

Paul J. J. Welfens
Cillian Ryan
Suthiphand Chirathivat
Franz Knipping
Editors

EU – ASEAN

Facing Economic
Globalisation

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Prof. Dr. Paul J.J. Welfens
EIIW - European Institute for International
Economic Relations
University of Wuppertal
Rainer-Gruenter-Str. 21
42119 Wuppertal
Germany
welfens@eiiw.uni-wuppertal.de

Prof. Dr. Suthiphand Chirathivat
Faculty of Economics
Chulalongkorn University
Phayathai Road
Bangkok 10330
Thailand
Suthiphand.c@chula.ac.th

Prof. Dr. Cillian Ryan
Jean Monnet Chair in European Economics
University of Birmingham
Edgbaston
Birmingham, B152TT
United Kingdom
c.ryan@bham.ac.uk

Prof. Dr. Franz Knipping
Chair in Modern and Contemporary History
University of Wuppertal
Gaußstr. 20
42119 Wuppertal
Germany
fknipp@uni-wuppertal.de

ISBN 978-3-540-87388-4

e-ISBN 978-3-540-87389-1

Library of Congress Control Number: 2008936475

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Cover design: WMXDesign GmbH, Heidelberg, Germany

Printed on acid-free paper

9 8 7 6 5 4 3 2 1

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List of Contributors

Noer Azam Achsani

Bogor Agricultural University, Indonesia

Dora Borbély

University of Wuppertal and European Institute for International Economic Relations (EIIW), Germany

Suthiphand Chirathivat

Chulalongkorn University, Thailand

Andrew J. Crozier

University of London, UK

Günter S. Heiduk

Duisburg-Essen University, Germany

Chantal Herberholz

Chulalongkorn University, Thailand

Lay Hwee Yeo

Singapore Institute of International Affairs (SIIA), Singapore

Martin Keim

University of Wuppertal and European Institute for International Economic Relations (EIIW), Germany

Toby Kendall

University of Birmingham, UK

Franz Knipping

University of Wuppertal, Germany

Norbert Koubek

University of Wuppertal, Germany

G. R. Krishnamurthy

Transformational Institute for Managerial Excellence (TIME), India

Sompop Manarungsan

Chulalongkorn University, Thailand

Kirsten Meyer

University of Wuppertal, Germany

Stephan Weinert

Mercer Deutschland GmbH

Alexander Proelß

Christian-Albrechts-Universität zu Kiel, Germany

Cillian Ryan

University of Birmingham, UK

Hermanto Siregar

Brighten Institute, Bogor-Indonesia

Paul J. J. Welfens

University of Wuppertal and European Institute for International Economic Relations (EIIW), Germany

Zhu Yiping

Duisburg-Essen University, Germany

Introduction

**Paul J.J. Welfens, Cillian Ryan, Suthiphand Chirathivat,
and Franz Knipping**

This volume, the outcome of the Jean Monnet-sponsored project, *EUROPEAN UNION and ASEAN: Historical Dimensions, Comparative Analysis and Politico-Economic Dynamics*, seeks to enhance our understanding of the ASEAN and Asian Economies, and to study EU integration as a means of improving our understanding of potential developments in the ASEAN integration process. The previous volume focussed on a wide range of historical, political and social issues in addition to economics matters. This volume is more closely focussed, with one or two exceptions, on economics issues with a range of both discursive and theoretical pieces (including the development of some new theoretical tools) to better understand regional economics integration.

The contribution by Welfens and Borbély takes a closer look at key issues of structural change and trade dynamics in the context of economic globalization and EU integration. The authors present fresh theoretical approaches and a battery of empirical material, which partly puts the focus on the issue of international outsourcing and offshoring. The analytical findings, based on input–output analysis, do not support the bazaar hypothesis according to which Germany’s export dynamics reflect structural weaknesses. For example, the fact that the share of imported intermediate inputs in Germany’s exports has increased largely reflects successful international specialization and a profitable global division of labour. Moreover, exports are also contained in imports, and with respect to major German trading partners, one may assume that the share of exported intermediate inputs in Germany’s imports of goods and services has increased. As regards the specialization of selected EU countries – including countries from eastern Europe – and Asian countries, one can identify clear patterns on the EU15 market, which largely are in line with a modern interpretation of the Heckscher-Ohlin approach: Asian countries are often strongly specialized in labour-intensive products. Only after some transition and modernization process does one find that China and selected ASEAN countries have established a comparative advantage in technology-intensive goods and in science-intensive goods; export unit values have also improved in some fields over time for some countries. The considerable role of foreign direct investment (FDI) inflows for such specialization dynamics is emphasized, and major policy conclusions are derived. For the EU, economic globalization has created many opportunities. However, there is also additional adjustment pressure in

the wake of the US financial market crisis. With the US banking crisis unfolding and showing negative spillover effects, one should not rule out that the combination of the banking crisis and the impact of US policy intervention – for example, expansionary monetary policy, which implies additional side effects of much higher oil prices as well as a depreciation of the US dollar – will lead to new social conflicts in the context of enhanced redistribution conflicts at the national and international level; this could slow down structural change and Schumpeterian dynamics. Whether globalization will be sustainable is still an open question, and there is no doubt that policymakers would be wise to organize the process of globalization in a consistent manner. Excessive financial globalization with inadequate regulation could undermine the long-term benefits from globalization in the real sphere.

In order to place the ensuing analysis in its wider EC–ASEAN context, Yeo Lay Hwee in Chap. B provides an account of the evolution of co-operation over the last 35 years. Hwee notes that global and particularly intra-regional distractions such as the compromise reform treaty to replace the ill-fated constitution and a return to nation-centred, non-interference policies in ASEAN due to the situation in Myanmar may slow the development of a truly integrated long-term agenda. An alternative, optimistic hypothesis might be that the two regions will look outwards to distract their members from internal tensions and to focus on their unity of purpose.

Andrew Crozier provides another perspective by examining the trade and aid policy of the European Union in Chap. C, noting its key role in the development of the EEC and its roots in the realization in the US, Britain and France in the late 1930s that an alternative to the post-depression retrenchment was a necessity. Crozier discusses both the internal development of the single market and the EU's approach to external trade and aid. Focussing specifically on the EU–ASEAN context, he examines why trade and investment relations did not develop as quickly as expected between ASEAN and the EU. This conundrum is especially puzzling given that one of the motives for the development of ASEAN was to increase trade diversification and reduce its members' dependence on Japan. Of course, the asymmetric nature of the relationship whereby the EU accounts for about 33% of ASEAN exports while ASEAN is still a relatively small market from an EU perspective (about 5%) is a part of the explanation, a problem ASEAN nations share with EU neighbourhood states when trying to claim a place on the EU agenda.

The next set of chapters is concerned with lessons for closer cooperation within ASEAN itself drawing, in part, on the EU experience. Günter S. Heiduk and Yiping Zhu in Chap. D examine the process of economic integration in ASEAN + 3 and consider whether current and future integration policy should rely on free trade arrangements or concentrate on an integration strategy which gives priority to monetary cooperation. The conventional view is that regional integration policy should start with a free trade and free factor movement strategy. This fits with the hypothesis of the optimum-currency-area theory, which argues that monetary union is achieved when goods and factor markets are open and deeply integrated. Empirical studies on the interdependencies between integration in the real and in the monetary sector show that the development of intra-regional trade influences exchange rate

stability, but also that a currency union has positive effects on trade and factor movements. To put the second hypothesis in an empirical context, regional integration policy must develop an optimum sequencing and timing of the steps towards monetary and real integration.

The integration concept of ASEAN + 3 thus far has had a strong trade bias. Monetary cooperation continues to be relatively weak. However, the Asian crisis has shown that distortions in the monetary sector can significantly slow down intra-regional integration in goods and capital markets even if trade barriers are continuously removed. The chapter first argues that a stable and balanced integration by reducing tariff barriers between ASEAN and each of the three East Asian countries cannot be expected to occur because of the China-pull effect. Second, incentives for further integration of goods and capital markets especially among ASEAN countries could result from intensifying monetary integration. On the basis of trade data and correlations between macroeconomic indicators, the chapter suggests that there should be closer monetary cooperation among an Asian core of Thailand, Singapore, Philippines, Indonesia, Malaysia and China.

The second chapter in this section considers the lessons which can be drawn from the EU Single-European market, and the liberalization of services including financial services, the EU27 enlargement and the Euro in particular. Both the EU and ASEAN are facing economic globalization in the sense that there is a long run increase in the trade of financial services, in FDI in the banking and insurance sector and a growing influence from global international organizations such as the IMF and the Bank of International Settlements (BIS). Thus, drawing on a wide range of European data, in Chap. E Welfens and Keim review the main developments in the EU and draw the key lessons for regions facing increased globalization. The authors also focus on the international banking crisis.

They note that if one considers the interdependencies of the overall economic system, it is not very realistic to expect major benefits from financial market integration if there are blockages to structural change in labour markets. The high unemployment rate in the Euro area represents a blocking factor in this respect. At the same time, they argue one should take into account that more integrated financial markets – in a period of global financial market liberalization as enshrined in GATS – could be subject to larger shocks and more extreme bubble problems than was previously the case. To the extent that stock market bubble problems are related to short-sighted speculations, it is worth considering strong tax incentives for long-term investment while short-term yields could be taxed more heavily. Such a development is unlikely to happen unless OECD countries agree upon some joint framework in this respect.

In addition to arguing for employment and social security reforms, the authors focus considerable attention to the impact of financial market liberalization and the implications for state-owned savings banks in several member states, a problem also facing ASEAN members if they are to pursue the GATS in full. The GATS envisages that such banks, which are often crucial in mobilizing local and SME savings and are major providers of start-up finance, should no longer earn privileged backing by government, since it prevents the establishment of a level playing

field with private banks. The authors are unconvinced as to the economic benefits of full compliance arguing that because such enterprises perform such a crucial quasi-social development role that governments should be allowed to preserve these institutions passing on the benefits of their triple-A ratings.

This chapter also considers issues which arise elsewhere in the volume such as the role of FDI (see also Chaps. L and M) and lessons from increased monetary integration relevant to the argument in Heiduk and Zhu above should the six Asian countries he identifies choose to pursue greater monetary cooperation.

In an alternative approach to Heiduk and Zhu to classifying ASEAN + 3 countries, Achsani and Siregar in Chap. F utilize Fuzzy Clustering to identify which countries are natural partners at similar stages of development. By studying a range of macroeconomic data based on the Maastricht criteria, and by essentially minimizing the variance or dissimilarity between members within a cluster, they show that the countries can be classified into five clusters. From a policy perspective, Singapore, Japan, Korea and China can be seen as the leading economies in the region and the authors argue that in order for a single market to function effectively, these countries should consider limitations and bottlenecks faced by other countries within the region when taking initiatives.

The next set of chapters provides a series of reflections on Thailand, India and China in the ASEAN context. In Chap. G on the impact of foreign banks on the Thai commercial banking sector, Chantal Herbolz notes that research has previously suggested that the relaxation of restrictions on foreign equity participation in locally incorporated banks led to increased efficiency in the sector. This chapter provides further analysis of the presumed benefits of opening up to foreign financial institutions, and the findings confirm a positive impact of foreign bank participation. The main finding is that increases in the asset share of foreign-owned banks incorporated in Thailand appear to have lowered net interest margins, personnel expenses (scaled by total assets) and return on assets in commercial banks incorporated in Thailand, which indicates that foreign entry has tended to increase competition and efficiency. The results further indicate that foreign bank participation has had an impact on both foreign-owned and domestically owned banks incorporated in Thailand. Comparisons between domestically owned and foreign-owned commercial banks incorporated in Thailand suggest that foreign-owned banks incorporated in Thailand have performed better in terms of net interest margins, non-interest income (scaled by total assets) and return on assets, while nevertheless incurring higher personnel expenses than their domestically owned counterparts.

In a wide ranging discussion in Chap. H, G. R. Krishnamurthy provides a contrasting analysis of Chinese and Indian engagement with ASEAN, the US, and the EU. This chapter explores the role played by the dialogue partners in the ASEAN Regional Forum, the possible channels of co-operation between ASEAN and India (a knowledge-based giant in the region) and explores several future scenarios including the role the European Union and NAFTA may play with businesses located in ASEAN.

Focusing on China in Chap. I, Sompop Manarungsan examines the causes and consequences of Chinese outward investment as a result of the growth in its external

reserves. This chapter highlights the growing competition between the US and China in several spheres (energy, finance and raw materials) as well as the consequences of growing Chinese expertise in R&D and brand and service development.

The next two chapters focus more directly on lessons from the EU. In Chap. J, Franz Knipping builds on Hwee's analysis in Chap. B and reflects on the EU constitutional crisis and its rejection by France and the Netherlands. He attempts to draw lessons from this experience for future development of the European project, and in particular, the implications for the political leadership of the EU. In Chap. K, Alexander Proeß examines the role of the European Community as the first international organization to join the WTO, and analyzes the legal interaction between the laws of the Community as an organization on the one hand and international trade law on the other. In particular, he investigates whether WTO regulations are capable of having a 'direct effect' on the Community's legal order. He concludes that they do not, but that the European Community, when compared with other major economic members of the WTO, is not alone in this and hence it is not a function of the Community's supranationality. However, he goes on to argue that the denial of the direct effect should not be overestimated and that in practice the European Court of Justice follows a rather trade-friendly approach. While it is difficult to draw direct comparisons with the ASEAN experience, he nevertheless observes that the denial of the direct effect in the European Community does not result in legal uncertainty.

The final set of chapters complements Manarungsan's earlier analysis of China's outward investment by focussing on FDI into the ASEAN region. In Chap. L, Koubek notes that offshoring to Asia has become an important strategy for many Western companies to enhance competitive advantage. However, the majority of analysis in the literature thus far has focussed exclusively on a specific topic such as offshoring strategies or typical offshoring locations. Yet, little has been written about the interrelation of strategic aspects and regional considerations on the one hand and adequate underlying theoretical aspects on the other. Thus, this chapter combines three different theoretical perspective, the TRIAD model, the core-competence concept and value chain analysis, to provide a comprehensive picture of today's offshoring activities. Using a variety of indicators, Koubek argues that offshoring leads to economic convergence and while Western multinational companies appear to be benefiting the most from such relocations, certain countries such as India and China are also benefiting significantly. However, the author argues that the ASEAN countries are also demonstrating high potential and are quickly catching up.

The final chapter observes that the most common form of FDI is not new 'green-field' investment but rather occurs in the form of mergers and acquisitions. Mergers have been notoriously difficult to explain in traditional economic theory; however, using recent theoretical developments in the theory of mergers and technology transfer Kendall and Ryan in Chap. M present a three-stage Cournot game in which foreign firms choose between exporting, FDI and acquiring a domestic firm as means of supplying the domestic market. The analysis discusses the welfare and policy implications of the new theory for ASEAN. They observe that reductions in

intra-union tariffs associated with ASEAN is likely to favour foreign predators over (possibly) more efficient domestic market leaders due to the external tariff-jumping motive, promoting the investment described in Koubek's chapter. Regional integration in this new theory results in both mergers and FDI becoming more profitable for the foreign firm, relative to exporting, and regional integration is thus likely to promote foreign ownership in the region. However, while such mergers are frequently portrayed as market concentrating, in this model, the beneficial effect of the technology transfer is pro-competitive and consumers in the region will benefit. While likely consumer gains suggest that ASEAN competition policy towards acquisitions should generally be *laissez faire*, there may be a role either for supranational ASEAN or national regulation where a foreign firm has an incentive to outbid a more efficient domestic rival for a target firm in an ASEAN member state.

In providing this eclectic collection of essays from diverse Asian and European perspectives and from a range of academics and practitioners, we hope that the reader will gain an insight into the complexities of the challenges for the future facing the EU and ASEAN member states.

We greatly appreciate the technical support by Deniz Erdem (European Institute for International Economic Relations, EIIW), Wuppertal and the editorial assistance provided by Michael Agner, Odense.

Chapter A

Structural Change, Growth and Bazaar Effects in the Single EU Market

Paul J.J. Welfens and Dora Borbély

A.1 Introduction

Economic globalization is a major challenge for the EU15 group which is facing both the challenges of EU eastern enlargement and of economic globalization – in particular this means the rise of ASEAN and China (plus India) in the world economy. In a world economy with overall growth, regional economic catching up and continued technological progress, Europe will have to develop a new pattern of economic specialization; this will include digital modernization and the growth of the information and communication technology sector. As regards the expansion of ASEAN countries and China it is crucial to analyse in which fields they have achieved a comparative advantage in trade with EU15 and to sketch the pattern of export unit value (EVU) dynamics. We expect from a theoretical perspective that both east European accession countries and Asian countries should achieve an absolute rise of export unit values in key sectors over time; the notion of key sectors is, however, ambiguous because the most important sectors in terms of export revenues (or patenting or employment) are changing over time. Economic-technological catching up should go along with a growing emphasis on an improvement of the revealed comparative advantage (RCA) in skill and knowledge intensive sectors. One also may anticipate that export unit values in key sectors rise relative to a benchmark country which often is the US.

It is not only interesting to analyse the RCA – the sectoral export-import position compared to the aggregate export–import position – with respect to the EU15 countries, but to global markets as well. This comparison sheds light on two aspects:

- the impact of geographical proximity which might matter both in terms of trading costs and opportunities for technology diffusion: Following the logic of the gravity equation of trade we expect that trade relations will be more intensive with neighbouring countries and hence opportunities for catching-up should be positively correlated with the RCA of leading trading partners to the extent that there is considerable trade in intermediate products. The EU15 countries' sectoral export–import ratio with respect to the US could indeed be reinforced through rising imports of intermediates from Eastern Europe.

- if RCA patterns with respect to the EU are different from the global pattern this could point to some indeterminacy in specialization or for high structural dynamics in general; or simply that demand patterns in the EU15 and the world economy diverge considerably.

In the 1990s US economic growth has exceeded that of the EU15 and Euro zone and there is no easy explanation for this transatlantic growth gap in the 1990s. If the transatlantic growth differential should go on for a protracted period there will not only be a major global shift in terms of economic and political power in favour of the US. There also will be an aggravation of the US current account balance deficit since China's export surplus to the US is expected to grow while net EU exports to the US will also increase; the high US current account deficit-GDP ratio can be corrected only by a major real depreciation of the US currency which would destabilize the world economy – too many Asian currencies are de facto pegged to the dollar.

Information and communication technology (ICT) plays an important role in the internationalization of the economy and for the growth differential US versus EU15: Audretsch and Welfens (2003), Barfield, Heiduk, and Welfens (2004), Colecchia and Schreyer (2002), Inklaar, O'Mahony, and Timmer (2003), Jorgensen and Stiroh (2000a, 2000b), Oliner and Sichel (2002), Stiroh (2001), and Van Ark and Piatkowski (2004) have argued that ICT production and the use of ICT – that is ICT investment – are important drivers of productivity growth. More cautious about the link between ICT and growth is Gordon (2004): he argues that only ICT producing activities are associated with high productivity growth. Comparing the periods 1995–2000 to 1979–1995 the Inklaar et al. analysis of labour productivity growth in the US and EU-4 finds a rise of 1.25 percentage points in the US and a reduction of 0.27 points in the EU. ICT has been an important driver of productivity growth, innovation and employment in many OECD countries, including in Korea, Japan and some ASEAN countries. ICT is a general purpose technology whose benefits depend on ICT capital accumulation and the availability of complementary human capital. ICT stands for about 10% of value-added in leading OECD countries. Falling relative computer prices and absolutely falling digital services prices will contribute for many years to come to a rising of ICT use in the economy. National and international networks are expanding and becoming faster due to the expansion of broadband technologies; internet-based telecommunications (VOIP) will slash global communication costs which will create larger markets. The creation of larger regional markets could be reinforced by regional integration schemes. Larger markets will go along – following the classical argument of Adam Smith – with bigger optimum plant size and hence larger firms.

Thus the role of multinational companies will continue to increase; and those companies typically are quite aware of differences in international communication costs. The dominant source countries of foreign direct investment will record GNPs exceeding GDPs as profit transfers from abroad are considerable. Thus the ability of countries to have a fertile breeding ground for multinational companies to emerge will become important. Hence both FDI and rising trade shape modern

economic globalization where a considerable part of trade is intra-company trade, that is trade within multinational firms.

According to the European Commission (2005) economic globalization is shaped not only by rising capital flows and a growth rate of trade exceeding that of national output; rather a particular feature is that there is increasing vertical trade, that is a growing role of trade in intermediate products. Moreover, in advanced OECD countries the impact of cumulated FDI is quite important. Cumulated FDI of EU firms in the US and of US firms in the EU seems to be more important than trade in the sense that the share of sales from subsidiaries in the US and the EU, respectively, exceeds the respective import figures by roughly 3.5:1; and at the beginning of the twenty-first century a high share (about 30%) of US imports from the EU is accounted for by EU subsidiaries in the US. If one follows the DUNNING approach to foreign direct investment the relative rise of FDI relevance must be linked to the fact that ownership specific advantages – read technology advantages – have become increasingly important over time.

Rising trade in intermediates should lead to a tendency towards global business cycle synchronization. The rather puzzling empirical finding that the industrial trade structure in EU15 has become similar over time while production structures continue to differ (Jungmittag, 2006) needs to be explained; similarly, Borbely (2005) has found for EU eastern European accession countries that there is structural trade convergence with EU15 over time. If there is increasing vertical trade while trade patterns are becoming increasingly similar – and production patterns continue to be dissimilar – one may explain this by the interplay of rising specialization in the production of final products while trade in intermediate products (which are the less specific the further down the supplier ladder we move) is benefiting from economies of scale. With a growing world population – 2.5 billion in 1950, 6 billion in 2000 – in combination with global trade liberalization and regional integration schemes, one should indeed expect considerable economies of scale.

There has been considerable integration dynamics since 1958, when the six countries Germany, France, Italy, Belgium, Netherlands and Luxembourg created the EU. The EU has grown over time, NAFTA was created in North America and ASEAN has made rapid progress after the end of the Vietnam War. In Latin America MERCOSUR is an interesting case since Brazil has become a very dynamic country since the late 1990s in this group.

As regards Europe it is noteworthy that the EU club has enormously grown but seems to have problems with further enlargements. Adding ten countries in 2004 has brought clear benefits for the accession countries as confidence has improved and many institutions and rules – for example, for competition and regulation – have been imported from Brussels. The end of the Soviet Union and the transformation of eastern Europe has indeed opened up more than two dozen post-socialist economies for trade and foreign direct investment. Eight relatively poor eastern European countries joined the EU on May 1, 2005, and taking into account growth theory and trade theory it is clear that one should expect a medium-term catching-up process and considerable trade creation in the context of EU eastern enlargement. In 2007 Bulgaria and Romania are also expected to join the Community which will cause

further structural adjustment in the enlarged single market with additional options for outsourcing, trade in final products and foreign direct investment. Further expansion plans will be difficult to realize since the negative referenda in France and the Netherlands has largely tilted the scales to the No-side due to strong popular opposition to the Turkish EU enlargement project envisaged by the European Council and the European Commission.

The combination of economic globalization – the rise of trade and FDI (partly related to the opening up of China) in combination with the digitization of the world economy – and EU eastern enlargement have generated considerable pressure for structural change in the EU25. In the eastern European new member countries – post-socialist transition economies – economic opening up, systemic transformation and the rise of real per capita income have brought strong shifts in relative prices and hence structural change. With the Europe Treaties of the early 1990s opening up the EU15 markets for prospective EU accession countries, external impulses overlapped the early transformation process which included the restructuring and privatization of firms. Moreover, foreign direct investment inflows have considerably contributed to the modernization of the supply side, technology transfer and growth in most east European countries. In 2004, the year of full EU membership for eight eastern European countries, per capita GDP stood at 45% (at PPP figures) of EU15. Growth rates in those countries have exceeded those of Western Europe in the 15 years after the start of transition in 1990, which was marked by transformational recession. The EU implemented an asymmetric trade liberalization strategy in the 1990s when the so-called Europe Treaties, with potential access countries from Eastern Europe, offered relatively generous access to the EU market. In the period 1990–2005 there has been some economic catching-up in Eastern Europe where Poland, Hungary, the Czech Republic and the Slovak Republic were rather successful in attracting FDI inflows. The latter came mainly from Western Europe and the US; the sectoral focus was not only on industry but it included the services sector – in particular banking and finance – as well. Restructuring and economic modernization in eastern Europe's low wage economies (at the beginning of the twentieth century wage rates were about 1/5 of those in EU15) generated growth and stimulated trade with the EU15 where many firms realized outsourcing to or off-shoring in accession countries.

The following analysis looks first at the theory of structural change and selected approaches on innovation and growth (Sect. A.2) before we take a closer look at empirical aspects of economic dynamics in Europe (Sect. A.3). We are interested in describing the dynamics of structural change and the developments of revealed comparative advantage and other trade indicators – this includes aspects of the role of imported intermediates in exports and of exports in imported goods. We also look at some key aspects of the “bazaar effect” (including the distinction between a gross bazaar effect and a net bazaar effect) which emphasize the problem of hollowing out in the sense that exports contain an increasing share of imports. The analysis presented sheds new light on the problem. The final section suggests various policy options for both EU15 and the accession countries on the one hand; on the other hand, we also take a look at perspectives for Asian countries.

A.2 Theory of Structural Change, Innovation and Growth

A.2.1 *Basic Dimensions of Structural Change*

Economic globalization implies that there will be considerable changes in the relative price of tradables which in turn will cause relative factor price adjustment which – in a neoclassical perspective – largely should follow the logic of the Heckscher-Ohlin Samuelson (HOS) model. These are that countries which are relatively richly endowed with unskilled labour, skilled labour, capital and technology, will specialize on those goods which use the relatively abundant respective input factor intensively. However, in the existing world economy there are some critical deviations from the basic assumptions of the HOS model; we have economies of scale, network effects (endogenous growth of demand) in the ICT sector, technology spillovers – hence positive externalities – and foreign direct investment which all are not in the standard HOS model. Take for instance the Stolper-Samuelson theorem which says for a neoclassical world with free trade, factor immobility and perfect competition: If the relative price of good i is rising, the relative factor reward to that factor will increase that which is used relatively intensively in the production of good i . However, with scale economies and network effects a certain modification is necessary: If p_i falls, the factor reward of the intensively used factor will rise if there is a dominant network effect or scale effect. Take as an application the following case: At first glance the long term relative fall of ICT prices imply a relative fall of remuneration for software engineers, but network effects and scale effects bring about a relative rise of the remuneration of such engineers.

With tradable prices adjusting across countries and factor prices reacting to output prices, there will be real income effects and effects in factor markets; this can include unemployment to the extent that wages are rigid downwards for workers for which firms' relative demand is falling. As modern globalization includes the opening up and industrialization of China it is obvious that the relative prices of labour intensive goods will fall which in turn will reduce the relative wage rate of unskilled labour in Europe and the US.

As regards international the competitiveness of a country, one may define this as the ability to organize trade in a way which contributes to the growth of long run per capita gross national product (alternatively one may say “contributes to a level of growth sufficient for sustained growth and full employment”). This definition is slightly different from the usual perspective that competitiveness simply is the ability to sell in international goods markets; in particular we do not only emphasize exports but also consider imports as a potentially useful ingredient for international competitiveness. By emphasizing a growth perspective we argue that not simply selling whatever products at whatever price in world markets is important. Rather we emphasize the ability to sell increasing quantities or quality of products where the latter should go along with a relatively rising unit export value (unless dynamic economies of scale effects dominate); moreover, we are interested to establish links between the growth of trade and the growth of real income per capita.

Structural change and growth go together since structural change in a competitive economy should relocate resources from low-productivity sectors towards high-productivity sectors on the one hand; and from low stages of value-added (production of simple intermediate products) to more advanced stages (semi-finished goods) and finally to the production of finished goods. An upward move in terms of quality or technological refinement typically will be accompanied with rising – relative – unit export values so that the marginal value product of labour in the respective sector is rising. Internationally improving competitiveness in the respective sector can also be measured by the RCA, the revealed comparative advantage (Fig. A.1).

