100.0
Total															

^a Australia, Canada, France, Federal Republic of Germany, Italy, Japan, Netherlands, United Kingdom and the United States; together these countries accounted for almost 90 percent of outward FDI stock in 1990. 1970 data and 1971-1975 growth data exclude Australia and France.

^b Australia, Canada, France, Federal Republic of Germany, Italy, Japan, Netherlands, Spain, United Kingdom and the United States; together these countries accounted for approximately 72 percent of total inward FDI stock in 1990. 1970 data and 1971-1975 growth data exclude Australia, France and Spain.

^c Argentina, Brazil, Chile, China, Colombia, Hong Kong, Indonesia, Malaysia, Mexico, Nigeria, Philippines, Republic of Korea, Singapore, Taiwan Province of China, Thailand and Venezuela; together these countries accounted for 68 percent of total inward FDI in developing countries.

Source: UN (1993b)

Prospects: The Primary Sector

The UN (1993b) observes that FDI associated with the mergers and acquisitions of petroleum and mining companies is being replaced by a retreat to core business activities. This leads the UN (1993b) to expect a reduction in FDI flows to developed countries, as the developing countries and the Commonwealth of Independent States offer the best opportunities for privatization and new activities. In many regions of the former Soviet Union experts have concluded to a high probability of discovering large new oil and gas fields. Secondly, prospects for FDI in the oil industry depend on conditions in the world energy markets. Capacity constraints in the more mature fields will move the large transnational corporations (TNCs) away from the North Sea and North America (where production costs are high) in search for oil and gas into regions in Asia, Latin America and Eastern Europe. The attractiveness of these regions for inward FDI can be enhanced by government policies on privatization, liberalization and contractual reliability.

Prospects: The Manufacturing Sector

Since the mid-1970s the important industries for inward FDI in manufacturing have been: chemicals, food (including beverages and tobacco), electrical equipment, metals and mechanical equipment. In the developed countries the largest share of FDI still goes to natural-resource based and labour-intensive industries, although the share steadily declined from 73 to 60 percent between 1975 and 1990. The stock of inward FDI in developed economies in capital- and technology-intensive industries rose correspondingly from 27 to 40 percent (UN, 1993b).

It is noteworthy that between 1980 and 1990 the share of capital- and technology-intensive industries in FDI rose faster in developing economies than in the developed countries. This development is particularly significant in the newly industrialized economies such as Hong Kong, Singapore, South Korea, Taiwan and Thailand (UN, 1993b).

These trends in manufacturing FDI are likely to strengthen over time. Many developing countries and economies in transition pursue policies to upgrade their economies and to attract TNCs in the technology-intensive industries (UN, 1993b).

Prospects: The Services Sector

The rapid growth of FDI in services has not come only from transnational service corporations (TSCs) but also from substantial investment in service activities by transnational industrial corporations. Within the services sector, finance- and trade-related activities account for two-thirds of the FDI stock in services in developed economies and the majority in developing countries. Banks, insurance companies, and trading companies are among the most prominent TSCs. Furthermore TNCs tend to establish their own finance-related foreign affiliates and have invested in wholesale and marketing facilities (UN, 1993b).

At present some capital- and technology-intensive service industries are opening up to FDI.

Airlines

Deregulation has provided a major stimulus for the airline industry to open up to FDI. Deregulation in the USA in the late 1970s and further liberalization in 1991, deregulation in the EU surrounding the Internal Market 1992-programme and the negotiations in the framework of the Uruguay Round have led to increasing competition among airlines for market shares and have led in consequence to many strategic alliances through FDI. The most active investors are airlines from Western Europe, with the USA as the major host country of this type of FDI (UN, 1993b).

Telecommunications

As with the airline industry, the impetus for FDI in telecommunications is likely to intensify. In the USA where overall outward FDI has been on the decline, the outward stock of FDI in telecommunications increased in two years not less than 8-fold from 560 million dollar in 1989 to 4.4 billion dollar in 1991 (UN, 1993b).

Until recently, the telecommunications industry has been fenced off from FDI. Recently however, technological developments have been a major factor in the implementation of regulatory changes. These include privatization and liberalization, leading to increased access to FDI in previously sheltered markets. New technologies - such as satellite transmissions - have been decentralizing in nature, and have therefore

undermined the monopoly status of these industries and the governments ability of control. The availability, price and quality of telecommunications services are essential to many economic activities, leading to pressures for deregulation and efficiency, as well. In developed countries large public and private telecommunications companies are increasingly competing among each other, and in developing countries the privatization of telecommunications monopolies has accompanied the liberalization of FDI rules especially in Latin America.

The limited tradability of many services has been a major factor for the rapid growth of FDI in services. The convergence of computer and telecommunication technologies eases this constraint considerably, because transborder flows of data permit instantaneous, long-distance, interactive transactions. These developments render it possible for certain services to be produced and consumed in different locations. The increased transportability of some services, especially those that are information-intensive, may therefore reduce in time the need for FDI as tradability increases.

3.6 Explaining International Production

In explaining international production Dunning (1993a) distinguishes three factors:

1. Ownership advantages of the firm, providing a cost advantage of its products over those of its competitors.
2. Internalization advantages, rendering it more efficient to carry out the production within the own firm rather than by other, for instance by subcontracting.
3. Locational advantages, making it profitable for a firm to engage in value adding activities in another country.

Within the context of the present study, the third factor, that of the *locational advantages*, will be described in some detail. Dunning (1993a) mentions the following location specific variables:

- Spatial distribution of markets.
- Spatial distribution of natural and created resource endowments.

- Input prices, quality and productivity (e.g. labour, energy, materials, components, semi-finished goods).
- International transport and communication costs.
- Investment incentives and disincentives provided by the government (including performance requirements, etc.).
- Artificial barriers (e.g. import controls) to trade in goods and services.
- Societal and infrastructure provisions (commercial, legal, educational, transport and communication).
- Economic system and strategies of government: the institutional framework for resource allocation.
- Cross-country ideological, language, cultural, business, political differences.

The factors of location may vary in relevance, of course, with the type of international production (Dunning, 1993a):

<i>Types of international production</i>	<i>Location advantages</i>
Market seeking	Material and labour costs; market size and characteristics; government policy (e.g. with respect to regulations and to import controls, investment incentives, etc.)
Efficiency seeking	
(a) of products	(a) Economies of product specialization and concentration
(b) of processes	(b) Low labour costs; incentives to local production by host governments
Trade and distribution (import and export merchanting)	Source of inputs and local markets; need to be near customers; after-sales servicing, etc.
Support services	Availability of markets, particularly those of 'lead' clients.

Dunning (1993a) also observes a change in the relative importance among locational advantages over time.

In the period 1945-60, the overriding and unique variable that influenced the locational choice of value-added activity by international firms was the world shortage of US dollars. Furthermore, anxious to be the leaders

in exploiting their new technological and marketing advantages in foreign markets, US oligopolists in the motor vehicle, pharmaceutical, electrical goods, computer, industrial instrument and other industries were quick to establish branch plants in Europe, Canada, Australia and in some wealthier Latin American countries.

Much early post-war European direct investment was also of this kind and there was a certain pattern to it. First, a sales and services facility was set up to promote exports, then came local production using imported materials and components, followed by production with a higher local value-added content.

The rapid growth in industrial output following the end of the Second World War led to an unprecedented demand for raw materials to sustain that output, so increasingly the main industrial countries were forced to seek new sources of supply. For reasons exactly parallel to those prompting backward vertical integration in the 19th century, large firms purchasing primary products for processing and fabrication sought to internalize their sources of supply.

Dunning (1993a) therefore concludes, that the significance of the variables influencing the 'where' to produce vary with the type of FDI and the stage of development of both the investing and recipient countries. The one exception is the political and economic stability of the recipient country. Almost invariably this is a necessary, though not a sufficient, condition for TNC activity.

3.7 International Investment, Trade and Commercial Policies

Evaluating the Uruguay Round

The extent of the market was identified in sections 3.1 and 3.2 as the major constraint on specialization and its benefits. In this perspective the successful conclusion of the Uruguay Round in December 1993 is of great importance.

The outcome of the Uruguay Round can be seen as instrumental to enlarging the extent of the world trade market. By including for the first time

agriculture, textiles and clothing, and services, an additional 36 percent of total world trade is now within GATT. The number of participating countries in the Uruguay Round was eventually 117, larger than the 99 of the Tokyo Round. A further reduction in tariffs and above all the replacement of quota and other forms of non-tariff barriers by tariffs have been agreed upon in the Uruguay Round. These three elements testify to the success of the Uruguay Round in keeping the world market for trade and investment as open as possible.

That the openness of the world market matters with respect to growth in the world economy, cannot be proven for a fact. There are however two important insights that point to a positive relationship:

1. The first one is the insight of Adam Smith that division of labour is a powerful factor in stimulating economic growth, but that the division of labour is limited by the extent of the market. Enlarging the extent of the world market as in the Uruguay Round agreement supports the international division of labour and as a result economic growth in the world economy.
2. In economic history the experience is that in times of trade liberalization (1953-1972) the growth figures for world trade and world output are significantly higher than in periods of increasing protection (1930-1938, 1973-1980). The figures in Table 3.7 testify to this and show also that in times of trade liberalization the difference in growth rates of world trade and world output is particularly large, indicating increased interdependence between nations and increased international division of labour.

Table 3.7 World output and world trade, 1930-2005 (Annual growth rates in percentages)

	1930-1938	1953-1962	1963-1972	1973-1980	1980-1992	1992-2005	
						Without Uruguay Round	With Uruguay Round
World Output	3 ¹	4	5	2.5	2	3	3.5
World Trade	-0.5 ¹	6	9	3	5	4	5

¹ only manufactures

Sources: UNCTAD (1972), Hufbauer and Schott (1985), GATT (1993a, 1993b).

In this perspective, Bhagwati (1991a, 1992a) recently discussed four main threats to the world trade system, as this has been functioning under GATT:

1. *The Focus on Fair Trade*

Successful exporting countries meet suspicion from their less successful trade partners, who attribute the former's success to dumping, too low wages, unacceptable working conditions and too loose standards on health and the environment. Revealed comparative advantage becomes suspect, as the sources of it get immediately questioned.

The threat to the world trade system is that each importing country sets rules for proper trade practices by itself, instead of such issues being settled multilaterally under GATT.

2. *The Menace of Managed Trade*

The obsession with 'Fair Trade' finds its logical consequence in successful exporters being forced to conclude so-called Voluntary Export Restraints to limit their exports, or become subject to other forms of managed trade.

The threat to the world trade system is that managed trade fragments the world market, limiting in turn the scope for the international division of labour.

3. *The Upsurge of Unilateralism*

The attention for fair trade and the application of managed trade have an ally in the increasing unilateral approach to trade relations. For instance Section 301, Super 301 and Special 301 of the Trade and Tariff Act enable the USA to threaten individual trade partner countries, whose behaviour in trade issues is not agreeable to the USA ²². The EU is likely to follow suit in this respect ²³.

The threat to the world trade system from these unilateral threats and actions is, that they invalidate the settlement of trade frictions in the multilateral setting of the GATT and furthermore undermine the credibility of commitments to this multilateral setting of nations pursuing such unilateralism.

4. *The Rise of Regionalism*

The impression is that regional economic integration is fragmenting the world economy into three internally coherent trading blocs: in the Americas, in Europe and around the Pacific. Empirical evidence however indicates that an increasing focus on internal trade is only a clear tendency in the EU, not so much in the NAFTA countries and certainly not in the Pacific area (Schott, 1991). Moreover regional economic integration is welcomed under GATT.

The threat to the multilateral trade system from regionalism would only arise if economic liberalization within the region would be complemented with increasing protectionism against the other trading blocs.

These four threats to the multilateral world trade system present a second perspective from which the outcomes of the Uruguay Round can be evaluated.

²² For instance, measures have been announced toward Brazil, India and Japan in case these countries would not meet US demands regarding import restrictions, foreign investment requirements, and market access, respectively. For an extensive treatment of these issues see Bhagwati and Patrick (eds.) (1991).

²³ Financial Times, 16 April 1994.

Of course the successful conclusion of the Uruguay Round will not keep in check completely these tendencies towards bilateralism and regionalism, but certainly these tendencies would have had more leeway, had the Uruguay Round failed. In this respect the clarification, streamlining and strengthening of GATT rules and dispute settlements is of great importance. In addition, the agreement on the establishment of the new World Trade Organization represents a commitment of all contracting parties to the multilateral setting of rules of conduct in international trade and investment.

The FDI-trade relationship

It has been mentioned before, that a rise in protection may induce the exporter to engage in FDI in the increasingly protected market. This process is sometimes labelled 'tariff jumping', although non-tariff measures (NTMs) are usually more relevant in this respect. The reason is, that tariffs only increase the price of the imported good, whereas NTMs, such as quotas, limit the imports to a certain quantity. Nevertheless, protection as a reason for locating production facilities in the protected market through FDI gives the suggestion, that trade and FDI are substitutes for each other in international economic activities. The relations between FDI and trade are more complicated than that, however.

In a study 'Foreign Direct Investment: The Neglected Twin of Trade', Julius (1991) suggests four subdivisions of trade-related FDI:

1. *FDI substitutes for international trade*

This represents the case, mentioned above, where foreign investment is directed at import substituting activities in the increasingly protected market.

2. *FDI promotes international trade*

In this case FDI is meant to set up manufacturing facilities, the products of which are to be exported. Usually this form of FDI takes place under favourable conditions such as tax exemptions and others.

3. *FDI complements international trade*

FDI may take the form of activities on an export market that are necessary or desirable in view of an already existing export flow. Examples are a service network to support the sales of exported automobiles, and the set up of commercial banks and other services in order to facilitate export activities more in general.

4. *FDI diverts international trade*

International trade in a number of cases is regulated by preferential arrangements, which may take the form of tariff quotas. Such tariff quotas are usually specific with respect to the type of products and exporter. FDI may shift production from locations with no or exhausted preferential quotas to those where such quotas are yet unfilled.

Trade Related Investment Measures

The relationships between international trade and FDI have made it necessary that under GATT the Uruguay Round included negotiations on trade related investment measures (TRIMs). Greenaway (1990) provides an overview of the issues, distinguishing TRIMs at the input and the output side of the production process.

Input TRIMs

Perhaps the most pervasive of investment measures are various forms of *local content requirements*. These specify that some proportion of value added, or of intermediate inputs must be locally sourced. If local inputs have higher costs than their imported counterparts, then this particular instrument has obvious trade effects. *Trade balancing requirements* can take a variety of forms. They could for instance link imports of one product (e.g. an input) to a specified performance on exports of some other product, which could be the final good. Again the instrument has very clear trade effects. *Laws of similars* require foreign investors to use local substitutes for imported inputs if a 'similar' component is manufactured locally. Clearly, if a multinational enterprise (MNE) would otherwise import the input, the trade restricting and distorting effects are obvious. *Limitations on imports*, generally by quota, accomplish the same end, though by a slightly more transparent route, and are self explanatory. Likewise with *foreign exchange restrictions*. These are often

directed at constraining an investor in terms of the amount of intermediate inputs which can be imported. In practice they operate like an import quota, and there is again a clear linkage to trade flows.

Local equity participation is a very common precondition for investment, which like *local hiring targets*, *expatriate quotas* and *national participation in management*, is designed to indigenise part of the operations of the affiliate. The trade effects of these requirements are less obvious than those discussed above. Insofar as they result in the decision making process being shifted away from purely commercial criteria, the balance between locally produced and traded products will be altered. Both *R&D requirements* and *technology transfer requirements* distort the type of investment undertaken, and the firm's commitment to technology transfer. As such they impact directly on the composition of the capital stock and its upgrading through time as the firm may be locked into a given R&D commitment, or a certain type of technology which would not otherwise be chosen. These may reduce import requirements, and/or limit opportunities to export. *Earnings remittance limits* typically restrict the amount of profit which can be repatriated. In turn this can result in a diversion of earnings into investment for local production.

Output TRIMs

The most frequently reported form of output intervention are *minimum export requirements*. Many host governments insist that a certain proportion of final output is exported or that a certain value of exports is met. Where this intervention is effective, it can have potentially serious trade effects - exports would be higher than otherwise, resulting in trade deflection elsewhere. *Trade balancing requirements* can operate in a similar fashion by compelling the investor to export more of its output than it would do otherwise. A far less common intervention is *export controls* directed at ensuring that exports of specified commodities are precluded, or restricted. *Market reserve policy* is applied when the local market is reserved for actual, and sometimes even potential, producers of a competing product. This condition appears to be especially common in connection with investments in export processing zones in Less Developed Countries (LDCs). If it locks the affiliate into exporting rather than supplying the domestic market, again it has clear trade

effects. *Product mandating requirements* oblige the investor to export the mandated product from the host country only. Depending upon the level of demand to be satisfied globally, and the parent company's global investment strategy, this could lock the MNE into exports from higher cost locations. These differ from *licensing requirements* which oblige the investor actually to license production of the output in the host country. This may mean that the amount of royalties the firm can receive is limited, as well as restraining what can be imported from the parent company. Finally, *technology transfer restrictions* can operate on outputs as well as on inputs - the potential for distortion of trade has already been discussed above.

From this overview, it is clear that some TRIMs have direct trade distorting effects. Local content requirements are a case in point. So too are minimum export requirements, trade balancing requirements and export controls. Thus even if one accepts that they are measures designed to influence investment rather than trade in goods, the fact remains that they have a direct impact on the latter. As such, there is at least a *prima facie* case for extending GATT disciplines to cover TRIMs, although by reference to the effects of the measure rather than the measure *per se*. However, it is equally clear that the primary impact of most TRIMs is not on trade: local equity requirements, expatriate quotas, R&D requirements and technology transfer requirements are all examples of this. Here trade flows may be affected indirectly, via, for instance, influencing the firm's choice of production technique or location of production, and it is not clear that an *a priori* case for bringing GATT disciplines to bear exists.

Tables 3.8 and 3.9 set out those TRIMs where existing GATT provisions appear to be applicable/inapplicable respectively. As can be seen in those cases where economic theory ascribes direct trade distorting effects, existing GATT articles may provide a mechanism for disciplining their use - this certainly applies to local content requirements, and possibly to export requirements. However, the case for GATT disciplining those TRIMs listed in Table 3.9 is less clear.

Within the framework of the Uruguay Round an agreement on TRIMs was reached, that can be summarized as follows (GATT, 1993c).

The agreement on TRIMs recognizes that certain investment measures restrict and distort trade. It provides that no contracting party shall apply any TRIM inconsistent with Articles III (national treatment) and XI (prohibition of quantitative restrictions) of the GATT. To this end, an illustrative list of TRIMs agreed to be inconsistent with these articles is appended to the agreement. The list includes measures which require particular levels of local procurement by an enterprise ('local content requirements') or which restrict the volume or value of imports an enterprise can purchase or use to an amount related to the level of products it exports ('trade balancing requirements').

Table 3.8 GATT provisions which may be applicable to TRIMs	
(A) Trade Effect: Reduction of Imports Into the Country Applying TRIMs	
<u>TRIM</u>	<u>GATT Article</u>
Local Content Requirements	3.4, 3.5
Trade Balancing Requirements	11.1, 3.4
Manufacturing Requirements	11, 3.4, 3.5
(B) Trade Effect: Increase/Decrease of Exports from the Country Applying TRIMs	
<u>TRIM</u>	<u>GATT Article</u>
Minimum Export Requirements	1, 16.4
Product Mandate Requirements	1
Trade Balancing Requirements	16.4
Domestic Sales Requirements	11

Source: Greenaway (1990).

<p>Table 3.9 TRIMs which may have trade effects but to which existing GATT articles are inapplicable</p>

<p>Licensing Requirements Technology Transfer Requirements Earnings Remittance Restrictions Local Equity Requirements Expatriate Quotas Local Hiring Targets National Participation in Management</p>

Source: Greenaway (1990).

The agreement requires mandatory notification of all non-conforming TRIMs and their elimination within two years for developed countries, within five years for developing countries and within seven years for least-developed countries. It establishes a Committee on TRIMs which will, among other things, monitor the implementation of these commitments. The agreement also provides for consideration, at a later date, of whether it should be complemented with provisions on investment and competition policy more broadly.

Government Policies

From the previous section it follows that a prudent use of TRIMs provides a government of a potential host country the possibility at least not to deter FDI. The range of government policies for attracting FDI is however much wider (Dunning, 1993a). These include:

- (a) conditions of entry;
- (b) operating requirements;
- (c) exit conditions;
- (d) achieving cost effective FDI.

It is outside the scope of the present study to discuss these policy elements in detail. In general, Dunning (1993a) observes:

The opening up of national economies to the winds of global competition, and the role which MNEs play both as actors in global markets and as brokers in the allocation of economic activity between nation states, has meant that host governments are now evaluating inward investment less for the new resources it provides and more for the way in which it can integrate their economies into the global market place and help upgrade the quality of indigenous human and physical capital. At the same time, to promote the right kind of MNE activity, governments have had to

reappraise the efficiency of the markets under their jurisdiction and, where necessary, to help create the conditions under which they might work to the social good.

Creating a stable political and economic environment is one of the main necessary conditions for attracting FDI.

3.8 Globalization and Employment

Recently the OECD (1994a) studied the situation of unemployment in the OECD countries. It concludes that unemployment is probably the most widely feared phenomenon of our times, and furthermore that the present level of unemployment of some 9 percent of the OECD labour force represents an enormous waste of human resources, that it reflects an important amount of inefficiency in economic systems, and causes a disturbing degree of social distress.

The OECD (1994b) presents an overview of developments in unemployment in the OECD area over the period since 1950. The results are represented in Figure 3.3.

In North America, unemployment rates were relatively high in the 1950s and 1960s. But there has been only a modest trend increase since 1970, albeit with large cyclical fluctuations. Unemployment peaked at just over 7.5 percent in 1992 - well below the previous peak of over 9.5 percent in the early 1980s - and is currently around 7 percent.