The main dimensions can be summarized as follows, namely changes in

- relative prices of goods: this concerns in a broad perspective the ratio of non-tradables to tradables $\phi =: [P^N]/[P^T]$ which is expected to increase in parallel with relative per capita income. This relative price change typically goes along with a real appreciation of the currency (Balassa-Samuelson effect): The ratio $P/[eP^*]$ will rise over time as either the nominal exchange rate e – with given price levels at home and abroad P and P^* , respectively – will fall or the domestic price level P will rise (at given e and P^* , respectively). One should note that the overall price level $P =: [P^N]^a [P^T]^{(1-a)}$ which implies that $P = \phi^a P^T$ (a is a parameter indicating the share of nontradables in overall consumption). As regards tradables prices one may anticipate that countries catching-up will record a growing share of intra-industrial trade; this holds for eastern European accession countries (Borbély, 2004, 2005). This change in the composition of trade will go along with a rise of the average export unit value reflecting a shift towards a

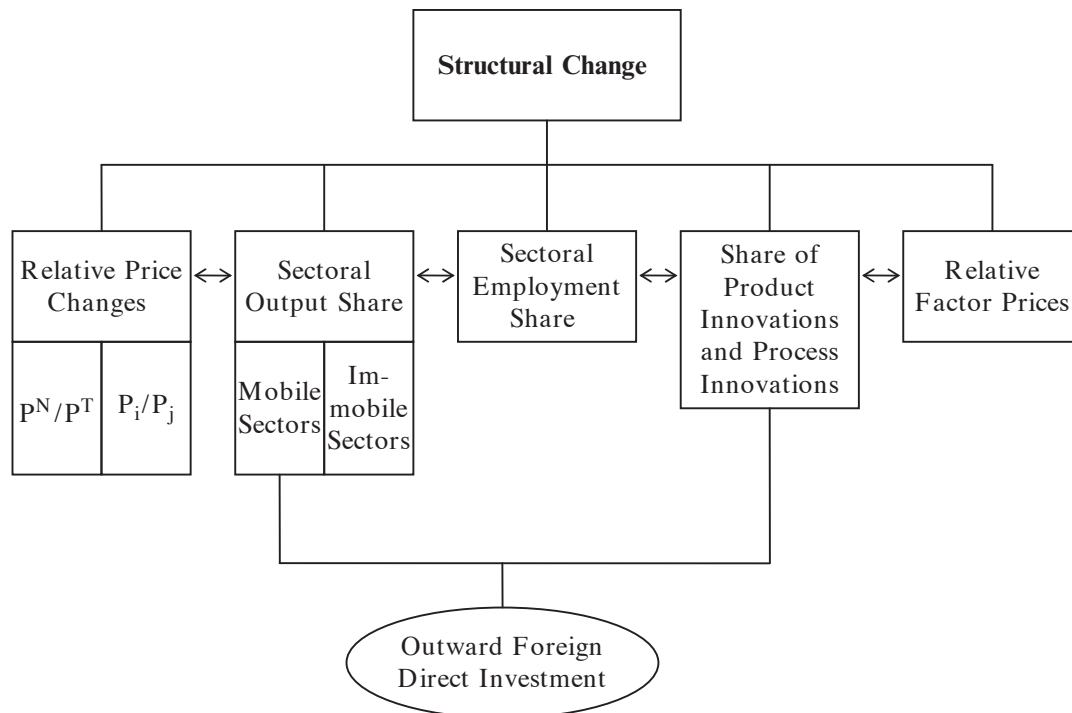


Fig. A.1 Structural change and its five dimensions

greater share of high quality goods and other goods fetching a premium in world markets – the latter can include product innovations which allow the getting a higher price in the market (Welfens, 2006);

- relative prices of input factors: the factor used relative intensively in the good whose output is rising will benefit in terms of relative factor rewards (STOLPER-SAMUELSON theorem); for example, if the production and export of (unskilled) labour-intensive goods in China is increasing the wage rate of unskilled workers is raised – note that this leaves open the role of the price of nontradables which may be expected to affect the reservation wage rates and international factor price convergence. If unskilled labour intensive production is increasing in China it is rather unlikely that unskilled labour intensive production in Eastern Europe also will increase unless transportation costs amount to effective regional market demarcations. Thus one may expect that eastern European countries will specialize partly on goods using unskilled labour intensively, but also on goods using skilled labour intensively. By contrast leading EU15 countries – following the logic of Heckscher-Ohlin – will specialize increasingly on goods which are technology intensive or knowledge intensive and thus particularly require skilled labour. This does not rule out some employment of unskilled workers, but it will be mainly in the nontradables sector, in particular in the services sector. From this perspective it is not surprising that Germany's specific unemployment rate of unskilled workers has strongly increased in the 1990s; at the beginning of the twenty-first century it was twice as high than the average unemployment rate.
- shifts in sectoral output shares; and this will include shifts in the share of intermediate imports. Leading OECD countries may be expected to specialize not only more on technology and knowledge intensive production, but they also are likely to increasingly outsource production nationally and internationally; opening up of Eastern Europe, which already started in the early 1990s in the context of the Europe Treaties of the EU, which has stimulated international outsourcing towards eastern Europe.
- shifts in sectoral employment shares: Following the Stolper-Samuelson theorem the globally increasing relative demand for knowledge-intensive and technology-intensive goods will raise the relative wage of skilled worker which in turn improves opportunities for expansion of the education system and training/retraining activities; countries with a rather flexible supply side in the education system thus stand to gain particularly (e.g., the US, the UK, the Netherlands).
- share of process innovation versus product innovations: Given the growing role of software in all sectors and all countries one may assume that process innovations will dominate in the digital world economy. Moreover, we may assume that modern software development amounts to capital-saving technological progress so that effectively capital is relatively more abundant in the early twenty-first century than in the twentieth century which could lead to a fall of the relative price of capital; and a decline of the capital rental rate relative to the wage index (a composite index for skilled and unskilled labour). The Rybczynski theorem says: An exogenous increase in the endowment of production factor

j – given relative goods prices – will lead to higher output of that good which is using the more abundant factor (j) relatively intensively. Therefore we expect a global growth of software intensive – more generally of ICT intensive – goods production; skilled labour which is largely complementary to ICT stands to benefit from this development. Ignoring the early transition period with its many distortions (including variable political risk premium) the Rybczynski theorem also might be applied in the context of FDI flowing to Eastern Europe where the yield on investment should decline relative to the wage ratio. Taking a look at Asia one may apply a similar reasoning to China. However, the Rybczynski theorem overlooks the importance of network effects and positive regional technology spillovers which obviously are relevant if many multinationals invest in a particular region. Such network effects and positive spillover effects are bound to at least transitorily raise the rate of return of foreign investors.

Given the opening up of China in the 1980s and eastern Europe and Russia in the 1990s on the one hand and on the other hand the expansion of ICT – facilitating the international organization of production abroad (e.g., through digital reporting and networked management activities) there are new opportunities for foreign direct investment. Moreover, the global innovation race has accelerated as is visible in rising R&D-GDP expenditure ratios in OECD countries so that ownership specific advantages – here technology advantages – of firms play a greater role. Following the OLI approach of Dunning (1977) who explains FDI in terms of a combination of ownership specific advantages, locational advantages and internationalization advantages (savings on transactions costs through firm-internal transactions) we may expect that FDI growth will exceed that of global output. FDI clearly is a non-neoclassical element in modelling of open economies and it is unclear whether standard neoclassical theorems hold without modifications. As FDI is often combined with innovation dynamics we also have to consider Schumpeterian dynamics and hence deviations from the neoclassical world of perfect competition. As a macroeconomic implication we should carefully distinguish between GDP and GNP where a simple asymmetric model of an open economy with FDI would have to consider that in the case of identical GDPs (Y in country I which is the host country, Y^* in the source country) – produced with a Cobb-Douglas technology according to $Y = K^\beta L^{1-\beta}$ and abroad $Y^* = K^{*\beta} L^{*1-\beta}$ – the GNP in the domestic host country is $Z = Y - \beta Y$ (where βY is profit accruing to foreign investors assumed to own the total capital stock K) while GNP in the source country is $Y^* + \beta Y$ (Welfens, 1997): If $\beta = 1/3$ and population L in both countries is the same the relative per capita income position y/y^* ($y = Y/L$) is 2:1 in favour of the source country so that there is no real convergence even with free trade and free capital flows. Both the US and in west European countries the late 1990s have witnessed a lively debate about outsourcing and off-shoring.

As regards mobility of capital one should distinguish between mobile Schumpeter (real: technology-intensive) sectors and immobile Schumpeter industries where the latter refer to an effective inability to separate research and development (R&D) from the production process (Klodt, 1993). Relevant industries are the air and space industry and the special machinery industry so that international wage cost differentials for labour are irrelevant.

One should note that the existence of immobile Schumpeterian industries can impair international factor price equalization. Another impediment – from a theoretical perspective – refers to the existence of nontradables. As regards the role of the latter the digitalization of the world economy has reduced the share of nontradables in overall output. The internet and digital networks have enhanced tradability of many services since it has effectively rendered the supply side or the user more mobile across countries.

Structural dynamics in a digital world economy bring about shifts in the structure of output and can go along with long term relative factor price changes; changes in goods prices also can play a role. From the perspective of a small open economy in catching-up countries one may assume that the prices of certain goods are subject to an exogenous long term decline – as is observed with ICT goods – or a long term increase as is the case with sectors with small process innovation rates plus a global income elasticity of demand exceeding unity.

From a radical macroeconomic point of view one might argue that the composition of output is rather irrelevant; in a pure neoclassical perspective with Harrod-neutral progress, the level of the growth path of output per efficiency unit of labour and hence labour productivity is determined by the savings rate, the growth rate of the population, the rate of capital depreciation and the exogenous growth rate of technological progress. If production is determined by a Cobb-Douglas production function $Y = K^\beta(AL)^{1-\beta}$ – where A is the level of labour-saving technology – we additionally can state that the parameter β influences the steady state situation. The growth rate of progress itself is exogenous. In endogenous growth theory one may focus on several ingredients which explain the growth rate of progress, including such factors as:

- human capital accumulation (Lucas, 1988)
- positive external effects from capital accumulation (Romer, 1990)
- R&D expenditures (Grossman and Helpman, 1991)
- intermediate products which allow the production of a greater variety of final products which stimulates demand; and this in turn stimulates output growth (Bretschger, 1998; Grossman and Helpman, 1991; Romer, 1990)

A major aspect of structural change is the increase in international outsourcing which leads to the problem of the bazaar economy – to use the term dubbed by Sinn (2005). Sinn has argued that Germany's large trade balance surplus is not really impressive, rather Germany's economy would be facing a major problem in international competitiveness as increasingly German exports consist of exported goods containing rising shares of imported intermediates.

A.2.2 A Global Perspective of Structural Change

With China's integration into the world economy there are major changes in the world economy. China has specialized at first – in the 1980s and early 1990s – in the production of labour intensive products, and where it has done so it has captured

considerable global market shares; since China is a big economy its exports will affect, once they have achieved a critical threshold, relative world market prices, and with a fall of the respective relative price China's exporters have favourable perspectives to capture a large global market share in all those sectors where static and dynamic economies of scale play a crucial role. Since the mid-1990s China's exporters have increasingly specialized in the production of knowledge-intensive and technology-intensive goods – a phenomenon which, of course, is strongly linked with the expansion of foreign direct investment inflows. This structural change and technology upgrading in China is supported by a rise of the ratio of R&D expenditures to GDP which has exceeded 1% at the beginning of the twenty-first century and thus can be taken as a signal that China's economy is switching from mainly imitating foreign technology to true innovation dynamics. However, this regime switch has taken place only in a few industries and it is unclear whether or not China's government has a consistent strategy towards strengthening the Schumpeterian dynamics of the economy.

A.3 Empirical Analysis

The following chapter will concentrate on the analysis of selected innovation traits, structural change and the bazaar effect mainly through descriptive statistics. We will focus on selected EU-15 countries, as well as some new EU member states and partially also the USA.

A.3.1 Selected Innovation Traits and Structural Change

Product innovations allow for the increase in product prices in world markets and hence the earning of high incomes (wages and profit). Process innovations are equivalent to cost reductions and allow firms to fetch higher market shares and high incomes, in particular if price elasticity is larger than unity or if increased market share also allows for the exploitation of dynamic scale economies (e.g., learning by doing effects). Innovation dynamics can be assessed in different ways:

- Innovation expenditures, usually scaled by sales ("R&D intensity"); this is an R&D input indicator
- Patents per capita (R&D output indicator)
- Product innovation rate (new products to the market in % of sales, survey data, innovation output indicator)
- Diffusion rate (new-to-the-firm products, figures are from surveys)

Taking a closer look at selected EU countries, one finds that Sweden, Germany and Finland were leading in R&D intensity in manufacturing (6.4, 4.7 and 3.9, respectively, in 2003; EU average 3.45; see (Table A.1). France and the Netherlands

Table A.1 European innovation scoreboard, 2003

European innovation scoreboard 2003 – selected member states								
	EU 15	DE	FR	NL	AT	FI	SE	UK
Innov exp manuf	3.45	4.71	3.08	3.07	2.83	3.91	6.42	2.96
Innov exp serv	1.83	1.64	1.57	0.79	0.92	0.96	19.11	1.39
New-to-mark prods manuf	10.5	7.1	9.5	–	8.4	27.2	3.5	9.5
New-to-mark prods serv	7.4	3.7	5.5	–	4.3	12.2	9.3	–
New-to-firm prods manuf	28.6	40.3	17.5	23.8	23.1	31.1	32.1	–
New-to-firm prods serv	18.8	16.4	17.1	13.9	12.8	18.8	23.7	–
New-to-firm/New-to-mark prods manuf	2.7	5.7	1.8	–	2.8	1.1	9.2	–
New-to-firm/New-to mark prods serv	2.5	4.4	3.1	–	3.0	1.5	2.5	–

Source: European Commission (2003), Staff Working Papers, European Innovation Scoreboard 2003, page 27, Brussels and own calculations (*DE* Germany, *FR* France, *NL* Netherlands, *AT* Austria, *FI* Finland, *SE* Sweden, *UK* United Kingdom)

achieved 3.1, the UK 3.0. Germany's R&D intensity in the services sector was much weaker, namely 1.6 compared to the EU average of 1.8. Sweden was a clear leader in this field. France and the UK recorded 1.6 and 1.4, respectively. It is interesting to observe that in the field of product innovations in manufacturing, Germany was below the EU average despite its leading position in R&D intensity. Finland, Sweden and France were leading countries in the field of product innovations. This suggests that the German innovation system might have considerable efficiency problems. A similar picture is found in production innovation in the services market. As regards diffusion indicators, Germany is a leading EU country. Moreover, Sweden and Germany recorded a high ratio of New-to-firm to New-to-market in the manufacturing industry, which points to relatively fast diffusion (this could reflect strong competition).

Against such apparent innovation weakness, one might consider it surprising that Germany has such a high current account surplus, for example, 5% of GDP in 2002. However, 90 billion net exports recorded in 2002 would quickly melt away if full employment could be restored; investment would increase by about 10% or by about €20 billion, consumption also by about 5% or 60 billion, which would leave net exports down at €10 billion. The assumption here is that consumption is a positive function of disposable income and a negative function of the expected unemployment rate. Investment is assumed to depend negatively on the real interest rate and the expected unemployment rate. To put it differently, a high net export position of a country with a high unemployment rate cannot simply be considered an indicator of high international competitiveness. Rather, it largely reflects weak domestic demand. The reduction of net exports in the case of rising employment and hence a falling expected and actual unemployment rate will hold even if one takes into account the expansionary impact of higher employment on the supply side. This perspective is, of course, not to deny that in a situation of high net exports (and also in the case of net imports: see the US in the 1990s), certain sectors are

positively successfully-specialized in production and export of technology intensive or innovative products.

International competitiveness in specific sectors can be assessed on the basis of revealed comparative advantage indicators (RCA: sectoral relative export share in country i as compared to the same industries relative export share in the EU15 single market, with an indicator above unity indicating a sectoral competitive advantage) or with respect to export unit values (EUV). A sectoral increase in the weighted export unit value indicates improved competitiveness in the EU single market as higher prices can be fetched in a very competitive market (there might, however, be cases where changes in market power or government intervention also affect the export unit value).

According to the Heckscher-Ohlin theory the RCA should depend on relative factor endowments. Higher RCAs and higher export unit values in certain sectors are likely to contribute quite strongly to output growth in the long run. Scale intensive sectors and science intensive sectors are obviously two potentially relevant sectors. In a high wage economy, emphasis on science-based products can strengthen competitiveness through product innovations which will temporarily lead to rising export unit values and hence higher profitability. This is a Schumpeterian perspective which leads away from perfect competition. Scale intensive products also imply that the perfect competition model does not hold. In some cases, scale intensive products exhibit both static and dynamic scale economies so that high production volumes could be combined with first mover advantages.

Interestingly, the US has achieved a higher export unit value in all fields where it has enjoyed a positive comparative advantage. This suggests a positive feedback mechanism in the sense that a higher export unit value goes along with increased profitability which in turn reinforces investment and hence should contribute to an improving RCA.

The US has achieved a strong increase in the GDP weighted export unit value in NACE 30, 32, 33 and 35, respectively: manufacture of office machinery and computers; manufacture of radio, television and communication equipment and apparatus; manufacture of medical, precision and optical instruments, watches and clocks; manufacture of other transport equipment (e.g., airplanes). US companies apparently are well positioned to fetch higher prices in those sectors which stand for a relatively large share of the economy. In the fields of NACE 32 and 35 the improvements in export unit values also stand for a large share of US exports. The rise of the export unit value was quite impressive in NACE 32 and NACE 35 in which the value doubled and nearly quadrupled, respectively. In NACE 35 the US export value is five times as high as in the case of Germany, ten times as high as in the case of Italy and about fifty times as high as in the case of Hungary (Table A.2).

As regards export unit values and the change of export unit values over time, one should also take a look at weighted export unit values so that the relative economic significance of certain sectors can be understood. As regards Germany, it is well-known that the country has a positive RCA – read RCA above unity – in both the automotive industry and in other transport equipment (NACE 34 and 35).

Table A.2 USA – RCA, EUV, EUV weighted with the sectoral export shares of manufacturing and of GDP

NACE rev.1 (2-digit)	RCA				EUV 2001		EUV 1993		dEUV		EUV 2001		EUV 1993		dEUV	
	2000/2001	EUV 2001	EUV 1993		Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)	
15	0.24	0.40	0.26		0.01	0.01	0.01	0.00	0.00	0.16	0.11	0.06	0.11	0.01	0.06	
16	0.07	2.04	1.64		0.00	0.00	0.00	0.00	0.00	0.02	0.01	0.00	0.01	0.01	0.00	
17	0.28	6.85	5.28		0.04	0.06	0.06	−0.02	−0.02	0.95	0.67	0.28	0.67	0.67	0.28	
18	0.11	28.16	17.75		0.06	0.11	0.11	−0.05	−0.05	1.25	1.23	0.02	1.23	1.23	0.02	
19	0.16	9.17	11.17		0.02	0.04	0.04	−0.03	−0.03	0.39	0.48	−0.09	0.48	0.48	−0.09	
20	0.79	1.37	0.82		0.01	0.01	0.01	0.00	0.00	0.21	0.14	0.08	0.14	0.14	0.08	
21	0.50	0.84	0.50		0.01	0.01	0.01	0.00	0.00	0.29	0.12	0.16	0.12	0.12	0.16	
22	1.10	14.21	9.48		0.14	0.11	0.11	0.03	0.03	3.07	1.20	1.87	1.20	1.20	1.87	
23	0.29	0.11	0.09		0.00	0.00	0.00	0.00	0.00	0.02	0.01	0.00	0.01	0.01	0.00	
24	0.91	3.95	2.25		0.52	0.32	0.32	0.20	0.20	11.56	3.50	8.06	3.50	3.50	8.06	
25	0.57	8.00	6.13		0.14	0.13	0.13	0.00	0.00	3.09	1.49	1.61	1.49	1.49	1.61	
26	0.49	3.91	2.66		0.03	0.02	0.02	0.01	0.01	0.65	0.24	0.41	0.24	0.24	0.41	
27	0.53	7.35	4.33		0.21	0.14	0.14	0.07	0.07	4.75	1.54	3.21	1.54	1.54	3.21	
28	0.56	12.57	8.64		0.18	0.13	0.13	0.05	0.05	3.90	1.43	2.48	1.43	1.43	2.48	
29	1.24	20.61	14.22		2.16	1.57	1.57	0.59	0.59	48.12	17.43	30.70	17.43	17.43	30.70	
30	1.40	144.84	117.88		22.11	20.29	20.29	1.82	1.82	492.25	225.17	267.08	225.17	225.17	267.08	
31	1.31	35.90	25.52		1.60	1.01	1.01	0.58	0.58	35.52	11.22	24.29	11.22	11.22	24.29	
32	1.93	252.79	125.42		27.94	8.35	8.35	19.59	19.59	622.02	92.67	529.35	92.67	92.67	529.35	
33	3.64	150.75	84.41		13.41	7.53	7.53	5.88	5.88	298.58	83.58	214.99	83.58	83.58	214.99	
34	0.20	9.73	6.96		0.32	0.22	0.22	0.10	0.10	7.06	2.43	4.63	2.43	2.43	4.63	
35	4.73	299.91	76.10		53.81	10.36	10.36	43.45	43.45	1197.95	114.99	1082.96	114.99	114.99	1082.96	
36	0.97	22.27	12.45		0.44	0.23	0.23	0.22	0.22	9.89	2.50	7.39	2.50	2.50	7.39	

Note: Fields of positive RCAs are bold typed; strong improvement in GDP-weighted export unit value is underlined; fields of declining export unit value are in Italics

Source: EIIW calculations

Taking a closer look at German industry, one can see that specialization in terms of RCA changed slightly in the decade after 1993. Germany has one important loser industry (see by contrast Italy), namely NACE 19 which stands not only for a negative RCA but also for declining export unit values: tanning and dressing of leather, manufacture of luggage, handbags, saddlery, harness and footwear; NACE 17 and 18 – they are classified as labour intensive sectors – also show weak international competitiveness ($RCA < 1$), Sectors 28 and 36 which also are labour-intensive show at least an improvement of export unit values. There is a high RCA in the manufacturing of fabricated metal products (NACE 28, not including machinery and equipment). It is also noteworthy that the export unit value has increased over time for this product group. In the field of office machinery and computers (NACE 30) – a sector which (together with NACE 32: telecommunications equipment) is considered highly relevant for medium-term productivity growth –, Germany has a negative RCA. Worse yet, the export unit value in this sector has declined. NACE 32 has improved over time. The overall picture with respect to the long term development of export unit values in German industrial exports reveals that export unit values – average revenue per quantity unit (e.g., kilogram of steel etc.) – showed few changes over the period from 1993 to 2001. Which sectors are most important for economic dynamics: In a narrow sense those sectors which show a positive RCA and a high weighted export unit export value; this at least is the concept presented here. As regards the economic significance of export unit values it is indeed useful to take a closer look at weighted unit values where sectoral shares in overall manufacturing exports are taken as weights. Considering only weighted indicators reaching at least 0.75 (hence export unit value must be high or the share of the respective sector in overall export of manufacturing) – see the bold figures in the respective tables – we see that 29, 30, 32, 33, 34 and 35 are crucial sectors for Germany.

Note that the change in the weighted export unit value of 32, 33 and 34 was positive in Germany over the period 1992–2001; this should translate into relatively rising wages for skilled workers as we may assume that these sectors are using skilled labour intensively. As regards Germany, 29, 33, 34 and 35 stand for an economically significant positive RCA; as regards Hungary we find 18, 30, 31, 32, 34 as positive RCA: 34 is an overlap with Germany. The fact that Hungary could improve the weighted export unit value strongly in 34, the automotive sector, points to a strong catching-up process in the Hungarian automotive sector. To the extent that this finding is representative for accession countries in Eastern Europe, Germany's automotive firms acting in the lower quality segments of the market might face profitability problems in their German plants. The new international division of labour in Europe suggests that mass production of standard cars will be largely relocated to Eastern Europe's low wage countries. Hence the respective regions will face serious labour reallocation challenges in the early twenty-first century (Fig. A.2 and Table A.3).

NACE 30, 31 and 32 indicate successful Hungarian specialization. However, note that 31 and 32 – differentiated goods (this also includes 29) – stand for relative footloose industries: the manufacturing of office machinery and computers (30) and

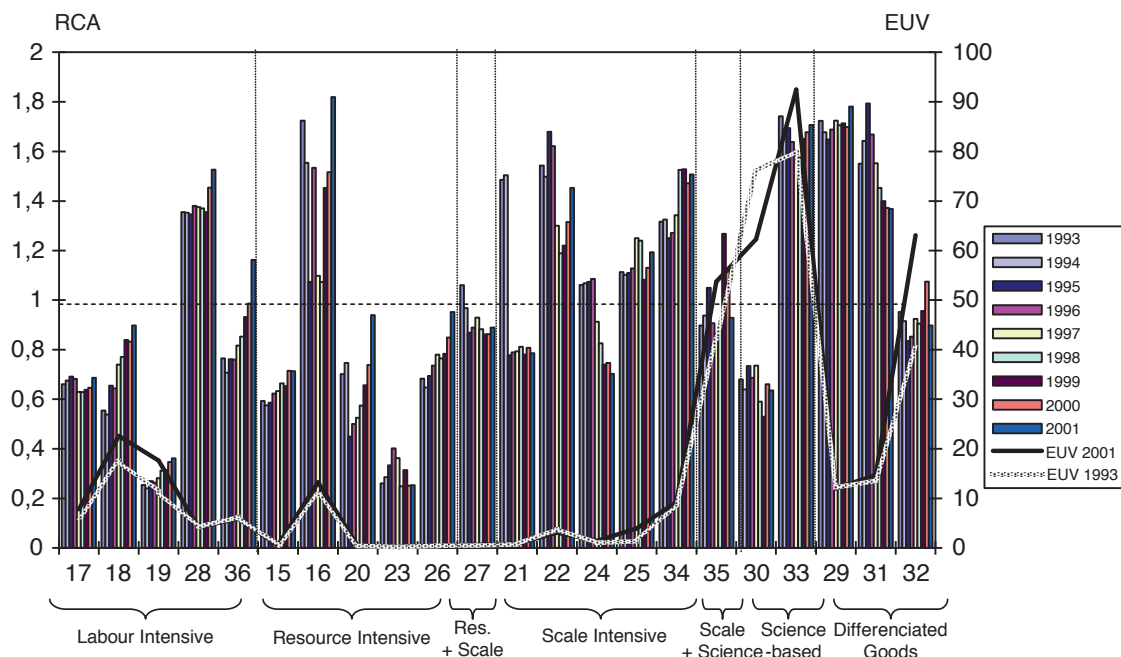


Fig. A.2 Germany – mRCA and export unit values (*Source: EIIW calculations*)

of electrical machinery and apparatus n.e.c. (31) could internationally be relocated relatively quickly.

One should point out that RCAs typically follow relative sectoral patent positions. A rising share in global patents in the respective sector translates with a time lag of 3–4 years into an improved sectoral RCA. Hence expenditures on research & development and innovation policies are important.

Compared to the apparently stable German industrial specialization pattern, Hungary has launched a rather impressive catching-up process since reinforcing the RCAs in some technology intensive sectors and was also able to fetch higher export unit values – a proxy for its ability to extract high prices in competitive EU market – in EU-15 markets. Hungary has many fields, which have shown a rise of the export unit value (Fig. A.3 and Table A.4).

Germany's industry shows some clear fields of comparative advantage as does Hungary's, this is an interesting case of new economic dynamics in an EU accession country. It is quite noteworthy that Hungary achieved higher export unit values in several sectors. The table shows that weighted improvements of export unit values were strong in 30, 32 and 34, essentially electronic products which represent scale-intensive goods, science-based goods and differentiated goods (Fig. A.4).

Italy has suffered in a traditional field of comparative advantage from a fall of the export unit value, namely in NACE 18 (manufacture of wearing apparel; dressing and dyeing of fur) which indicates stronger global price competition for an important sector of the Italian economy. There also was a strong fall of the export unit value in NACE 30 which is the crucial manufacturing of office machinery and computers, but in this group Italy also stands for a revealed comparative weakness as the RCA is much below unity. More encouraging looks 35 which is close to an

Table A.3 Germany – RCA, EUV, EUV weighted with the sectoral export shares of manufacturing

NACE rev.1 (2-digit)	RCA				EUV 2001		EUV 1993		dEUV		EUV 2001	EUV 1993	dEUV	
	2000/01	EUV 2001	EUV 1993	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)
15	0.71	0.62	0.52	0.03	0.03	0.01	0.01	0.01	0.01	0.01	8.55	2.93	5.62	5.62
16	1.67	13.25	10.82	0.07	0.07	0.01	0.01	0.01	0.01	0.01	8.37	4.00	4.37	4.37
17	0.67	7.82	6.12	0.13	0.13	0.03	0.03	0.03	0.03	0.03	20.67	11.22	9.44	9.44
18	0.86	22.60	17.51	0.33	0.33	0.07	0.07	0.07	0.07	0.07	25.94	13.86	12.08	12.08
19	0.35	17.65	11.39	0.08	0.08	0.03	0.03	0.03	0.03	0.03	0.89	4.96	-4.07	-4.07
20	0.84	0.38	0.40	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.43	0.15	0.28	0.28
21	0.80	0.85	0.73	0.02	0.02	0.00	0.00	0.00	0.00	0.00	3.58	1.56	2.02	2.02
22	1.38	3.11	3.83	0.03	0.03	-0.01	-0.01	-0.01	-0.01	-0.01	5.21	2.81	2.40	2.40
23	0.25	0.26	0.18	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.64	0.10	0.55	0.55
24	0.72	1.43	1.01	0.16	0.16	0.05	0.05	0.05	0.05	0.05	28.49	11.78	16.71	16.71
25	1.16	3.92	1.38	0.13	0.13	0.09	0.09	0.09	0.09	0.09	21.49	9.50	12.00	12.00
26	0.90	0.43	0.44	0.01	0.01	0.00	0.00	0.00	0.00	0.00	1.17	0.60	0.57	0.57
27	0.88	0.66	0.51	0.04	0.04	0.01	0.01	0.01	0.01	0.01	6.50	2.10	4.40	4.40
28	1.49	4.22	4.18	0.14	0.14	0.00	0.00	0.00	0.00	0.00	21.27	9.46	11.81	11.81
29	1.74	12.02	12.20	1.50	1.50	-0.02	-0.02	-0.02	-0.02	-0.02	197.64	96.45	101.19	101.19
30	0.65	62.26	76.05	4.29	4.29	-0.95	-0.95	-0.95	-0.95	-0.95	799.70	208.07	591.63	591.63
31	1.37	14.70	13.64	0.69	0.69	0.05	0.05	0.05	0.05	0.05	101.16	35.49	65.68	65.68
32	0.99	63.06	40.44	3.54	3.54	1.27	1.27	1.27	1.27	1.27	561.74	113.08	448.66	448.66
33	1.69	92.49	80.01	3.16	3.16	0.43	0.43	0.43	0.43	0.43	217.73	114.93	102.80	102.80
34	1.49	9.27	8.80	1.94	1.94	0.10	0.10	0.10	0.10	0.10	307.56	107.29	200.27	200.27
35	1.03	53.74	42.32	2.53	2.53	0.54	0.54	0.54	0.54	0.54	341.70	163.22	178.48	178.48
36	1.07	5.92	6.28	0.12	0.12	-0.01	-0.01	-0.01	-0.01	-0.01	19.83	8.25	11.58	11.58

Source: EIIW calculations

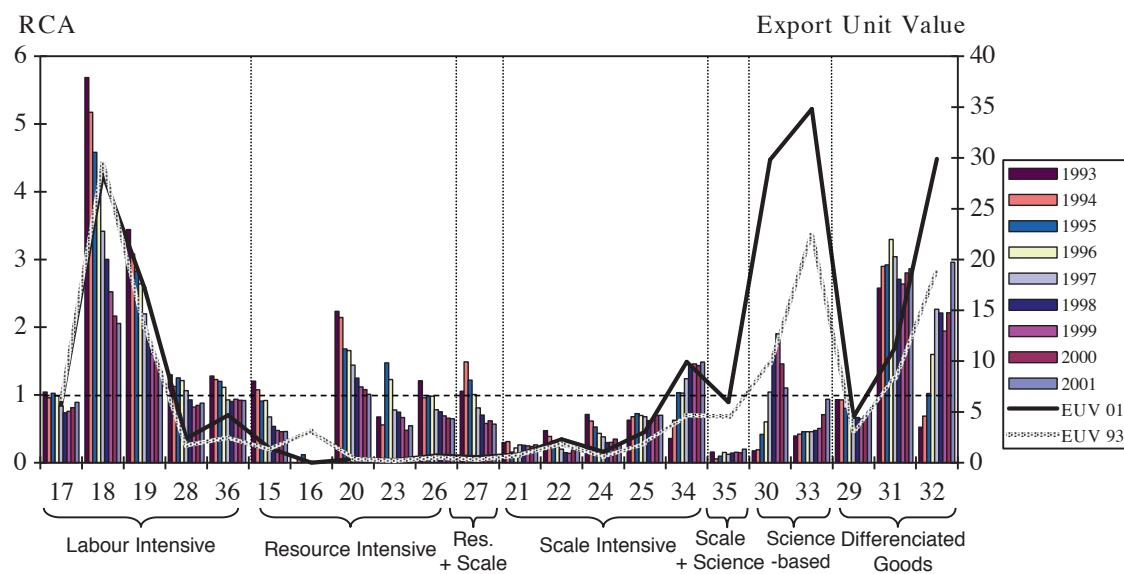


Fig. A.3 Hungary – mRCA and export unit values (*Source: EIIW calculations*)

RCA exceeding unity and where the export unit value has improved. Very encouraging is also NACE 19 – with a high RCA and improved export unit value – which is a traditional strength of the Italian economy: tanning and dressing of leather, manufacture of luggage, handbags, saddlery, harness and footwear. A successful adjustment can also be found in NACE 28 and 29; Manufacture of fabricated metal products, except machinery and equipment (28) and manufacture of machinery and equipment n.e.c. (29). From this perspective Italy could benefit considerably from EU eastern enlargement both through rising exports of sophisticated consumption goods and of industrial goods (Table A.5).

So far we have analysed the relative export position of selected countries as suppliers on the EU-15 market. However, having a flourishing export market does not necessarily mean that a country is competitive and is dealing well with the challenges of structural change. What counts is the ratio of domestic to foreign value added in production, as well as the ratio of domestic to foreign intermediated inputs in production. This will have an impact on how well factor markets can cope with structural change. Thus, we will now turn to the analysis of the importance of intermediate imports, which brings us to the so called bazaar effect.

The results for China also are quite interesting and indicate that China has a rather strong position on the EU15 market in labour-intensive products and in scale & science-intensive products and in differentiated products; the latter two categories to some extent reflect the strong presence of cumulated foreign direct investment in the respective sectors on the one hand, on the other hand China's R&D policy has increasingly – although starting at a low level – favoured these sectors. Between 1993 and 2003 China's export unit value has not improved on the EU single market, except for the case of differentiated products (Figs. A.5–A.8).

Table A.4 Hungary – RCA, EUV, EUV weighted with the sectoral export shares of manufacturing or respective sectoral shares in GDP

NACE rev.1 (2-digit)	RCA				EUV 2001		EUV 1993		dEUV		EUV 2001		EUV 1993		dEUV	
	2000/2001	EUV 2001	EUV 1993	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)	Weighted (GDP share)
15	0.46	1.45	1.27	0.05	0.04	0.01	0.01	19.29	16.37	2.92						
16	0.00	0.00	3.19	0.00	0.00	0.00	0.00	0.00	0.00	0.00						
17	0.85	5.72	6.29	0.11	0.12	-0.01	-0.01	48.85	26.15	22.70						
18	2.11	28.39	29.41	1.05	1.09	-0.04	-0.04	494.83	438.19	56.65						
19	1.42	17.21	13.31	0.28	0.21	0.06	0.06	118.38	70.66	47.72						
20	1.05	0.37	0.38	0.00	0.00	0.00	0.00	1.62	0.63	0.99						
21	0.25	0.84	0.75	0.01	0.01	0.00	0.00	2.72	0.50	2.22						
22	0.19	2.32	1.89	0.00	0.00	0.00	0.00	1.69	0.83	0.87						
23	0.51	0.27	0.18	0.00	0.00	0.00	0.00	1.59	0.29	1.30						
24	0.31	1.09	0.56	0.04	0.02	0.02	0.02	22.93	5.09	17.85						
25	0.70	3.04	1.93	0.07	0.04	0.02	0.02	27.75	4.43	23.32						
26	0.65	0.73	0.53	0.01	0.01	0.00	0.00	2.89	1.46	1.44						
27	0.60	0.56	0.29	0.02	0.01	0.01	0.01	8.56	1.76	6.80						
28	0.87	2.40	1.69	0.05	0.04	0.02	0.02	21.86	6.41	15.45						
29	0.73	4.51	3.16	0.29	0.20	0.09	0.09	113.75	26.54	87.21						
30	1.28	29.81	9.74	3.59	1.17	2.42	2.42	2503.98	9.06	2494.92						
31	2.83	11.36	8.32	1.10	0.81	0.29	0.29	489.95	74.79	415.16						
32	2.59	29.91	18.76	5.06	3.17	1.89	1.89	1624.24	35.17	1589.07						
33	0.82	34.83	22.37	0.80	0.51	0.29	0.29	198.11	20.40	177.71						
34	1.46	9.93	4.68	2.35	1.11	1.24	1.24	941.11	20.94	920.17						
35	0.18	5.96	4.54	0.05	0.03	0.01	0.01	6.85	2.63	4.23						
36	0.92	4.69	2.50	0.09	0.05	0.04	0.04	37.21	8.30	28.91						

Source: EIIW calculations

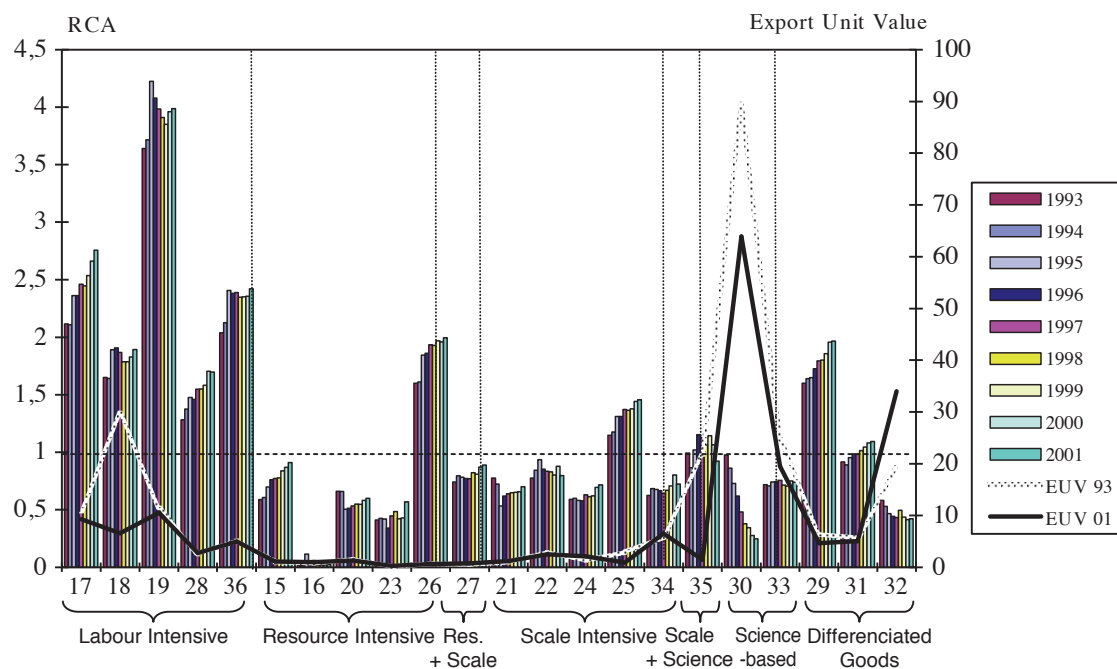


Fig. A.4 Italy – mRCA and export unit value (*Source: EIIW calculations*)

A.3.2 The Bazaar-Effect

The Bazaar-Effect according to Sinn (2005) states that the share of domestic value added in total output of an industry i falls to the benefit of foreign countries. This means that a declining part of the final product's value added is generated domestically. There is a tendency towards outsourcing and offshoring, while the first implies the purchase of intermediate products from external firms and the latter indicates that a (mostly labour intensive) part of the value added production chain is relocated to a foreign country. In the extreme case, the economy would merely buy and sell products, just like on a bazaar. The question of outsourcing and offshoring is especially brigand within an EU25 perspective, since many western European companies offshore production to eastern Europe and also buy eastern European intermediate inputs.

Indeed, one can show that the share of domestic value added in production is declining in Germany, as well as in some other European countries. However, this needn't cause a problem for the domestic economy. As long as the sum of domestic value added share plus domestic intermediate inputs' share to total production does not decline, there should not be a negative effect to the domestic factor markets. If, for example, domestic value added in production declines by 2 percentage points, but at the same time the share of domestic intermediates in production rises by 2 percentage points, the share of domestic participation in production remains the same, causing no harm to the domestic economy. This is merely a relocation of economic activity among domestic industrial sectors. For total manufacturing one can observe a decline in the share of value added plus the share of domestic

Table A.5 Italy – RCA, EUV, EUV weighted with the sectoral export shares of manufacturing and of GDP

NACE rev.1 (2-digit)	RCA				EUV				dEUV				
	2000/2001	EUV 2001	EUV 1993	EUV 2001		EUV 1993		dEUV		EUV 1993		dEUV	
				Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (export share)	Weighted (GDP share)	Weighted (GDP share)		
15	0.84	1.07	1.04	0.07	0.07	0.07	0.00	0.00	7.93	4.70	3.23		
16	0.01	0.70	0.75	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.00		
17	2.79	9.53	10.83	0.59	0.59	0.96	-0.37	-0.37	69.33	65.67	3.67		
18	1.85	15.80	29.77	0.52	0.52	1.36	-0.83	-0.83	61.52	92.67	-31.14		
19	3.76	17.62	11.43	0.78	0.78	0.68	0.11	0.11	92.16	46.23	45.93		
20	0.62	1.30	1.49	0.01	0.01	0.01	0.00	0.00	0.84	0.53	0.31		
21	0.68	1.12	0.99	0.02	0.02	0.02	0.01	0.01	2.72	1.24	1.48		
22	0.89	2.69	2.88	0.02	0.02	0.02	0.00	0.00	2.51	1.48	1.02		
23	0.49	0.28	0.15	0.00	0.00	0.00	0.00	0.00	0.36	0.11	0.25		
24	0.65	1.79	1.30	0.17	0.17	0.10	0.07	0.07	19.81	7.00	12.82		
25	1.46	2.95	2.90	0.13	0.13	0.13	0.00	0.00	15.50	8.73	6.77		
26	2.00	0.59	0.65	0.02	0.02	0.02	-0.01	-0.01	2.10	1.70	0.39		
27	0.92	0.71	0.57	0.04	0.04	0.02	0.01	0.01	4.23	1.71	2.52		
28	1.72	2.58	2.57	0.11	0.11	0.10	0.01	0.01	13.07	6.92	6.14		
29	1.99	6.19	6.35	1.04	1.04	0.96	0.08	0.08	122.32	65.92	56.40		
30	0.29	56.58	89.47	1.81	1.81	4.88	-3.06	-3.06	212.81	333.21	-120.39		
31	1.10	6.54	5.67	0.24	0.24	0.19	0.05	0.05	28.73	13.04	15.69		
32	0.45	24.50	19.24	0.63	0.63	0.42	0.21	0.21	73.63	28.80	44.83		
33	0.72	20.28	24.72	0.36	0.36	0.43	-0.08	-0.08	41.91	29.62	12.29		
34	0.77	6.32	5.81	0.78	0.78	0.48	0.30	0.30	91.19	32.51	58.68		
35	0.95	24.99	21.79	0.90	0.90	0.82	0.09	0.09	105.96	55.71	50.25		
36	2.39	3.89	5.20	0.19	0.19	0.29	-0.10	-0.10	22.38	19.76	2.62		

Source: EIIW calculations

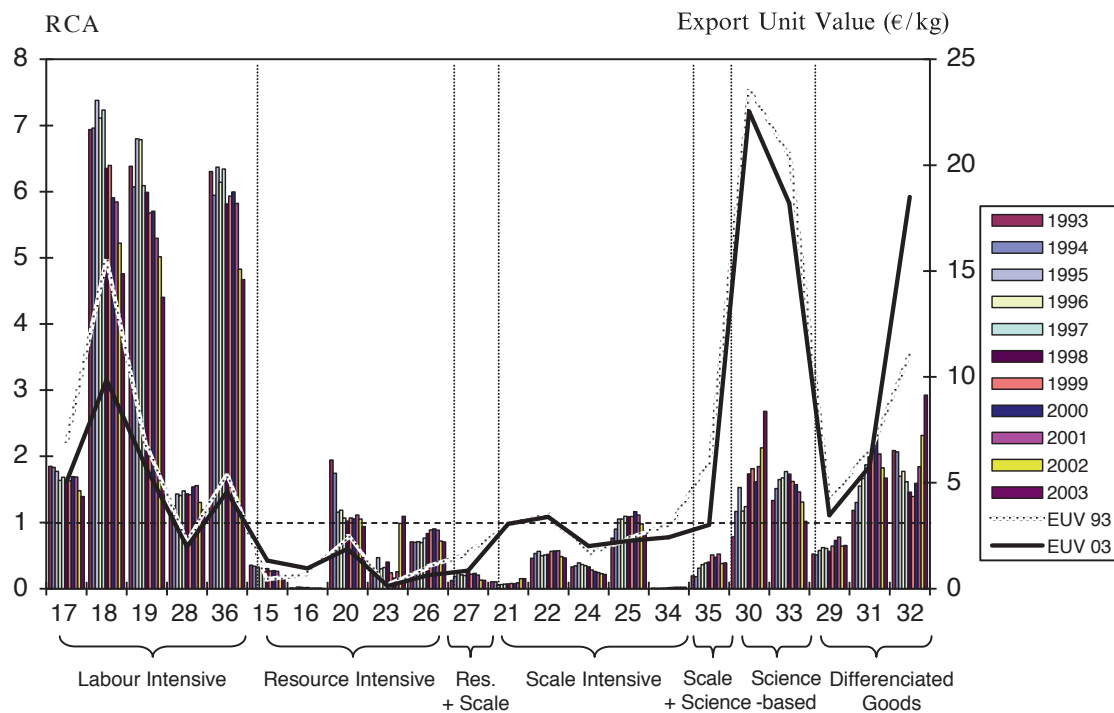


Fig. A.5 mRCA for China and export unit values (*Source: EIIW calculations*)

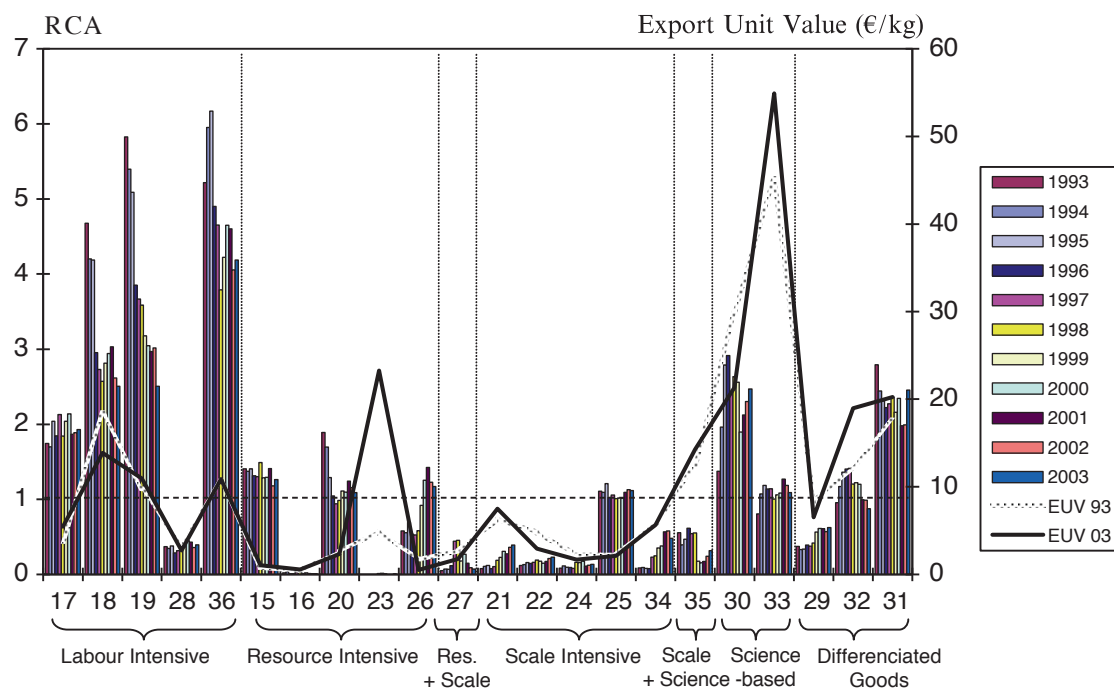


Fig. A.6 Thailand – mRCA and EUV (*Source: EIIW calculations*)

intermediate inputs since the second half of the 1990s, however, this is not valid for all industries. Therefore we will now turn our attention to the economically most important six German industries.

These are motor vehicles, machinery, chemicals, radio/TV/communication equipment, textiles/wearing apparel and office machinery. These six industries

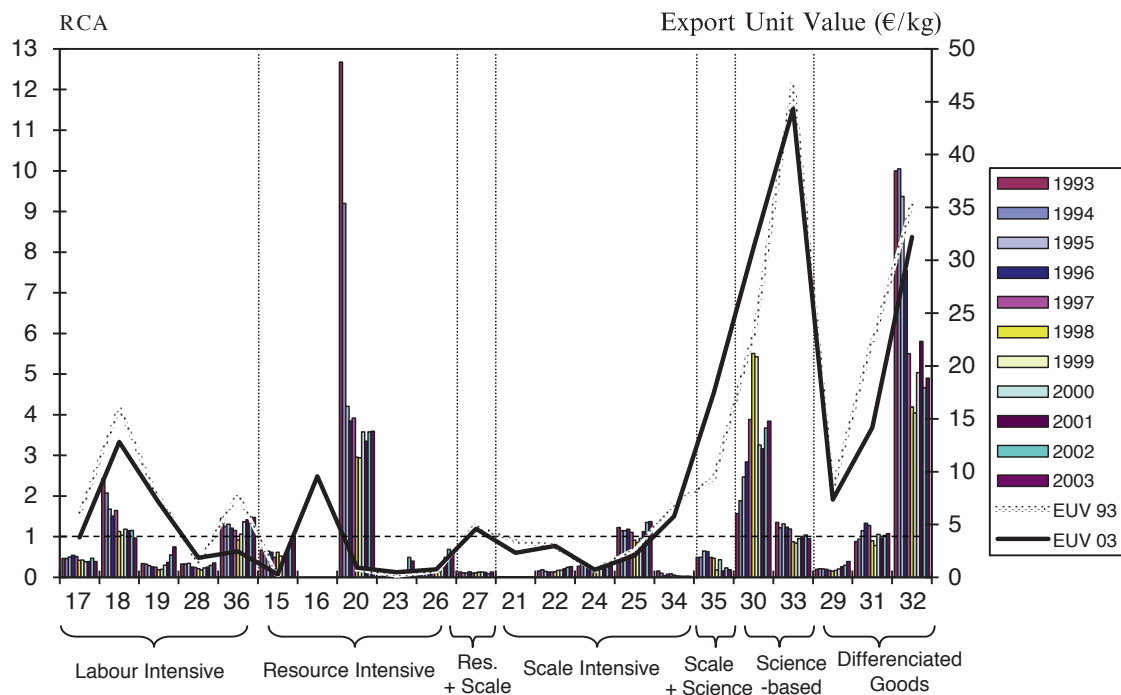


Fig. A.7 Malaysia – mRCA and EUV (*Source: EIIW calculations*)

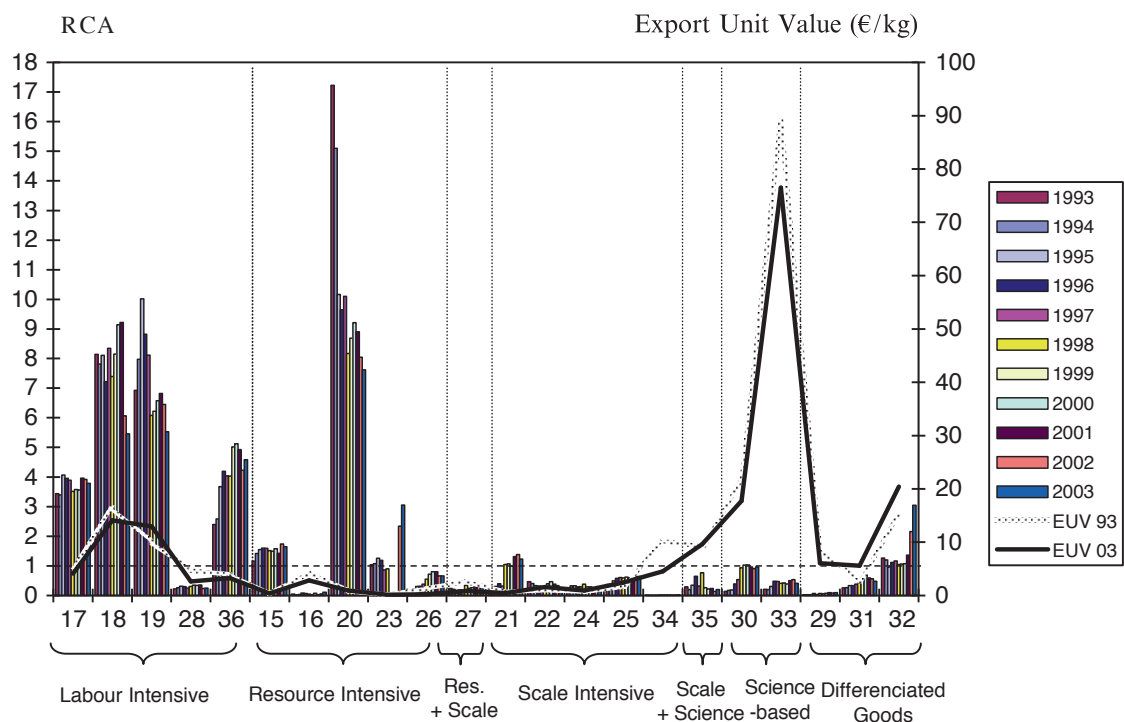


Fig. A.8 Indonesia – mRCA and EUV (*Source: EIIW calculations*)

make up roughly 62% of German exports and 52% of German imports in the year 2004. The share of these six industries in the foreign trade position of the other countries considered in the analysis is also rather high (e.g., 60% of Hungarian

exports, and 59% of Hungarian imports in 2002). We will analyse the extent of the bazaar effect for these six industries.

A.3.2.1 Motor Vehicles

The following figure shows the share of domestic value added, of domestic intermediate inputs and of foreign intermediate inputs in the total output of the motor vehicles industry in selected countries. These include three new EU member states; Slovenia, Hungary and Poland. Furthermore it includes Italy and Germany as the “sick men” in Europe, the Netherlands as a small open economy and especially concerning the telecommunications industry, Finland has been included into the analysis.

The Bazaar-effect as described by Sinn (2005) refers to the decline of the share of domestic value added in total output. Indeed this is the case for motor vehicles in Germany, where the share of value added fell from 32.5% in 1995 to 21.8% in 2000. At the same time, however, the share of domestic intermediates rose from 51.1% to 60%. The total share of domestic formation of output therefore only slightly declines from 83.6% to 81.8%. This corresponds to relocation to foreign countries in the production of motor vehicles to the extent of 1.8% of output. However, still 81.8% of output is produced in the home country, either as value added in the motor vehicles industry, or as intermediate production in other domestic industries. Thus the bazaar-effect is rather small in the German motor vehicles industry (Fig. A.9).

A similar rise in the share of foreign intermediates can be observed in the Netherlands, Finland and Italy and to a greater extent in Poland and Slovenia. The Netherlands, Hungary and Slovenia, as being small open economies, are expected

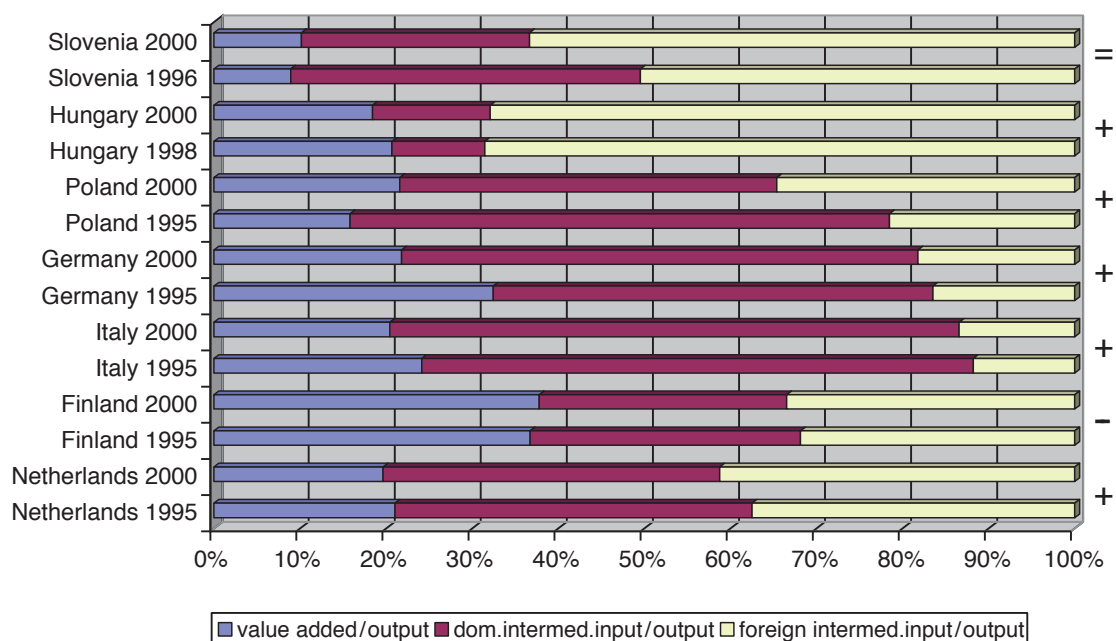


Fig. A.9 Motor vehicles – bazaar effect

to have a higher overall share of foreign intermediates, which is shown in the figure. However, the share of foreign intermediates is considerably higher for the small new EU economies than for the Netherlands.