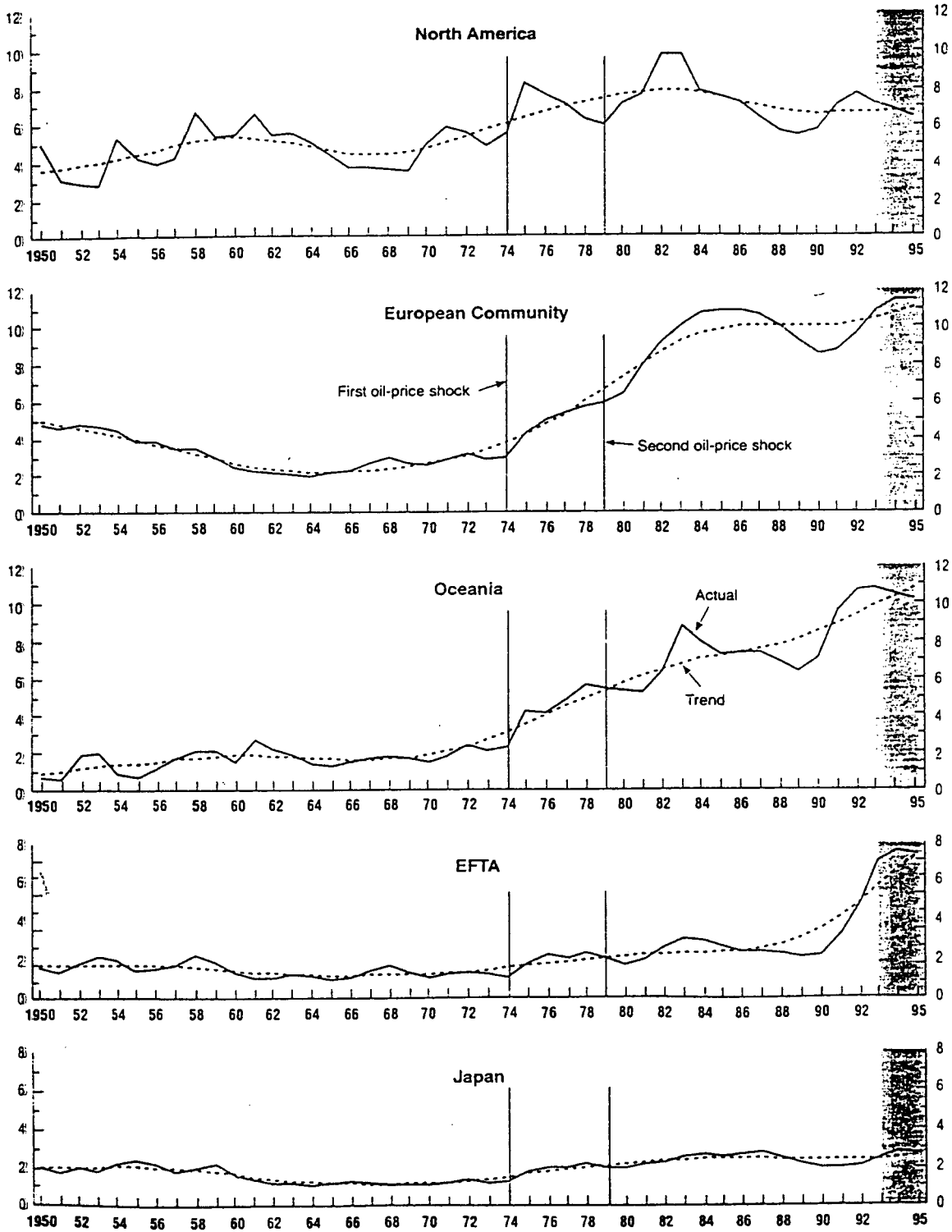
By contrast, unemployment in both the European Community (EC) and Oceania has risen sharply since the mid-1970s, with the unemployment rate in both regions currently at record rates of around 10-11 percent.

The EFTA countries successfully stabilized unemployment in a range of 2 to 4 percent until 1990. Since then, the rate has risen sharply, to almost 8 percent.

Japan has managed to keep unemployment low, at between 1 and 3 percent, throughout the entire post-War period. The current unemployment rate is almost 3 percent.

In addition the OECD (1994a) observes, that for any given rate of unemployment the share of long-term unemployment is much higher in EC countries, than in North America. In the EC countries it ratcheted up, rising sharply during the recession in the early 1980s and declining only moderately during the upswing. By contrast, in North America the share of long-term unemployment increased much less during the recession, and subsequently fell back sharply. By 1989, it had fallen almost to its 1979 level.

Figure 3.3 Unemployment rates in OECD regions, 1950-1995 ¹
 (As a percentage of the labour force)



¹ OECD projections in shaded area
 Source: OECD (1994b).

It is well established (Kuznets, 1971) that with a rising level of economic development the share of various broad sectors in an economy's GDP changes considerably. A very high share of agriculture in the early stages of development is not sustainable in most cases, and the share of agriculture goes down with development gradually to very low levels in the most advanced countries today. The manufacturing sector first has a share growing to about 60 percent of GDP, later to decrease again, its most important position gradually being taken over by the services sector, that however has a considerably share at practically all stages of development in a monetized economy (Chenery and Syrquin, 1975).

With respect to the OECD, today agriculture accounts for only 7 percent of total OECD civilian employment, compared with 14 percent in 1970 and almost 50 percent in 1870. The relative importance of employment (although not of output) in industry has also decreased, down from nearly 40 percent of OECD employment in 1970 to under 30 percent in 1992. The counterpart has been a continual rise in the importance of employment in the service sector (OECD, 1994a).

The share of OECD employment in the service sector has risen, from less than 50 percent in 1970 to around 65 percent in 1992. Most of the new job growth during the 1980s occurred in services such as finance, insurance and business services, and community and personal services.

These shifts in the sectoral composition of jobs are driven by many forces for change, including, international trade and technology. International trade has generally grown faster than GDP. Most trade flows are between OECD countries, and consist to a large extent (70 to 80 percent in the EU countries) of trade in similar products within sectors, commonly labelled as intra-industry trade. Trade with non-OECD regions, such as the East Asian NICs and China, while growing fast, is still comparatively small.

Imports from non-OECD countries are in substantial part labour-intensive manufactured products and primary materials, whereas exports by OECD countries very often have a relatively high skill content. Trade in manufactured goods with non-OECD countries remains in surplus, albeit

diminished during the 1980s due to: a sharp contraction of the OPEC market; stagnating demand in debt-ridden developing countries; and a movement into trade deficit with the industrializing countries in Asia.

Earlier, the deterioration was concentrated in a few labour-intensive sectors, notably textiles, clothing and footwear. Over the last 10 years the pattern changed with some non-OECD trading partners: in particular the East Asian NICs increased their market shares in knowledge-intensive sectors such as office equipment and telecommunications.

Technological change continues to alter the nature of jobs. The main OECD countries, with their large domestic markets, have generally had the highest share of employment in high-technology manufacturing. But the rapidly growing international market for new technology products makes high-tech production feasible even for small countries. Thus not only Japan, but also some smaller countries (notably Ireland, Australia, Finland and Norway), have been particularly successful in strengthening their competitiveness in high-tech industries. Many other European countries have a relatively poor record in shifting to high-tech exports. The only large EC country that strengthened its comparative advantage significantly in high-tech products, the United Kingdom, did so not by increasing its market share for high-technology commodities, but through a large loss of market share for low- and medium-tech products in the early 1980s (OECD, 1994a).

With respect to job creation there is a striking difference between Japan and the USA on one side and the EC and EFTA on the other. Job growth in the United States and Japan has taken place largely in the private sector. By contrast, some two-thirds of the 10 million jobs created in the EC and EFTA since the early 1970s have been in the public sector. During the 1980s, however, the pace of public sector job growth slowed considerably in Europe, and private sector employment, which had fallen between the mid-1970s and early 1980s, picked up. Private sector employment gains over the past decade were largest in Germany, the Netherlands and the United Kingdom (OECD, 1994a).

Public sector discussion on the causes of high and rising unemployment usually runs along the following lines (OECD, 1994a):

- Technology causes rising unemployment. This view holds that the pace of technological change should be slowed, for example through the development of a two-tier economy: one highly productive sector and the other, favoured by policy, much more labour-intensive.
- Imports from low-wage countries cause higher unemployment and drag down wages of low-skilled workers. Proponents of this view regard import competition from low-wage countries and regions as unfair and support protectionism to curb what they see as social dumping.
- The intensity of competition is to blame. Competition has intensified, partly as a result of globalization, obliging firms to become ever more efficient through processes such as mergers, downsizing or re-engineering - all of which raise the spectre of fewer stable jobs in large enterprises. The response would be to reduce the intensity of competition, using tools such as anti-dumping actions, merger controls and financial regulations and job security provisions.

Evidence from a range of countries and experiences over the past four decades and especially over the past few years indicates that none of these suggested causes is primarily or even importantly responsible for today's unemployment.

Analyses of trade in goods suggest that there has been a small negative effect on demand for unskilled labour in OECD countries due to trade with non-OECD countries, but that losses of unskilled jobs have been largely offset by jobs gained through trade in goods produced by skilled labour. The relation between trade and earnings is less clear, due to difficulty in clearly isolating trade from other effects on earnings, and to lack of necessary data. The main impact of international investment flows is felt in OECD countries, which are the major sources and destinations of investment. Net flows to non-OECD countries are small relative to fixed investments, and they are unlikely to have had significant impact on employment to date (OECD, 1994a).

Table 3.10 presents a decomposition of developments in employment up to the mid-1980s in seven important OECD countries. The change in employment has been decomposed into six effects: the expansion of domestic final demand, of foreign final demand (exports), of final demand for foreign products (imports of final goods), the imports of intermediate goods, the changes in the structure of intermediate deliveries (input-output coefficients), and the change in labour intensity of production (productivity).

Country	Sector	Total change in employment growth rate (percent)	Sources of Change					
			Domestic final demand expansion	Export expansion	Imports of final goods	Imports of intermediate goods	Technology (change in I/O coeff.)	Productivity change
Australia (1974-86)	High-growth	2.28	2.74	0.38	-0.16	-0.16	0.67	-1.20
	Medium-growth	1.71	3.32	0.48	-0.10	-0.10	-0.82	-1.07
	Low-growth	-2.15	2.30	0.55	-0.50	-0.49	-0.76	-3.25
Canada (1981-86)	High-growth	2.14	3.01	0.93	-0.05	0.04	0.23	-2.02
	Medium-growth	-0.47	0.87	1.40	-0.14	-0.15	-0.23	-2.22
	Low-growth	-1.20	0.54	1.20	-0.46	-0.24	-0.50	-1.74
France (1977-85)	High-growth	1.42	2.42	0.35	-0.08	-0.08	0.42	-1.60
	Medium-growth	-1.55	0.70	1.08	-0.23	-0.17	-0.18	-2.74
	Low-growth	-3.52	0.03	0.65	-0.59	-0.67	-0.35	-2.59
Germany (1981-86)	High-growth	1.36	1.88	0.50	-0.05	-0.09	0.23	-1.11
	Medium-growth	-0.53	0.56	1.37	-0.25	-0.36	0.08	-1.92
	Low-growth	-1.93	0.16	1.09	-0.46	-0.55	-0.75	-1.40
Japan (1975-88)	High-growth	2.33	4.80	1.05	0.04	-0.02	0.28	-3.82
	Medium-growth	-0.25	2.40	0.61	-0.07	-0.17	-0.19	-2.84
	Low-growth	-0.59	2.04	0.57	-0.12	-0.12	0.56	-3.51
UK (1979-84)	High-growth	0.47	2.64	0.36	-0.16	-0.10	-1.20	-1.07
	Medium-growth	-1.44	0.26	0.60	-0.54	-0.55	-0.44	-0.78
	Low-growth	-6.99	-1.09	-1.18	-0.84	-0.87	-0.14	-2.87
USA (1977-85)	High-growth	2.85	2.97	0.22	-0.07	-0.03	0.33	-0.56
	Medium-growth	1.22	2.20	0.20	-0.20	-0.03	-0.63	-0.32
	Low-growth	-1.84	1.31	-0.06	-0.68	-0.62	-1.17	-0.62

Source: OECD (1992)

The analysis was carried out by the OECD (1992) for three groups of industries separately: those with high-, medium-, and low-growth in

output. As can be seen from Table 3.10, domestic demand tends to be the dominant factor for the high-growth group; domestic demand and exports generally have a similar impact on the medium-growth groups; and technological changes usually had a positive impact on the employment growth rate of the high-growth group, but had a negative effect on the low-growth group. The significant change from this pattern is in the low-growth group where productivity changes were the dominant factor associated with declining employment growth rates, exceeding the impact of imports or changes in technology. In nearly every country, the relative impact of productivity compared to the other factors was the largest in the low-growth group.

It is noteworthy in particular, that in sectors experiencing low output growth, growth of employment was negative in all countries investigated. The predominant factor turns out to be the change in productivity. The import factor is far less important generally, with the exception of the USA. Of course the methodology followed by the OECD (1992) does not preclude that the changes in productivity upon closer investigation could turn out to be import induced to some extent. However the present analysis is perfectly clear in its result that it is not imports per se that leads to disappointing employment developments in low-growth industries. Besides, the results confirm the common notion that employment creation is served best by expansion of high-growth industries rather than protecting those with a low-growth, protracting necessary adjustments at the same time.

Difficulties in absorbing technology have been handled differently in different countries. Japan, Germany and Sweden are considered leaders in the use of information technologies for advanced manufacturing processes, ahead of countries with poorly adapted industrial structures or, more importantly, with firms that have been slow to re-design organization and production systems. The United States, while behind on information technologies use in industrial production, has a computer orientation that produces a high rate of information technologies applications, in computer-aided design and engineering (OECD, 1994a).

The basic policy message of the OECD (1994a) is unambiguous: high unemployment should be addressed not by seeking to slow the pace of change, but rather by restoring economies' and societies' capacity to adapt to it. But this must be undertaken in ways which do not abandon the social objectives of OECD societies. Rather, social objectives must be met in new, more carefully-designed ways that do not have the past unintended and undesirable side effects.

The OECD (1994b) presents four policy approaches to facilitate adjustments in the labour market:

1. *Measures to reduce barriers to labour mobility.*

Two important barriers to labour mobility are housing market distortions and the non-portability of employer pension plans.

2. *Reform of employment protection provisions.*

A certain degree of employment protection is justified in order to protect the workers from arbitrary dismissals. However, dismissals which are required on economic grounds should be allowed.

3. *Facilitating school-to-work transition.*

There is no single approach for improving the transition from school to work that is valid for all countries. In general, evidence shows that a smooth transition from the formal education system to the labour market depends on partnerships linking the two.

4. *Improving investment in further education and training.*

Upgrading of knowledge and competences later in working life is impeded by the lack of incentives for employers and individuals to invest in further training. Governments can act to reduce the uncertainty surrounding investment in further training by among others improving the transparency of the costs and benefits of training.

3.9 Economic Developments in Central and Eastern Europe

3.9.1 Introduction

The focus of foreign trade relations of the countries in Central and Eastern Europe (CEE) on Western Europe was identified in section 2.8 as a major recent development. In view of the importance of East-West economic relations both from the perspective of the CEE and of the EU, the present section will examine these relations in more detail.

The foreign trade position of the Central and Eastern European countries has changed since the transition from central planning economies to market economies around 1989. As a result of this transition trade between the CEE countries declined substantially, while trade with the developed market economies increased. These movements in overall exports and imports caused trade surpluses to drop or even become trade deficits (United Nations, 1994).

This section examines recent economic developments in the CEE transition economies. Section 3.9.2 reviews foreign trade of Central and Eastern Europe, focusing on trade between the CEE economies and the European Union. Section 3.9.3 analyses the trade policies of Central and Eastern Europe and of the EU. Finally, in section 3.9.4 recent developments of FDI in Central and Eastern Europe are presented.

3.9.2 Foreign Trade of Central and Eastern Europe

After the transition from central planning economies to market economies around 1989, total exports and imports of the CEE countries declined considerably. Table 3.11 shows that both total exports and total imports of the 6 CEE countries studied in this section (Bulgaria, former Czechoslovakia, Hungary, Poland, Romania and the former USSR) halved between 1989 and 1992. However, the trends in exports and imports vary considerably among the different countries.

A considerable decline in exports of Bulgaria, Romania and the former USSR during the period 1989-1992 can be observed. Exports of Poland

remained stable, while Hungary increased its exports in the period mentioned. The decline of exports in former Czechoslovakia is reversed in 1992.

A slightly different pattern can be observed for imports. Imports of Bulgaria and the former USSR declined substantially, while imports of Hungary and Poland increased. Imports of Romania and former Czechoslovakia show a modest decline.

In five of the CEE countries mentioned an overall trade surplus in 1989 has changed into an overall trade deficit in 1992. Only in the former USSR a trade deficit reversed into a trade surplus.

		1989	1990	1991	1992
Bulgaria	Exports	16013	13347	3835	4071
	Imports	14881	12893	3017	4239
	Trade Balance	1132	454	818	-168
Czechoslovakia (former)	Exports	14440	11882	10878	11656
	Imports	14277	13106	10014	12530
	Trade Balance	163	-1224	864	-874
Hungary	Exports	9584	9707	10301	10680
	Imports	8803	8764	11532	11122
	Trade Balance	781	943	-1231	-442
Poland	Exports	13155	14322	14460	13187
	Imports	10085	9528	14261	15913
	Trade Balance	3070	4794	199	-2726
Romania	Exports	10486	5870	4124	4372
	Imports	8436	9115	5600	6147
	Trade Balance	2050	-3245	-1476	-1775
USSR (former)	Exports	109173	104177	46274	43761
	Imports	114567	120651	43458	38653
	Trade Balance	-5394	-16474	2816	5108
Total	Exports	172851	159305	89872	87727
	Imports	171049	174057	87882	88604
	Trade Balance	1802	-14752	1990	877

Source: UNCTAD (1994).

After the transition trade flows of the CEE countries were diverted from intra-trade with other CEE countries towards Western market economies (European Commission, 1994). Table 3.12 shows the geographical pattern of foreign trade of Central and Eastern Europe and the former USSR in 1970, 1980 and 1992.

The share of intra-CEE trade in total exports of the CEE countries declined substantially (from 60 percent of total exports in 1970 to 19 percent in 1992), while the share of intra-CEE trade in total imports of the CEE countries declined even more (from 64 percent of total imports in 1970 to 17 percent in 1992).

For the CEE countries the importance of the EU as a market of destination increased in the period 1970-1992. The share of total CEE exports directed to the EU increased from 12 percent in 1970 to 45 percent in 1992. Looking at the trade flow from the EU to the CEE countries a similar conclusion can be drawn. The EU as a source of origin for imports increased in importance for the CEE countries from 13 percent of total CEE imports in 1970 to 43 percent in 1992.

From the EU perspective the share of total EU imports originating from Central and Eastern Europe has decreased from 3.4 percent in 1970 to 2.9 percent in 1992 and the share of EU exports going to the CEE countries decreased from 3.4 percent in 1970 to 3.1 percent in 1992.

For the former USSR a similar pattern can be observed as for the CEE countries as a whole. The share of former USSR exports directed to the EU rose from 11 percent in 1970 to 45 percent in 1992 and the share of former USSR imports originating in the EU increased from 12 percent in 1970 to 33 percent in 1992. Simultaneously the share of trade with Central and Eastern Europe in total trade of the former USSR decreased (for exports from 53 percent in 1970 to 14 percent in 1992 and for imports from 58 percent in 1970 to 15 percent in 1992).

Table 3.12 Direction of foreign trade of Central and Eastern Europe, 1970-1992			
Total trade of CEE	1970	1980	1992
Exports (million dollars)	30525	155115	92890
Of which to (%):			
EU-12	12	19	45
EFTA	5	6	11
USA	1	1	2
Japan	2	1	3
CEE	60	51	19
Imports (million dollars)	28634	143964	102996
Of which from (%):			
EU-12	13	17	43
EFTA	5	5	9
USA	1	3	5
Japan	2	2	3
CEE	64	55	17
<i>Trade flow to EU</i>			
Share of total EU imports	3.4	4.0	2.9
<i>Trade flow from EU</i>			
Share of total EU exports	3.4	3.5	3.1
Total trade of former USSR	1970	1980	1992
Exports (million dollars)	12800	76449	46993
Of which to (%):			
EU-12	11	23	45
EFTA	4	7	10
USA	1	0.3	2
Japan	3	2	6
CEE	53	42	14
Imports (million dollars)	11451	61924	48808
Of which from (%):			
EU-12	12	17	33
EFTA	5	6	5
USA	1	2	8
Japan	3	4	5
CEE	58	44	15

Source: UNCTAD (1994).

There are marked differences in the structure of exports of the former USSR and the other CEE countries to the EU. From Table 3.13 can be seen that for the former USSR exports to the EU consist mainly of primary goods, with a share of 75 percent of total exports in 1992 (of which fuels represent around 60 percent). The other CEE countries mainly export manufactured products to the EU, with a share varying between around

60 percent (for Poland and Bulgaria) and almost 90 percent (for Romania) of their total exports in 1992.