The signs at the end of the rows indicate the tendency of Export Unit Values (EUV) since 1993. It seems that a problem might occur if a strong decline of the domestic share of production is accompanied by declining tendency of Export Unit Values. In the motor vehicles industry, only Finland shows a decline in EUVs, however at the same time that share of value added has increased.

A.3.2.2 Machinery and Equipment

Most countries show a considerably high share of domestic production. The sum of the share of value added and domestic intermediates exceeds 70% in most cases. Only in some new EU member states can one find a higher share of foreign intermediates: Slovenia and Hungary.

Except for Slovenia the share of foreign intermediate inputs has risen in the time period considered. A relatively strong rise occurred in Hungary with 11%, followed by Finland and Germany with roughly 4%. Although there is negative tendency in the development of the EUVs in Germany, the situation is not alarming, since the share of foreign intermediates is still very low (16%). In most of the countries the EUVs tend to increase, except for Italy and the Netherlands, where they rather stagnate (Fig. A.10).

All in all, the picture in the machinery industry is rather homogenous with a relatively high percentage of domestic activity in production.

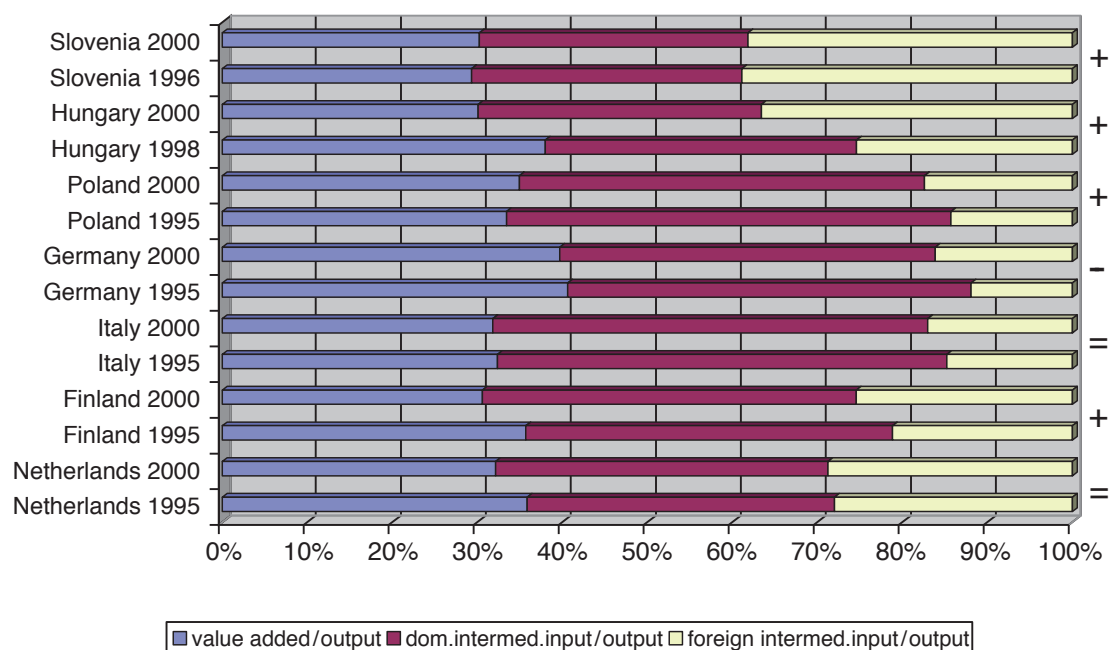


Fig. A.10 Machinery and equipment – bazaar effect

A.3.2.3 Chemical Products

Homogeneity is also given in the chemicals production. In most countries the share of domestic value added makes up to 25–35% of the industry output. Except for Italy, where the share has remained constant, domestic value added in production is declining in western European countries, giving rise to the bazaar-effect. This is also the case for Hungary. However, both in Slovenia and in Poland the share is increasing considerably. At the same time the rise cannot compensate for the loss in the share of domestic intermediates, thus the share of foreign intermediates in output has risen in both countries considerably (Slovenia 13%, Poland 14%). The only country where the total domestic share in 2000 exceeded the previous value is Hungary. EUVs show a clear tendency to rise in all but one country, Slovenia (Fig. A.11).

A.3.2.4 Radio, Television and Communication Equipment

The figure is not as harmonious any more in the radio, television and communication equipment industry.

The new EU member states stick out through relatively low shares of value added and domestic intermediates. This is valid for Slovenia and Hungary for both years considered and for Poland especially for the year 2000. Furthermore the share of foreign intermediates is extraordinarily high, reaching values of over 80% in Hungary. Also the very strong increase of the foreign intermediates is striking: 27% in Poland and 19% in Slovenia. As mentioned before small countries are expected

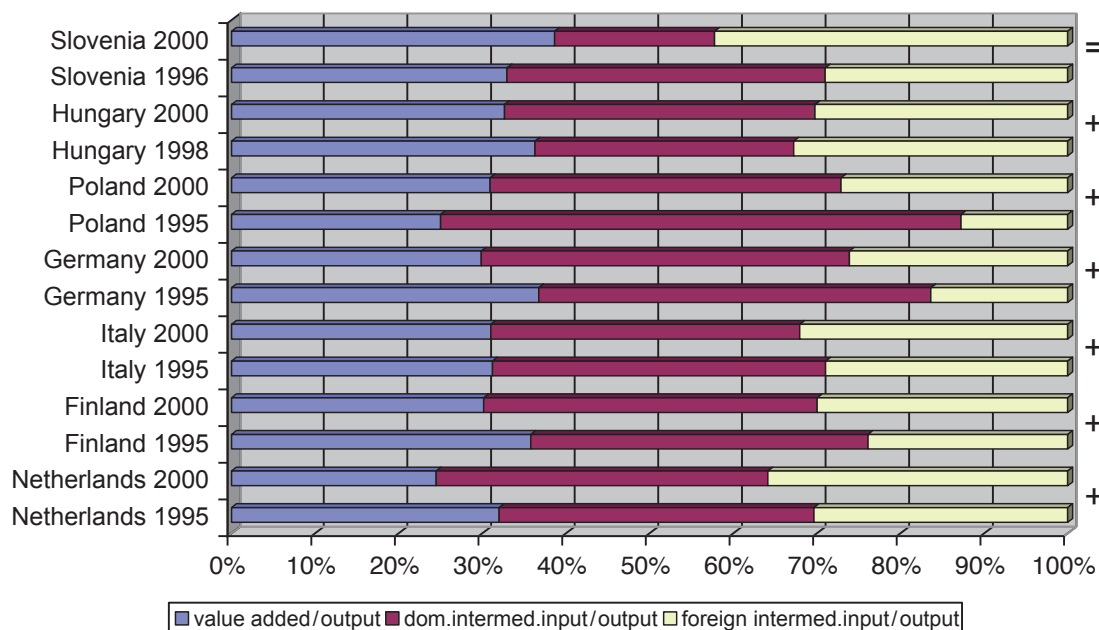


Fig. A.11 Chemical product – bazaar effect

to have higher shares of foreign intermediates, since they are more dependent on foreign trade (especially foreign imports) than big open economies, but also compared to other western European small economies such as the Netherlands, these ratios are very high. Hungary with merely 13% of value added and 4% of domestic intermediates appears to be the real bazaar economy in the radio, television and communication equipment industry.

The only country with a relative stable share of foreign intermediates is Italy and the only country with a decline in the share of foreign intermediates is Finland. The latter is not surprising and adding the outstanding rise in EUVs in this industry underlines the dominant position of Finland in the telecommunications market. But also in most other countries one can observe a rise in EUVs (Fig. A.12).

A.3.2.5 Textiles

In contrast to that, export unit values decline in most of the countries in the textiles industry. Only in Poland and Germany do the EUVs seem to stagnate and there is weak increase in the Netherlands.

The Netherlands is also the only country where the share of foreign intermediate inputs has declined (by roughly 2%); in all other countries the share has increased. The strongest increase occurred in Hungary with 24%, followed by Poland with 17% and Slovenia with roughly 7%. At the same time value added rose by 2.5% in Slovenia and declined by almost 13% in Hungary. This does not underline the predictions of the traditional trade theory, namely, that eastern European countries will mainly specialize in labour intensive production, due to the abundance of labour.

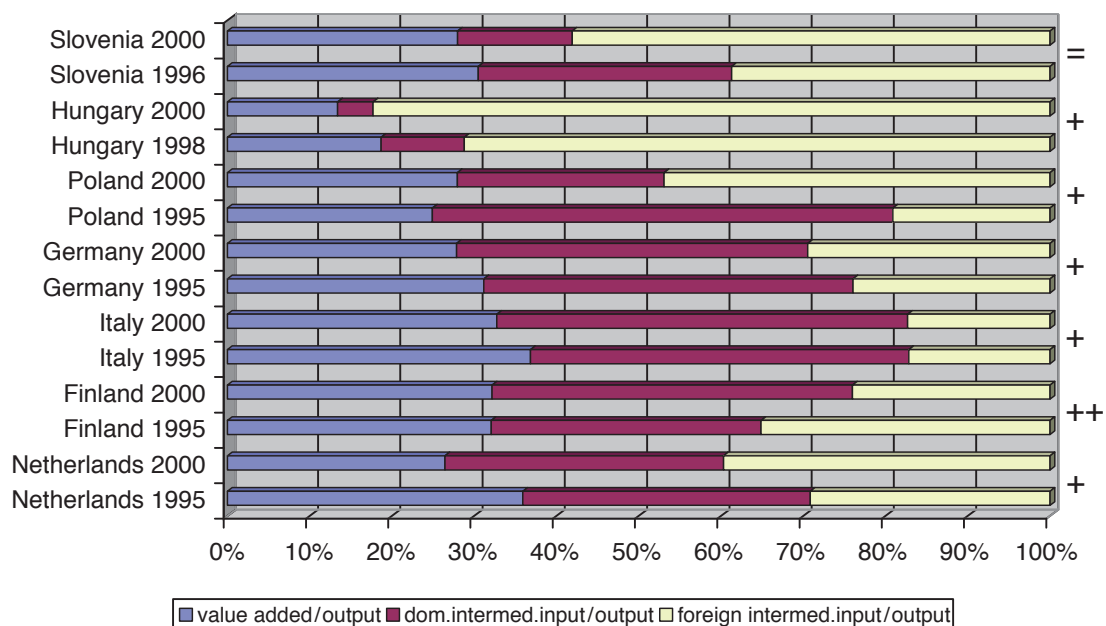


Fig. A.12 Radio, television and communication equipment – bazaar effect

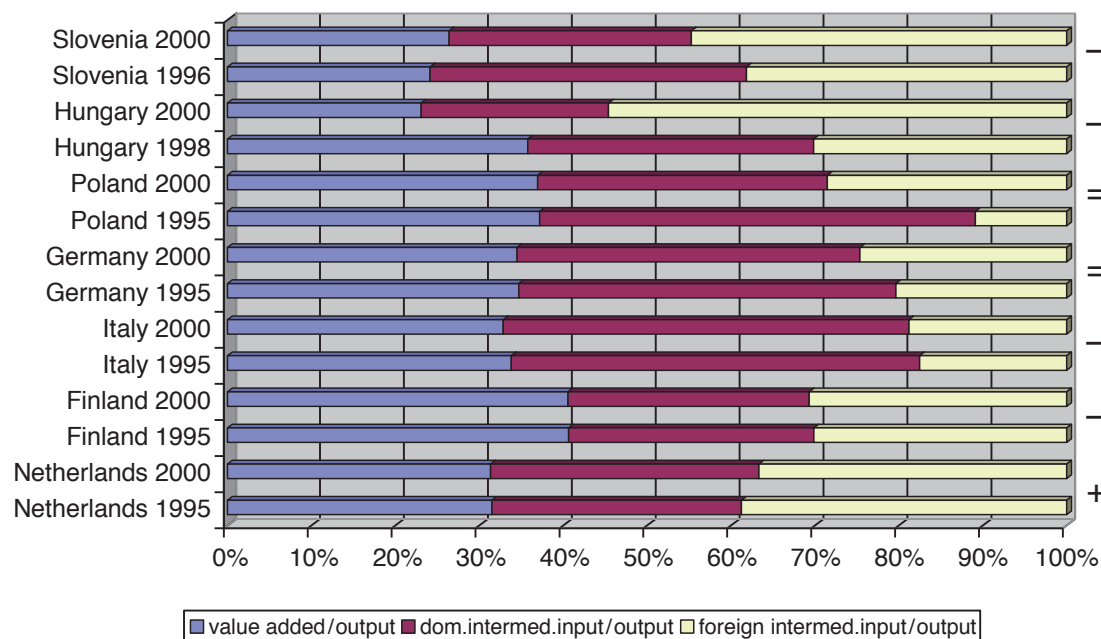


Fig. A.13 Textiles – bazaar effect

However, there are other labour intensive industries, such as wearing apparel and leather and fur, where some of the new EU member states have considerable comparative advantages (Fig. A.13).

A.3.2.6 Office Machinery

Finally, we take a look at the composition of the industrial production of office machinery. It reveals the most diversified picture of all industries.

In general the share of foreign intermediates is the highest (when compared to the other industries). Starting with 28% in Slovenia in 1995, the average share is roughly 40–60%, with extremely high shares of over 90% again in Hungary. But also in Finland and Italy the share of foreign intermediates exceeds by far 50% of output.

A clear bazaar effect can be identified in Finland, Italy, Germany and Hungary. In these countries the share of domestic value added decreased strongly. In all these countries the share was already rather low in 1995, but it almost disappeared in the year 2000, mostly in Hungary with 6% and in Finland with merely 2%. Especially Hungary, with a domestic intermediates share of 1.5%, seems to play only a bazaar function on the office machinery market.

However, we also find countries, where the share of domestic value added has increased in the second half of the 1990s. In the Netherlands it rose by 1.5%, in Poland by roughly 6%, and in Slovenia by 3%. In addition the share of domestic intermediates rose in the Netherlands by 4.6%, added up to an increase in the domestic share of production by almost 6%. This is the clear opposite effect to

the bazaar. This effect is also visible in Poland with an increase of the domestic share in production by 1.6% (Fig. A.14).

At the same time EUVs show a clear tendency to rise in Poland, but to fall in the Netherlands. The latter is the case for almost all other countries, too, which indicates that the bazaar-hypothesis is strongly relevant on the market for office machinery especially in Italy, Germany and Hungary.

All in all it is important to look at the sectoral level when analyzing the bazaar effect, since the differences among the industries are large. Also it is not the share of domestic value added that matters, but the sum of the shares of domestic value added and domestic intermediate inputs. Only if this sum declines, will we see an increase in the foreign intermediates inputs, which might have negative implications on domestic factor markets, such as the labour market.

A.3.3 Net Bazaar Effect

Finally one might not only look at the “gross” bazaar effect as described above, which controls for the intermediate imports in production and thus in exports in country I. But one should also consider that imports of country I from country II also contain to some extent exported intermediates from country I to country II. Controlling for this would reduce the “gross” bazaar effect, which we call the “net-bazaar effect”.

It is rather challenging to calculate the net bazaar effect for a country, because one needed statistical information on the share of intermediate products in exports in relation to the share of intermediate products in imports. We can, however, approximate by assuming that the import/export ratio in total foreign bilateral trade

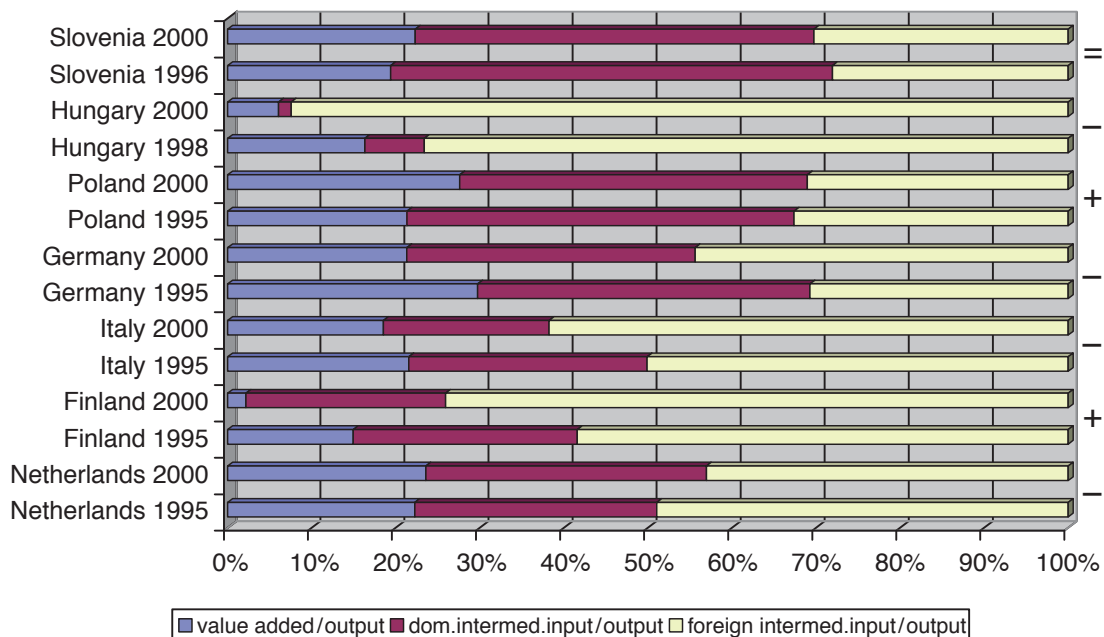


Fig. A.14 Office machinery – bazaar effect

corresponds to the import/export ratio of bilateral trade in intermediates. Thus one can calculate the net bazaar effect on the bilateral basis. The effect is visible if one calculates the net bazaar effect towards the most important trading partners.

This is done in the following for the German EU14 bilateral trade for the motor vehicle industry. First one has to identify the share of EU 14 imports in German total imports. This accounts for 60.4% for 1995 and for 54.8% for 2000. Furthermore the import/export share of motor vehicles for the bilateral trade Germany – EU 14 in the year 1995 was 0.7 and in the year 2000 it was 0.56. Subtracting the intermediate exports contained in intermediate imports reduces the share of foreign intermediate imports accordingly (Fig. A.15).

According to the figure, the share of foreign intermediates declines in 1995 from 16.5% to 2.4% and in 2000 from 18.2% to 0.7%. Thus the domestic share of production (measured as the sum of the share of value added plus the share of domestic intermediates) rises. The greater the economic importance of the trading partner, the greater is the difference between the gross and the net bazaar effect.

A.4 Policy Conclusions

A.4.1 Policy Perspectives: New Challengers in the World Economy

As regards the EU15 market, China has shown a consistent specialization in labour intensive products in the period 1993–2003. China also has developed a positive specialization – in the sense of an RCA > 1 – in the field of science intensive goods

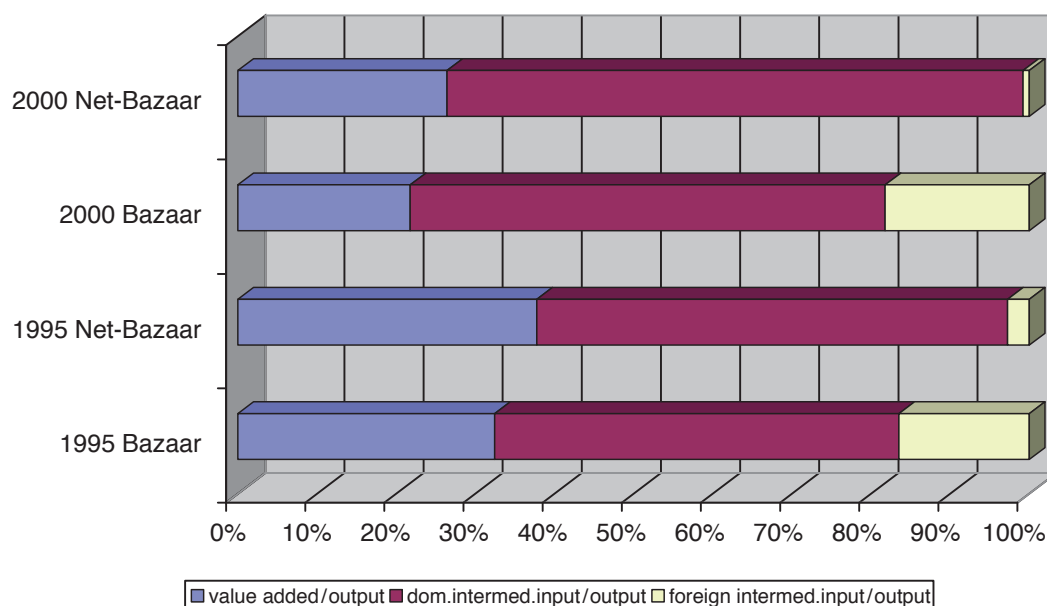


Fig. A.15 The gross and the net bazaar effect in the motor vehicles industry in Germany's trade towards EU 14

(sectors 30 and 33) and in differentiated goods (sectors 31 and 32). As regards the latter in these sectors it was able to slightly increase export unit values so that the degree of product sophistication and quality were obviously raised. There is little doubt that favourable specialization and export unit values in the sector of differentiated products and in science intensive goods partly reflect the high cumulated foreign direct investment which China was able to attract in these sectors. In the long run, one may anticipate that China will be able to become a major exporter of automobiles and other scale intensive goods: the large Chinese market offers great opportunities for such a long term specialization. For the EU this will hardly undermine much long term overall growth, namely for two reasons:

- while the automotive industry is one of the most important sectors of the EU in terms of value-added, employment and innovation, one may anticipate that automotive firms in EU countries will increasingly specialize on the high end of the automotive industry; at the same time EU suppliers of electronic intermediate inputs – important for high fuel efficiency and low CO₂ emissions – should find increasing market volumes in expanding Chinese and other Asian markets;
- structural change will bring about a gradual shift in the sectoral composition of sectoral output in the EU. Many EU countries will further expand in the services sectors, in particular in knowledge-intensive industries. This brings, however, a major challenge for EU countries in terms of intensifying human capital formation and the drive towards technology-intensive industries.

Long term structural adjustment in Europe and Asia are a natural part of international competition, sustained innovation dynamics and ongoing economic globalization.

The European Commission (2007, pp. 42–43) notes with respect to China, India and Russia:

China's contribution to world-wide growth in the more recent past has indeed been impressive, particularly considering the Asian financial crisis in 1997/98 and the worldwide slowdown following the bust of the IT-bubble in the United States in 2000. In real terms, GDP growth in China accelerated from 7.8% in 1998 to reach slightly more than 10% on average per year over the period 2003–2006. China's share in global output has risen from 1.7% in 1990 to 5% in 2005. Since 2000 the country has contributed about one third to overall worldwide GDP growth. Fixed asset investment, both in the industrial sector and in real estate, has contributed strongly to this impressive growth performance, as has the ongoing rise in exports, which are supported by a very competitive exchange rate. At the same time, the growth rate of private consumption has been much lower, as the lack of an adequate social security system keeps the savings ratio at high levels. As a consequence, the savings investment gap has increased, driving up the current account surplus and foreign exchange reserves...

Trade and investment flows between China and the euro area have been rising. The euro area is a very important export destination for China, accounting for 19.4% of its total exports in 2005, equalling 9.7% of overall euro area imports in that year ... Although euro-area exports to China have also risen considerably, to EUR 43.5 billion in 2005, they remain modest as a percentage of total euro area exports. This suggests, however, a significant potential for further expansion. The euro-area trade deficit with China has kept growing, reaching slightly more than EUR 74 billion in 2005. Regarding, Foreign Direct

Investment (FDI), euro-area flows to China have been rising both in absolute value and as a percentage of total euro-area outward FDI.... The euro area, however, remains a less important direct investment partner for China than the United States or Japan, which together accounted for 18.1% of China's total FDI inflows in 2005.

Against this background, it would be useful to broaden the political, economic and scientific links between Europe and China as well as between the EU and India and the EU and Russia. The economic relations between the EU and ASEAN will be of particular relevance in the future (Welfens, Knipping, Ryan, and Suthipand, 2006). If the EU can achieve sustained growth the European integration model will become an important role model for international cooperation.

The international division of labour, innovation and growth should be considered as an interdependent phenomenon. A Schumpeterian perspective with foreign direct investment – a Heckscher-Ohlin-Samuelson-Dunning-approach – is useful from a policy perspective. In the period of globalization, fast structural change is a key challenge. As EU countries and (with a delay) the US are facing ageing problems one should emphasize that sustained growth in the EU and the US requires particular emphasis on productivity growth and innovation. Besides an increasing use of ICT one may hope that a dynamic international division of labour – trade and two-way FDI – will contribute to this. Governments thus should maintain open trade and open up to foreign direct investment and this requires accepting the dynamics of outsourcing and offshoring in competitive global markets. International outsourcing should not be seen as a major problem; rather it reflects the dynamics of productivity-enhancing global trade. There is no need to generally consider “bazaar effects” as a problem; such effects are unlikely to reflect problems in competitiveness as long as the country which relies increasingly on intermediate imports is itself moving up the technology ladder – as shown in reliance on more sophisticated domestic intermediate products and a general direction of structural changes towards more technology-intensive and skill-intensive products. More technology intensive products should be able to fetch high prices and Schumpeterian rents in global markets.

To the extent that moving up the technology ladder implies the emergence of more owner specific advantages one should expect high wage countries with a high ratio of R&D expenditures to GDP (and a correspondingly high share of global patents) to face a rising ratio of foreign direct outflows to national income. The existence of a high inward or outward FDI stock in turn requires the making of a careful distinction between GNP and GDP, which rarely is made in macro models (a problem emphasized in Welfens, 2005).

Relatively poor countries eager to catch up in economic and technological terms should put adequate policy emphasis on:

- competition policy
- free trade policy
- creating an economic system and adopting a policy framework conducive to high FDI inflows

After the first stage of catching-up, more emphasis must be put on improving education, training and retraining as well as the modernization of the infrastructure.

Moreover, a distinct innovation policy has to be developed which will have to shift emphasis from diffusion of new technologies towards innovation: To achieve this end the R&D expenditure-GDP ratio must exceed the 1% threshold over an extended period. Along with economic catching up goes the need to upgrade the workforce, that is to spend more on high education and retraining so that a lack of skilled labour does not become a bottleneck for economic catching up. A modern financial market system also is required. From a long term perspective countries which have achieved a medium term income position should thus emphasize

- innovation policy which naturally will include emphasis on both diffusion and product and process innovations;
- education policy – with elements of private suppliers in higher education;
- financial market development which must include a growing role of stock markets which will naturally play an important role for financing investment in innovative projects and firms. The asymmetric information on the side of innovators and bankers will impair long run innovation dynamics in a system where firms' investment financing mainly relies on bank loans.

There also are other important ingredients for long run catching up:

- Maintaining adequate labour market flexibility – this might be only a minor problem in small open economies, but in a large economy (with a relatively large home market and nontradables sector) this is a major challenge. Government ownership of firms also can cause problems here.
- A stability-oriented monetary policy which should include an adequate choice of the exchange rate regime.
- Low budget deficits also are crucial ingredients for long run growth and economic catching up.

The global innovation race has intensified and therefore more flexibility and greater incentives for innovations, learning and flexible adjustment are needed in Europe. There is an adjustment overhang in those countries which have high unemployment rates and this particularly concerns some of the large Euro zone countries. Germany and Italy are two countries with serious problems, not least because of their declining trend growth rates and stubborn budget problems. Italy's rising unit labour costs after the start of the Euro zone point to a failure of the country's collective bargaining system to adjust to the new monetary reality. However, Germany is not much better since the Euro zone's largest economy has had enormous problems for many years; not only starting with German unification. The R&D-GDP ratio which stood at 2.9% in 1989 has fallen over a decade and only after 1999 has there been a modest increase. Germany's position in ICT modernization is not top in the EU and recent analysis (Welfens, Jungmittag, & Vogelsang, 2005) points to problems with technological progress in core regions both of western Germany and eastern Germany. France has emphasized high-technology growth in the Western Europe more than any other EU15 country; however, it has recorded both success stories – including Airbus (actually an EU joint venture) and the nuclear industry – and failures (e.g., Bull in the computer sector) with its industrial policy. Germany's

structural adjustment has been relatively slow in industry, the adjustment dynamics in the UK and France were more pronounced. Italy is rather dependent on the international economy and it risks – similar to Germany – facing reduced growth if global economic growth should slow down.