	Year	Bulgaria	Czecho- slovakia (former)	Hungary	Poland	Romania	USSR (former)
Total Merchandise	1990	100.0	100.0	100.0	100.0	100.0	100.0
	1992	100.0	100.0	100.0	100.0	100.0	100.0
Primary products	1990	32.7	21.1	32.2	41.5	25.4	75.6
	1992	34.6	16.6	28.8	36.1	11.0	74.5
Of which:							
Food	1990	20.4	6.3	21.1	18.3	2.3	1.1
	1992	18.9	4.8	19.8	12.9	4.9	2.3
Fuels	1990	5.1	5.5	2.4	10.3	18.7	60.3
	1992	1.7	3.1	1.6	7.2	2.8	57.7
Manufactures	1990	65.7	76.8	66.1	54.4	73.9	18.6
	1992	64.8	81.4	69.9	62.8	88.0	17.5
Of which:							
Iron and steel	1990	9.0	11.2	4.6	4.8	5.4	4.2
	1992	5.9	10.0	3.3	4.5	7.0	3.1
Chemicals	1990	8.7	11.0	8.7	8.3	3.4	3.9
	1992	8.2	8.8	9.8	7.1	4.9	5.5
Other semi- manufactures	1990	4.9	11.5	7.7	8.6	8.5	2.8
	1992	6.7	17.3	9.2	12.9	9.2	3.1
Machinery and transport equipment	1990	28.6	25.1	23.0	15.4	14.7	6.6
	1992	12.1	20.7	19.1	13.4	8.3	4.3
Textiles	1990	2.5	5.3	2.9	1.8	2.0	0.3
	1992	3.9	5.2	2.5	1.9	2.1	0.4
Clothing	1990	6.9	4.2	10.6	8.7	20.4	0.0
	1992	17.6	7.5	14.5	14.0	33.2	0.5
Other consumer goods	1990	5.2	8.4	8.6	7.0	19.5	0.9
	1992	10.4	11.9	11.5	9.1	23.6	0.7

(Source: GATT, 1993a).

Although there are variations between the individual CEE countries, within manufactured products the main export categories to the EU include clothing, machinery and transport equipment, chemicals, and iron and steel.

3.9.3 Trade Policies in Central and Eastern Europe and the EU

Trade policies in Central and Eastern Europe

Recently the IMF (1992) presented an overview of trade liberalization in Central and Eastern European (CEE) countries, against the background of the situation before the transition.

After World War II the CEE countries were reorganized under the influence of the former USSR system of central planning.

The coordination of imports and exports was an integral part of the central planning process. The composition and level of trade were influenced by a number of control mechanisms including central allocation of foreign exchange and licensing. Foreign trade organizations were established and had a state monopoly on foreign trade. Firms did not trade directly with their foreign counterparts or face world prices; they exported and imported products through foreign trade organizations at ruling domestic prices with the difference between international and domestic prices being absorbed (in the case of losses) or taxed (in the case of profits) by the government budget. Thus, although tariffs were generally low, central-plan tools and exchange controls provided a high level of protection for domestic production (IMF, 1992).

Trade with other centrally planned economies and market economies involved different arrangements. The former was largely undertaken in non-convertible currencies within the arrangements of the CMEA²⁴. This trade was based on five-year bilateral agreements with annual negotiations to agree on prices and other details. A bilateral surplus with one country could not be used to finance a bilateral deficit with another country. Trade with market economies was undertaken mainly in convertible currencies and was subject to state control.

The commodity composition of CMEA trade with socialist countries (mostly in the CMEA area) differed significantly from that with the market economies. Machinery and transport equipment were the most important exports to socialist countries; while food, crude materials and manufactured articles generally were the most important exports to industrial countries. The CEE countries exported mainly machinery equipment and other manufactures to the former USSR in exchange for fuels and raw materials.

²⁴ The CMEA was founded by Bulgaria, Romania, former Czechoslovakia, Poland, Hungary and the former USSR in 1949.

The overall terms of trade of CEE countries were quite favourable compared with what they would have been without the CMEA arrangements; it has been estimated that moving to world market prices would involve a terms of trade deterioration in the range of 20 to 30 percent for Central and Eastern Europe ²⁵.

Some CEE countries had undertaken partial economic reforms prior to the political revolution that swept Central and Eastern Europe in 1989.

In the past few years CEE countries have initiated and in some cases accelerated comprehensive reform programmes designed to transform their economic systems rapidly into market-based economies ²⁶. Liberalization of the trade and exchange system is an important component of these reforms. All six countries have eliminated the state monopoly of foreign trade, substantially reduced quantitative restrictions, and moved towards a trade regime in which price-based measures (tariffs and exchange rates) are the main trade policy instruments. Export subsidies, except those on some agricultural products, have been removed, and export licensing has been reduced significantly. In parallel with the removal of trade restrictions, all six countries have established the essential elements of convertibility for current international transactions although some restrictions remain in place (IMF, 1992).

Notwithstanding these reforms, the CEE countries are not yet fully integrated into the multilateral trade system. Further progress in this area will depend, inter alia, on (i) the continuation of the systemic reforms; and (ii) sufficient access to foreign markets, particularly those of industrial countries. The latter is of particular importance given the collapse of trade among former members of the CMEA, and the rapid deterioration in economic conditions in most of Central and Eastern Europe.

²⁵ Kenen (1991).

²⁶ The countries covered in this section include Bulgaria, the Czech and Slovak Federal Republic (former Czechoslovakia), Hungary, Poland, Romania and Yugoslavia.

In all countries reforms are being supported by financial resources and technical assistance provided by the IMF and the World Bank.

A move towards currency convertibility and more open trade regimes are important components of reform in all CEE countries.

In Hungary and Poland convertibility is largely limited to the enterprise sector, and most countries have maintained limits on travel allowances.

All countries permit inward foreign investment and repatriation of dividends and profits (IMF, 1992).

The elimination of most implicit and explicit non-tariff barriers and the liberalization of exchange controls means that tariffs and exchange rates have become the principal trade policy instruments in these countries.

Measures have also been taken to liberalize exports. Most export subsidies have been removed and export licensing has been significantly reduced in most countries. However, some restrictions remain in place in all CEE countries, in particular, to comply with VERs and quotas applied by trading partners in sectors such as textiles and clothing, agriculture, steel, and coal. In addition, temporary export bans were introduced (Bulgaria in 1990) and licensing retained (former Czechoslovakia) to ensure adequate domestic supplies of products such as foodstuffs and raw materials during the adjustment process and to prevent the export (or re-export) of products that are subject to domestic price controls or imported at the official exchange rate (Romania).

In addition, partly in response to access difficulties in industrial country markets and EU export subsidies, some of the CEE countries have introduced measures to protect their agricultural sectors.

Issues in the design of trade reform

A broad consensus has emerged both on the need for a rapid and comprehensive reform in Central and Eastern Europe and on the main elements of such a reform package. The latter include macroeconomic stabilization and control, liberalization of trade and establishment of convertibility for current account transactions, price liberalization and the development of a competitive private enterprise sector, the creation of efficient financial institutions and the liberalization of financial markets, deregulation of labour markets, and the establishment of a social safety

net. Reform programmes must be credible and specify the long-term objectives and transaction path at the outset of the reform (IMF, 1992). Within this context, there is a broad consensus that trade liberalization should be implemented early in the reform process. The well-documented experiences of other countries, such as Korea, might provide useful guidelines (World Bank, 1992).

An accelerated pace of trade liberalization in reforming socialist economies is considered essential because, compared with market economies, relative prices are highly distorted, factor markets function poorly, domestic production is more highly concentrated, the extent of state ownership is much greater, and trade has been distorted by arrangements among former CMEA members ²⁷. Notwithstanding the above considerations, it has been suggested that temporary tariff protection might be provided in the short run to avoid the move to world prices being disruptive.

This approach would partly negate the positive contribution trade liberalization can make toward eliminating distortions due to monopolistic market structures (IMF, 1992).

CEE countries have negotiated or are seeking new bilateral trade and barter agreements with the former USSR or the Commonwealth of Independent States (and in some cases with other former CMEA countries) as a way of cushioning the impact of the collapse of CMEA trade. In the current circumstances, with the collapse of trade due to the shortage of foreign exchange and disorganization in the Commonwealth of Independent States, these arrangements are considered necessary to maintain a certain level of trade and avoid unnecessary enterprise closure. In most cases, barter trade appears to involve inter-enterprise arrangements. These agreements tend to sustain the distorted production structures and trade flows and to delay the process of adjustment (IMF, 1992).

²⁷ Havrylyshyn and Tarr (1991).

Integration into the multilateral trade system

The full integration of the CEE countries into the multilateral trade system will depend - as mentioned before - on (i) the continuation of the systemic reforms; and (ii) sufficient access to Western markets.

During the last few years industrial countries have taken a number of steps to improve the access of Central and Eastern Europe to their markets. The United States extended MFN status to former Czechoslovakia in November 1990 and to Bulgaria in April 1991. In addition, the United States has increased the quantities of steel products subject to VERs that may be imported from Hungary and Poland.

Major changes in EU relations with Central and Eastern Europe have occurred recently. This issue will be taken up more extensively below.

Membership in GATT on normal terms is essential to provide Central and Eastern Europe with greater security of access to markets of other Contracting Parties. At the same time, acceptance of the full obligations of GATT membership may enable CEE governments to lock in trade reforms and to resist protectionist pressures that may arise to backtrack on reforms.

Trade policies of the European Union towards Central and Eastern Europe

CEE countries were subject for a long time to a very restrictive import regime by the EC, based on a tight quantitative regulation of flows. Until 1989 EC imports from the state-trading countries of Central and Eastern Europe (with the exception of Romania)²⁸ were governed by Regulations No. 1765/82 and No. 3420/83. The former set the trade regime applicable to products not subject to quantitative restrictions, including the safeguard measures. The latter dealt with products not liberalized at the Community level and with the administration of the special import arrangements that applied to them (Grilli, 1995).

Recently, the European Union (EU) implemented a programme of trade liberalization towards the CEE countries. The process of reduction of EU

²⁸ Romania has been a (partial) GSP beneficiary since 1974.

trade barriers started in 1990 with the unilateral abolition of the specific quantitative restrictions that applied to state-trading countries and the suspension of quantitative restrictions applying to all countries; it continued in 1991 with the concession of GSP status to five of the CEE countries, and culminated in the five Association or Europe Agreements signed between the end of 1991 and the beginning of 1993, which established a differentiated schedule for further trade liberalization between the signatory countries and the EU, having as the final objective the establishment of a free-trade area between them at the end of a transitional period having a maximum duration of 10 years. These agreements, first signed with Poland, Hungary and the Czech and Slovak Republic (December 1991), and subsequently with Bulgaria and Romania (in February and March 1993 respectively), commit the EU to eliminate import tariffs over a 2 to 5 year period (6 years for tariffs on textiles and clothing) and the CEE countries to do the same in 4 to 9 years. They also commit the EU to phase out its quantitative restrictions on imports of textiles over a period of 5 years. The agreements do, in addition, improve market access for agricultural products from Central and Eastern Europe and extend GATT consistent anti-dumping rules to these countries. Further improvements in the access to EU markets of these countries was pledged by the European Council held in Copenhagen in June 1993 (Grilli, 1995).

Yet, the Europe Agreements contain numerous protectionist escape clauses. There are safeguard provisions built into them in case of both serious injury to EU producers and of serious sectoral difficulties leading to a significant deterioration of economic conditions in a region of the EU. There are specific safeguard clauses concerning textiles, and the possibility of a return to managed trade in specific sectors (such as steel) is in no way diminished by the content of the Agreements.

At present EU tariffs are relatively high on, among others, chemicals and food, both products of particular interest to CEE countries' exports. With respect to non-tariff measures (NTMs), the EU concluded voluntary export restraints and took anti-dumping and other NTMs for steel and chemicals from Central and Eastern Europe. Between 1986 and 1990 however, CEE countries only accounted for 13 percent of total anti-dumping actions

initiated by the EU. In addition five MFA type of arrangements were concluded with CEE countries; in 1993 quotas by member states were substituted for however by EU-wide restrictions. The liberalization of imports from Central and Eastern Europe, especially in the textile and clothing sectors, has also contributed to the reduction of the number of import quotas and VERs in force in the EU (Grilli, 1995).

According to recent estimates (Kaminski, 1994) the industrial product provisions of the Europe Agreements cover about 80 percent of the signatory countries' exports to the EU and improve significantly access to its market. In 1992, their first year of application for Hungary, Poland and former Czechoslovakia, the Agreements freed about 50 percent of the exports of these countries to the EU. The equivalent share for Bulgaria and Romania in 1993 is estimated at 54 percent and 39 percent respectively. Over the first five-year period of their application, the Agreements are expected to let free trade with the EU increase 80 percent in former Czechoslovakia, 60 percent in Hungary and 70 percent in Poland.

The recent considerable reduction in the use of tariffs and NTMs towards imports from Central and Eastern Europe represents an important change in EU trade policies. As Table 3.14 illustrates, the trade performance of CEE countries²⁹, lackluster for many years, began to improve in the aggregate at the very end of the 1980s, in concomitance with the generally improving access of their exports to European markets. The overall share of these countries in extra-EC imports, which had fallen to about 2 percent by the end of the 1970s, remained unchanged at such a low level until 1989. Since then it rose steadily to over 4 percent in just three years. In EC markets these countries did better as exporters in practically all product categories, both when directly competing (food products and manufactures) and when not competing (crude materials, non-ferrous metals) with EC domestic producers. The only exception was fuels, whose market share remained unchanged. Liberalization of imports by the EU appears to have helped particularly in textiles, clothing, footwear, furniture, steel and metal manufactures. These are mostly labour-intensive export products on which the labour cost advantages enjoyed by the

²⁹ The aggregate is here defined as the summation of Poland, Hungary, former Czechoslovakia, Bulgaria and Romania.

CEE countries weighed very strongly, once access to the EU market became less encumbered. For these countries broad based improvements in market positions correspond in time and product composition to broad based liberalization of imports implemented by the EU since 1990 (Grilli, 1995).

	1976	1980	1988	1990	1992
Competing food and agricultural products	3.0	4.4	4.8	6.5	6.1
Crude materials (excl. fuels)	2.5	2.1	2.5	2.8	4.2
Fuels	5.8	1.0	1.3	1.1	1.2
Chemicals	6.0	3.4	3.0	3.8	4.4
Footwear and leather goods	4.1	4.3	3.0	3.9	6.5
Rubber, cork and paper products	1.5	1.9	1.6	2.3	4.3
Iron and steel	15.4	9.2	7.0	9.5	12.5
Non-ferrous metals	3.9	3.6	3.4	3.5	6.7
Metal manufactures	4.2	3.3	2.9	4.2	8.3
Electrical machinery	2.6	2.0	1.1	2.1	3.0
Non-electrical machinery	5.7	2.7	1.5	1.9	2.7
Transport equipment	1.0	2.1	1.3	0.8	2.5
Furniture	3.3	11.1	8.9	10.7	17.4
Textiles	6.8	3.4	3.0	3.3	4.7
Clothing	4.8	7.2	4.4	5.1	7.9
Other manufactures	3.2	1.3	0.8	0.8	1.4

¹ Total imports exclude intra EC-trade
Source: Grilli (1995).

3.9.4 Foreign Direct Investment and Central and Eastern Europe

In the World Investment Directory 1992 the UN (1993a) in collaboration with the UN Economic Commission for Europe presented an overview of developments of Foreign Direct Investment (FDI) in Central and Eastern Europe. Inward and outward FDI are dealt with separately. The present subsection provides a summary of the main findings by the UN (1993a) emphasizing inward FDI.

Inward FDI

The reintegration of the long isolated Central and Eastern European (CEE) economies into the world economy began in the late 1960s. This long-term trend was greatly accelerated in the late 1980s by the collapse of its

regional organizations and initiated the longer-term transformation of the CEE economies and societies ³⁰.

One important dimension of the process of CEE reintegration into the world economy is FDI, both inward and outward. In their post-war isolation the CEE countries remained on the sidelines as the role of transnational corporations (TNCs) grew rapidly in importance in the global economy and annual flows of FDI increased to 225 billion dollar in 1990. Then gradually over the decades of the 1970s and 1980s, the CEE countries began to develop a more open environment towards FDI. At first, outflows of FDI from CEE economies expanded faster than inflows of FDI. During the second half of the 1980s, however, inward FDI began to grow rapidly, both in terms of number of investments and value of foreign equity participation, as the reforms in the CEE countries served to open their relatively closed economies to an unprecedented degree (UN, 1993a).

By October 1991, committed foreign equity participation in about 34,000 affiliates of foreign-based TNCs in CEE economies (excluding former Yugoslavia) was an estimated 9 billion dollar. On the other hand, total capital invested in foreign affiliates of TNCs based in CEE (excluding former Yugoslavia) was 1.2 billion dollar, a negligible share of global outflows. In spite of the small size of investment flows, the potential benefits that such investments carry for the host country can have a significant impact on the economic restructuring and the reintegration of CEE countries into the world economy over and above what the magnitude of the flows might suggest. Estimates are that cumulative investment flows

³⁰ In the publication by the UN (1993a) Central and Eastern Europe (CEE) cover 25 economies: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, former Czechoslovakia, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, the Republic of Moldova, Poland, Romania, the Russian Federation, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan and Yugoslavia. All of these countries were long ruled by communist parties, and their economies were based on principles of state or collective (as opposed to private) ownership and administrative (as opposed to market) allocation of resources. All are former members of the now defunct Council for Mutual Economic Assistance (CMEA), with the exception of former Yugoslavia, which was an associate member.

to the countries of the region could surpass 50 billion dollar by the end of the 1990s (UN, 1993a).

The dismantling of their old centrally planned and controlled systems will greatly facilitate the commercial and financial integration of the CEE economies into the world economy. The traditional institutions of the state monopoly of foreign trade served to limit the scope for interaction between domestic enterprises and foreign markets. The shift to a market-price system is also creating conditions that are more familiar and favourable to foreign investors, and that are, at the same time, opening up many new investment opportunities to them.

Major developments at the international level also help to explain the acceleration of FDI into the area. The end of the Cold War has seen the beginning of ambitious bilateral and multilateral programmes to assist their transformation. The collapse of the Council for Mutual Economic Assistance and the Warsaw Treaty Organization has led their former members to look westward to establish new ties. The transformation of the CEE economies and the abandonment of the preferential system for their mutual trade has greatly increased the need to be reintegrated into the world economy. The reorientation of the external relations has been especially towards Western Europe, with the unified European Union (EU) market from 1993 on adding to the attractions of geographical and cultural proximity. All of the Eastern European countries (with the exception of Albania) have signed new trade and cooperation agreements with the EU, and the Central European countries have negotiated second-generation agreements of association with the EU. All of the CEE countries now belong to the major international economic organizations, or have indicated a desire to join. The new policy developments were accompanied by various measures to strengthen incentives and guarantees, including the negotiation of bilateral investment protection treaties (UN, 1993a).

The unsettled conditions of the post-Communist transition in Central and Eastern Europe have, however, created difficulties in attracting the desired FDI inflows. These conditions also explain why the volume of actual investment in most countries of the region has been fairly limited

so far. The investment climate in the CEE countries is complex and varied. The common problem areas can be briefly identified, however (UN, 1993a):

- * *Legal/regulatory conditions.* The rapidly changing circumstances in which policy makers in the CEE countries had to work out a new legal framework and, with respect to the regulation of FDI, have resulted in a typically ad hoc, piecemeal approach, in particular in the former USSR. This in turn has led to a stream of legislative measures governing FDI. The instability in the legal conditions for FDI (including the matter of property rights) has in itself constituted a major deterrent to foreign investors.
- * *Economic conditions.* The CEE economies are passing through an economic crisis, reflected in declines in industrial output, the collapse of traditional export markets, unprecedented unemployment and strong inflationary pressures. The Central European economies may recover sooner, but the deep structural roots of the crisis suggest that it will be of a prolonged nature for all. Pending restructuring, underdeveloped areas of the economy - especially in business services and telecommunications - impede the FDI process. A heavy burden of external debt has added to traditional scarcities of hard currencies. Limited foreign exchange reserves have made it difficult to liberalize conditions on currency convertibility, although considerable progress towards the common goal of convertibility has nevertheless been made in some countries, typically with some external financial assistance.
- * *Political conditions.* From monolithic, one-party rule, CEE countries have shifted to fractured, multi-party politics. Governments face daunting economic and social problems. The collapse of communist rule has initiated processes that have led to the disintegration of federal structures in some countries of the region (e.g. in the former USSR and former Yugoslavia). Foreign investors often find themselves confronted with jurisdictional conflicts among competing authorities.
- * *Institutional conditions.* The transformation of CEE societies involves changes that, when carried out, will remove the long-standing institutional obstacles to FDI. The processes of marketization, privatization and reintegration into the world economy

will inevitably be long and difficult. Meanwhile, the institutional legacies of the centrally planned system create obstacles for FDI: underdeveloped markets (especially capital markets), a dominant but inefficient state sector, weak domestic currencies and foreign exchange controls, a fledgling commercial banking system, insufficient telecommunication facilities and management and accounting practices that differ significantly from international standards.

The national regulatory framework

Regulations concerning FDI were liberalized in many countries during the late 1980s. Such has been the extent of this liberalization, that purely legal barriers to the establishment and operation of foreign enterprises have virtually been removed (although other factors continue to hinder FDI). Nevertheless, the promulgation of these laws is still recent, and it will inevitably be some time before lawyers and judges and the civil services of the countries involved acquire the necessary experience in their practical application. Thus, in this period of transition, foreign investors may not be able to expect from the local courts the same degree of protection and guarantees for their various business activities that they are accustomed to elsewhere.

Of equal importance to TNCs in the CEE economies are the laws regulating the transfer of ownership of state-owned enterprises and their assets from the state into private hands (UN, 1993a). Since the beginning of the 1990s ambitious privatization programmes have been pursued in the CEE countries in which FDI is likely to play an important role. All the countries have introduced various laws to guide the privatization process, including the creation of government agencies to overview the process and to facilitate the technical procedures of the transfer. These laws principally authorize TNCs to acquire majority stakes in former state-owned enterprises, although restrictions can be found in areas considered sensitive by governments, such as defence and mining.

Geographical distribution

Western Europe has traditionally been and still is the principal source of FDI in CEE economies, as measured by the number of enterprises and the

value of investments (Table 3.15). Transnational corporations from Western Europe account for three-quarter to four-fifth of all FDI (disregarding the case of Bulgaria, for which the numbers of instances of FDI for which the source is unknown is very high, and the case of Romania). Geographical proximity, historical links and strategies of TNCs are the main factors behind this trend. The sources of FDI in the former USSR are distinctly more diverse, with about 20 percent of the value of FDI being accounted for by developing or CEE countries. The proximity of several republics of the former USSR to dynamic Asian economies has been a contributing factor, with a number of TNCs from the Republic of Korea and other Asian countries investing there.