Some of the EU accession countries have shown remarkable structural adjustment; technological upgrading has been an important element in several eastern European countries which have been able to attract high FDI inflows. Given high sustained unemployment rates in most accession countries one must, however, be worried about the unemployment problem. Jobless growth could be one of the new problems in transition countries. To the extent that the mass unemployment problem contributes to social and political conflicts as well as political radicalization, high long term unemployment could contribute to political destabilization which in turn will raise the political risk premium and weaken growth in the long run. A EU25 in which economic divergence across countries should be observed is likely to be highly unstable. Already in 2005 – just a year after EU enlargement – the EU shows signs of increasing weakness; failed referenda in France and the Netherlands have shown that the EU has lost broad popular support in EU founding countries. The apparent inability – so far – to complete the Euro zone as planned originally, namely by including the UK, also shows a lack of consistency and political consensus. Overblown projects such as Turkish EU enlargement have clearly undermined the political support for EU integration in Germany, the Netherlands, France, Austria and some other EU countries. If the EU25 should turn out to be a rather heterogeneous political club with weak economic growth and inability to organize innovation, growth and sound public finance in combination with low inflation rates and full employment the EU is unlikely to survive for many decades.

The basic policy conclusion is that the EU25 should be able to benefit from both EU enlargement and from economic globalization. The EU is a major host country of FDI and also a major source country so that it can benefit from outsourcing. In the high wage economies of Western Europe it is fairly clear that the accelerated structural change in Europe requires more wage differentiation which should be more in line with differential productivity growth rates in EU countries. The existence of a high minimum wage is a doubtful exercise, in particular if it is a nation-wide minimum wage as in France and Italy which both have high unemployment rate. Germany's social security system still is relatively generous and implicitly defines a minimum wage which is relatively high, namely in the sense that overall labour costs of unskilled labour is high. The specific unemployment rate of unskilled workers should gradually be brought down to the average unemployment rate; greater wage dispersion as well as stronger retraining could be useful in Germany, France and Italy. More wage dispersion could go along with a higher average growth rate of wages provided that greater wage flexibility brings about higher average productivity – partly related to higher regional labour mobility. As regards the incentives of firms to invest more in training and retraining, one clearly should point out that the globalization process is weakening such incentives; the average tenure of workers is declining so that the incentive for firms to invest in training and retraining is declining. Here government's tax

policy might want to envisage new adequate incentives which stimulate training and retraining.

In an EU in which national R&D programs are increasingly likely to generate cross-border benefits through international technology spillovers there is some risk that national policymakers will cut innovation promotion expenditures; R&D expenditures could fall below an optimum level – positive external effects of innovation would not be fully internalized in the EU. Shifting more funds in R&D to the supranational policy level might not be a reasonable way to cope with the problem since the poor political control of the European Commission and the established budgetary priorities for agriculture and structural funds, means that an efficient EU innovation policy should not be expected. However, the EU could be quite useful in innovation policy, in particular by performing regular analysis of innovation dynamics in EU countries and in the regions of the EU. More transparency could generate stronger incentives towards adequate national policy reforms. In Europe's ageing society there also is a problem that the majority of increasingly elderly voters might be reluctant to support rising outlays for education and for higher R&D-GDP expenditure ratios. Rather, a political bias in favour of spending more on social security could undermine necessary increases for R&D or the education system.

In eastern European accession countries, economic development has been relatively favourable in the decade 1995–2005. However, even with growth rates of about 5% p.a. in several years in the run-up to accession, Poland, Hungary, the Czech Republic and other transition countries have witnessed very high stubborn unemployment rates. If joining the EU should bring about more rigid labour markets then there could be a tendency towards sustained mass unemployment in Eastern Europe. As firms in accession countries themselves will face considerable pressure to outsourcing internationally, some of the problems of the large Euro zone core countries could soon also be a plague in Eastern Europe. Eastern European countries face the problems of ageing no less than Western Europe; thus policymakers should stimulate innovations and human capital formation on the one hand, on the other hand it will be important to encourage creation of new firms which often not only create new jobs but contribute to overall flexibility and innovativeness.

The European Council has adopted the Lisbon strategy in 2000 as a political agenda to encourage growth and employment in the EU. While many small EU15 countries and the UK have been rather successful in this respect Germany and Italy – and to a lesser extent France – have faced slow growth, insufficient innovation dynamics and only modest ICT dynamics outside mobile telecommunications. Here governments should reconsider ICT policies and R&D policies as well as education policies. New tax incentives for encouraging training and retraining might be useful, at the same time expenditures in the field of social security policies and most subsidies (not for R&D!) should be cut. Inflexibility of labour markets and wage rigidities seem to be problems in those countries so that policymakers and trade unions plus employer federations should look for remedies. If the EU15 should be unable to regain sustained growth and full employment, this will

undermine the overall integration of EU25, would undermine political support for integration and would undermine Europe's position in the global competition of market systems. As regards the role of the EU itself it is not clear whether Brussels really can stimulate innovation, growth and employment in the Community in the early twenty-first century.

All in all policy makers should not understand our argument as broad support for naïve industrial policy. In accession countries it would be wise if policy makers would emphasize education and R&D support in the course of catching-up, which implicitly means strict control for social policy. For EU 15 countries it is important to set the right incentives for the actors in labour markets to avoid overpricing especially in market segments for unskilled labour. Avoiding a naïve industrial policy in EU25 countries is crucial, rather it is important to emphasize competition policy, the nurturing of venture capital and the growth of innovation activities

Appendix: NACE rev. 1.1. Classification (In Parts)

- D Manufacturing
- 15 Manufacture of food products and beverages
- 16 Manufacture of tobacco products
- 17 Manufacture of textiles
- 18 Manufacture of wearing apparel; dressing and dyeing of fur
- 19 Tanning and dressing of leather, manufacture of luggage, handbags, saddlery, harness and footwear
- 20 Manufacture of wood and of products of wood and cork, except furniture; manufacture of articles of straw and plaiting materials
- 21 Manufacture of pulp, paper and paper products
- 22 Publishing, printing and reproduction of recorded media
- 23 Manufacture of coke, refined petroleum products and nuclear fuel
- 24 Manufacture of chemicals and chemical products
- 25 Manufacture of rubber and plastic products
- 26 Manufacture of other non-metallic mineral products
- 27 Manufacture of basic metals
- 28 Manufacture of fabricated metal products, except machinery and equipment
- 29 Manufacture of machinery and equipment n.e.c.
- 30 Manufacture of office machinery and computers
- 31 Manufacture of electrical machinery and apparatus n.e.c.
- 32 Manufacture of radio, television and communication equipment and apparatus
- 33 Manufacture of medical, precision and optical instruments, watches and clocks
- 34 Manufacture of motor vehicles, trailers and semi-trailers
- 35 Manufacture of other transport equipment
- 36 Manufacture of furniture, manufacturing n.e.c.
- 37 Recycling

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Chapter B

Political Cooperation Between the EU and ASEAN: Searching for a Long-Term Agenda and Joint Projects

Lay Hwee Yeo

B.1 Introduction

Cooperation between the EU and ASEAN has gone through ups and downs in the last 30 years since informal dialogue first took place in 1972. The dialogue started with initial focus on narrow issues on trade and market access, but ties between the two regions have broadened to include political dialogue and functional cooperation.

Despite more than 30 years of dialogue and cooperation, ASEAN–EU ties continued to be low key, fraught with challenges and some say even “benign neglect”. Yet there is also a growing understanding that there are opportunities to nurture and grow this partnership which will be in the long-term interests of both regions.

This chapter first gives an historical review of ASEAN–EU relations. Generally, the ties between ASEAN and the European Community in the last 30 years can be divided into four different phases – the first phase from 1972 to 1980 was the period of courtship; the second phase from 1980 to 1991 was a period of consolidation; the third phase (1991–2001) was one of turbulence with frosty ties from 1991 to 1993, but a new dynamism from 1994 to 1996, and then stagnation from 1997 to 2001. The current phase of the relationship which started in 2002 was one of re-discovery. We are entering into a new phase of rebuilding our ties in view of the changing regional and global dynamics.

The second part of the chapter looks into some of the key changes within the global context and within the Southeast Asian region and the European Union. How will these changes in turn impact the further development of ASEAN–EU relations, and what should be the long-term agenda?

B.2 Thirty Years of ASEAN–EU Relations in a Nutshell¹

ASEAN was founded in 1967 by Indonesia, Malaysia, Philippines, Singapore and Thailand, amidst uncertain times in Southeast Asia. At the time of its formation ASEAN was scoffed at by many political observers, both in the region as well as beyond. In a region marred by war and intra-regional conflicts, it was difficult to perceive that the leaders of these independent, sovereign states with different historical experiences would have the political will to overcome their suspicions and latent hostilities.

ASEAN's growth as a regional organization proceeded at a slow pace in the initial years. There were very little real integrative efforts as sovereignty was jealously guarded. In any case, ASEAN was never intended to be an instrument of integration with supranational authority. ASEAN's *raison d'être* was, and still is, to turn a region in turmoil and instability into a region of peace and tranquillity. It was to be an instrument for managing and containing intra-regional conflicts, and in so doing, to maintain and strengthen national sovereignty.

ASEAN from its onset has been an outward-oriented organization. Most of ASEAN's success really came by way of a common stance vis-à-vis third parties. This was reflected, for instance, in the role it played in the Cambodian issue in the 1980s. It has also sought to establish friendly ties with key players in the region and the world in order to secure its own interest. One channel in which ASEAN used to articulate its interest was through the dialogue sessions that it established over the years with the major powers and other key countries in the region. Its dialogue partners include the EU, US, Canada, Australia, New Zealand, Japan, China, South Korea and most recently, Russia and India. In many ways, it was through such interaction with the others that helped ASEAN define its identity.

B.2.1 First Phase (1972–1980)

The EEC was ASEAN's first dialogue partner. Informal dialogue between ASEAN and the EEC first took place in 1972 between ASEAN Ministers and the Vice-President and Commissioner of the European Commission. Initially, the dialogue was aimed exclusively at achieving greater market access for ASEAN's exports and a price stabilization scheme for ASEAN's primary commodities.

After a few annual informal meetings, it was decided in 1975 that an ASEAN–EC Joint Study Group be set up, not only to look into trade matters, but also to evaluate other possible areas of cooperation, such as joint ventures in the exploration of ASEAN resources, the possibility of encouraging some degree of EC participation in ASEAN manufacturing activities and of mobilizing capital for financing ASEAN projects (Luhulima, 1992).

¹This section is drawn extensively from an earlier paper I wrote on "The role of ASEAN in EU-East Asian relations": ASIEN, No. 72, pp 19–28. See reference

ASEAN–EC relations were given a boost and greater political significance with the inaugural ASEAN–EC Ministerial Meeting (AEMM) in 1978. Under the direction of the AEMM, the ASEAN–EU Cooperation Agreement was formulated and signed during the second ASEAN–EC Ministerial Meeting held in Kuala Lumpur in March 1980.

B.2.2 Second Phase (1980–1991)

The signing of the ASEAN–EC Cooperation Agreement in 1980 was to mark the beginning of a new stage of cooperation. With the signing of the Framework Agreement, links between ASEAN–EC were institutionalized. The main emphasis of the Agreement was on economic cooperation and development. The Agreement extended the Most Favoured Nation (MFN) status to the contracting parties. More importantly, it opened up an exclusive channel for the exchange of information and requests that paved the way for EC assistance in several development projects. It opened up a second track of cooperation which specifically covered the EC and the signatories of the Cooperation Agreement. Under the Agreement, objectives for commercial, economic and technical cooperation were established, and a Joint Cooperation Committee (JCC) was formed as a mechanism for monitoring ASEAN–EC cooperation.

Despite all these positive developments in general, however, ASEAN economically remained at the bottom of EC's hierarchy of relations until the 1980s, below even that of the African, Caribbean & Pacific (ACP) and Latin American countries. The low priority accorded was reflected in the fact that the ACP countries received more favourable trade benefits covered by the Lome Convention and by the irregular attendance of the AEMM by the EC ministers. ASEAN–EC relationship was seen very much as a donor-recipient relationship. It was an unequal relationship in which the ASEAN countries were inevitably in a weaker bargaining position (Ruelend, 1996, pp. 16–17).

In contrast to this unequal economic relationship, political cooperation between ASEAN and the European Community was markedly more successful in the 1980s. Political cooperation was stepped up to deal with what was seen as a Soviet expansionist threat. Specifically, Vietnam's invasion of Cambodia (then Kampuchea) in December 1978 and the Soviet invasion of Afghanistan in 1979 were impetuses for the two regions to work closely in coordinating and supporting each other's positions on the Cambodian and the Afghanistan issues in international fora such as the United Nations. During the 1980 AEMM, an unprecedented joint statement was indeed issued deploring the armed interventions of Cambodia and Afghanistan. An analysis of the votes for the UN General Assembly Resolution from 1979 to 1984 showed that ASEAN and the EC voted as a bloc in support of calls for Soviet withdrawal from Afghanistan and Vietnamese withdrawal from Cambodia (Robles, 1998, p. 16). These two issues also remained dominant subjects of political discussion at every successive AEMMs until their resolution in 1991.

B.2.3 Third Phase (1991–2001)

The political relations, however, took a turn for the worse in the early 1990s due to the East Timor incident in 1991 when differences emerged over how to treat Burma in the midst of its ruling junta's violent suppressions of pro-democracy movements. It was also the time of the triumphant mood in the West following the collapse of the Berlin Wall and the break-up of the Soviet Union and the wave of democratization movements in the former Communist countries in Central and Eastern Europe. Riding on this wave of self-belief, Western countries started pushing other developing countries toward greater democratization. Free from the Cold War necessities of courting authoritarian but pro-Western countries, Europeans introduced a policy of conditionalities linking trade and aid to issues on human rights, democratization and environmental protection. The politicization of aid and economic cooperation policy heightened tension with the ASEAN nations. This new moralism of the West was criticized as "neo-colonialism" by leaders such as Dr. Mahathir of Malaysia.

The past decade of continued economic growth in the ASEAN countries, the general dynamism and growing economic prowess of the East Asian region in which ASEAN is located as well as ASEAN's success as a diplomatic community has made the latter more confident and assertive. A new sense of pride drawn from the decade of economic achievements translated into the ability to confront and challenge the decisions or actions of Western countries. The ninth and tenth AEMMs held in 1991 and 1992 respectively were thus marked by heated exchanges over East Timor and the new conditionalities of EC aid and cooperation policy.

The confidence and dynamism of ASEAN was also reflected in other more proactive and positive measures it took in response to the new challenges in its environment. For instance, in the face of an uncertain politico-strategic situation with the rise of China and the wavering commitments of US to the security of the region, ASEAN first sought to bring all its dialogue relationships under the ambit of what was to be called the Post-Ministerial Conference which is held immediately after the annual ASEAN Foreign Ministers Meetings. It then went a step further by developing an ambitious multilateral framework for security and political dialogue, the ASEAN Regional Forum (ARF). The creation of ARF was especially significant as it reflected the willingness of ASEAN to assume new functions and responsibilities in order to shape its strategic environment.

Faced with intensified economic competition, ASEAN announced the establishment of an ASEAN Free Trade Area (AFTA) by the year 2005 at the 1992 Summit in Singapore. This, deadline was subsequently brought forward to the year 2000 for certain products and by 2003, 95% of manufactured goods and services had been included in AFTA. Work also commenced on drawing up an ASEAN Investment Area (AIA) to attract more direct investments into the region.

Examining the past 20 years of ASEAN relations with the EU on a bilateral basis, it is worth noting that while promotion of economic cooperation has translated

into increases in the absolute values of trade and investments, it has not altered the relative importance of each region to the other. The challenge then is to imagine new channels and identify new areas for cooperation. In the midst of EU reassessment of its strategy towards Asia, ASEAN was quick to cash in and promote itself as the gateway to the wider Asia-Pacific region and an interlocutor for the wider dialogue between Asians and the Europeans. ASEAN also recognized that future efforts at creating a new dynamic would have to involve European production in Southeast Asia. Hence, ASEAN has been relentless in driving the message that peace and stability in the region and the launch of AFTA and AIA would provide a secure and profitable environment for European direct investments.

On the back of the economic success and growing self-confidence of the ASEAN states, the EU was sold the idea of ASEAN being the linchpin of its wider Asia-Europe relations. ASEAN's attraction as a rapidly growing market of 500 million people (in anticipation of an ASEAN-10) was also in the minds of key European decision-makers when a consensus decision was taken by the EU (especially by the four big powers – UK, Germany, France and Italy) to put aside sensitive political issues and return to a pragmatic course of focusing on economics. This, of course, must be seen together in the context of EU's general shift in policy towards Asia as reflected in the July 1994 EC Communications "Towards a New Asia Strategy" (NAS).

The pragmatic course taken was reflected in the 11th AEMM held in Karlsruhe in September 1994, which revealed that ASEAN has gained the upper hand in determining the topics, style and procedure of the meeting (Ruelend, 1996, p. 31). The meeting was congenial unlike the previous few meetings. East Timor was not raised and human rights issues were only briefly mentioned. Another concrete example of this pragmatic approach was the sidestepping of the issue on a new agreement that was blocked by Portugal. The Ministers resolved to continue and expand their dialogue through other existing channels and also commissioned an ASEAN-EU Eminent Persons Group to develop a comprehensive approach of ASEAN-EU relations towards the year 2000 and beyond. The European Commission's Communications "Towards a New Asia Strategy" also pinpointed ASEAN-EU relations as the cornerstone of the new partnership that Europe would seek in Asia.

However, the recommendations in both the 1996 report by the EEP on "A Strategy for a New Partnership" and also the Communication from the Commission to the Council on "Creating a New Dynamic in EU-ASEAN relations" on revitalizing the ties did not, in the end, result in concrete measures. A series of events, notably the Asian financial crisis, the launch of ASEM, the enlargement of ASEAN to include Cambodia, Laos and Myanmar, and the enlargement of the EU changed the fundamental dynamics and further impacted the state of ASEAN-EU relations. There was a period of stagnation, but from the beginning of the twenty-first century, the changing dynamics within both regions and the wider global context "forced" ASEAN and EU to once again place emphasis on their partnership. Hence, we are now into this fourth phase of rediscovery and are searching for a long term agenda that will bind the two regions more closely together.

B.3 The Changing Dynamics

Much has changed in the global and regional environment in the first few years of the twenty-first century. The two regional organizations themselves have evolved and are confronting a different set of issues and challenges. It is therefore appropriate to re-evaluate the long-standing relationship between ASEAN and EU and to consider the appropriate agenda for cooperation over the longer term.

B.3.1 The Global Environment: Dominance of American Power and Its Repercussions

The 1980s and early 1990s saw American influence on the wane in both Asia and Europe. However, America entered the twenty-first century with a booming economy and regained confidence. This confidence was shaken with the 11 September 2001 terrorist attacks on the World Trade Centre, but the political response was an overwhelming show of American military might.

President George W. Bush has steered the US on a path which has brought serious repercussions for the international community. A conservative, inward-looking nationalism now pervades US policy thinking. While the roots of American foreign policy have always been national, the US has rather successfully realized its foreign policy goals through international institutions that it helped to create and which enjoy a good deal of legitimacy. Since Bush came into power, American unilateralism has become particularly “virulent”.

The events of 9/11 offered the opportunity for hawks in the Bush administration to develop an agenda that privileges security and securitizes globalization to the extent that all broader issues in the global economy are being subjugated to the imperatives of the US security agenda (Higgott, 2005).

The US is the only country capable of projecting military power throughout the globe, and its unipolar dominance in this era has no serious rival. Yet the invasion of Iraq also highlights the limitations of the exercise of such military might and America’s economic vulnerabilities. The war in Iraq has made a fragile fiscal position dramatically worse. For all its military might, the US remains dependent on other countries – especially in East Asia – to continually fund its debt and consumption patterns. The war in Iraq has also accentuated differences not only between but within nations, especially diverse societies with significant Muslim communities.

The need to temper US unilateralism and its disregard for international institutions and norms, as well as the necessity to strengthen a multilateral international system which remains benign to all nations, big and small, and allows for cooperation and diversity at the same time, is all the more urgent. What could the EU and ASEAN inject in their joint agenda for political cooperation to make up for the increasingly uncertain and unstable global order?

B.3.2 EU at a Crossroads

The enlargement of the EU in 2004 from a union of 15 to 25 (and to 27 in 2007) was hailed as an historic moment for Europe. There was much euphoria that peace and stability has been extended to the heart of Europe, and the rhetoric was generally positive. However, such a massive enlargement required a rethinking of how existing institutions and procedures needed to be organized to ensure efficient decision making. The EU therefore embarked on an ambitious project for a new Constitution aimed at streamlining EU institutions and decision-making processes, thereby offering further prospects of enlargement. Unfortunately, the ratification of the Constitution hit a snag when two founding members of the European Community, France and the Netherlands, rejected the Constitution during their respective referenda.

The rejection of the Constitution by the peoples of France and Netherlands was seen as a major setback for the European Union project. There was speculation that the rejection would carry in its wake an end to the further enlargement of the EU and could weaken the EU's stabilizing influence over its immediate neighbours such as the Balkans. Following the rejection of the Constitution, confidence in the euro fell dramatically, slipping by some 10%.

There are many analyses as to why the French and Dutch voted "no" to the Constitution. Many attributed this to the lack of explanations by European leaders on the need for reforms as embodied in the Constitution. The convoluted, impenetrable and incomprehensible nature of the Constitution only reminded the people of what they see as an excessively bureaucratic institution that has become disconnected from its citizens. There is a sense that the EU is moving in a direction in which citizens do not want to go. Domestic politics and social factors, particularly in France, further compound the problems of disenchantment. At the root of the rejection, however, was the feeling that the new Europe does not offer its citizens security, prosperity and a clear identity. The rejection revealed the extent to which the EU has become disconnected from its citizens.

However, Jean-Pierre Lehmann, professor of international political economy at IMD in Lausanne perhaps hit the nail on the head when he pointed out that "the French and the Dutch have voted 'no' not so much against the Constitution, but as a visceral reaction to the perceived malaise induced by globalization" (Lehmann, 2005).

European woes were further compounded with the failure of the first EU summit – which came after the setback in the ratification of the Constitution – to agree on budgetary reforms and a workable budget. The rejection of the Constitution and the collapse of the budget talks in Brussels revealed the growing strength of national sentiments in major member states. Across the continent, countries are turning inwards, and nationalism has been much more persistent than was imagined in Brussels. The EU has also become the convenient scapegoat for nationalistic concerns. EU claims to represent a new form of internationalism is now in tatters.

The double blow of the rejection of the proposed Constitution and the collapse of the EU budget talks in the June 2005 summit could leave the EU in crisis and paralysis.

If the new compromise reform treaty is not ratified (it is by no means a foregone conclusion) EU decision-making could be paralysed for a long time. The process of admitting new members from the Balkan region could be stalled, while imposing discipline on members' spending and inflation levels could become difficult.

What would this mean for Asia and ASEAN? European policies in Asia have always been diverse, and despite rhetoric, Asia is still not judged as central to European interests. The rise of China and India have the EU looking east, but this is confined to these two main rising giants to the detriment of other smaller Asian states and, particularly, to the neglect of Southeast Asia. Europe's internal discord and problems would not make the situation better, though one could be an eternal optimist and turn the logic around to speculate that Europe would look outwards for unity of purpose to paper over its internal disunity. Indeed, one could argue that the European response to the stalemate of the Doha Round (itself a product of internal European disunity) whereby it has refocused on regional agreements based on a narrower, less contentious European agenda, including the proposed new agreement with ASEAN, is precisely a manifestation of this outcome.

B.3.3 ASEAN at a Crossroads

ASEAN as an organization is slowly regaining its confidence after the devastating Asian financial crisis in the late 1990s. ASEAN's minimalist approach to cooperation and preference for informality, rather than institutions and rules, accounts for the difficulties in formulating a collective response to prevent economic and political disruptions in the region. After being called irrelevant because of its seeming inability to respond collectively and effectively to the Asian crisis, ASEAN has made some attempts to salvage its reputation and repudiate the claim that ASEAN is a sunset organization.

Egged on by the lessons drawn from the Asian financial crisis and fuelled by the democratizing process within Southeast Asia itself, ASEAN has embarked on building new regional capacities inspired by the European experience. Calls for more institutionalized processes and mechanisms to govern ASEAN's affairs were prevalent in the immediate aftermath of the Asian financial crisis. Oddly enough, however, the slow transformation of ASEAN from a league of sovereign nations to a more interventionist institution has stopped recently. This seems to have happened as the balance was shifting towards democracy among ASEAN members. ASEAN countries seem to have retreated into the management of their domestic problems and political transitions, and their external agenda is dominated by the shadow of China's influence and the games of bandwagoning or power balancing that this situation requires (Godement, 2005).

The term "integration", frequently invoked in the aftermath of the Asian financial crisis, has recently lost the connotation of institutionalization and regime-building and seems to be increasingly applied to the multitude of initiatives of loose cooperation which ASEAN has been proliferating over the last few years. The principle

of “coalition of the willing” and the acceptance of the ASEAN 2 + x principle is a testimonial to the return of the classic realist approach towards cooperation.

At the same time, tension is building within ASEAN as it faces a potential public relations disaster and problems with external dialogue partners like the US and the EU over Burma. The more democratic states were willing to loosen the non-interference rule to “force” Myanmar to give up its chair in 2006, but strong reservations were expressed by those who hold dear to the principle of non-interference that this would set a bad precedent; ASEAN’s incoherence and disunity in this matter could again fuel talks of its irrelevance.

While there is increasing recognition within and outside ASEAN that the association needs to develop into a more coordinated, integrated community if it wants to remain relevant as a grouping, it is also increasingly clear that the political will to do so is lacking. ASEAN governments remain unwilling to invest in regional mechanisms and institutions with any supranational powers and are determined to hold on dearly to the final say over any ASEAN policies and their implementation.

After a short phase of enthusiasm about the reform of ASEAN structures and building norms and institutions, rules and procedures that would enhance regional integration, ASEAN seems to be back on the old “ASEAN way”, with its traditional emphasis on nation-cantered and decentralist structures highlighting non-interference as well as decision-making based on consensus and lowest common denominators. What does this signify for regional and inter-regional cooperation? Can a “loose” ASEAN remain in the driving seat or will ASEAN fade into the background as the ASEAN + 3 process gathers pace and transforms into the East Asian community building project? ASEAN is at another crossroads, after to fully re-invent itself after the Asian financial crisis.

B.3.4 Political Cooperation: Searching for a Long-Term Agenda

The changing global and regional dynamics, in addition to problems within the two regional organizations themselves, will no doubt impact the search for a long-term agenda in inter-regional cooperation. The political agenda for both ASEAN and EU will be driven by both regional and international concerns.

The ASEAN–EC Joint Cooperation Committee (JCC) held in February of 2005 and the 15th ASEAN–EU Ministerial Meeting that followed shortly thereafter reaffirmed the commitment of both sides to strengthening and enhancing ASEAN–EU cooperation through a more comprehensive and balanced agenda. Trade and investments remain the key priorities seen particularly from the ASEAN perspective. (15th Asean-EC JCC, Press Release).

For example, the Trans-regional EU–ASEAN Trade Initiative (TREATI) was launched in 2003 in reaction to the establishment of the three-pillar ASEAN Community by 2020. This would allow the EU and any two ASEAN members to engage in a project which can be implemented according to an agreed-upon road

map while remaining open to all ASEAN partners. At the September 2004 meeting in Jakarta between ASEAN Economic ministers and Commissioner Pascal Lamy, agreement was reached to relate TREATI activities more closely and directly to the sectoral initiatives prioritized by ASEAN in building its Economic Community through accelerated integration in the vital sectors of automotive, electronics, textiles and clothing, agrifood and fisheries. Consequently, the EU–ASEAN cooperation will concentrate on sanitary and phytosanitary standards in agrifood and fisheries, technical standards for electronics and wood-based industries. These sectoral activities will be complemented by cross-sectoral cooperation on trade facilitation and investment, which are of particular importance to the business communities in Asia and Europe.

The same EU plus ASEAN2+X principle is applied to non-trade dialogue and cooperation through the Regional EC–ASEAN Dialogue Instrument (READI). During the 15th ASEAN-EU Ministerial Meeting in March 2005, an Informal Coordinating Mechanism task force was asked to finalize the implementation modalities and mechanisms and to discuss and agree upon possible areas for dialogue. TREATI and READI are EU responses to the lessons learned with regard to EC–ASEAN cooperation. It was spelled out and elaborated on in the European Commission's 2003 Communications on "A new partnership with Southeast Asia" that "most EU development assistance shall be implemented through bilateral channels. Regional approaches will, however, be chosen when economies of scale are evident, where the development of country-neutral toolboxes makes sense or in support of dialogue conducted at regional level..."