Country	EU	EFTA	USA/ Canada	Other DCs	LDCs	CEE	Unknown	Total a
By number of investments								
Bulgaria	32	18	4	-	-	-	45	100
Czechoslovakia ^b	43	38	5	-	-	2	12	100
Hungary ^c	41	37	8	1	2	2	9	100
Poland	59	22	9	2	1	2	4	100
Romania ^d	38	6	7	14	28	6	-	100
former USSR	34	23	15	4	10	9	6	100
former Yugoslavia	57	26	5	-	-	-	13	100
By foreign capital								
Bulgaria	-	-	-	-	-	-	-	100
Czechoslovakia ^b	41	14	-	-	-	13	32	100
Hungary ^c	30	32	11	-	7	1	18	100
Poland	54	26	9	3	1	1	6	100
Romania ^d	58	6	13	7	13	3	-	100
former USSR	34	22	14	3	7	12	8	100
former Yugoslavia	51	30	7	-	-	-	12	100

a. Totals may not add up due to rounding.

b. Data for 228 operational foreign affiliates as of 25 March 1991.

c. Data for 1,006 operational foreign affiliates as of January 1991.

d. As of 17 January 1992; cumulative flows since 1987.

Source: UN (1993a).

Sectoral distribution

Table 3.16 summarizes data on the distribution by sector of FDI in the CEE economies. The following sectoral pattern emerges:

* Because of the limited data available, the sectoral distribution is shown by two measures, the number of investments and the total value of capital committed (but not necessarily actually invested). There is a considerable variation in the pattern

according to the two measures. This is because the typical investment in the primary and secondary sectors is substantially greater than in the tertiary sector.

- * The relative shares of FDI in the secondary and tertiary sectors vary considerably among countries. The secondary sector is clearly dominant in Bulgaria, Czechoslovakia and Poland. For Hungary, the tertiary sector has been the principal target for foreign investors. For the former USSR, and especially for former Yugoslavia, FDI has been more evenly distributed between the two sectors.

Country	Bulgaria ^a	former Czecho- slovakia ^b	Hungary ^c	Poland ^d	former USSR	former Yugo- slavia ^e
By number of investments						
Primary	-	4	1	4	2	-
Secondary	68	32	40	73	50	-
Tertiary	13	64	59	22	48	-
Unknown	19	-	-	-	-	-
Total	100	100	100	100	100	-
By value of FDI						
Primary	-	8	-	10	3	7
Secondary	-	65	59	67	61	41
Tertiary	-	28	41	23	36	51
Unknown	-	-	-	-	1	1
Total	100	100	100	100	100	100

^a For 117 operational affiliates only.

^b As of 25 March 1991, 228 operational affiliates only.

^c As of January 1991, 1,006 operational affiliates only.

^d As of end-1989.

^e Cumulative flows 1985-1988.

Source: UN (1993a).

The share of FDI in the primary sector is less than 10 percent of the value of capital committed. It is not surprising that it is highest in Poland, given the importance of that sector for the Polish economy. It is surprising, that the proportion of the primary sector in the former USSR is relatively low, given its vast reservoirs of oil and other natural resources and the interest expressed by several TNCs in exploring

investment possibilities in that sector. This reflects limitations on FDI in resource exploitation which are currently being relaxed, and the need for TNCs to re-negotiate agreements with Governments of newly formed States following the disintegration of the former USSR.

Outward FDI

At the end of the 1980s, and extending into the new decade, there was an increase of outward FDI from some of the more important CEE countries, associated with their new external and domestic reform programmes. It is not clear whether this increased pace of investment activity will persist, given the political and economic difficulties that those countries face in the 1990s. The need for an infrastructure to support a higher level of trade with developed and developing countries creates continued pressure to expand transnational operations. Many of the state-sector TNCs that have hitherto played a dominant role are in financial difficulties and face restructuring. The evidence to date suggests that restructured or privatized state enterprises will retain most of their foreign affiliates, since they are essential to their international operations. Meanwhile, new private enterprises are entering the field. Although immediate problems linked to the transition may well result in a deceleration of outward investment activity in the short-term, this is likely to be a temporary phenomenon. In the longer run, the closer links now being forged with Western Europe and the reintegration of the CEE economies into the world economy will require the direct presence abroad of CEE enterprises on an enlarged scale (UN, 1993a).

3.10 Globalization of Financial Markets and Policy Coordination

3.10.1 Introduction

The end of the Bretton Woods system in 1971 implied a shift from pegged exchange rates to a system with more flexible exchange rates. Since then, according to the International Monetary Fund (IMF), two other key structural changes in the international financial system can be observed (Mussa et al., 1994):

1. the rapid expansion of private international financial markets

2. the removal of capital account restrictions in the industrial countries.

These changes in international finance reflect various underlying tendencies (Mussa et al., 1994):

- the growing commitment by many countries to current and capital account convertibility,
- the large expansion in the scale of net and gross capital flows in the major industrial countries,
- the globalization and integration of offshore and major domestic markets,
- the dominant role of private flows in the financing of fiscal and current account imbalances,
- the growing importance of institutional investors in cross-border securities transactions, and
- the sharp increase in the use of derivative financial instruments.

The next subsections present an overview of the main structural changes in the international financial system (3.10.2) and will discuss the policy implications (3.10.3).

3.10.2 Structural Changes in the International Financial System

Private capital flows played only a limited role in financing fiscal and current account balances in the 1950s and 1960s. However, for developing countries in the 1970s and again in the early 1990s, and for industrial countries since 1970, private capital flows provided most of the cross-border financing of these countries' financial imbalances³¹. The ability of international financial markets to respond to the financing needs associated with adjustments to unanticipated shocks was demonstrated in the early 1990s following the re-unification of Germany. In the three years prior to German re-unification, Germany was a net exporter of capital to the rest of the world, with a current account surplus of about 50 billion dollar per annum. Following the re-unification, the German current account balance switched to deficits of 20 billion dollar or more per annum; and although German outward FDI declined, the current account

³¹ An overview of recent developments is furthermore presented in the IMF study by Goldstein et al. (1993).

deficit was financed principally by sharp increases in inflows of portfolio investment and by the banking sector (Mussa et al., 1994).

The growth of private international financial markets has been accompanied by an ongoing expansion of *current and capital account convertibility*³². In the industrial countries the capital account convertibility has led to a large expansion of net and gross capital flows between these countries, as well as increased participation by foreign investors and foreign financial institutions in major domestic financial markets. For example the net capital inflow into the USA rose from an average of 2 billion dollar per annum (0.1 percent of GNP) in the period 1970-1972 to 139 billion dollar a year (3 percent of GNP) in 1985-1988. Since then it dropped again to 65 billion dollar in the early 1990s (representing 1.25 percent of GNP). (Mussa et al., 1994)

An even more rapid expansion occurred in *gross capital flows*, reflecting increased cross-border banking transactions and flows of securities, the development of offshore (Eurocurrency) markets, and the entry of foreign financial institutions into domestic markets. For example, the stock of international loans (net of redepositing by banks) rose from 175 billion dollar at the end of 1973 (representing 5 percent of industrial countries' GNP) to 3.6 trillion dollar at the end of 1993 (19 percent of industrial countries' GNP) (Mussa et al., 1994).

Another aspect of the structural changes in international financial markets has been the growing importance of institutional investors in cross-border capital flows, especially in securities transactions. In the early 1970s, large institutional investors, such as pension funds, insurance companies, and mutual funds, played only a limited role in cross-border capital flows, owing to both official restrictions and the high costs of acquiring and managing diversified international portfolios. In the 1980s, however, the role of institutional investors in channelling funds between savers and investors increased, reflecting the

³² In 1975 only about one-third of all IMF members had accepted the obligations to allow current account convertibility, whereas by mid-1994 over one-half had done so, even as IMF membership had increased from 128 to 178 countries (Mussa et al., 1994).

lower transactions costs for institutional investors relative to individual investors, the increased willingness of individual savers to allow their portfolios to be managed by agents, and, in some countries, the tax advantages enjoyed by contractual savings plans (Mussa et al., 1994).

The Group of Thirty published a study on the interdependence of capital markets, underlining two major aspects in recent globalization.

Emergence of Japan

The arrival of Japan as a key player on global capital markets was inevitable, but in its timing it can be construed as a response to macro-economic policies adopted in the 1980s. The decision early in the 1980s to reduce the Japanese fiscal deficit led, in the economic conditions of the time, to a large Japanese export surplus. Otherwise, full employment could not have been maintained in the face of a growing surplus of domestic saving.

Japan's domestic financial institutions had to be given the opportunity to shift surplus domestic saving into foreign markets, to provide financial support to the current account surplus. The emergence of Japan has occurred along with the dismantling of exchange and capital controls in major industrial countries. This has led to a huge increase in cross-border flows, net and gross. Figures published in the latest annual report of the Bank for International Settlements show that net long-term capital outflows into securities from residents of 13 industrial countries rose from an annual average of 17.5 billion dollar in 1975-79 to 269 billion dollar in 1989, with almost 45 percent of that rise coming from Japan. Direct investment outflows showed a similar though somewhat less spectacular rise over the same period - from 34 billion dollar to 174.5 billion dollar, with about 30 percent of the increase coming from Japan (Axilrod, 1990).

Implications of Modern Financial Technology

The enlargement and greater interconnectedness of international capital markets has been intensified by the revolutions in communications and computer technology. Financial technology advances are also the basis for the burgeoning worldwide markets for derivative instruments. The enhanced

capacity of computers makes it easy to devise and to implement sophisticated strategies involving the futures, options and cash markets. All of this makes for great increases in overall trading volumes as market participants, drawn into arbitrage and hedging operations, take advantage of opportunities to bet on volatility or on price ranges (Axilrod, 1990).

Developments in the international financial markets in the 1980s and early 1990s have stimulated furthermore the use of a variety of exchange-traded *derivative instruments*, mainly futures, options, and swaps. For example, at the end of 1992, the principle value of outstanding interest rate and currency swaps was 5.6 trillion dollar, five times the value at the end of 1987. The principal amount of exchange-traded derivative instruments increased twelve times since 1986 to arrive at 7.8 trillion dollar in 1993 (Goldstein et al., 1993).

3.10.3 Policy Implications of Structural Changes in International Financial Markets

The structural changes that have occurred in international capital markets since the collapse of the Bretton Woods system have clearly increased the international linkages between major domestic and offshore financial markets, particularly in the industrial countries. The capital markets of developing countries are also becoming more closely integrated with markets in the rest of the world, although they have progressed far less in that direction than industrial countries. It is still premature to speak of a single, global market where most of the world's savings are auctioned to the highest bidder and where a wide range of assets carry the same risk-adjusted return. However, access to international financial markets has become an increasingly important determinant of the share of global savings that is likely to accrue to a particular country (Mussa et al., 1994).

Experience since the debt crisis has demonstrated that creditworthiness considerations play a dominant role in determining both the cost and availability of credit from international financial markets. While there is considerable debate about how well the markets evaluate the willingness and the ability of borrowers to service their debt obligations, it

is clear that the perception that a borrower's creditworthiness has deteriorated or is about to deteriorate can lead to an abrupt curtailment of funding, which may be difficult - even in the medium term - to reverse. The evaluation of a country's creditworthiness is done on a continuing basis and is influenced by the market participants' perception of the quality of a country's macro-economic and financial policies. Creditworthiness is evaluated most explicitly by credit-rating agencies, which characterize the investment quality of a country's external debt (Mussa et al., 1994).

These tighter connections between access to major domestic and offshore financial markets and the market's evaluation of a country's policies have reduced in some respects the authorities' autonomy in conducting macro-economic policies. It has become difficult to resist private markets when they have reached the concerted view that the outlook for a particular security or currency has changed. Thus, perceptions that a country is following weak or inconsistent policies can have an immediate impact on not only its cost of funds and access to international credit but also its ability to sustain a particular exchange rate or monetary policy (Mussa et al., 1994).

The evaluation of a country's creditworthiness described above implies an important incentive for governments to adopt macro-economic and monetary policies that are considered appropriate from that perspective. As a consequence, there will be a tendency for individual countries' policies to converge.

With respect to the members of the European Union (EU), the conditions for joining the European Monetary Union (EMU) provide a further stimulus for economic policy convergence ³³.

³³ IMF (1993) provides a recent overview of these conditions.

3.11 Globalization and Economic Convergence

In a recent report the Group of Thirty addressed the question of globalization and its impact on the convergence of economic policies among countries (Ostry, 1995).

Globalization is defined as the increasing economic linkage among countries by trade, by financial flows and by FDI. As an illustration of the process, it is observed that by the end of the 1980s worldwide sales of foreign affiliates of firms from all countries were nearly twice the value of world exports of goods and services.

The process of globalization is believed to continue. The main reasons are that firms face competitive pressures to capture global economies of scale and scope and to have access to leading technologies, whereas developments in information technologies will allow the process of globalization to continue and to gain further importance.

It is argued (Ostry, 1995) that firms opt for locations that are most harmonious in terms of communications, transportation and other infrastructural facilities, and furthermore in terms of access to markets and of the policy environment. In turn, as international firms become increasingly footloose, governments become fearful that their countries might diminish in locational attractiveness. The activities of Transnational Corporations (TNCs) therefore put pressure on governments for more extensive coordination and harmonization of domestic policies, institutional arrangements and practices, especially in areas that relate to the attractiveness of a country as a location for investment.

Differences in tax regimes might serve as an example. As TNCs tend to exploit such differences by transfer pricing practices, a tendency to harmonize tax regimes would consequently follow in time.

Another consequence is that a number of policy issues have entered the agenda of international negotiations on trade and investments, that hitherto would have been considered as economic policies of domestic relevance only. Such issues include regulations regarding domestic

subsidies, government procurement, technical standards, barriers to entry and competition policy, and policies to protect the environment and regarding labour rights and social standards. As these issues play an increasing role in the developments of trade and investments it is advocated that international negotiations within the framework of the OECD and the WTO would address these policies. Where bilateral or regional negotiations provide an appropriate start, it is advocated that a mechanism would be found by which the outcomes of such negotiations could be made to apply multilaterally.

4. FRAGMENTATION IN THE WORLD ECONOMY

4.1 Fragmentation and Economies of Scale

In a seminal article Young (1928) expanded the notion of the division of labour among workers as developed by Adam Smith to specialization among firms and industries. Young (1928) observed that it would be wasteful to make a hammer to drive a single nail. There are economies of scale that might be called of secondary order. How far it pays to go in equipping factories with special appliances for making hammers or for constructing specialized machinery for use in making different parts of automobiles depends (...) upon how many nails are to be driven and how many automobiles can be sold. Again, the profitable use of machinery and even more the efficiency of setting up factories producing specialized machinery, the second order of division of labour, depends on the extent of the market.

Young (1928) gives the following example. Industrial differentiation has been and remains the type of change characteristically associated with the growth of production. Notable as has been the increase in complexity of the apparatus of living, as shown by the increase in the variety of goods offered in consumers' markets, the increase in the diversification of intermediate products and of industries manufacturing special products or groups of products has gone even further. The successors of the early printers are not only the printers of today, with their own specialized establishments, but also the producers of wood pulp, of various kinds of paper, of inks and their different ingredients, of type metal and of type, the group of industries concerned with the technical parts of the producing of illustrations, and the manufacturers of specialized tools and machines for use in printing and in these various auxiliary industries, observes Young (1928) in a concrete example, that reflects the situation at the time.

Young (1928) concludes, that over a large part of the field of industry an increasingly intricate nexus of specialized undertakings has inserted itself between the producer of raw materials and the consumer of the final product. This division of labour among industries is a vehicle of

increasing returns and an adjustment to a new situation created by the growth of the market for the final products of an industry. It permits furthermore a higher degree of specialization in management and lends itself to a better *geographical distribution* of industrial operations; a better combination of *advantages of location*, with a smaller amount of compromise in this respect.

4.2 Fragmentation and Location of Production

4.2.1 The Textiles and Clothing Industry

The textiles and clothing industries are the most geographically dispersed of all industries across both developed and developing countries. They are changing very rapidly in their geography, their organization, and their technology and these changes are causing many frictions, particularly in trade relations between developed and developing economies. Figure 4.1 reveals the many differences between the production characteristics of each sub-sector of the textiles-clothing production sequence. Whereas in clothing manufacture capital intensity is generally low, labour intensity is high and the technology used relatively unsophisticated, the reverse is true for the textiles industry. This difference helps to explain the survival of the textiles industry in the industrialized countries, while the clothing industry is being largely relocated to developing countries.

Figure 4.1 Variations in production characteristics between major components of the textiles-clothing production sequence

Production characteristics	Fibres (synthetic)	Textiles	Clothing
<i>Capital intensity</i>	High	←————→	Low
<i>Labour intensity</i>	Low	←————→	High
<i>Material costs</i>	High	←————→	Medium
<i>Average size of production unit</i>	Large	←————→	Small
<i>Technology</i>	Sophisticated	←————→	Simple

Source: Dicken (1992).

The global pattern in production and trade in the textiles and clothing sector has been one of relative decline in the older established centres of production in Western Europe and a rapid growth in a number of developing countries. In the developed market economies *textiles production* grew very little overall, although production growth in North America was considerable (12 percent between 1980 and 1987). In the EU, the best overall performance was achieved by Italy and the United Kingdom. France, Germany and the Netherlands all performed poorly (Dicken, 1992).

Like textiles, the manufacture of clothing is very widely spread geographically, although there is a greater dispersion of clothing-exporting countries. The worldwide *production of clothing* increased at the same rate as textiles manufacture. In the case of the clothing industry, however, the developed economies fared far worse than in textiles. Between 1980 and 1987, clothing production in the developed economies decreased with 6 percent. Within the EU, the production of clothing in Germany decreased with 23 percent, in the Netherlands with 25 percent, and in France with 10 percent. Conversely, the United Kingdom did relatively very well, with a production increase of 11 percent between 1980 and 1987 (Dicken, 1992). Clothing production increased very substantially in the developing countries as a whole (24 percent between 1980 and 1987).

From the viewpoint of the changing global distribution of these industries the most important consideration is the extent to which individual production factors are geographically variable in either cost or availability. The textile industry is considered as capital-intensive, while in the clothing sector labour remains the major means of production. Therefore, for the clothing industry labour costs are the most significant production element of total costs.

Although EU textiles manufacturers transferred part of their activities towards low-wage countries, they remained competitive by increasing their flexibility, by raising the productivity through increased automation, and by diversifying their product ranges (European Commission, 1994). These developments in the technologies of production have increased the

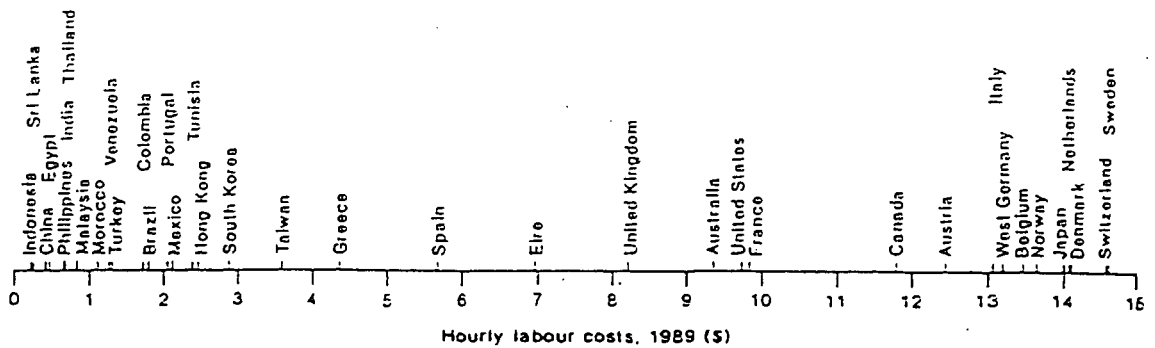
intensity of capital in the textiles industry. Other factors, however, in particular the orientation to specific markets and the space-shrinking technologies of transport and communications have also played a role in the location of textiles production (Elson, 1988).

Although the textiles and clothing industries have long been involved in foreign operations in developing countries, *foreign direct investment* (FDI) was never significant. A growing number of companies can earn attractive returns from certain of their tangible or intangible assets - for example, technological, managerial, or international marketing capabilities - without having to own or finance investment projects in developing countries (Oman, 1989).

For clothing - one of the most labour-intensive industries in the world economy today - labour costs are an important factor of location. Figure 4.2 shows how much the labour costs in spinning and weaving vary between different countries. The spread is very large, from 14.60 dollar per hour in Switzerland to less than 25 dollar cents per hour in Indonesia. All the high-cost producers are in Europe, North America and Japan. Even allowing for productivity differences the developing countries have a large labour-cost advantage over the developed market economies, particularly in the production of staple items of clothing, which sell largely on the basis of price, rather than in fashion garments in which style is more important.

Investment in the EU textiles industry fell in 1992, but is likely to rise again. The industry has now become very capital-intensive, and has seen large rises in productivity. In the long term its growth will depend partly on future high-tech developments, which may give little incentive for the industry to delocalise production to low-wage countries (European Commission, 1994).

Figure 4.2 International variations in labour costs in the textiles industry

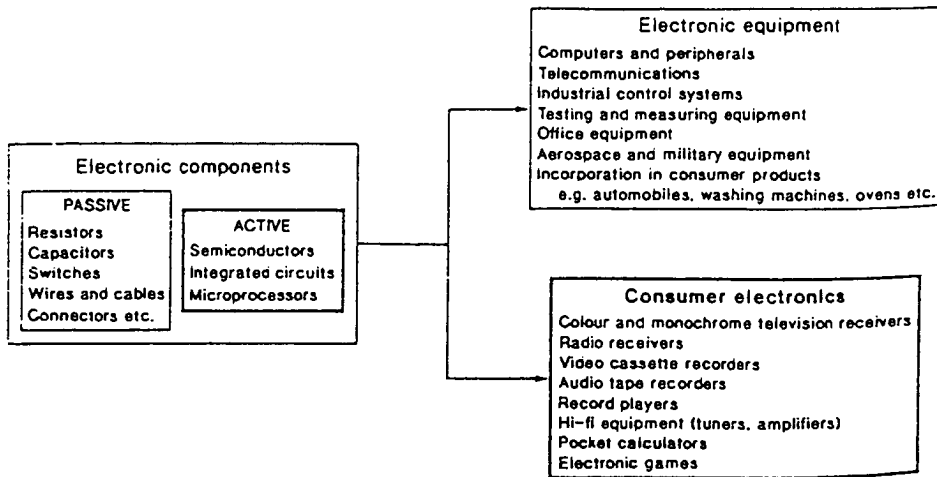


Source: Dicken (1992).