While recognizing the realities of lack of integration and finding a way forward in ASEAN–EU relations through initiatives such as TREATI and READI, the EU also remained committed to supporting ASEAN integration as a basis for stability and prosperity in Southeast Asia. The ASEAN–EC Project on Regional Integration Support (APRIS) is a framework programme to assist ASEAN member countries in regional integration. It aims at drawing lessons from the experience of the EC in forging regional economic integration, contributing to improving ASEAN mechanisms and communications systems and supporting capacity building activities for the ASEAN Secretariat and ASEAN member states. More importantly, it is hoped that through APRIS and also through the EU's participation in Initiatives for ASEAN Integration (IAI), development gaps between ASEAN members can be closed, which would in turn facilitate the further economic integration of ASEAN.

In short, one can identify three major instruments with regards to EU's cooperation with ASEAN – APRIS in support of ASEAN integration and region-to-region dialogue, TREATI for trade-related dialogues among members who are ready, and READI for dialogue areas such as transport, justice/home affairs and the environment.

The EU, however, which raised its foreign and security ambitions a decade ago with the CFSP and the appointment of Javier Solana as Mr. CFSP, still has not developed its full potential as a global player. EU foreign and security policy attentions remain focused on its immediate neighbourhood and near-abroad. Southeast Asia as a region continues to be neglected in EU strategic considerations. Using inter-regional

(EU–ASEAN) and trans-regional (ASEM) dialogues may have served well in building symbolic and diplomatic ties, but this has not translated into a coherent strategy for long term cooperation. In some cases, dialogues become prisoners of their own rules. For example, it is frustrating that the Myanmar issue – as important as it is – can be allowed to derail EU cooperation with ASEAN and the ARF. With little progress in sight for reforms the “Myanmar problem” is again likely to dominate EU–ASEAN relations for some time.

How can EU and ASEAN look beyond such immediate problems to focus on the long-term cooperation agenda? Is it realistic to expect any new initiatives and ideas from the EU at this juncture, when the latter is mired in crisis over the rejection of the draft constitution, the collapse of the budget talks and the uncertain ratification of the compromise reform treaty? Will the lack of solidarity within ASEAN with regards to the Myanmar issue and the lack of political will for institutional reforms become obstacles in the search for a common agenda? How can one realistically move forward in such a climate?

TREATI and READI are two distinct instruments that should be effectively used to hold ASEAN–EU relations on track. More importantly, however, the practical way forward is to allow relations to be project-driven rather than meeting-driven. Beyond dialogue, there must be some concrete deliverables: information sharing and capacity building to help fight terrorism; programmes for human resource development – whether in skills training, business education or in general higher education; environmental programmes for Southeast Asia aimed at providing sustainable development; and poverty alleviation programmes to help ASEAN countries achieve its Millennium Development Goals.

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Chapter C

The Trade and Aid Policy of the European Union: A Historical Perspective

Andrew J. Crozier

While in recent years the origins of the European Union have been shown to be multifaceted and not simply a matter of collaboration with the purpose of avoiding war, what cannot be gainsaid is that economic priorities and the need to facilitate and liberalize trade have lain very much at the heart of the European project from the first. This was not merely a post-war phenomenon, for during the latter half of the 1930s the governments of Britain, France and the United States did exhibit an inclination to collaborate in facilitating and liberalizing trade in the confident expectation that the principal dividend would be peace. As Cordell Hull, the American Secretary of State, put it: ‘unhampered trade dovetailed with peace. High tariffs, trade barriers and unfair economic competition with war’ (Carr, 1985, p. 11). Within the 1930s Roosevelt administration Hull was not a lone voice. Henry Morgenthau, the Secretary of the Treasury, emphatically endorsed his views. He believed that the Three Power Currency Declaration of September 1936, which aimed at promoting stability between the dollar, sterling and the franc, would aid the liberalization of trade. For Morgenthau, it was possibly ‘the greatest move taken for peace in the world since the World War’ and might ‘be the turning point for again resuming rational thinking in Europe’ (Blum, 1959, p. 171).

For their part, the British and French governments endeavoured to build upon the Three Power Currency Declaration by appointing Paul van Zeeland, the Belgian banker and politician, to conduct an enquiry into the possibilities of dismantling the economic nationalism of the European dictatorships. The Van Zeeland Report when it was published on 26 January 1938 stated that the autarchic economic policies pursued in the wake of the depression could do nothing other than lower the standard of living for all. It was confidently asserted that only the fostering of international trade could ensure prosperity within national frontiers. It would be otiose here to go into further detail. Suffice it to say that the thrust of the Van Zeeland report was in the direction of freer or free trade by the elimination of tariffs and quotas and the encouragement of bilateral trading treaties containing the most-favoured-nation clause.

The year 1938 was in retrospect a bad one for launching a scheme of this type and despite the best efforts of Neville Chamberlain it came to nothing. In the event it was to have a resonance for the future rather than the present and was to serve as a precursor of the kind of economic collaboration established after 1945. Interestingly,

in the late 1940s Van Zeeland was to emerge as an emphatic supporter of European integration and unity and, of course, economic recovery and the expansion of trade through the elimination of restrictions were central to the integration dialogue during this period.

From a practical point of view the post-war integration process might be said to have begun with the Marshall Plan, which was given effect by the United States Economic Cooperation Act of 1948. This was very explicit about the economic agenda in post-war Europe. The Act stated:

Mindful of the advantages which the United States has enjoyed through the existence of a large domestic market with no internal trade barriers, and believing that similar advantages can accrue to the countries of Europe, it is declared to be the policy of the United States to encourage these countries through a joint organization to exert substantial common efforts...which will speedily achieve that economic cooperation in Europe which is essential for lasting peace and prosperity. (Weigall & Stirk, 1992, p. 45)

Significantly, when the Benelux Customs Union came into force in January 1948 all tariffs between the participants were abolished and replaced by a common external tariff. Furthermore, at the end of 1949 the Organization for European Economic Cooperation (OEEC), the organization created by the Marshall Plan to oversee the distribution of funds, agreed upon the removal of quotas directed against each other on 50% of their private trade (imports on government accounts were exempted), although under American pressure, through the Economic Cooperation Agency, the target was eventually raised to 75%. In a very real sense, therefore, trade liberalization was an issue of cardinal importance in the process of European integration from the beginning.

The modern European Union has a history that involves the Briand Plan, the Marshall Plan and the European Coal and Steel Community; arguably, its roots reach back beyond the inter-war period and into the nineteenth century. For the purposes of this chapter, however, the *terminus a quo* of the European Union will be taken as the Treaty of Rome, 1957, which created the European Economic Community. In June 1955 the ministers of the European Coal and Steel Community (ECSC) foregathered at Messina in Sicily to discuss the replacement of Jean Monnet as President of the ECSC High Authority. In the event, however, other items were on the agenda that were to have a much more far-reaching impact. By 1955 the Dutch government was agitated by the adverse effect upon the Dutch economy of trade barriers, prompting the Dutch foreign minister, Jan Willen Beyen, to resurrect a scheme for an industrial community that had originally been devised within the context of the abortive European Defence and Political Communities. In conjunction with his Belgian opposite number, Paul-Henri Spaak, he, therefore, submitted in May 1955 the so-called Benelux Memorandum that, among other things, advocated the creation of a regional organization of the ECSC Six that would have the necessary authority to create a common market that, in addition to promoting free trade within the customs union of the Six, would also have the collective leverage to hasten negotiations within the General Agreement on Tariffs and Trade (GATT) for lower tariff barriers generally. The truth was that the Dutch and other members of the Low Tariff Club had become frustrated by the limited progress towards tariff

reduction within the GATT and the poor progress of the OEEC's Trade Liberalizing Program. The Dutch economy in particular was very dependent upon international trade and this explains why Beyen wanted action of the kind he was proposing.

The Messina Conference led through intergovernmental conferences and the Venice Meeting of foreign ministers in May 1956 to the Treaties of Rome of 25 March 1957 which set up the European Atomic Community and the European Common Market. The latter was to emerge thereafter as the driving force of European integration in a political as well as economic sense. It would, however, be wrong to claim that there was an unimpeded linear progression between Messina and the Treaties of Rome. Within Germany the economics minister, Ludwig Erhard, favoured a multilateral approach to the liberalization of trade and deprecated the creation of a putative customs union. On the other hand, Walter Hallstein, the state secretary in the German foreign ministry favoured a customs union of the Six because he believed that in addition to acting as a force for the liberalization of trade, Germany would derive the political benefits of deeper European integration. Within France the advocates of free trade were in a minority. And yet what the ECSC Six agreed to create in March 1957 was a customs union that as far as possible in matters economic would present to the outside world a united front. Articles 2 and 3 of the EEC Treaty of Rome stated:

Article 2

It shall be the aim of the Community, by establishing a Common Market and progressively approximating the economic policies of member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increased stability, an accelerated raising of the standard of living and closer relations between its Member States.

Article 3

For the purposes set out in the preceding Article, the activities of the Community shall include, under the conditions and with the timing provided for in this Treaty:

1. the elimination, as between Member States, of customs duties and of quantitative restrictions in regard to the importation and exportation of goods, as well as of all other measures with equivalent effect;
2. the establishment of a common customs tariff and a common commercial policy towards third countries (Weigall & Stirk, 1992, p. 105).

Clearly, there was every intention of creating as far as possible free trade within the customs union, but what of its common front towards the outside world?

C.1 The Trade Policy of the European Union

The Common Commercial Policy (CCP) of the EEC was enshrined in Articles 110–116 of the original Treaty of Rome (TR) and subsequently in Articles 131–135 of the Treaty Establishing the European Community (TEC), the original Articles

111, 114 and 116 being repealed. Article 110/131 is quite explicit about the main thrust of the commercial policy of the EEC, as it then was, and the European Union as it is today. Namely, the Common Commercial Policy is 'to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade, and the lowering of customs barriers' (Dinan, 1999, p. 484). The EEC was, therefore, not conceived as an autarchic economic entity and since 1957–1958 has elaborated numerous relationships with virtually every country in the world. These relationships are variously multilateral, interregional and bilateral.

The body that is responsible for the EU's external trading relations is the Commission and it is given authority for this by Article 113 of the TR and 133 of the TEU. The Commission, however, must act under the direction the Council of Ministers. Article 113 also provides for the constitution of a committee, known as the '113 Committee', which exists for the purpose of assisting the Commission in the conduct of negotiations authorized by Council directives. Article 300 of the TEC similarly empowers the Commission to negotiate international agreements subject to the surveillance of the Council of Ministers. Inevitably these arrangements have produced tensions in the relationship between the Council and the Commission. The 113 Committee, of course, is in one sense a source of strength, for third parties will know that a position struck by the Commission has the support of the Council of Ministers. In practice the Commission has frequently exceeded its instructions, especially when the negotiations are politically and economically of the greatest importance.

Another problem for the Commission is the interpretation of Article 113 by member states who have disputed the competence of the Commission as trade has assumed a higher profile in national GDP statistics. Moreover, the growing complexities of the international economy and the resourcefulness of governments in constructing non-tariff impedimenta to trade, such as imposition of standards, conformity testing, certification and product approval, have also provided a source of disputes. Furthermore, trade in services has assumed a much higher profile. While the Commission's position has generally been to argue that such developments come within its competence, the attitude of member states has been much less accommodating. The problems that the member states' zealous pursuit of their rights create can be seen in the fact that in the World Trade Organization's committee on trade in goods the EU is represented by the Commission, but in the committee on trade in services and intellectual property the EU is represented by both the Commission and the member states (Dinan, 1999, p. 486).

Nevertheless, these complexities do not stop third powers concluding agreements with the EU, nor do they limit the EU's position as a formidable world trading entity. In 1992 the EU accounted for 40% of world exports, including intraregional trade. In essence, it is an economic superpower, outstripping both the United States and Japan (Gibb, 1999, p. 45). Excluding trade between member states, the EU's share of world merchandise exports in 1993 was 20%, in comparison with 16% for the USA and 12% for Japan. Within the commercial services market the dominance is even more emphatic. In 1992 the EU, including intra-EU trade, accounted for 43% of all world exports of commercial services, as against 16% for the USA and 5% for Japan. Nevertheless, these figures are only valid in relation to Europe as 'an effectively

functioning and integrated market' and it has to be recognized that Europe has not been a complete whole in this respect. Arguably, the consequence of this is that Europe has performed less well than her major comparators in terms of GDP. Thus in 1993 the GDP per head of population measured in terms of purchasing power standards in 1993 was 30% and 15% higher in the USA and Japan respectively than it was in Europe. On the other hand, however, in 1994 the EU with 378 million inhabitants was as big a market as the USA and Japan combined. Moreover, its combined GDP of 5905 billion ecu exceeded that of the USA with 5346 ecu and that of Japan with 3601 ecu (Gibb, 1999, pp. 48–49).

It is, nevertheless, perhaps also prudent to consider the position of the EU in relation to other regional trading blocs, such as NAFTA and ASEAN +, that is to say ASEAN plus Hong Kong, Japan, South Korea and Taiwan. In 1991 intra-regional trade within these three blocs accounted for 38% of the world's merchandize imports and exports and inter-regional trade between these three blocs accounted for 10% of the world's merchandize exports and 19% of imports. The significance of these statistics is that they illustrate the dominant part played by regionalism in the world economy, given that 67% of world trade involves these three blocs. Moreover, among these three groupings intra-regional trade is most pronounced within the EU. Within the EU states intra-regional trade grew from 35% of all EU merchandize imports and exports in 1957 to 59% in 1991. In addition, by 1991, whereas some 69% of NAFTA exports were destined for the EU and ASEAN + and some 66% of ASEAN + exports were destined for the EU and NAFTA, only 34% of EU exports were destined for NAFTA and ASEAN +. Nevertheless, the position of the EU is rather more complex than these statistics would suggest. First, the largest members within the EU, such as Germany, Britain, France and Italy, and particularly the first three, send ~50% of their exports to destinations outside the EU, while intra-regional trade is more important for the smaller states. Secondly, the period when intra-regional trade within the EU expanded fastest was from 1957 until 1973 when the EU was limited to the original six. Since that time until 1991, when the EU had increased to twelve member states, intra-regional trade increased by 10% (Gibb, 1999, pp. 50–52).

Nevertheless, however it is construed, the EU is an economic superpower, its individual members collectively forming the largest single element in the world economy, followed by the USA in second place. Moreover, while intra-regional trade within the EU is greater than its exports to the world economy outside, its trading profile, particularly when the trading patterns of its largest members are considered, is global in nature. Nevertheless, during the 1980s when the European Community, as it then was, embarked upon a program that aimed to create a Single European Market (SEM) in 1992, alarm bells rang in the wider world over the prospect of a protectionist Europe, or as it was described 'fortress Europe'. The states and groupings most agitated by this development were the United States, Japan and EFTA. To these players the SEM seemed to herald a hermetically sealed Europe that would make access for their exports ever more difficult through a reinforcement of the CCP. The issues that concerned Europe's trading partners most were the following: reciprocity, standards and rules of origin. For the European

Community the issue of reciprocity was to be central regarding the development of its external trade policy. This was something that particularly exercised the United States government. For Washington the issue of reciprocity conflicted with the basis of the multilateral trading system, based upon the 'most favoured nation' principle, which was the foundation of the agreements concluded within the GATT, or, as it is known today, the World Trade Organization (WTO). The incorporation of the 'most favoured nation' clause into trade agreements inhibited discrimination by ensuring that concessions, conceded by a member state of GATT, were automatically applied to all contracting parties. Nevertheless, the European Commission in 1988, while insisting upon reciprocity, was at pains to convince critics of the European Community's free trading credentials. For example, the external trade commissioner, Willey de Clercq, stated:

...the benefits of our internal liberalization should not be extended unilaterally to third countries. We shall be ready and willing to negotiate reciprocal concessions with third countries, preferably in a multilateral context, but also bilaterally. We want to open our borders, but on the basis of a mutual balance of advantages in the spirit of the GATT. (Gibb, 1999, p. 54)

Moreover, a statement issued by the Commission in December 1988 argued that the single market program would be advantageous to EC and non-EC members alike. It was held that the single market would encourage and sustain continued economic growth and that the EC would 'not close in on itself'. Rather: '1992 Europe will be a partner and not a fortress Europe' (Dinan, 1999, p. 487).

This commitment to 'partnership' was in the early 1990s tested in the Uruguay Round of the GATT. It could be argued that the position adopted by EU countries in these negotiations damaged the free trading credentials of the EU in the eyes of world opinion. This was certainly true in the field of agricultural protectionism where the posture adopted by the EU countries almost brought the Uruguay Round to collapse. On the other hand, the EU has been credited by some commentators with having played an influential role in bringing the Uruguay Round negotiations to a successful conclusion and thus preserved its reputation as an agent of free trading. According to the writers T. Bainbridge and A. Teasdale:

In spite of substantial national and political differences between Member States in trade policy, the Union has, on the whole, achieved a high degree of coherence and consistency in trade matters....The Union has also largely succeeded in dispelling the fears of a Fortress Europe promoted by the single market program, in spite of the recession still affecting the economies of many Member States. (Bainbridge & Teasdale, 1996, pp. 54–55)

Since the 1940s GATT reduced tariff barriers on manufactured goods from 40% to 6% in the early 1990s. By the time the Uruguay Round was concluded on 15 December 1993, it had been agreed that there should be a cut on EU–USA tariffs of some 50% and a cut on world trade tariffs of 40%. This meant in effect that average tariff barriers among developed countries following the Uruguay Agreement were of the order of 3–4%.

Moreover, the position was much improved in respect of non-tariff barriers, which had proliferated during the 1970s and 1980s as countries endeavoured to

avoid the demands of the GATT rules. Following the Uruguay Round it can be said that the EU now allowed overseas companies access to a genuinely integrated European market of 378 million people without the cost penalties of nationally favourable non-tariff barriers which improved the export possibilities of third countries. The reality was that member states of the EU were now unable to impose on imported goods from third countries non-tariff barriers, which meant that goods could move from one part of the EU to another with ever-increasing facility. This gave rise to fears that in the long term the major beneficiaries of the single market would be American and Japanese multinationals.

In the wake of the Uruguay Round it might be argued that the notion of a fortified and protectionist Europe was overblown and that in many respects its practices were no better and no worse than those of the United States and Japan. Nevertheless, it is clear that the EU remained firmly protectionist in respect of agriculture. Having said that, it should not be imagined that the records of the United States and Japan in this sphere are unblemished. In 1990 these two latter states subsidized their agricultural sectors by US \$76 and 59 billion respectively. On the other hand, the EU did so to the extent of US \$134 billion (Gibb, 1999, p. 58). Clearly, the EU was susceptible to substantial criticism. As has already been noted, this was an issue that almost brought the Uruguay Round to collapse, for the demands of the USA and the so-called 'Cairns Group' of agricultural exporters – Australia, New Zealand, Canada and Argentina – met firm resistance from France, Ireland, Denmark and the Netherlands within the EU. Ultimately the Blair House compromise produced an agreement on agriculture which stipulated that there should be no future export subsidies, that non-tariff barriers should be converted into tariffs and that there should be an overall reduction of 36% in domestic tariff barriers during a period of 6 years. Nevertheless, it is worth noting that the EU was the single biggest importer of agricultural produce.

On 1 January 1995 the World Trade Organization (WTO) came into being as the successor to the GATT. This was a development some 50 years delayed as the US government had never intended the GATT to be anything other than a stopgap measure. The WTO is a much more influential organization than the GATT system ever was, for it incorporates regular ministerial meetings and in addition to subsuming the functions of GATT also embraces the General Agreement on Trade in Services (GATS) and Trade-Related Aspects of Intellectual Property Rights (TRIPs), which were both negotiated during the Uruguay Round. Along with the USA the EU is one of the two major actors in the WTO, although the EU as such is not a contracting party to the WTO as indeed it was not to the GATT. The EU is represented by virtue of the fact that the member states of the EU are obliged by treaty to act as one in the arena of international trade. During the later 1990s the EU's involvement in the WTO consisted of fulfilling the commitments undertaken in the Uruguay Round, usage of the Disputes Settlement Body in pursuit of its perceived rights and, finally, continuing efforts to promote the liberalization of trade particularly in the areas of telecommunications, information technology and foreign direct investment.

Today the EU continues to be a major advocate of freer and free trade. The Mission Statement of the Commission's DG Trade states that its task is to conduct

the EC's commercial policy in accordance with the objectives set out in Article 133 of the EC treaty, namely: 'to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers'. The current external trade commissioner, Peter Mandelson, is an emphatic supporter of such a course, arguing the case that open markets are at the heart of modern progressive politics. In a speech to the Council for Foreign Relations in New York on 28 June 2005, he stated:

My contention is we are at risk of seeing an unhealthy isolationism gathering force in Europe and America, driven by a misguided critique of globalization. It is not exactly the kind of critique one might hear from the 'green' movement or the more thoughtful elements that backed the demonstrations in Seattle five years ago.

It is a more basic, economic street level gut reaction which says 'foreign goods and foreign competition are threatening my job and what are you going to do about it?'

The new Asian competition is stoking public fears – doubly terrifying because it combines low wages and costs we simply can't compete with, together with mounting skills, research and other capabilities which, eventually, we may fail to match.

So the age old fear of job loss on both sides of the Atlantic is now compounded by the fear that as a result of this unprecedented wave of competition, old jobs will not be replaced by new ones.

For Mandelson the answer to such anxieties was not protection. On the contrary, there was every indication that a 'fresh case' should be made for 'an open trading system'. He continued:

For liberalizing trade, and making the case for open markets, we have substantial past achievements to build on. By working together in the GATT, Europe and America steadily knocked chunks off the walls of protectionism between the more developed countries – and as a result helped deliver a large part of the prosperity we have enjoyed in the past half century.

The establishment of the World Trade Organization was a culmination of decades of progress towards more open trade, with the establishment of a multilateral system of rules based order, including a unique international arbitration system for settling trade disputes. These achievements are remarkable. They must be nurtured.

Public opinion is constantly told that globalization is inevitable, which was fine when we were the principal beneficiaries of its power. Now that globalization is dramatically serving the needs of more economies than our own, public opinion is restless and has to be more carefully addressed. We have to demonstrate that globalization, if properly harnessed, can deliver benefits and opportunities for all and that sheltering our economies from growing foreign competition will be self-defeating.

According to Mandelson, this was all the more essential because the expansion of the EU to 25 states had intensified the pressures of globalization in Europe with the consequent 'public backlash' witnessed in the recent referenda on the constitutional treaty. (http://europa.eu.int/comm/commission_barroso/mandelson/speeches)

Clearly, in 2005 as in 1955 at the time of the Messina Conference free trade, or freer trade, remains central to the aims of the EU.

Not only is free trade seen as desirable in promoting prosperity among member states of the EU, it is also regarded as an essential element in the advancement of the

economies of the least developed economies. A European Commission White Paper of 23 May 2005 clearly demonstrated that the EU takes some pride in the market access it permits to developing economies. In general it showed that 40% the EU's imports, amounting to 362 billion Euros worth of trade, come from developing countries and that 79% of these imports enter the EU duty free or at reduced rates of duty. Furthermore, in 2003 only 3% of African, Caribbean and Pacific countries' exports paid full duty on exports to the EU, the remaining 97% entering at zero duty or reduced rates of duty, making the EU the most open regime in respect of these regions. In the same year the EU absorbed 63% of the total exports of the 50 poorest nations to the EU, USA, Japan and Canada. Under the EU Generalized System of Preferences the share of developing countries in total imports into the EU rose between 1999 and 2003 from 33% to 40%. Finally, the White Paper illustrated that the EU is the main importer of agricultural products from developing countries absorbing more than the USA, Japan and Canada together. (http://europa.eu.int/comm/trade/issues/global/development/sum23505_en.htm).

C.2 The Aid Policy of the European Union

Despite the current fashion for trade rather than aid, 'trade-and-aid' has always been the *leitmotiv* of the EU's development policy in respect of less advanced economies and was enshrined in the Lomé Convention of 1975. This convention owed its origins to provisions in the Treaty of Rome (Articles 131–136, Part IV, Treaty of Rome), which permitted extra-European countries, and territories that had a 'special relationship' with a Common Market state, to acquire associated status. What this really referred to were the French-African colonies (Grilli, 1993, p. 7). The essential elements of the association scheme and the development cooperation it promised were 'free trade in both directions and economic aid' (Grilli, 1993, p. 11). The subsequent rapid decolonization, however, meant that new instruments had to be negotiated, for 'association with the Community had changed from being involuntary and unilaterally granted, to being voluntary and negotiated' (Grilli, 1993, p. 19). The Yaoundé Convention of 1963 and Yaoundé II of 1969 recognized the new situation by making the trade regime between the European Community and the former colonies multilateral, while maintaining intact the aid system that had been established by the Treaty of Rome (Grilli, 1993, p. 20).

The need to revise this arrangement in the early 1970s was stimulated by two things. First, the success of the Organization of Petroleum Exporting Countries (OPEC) in mastering control of the world oil market and the fears that this aroused of 'commodity power', given that the European economy was highly dependent on imported oil and non-oil raw materials. Secondly, the accession of Britain to the European Community in 1973 meant that the problem of the Commonwealth countries had to be addressed. Suddenly they, and particularly the African ex-colonies, appeared to be attractive partners in what appeared to be uncertain circumstances. Arguably the notion of EurAfrica promised 'secure supplies of raw materials in

uncertain times (Grilli, 1993, p. 26). Negotiations began in July 1973 and were concluded in February 1975 when the EC countries and the so-called ACP states (the former French and British colonial territories located in Africa, the Caribbean and the Pacific) signed a new Convention at Lomé, the capital of Togo.

The Lomé Convention promised to embrace sustainable economic and social development in the world's poorest states, the gradual and comfortable integration of these economies into the global economy generally, the mitigation of global poverty, the promotion and establishment of democracy, the advance of the rule of law and the promotion of respect for human rights. It was a 'mixed' agreement in that member states were also signatories to the Convention in their own right. While the Convention required EC states to coordinate their development policies with that of the EC, the fact of the matter was that in practice individual member states were unwilling to surrender their prerogatives in this area. By the 1990s some EU states were contributing more in aid than the EU itself and the EU's development assistance as a whole was less than 20% of member states total commitment in this sphere.

At the heart of the EC-ACP relationship in the Lomé Convention was a desire to stimulate economic co-operation reflected in aid flows and non-reciprocal trade benefits. The Convention comprised a development assistance program; a system of generalized preferences in trade, which meant that almost all produce from ACP countries was accorded free access to the EC, while the ACP had only to accord most-favoured-nation status to EC states; and the system for the Stabilization of Export Earnings from Products (STABEX), which guaranteed ACP export prices despite fluctuations in the world commodity markets (Matthews, 1985, p. 74). The Lomé Convention was renegotiated quinquennially until 1995 hence the designations Lomé I, Lomé II, etc.

The achievements of the Lomé Convention have been mixed and the relationship between the EU and the ACP has been at times difficult. In essence it has been a master-servant relationship. Moreover, the SEM, the posture struck by the EU during the Uruguay Round of the GATT and the implications for the EU of the collapse of Communism in Eastern Europe all seemed to suggest that Europe was turning in on itself and abandoning the wider world. From the point of view of the EU it was clear by the 1990s that the Lomé Convention had not succeeded in modernizing the economies and structures of the ACP states. Thus with the ending of the Communist threat in the world generally the EU countries now began to make commitments to democracy and ending corruption in government essential conditions in the award of aid to developing nations.

The original Lomé Convention stated that one of its aims was 'to promote and expedite the economic, cultural and social development of the ACP states and to consolidate and diversify their relations in a spirit of solidarity and mutual interest', but progress by 1995 was rather limited. By the early 1980s the EU was the ACP states' principal trading partner with the EU in 1981 accounting for 39% of ACP exports and 46% of ACP imports. For their part, however, the perception of the ACP countries was that the EU was ungenerous. While ACP countries had duty-free access to the EU, they did not have it for agricultural produce covered by the CAP (Common Agricultural Policy), although there was some access for beef, veal, bananas and sugar subject to

strict quota limits (Matthews, 1985, p. 74). This represented and continues to represent a real disadvantage. Moreover, although the ACP countries were granted substantial and wide-ranging preferences, these countries export performance in respect of the EU had gone into reverse by the 1990s. In 1976 6.7% of the EU's total imports, excluding intra-regional trade, originated from ACP countries, but by 1992 this figure had fallen to 3.7%. There were of course many factors at work here, but one was surely the success of the GATT/WTO process. With tariff barriers between industrialized countries averaging out at 3–4%, Third World producers, even with duty-free access, were still at a comparative disadvantage (Gibb, 1999, p. 59).