4.2.2 The Electronics Industry

The electronics industry can be described as manufacturing those products or systems that use electronic circuits handling small currents which incorporate active components capable of modifying the flow of electricity (Cable and Clarke, 1981). The electronics industry is not a homogeneous industry, however; it can be divided into three subsectors: electronic components, electronic equipment and consumer electronics (Figure 4.3). This section will concentrate on two main subsectors of the electronics industry: the *semiconductor industry* and the *television receivers industry*, which are important branches in representing the electronic components and consumer electronics, respectively. In addition, both branches have a large presence of transnational firms (Dicken, 1992).

Figure 4.3 The electronics industry



Source: Dicken (1992).

Semiconductors

The US has dominated world production of semiconductors for nearly two decades, after which Japan took over. In 1992 the world semiconductor market amounted to 60 billion dollar, a 9.6 percent increase over 1991. Japan accounted for 32 percent of the world total sales, the US for 31 percent, and the whole of Europe for only 19 percent. In the late 1980s, world sales increased with an average of 3 percent per year, resulting in a recovery of production in Europe and the US, from 1991 onwards. However, as illustrated in Table 4.1, no such recovery took place in Japan, where sales declined in 1992. Outside these three core areas the major centres of production are in East and South Asia, with a combined share in production of 18 percent. The world's ten leading semiconductor firms accounted for almost 54 percent of the world production in 1992. There is only one European producer in the top ten of firms in the production of semiconductors (Philips) (UNIDO, 1993).

Region, country or area	1991	1992	Percentage change 1991-1992	Percentage share 1992
	(billion dollars)			
Japan	21	19	-7.4	32
United States	15	18	19.7	31
Europe	10	11	15.0	19
Asia and the Pacific	8	11	29.6	18
World	55	60	9.6	100

Source: UNIDO (1993).

As illustrated in Table 4.2, a division can be made between the different stages of the production process of the semiconductors industry. In general, the manufacture of semiconductors is highly capital- and research-intensive, but a distinction can be made between the design and fabrication stage, requiring high-level scientific, technical and engineering personnel, and the assembly stage, which is carried out by low-skilled labour. The research- and capital-intensive stages of design and production have tended either to remain in the firm's home country or to be established in other developed countries where the necessary labour skills and physical infrastructure are more readily available. The assembly of semiconductors is carried out by low-skilled labour and, given the low-weight/high-value characteristics of semiconductors, this stage of the semiconductor production process has been relocated to low-labour cost countries.

Whereas offshore production in most developing countries is aimed at cost-minimization, the dominant factor for overseas location in developed countries is market access. In the 1980s, the Asian region has also become an important market for semiconductors, thus causing semiconductor firms to establish regional headquarters in this region as well as assembly plants.

Table 4.2 Stages in integrated circuit production

Stage
1. <i>Design of a new circuit</i> The precise location of each element in the circuit and the connections between them.
2. <i>Production of masks</i> Each mask represents an individual circuit layer and contains hundreds of identical images next to one another.
3. <i>Fabrication of wafers</i> <ul style="list-style-type: none"> (a) Production of pure silicon crystal. (b) Slicing into wafers roughly 0.5 mm thick. (c) Etching of the patterns contained on the masks on to the silicon wafer using photolithography techniques and a variety of chemical 'dopants'. The complete device is built up in layers. (d) Separation into individual chips and mounting into separate package.
4. <i>Assembly of integrated circuit</i> <ul style="list-style-type: none"> (a) Bonding or wiring of circuits to external electrodes using extremely fine wires. (b) Sealing of packages.
5. <i>Final testing and shipping</i>

Source: Dicken (1992).

Television receivers

The manufacture of consumer electronics, part of which are television receivers, is more concentrated than that of semiconductors. In 1988, the ten leading consumer electronics manufacturers together accounted for almost 80 percent of world TV production (Dicken, 1992). Eight of the ten leading firms in consumer electronics are Japanese, while in 1978, only five of the top ten firms were Japanese. Besides, there is not a single US firm in the top ten and the presence in consumer electronics of the European producers is more substantial than in semiconductors (European Commission, 1994).

The production process of television sets consists of three related stages. As in semiconductor manufacture each stage has rather different characteristics which have important organizational and locational implications. The design stage is highly research-intensive, as efforts are made to develop new functions for TVs and to improve the efficiency of the production process. The manufacture of components is highly

capital-intensive with significant economies of scale. Finally, the assembly stage is more labour-intensive, employing large numbers of low-skilled workers and can therefore find a potential advantage in the low labour-cost areas (Dicken, 1992).

Employment decline in the past decades, particularly in the production of television sets, can be explained by a number of reasons. Apart from the global economic recessions, reductions in the number of components used in a television set and increased automation of the production process have reduced the need for various types of labour. In general, fewer skilled workers are now needed to manufacture a television set. In addition, in North America and Western Europe the consumer electronics sector as a whole has been adjusting to the competition from lower-cost producers.

Besides, two other factors - technological change and corporate rationalization - are particularly involved in reducing the need for labour. A major effect of the technological change has been to increase greatly the productivity of the labour force and, thus, greatly reducing the number of workers required for a given level of production in the manufacturing of both semiconductors and television sets (Dicken, 1992).

Japanese electronics exports to the EC have been the cause of trade frictions between the EC and Japan for almost two decades. In the 1970s it mainly concerned colour TVs. In the 1980s, the rising exports of Japan caused trade imbalances between Japan, the US and the EC for other electronics products as well. Trade frictions between these regions mounted together with the lobbies within the US and the EC for protectionist measures against Japanese imports. To circumvent protectionist pressures so-called 'tariff jumping FDI' from Japan in the EC occurred. The increased investments of Japanese electronics firms in Europe can indeed be partly explained by this type of FDI. Furthermore, sales opportunities in the US market decreased, thus causing Japanese firms to shift their attention to the EC market.

Production and export figures reveal only where the commodities originate, but can not answer the question which nationality the firm has

that produces these commodities. In fact, a substantial proportion of European production in the electronics industry is in foreign-owned plants, primarily Japanese and other Asian firms. The United Kingdom was the most important location of Japanese subsidiaries in 1989 in the EC. The factors behind the attractiveness of the UK for Japanese firms are well known. English forms the least important language barrier for Japanese firms, business attitudes and culture are quite similar to those in the US, where Japanese firms have built up experience in running factories, and the UK government has been actively inviting Japanese investments to help fight unemployment in depressed areas and to revive local industries (Belderbos, 1994).

4.2.3 Services

A significant development in the global economy during the last few decades has been the growing internationalization of the service industries. Services account for the largest share of countries' gross domestic product (GDP), are a major source of employment and have a significant share in international trade and foreign direct investment (FDI). However, the services activities involved vary between country groups. Much of the service sector in the developing countries consists of low-skilled, low-technology activities (including wholesale and retail trade), whereas in the developed economies high-skilled, high-technology services (including finance) are more important.

As Table 4.3 shows, services are the main sector contributing to GDP, with a share varying between 40 percent in low-income countries and 65 percent in developed countries in 1992.

Table 4.3 The contribution of the service sector to gross domestic product in developed and developing economies ¹ (in percentages of GDP)						
Country group	Agriculture		Industry		Services	
	1965	1992	1965	1992	1965	1992
Developing countries						
Low income	43	29	27	31	30	40
Lower-middle income	22	19	28	37	50	44
Upper-middle income	18	8	39	41	42	51
Developed countries	5	3	40	32	54	65

¹ Non-weighted averages

Source: based on World Bank (1994).

The services sector is the major source of *employment* in all the developed market economies. The service sector accounts for over 60 percent of total employment in the OECD countries in 1992, and in many developing countries as well. By 1990, half of the total employment in the OECD area was in the private services sector, representing an average annual increase of 3 percent since 1971. The financial services sector was a main source of employment within the service sector and has experienced a relatively constant growth over the last two decades (OECD, 1994b).

International trade in commercial services has increased to 1000 billion dollar in 1992 representing 21 percent of total world trade in goods and services. Trade in services is concentrated in a number of OECD countries. The ten leading OECD countries in world trade in commercial services accounted for 63 percent of world exports and 64 percent of world imports in 1992. The United States account for 16 percent of the export in commercial services, followed by the four main EU-countries with a total share of almost 29 percent. Japan ranks sixth in the list of leading exporters with a share of 5 percent. Japan is a substantial net importer of commercial services (GATT, 1993a).

Within commercial services, 'other services', which includes all the major financial and business services, contributed both in 1982 and 1991 around 40 percent to the total exports of commercial services of the USA

and the EU. In Japan the share of 'other services' in exports increased considerable from 32 percent in 1982 to 50 percent in 1991 (Table 4.4).

	Share in exports of commercial services, 1982			Share in exports of commercial services, 1991		
	EU	USA	Japan	EU	USA	Japan
Transport services	34	35	64	33	26	42
Travel	20	28	4	24	33	8
Other services	43	37	32	41	41	50
Other not allocated services	3	0	0	2	0	0
Total	100	100	100	100	100	100

Source: Eurostat (1994).

For many service industries the initial stimulus to their internationalization was the rapid growth and global spread of transnational corporations (TNCs) in manufacturing industries. As manufacturing TNCs have proliferated globally, so, too, have the major banks, insurance companies, credit card enterprises, legal firms, travel chains etc. Conversely, the existence of an extensive global network of the familiar business service corporations helps to guide the further evolution of transnational manufacturing activities. Furthermore, as these business services have become internationalized they have also acted as a stimulus for the internationalization of other service activities (Dicken, 1992).

The growing importance of services in production has been mirrored in *FDI* and in the activities of the TNCs. Some 50 percent of the world stock of *FDI* and 50 to 55 percent of annual flows are in services. Table 4.5 shows that, for six major industrialized countries, services accounted for a larger share in total *FDI* than both the primary and the manufacturing sector in 1989/90.

	Primary		Secondary		Tertiary	
	1980	1989/90	1980	1989/90	1980	1989/90
United States	12.1	8.3	49.0	44.3	38.9	47.4
United Kingdom ²	27.9	27.0	35.9	34.4	36.2	38.6
Japan	21.9	5.7	34.4	26.7	43.7	67.6
West Germany	4.4	2.3	47.6	39.1	48.0	58.6
Netherlands	51.6	35.1	29.4	23.9	19.0	41.0
Canada	9.9	6.6	64.2	53.1	25.9	40.3

¹ Totals do not add to 100 because of residual categories

² For the UK, 1981 and 1987

Source: United Nations (1993a).

Table 4.6 gives the composition of outward FDI within the services sector for six major industrialized countries in 1980 and 1989/90. For five countries the share of financial services in FDI has increased in the period mentioned. Furthermore, for all six countries, the financial services have a large share in total services ranging from close to one third in Japan to over 70 percent in the Netherlands and Canada in 1989/90 (United Nations, 1993a).

Within the services sector in developed countries the *financial services* are of growing importance. The progressive deregulation of financial markets is the most important current development in the internationalization of the financial system (European Commission, 1994). Especially in the EU, there is an increase in inward FDI, caused by, among others, the rising yen and the 1992-programme for completing the internal market (Dunning, 1993b). The reduction of intra-EU transaction costs, and the perceived need of non-EU firms to be insiders in the single market, can lead to a substantial increase in both intra-EU investment in services and a stepping up of investment by other European investors (Dunning, 1993b). Although the technology is available, the organizational structure and/or the national regulatory environment remain obstacles for the financial services corporations (Dicken, 1992).

	Finance and Insurance		Distributive		Transport and Real Estate ¹	
	1980	1989/90	1980	1989/90	1980	1989/90
United States	46.2	59.9	40.0	28.9	2.2	1.1
United Kingdom ²	40.0	34.8	23.5	23.3	-	-
Japan	15.2	31.0	33.9	16.5	6.0	21.8
West Germany	22.5	34.4	41.3	31.5	18.0	17.1
Netherlands	19.4	71.9	38.4	22.2	8.7	3.9
Canada	52.9	70.9	16.9	6.3	-	-

¹ Numbers for West Germany and Japan are real estate percentages

² For the UK, 1981 and 1987

Source: United Nations (1993a).

Recently, the *relocation* of economic activities to relatively low-wage countries has also taken place in the services sector. In particular, US-based airlines and insurance companies are shifting their low-skill administration work towards the Philippines and to countries in the Caribbean. Infrastructure, such as telecommunications, roads, energy, ports and airports, is an important factor for these US companies. Similar developments have been reported with respect to the software services transferring high-skilled programme development and debugging towards countries such as India. India has relatively cheap high-skilled engineers, who can supply Western companies with the services they need. Companies like General Electric, Nestlé and Holiday Inn all use the services of software companies located in Bangalore (India). Financial services companies are also relocating their activities, e.g. to Hong Kong to be able to provide China with the financial services it will need in the near future (Financial Times, 30 March, 5 May and 12 September 1994).

4.3 Unilateralism in World Trade

The previous sections 4.1 and 4.2 discussed fragmentation in the world economy from the viewpoint of different stages in the production process. An increasing extent of the market would allow an increasing complexity

of intermediate deliveries and roundabout methods of production, according to the view of Young (1928) (section 4.1). Furthermore an increasing extent of the market would allow the location of various stages of the production process to be implemented with less compromise regarding the differences of locational advantages (section 4.2). These aspects of fragmentation would - seen from an international perspective - represent an increasing interdependence between countries. From the viewpoint of the present study these phenomena would therefore represent integrating forces in the world economy.

The present section presents two phenomena from the area of trade policies that in its implementation would imply a tendency towards a fragmentation of the world market:

- unilateralism,
- anti-dumping measures.

4.3.1 Unilateralism

The implementation of US trade law to open foreign markets was intensified after 1988. Section 301 of the 1974 Trade Act gives the President the right to take action against trade practices deemed unreasonable, unjustifiable, or discriminatory and burdensome or restrictive for US commerce. It covers practices related to trade in goods and services, to US foreign investment, and to the protection of US intellectual property rights. The 1988 Omnibus Trade and Competitiveness Act strengthens Section 301 in several ways: inter alia, it transfers authority to initiate unfair cases from the President to the US Trade Representative (USTR); it requires the USTR, under the 'Super 301' provision, which expired in 1990, to identify priority countries and practices and establish a timetable for the investigation and resolution of identified practices; and it requires the USTR under 'Special 301', to identify countries that violate the US intellectual property rights. The 1988 Act also requires identification of countries and practices that restrict the US exports of telecommunication equipment and services and US access to foreign government procurement (IMF, 1992).

Actions taken under the Super and Special 301 provisions of the 1988 Act are summarized in Table 4.7. In 1989, three countries - Brazil, Japan and India - were identified as priority countries under Super 301; issues were resolved with Brazil and Japan, but India was identified again in 1990. After consultations with India, USTR decided not to take action since the practices under investigation, which relate to investment measures and access to the insurance market, were being addressed in the Uruguay Round. No priority countries were identified under Special 301 in either 1989 or 1990 because of progress made in ongoing negotiations; however, in 1991, three priority countries were identified for violating US intellectual property rights: China, India and Thailand. Under the telecommunications provision of the 1988 Act, the EC and Korea were designated as priority foreign countries in 1989 and agreements on market access were reached in subsequent negotiations. No countries have been identified as discriminating in government procurement and, thus far, no retaliatory measures have been taken under the Super and Special 301 provisions of the 1988 Trade Act (IMF, 1992).

Bhagwati (1991b) provides a further analysis of the Section 301 legislation.

At the outset, it is useful to distinguish among three ways in which '301' is intended to establish new trade obligations:

- (i) opening markets in sectors where GATT already operates, e.g. getting foreign countries to make additional concessions in manufactures;
- (ii) opening markets and/or establishing new rules or disciplines in new sectors, e.g. in services and agriculture; and
- (iii) establishing new rules that may apply to old as well as new sectors, e.g. prohibition of export targeting, prescribing workers' rights, and enforcing intellectual property rights.

These objectives are driven mainly by two underlying motivations: first, to eliminate unfair trade practices by others; second, to open foreign markets.

	Date	Countries and Regions Affected	Practices or Measures
Super 301 ²	May 1989	Brazil	Quantitative import restrictions
		Japan	Procurement of satellites and supercomputers Technical standards on forestry products
Special 301 ³	April 1990	India	Export performance requirements Protection in insurance markets
		India	Export performance requirements Protection in insurance markets
	May 1989	Brazil, China, India, Rep. Korea, Mexico, Saudi Arabia, Taiwan, Thailand	Designation on a Priority Watch List
	April 1990	Brazil, China, India, Thailand	Designation on a Priority Watch List
	April 1991	Argentina, Canada, Chile, Colombia, Egypt, Greece, Indonesia, Italy, Japan, Rep. Korea, Malaysia, Pakistan, Philippines, Saudi Arabia, Spain, Taiwan, Turkey, Venezuela, Yugoslavia	Designation on a Watch List
China, India, Thailand		Initiated investigation of alleged violations of intellectual property rights	
Australia, Brazil, European Community		Designation on a Priority Watch List	
		Argentina, Canada, Chile, Colombia, Cyprus, Egypt, Germany, Greece, Hungary, Indonesia, Italy, Japan, Rep. Korea, New Zealand, Pakistan, Philippines, Saudi Arabia, Spain, Taiwan, Turkey, United Arab Emirates, Venezuela, Yugoslavia	Designation on a Watch List

Source: Office of the United States Trade Representative (USTR); IMF (1992)

- ¹ Section 301 of the 1974 Trade Act gives the President broad authority to retaliate against allegedly unfair trade practices of other countries. Since 1974, just over 100 complaints against developing and industrial countries have been filed (this excludes actions under Super and Special 301) of which approximately 25 percent were rejected and less than 10 percent led to trade retaliation. Of the remainder, some cases led to trade liberalization action by trading partners, but the majority had indeterminate results. In several cases, Section 301 actions have been followed up through GATT dispute settlement procedures.
- ² Super 301, which expired in 1990, required the USTR to (i) identify US trade liberalization priorities in terms of countries and practices; and (ii) initiate Section 301 investigations with a view to seeking the elimination or reduction of the practices, or compensation from them. The case against Brazil was dropped in 1990. The Japanese cases were dealt with within the wider context of the Structural Impediments Initiative. India was redesignated in 1990, but no retaliatory action has been taken so far.
- ³ Special 301 requires USTR to identify foreign countries that deny adequate intellectual property protection or fair and equitable market access to US persons that rely upon intellectual property protection, and that are not entering into good faith negotiations or making significant progress in improving intellectual property protection. The 1989 and 1990 Watch Lists did not require further action. In 1991, for the first time, investigations were initiated under Special 301.

Unfair trade

The question of unfair trade lies behind virtually all of the three objectives distinguished above. Thus, demands for reciprocity may lead to objective (i). For example, even though the access by South Korean automakers to the US market is greater than US access to the Korean market, by way of tariffs as a result of obligations adopted earlier which are GATT-legal, it is now considered unfair, as evident from Congressman Gephardt's campaign pronouncements in the 1988 presidential campaign, and is fair game for 301 pressures on South Korea. Then again, the notion that it is unfair that countries with comparative advantage in manufactures, covered by GATT, have GATT-defined access to foreign markets in these sectors, is another potent force fueling objective (ii). Finally, objective (iii) is most explicitly focused on the unfairness of foreign traders: e.g. the South Koreans get unfair advantage by violating workers' rights that the United States supports, whereas the Japanese resort to export targeting that destroys US industry (Bhagwati, 1991b).

Opening Foreign Markets

There is also the distinct sense that the United States is opening foreign markets through '301' actions. This focus on *exports* is somewhat novel, compared to traditional preoccupations with regulating or managing *imports* in trade policy. In fact, this is seen as reflecting a benign aspect of '301' policy, as securing freer world trade is seen as a desirable goal (Bhagwati, 1991b).

Of course, not all '301' actions can be interpreted as opening foreign markets and, therefore, trade augmenting. Thus, for instance, the proposed restraints on export targeting would reduce exports and trade. So would workers' rights prompted wage increases if they make exports more expensive, as intended. These are areas of '301' actions and intentions that reflect unfair trade concerns but are trade reducing, not trade expanding, in their effects.

In conclusion, Bhagwati (1991b) observes that the use of Super 301 and Special 301 provisions represents, overall, a forceful use of US power with a view to obtaining foreign trade concessions, often one-way and unrequited, and always on a US time schedule.

Now, if the United States retaliates, as it did in earlier '301' actions and as it might as a consequence of present Super 301 actions, with its typical 100 percent ad valorem tariff applied selectively to the goods of the targeted country, the GATT illegality is at several levels. The discriminatory nature of such tariffs violates Article I, which imposes the MFN obligation. Also, since the tariff is likely to be bound at a lower level in practice, the 100 percent punitive tariff will generally be in violation of Article II as well.

As '301' and Super 301 actions are undertaken, unilaterally accusing others of unfair trade practices and demanding their removal, the notion is also reinforced that others are unfair traders, creating a poisoned atmosphere that conventional protectionist can hope to exploit to their own advantage.

The world trading regime should not be built on the assumption that any one player, no matter how dominant, can impose its own rules, unilaterally claiming social legitimacy for them.

4.3.2 Anti-Dumping Measures

Under GATT rules, anti-dumping and countervailing duties can be imposed by countries to protect their domestic producers from injury owing to the dumping of goods by foreign suppliers or to trade-distorting subsidies. The use of such measures has been cited as a form of selective protection; it has been argued that countries find it easier to use anti-dumping and countervailing measures, which involve a weaker injury test, when a safeguard action would be more appropriate, that is, when the nature of the problem is injury from trade, not unfair trade. Questionable practices and vague rules and definitions for determining injury, dumping margins, and subsidies provide considerable scope for variations in domestic legislation and the application of unfair trade laws. In examining the use of unfair trade remedies in the EU and the United States, it was found that they often led to the introduction of more secure non-tariff barriers, such as VERs or quantitative restrictions (steel, electronic products, and textiles and clothing), or they became the main tool of protection (chemicals, abrasives) (IMF, 1992).

The pattern and volume of anti-dumping and countervailing actions lend support to the view that these measures respond to pressures for protection by import-competing firms. In the early 1980s, in the wake of a second round of oil price increases and a severe world-wide recession, the demand for relief from import competition through anti-dumping and countervailing measures increased. Since the mid-1980s, the number of investigations initiated has declined significantly; although, the trade coverage ratios suggest that the proportion of trade affected by anti-dumping and countervailing actions has increased somewhat since 1988. The sectors most affected by these measures are motor vehicles, steel, textiles and clothing, and leather products, the same sectors that are protected by other non-tariff measures (IMF, 1992).

The United States, the EU, Canada, and Australia account for nearly all anti-dumping investigations initiated by industrial countries. In the United States, the sharp rise in anti-dumping cases in the first half of the 1980s has been attributed to the real appreciation of the dollar and structural problems in the international steel industry. While the number of anti-dumping investigations initiated declined during the second half of the 1980s, the stock of outstanding cases continued to rise until 1989/90, when it declined slightly. At the end of 1990, Japan, China, Korea, and Taiwan Province of China accounted for 83 of the 195 outstanding cases; developing countries accounted for most of the rest. The iron and steel sector accounted for most (54 percent) of the anti-dumping cases initiated in 1980-87, followed by chemicals (11 percent) (IMF, 1992).

The EC has been a frequent user of anti-dumping procedures; its stock of outstanding cases rose from 124 in 1983/84 to 170 in 1988/89, but declined to 152 in 1989/90, partly because of a reduction in cases involving Central and Eastern Europe. Measures against these countries have accounted for more than half of the total cases. EFTA countries, Japan, China, Hong Kong, and Korea have also been frequently investigated. The principal sectors initiating cases in 1980-87 were chemicals (42 percent), iron and steel (11 percent), non-electrical and electrical machinery (15 percent) (IMF, 1992).

Both the EU and the United States have widened the provisions of their anti-dumping legislation to address the circumvention of anti-dumping duties, although the EU has been the main user of anti-circumvention measures (all directed against Japan). The EU legislation was challenged in the GATT and found inconsistent with GATT rules. As a result, the EU has suspended the use of its anti-circumvention legislation. The ongoing globalization of investment and production and the increase in regional arrangements is likely to increase trade frictions related to rules of origin.

Reviewing recent tendencies in industrial countries' trade policies, the IMF (1992) concludes, that the salient feature is the threat of reduced reliance on the multilateral approach in relations with trade partners. Issues of fair trade and market access are often dealt with bilaterally, outside the scrutiny of the GATT Contracting Parties and in ways that are at variance with GATT rules or the principles of non-discrimination and transparency that underlie the GATT.

4.4 Bilateralism in World Trade

The League of Nations (1936) observed an increasing tendency towards the elimination of bilateral trade imbalances in the years preceding the publication by attempts to equalize as far as possible the imports and exports exchanged between any two individual countries.

To assess this tendency empirically, the foreign trade of 22 countries was partitioned into three components:

1. Bilateral trade.
2. Balance of total trade.
3. Triangular trade or Multilateral balancing.

The first component, bilateral trade, comprised all foreign trade where exports and imports with each of the trade partner countries balanced. The second component represented the overall deficit or surplus of foreign trade. The third component contained the remainder, being the sum of bilateral balances as far as they were cancelled and thus not reflected in the total trade imbalance.

The League of Nations (1935) described two reasons which at least account for the tendency towards bilateralism as contributing to the fall in the value of world trade in the early thirties. First, measures taken by any country in order to reduce its trade deficit with another are likely to influence not only the trade of the partner country but of a whole series of countries. With possibilities for expansion of trade being small, the affected country may be forced to curb its own imports from third countries rather than expanding its exports to them. A move in the direction of bilateralism may thus cause a reduction in world trade many times greater than that in the trade between the two parties originally involved. Secondly, the fall in demand for the products, which the victims of this policy can no longer afford to buy to the same extent, causes a reduction or prevents an increase of world market prices.

The League of Nations (1936) reported that the methods of bilateral trade policy have been extremely varied. Practically all trade restrictions, however general their character may appear, have discriminatory effects and had been employed in the early thirties as a means of promoting reciprocity in trade. Yet, the most effective methods are reported to have been quantitative restrictions in the form of *quotas* and *bilateral arrangements* for the settlement of foreign payments.

The League of Nations (1936) presented the following results regarding the degree of bilateral and multilateral balancing in trade of 22 countries representing 71 percent of total world trade in 1935.

	1929	1934	1935
1. Bilaterally balanced	71.7	71.9	74.2
2. Multilaterally balanced	18.4	15.1	13.8
3. Overall trade balance	<u>9.9</u>	<u>13.0</u>	<u>12.0</u>
Total trade	100.0	100.0	100.0

The figures above represent percentages in total trade. Between 1929 and 1935 a considerable decline is recorded for the share of multilaterally balanced trade in total trade. Till 1934 this has mainly be accompanied by a rise in the overall trade balances relative to total trade, but from 1934 to 1935 it is rather the degree of bilaterally balanced trade that has increased.

The League of Nations (1936) commented that this increase may be partly accounted for by the fact that 1935 was the first full year during which the clearing and payment agreements were in operation that Germany had concluded with 18 countries in 1934, in view of its transfer moratorium and increasing foreign exchange difficulties.

The League of Nations (1934) published in the Review of World Trade 1933 the extent of bilateral and multilateral balancing in trade for 22 countries for 1929 and the early thirties. For three of these years these results regarding Japan, the United Kingdom and the United States are repeated in Table 4.8 complemented by the results for 1985 ³⁴.

Table 4.8 Bilateral and multilateral balancing in trade for Japan, the UK and the USA, 1929-1985				
	in percentages of total trade ¹			
	1929	1931	1933	1985
<i>Japan</i>				
1. Bilateral balancing	74	79	70	64
2. Multilateral balancing	25	18	27	21
3. Trade balance	1	3	3	15
<i>United Kingdom</i>				
1. Bilateral balancing	75	65	69	80
2. Multilateral balancing	5	3	6	17
3. Trade balance	20	33	25	4
<i>United States</i>				
1. Bilateral balancing	69	70	71	69
2. Multilateral balancing	21	19	20	6
3. Trade balance	10	11	9	26

¹ Figures may not add to 100 exactly due to rounding.

Sources: League of Nations (1934) (for 1929, 1931 and 1933), UN (1986) (for 1985).

³⁴ In the League of Nations (1934) the inquiry was confined to the trade of each country with its principal import and export markets in most cases representing more than 90 percent of the entire trade of the country concerned. For 1985 trade with all partner countries is included.

Comparing the figures in Table 4.8 for 1929 and 1933 it can be seen that in Japan and the UK the amount of bilateral balancing decreased somewhat, with the overall trade balance increasing. For the USA no substantial changes are recorded.

Including the figures for 1985, Japan has still the largest degree of multilateral balancing of the three countries considered. Furthermore, the overall trade balance of Japan is considerably larger in 1985 than in the thirties, while the degree of bilateral balancing declined. The amount of multilateral balancing in the UK in 1985 is considerably larger than in the thirties, while the overall trade balance is much smaller. The opposite development is reflected in the figures for the USA.

5. STRATEGIC TRADE POLICIES

5.1 Traditional Trade Theories

According to the traditional theories, international trade results from differences among countries. These differences refer mainly to the technologies used in production processes and endowments with factors of production. Making use of these differences in technology and endowments leads to international trade that can be proven to be of mutual benefit to the partner countries. From a global point of view it implies that this type of international specialization maximizes output given the availability of resources. Consequently, the policy recommendation of free trade follows as a logical implication ³⁵.

The traditional trade theories are based on a number of assumptions of which two essential ones are:

- constant returns to scale in production, and
- perfect competition on product- and factor-markets.

However, it is economies of scale next to imperfect competition that together with differentiated products, intra-industry trade and high-technology industries provide the essential elements of the new international economics (Baldwin, 1992; Salvatore, 1993; Smith, 1994).

5.2 The Scope for a Strategic Trade Policy

In a number of industries larger firms produce at lower costs than smaller enterprises: such industries have internal economies of scale. Because of these internal economies of scale there will be a tendency in the industries concerned towards domination by one or a few large firms. In other words, these industries will be characterized by imperfect competition.

Internal economies of scale are in particular of importance in high-technology industries where fixed costs are a high proportion of total costs of production.

³⁵ For an overview of these issues see, among others, Falvey (1994) and Salvatore (1993).

These new elements suggest that there exist opportunities for an active interventionist trade policy, which may lead to an increase in welfare for a country, compared to a situation of free trade. These opportunities can best be analyzed in connection with the concepts of 'rent' and 'external economies' ³⁶.

The new international economics open up the possibility that there may be 'strategic' sectors, where labour and capital receive a higher return than they get elsewhere. Such a rent may provide an intellectually correct argument for a country to raise its national income by interventionist policies at the expense of other countries ³⁷.

There is another justification for activist trade policies: external economies. This time it is not the case that capital and labour in the sector concerned will themselves obtain exceptionally high returns, rather, they will yield high returns to society because in addition to their own earnings they provide benefits to capital and labour employed in other activities. The point here is that there may be good reason to protect certain high-technology sectors which generate large technological spill-overs to the rest of the economy.

The above reasoning means that the extreme pro free-trade position has become theoretically invalid. There is, however, a large difference between showing that free trade is not always optimal and formulating a specific policy alternative. The practical application of the new and theoretically valid arguments for policy intervention are beset with difficulties ³⁸.

Firstly, identifying strategic sectors is extremely difficult; there are no reliable methods available for this purpose. Secondly, the precise nature of the intervention to be used critically depends on the nature of

³⁶ For a detailed discussion see Grosman and Richardson (1985) and Krugman (1986).

³⁷ A detailed analysis of such situations can be found in Brander and Spencer (1983, 1985), and Laussel and Montet (1994).

³⁸ For an extensive survey of counter arguments see Krugman (1987), Bhagwati (1988), Baldwin (1992) and Laussel and Montet (1994).

the strategic interaction between the oligopolistic firms. It follows that the information requirements for an effective interventionist policy will, in general, be far above what is feasible.

There are some more dangers to mention. It is not at all excluded that powerful lobbies will interfere in the decision making process, leading to policies that are not likely to benefit the nation as a whole.

Finally, there is the very likely possibility that other countries will retaliate. This may, in the end, lead to trade wars and a considerable reduction of world trade and welfare.

For these reasons it should be concluded that free trade - though not being an optimal policy - should be maintained as practical guideline.

5.3 The Case of Airbus and Boeing

One of the cases that has attracted attention in the area of strategic trade policies is the Airbus aircraft industry and the subsidies channelled towards it. Pomfret (1991) has analyzed this case in particular.

Much has been written about the Airbus project and the conflict between Boeing and Airbus, but most of the literature is either descriptive or polemical. There have been attempts to estimate the amount of subsidies given to Airbus by European governments, but no convincing test of whether these were a strategic policy successfully switching rents from Boeing to the European firm. Part of the problem is that Airbus does not publish accounts, and even Boeing's profits on individual planes are difficult to assess. Economic studies have thus focused on modelling the industry and having the welfare impacts of Airbus's subsidised entry fall out of the model.

Which is the right model? Krugman (1987) labelled the firms in the game in Table 5.1 Boeing and Airbus and, although he warned that these names were just for illustration, his example has been frequently reprinted. It is, however, clearly not a model of the real world. Apart from the

numbers being pure invention, the reality was that Airbus entered but Boeing did not exit - contrary to Krugman's model.

The two most serious attempts to assess this case (Baldwin and Krugman, 1988; and Klepper, 1990) work in the spirit of Brander and Spencer by modelling the industry as a Cournot duopoly. They are, however, not analyzing the use of policy tools to change the nature of competition among established duopolists, but rather asking whether a subsidised entrant benefited the EC. Since the USA remains a net exporter, it clearly loses from Airbus entry. The lower price in a duopoly is equivalent to a terms of loss and the USA also loses rent on the lost sales, if the price is above Boeing's marginal cost. The rest of the world's consumers benefit from the lower price. The Airbus countries gain part of this consumer surplus, plus any rent snatched from Boeing - or minus Airbus losses if its average cost is above the duopoly price. Whether the world as a whole gains or loses from Airbus entry depends upon the relative size of the consumer surplus on the added sales at the lower price and of the efficiency loss (or dissipated rent) from Airbus being less efficient than Boeing.

Baldwin and Krugman (1988) and Klepper (1990) adopt a similar approach. They both assume the industry is a Cournot duopoly, derive some cost and demand parameters from the literature, and then calibrate the other parameters to reproduce the actual situation in a base year. They can then simulate alternative scenarios, of which the central case is a Boeing monopoly. The main results are summarized in Table 5.2. Klepper obtains larger efficiency costs, perhaps because he includes economies of scope whereas Baldwin and Krugman's single model comparison (A300 and B767) only has economies of scale. Both exercises produce a net global welfare loss from Airbus entry, but Klepper finds a net welfare gain for Europe. In Baldwin and Krugman's paper the net welfare effect on Europe is close to zero, but Katz and Summers (1989) have extended the model to include rent to labour and this is sufficient to produce a net welfare gain for Europe. Thus both models can show Europe benefiting from subsidised Airbus entry, at the expense of the USA (Pomfret, 1991).

How reliable are these exercises? Calibrated models are not testable, and all that can be done is to ask what drives the models and are these assumptions reasonable. Both models assume a Cournot duopoly and strong learning effects, assumptions which are likely to produce a European welfare gain and a net welfare loss to the world. If the average cost of Airbus is above the duopoly price, which both studies assume to be true (because Airbus is subsidised and costs are measured without subsidy), then the likelihood of European net gains is greater the higher the price; Cournot behaviour is relatively restrictive (in the sense of leading to a higher price) among non-collusive outcomes. Assuming strong learning effects imposes a significant cost differential between an incumbent with a large cumulative output and a new entrant, so that rent dissipation is likely to be high and the global welfare effect negative. In sum, these models' conclusions follow from their assumptions (Pomfret, 1991).

In Table 5.1(a) a monopolist makes a large profit, but if both firms produce they both make losses. If firm B has a head start, then firm A will not enter. In Table 5.1(b) firm A receives a subsidy of 10 units. This induces A to produce and B to exit. The subsidy allows firm A therefore to snatch the monopoly rent from firm B.

Table 5.1 Krugman's Boeing-Airbus game

(a) Hypothetical Pay-off Matrix			
		A(airbus)	
		p	n
B(oeing)	P	-5	0
	N	100	0
		0	0

(b) Hypothetical Pay-off Matrix after European Subsidy			
		A(airbus)	
		p	n
B(oeing)	P	+5	0
	N	-5	100
		0	0

Note: Each firm's choice is to produce (p,P) or not produce (n,N); the pay-off depends upon both firms' decisions.

Source: Krugman (1987).

How realistic are these assumptions? Cournot behaviour, where Airbus decides how many planes to sell assuming Boeing's sales as given, does not capture the active price competition in the industry. Klepper justifies the Cournot assumption with the Kreps-Scheinkman argument that capacities are fixed, which also does not capture production decisions in the aircraft industry. There are large fixed costs before a new model can be produced, but these fixed costs do not entail any quantitative capacity; rather the number and pace of deliveries seems to be demand-driven within a fairly broad range. If competition is by price, then duopoly price will be lower and the USA will lose more and non-producers gain more; there is less possibility of a European net gain, but greater probability of a global welfare gain. The cost assumptions are more difficult to question, but if the competition is in price and Airbus has deep pockets then Boeing will price at marginal cost and there will be less possibility of rent dissipation dominating the global welfare effect.

Most important of all, the duopoly assumption is inaccurate. McDonnell Douglas never did exit and in 1990 they introduced a new model (the MD11). Lockheed has exited, but remains committed to re-entering civil aircraft production. There are barriers to entry, but for military aircraft producers like Lockheed or General Dynamics they are not insurmountable. The civilian aircraft industry is a contestable triopoly, and life without Airbus would not be a Boeing monopoly, as Baldwin and Krugman assert. The larger number plus contestability place limits on Boeing's possible monopoly rents, and hence on the extent of rent-snatching by Airbus (Pomfret, 1991).

	Baldwin & Krugman ²	Klepper ³
<i>Europe</i>		
Consumers	+ 1.43	+ 10.5
Producer & government	- 1.47 (- 0.57)	- 2.8
Net welfare effect	- 0.04 (+ 0.86)	+ 7.7
<i>USA</i>		
Consumers	+ 2.3	+ 12.6
Producer	- 5.3	-107.6
Net welfare effect	- 3.0	- 95.0
<i>Rest of world</i>		
Consumers	+ 1.8	+ 13.6

¹ Calculated differences between an Airbus-Boeing Cournot duopoly and a Boeing monopoly (in billion US dollars).

² Net present value in 1974 with a 5 percent discount rate (limited to A300 and B767), from Baldwin and Krugman's (1988) preferred formulation with intertemporal demand substitution. The figures in parentheses are from Katz and Summers (1989) assuming 20 percent labour rents at the final stage of production; for consistency the negative effect on US producer surplus would also be larger in the presence of labour rents, but Katz and Summers do not report this calculation.

³ Undiscounted cumulative totals, 1970-2006, from the base case in Klepper (1990).

In sum, the Katz-Summers and Klepper conclusion that Europe gained from subsidising Airbus follows from assumptions that do not capture the real world situation. More plausible assumptions about the structure and conduct of the industry make rent-snatching subsidy implausible. Boeing's risk-adjusted profits are unlikely to be above normal profits, without stimulating a response from other US producers.

Pomfret (1991) concludes that rent-snatching arguments are neither sufficient nor necessary to explain Airbus subsidies. The subsidies can be explained by more traditional reasons. In a concentrated global industry they may have a beneficial anti-trust role, but it is doubtful if Boeing was not making significant monopoly profits. If Airbus's subsidised entry drives down the world price, then the USA as a net exporter will suffer in terms of trade loss, but again this is a traditional outcome (familiar, for example, to grain or sugar exporters). In

sum, analyzing the aircraft industry does not require new trade theories, and the industry provides no empirical support for any rent-snatching hypothesis. Given that this is an exceptionally highly concentrated global industry and in the absence of other plausible cases, this last conclusion suggests that rent-snatching arguments for interventionist trade policies are theoretical curiosa rather than useful policy guides.

5.4 Strategic Trade Policy and Economic Integration

Richardson (1989) provides a survey of studies on trade liberalization, in which the models are characterized by economies of scale and imperfect competition.

The most important conclusion from the research surveyed is that simultaneous reduction of barriers to international and internal competition creates sizeable and mutually reinforcing increases in an economy's real income. As a rule, trade liberalization leads to gains which may be two or three times more substantial than those estimated under perfect competition; gains are measured by an economy's change in real income.

It thus follows that precisely the elements of economies of scale and imperfect competition provide on the one hand an intellectual argument for increased protection in the form of a strategic trade policy and on the other hand lead to increased benefits from trade liberalization for instance through economic integration (Kol and Mennes, 1990). This is a paradox, apparently, the solution of which hinges on the observation that a strategic trade policy is designed to benefit the country that pursues such a policy at the expense of another country's welfare. This in turn implies that external effects are involved and thus the choice of the appropriate level of decision making, which is the subject of the next chapter.

6. THE LEVEL OF DECISION MAKING

6.1 Introduction

The WRR rightly concludes that the elements of integration and fragmentation also apply to the level of decision making. It is observed that the globalization of markets should have its equivalent in the area of government intervention. At a practical level, the WRR (1994) observes that the transfer of real competences from the national to an international level is to be preferred over a process of coordination and harmonization of national policies, a process which can be very tedious and may well lead to sub-optimal results.

This chapter analyses the level of decision making from an economic perspective. It starts off with an analysis of the discussion on subsidiarity in the European Union (EU) and the contributions to this discussion to be made by the economics of the level of decision making (section 6.2). Some refinements in the analysis are presented as well as the role of democratic control (section 6.3). Institutional consequences are reviewed next (section 6.4) and the chapter concludes with an evaluation of the main findings (section 6.5).

6.2 Subsidiarity and the Optimal Level of Decision Making

In 1975 A. Spinelli reported on the prospects for a European Union and within that context defined the concept of subsidiarity as: 'The Union only acts for effecting tasks which may be undertaken in common in a more efficient way than if member states were to act separately.'

Delors (1991) rightly comments that the applicability of subsidiarity as a concept would be greatly enhanced when it would be relevant to other levels of decision making than just the EU and its member states. And one could add, the applicability of subsidiarity would also benefit from a more precise definition of the term 'more efficient'.

The criteria for selecting the optimal decision level should indeed not be limited to the two levels of the EU and its member states but be

applicable to the levels of a town, region, country and groups of cooperating countries, be it a customs union or some more loose form of cooperation, and furthermore also to the world level.

Two criteria apply for selecting the optimal level of decision making (Tinbergen, 1965):

1. The decision level should be as low as possible, to allow for freedom and participation for those concerned, and to minimize transaction costs.
2. The decision level should be high enough to include all those affected by the decision envisaged. That is, external effects should be incorporated at the decision level chosen, but of course, only to a reasonable extent.

These principles, in combination, steer the choice of the level of decision making. Perhaps the most striking characteristic of the two criteria is that they represent a two-way tendency, namely a tendency to lower levels to save transaction costs and a tendency to higher levels to internalize external effects. This is in contrast with the principle of subsidiarity which has a downward bias. In contrast, the criteria above for choosing the optimal decision level are strictly neutral regarding the most appropriate level. And indeed, it is obvious that dealing with certain aspects of, for instance, environmental policies and trade policies, it is only the world level that is appropriate.