Clearly, by the 1990s the Lomé system was stagnating. According to some commentators the principal reason for this lay simply in the fact that changes in the world economic system meant that the ACP states were no longer as important to the EU as they had been. The commodity power of the developing countries had vanished. Subsequently, the renegotiation of the Convention in Lomé IV of 1990 signified 'the beginning of a substantial movement in EC-ACP relations away from any pretense of partnership and towards a more traditional (and thus inherently unequal) North–South relationship in both trade and aid – a relationship strictly conditioned by the priorities, ideology and economics of the North' (Grilli, 1993, p. 43).

In 2000 the Lomé Convention was succeeded by the ACP-EU Cotonou Agreement. This is a comprehensive trade and aid agreement between 77 ACP countries and the EU. For the period 2000–2005 ~15.2 billion Euros have been allocated through the European Development Fund for disbursement throughout the ACP group. With regard to economic and trade co-operation, the regime of non-reciprocal tariff/trade preferences under the Lomé Convention has been amended in order to comply with the rules of the World Trade Organization and it is envisaged that a set of reciprocal regional economic partnership arrangements will be established from 2008. Despite this change, the EU is examining measures that will maintain the competitive position of ACP countries in the EU market. The least developed countries are entitled to maintain non-reciprocal preferences and ACP countries will be invited to sign as groups or individually, building on their own regional integration schemes. The objectives of the new trade provisions are thus to promote the smooth but gradual integration of ACP economies into the world economy.

The fundamental purpose of the Cotonou Agreement is to reduce poverty. To achieve this it provides financial and technical support for economic development, regional co-operation and social and human development. An integrated approach to poverty reduction strategies has been adopted in order to ensure that there is complementarity and inter-linkages between the economic, social, cultural, gender, institutional and environmental dimensions of policies. The whole is underpinned by a set of fundamental principles. First, it is recognized that the ACP countries should themselves determine how their economies and societies should develop. Secondly, actors other than central governments are acceptable as participants. These actors embrace civil society, the private sector and local government. Thirdly, there is to be mutual dialogue beyond the simple transfer of assistance. Both the EU and ACP now assume mutual obligations covering essential elements such as respect for human rights, democratic principles and the rule of law and the fundamental element

of the recognition of the need for good governance (elimination of corruption). The violation of any essential element may provide grounds for the suspension of EU assistance and trade co-operation with the state concerned (THE ACP–EU COTONOU PARTNERSHIP AGREEMENT <http://www.saferworld.org.uk>).

C.3 Trade and Aid in EU–ASEAN Relations

The trade and aid relationship between the EU and the ACP countries is not unique. The EU has forged relationships of this kind throughout the world. The relationship with the Association of Southeast Asian Nations (ASEAN) is, however, perhaps most interesting because it is surprising that it has not developed more than it has. ASEAN came into existence in 1967. Among the rationales for ASEAN's existence was the perception that collectively the member nations could achieve more in respect of developed countries with regard to stabilizing exports and ensuring uniform prices. Nevertheless, ASEAN did not really begin to develop until the Bali meeting of Economic Ministers in March 1976, which outlined a program of common approaches to international problems. But even before this event ASEAN had already begun to court the EU.

A primary motivation for this seems to have stemmed from fears of Japanese economic domination. By the late 1960s Japan had huge trade surpluses with both Thailand and Indonesia coupled with massive investments in all ASEAN states. This gave rise to a broad anti-Japanese campaign throughout the region. The governments of the ASEAN states responded by starting to explore options that might reduce their economic dependence on Japan. In this way the EU came into focus as a potential partner. In November 1971 ASEAN representatives began to consider the possibility of closer relations and in February 1972 the European Commissioner, Ralf Dahrendorf, visited the region to examine the prospects for European investment. During 1975 a special coordination committee of ASEAN was also formed with the purpose of creating new economic links with the EU. This committee would meet alternately in the EU and ASEAN and its remit was to consider all facets of economic cooperation between the two groupings. This was followed by the creation in 1975 of an ASEAN–EU joint study group charged with fostering talks on economic cooperation and trade. By 1978 a conference on ministerial cooperation was held in Brussels, with representatives from both sides, although it was not very productive. Nevertheless, there was an exchange of views on issues such as capital transfer and technical assistance (Kesavan, 1981, p. 257).

The interest in the EU–ASEAN relationship was not, however, all one way. There were also imperatives working on the EU leadership for the development of the EU–ASEAN relationship. First the entry of the United Kingdom into the EU made it essential to provide alternative arrangements for states such as Malaysia and Singapore that had lost Commonwealth preferences. Secondly, the American evacuation from Indochina following their failure in the Vietnam War left the ASEAN states suddenly vulnerable to external threats from the new potential regional hegemonic power, North Vietnam. The EU wished, therefore, to compensate for this

by supporting the region. Finally, some EU countries did have commercial interest in the region. This was particularly true of the United Kingdom and the Netherlands, both of whom had strong investment interests in ASEAN countries (Grilli, 1993, pp. 283–284).

The conference on ministerial cooperation was followed in November 1978 and February 1979 by the first and second ASEAN–EU ministerial conferences. The nine EU ministers who attended the first conference considered ASEAN to be an agent for economic and political stability in the region and thought that it should be afforded as much economic assistance as possible. They were also of a mind that EU investment in industry in the region should be stimulated. Not surprisingly the theme of the second conference was industrial development in ASEAN (Kesavan, 1981, p. 257). By 1980 the EU had extended to ASEAN its Generalized System of Preferences (GSP). This allowed ASEAN's finished, semi-finished, and agricultural products to enter the EU markets at lower tariffs. The ASEAN perception, however, was that the GSP did not go far enough and there were demands for more concessions. In the view of one contemporary, it was unlikely that ASEAN would ever enjoy the privileges of the Lomé Convention (Kesavan, 1981, p. 259).

This is clear if the EU–ASEAN Economic and Commercial Cooperation Agreement of 1980 is considered. It did not, in fact, establish a firm framework for the development of trade and economic collaboration. There were few 'solid reciprocal obligations concerning trade'. Moreover, the 'basic (preferential) export regime unilaterally extended by the EC in 1971 to non-associated, developing countries, including those in ASEAN, was not altered in any way by the 1980 Cooperation Agreement'. In terms of technical cooperation collaboration between firms was envisaged. In respect of development cooperation there was a fundamental reliance on current EU aid programs for non-associated developing countries (Grilli, 1993, p. 284). Not surprisingly, the 1980s saw little advance in the commercial relations between the two regions. The EU did little to enhance market access for ASEAN exports and EU investment in ASEAN was limited. Undoubtedly, the explanation for this is to be found partly in the fact that by the time relations between the two regions were institutionalized the post-Vietnam War crisis was over and, secondly, the rise of ASEAN manufactured exports, stimulated by Japanese investments, caused the EU to accord ASEAN a low priority development status. Not surprisingly, the EU proved unwilling to grant ASEAN states trade preferences other than GSP status (Grilli, 1993, p. 285). On the other hand, these were advantageous during the 1980s as ASEAN manufactured exports began to develop.

Whatever the limitations it is, nonetheless, true that trade and investment lie at the heart of the EU–ASEAN relationship and it is perhaps this area more than any other that binds the two regional groupings together. Traditionally basing their development strategy on export led growth, ASEAN exports to all parts of the world have recorded dramatic rises in the last decade but the region has been particularly successful in developing trade with the EU. Statistics bear testimony to the growing scale of commercial involvement. From 1990 to 1998, ASEAN exports to the EU trebled to reach some 45 billion Euros. Meanwhile, the onset of the economic crisis in 1997 saw imports from the EU collapse while ASEAN exports soared providing the ASEAN states with much-needed foreign exchange. In 2001, the EU was ASEAN's

second largest export market and the third largest trading partner after the United States and Japan. EU exports to ASEAN were estimated at 42.2 billion Euros, while EU imports from ASEAN were valued at 65.7 billion Euros, demonstrating that the EU maintained its commitment to keeping its market open to ASEAN after the 1997 Asian Financial Crisis. As a region, ASEAN has benefited significantly from the EU's Generalized System of Preferences. ASEAN countries such as Thailand and Indonesia for example, have become ultimately very competitive in several sectors during the last few years and have lost their GSP benefit, in particular fishery products from Thailand. Singapore, because of its advanced level of development is excluded from the system. European investment was high in the region before the crash of 1997 and although the trend is again rising pre-1997 investment levels have not yet been achieved (<http://www.delkhm.cec.eu.int/eu/asean/trade.htm>).

An important study on EU–ASEAN trade and investment issues, edited by Strange, Slater and Molteni and published in 2000, indicated, however, that EU–ASEAN trade and investment links were not strong and had been declining. Moreover, it suggested that relations between the two groups are asymmetric in that the EU was more important to ASEAN than the reverse. Nevertheless, it recognized that during the 1990s both inward investment into and outward investment from ASEAN grew rapidly and that inward investment had probably been the motor of rapid domestic growth. The study also suggested that the links between the EU and ASEAN were insufficiently strong on both sides to give rise to dependency, which inevitably minimized the impact of the 1997 crisis on the EU. In his concluding comments, however, Slater, wrote: “It would be trite, but probably true, to conclude that current economic relations between the ASEAN states and the EU understate the potential for mutual gains from both trade and investment” (Slater, 2000, pp. 238–240).

This would appear to be a general view if the relations between the EU and ASEAN are considered over an extended period of time. The EU is a longstanding dialogue partner of ASEAN. In September 2001, the European Commission presented its communication ‘Europe and Asia: A Strategic Framework for Enhanced Partnerships’. This identified ASEAN as a key economic and political partner of the EU and emphasized its importance as a locomotive for overall relations between Europe and Asia. The Commission Communication, ‘A New Partnership with South East Asia’ presented in July 2003 reaffirmed this view. Political dialogue between the EU and ASEAN began in 1978 and the foreign ministers of both the EU and ASEAN have met every second year since then, the most recent and fifteenth meeting having been held in Jakarta on 10 March 2005 (<http://www.delkhm.cec.eu.int/eu/asean/relations.htm> and JOINT CO-CHAIRMEN’S STATEMENT OF THE 15TH ASEAN–EU MINISTERIAL MEETING JAKARTA, 10.3.2005 AT <http://www.aseansec.org/17355.htm>).

In 2003, the EU was ASEAN’s second largest export market and the third largest trading partner after the United States and Japan. EU exports to ASEAN were estimated at 39 billion Euros, while imports from ASEAN were valued at 66 billion Euros. The main exports from ASEAN to the EU are machinery, agricultural products and textiles. In general, both EU imports and exports of goods to ASEAN between 2000 and 2003 have decreased, largely reflecting global trends, although at a slightly

higher rate. In contrast, trade in services during the same period has increased for both EU imports and exports of services with ASEAN. EU FDI flows to ASEAN are now recovering. Singapore attracts more FDI than all the other ASEAN countries taken together and was the fourth largest destination for EU direct investment in 2003, after Russia and ahead of China. The EU–ASEAN Joint Co-operation Committee (JCC) promotes and keeps under review the various co-operation activities envisaged in the Co-operation Agreement. An official-level Committee usually meets every 18 months. Sub-committees have been established in Trade and Investment, Economic and Industrial Co-operation, Science and Technology, Forestry, Environment and Narcotics: (http://www.europa.eu.int/comm/external_relations/asean/intro).

The promotion of free trade has been the fundamental narrative of the EU since its inception. This applies both inside the EU and to the EU's relations with other states and regional organizations. It also applies to the EU's relations with former colonies of member states, where there is also the dimension of aid and development. The ideal is not, though, always easily attainable and the limitations of this policy can easily be perceived in the history of the EU's relationship with ASEAN. Nevertheless, dialogue has flourished between these two regional actors and seems set to continue well into the twenty-first century (Nathan, 2002, pp. 11–24).

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Chapter D

The Process of Economic Integration in ASEAN + 3: From Free Trade Area to Monetary Cooperation or Vice Versa?

Günter S. Heiduk and Yiping Zhu

D.1 Introduction

Since the late 1960s, ASEAN member states have achieved considerable progress in reducing trade barriers between them. As a result, intra-regional trade grew from 15% of ASEAN's total trade in the early 1970s to almost 25% in the middle of the 1990s (Fig. D.1). The Asian financial crisis in 1997, however, drew attention away from trade to the monetary sector – at least for a short time. Since then a vivid but controversial academic discussion on the basic features of the future integration strategy has evolved. Put clearly, the discussion addresses the question as to whether ASEAN integration strategy should focus on creating a closer monetary cooperation or on furthering integration in product markets. The second strategy is often challenged by arguments that it represents a European model, which cannot work in ASEAN.

Some economists also argue that ASEAN is not ready for deeper monetary integration, because this region does not meet the criteria of an Optimum Currency Area (OCA). The theory of the OCA deals with the costs and benefits of a common peg currency regime in an integrated region. Mundell's (1961) seminal article first set out the concept of an optimum currency area. Later literature includes classic contributions by McKinnon (1963) and Kenen (1969) among others. These economists propose different criteria suitable for measuring the degree of integration required for the introduction of a common peg currency regime:

1. The extent of trade: If the intra-regional trade ratio is high, the establishment of a monetary union will reduce transaction costs.
2. The similarity of the shocks and cycles: If countries experience similar shocks, the cost of giving up monetary policy independence will decrease.
3. The degree of labour mobility: Higher cross-border labour mobility can be a useful mechanism for adjusting to asymmetric shocks which lead to high unemployment rates in a sub-group of members.
4. The system of fiscal transfers (if any): A fiscal transfer system can alleviate the impact of regional shocks from income differentials.

Later studies found that the greater the linkages between the countries regarding any of the four criteria, the more suitable the introduction of a common peg currency system or even a common currency in the region. Frankel and Rose (1996) found that

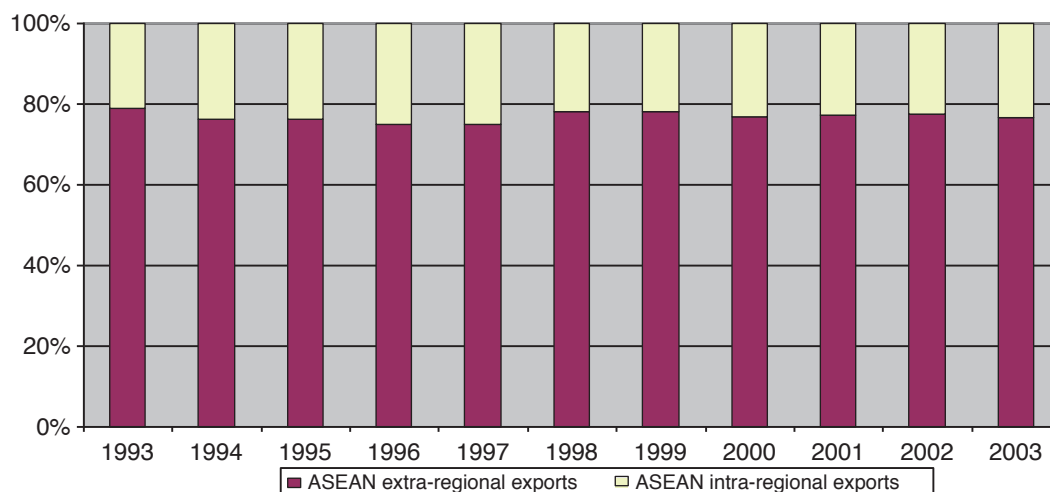


Fig. D.1 ASEAN's intra- and extra-regional export shares (constant total exports). Data for 1993–1998 ASEAN6, 1999 including Myanmar, 2000–2003 including Cambodia

Source: ASEAN Secretary

closer trade links between countries – especially if intra-industry trade dominates – imply a higher probability of similar business cycles. Then, the establishment of a common currency regime may have positive effects on trade which – on its part – synchronize the business cycles further. This leads to the conclusion that countries can join a monetary integrated region without fulfilling the OCA criteria *ex ante*. In fact, many countries may come to fulfil the OCA criteria *ex post*.

According to this knowledge, an integration strategy in ASEAN + 3 might be successful by using monetary cooperation and tariff reduction simultaneously. If parts of this large region show a critical degree of symmetric macroeconomic development resulting from increasing intra-regional trade, measures to integrate the monetary sectors might pave the way for further integration on the goods and factor markets. Meanwhile, tariff reductions resulting from the Free Trade Agreements between ASEAN and China, Japan and Korea increase the level of the real sector integration.

The following chapters find evidence for this proposed strategy. After a brief review of the European Union's first steps towards monetary integration in Sect. D.2, the chapter will proceed by analyzing the effects of ASEAN's tariffs reductions in Sect. D.3. Section D.4 investigates the effects of the lack of a monetary strategy during the Asian financial crisis (IV) and the current loose binding agreements while Sect. D.5 presents a proposal for a sub-regional monetary cooperation framework is sketched out. A brief conclusion then summarizes the results.

D.2 Experiences with Monetary Integration: The Case of the EU

A similar discussion on optimum integration strategies took place in the European Community (EC) after the internal tariff barriers had been abolished. In 1970, an expert group submitted the “Werner Plan” to the EC Council of Ministers

recommending the establishment of a monetary union in 1980 based on fixed and irrevocable exchange rates. In addition to the already implemented customs union, the “Werner Plan” put forth a second incentive to concentrate the integration efforts on the monetary sector. This was due to the rising instability of the Bretton Woods system of fixed exchange rates and the dependence of the European currencies on the US Dollar.

The “Werner Plan” was doomed to fail. In the academic community, a common sense was that deep economic and monetary integration between economies which differed considerably in their macroeconomic developments and performances could not be reached. The “real economy approach” argued that further integration of the goods and factor markets had to have priority over monetary integration. Convergence would be the result, because increasing competition on these markets was the most efficient incitement for integration. In order to build a buffer into the integration processes, the monetary policy should maintain the option of exchange rate adjustments. After deep integration in the real sector had been achieved, exogenous shocks would become symmetric. This stage of integration opened the chance for monetary integration, even for a common currency. In opposition to this argument, the “monetary approach” put the priority on measures that assured monetary integration. A common institutional arrangement which guaranteed fixed exchange rates would create high pressure on the economic policies of the member countries to follow the road of convergence.

It is obvious that the preference of a Member State government for either of these approaches depended on the initial macroeconomic situation and the ranking of the macroeconomic goals. Countries with relatively high inflation rates and therefore weak currencies tended to prefer the “monetary approach”, because the pressure to adjust would probably be lower than in the “economistic approach”. To compete with countries featuring price stability, and therefore strong currencies, required relatively high adjustment costs. It took a long time until a compromise was reached. In 1979, France (representing the “monetary approach”) and Germany (representing the “real economy approach”) agreed to establish the European Monetary System (EMS). This system was based on the idea that, in principle, exchange rates are fixed but could be adjusted if necessary. This package of opposite corners of a currency system could be interpreted as a compromise between the two approaches.

However, the academic discussion on the “right way” continued and was from then on mostly based on the experiences with the EMS. Later studies on the EMS found that closer trade relations could come with increasing currency volatilities. This observation supports the argument that a currency regime should not consist of a mixture of fixed but adjustable exchange rates. It is always preferable to move toward one of the corner solutions (Eichengreen & Bayoumi, 1996; Frankel, 2003; Obstfeld & Rogoff, 1995).

Looking at today’s discussion on the best practice in integration for ASEAN + 3, the “real economy approach” still dominates. Additionally, there are doubts that the political leaders involved will agree even on a common currency regime – not even as a vision for the more distant future. At the same time, it is common sense that in

the Asian financial crisis, the monetary system between these countries could not buffer external monetary shocks. The lessons are as follows:

- None of these countries could cope with the crisis by standing alone.
- Contagion effects pulled countries into the crisis even if the macroeconomic performance was quite good.
- Monetary cooperation within the framework of the ASEAN Swap Agreement failed.
- Trade-induced integration suffered a setback.

It seems that despite the crisis, Asia's current integration strategy did not change from its "trade track" to a "currency track". Even efforts to reduce dependence on the US Dollar cannot be seen as a coordinated policy for monetary integration. There is, however, some evidence that the current shift in the economic (and maybe in the future political) centre of gravity to China will particularly open the door to a process of re-thinking the integration strategy in Asia. Besides China's Free Trade Agreement with ASEAN, the introduction of a new exchange rate regime could pave the way for a policy-oriented discussion of monetary integration in ASEAN + 3. The European experiences have shown that monetary integration needs strong leadership. In ASEAN + 3, the driving force for deeper and wider integration could emerge from leadership that also gives space for a cooperative strategy. The latter should motivate all members of ASEAN + 3 to play their part in contributing to the integration of this region. It goes without saying that within this political concept the integration policy must be based on the results of sound economic analysis. Other than timing and sequencing of integration measures, a third aspect should be considered as a promising way toward monetary integration: the concept of a core-periphery model of monetary integration, which will be discussed in Sect. D.6.

D.3 Integration Policy and Trade in ASEAN + 3

The Association of Southeast Asian Nations (ASEAN) was established on August 8, 1967, in Bangkok by the five initial Member Countries: Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei joined on January 8, 1984, Vietnam on July 28, 1995, Laos and Myanmar on July 23, 1997, and Cambodia on April 30, 1999. The main aim of ASEAN is to promote intra-regional trade by reducing tariffs between member states. In the 1960s and early 1970s, the share of intra-ASEAN trade in the total trade value of its Member Countries was between 12% and 15% (<http://www.aseansec.org>). In 1977, ASEAN introduced the first Preferential Trading Arrangement, which contractually accorded tariff reductions among ASEAN economies. In 1992, the *Framework Agreement on Enhancing Economic Cooperation* was adopted at the Fourth ASEAN Summit in Singapore. It included a scheme of the *Common Effective Preferential Tariff (CEPT)* within the ASEAN Free Trade Area (AFTA). The elimination of tariff and non-tariff barriers among the member countries was expected to promote greater economic efficiency and productivity. This had the final goal of increasing competitiveness of production locations in

ASEAN. Within 3 years from the launch of AFTA, the share of intra-regional trade in ASEAN's total trade volume rose from 20% to almost 25% (Fig. D.1).

In 1995, the Fifth ASEAN Summit held in Bangkok adopted the *Agenda for Greater Economic Integration*, which included an accelerated timetable for the launch of AFTA from a 15-year timeframe to 10 years. In 1997, the ASEAN leaders adopted the *ASEAN Vision 2020*, which called for *ASEAN Partnership in Dynamic Development* aimed at forging closer economic integration within the region. The vision statement also resolved to create a stable, prosperous and highly-competitive ASEAN Economic Region, characterized by free flows of goods, services, investment, and capital. It was hoped that this deepening in integration would lead to a process of economic development that would reduce poverty and socio-economic disparities.

ASEAN has made significant progress in lowering intra-regional tariffs through the aforementioned *Common Effective Preferential Tariff (CEPT) Scheme* for AFTA. The most recent step forward was made on January 30, 2003 with the signing of the *Protocol to Amend the CEPT-AFTA Agreement for the Elimination of Import Duties*. This document contains the commitment of ASEAN-6¹ to eliminate tariffs on 60% of their products listed in the *CEPT Inclusion List (IL)* by 2003. In 2004, ASEAN announced that AFTA had virtually been established. More than 99% of the products in the *CEPT Inclusion List* of ASEAN-6 had been brought down to the 0–5% tariff range (Fig. D.2). The average tariff for ASEAN-6 under the CEPT Scheme was cut from 12.76% in 1993 to its current level of 1.51%. ASEAN's newer members, namely Cambodia, Laos, Myanmar and Vietnam, are not far behind in the implementation of their *CEPT* commitments. Almost 80% of their products are included in their respective *CEPT IL*. Of these items, about 66%

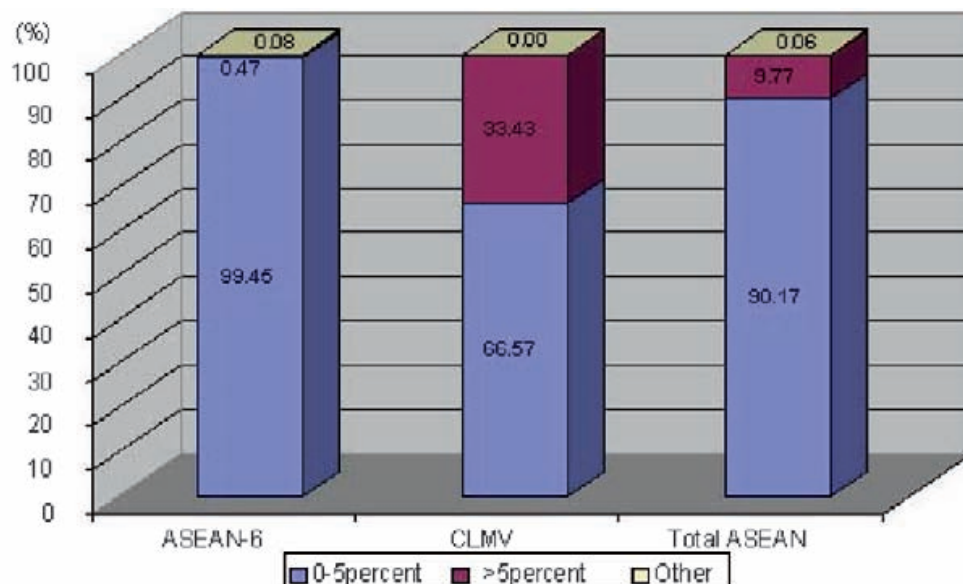


Fig. D.2 Percentage of tariff lines at 0–5% in the tentative 2004 CEPT package

Source: ASEAN Secretary

¹ Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand.

already have tariffs within the 0–5% band. Vietnam is expected to bring down tariffs on products in the IL to no more than 5% duties by 2006, while Laos and Myanmar are to follow in 2008 and Cambodia in 2010.

In addition, ASEAN member countries decided to put the elimination of non-tariff barriers (NTBs) on the agenda. Concerning this matter, a work program seems to be in the final stages of discussion. It includes among others

- a time table for the verification and cross-notification of NTBs,
- the updating of the working definition of Non-Tariff Measures (NTMs)/Non-Tariff Barriers (NTBs) in ASEAN,
- the establishment of a database on all NTMs maintained by member countries,
- the eventual elimination of unnecessary and unjustifiable NTBs.

Furthermore, the new agenda includes the preferential liberalization of services and investment, the harmonization of tariff nomenclature, co-operation in property rights issues, the harmonization of products standards and mutual recognition of conformity assessment tests.

There is evidence that ASEAN's intra-regional tariff and non-tariff reduction processes contributed to the observed integration in this region; the most significant evidence of this fact is the rapid increase in the intra-ASEAN trade. If weighted by export value, the share of intra-ASEAN exports on the total export value of the 5 ASEAN member economies increased from 12% in 1967 to 25%² in 1996. The latter data include two new member countries. Due to their comparatively small economic size, however, this ASEAN enlargement does not carry much weight. It seems plausible that the integration-led tariff reductions has contributed considerably to economic growth in this region.

The Asian financial crisis had noticeable influence on ASEAN's total exports (Fig. D.3). In 1997 and 1998, intra-ASEAN exports decreased more sharply than extra-ASEAN exports. Since the second half of 1999, ASEAN exports have recovered, reaching a peak in 2000. The extra-ASEAN exports contributed to this development to a greater extent than did intra-ASEAN exports. Even from a long term perspective, the trend of ASEAN's exports was more readily shaped by the development of extra- rather than intra-ASEAN exports except during the financial crisis in 1997–1998. It seems that several independent and dependent effects have influenced the development of the relation between ASEAN's internal and external trade:

- Tariff reductions increased the share of the intra-ASEAN exports and might even contribute to an increase in the absolute value of inter-regional trade via more competitive production locations.
- Internal instabilities in the monetary and financial sectors of ASEAN member countries seem to have a stronger negative impact on internal than on external trade.
- Positive business cycles in the USA and in other non-ASEAN countries might dominate the development of total ASEAN trade.

² 1967 data includes the former 5 member countries, namely Indonesia, Malaysia, Philippines, Singapore and Thailand. Data from 1996 also include Brunei and Vietnam.

Source: ASEAN Secretary.