The efficiency aspect in the two criteria is that costs are minimized. That is, the costs of including higher levels of decision making (transaction costs) and the costs of excluding these (the benefits of internalization) are minimized in combination.

In this perspective, Tinbergen (1965) distinguishes three classes of policy measures: conflicting, supporting and neutral instruments. *Conflicting instruments* are measures that have a negative effect on regions and their authorities not included in the process of decision making. In terms of measures taken by individual countries, examples are a devaluation, a restriction on imports, and also local preference in government procurement. *Supporting instruments* have a positive effect on outside territories and include examples such as expanding government

spending in a recession, reduction of trade barriers and cleaning upstream water pollution. Because of the effects the use of supporting and conflicting instruments have on outside territories, the appropriate level of decision making should include these territories. *Neutral instruments* do not have effects on outside territories. It follows, that centralization of supporting instruments will tend to intensify their use, whereas centralization of conflicting instruments will tend to eliminate or mitigate their use.

6.3 Refinements

The exposition in the two previous sections presents the framework for assigning public competences to the various levels of decision making.

This section discusses some refinements:

1. Types of externalities.
2. Alternatives for handling externalities.
3. Assignment of policies and instruments.
4. The number of decision levels.
5. Economic criteria versus other criteria.

Externalities can be geographical and functional. In a *geographical* sense externalities arise when decisions taken in one area affect other areas. *Functional* externalities relate to effects of activities within a specific area that are not accounted for. Examples are the pollution of the soil by a chemical plant (negative externalities) and beehives near an apple orchard (positive externalities).

Accounting for functional externalities can be done in a social cost benefit analysis of the activity concerned. This would make the beehives socially more desirable than privately and for the chemical plant the opposite holds true. In order to account for functional externalities in a private cost benefit analysis, prices should be attached to them by law.

Geographical externalities can be dealt with by choosing a sufficiently high level of decision making at which they are included, as set out in section 6.2.

An alternative to government regulation when dealing with externalities is provided by Coase (1960), leaving the problem to be solved by the market. This of course still requires decision making at a sufficiently high level on the item the market should deal with.

This alternative is present in the shift from *Harmonization* to *Mutual Recognition* in the strategy of the EU Commission (Delors, 1991). With harmonization an EU standard is arrived at by negotiations and government decisions, whereas with mutual recognition, competition in the market, decides on the outcome, but of course within the boundaries set by the authorities. Again, social and private cost benefit analysis will decide on the choice between regulation by the government alone or using the market.

Policies as well as instruments have to be applied at the proper level of decision making as was the subject of section 6.2. This in turn suggests a hierarchy of decision levels, in which the top level designs the broad policy and the derived objectives and the use of instruments is left to lower - but still appropriate - levels of decision making.

Public works in infrastructure may provide an example. The choice for a certain type of fast train may be taken at the EU level. Whether The Hague will be connected to the railway can be decided by the government of the Netherlands. The location of the station in Rotterdam can be decided by the municipality. In this way a hierarchy of decision levels is involved in implementing a certain policy on infrastructure.

In this sense Delors (1991) also discusses the difference between Directives and Regulations in EU policy making: 'The Directive stipulates the results to be achieved, but it leaves it up to the States to choose how they will be attained. It differs from the Regulation, which is directly applicable in all its elements to the States ...'. Again cost benefit analysis can be applied to choose from among these the alternatives.

This leads to *the number of decision levels*. In principle, the range of conceivable policies and instruments could on the basis of the criteria

set out in section 6.2, result in a number of decision levels that would be unworkable. Obviously, the number of levels of decision making is part of the optimum problem itself.

Economic criteria of efficiency and equity and possibly of other objectives of society naturally would take the lead, with administrative procedures and taxation being derived from it. *Democratic control* however seems to qualify as a necessary condition for transferring authorities to another level. This would imply, that a sacrifice in economic efficiency is readily accepted for the gain in democratic credibility of decision making.

6.4 Institutions and the Optimal Level of Decision Making

National policies on trade, by their nature, are designed to affect other countries through intervention in foreign trade relations. To avoid the fragmentation in the world economy of the 1930s, the General Agreement on Tariffs and Trade (GATT) was created after World War II to set the rules of conducting foreign trade on an international scale. A multilateral setting of the rules for international trade and trade policies was to avoid the tendency towards bilateralism in the 1930s (Wolf, 1988). More recently, the successful conclusion of the Uruguay Round in 1993 will not keep in check completely the present tendencies towards bilateralism and even unilateralism³⁹ in conducting international trade, but certainly these tendencies would have had more leeway, had the Uruguay Round ended in failure (Kol, 1995). On 1 January 1995 the World Trade Organization (WTO) was established, which will gradually supersede the GATT and assuming more competences (GATT, 1994a).

The GATT and the WTO provide examples of a transfer of competences from the national to the international level, that has proven to be beneficial in terms of economic performance. Equally, the transfer involved is still of a too limited nature, especially in enforcing the implementation of the outcomes of the dispute settlement mechanism (GATT, 1994a). Similarly, Tinbergen (1991) argues the case of reforming the United Nations in

³⁹ See Bhagwati (1992a) for an overview of these tendencies.

order to create a more and much needed effective supranational decision making.

In the 19th century international integration was consolidated predominantly in bilateral agreements. Most treaties were drawn up and implemented through the usual diplomatic channels, no permanent bodies being created.

Postal services and telecommunication however, were two noteworthy exceptions - the need for positive integration in both cases was so great to warrant the setting up of an international organization. These international organizations were the Universal Postal Union (1874) and the International Telecommunication Union (1865).

The Universal Postal Union

In the 19th century, the rationalization of international postal services lagged well behind those within national borders. Transit charges levied by countries were far above the actual costs. The consequence was poor service at high rates. The most complicated part of the whole process was the system of accounting. Incoming and outgoing mail had to be checked in such minute detail that there was a long delay in the dispatch and delivery of letters.

It became increasingly clear that national diversity in postal matters was too expensive to be retained. To overcome these national differences, it was decided to negotiate international postal services on a supranational level. In 1874, the General Postal Union came into being and began its operations. The name of the organization was changed in 1878 to Universal Postal Union (UPU). As a public international technical organization, the UPU has the power to ensure the smooth movement of international mail, using its supranational capacities to enact necessary postal legislation and to revise the provisions of the UPU Convention according to contemporary postal needs (Menon, 1965).

The contents of the UPU Convention have never been considered to be inviolable or immutable. However, the basic provisions of the UPU Convention have been drafted so thoughtfully, that they have been

retained throughout the years. The participating countries to the Convention have multilaterally agreed to (Menon, 1965):

- (a) Form a single postal territory, consisting of member countries, for the reciprocal exchange of correspondence;
- (b) Standardize charges to be collected by each country for the items of mail addressed to the whole of the Union's territory;
- (c) Abolish the sharing of charges between sender country and country of destination;
- (d) Permit each administration to keep the entire amount of the charges it collects on condition that it remunerates, in conformity with the rates laid down, the intermediary administrations carrying out the transit of these mails;
- (e) Guarantee freedom of transit within the territory of the Union;
- (f) Set up an arbitral procedure to settle conflicts between administrations;
- (g) Establish a central office under the name of the International Bureau, the expenditure for which is borne by all the contracting countries; and
- (h) Hold periodic meetings of a congress of plenipotentiaries of member countries to revise the acts of the Union and discuss questions of common interest.

The UPU can be regarded therefore as a successful 19th century implementation of a supranational level of decision making dealing effectively with cross-border activities with external effects.

The International Telecommunication Union

The radio spectrum consists of short, medium and long waves, which are used for different transmission purposes. Short waves travel considerable distances (thousands of kilometres), while medium and long waves are only operational on shorter distances. If two transmitters employing the same modulating technology use the same wave lengths to transport information at a given moment in time and in the same place, there is jamming or interference. The receiver receiving two sets of information simultaneously would be unable to understand the content. The spectrum resource is thus wasted to the extent that its use is totally inefficient for both the sender and the receiver (OECD, 1993).

It is necessary to create an administrative system in charge of the spectrum, whose authority is exercised in accordance with the physical characteristics of radio waves. Given the specific nature of radio waves, coordination of radio spectrum management can take place at *different levels*: supranational for short waves, continental for medium waves and national for long waves.

A well-established *supranational* system of coordination exists through the International Telecommunication Union (ITU), established in 1865, which handles the international regulation of the radio spectrum. Since the spectrum is an international resource, for short waves there is a primary division at world level within a framework of the ITU, the aim being to minimise the negative externalities, to guarantee access to frequencies for each country and to create economies of scale for the equipment used.

In addition, regarding medium waves, the importance of *continental* bodies, such as the European Radio Committee of the European Conference of Postal and Telecommunications Administrations (CEPT), has grown in recent years. For example, in the frequency administration field, CEPT continues to coordinate the use of frequencies in member countries and to establish joint positions at ITU conferences.

For long waves the spectrum management can be carried out on a *national* level, for example by the Ministry of Transport. The ITU has therefore proven to be an international institution, where international decision making has been implemented successfully, distinguishing furthermore various levels of decision making according to the extent of the external effects (OECD, 1993).

6.5 Evaluation

Subsidiarity has been called upon to refuse in practice the consequences of commitments to common policies in the EU that were formally endorsed in the Treaty.

This observation by Delors (1991) is also expressed in these words:

"Frequently, I have the impression that subsidiarity is a fig leaf used to conceal unwillingness to honour the commitments which have already been endorsed."

In such circumstances, a clarification of subsidiarity will assist in improving policy making.

Regarding *subsidiarity* as an *operational principle*, applicable in practice, the following conclusions have been arrived at:

1. The optimal level of decision making follows from two criteria, which operate in opposite directions:
 - a. the level of decision making is to be as low as possible in order to minimize costs and to maximize participation;
 - b. the level of decision making is to be sufficiently high so as to encompass external effects whether these are negative or positive.
2. The levels of decision making considered include the town, region, country, country group, continent and finally the world level.
3. In principle each activity has its own optimal decision level. A proliferation of decision levels could follow as a result. It follows, that the optimality of decision making includes the choice of the number of decision levels.
4. A certain policy may include a range of derived objectives and instruments leading to a hierarchy of levels of decision making involved.
5. With respect to the level of decision making economic aspects of efficiency and equity dominate aspects of taxation and law.
6. It is only democratic control that provides for a necessary condition for transferring authority to a certain level. This would imply a strong willingness to sacrifice efficiency for a gain in democracy.

7. CONCLUSIONS AND RECOMMENDATIONS

This chapter gives an overview of the main findings of this study and, based on these, presents recommendations with respect to government policies. As has been explained in the introduction the background of the present study relates to the reformulation of foreign policies of the Netherlands. This in turn gives the main focus of this study on international economic relations, namely a description and analysis of tendencies towards integration and of fragmenting forces in the world economy. Both, the conclusions and recommendations reflect this focus. The conclusions and recommendations are presented under the headings of the chapters to which they relate.

CHAPTER 2. REGIONALIZATION IN WORLD TRADE: CONCLUSIONS

The Customs Union Issue in the 19th Century

2.1 In the 19th century the principle of most-favoured-nation had become accepted as the general principle governing international economic relations. It was recognized that the formation of a customs union would violate most-favoured-nation treaties with outsiders. This controversy was solved by stipulating that only customs unions were acceptable that would be complete rather than liberalizing trade in one or a few products, that is, would act as a single entity in foreign trade relations.

Economic Integration and the GATT

2.2 During the 20th century the most-favoured-nation principle was replaced by the more powerful principle of non-discrimination. This principle is the main foundation of the General Agreement on Tariffs and Trade (GATT), providing the multilateral setting of rules for international trade since World War II. An agreement on economic integration extends preferential treatment to the participating countries, and, as a consequence, discriminates against outsiders. The GATT in Article XXIV has dealt with this controversy - much in the same way as it was done in the 19th century - by permitting departures from the non-discrimination principle, provided the proposed free-trade agreement would cover substantially all trade in all products originating in the participating countries.

The underlying idea is that agreements on free trade and economic integration with limited membership can be regarded as a practical route towards economic liberalization on a world scale.

Regionalism and the Multilateral Trade System

2.3 The threat from regionalism to the multilateral trade system under GATT and the World Trade Organization (WTO) would arise only if economic liberalization within regions would be complemented with increasing protectionism to outsiders.

Bloc Formation in the OECD Area

2.4 An OECD study on bloc formation among four country groups in the OECD area, among which the EC, in the period 1961-1989 concludes that there is only weak evidence that the intra-country group shares in total group imports have increased; apparently, multilateral reductions in trade barriers agreed upon under GATT provide a countervailing influence against any bloc formation as defined in the OECD study.

The Possibility of a Trading Bloc in East Asia

2.5 The implementation of a discriminatory trading bloc in East Asia is unlikely for a number of reasons. Important among these is the dependence of East Asian exports on markets outside the region. The countries in East Asia have a great interest in supporting the multilateral trade system under GATT and the WTO.

The Concepts of Regionalization

2.6 The analysis of possible regional concentrations of trade relations benefits from the conceptual distinction between

- a) *Bloc formation*, relating to the relative concentration of trade among countries bound by a formal agreement on economic cooperation;
- b) *Regionalization*, relating to the relative concentration of trade among countries with an informal cohesion, and
- c) *Polarization*, which can be regarded as a special case of regionalization, as it relates to a concentration of trade from a group of developing countries on a group of industrialized countries with geographical proximity.

The Network of World Trade

2.7 In the period 1960-1992 the pattern of world trade has undergone some important changes. During this period the share of *Japan* in world trade rose from 3 percent to 6 percent of world imports and 9 percent of world exports. The share in world trade of *Asia and Oceania* (except *Japan*) rose from 10 to 17 percent. On the other hand, the share in world trade of the countries in *Central and Eastern Europe* declined from 10 to 3 percent, and that of *Africa* from 4 to 2 percent. *North America* continued to hold a share of around 17 percent, while *Western Europe* continued to have by far the largest share that rose even further from 40 to 45 percent.

2.8 The network of trade relations in the world economy among the 8 country groups distinguished did not attain a substantially higher degree of cohesion in the period 1960-1992. In 1960 only 28 of the possible 63 trade relations attained a level of some importance with more than 0.5 percent of world trade, this figure having risen to only 31 by 1992.

2.9 Throughout the period *Western Europe* entertained the highest number of important trade relations in the network of world trade, this number having the maximum value of 14; second is *North America* with 9 such relations in 1992. *Asia and Oceania* continued to have a third position with 8 important trade relations. For *Japan* the number of important trade relations increased from 4 in 1960 to 7 in 1992. By 1992 *Central and Eastern Europe* and *Africa* were almost outsiders from the network of world trade, having trade relations of more than 0.5 percent of world trade only with *Western Europe*.

2.10 Between 1960 and 1992 the trade relations between *Western Europe* and *North America* declined in importance from 11 to 6 percent of world trade, but these still dominate the trade relations between *North America* and *Japan*, representing 4 percent of world trade, and those between *Western Europe* and *Japan*, accounting for 3 percent of world trade.

Polarization in World Trade

2.11 Foreign trade of *Africa* is for more than 50 percent concentrated on *Western Europe*. And after the collapse of internal trade in *Central and*

Eastern Europe, by 1992 also for these countries the concentration of trade on *Western Europe* had risen to well over 50 percent. On the other hand, seen from the viewpoint of *Western Europe*, trade with *Africa* and with *Central and Eastern Europe* amounts to only a small share of its total trade, being 3 percent in both cases.

A similar situation can be observed in the trade relations between *North America* and *Latin America*. Trade of *Latin America* is for more than 40 percent concentrated on *North America*; but to *North America* trade with *Latin America* amounted to only 11 percent of its total trade in 1992.

In contrast, trade relations of *Asia and Oceania* are by 1992 evenly spread across *Western Europe*, *Japan* and *North America*, each accounting for about 16 percent of its total trade.

By 1992 internal trade of *Asia and Oceania* amounted to 41 percent of its total trade; for *Africa* and *Latin America* these percentages were much lower, with 6 and 17 percent respectively in 1992.

Regionalization in World Trade

2.12 As can be expected the regional concentration reaches higher values for the internal trade of the country blocs considered than for trade between them.

The figures for *Asia and Oceania* show a certain degree of concentration in trade with *Japan*, though it is decreasing.

The index of regional concentration shows a low level of concentration for trade between *Western Europe* and *North America*, and is even lower for trade between *Western Europe* and *Japan*. Trade relations between *Japan* and *North America* have shown some degree of concentration throughout the period.

Bloc Formation in World Trade

2.13 With respect to the EC the index for measuring bloc formation in trade, rose threefold from 55 to 159 in the period 1960-1992 for *all commodity* trade. For primary products related to the Common Agricultural Policy the index increased twice as fast. For *textiles and clothing* the index of bloc formation remained constant during the period 1960-1992. For *road vehicles* the index doubled.

2.14 Although the US-Canada free-trade agreement is of much later date (1988) than the agreement on economic integration in the EC (1957), the US-Canada economic cooperation dates already back to the previous century.

Comparing the values of the index of bloc formation for the North American cooperation (NAFTA) with those for the EC reveals some marked differences.

For *all commodity* trade bloc formation is much lower in NAFTA than in the EC, and moreover declining in the period 1960-1992, whereas it is fastly rising in the EC. For *textiles and clothing* the index is 10 times lower for NAFTA than for the EC. For *telecommunications equipment* the index for NAFTA is 5 times lower than for the EC. Regarding *road vehicles* the figures for NAFTA show that the bloc formation index halved since 1960, but it doubled for the EC in the same period.

Policy Evaluation

2.15 Tendencies towards regionalization and bloc formation in the world economy cannot be judged on the basis of an analysis of trade flows alone. Important elements in the evaluation are also the policies designed and implemented regarding trade relations with trade partners outside the region or bloc considered.

In this perspective it is important to observe that in the three regions, the EU, NAFTA and East Asia there are strong tendencies towards liberalization, deregulation and privatization. With respect to the *EU*, the 1992-programme is characterized by liberalization and deregulation. This is apparent from the opening up to competition of the supply of utilities, of telecom networks and of public transport; it is also apparent in the removal of national quotas especially in consumer electronics, footwear, cars, and textiles and clothing.

NAFTA will liberalize trade also in sectors where tendencies towards protection are strong as well as in services. Moreover, Mexico is bound in *NAFTA* to a programme of trade liberalization in addition to having become a GATT member. In general the US-Canada free-trade agreement is pro-competitive.

In *East Asia* the policy trend is unambiguously towards trade liberalization. The first and second generation of Newly Industrializing Economies

in East Asia have embarked upon a programme of spreading competition to areas and sectors sheltered thusfar.

CHAPTER 2. REGIONALIZATION IN WORLD TRADE: RECOMMENDATIONS

2.1 It is recommended that foreign policies of the Government of the Netherlands reflect the view, as embedded in the GATT, that an agreement on economic integration is predominantly a practical but limited step towards economic liberalization on a world scale.

2.2 Recommendation 2.1 implies that foreign policies of the Government of the Netherlands are recommended to support tendencies towards openness and non-discrimination in EU trade policies.

2.3 It is recommended that foreign policies of the Government of the Netherlands would continue to support GATT and WTO policies towards multilateral trade liberalization, providing a countervailing influence against tendencies towards increased protectionism around emerging trading blocs.

2.4 The strong economic performance of countries in East Asia should be regarded as an opportunity for EU members rather than a threat. The countries in East Asia continue to have an interest in an open multilateral trade system. The implementation of a discriminatory trading bloc in East Asia is unlikely. The Government of the Netherlands would be advised to continue to act upon this view also in the framework of EU policy making.

2.5 Western Europe has a pivotal role in the network of world trade. It continues to hold a share in world trade of well over 40 percent and entertains the maximum possible number of important trade relations in the network. It is recommended that this central position is reflected in the foreign policies of Western Europe.

2.6 Given the concentration on Western Europe of well over 50 percent of total trade of Africa and of Central and Eastern Europe, it is recommended that Western European trade policies reflect the importance

of the Western European market for the expansion of trade with Africa and with Central and Eastern Europe.

2.7 The index of bloc formation in the EU shows a much faster increase for products related to the Common Agricultural Policy (CAP) than for other products. To the extent that the CAP is detrimental for more economically efficient supply from outside the EU especially from Central and Eastern Europe and from developing countries it is recommended that the CAP is revised in this perspective.

2.8 It is recommended that the Common Agricultural Policy, restrictive regulation and interventionism be recognized as being opposite to the underlying notion of the 1992-programme of the EU, and consequently be liberalized and reduced. EU trade policy practices on voluntary export restraints and anti-dumping procedures, as reported by GATT, are recommended to be modified and brought more in line with the notion of more competition inherent to the 1992-programme of the EU.

CHAPTER 3. GLOBALIZATION OF PRODUCTION: CONCLUSIONS

The Division of Labour

3.1 Specialization is a major force in economic growth. Specialization may arise between workers in a factory, between professions, between firms in the various stages of a production process, between industries and between countries.

Globalization and Technology

3.2 The scope for specialization is limited by the extent of the market. The size of the market is primarily determined by the amount of buying power, that is the size of the population combined with income per capita, and by the costs bridging geographical distances, including costs of transportation and communication.

3.3 The twentieth century and especially the past few decades have seen a rapid technological development in transportation and communication and a substantial decline in their costs.

FDI: General Trends and Characteristics

3.4 One of the important aspects of the globalization of production is the development in foreign direct investment (FDI). As a share of GDP the outward stock of FDI of the industrial countries rose from nearly 5 percent in 1967 to 8 percent in 1988. Between 1986 and 1991 the outflow of FDI from the industrial countries rose by 24 percent, twice the figure for gross domestic investment. These empirical data testify to the increasing globalization of production.

The Country Distribution of FDI

3.5 Throughout the last 25 years the industrial countries accounted for around 97 percent of the total stock of outward FDI, the developing economies accounting for the small remainder of around 3 percent. Of the total stock of inward FDI the share of the industrial countries rose since 1967 from 70 percent to nearly 80 percent recently; the developing countries being the location of a share of the total stock of FDI correspondingly decreasing from 30 to 20 percent. The changes however were not parallel among developing countries; the shares in the world stock of inward FDI halved in Africa and Latin America, while the share of Asia increased somewhat.

3.6 In terms of flows of FDI, those between Western Europe and North America in 1990 amounted to 505 billion dollar, five times the flows between North America and Japan, which in turn outweighed those between Japan and Western Europe with a factor four. However, the flows between Japan and Western Europe grew very fast since 1985 with 45 percent annually, much faster than the growth in FDI flows between Western Europe and North America and between Japan and North America.

3.7 The Netherlands continue to have an important position in outward FDI, with a share of 10 percent of total stock in 1967 - representing a third place among countries - and still a share of 7 percent in 1988 - representing a fifth position.

The Sectoral Composition of FDI

3.8 The sectoral composition of the world stock of FDI underwent important changes since 1970. The share of the *primary sector* was halved,

going down from 23 to 11 percent from 1970 to 1990. In the same period the share of the *manufacturing sector* decreased from 45 to 39 percent; the *services sector* increased its share considerably from 31 to 50 percent. Since these figures relate to the stock of FDI, the changes in flows have been even more considerable.

3.9 Within the services sector, finance- and trade-related activities account for two-thirds of the FDI stock in services. Deregulation and liberalization of trade and investment are major factors in this development; the same factors apply to the present opening up to FDI of some capital- and technology-intensive services: *airlines and telecommunications*. However, the increased transportability of some services, especially those that are information-intensive, may reduce in time the need for FDI in these sectors.

3.10 Between 1980 and 1990 the share of capital- and technology-intensive industries in FDI rose faster in developing economies than in developed countries; this development was particularly significant in Hong Kong, Singapore, South Korea, Taiwan and Thailand.

International Investment, Trade and Commercial Policies

3.11 The outcome of the Uruguay Round can be seen as instrumental to enlarging the extent of the world trade market. By including for the first time agriculture, textiles and clothing, and services, an additional 36 percent of total world trade is now within GATT. The number of participating countries in the Uruguay Round was eventually 117, larger than the 99 of the Tokyo Round. A further reduction in tariffs and above all the replacement of quota and other forms of non-tariff barriers by tariffs have been agreed upon in the Uruguay Round. These three elements testify to the success of the Uruguay Round in keeping the world market for trade and investment as open as possible.

3.12 In economic history the empirical evidence is that in times of trade liberalization (e.g. 1953-1972) world trade rises considerably faster than world output, compared to periods of increasing protection (1930-1938 and 1973-1980), indicating that trade liberalization goes

together with increased interdependence between nations and increased international division of labour.

3.13 The relationship between FDI and international trade is not straightforward but complicated. FDI may substitute for trade in the case of setting up production facilities in a protected market, it may promote trade as in export processing zones, it may complement trade as with a servicing network to accompany exports of products, and finally FDI may divert trade to exploit hitherto unexhausted preferential quota in other countries. Trade related investment measures (TRIMs) may relate to the input side of the production process, such as local input requirements, and to the output side, such as minimum export requirements. From the perspective of specialization and the extent of the world market, it is a positive development that within the framework of the Uruguay Round an agreement on TRIMs was reached.

Globalization and Employment

3.14 Unemployment in the European Union (EU) has risen sharply since the mid-1970s, with unemployment rates currently around 10 percent of the labour force, significantly higher than in Japan with 3 percent and the USA with 7 percent. In addition, for any given rate of unemployment the share of long-term unemployment is much higher in the EU than in the USA.

3.15 Evidence from a range of countries suggests that factors of technology, of imports from low-wage countries and of increased global competition - commonly suggested as causes for unemployment - are not primarily or even importantly relevant. In trade with non-OECD countries, losses in employment for unskilled labour in the OECD have been largely offset by skilled labour employment through exports. In industries with declining employment, the developments in productivity have been identified as the main factor behind this decline.

3.16 There is a striking difference between Japan and the USA on the one side and the EU on the other. Employment growth in Japan and the USA has largely taken place in the private sector, but in the EU mainly in the public sector.

3.17 Evidence confirms that employment creation is best served by expansion of high-growth industries rather than by protecting low-growth industries and postponing necessary adjustments.

Economic Developments in Central and Eastern Europe

3.18 After the transition, trade flows of the countries in Central and Eastern Europe (CEE) became diverted from intra-CEE trade towards the industrialized countries, especially Western Europe. From the viewpoint of the CEE countries, the importance of the EU as a market of destination increased considerably, receiving 12 percent of total CEE exports in 1970 and 45 percent in 1992. From the EU perspective, the share of total EU imports originating from the CEE economies decreased slightly from 3.4 percent in 1970 to 2.9 percent in 1992. Looking at the trade flows from the EU to the CEE countries a similar conclusion can be drawn. The EU as a source of origin for imports increased in importance in CEE countries' total imports from 13 percent in 1970 to 43 percent in 1992, while the share of EU exports going to the CEE countries decreased from 3.4 percent in 1970 to 3.1 percent in 1992.

3.19 There are marked differences in the structure of exports to the EU between the former USSR and the other CEE countries. Exports to the EU from the former USSR consist mainly of primary goods, with a share of around 75 percent of total exports recently, fuels representing 60 percent. The other CEE countries export mainly manufactured products to the EU. Although the product composition of manufactured exports varies among CEE countries, the main categories are machinery and transport equipment, chemicals, clothing and steel.

3.20 In the past few years the CEE economies have initiated comprehensive reform programmes designed to transform the economic system into a market based economy. Liberalization of the trade and exchange system is an important component of these reforms.

Notwithstanding the progress made, the CEE countries are not yet fully integrated into the multilateral trade system. Further progress in this area will depend, inter alia, on (i) continued domestic reforms, and (ii) sufficient access to foreign markets, especially in Western Europe.

3.21 Recently, the EU implemented a programme of trade liberalization towards the CEE countries, embodied in the Association or Europe Agreements, between the end of 1991 and the beginning of 1993, covering at present 80 percent of the signatory countries' exports to the EU and improving significantly access to the EU market, and having as the final objective the establishment of a free-trade area in 10 years time.

3.22 One of the important aspects of the reintegration of the CEE countries in the world economy is the position with respect to foreign direct investment (FDI). Since 1985, inward FDI expanded, estimates are that by the end of the 1990s cumulative investment flows to the CEE countries could surpass 50 billion dollars. Western Europe is the principal source of FDI in the CEE economies, accounting for well over 50 percent of foreign capital by the end of 1990. The sectoral composition of inward FDI varies considerably among the CEE economies, the manufacturing sector attracting 73 percent of total FDI in Poland, and services accounting for 64 percent in former Czechoslovakia.

3.23 Inward FDI is likely to have a significant positive impact on economic restructuring in the CEE countries and on their reintegration in the world economy.

The CEE countries could enhance their attractiveness to FDI by continuing the improvements in economies, institutional and legal conditions, including privatization, liberalization and infrastructural conditions, management and accounting practices, a commercial banking system, ownership regulations, and above all stability of the legal conditions and of the political system.

Globalization of Financial Markets

3.24 Since the breakdown of the Bretton Woods system the International Monetary Fund has identified two other key structural changes in the international financial system:

1. the rapid expansion of private international financial markets,
2. the removal of capital account restrictions in the industrial countries.

The globalization of financial markets has been stimulated by a range of factors including the emergence of Japan since the 1980s as a major

participant, the developments in communication technologies, liberalization and deregulation of the financial sector in industrial countries, and the development of new derivative financial instruments.

3.25 The globalization of financial markets has led to a more explicit international evaluation of the creditworthiness of individual countries. This in turn has led to an increased incentive for countries to adopt macro-economic and monetary policies that are considered appropriate from that perspective. As a consequence, this will strengthen the tendency for economic policies of individual countries to converge towards the most appropriate policies from the viewpoint of creditworthiness. Within the EU the process of convergence is strengthened furthermore by the conditions set for participating in the EMU.

Globalization and Economic Convergence

3.26 Globalization of economic activities implies that international firms are increasingly less bound by a specific location and opt for locations that offer the best conditions in terms of infrastructural facilities, market access and policy environment. This in turn implies that governments try to improve these locational conditions and at the same time are under pressure to coordinate policies on domestic subsidies, government procurement, technical standards, competition, environmental protection, and labour standards.

CHAPTER 3. GLOBALIZATION OF PRODUCTION: RECOMMENDATIONS

3.1 It is recommended that the globalization of production is regarded from the perspective of specialization and interdependence among national economies; the benefits of this process extend in principle to all countries involved.

3.2 The scope for international specialization is enhanced by the extent of the world market and consequently is diminished by tendencies to fragment it. A commitment to the multilateral setting of rules of conduct in international trade and investment, as presently embodied in the GATT and later on in the World Trade Organization, contributes to keeping in check tendencies towards fragmentation, such as protection,

bilateralism and managed trade. The principle of non-discrimination underlying GATT and WTO is instrumental and of major importance for participation in the world market on equal terms.

3.3 Government policies are instrumental to the attractiveness as a potential host country for FDI. Of importance are infrastructural provisions in law, education, transport and communication. Invariably, political and economic stability, have proven to be a necessary condition for attracting FDI.

3.4 Unemployment cannot be addressed adequately by attempts to seal the economy off from external developments, by protectionist and other measures. Rather, adjustments in the labour market are called for, such as reducing barriers to labour mobility. Improving investment in further education and training and facilitating the school-to-work transition are also of particular importance. Without considerable measures regarding labour market policies, the scope for low-skilled employment in the OECD countries will continue to be diminished.

3.5 The importance of Western Europe as a market for CEE exports and as a source of their imports has important implications from an EU policy perspective. The Europe Agreements testify that the EU is improving access to its markets for CEE exports. Technical assistance for the transformation programme to continue and to further improve the attractiveness for inward FDI in the CEE countries is recommended.

3.6 The globalization of financial markets has led to an increased exposure of individual countries to the international evaluation of their creditworthiness, as implied by their macro-economic and monetary policies.

In addition, in the EU the domestic policies are under scrutiny because of the conditions set for participating in the EMU.

It is recommended that the domestic economic policies would reflect the increased international exposure of their impact, in view of the globalization of the financial markets and requirements of participation in the EMU.

3.7 It is advocated that the tendency to coordinate domestic policies of relevance for a country's attractiveness as a location for international firms - including subsidy and competition policies - are channelled through international organizations such as the WTO and the OECD. Where bilateral or regional negotiations provide an appropriate start, it is advocated that a mechanism is designed through which the outcomes would eventually apply multilaterally.

CHAPTER 4. FRAGMENTATION IN THE WORLD ECONOMY: CONCLUSIONS

4.1 The notion of division of labour among workers being limited by the extent of the market was developed by Adam Smith and extended in 1928 by Allyn Young to include specialization among industries and firms. This latter type of division of labour is apparent from an increasing number of specialized undertakings between the producer of raw materials and the consumer of the final product.

4.2 The division of labour among industries is an adjustment to the growth of the market for the final product of a particular industry and is a vehicle for the exploitation of economies of scale. This fragmentation of industrial production processes allows furthermore a better exploitation of locational advantages across countries. This process of international fragmentation is apparent in a number of industries, which is illustrated for textiles and clothing, electronics and services.

4.3 The division of labour among industries represents - in an international context - a process by which a number of countries becomes engaged in a particular production process; this type of fragmentation therefore represents a tendency towards international integration.

4.4 Two elements in recent developments in trade policies imply a tendency towards a fragmentation of the world market, namely

- unilateralism, and
- anti-dumping procedures.

Section 301 of the 1974 US Trade Act and later provisions such as Super 301 and Special 301 allow the USA to take unilateral actions against policies of a particular country which are deemed unfair or restrictive

to US commerce. Unilateral actions tend to undermine the multilateral trade system as embodied in GATT, by fragmenting the world market into bilateral relationships.

The EU has been a frequent user of anti-dumping procedures. Such procedures are usually targeted towards specific suppliers from specific trade partner countries, thus contributing to a fragmented world market. The EU legislation on anti-dumping procedures was found inconsistent with GATT and therefore implies a reduced reliance on the multilateral trade system.

4.5 The League of Nations observed in the 1930s a tendency among countries towards bilateral balancing of their trade away from multilateral balancing. The most effective methods for increasing bilateral balancing were quantitative trade restrictions and bilateral payment arrangements. In 1933, Japan had a larger share of multilateral balancing of its foreign trade than both the UK and the USA. Figures for 1985 give the same result.

Multilateral balancing rather than bilateral balancing is more in line obviously with the principle of non-discrimination underlying the multilateral trade system.

CHAPTER 4. FRAGMENTATION IN THE WORLD ECONOMY: RECOMMENDATIONS

4.1 An increasing extent of the market allows the fragmentation of production processes into specialized undertakings, firms and industries; in an international perspective, this type of fragmentation represents a growing interdependence of national economies. On the other hand, present day practices in trade policies of unilateralism and measures targeting specific suppliers, tend to fragment the world market into bilateral trade relations.

Support for the multilateral trade system under GATT/WTO would support the process of fragmentation of production processes and impede the tendency to fragment the world market into bilateral trade relations.

CHAPTER 5. STRATEGIC TRADE POLICIES: CONCLUSIONS

5.1 The elements of economies of scale and of imperfect competition provide a *theoretically correct argument* against free trade as the optimal policy in all circumstances. Instead, a strategic trade policy could be followed designed to protect and favour industries, which generate important technological spill-overs to the rest of the economy.

5.2 The *practical implementation* of such a strategic trade policy is however beset with difficulties. Among these are the excessive information requirements, the detrimental interference of lobbies, and the possible retaliations by other countries. For these reasons the policy of *free trade* is still to be regarded as the most suitable practical guideline.

5.3 The case of subsidies to Airbus shows that even in the highly concentrated aircraft production industry the arguments for a strategic trade policy are theoretical *curiosa* rather than providing a useful policy guidance.

5.4 A strategic trade policy is designed to increase a specific country's welfare at the expense of other countries. This leads to the recommendation that the issues involving strategic trade policies are to be considered from a *supranational point of view*. This recommendation is corroborated by the empirical observation that the essential economic characteristics inherent to a strategic trade policy, namely economies of scale and limited competition, are precisely the elements enhancing the benefits from *economic integration*.

CHAPTER 5. STRATEGIC TRADE POLICIES: RECOMMENDATIONS

5.1 It is recommended that the Government of the Netherlands withstands internal pressures favouring strategic trade policies, while at the same time supporting the process of bringing industrial subsidization under international agreements, in the EU, the OECD and the GATT/WTO.

CHAPTER 6. THE LEVEL OF DECISION MAKING: CONCLUSIONS

6.1 The globalization of markets in itself calls for government intervention and policies at a higher than national level. More traditionally, economic activities - such as international trade - are in need of rules arrived at in a multilateral rather than a bilateral or unilateral setting. The appropriate level of decision making is also under discussion in the EU, with subsidiarity as the leading concept.

6.2 Economic analysis offers a twofold criterion guiding the choice of the optimal level of decision making:

- a) the level of decision making should be as low as possible in order to minimize transaction costs;
- b) the level of decision making should be sufficiently high to avoid the costs of external effects - both negative and positive - not being internalized.

6.3 A particular policy may include a range of derived objectives and instruments leading to a hierarchy of decision levels being involved.

6.4 The International Telecommunications Union (ITU) founded in 1865 and the Universal Postal Union (UPU) founded in 1874 are two examples of a successful implementation in the 19th century of supranational decision making in order to regulate border crossing activities with external effects. In addition, the ITU shows that various levels of decision making can be involved (the national, continental and world level) as the extent of the external effects require.

6.5 The clarification of the concept and the implementation of an appropriate level of decision making would benefit considerably from the application of *economic analysis*. Yet, *democratic control* seems to qualify as a necessary condition for transferring authority to another level.

CHAPTER 6. THE LEVEL OF DECISION MAKING: RECOMMENDATIONS

6.1 From the perspective of enhancing cohesion and checking disintegration in the world economy, the choice of the appropriate level of decision making is instrumental and of considerable importance.

6.2 It is recommended that the Government of the Netherlands gives considerable weight in its policies to the issue of the proper level of decision making, within the European Union in the context of the discussion on subsidiarity, and furthermore at the continental and world level as well as within the nation state, taking into account the conclusions arrived at above. Of particular importance is that economic analysis is given more weight than considerations of political power.

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ANNEX 2.1 COUNTRY CLASSIFICATION

In Chapter II the network of world trade has been investigated, using 8 countries and country groups in the world economy. This Annex provides details regarding the composition of the country groups.

1. *Western Europe (WE)*
 - o EU-12
 - o EFTA-6
 - o Faeroe, Gibraltar
2. *Japan (JPN)*
 - o Japan
3. *North America (NA)*
 - o Canada
 - o USA
4. *Central and Eastern Europe (CEE)*
 - o Albania, Bulgaria, (former) Czechoslovakia, (former) GDR (until 1990), Hungary, Poland, Romania
 - o (former) USSR
5. *Africa (AFR)*
 - o Africa (excl. South Africa)
6. *Asia and Oceania (ASIA)*
 - o South and South-East Asia (Afghanistan, Bangladesh, Burma, Brunei, Cambodia, Hong Kong, India, Indonesia, South Korea, Loa, Macau, Malaysia, Maldives, Nepal, Pakistan, Philippines, Singapore, Sri Lanka, Taiwan, Thailand)
 - o Socialist countries in Asia (China, North Korea, Mongolia, Viet Nam)
 - o Oceania
7. *Latin America (LA)*
 - o South America
 - o Central America
8. *Rest of World (ROW)*
 - o South Africa
 - o Israel
 - o West Asia (Bahrain, Cyprus, Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria, Turkey, United Arab Emirates, Yemen)
 - o Malta, (former) Yugoslavia

ANNEX 2.2 POLARIZATION IN WORLD TRADE

In section 2.8 the polarization of international trade has been analyzed, using percentage distributions of total trade of 7 country groups in the period 1960-1992. Section 2.8 presented Figures (2.3.1 to 2.9.2) for these country groups for the years 1960 and 1992. In this Annex the numerical values of the polarization of international trade are presented for all 5 years under consideration in this study: 1960, 1970, 1980, 1990 and 1992 (Tables A.2.1-A.2.5).

Table A.2.1 Polarization of international trade, 1960										
	percentage distribution									Total trade (bn \$)
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	World	
Western Europe	55	1	13	4	7	8	6	5	100	106
Japan	11	-	36	2	5	33	7	7	100	8
North America	30	6	30	1	2	10	18	3	100	46
Central/East Eur	17	1	1	62	2	13	2	1	100	26
Africa	67	3	8	5	6	5	1	6	100	12
Asia/Oceania	30	10	17	12	2	24	2	3	100	27
Latin America	33	3	42	2	1	2	17	1	100	20
Rest of World	49	5	15	3	6	9	1	12	100	11
World	41	3	18	10	5	11	8	4	100	256

Source: own calculations from UN trade data base
Note: total trade is represented by the sum of exports and imports

	percentage distribution									Total trade (bn \$)
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	World	
Western Europe	65	2	11	4	5	4	4	6	100	277
Japan	13	-	34	3	4	29	6	11	100	35
North America	27	11	35	1	2	10	12	3	100	110
Central/East Eur	19	2	1	62	3	5	3	4	100	59
Africa	61	7	8	7	6	5	1	4	100	24
Asia/Oceania	22	20	21	6	2	23	1	4	100	50
Latin America	31	6	37	5	1	2	17	1	100	36
Rest of World	48	12	10	8	3	7	2	9	100	33
World	44	6	18	9	4	8	6	5	100	624

Source: own calculations from UN trade data base
Note: total trade is represented by the sum of exports and imports

	percentage distribution									Total trade (bn \$)
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	World	
Western Europe	64	2	7	4	6	4	3	10	100	1678
Japan	12	-	23	2	3	32	5	23	100	254
North America	22	10	26	1	6	12	14	8	100	573
Central/East Eur	24	2	2	53	2	5	4	8	100	299
Africa	53	4	21	4	3	4	5	6	100	180
Asia/Oceania	16	20	18	4	2	26	2	11	100	392
Latin America	22	6	34	5	4	3	20	7	100	234
Rest of World	41	15	11	6	3	11	4	9	100	393
World	42	6	14	7	4	10	6	10	100	4002

Source: own calculations from UN trade data base
Note: total trade is represented by the sum of exports and imports

	percentage distribution									Total trade (bn \$)
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	World	
Western Europe	71	3	8	3	3	5	2	5	100	3151
Japan	20	-	31	1	1	36	3	7	100	487
North America	22	14	32	1	2	17	9	3	100	1089
Central/East Eur	32	2	3	41	2	8	5	8	100	315
Africa	58	4	13	4	5	7	2	8	100	149
Asia/Oceania	17	18	19	3	1	36	1	4	100	978
Latin America	23	6	38	6	1	5	14	8	100	266
Rest of World	42	10	10	7	3	12	6	10	100	351
World	46	7	16	5	2	14	4	5	100	6784

Source: own calculations from UN trade data base
Note: total trade is represented by the sum of exports and imports

	percentage distribution									Total trade (bn \$)
	WE	JPN	NA	CEE	AFR	ASIA	LA	ROW	World	
Western Europe	71	3	7	3	3	6	2	4	100	3349
Japan	19	-	28	1	1	38	4	8	100	549
North America	20	13	32	1	2	19	11	3	100	1185
Central/East Eur	54	3	5	18	2	10	3	6	100	196
Africa	56	4	14	2	6	8	2	8	100	154
Asia/Oceania	16	17	18	2	1	41	2	4	100	1237
Latin America	23	7	40	2	1	7	17	3	100	315
Rest of World	42	13	11	3	3	14	3	11	100	351
World	46	7	16	3	2	17	4	5	100	7335

Source: own calculations from UN trade data base
Note: total trade is represented by the sum of exports and imports