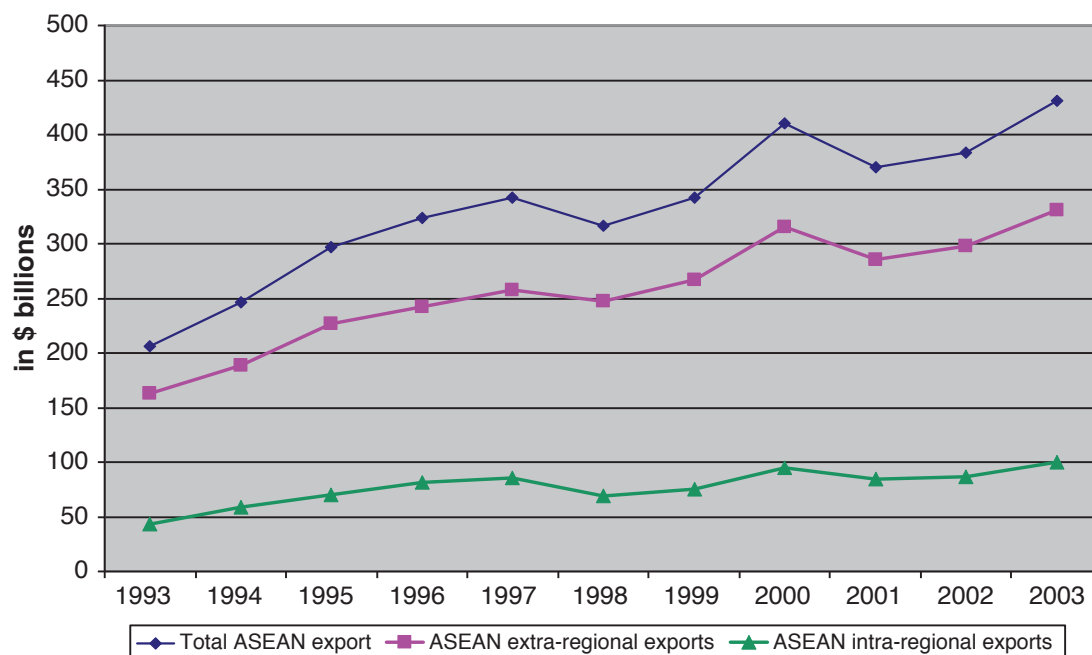


Fig. D.3 ASEAN's intra-regional, extra-regional and total exports data for 1993–1998 ASEAN6, 1999 including Myanmar, 2000–2003 including Cambodia

Source: ASEAN Secretary

In this sense, the trade of the ASEAN region is currently driven by external forces rather than by intra-regional developments or the integration process.

ASEAN's preferences for future integration are relatively clear; widening is of greater significance than deepening. The basis for this choice has already been established. ASEAN and most member countries have entered into bilateral free trade agreements (FTAs) with other countries in the Asia-Pacific region (Table D.1).

The most evident and important of these are the FTAs between ASEAN and Japan, Korea and China.³ These arrangements are to serve as building blocks for the establishment of an East Asia Free Trade Area (EAFTA) in the near future. There are, however, some arguments that reduce hopes for considerable trade creation effects from these treaties. First, the distribution of the benefits of reduced tariffs might be asymmetric. There are some reasons why China could reap greater benefits from an enlarged free trade zone in Asia than other countries. In China's fast developing regions, new high-tech centres will emerge. Their international competitiveness is high due to relatively low costs even for skilled labour. The existing labour-intensive, export-oriented industries in turn have the chance to move within China to low cost areas, therefore maintaining their comparative advantage. Asia's advanced and emerging economies thus come under a dual competitive pressure. The willingness of other countries in Asia to open their borders

³In 1997, ASEAN and the 3 East Asian states, Japan, Korea and China, signed joint statements for a cooperation framework towards the twenty-first century. Bilateral trading arrangements between ASEAN and China as well as between ASEAN and Japan have been established. Another agreement between ASEAN and Korea is underway.

Table D.1 Free trade agreement and Asian economies

In action	Under negotiation	Under consultation study
Bangkok Treaty (1976)	China–ASEAN	China–New Zealand
ASEAN FTA (1992)	Chinese Taipei–Panama (concluded)	Japan–Australia
Laos–Thailand (1991)	Hong-Kong–New Zealand	Japan–ASEAN
Singapore–New Zealand (2001)	Japan–Mexico (concluded)	Japan–Indonesia
Japan–Singapore (2002)	Japan–Korea	Japan–China Korea
Singapore–Australia (2003)	Japan–Thailand	Korea–Australia
Singapore–EFTA (2003)	Japan–Philippines	Korea–ASEAN
Singapore–US (2004)	Japan–Malaysia	Korea–Mexico
China–Hong Kong (2004)	Korea–Chile (concluded)	Korea–New Zealand
China–Macao (2004)	Singapore–Canada	Korea–Singapore
	Singapore–Mexico	Singapore–P3 (Aus, Chile, NZ)
	Thailand–Australia	Singapore–Chinese Taipei
	Thailand–Bahrain (concluded)	Thailand–Peru
	Thailand–India (concluded)	ASEAN–CER (Aus, NZ)
	Thailand–US	ASEAN–EU
		ASEAN–India
		ASEAN–US

Source: OECD

for Chinese imports might decrease. This could in turn influence China's willingness to reduce tariffs for Asian imports. This scenario is more likely as long as ASEAN + 3 integration is mainly based on a network of bilateral free trade agreements. The expansion of the AFTA to the APEC region might further create a serious new problem of challenging the WTO-based system of multilateral trade agreements.⁴ From a purely political perspective, the question of leadership in ASEAN + 3 opens another dimension of uncertainty about the success of creating free trade.⁵

In order to reduce the aforementioned potential for instability and uncertainty, the widening strategy should be accompanied by a deepening strategy focused on the monetary side of the integration process. Arguments in favour of this suggestion stem from experiences with the integration process – especially during the Asian financial crisis – as well as from theoretical analysis:

- Asian countries experienced the negative effects of regional sensitivity to the financial crisis and the malfunctioning of the existing common monetary framework.
- Monetary cooperation affects the whole economy which means that pressure from protection demanding industries does not exist or is relatively low.

⁴See, for instance, Park (2002).

⁵See Hwee (2005)

- Monetary cooperation corresponds to the interest of most Asian countries to gain more independence from the US Dollar without necessarily substituting it with dependence on another currency.
- Monetary cooperation can pave the way towards increased trade.
- Growing intra-regional trade can be a source of exchange rate instabilities.
- Considerable structural changes in intra-regional trade can also negatively influence exchange rate stability.

D.4 Trade, Exchange Rates and Monetary Integration: Experiences in the EU and ASEAN + 3

D.4.1 Interdependencies Between Intra-Regional Trade and Monetary Cooperation: Evidence From EU Experiences

The reason that the once strong trade-promoting effect of AFTA started to decelerate in 1997 and did not fully recover lies in the fact that trade and economic integration themselves suffered from the absence of a crisis-preventing, or at least crisis-reducing, cooperation in the monetary and financial sector. When a critical level of trade-induced integration has been exceeded, an isolated shock can penetrate the whole free trade area in the event there is no monetary counter-strategy. Further, asymmetric shocks create a set-back regarding the depth of integration. Experience shows that flexible exchange rates or exchange rate adjustments do not decouple the member countries of a free trade area while simultaneously keeping the level of integration stable. Besides the “trade-sustaining effect”, monetary cooperation can also have “trade-expanding effects”.

Empirical and theoretical studies have shown that there are interdependencies between the development of intra-regional trade and internal exchange rate development. Eichengreen and Bayoumi's (1996) study of the European Union found that the growth of intra-European trade increased the costs of uncontrolled intra-European exchange rate variability in EMS. The ‘*adjustable pegs under an implicit escape clause*’-system was unable to remain stable when intra-regional trade increased. The study does not, however, deal with the question as to the critical level of trade-induced integration to be reached for this effect to become evident. Because of the differences in the importance of intra-regional trade between the EU and ASEAN + 3, the results thus could not be transferred automatically. Frankel and Rose (2000) and Rose (2000) demonstrated that a currency union will promote trade. By using a gravity-based cross-section data analysis, estimates of the trade-creating effect of a currency union showed intra-regional trade triples, while no trade diversion effect could be observed. This in turn has beneficial effects on the economic performance of the member countries of the currency union.

D.4.2 Trade and Exchange Rates in ASEAN + 3 During and After the Asian Crisis

The 1997–1998 East Asian financial crises influenced trade relations within Asia and other regions in different ways:

- Total exports of ASEAN + 3 decreased despite the fact that the currencies of most ASEAN countries depreciated; the affected countries did not experience the same degree of economic downturn.
- ASEAN's intra-regional trade declined in absolute as well as in relative value
- The extra-regional trade of ASEAN declined to a lesser degree than intra-regional trade. Therefore, the relative dependence on the former increased. The regional distribution of ASEAN's exports changed in favour of China.

Moreover, the financial crisis seems to have been an accelerator for the openness process of ASEAN countries as well as of China and Korea. Their degree of openness measured by the trade/GDP ratio increased considerably in 1998 (except for Singapore) and did not fall back to their pre-crisis levels except for Laos (Table D.2). The increase in 1998 was mainly the result of a sharp decline in GDP rather than increases in trade volume.

The ensuing recovery period in Asian economies cannot be characterized by a uniform trend. In some ASEAN countries, the degree of openness increased yearly; in others it fell back and then remained relatively stable (and at a higher level than before the financial crisis), while in some countries the degree of openness fluctuated annually. It could be argued that the overall increase of the degree of openness was promoted by exchange rate adjustments. During the recovery period, the intra-regional exports in ASEAN partly recovered as well. A comparison between the development of the degree of openness and of intra-regional exports does not support the expectation that ASEAN's integration was a strong driving force for opening up after the financial crisis. The level of trade-induced integration still seems to be too low for a self-reinforcing process. The intra-regional export share on total ASEAN trade fluctuated between 23.74% in 1993, 21.89% in 1997, and 23.25% in 2002 (Table D.3).

Within Asia, other remarkable changes in the structure of trade relations occurred which received a special boost after the financial crisis as well as by China's WTO accession:

- The fast emerging markets in China absorbed an increasing part of ASEAN, Korean and Japanese exports (Table D.4). Because the agreements of China, Korea and Japan with ASEAN have not yet led to tariff reductions in goods markets, the increase in trade cannot be counted as an effect of the ASEAN + 3 concept. In fact, it is quite evident that China's WTO accession is a major factor in this development.
- ASEAN'S and Korea's share of exports to Japan dropped sharply due to Japan's ongoing recession.

Table D.2 Trade/GDP ratios in ASEAN, China and Korea

	Cambodia	Indonesia	Laos	Malaysia	Philippines	Singapore	Thailand	Vietnam	China	Korea
1986	–	0.32	0.18	0.88	0.34	2.67	0.42	0.11	0.25	0.62
1987	–	0.39	0.33	0.95	0.39	2.97	0.49	0.09	0.26	0.65
1988	–	0.37	0.37	1.07	0.42	3.28	0.59	0.15	0.26	0.62
1989	–	0.38	0.36	1.22	0.45	3.13	0.63	0.72	0.25	0.56
1990	–	0.42	0.31	1.33	0.48	3.07	0.66	0.80	0.30	0.53
1991	–	0.43	0.26	1.45	0.48	2.90	0.67	0.58	0.33	0.52
1992	–	0.44	0.34	1.36	0.48	2.72	0.66	0.52	0.34	0.50
1993	0.31	0.41	0.52	1.39	0.55	2.73	0.66	0.52	0.33	0.48
1994	0.47	0.41	0.57	1.59	0.56	2.82	0.69	0.61	0.44	0.49
1995	0.63	0.43	0.52	1.71	0.62	2.89	0.76	0.66	0.40	0.50
1996	0.52	0.41	0.55	1.55	0.67	2.78	0.70	0.75	0.36	0.50
1997	0.61	0.44	0.56	1.57	0.77	2.70	0.79	0.77	0.36	0.54
1998	0.67	0.80	0.70	1.82	0.94	2.58	0.87	0.77	0.34	0.65
1999	0.66	0.52	0.59	1.90	0.89	2.74	0.89	0.81	0.36	0.59
2000	0.84	0.64	0.50	2.00	0.99	2.94	1.07	0.97	0.44	0.65
2001	0.85	0.61	0.48	1.84	0.93	2.76	1.10	0.96	0.43	0.60
2002	1.08	0.51	0.42	1.83	0.93	2.73	1.05	1.04	0.49	0.58
2003	1.11	–	0.41	1.83	0.92	2.98	1.09	1.16	0.60	0.62

Source: ADB, MOFCOM China

Table D.3 Intra-regional export ratio in ASEAN

	1992	1993	1994	1995	1996	1997
Intra-export/total export	21.14%	23.74%	23.65%	25.04%	24.91%	21.89%
	1998	1999	2000	2001	2002	
Intra-export/total export	21.92%	23.20%	22.80%	22.51%	23.25%	

Source: ASEAN Secretary

Table D.4 ASEAN, Japan, China's major trading partners

Export value (Mio. US-\$)		Shares in total ASEAN trade (%)							
				Japan	USA	EEC	CN	Korea	ASEAN Others
1980	ASEAN	71.732	to	29.5	16.3	12.5	1.0	1.5	17.3 21.9
1990		144.372	to	18.9	19.2	15.6	1.8	3.3	19.0 22.0
2000		426.484	to	13.5	19.0	14.5	3.8	3.7	23.0 22.6
2003		456.794	to	12.4	16.6	13.9	6.7	3.8	22.1 24.7
1980	Japan	130.435	to		24.5	14.0	3.9	4.1	10.4 43.1
1990		287.664	to		31.7	20.4	2.1	6.1	11.8 28.1
2000		478.179	to		30.1	16.4	6.3	6.4	14.3 26.4
2003		473.911	to		24.8	15.3	12.1	7.3	12.9 27.6
1980	China	18.139	to	22.2	5.4	13.0		–	6.6 52.7
1990		62.876	to	14.6	8.5	10.0		0.7	6.8 59.6
2000		249.195	to	17.8	9.6	13.3		10.0	9.4 39.9
2003		438.250	to	21.1	21.1	16.5		4.6	7.1 37.2

ASEAN includes in all years the current 10 member countries

Source: IMF, Direction of Trade Statistics, Yearbooks

- Chinese exports are oriented more and more towards high income countries/regions such as the USA, Japan, and the EU.
- China's large trade deficits with ASEAN, Japan and Korea on the one hand and large trade surpluses with the USA and the EU on the other hand can create risky tensions on exchange rates within ASEAN + 3.

It is to be expected that tariff reductions in ASEAN + 3 will strengthen the "China-pull effect" for the other member countries and therefore increase the overall trade imbalances in this region. It is quite obvious that such imbalances influence exchange rates in ASEAN + 3. Current account imbalances always hold a high potential for speculation on foreign exchange markets. In addition, uncertainty about China's future exchange rate system as well as the underdeveloped financial institutions and markets in China might increase this speculative potential. Therefore, it seems to make sense that a monetary cooperation framework should accompany and ensure the ASEAN + 3 trade integration.

D.5 Present Currency Cooperation in ASEAN + 3: Loose-Binding Contingency Plan

Compared with the cooperative framework in trade, the present currency cooperation framework in ASEAN + 3 countries is rather primary and loose-binding. These countries did not pay much attention to building a future-oriented cooperative framework aside from the ASEAN Swap Agreement (ASA) constructed in 1977. Although ASA was expanded to ASEAN + 3 after the East Asian financial crisis, the current framework is not so different from the original contingency system. One of the outstanding characteristics of the Asian financial crisis has been the fact that most Asian economies suffered from the same shock. It may be astonishing that the contingency system was not activated during that time. There is a lack of operational procedures and instruments revealing the narrow confines of a common understanding for the needs of a comprehensive monetary approach to integration.

- *ASEAN framework: ASEAN Swap Agreement (ASA)*: The swap arrangements of the ASEAN date back to 1977. These agreements allowed members to exchange local currency for US Dollar on a short term basis to alleviate temporary international liquidity problems. Participation was confined to central banks and monetary authorities of ASEAN member countries. Each member contributed US \$200 million in 1978. Swaps had been laid out for a period of 1, 2, or 3 months and were renewable once for up to 3 months. The swaps were activated on five occasions, by Indonesia in 1979, Malaysia in 1980, Thailand in 1980, and the Philippines in 1981 and 1992. As already mentioned, the swaps were not activated during the Asian financial crisis in 1997–1998. In November 2000, ASEAN leaders agreed to expand their swaps to an overall size of US \$1 billion. Although ASA has been celebrated as a milestone in monetary cooperation and a symbol of ASEAN's solidarity, it proved to be a contingency plan for easy to handle cases, but inapplicable for a region wide crisis.
- *Bilateral ASEAN ± 3 framework: Chiang Mai Initiatives (CMI)*: Based on ASA, ASEAN + 3 financial ministers announced the Chiang Mai Initiative (CMI) in May 2000 on the margin of the annual meeting of the Board of Governors of the Asian Development Bank (ADB). Aside from the former ASA, the CMI provides for 33 Bilateral Swap Agreements (BSA) to be negotiated: 30 agreements between each of the 3 Northeast Asian countries and each of the 10 ASEAN members as well as 3 agreements among the 3 Northeast Asian countries.⁶ All agreements include the commitment to exchange local currency for US Dollar, except for the bilateral agreement between Japan and China. Both countries here committed to exchanging Japanese Yen to Renminbi and vice versa.

⁶ Among these 33 BSA, 16 BSAs have been successfully concluded with a combined total size of US \$36.5 billion.

D.6 Sub-regional Currency Cooperation Framework: Beyond Economic and Financial Convergence

Evans and Kim (2005) analyzed the convergence of per-capita GDP among 17 Asian countries from 1960 to 1992, finding that these countries converged in a rate of around 2% per year. Goto (2003) compared the degree of confluence of real GDP growth rates, stock prices and exchange rates, inflation rates, money supply and interest rates, for China, Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand in the 1990s and in the 1980s. He found that the fluctuations in real economic activities in East Asia have become more synchronized in the 1990s. Due to the fact that the supply shocks in Asian countries are more positively correlated with Japan and negatively with the US and EU, he concluded that Japan should play an important role in Asian financial cooperation.

Kwan's (1998) analysis of an optimum currency area in Asia started from the de facto US Dollar bloc. Because of Japan's turning to Asia, the study proposed the possibility of forming a Yen bloc. Japan's trade and FDI flows are more and more oriented toward other Asian countries with the trade structure similar to Asian NIEs but different to some ASEAN members and China; the inflation rate in Japan is lower than in other Asian countries. Contrary to his argument, however, recent statistics have shown that Japan is losing its importance as a selling market for products from ASEAN countries (Fig. D.4).

A study by Eichengreen and Bayoumi (1996), which is also based on the theory of optimum currency areas, found that Indonesia, Malaysia, Singapore and Thailand have highly correlated demand shocks. Furthermore, the analysis also shows that

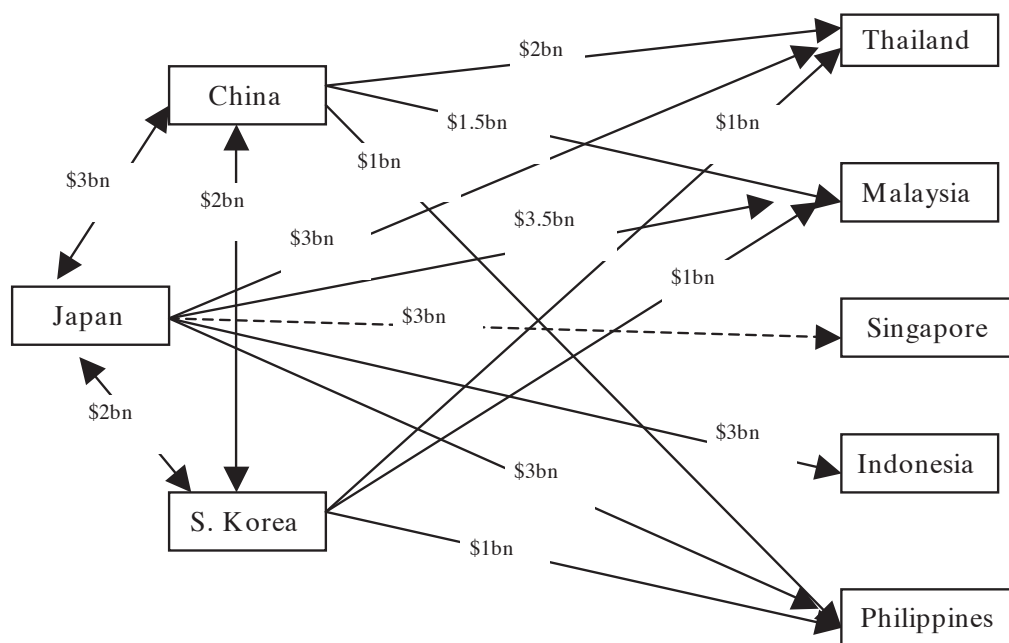


Fig. D.4 Bilateral currency swap agreements under the CMI
Source: Henning, 2002

the correlations of supply shocks in the region are high for two groups, with Japan and Korea in one group and Indonesia, Malaysia and Singapore in the second. Synchronous developments have a negative impact on the integration process when these countries experience the same economic and financial problems. It seems that there is currently no country or no group of countries in Asia that are large and strong enough to absorb significant demand and supply shocks.

Recent studies (e.g., Eckhardt, 2005) take the dynamics in the Asian region into account and expect that China will challenge Japanese economic leadership in Asia as the fastest growing economy. Besides China's rising economic status, the RMB's exchange rate revaluation, the expected higher flexibility and liberalization of its exchange rate regime are positive developments that strengthen China's potential to play a leading role in ASEAN + 3 monetary integration. The fact that RMB kept its exchange rate stable during the 1997 financial crisis despite trade competition from ASEAN countries supports this contention. China's high export growth rates especially to the US put new pressure on its exchange rate policy. Whereas the US hopes that further revaluations will slow down imports from China, ASEAN economies expect to see a speed up of their exports to China.

Contrary to the aforementioned literature, we argue that

- the starting point of monetary integration in ASEAN + 3 should not be the question of whether this region is an optimum currency area;
- a trade based discussion on monetary cooperation is too one-sided because the share of intra-regional trade is relatively low. Intra-regional FDI flows, however, play an increasing role in ASEAN + 3.

A starting point for a different approach to monetary integration which may lead to increased intra-regional trade is an analysis of the similarities and differences in the exchange rate regimes between ASEAN + 3 countries. A second step in determining the potential for closer monetary cooperation could be an analysis of the similarities and differences in macroeconomic performance in ASEAN + 3 countries measured by correlations in interest rates, M2 growth rates and unemployment rates.

ASEAN + 3 countries have different exchange rate and monetary policies (Table D.5). As categorized by IMF, Brunei has a currency board agreement and the monetary policy also anchors on the exchange rate. Malaysia (after the 1997 financial crisis) and China have conventional pegged agreements. Although Indonesia, Thailand, Laos, Vietnam and Singapore have managed floating systems with a pre-announced path for exchange rate adjustments, these countries have different monetary policy anchors on monetary aggregates, inflation or some other index. Kim and Lee (2004) found that by adopting a floating regime, the sensitivity of local interest rates in Asian countries to US interest rates had declined. Compared with other ASEAN countries, Korea and Japan have different exchange rate arrangements. Despite the fact that these two countries also suffered from the Asian financial crisis, their economies were less exposed to currency problems. The floating regimes seemed to guarantee a certain degree of independence. Korean monetary policy is inflation targeted, while Japan has not explicitly stated a nominal anchor, but rather monitors various indicators in conducting monetary policy.

Table D.5 Exchange rate arrangements and anchors of monetary policy of ASEAN + 3

	Exchange rate anchor	Monetary aggregate target	Inflation targeting	IMF supported	others
Currency board agreement conventional pegged arrangement	Brunei Malaysia China				
Managed floating with no pre-announced path for the exchange rate independently floating		Indonesia	Thailand Korea Philippines	Laos Vietnam	Singapore Japan ^a

^aNo explicitly stated nominal anchor, but rather monitors various indicators in conducting monetary policy

Source: IMF (2004)

Even if Japanese and Korean exchange rate regimes guarantee a certain degree of independence, a coordination of monetary policy – for example, by agreeing on the same anchor for the monetary policy – could pave the way for deepening integration. For other ASEAN countries, it seems to be more promising to start with currency cooperation if the aforementioned macroeconomic indicators show a high degree of correlation. The basis for the correlation matrices of the interest rates, M2 growth rates, unemployment rates and FDI net inflows are country-specific yearly data from the Asian Development Bank (ADB) and the Bank of Japan (for Japanese data) from 1986 to 2003. Due to the deficit of ADB data for Brunei, Myanmar and Cambodia, these countries are not included into the matrixes.

We observed the following correlation matrix results:

- Interest rate correlations. The correlations between the interest rates of ASEAN + 3 economies are positive (see Table D.6). The most notable feature of the relationships is that Singapore and Indonesia have more significant correlations with other countries. Singapore, which has the best-functioning financial market in the ASEAN region, is positively correlated with Indonesia, Malaysia, the Philippines and China. Indonesia, whose currency had the highest exchange rate volatility in the financial crisis, is also positively correlated with Korea, Malaysia, the Philippines, China and Singapore. Although Japan is positively correlated with Singapore and Korea is positively correlated with Indonesia, there is no further evidence that Japanese or Korean interest rate policy has any closer relationships with ASEAN economies.
- M2 growth rate correlations: Table D.7 shows the relationship of the M2 growth rates in ASEAN + 3 economies. In general, M2 growth rates are not closely correlated for ASEAN member states. Between Malaysia, Indonesia, Singapore, Thailand, Philippine and China, however, the correlations are more significant than between the other ASEAN + 3 countries. Korea, Vietnam and Laos are not significantly linked to other ASEAN economies.
- Unemployment rate correlations: The correlations of ASEAN-6, Korean and Chinese unemployment rates lead to the following results (see Table D.8): Korea

Table D.6 Correlations of ASEAN + 3 interest rate^a

		Indonesia	Korea	Malaysia	Philippines	China ^b	Singapore	Vietnam	Japan ^c
Indonesia	Pearson correlation	1							
	Sig. (2-tailed)	.							
Korea	Pearson correlation	0.515*	1						
	Sig. (2-tailed)	0.029	.						
Malaysia	Pearson correlation	0.612**	0.439	1					
	Sig. (2-tailed)	0.007	0.069	.					
Philippine	Pearson correlation	0.552(*)	-0.009	0.369	1				
	Sig. (2-tailed)	0.017	0.972	0.132	.				
China	Pearson correlation	0.577*	.137	0.870**	0.367	1			
	Sig. (2-tailed)	0.015	0.600	0.000	0.148	.			
Singapore	Pearson correlation	0.675**	0.445	0.799**	0.480*	0.704**	1		
	Sig. (2-tailed)	0.002	0.064	0.000	0.044	0.002	.		
Vietnam	Pearson correlation	^d	0.751	-0.497	0.807	-0.424	0.927*	1	
	Sig. (2-tailed)	.	0.144	0.394	0.099	0.476	0.024	.	
Japan	Pearson correlation	0.249	-0.100	0.347	0.416	0.328	0.665**	0.957*	1
	Sig. (2-tailed)	0.319	0.694	0.158	0.086	0.198	0.003	0.011	.

*Correlation is significant at the 0.05 level (2-tailed)

**Correlation is significant at the 0.01 level (2-tailed)

^aSource: ADB^bSource: People's Bank of China statistics, year average data^cSource: Bank of Japan^dCannot be computed because at least one of the variables is constant

Table D.7 Correlations of ASEAN + 3 M2 growth rate

		Indonesia	Korea	Laos	Malaysia	Philippines	China	Singapore	Thailand	Vietnam
Indonesia	Pearson correlation	1								
	Sig. (2-tailed)	.								
Korea	Pearson correlation	-0.004	1							
	Sig. (2-tailed)	0.989	.							
Laos	Pearson correlation	0.175	-0.120	1						
	Sig. (2-tailed)	0.501	0.646	.						
Malaysia	Pearson correlation	-0.020	0.120	-0.233	1					
	Sig. (2-tailed)	0.940	0.645	0.368	.					
Philippines	Pearson correlation	0.226	0.096	-0.028	0.614**	1				
	Sig. (2-tailed)	0.384	0.714	0.915	0.009	.				
China	Pearson correlation	0.099	0.194	-0.096	0.585*	0.492*	1			
	Sig. (2-tailed)	0.705	0.456	0.714	0.014	0.045	.			
Singapore	Pearson correlation	0.837**	0.136	0.427	-0.093	0.288	0.146	1		
	Sig. (2-tailed)	0.000	0.602	0.088	0.722	0.262	0.575	.		
Thailand	Pearson correlation	0.509*	0.329	0.186	0.436	0.631**	0.595*	0.578*	1	
	Sig. (2-tailed)	0.037	0.197	0.474	.080	0.007	0.012	0.015	.	
Vietnam	Pearson correlation	0.076	0.041	0.473	-0.274	0.263	-0.087	0.310	0.404	1
	Sig. (2-tailed)	0.773	0.877	0.055	0.287	0.308	0.739	0.226	0.107	.

*Correlation is significant at the 0.05 level (2-tailed)

**Correlation is significant at the 0.01 level (2-tailed)

Source: ADB

Table D.8 Correlations of ASEAN + 3 unemployment rate

		Singapore	Indonesia	Korea	Malaysia	China	Vietnam	Philippines	Thailand
Singapore	Pearson correlation	1							
	Sig. (2-tailed)	.							
Indonesia	Pearson correlation	0.205	1						
	Sig. (2-tailed)	0.414	.						
Korea	Pearson correlation	0.356	0.285	1					
	Sig. (2-tailed)	0.147	0.251	.					
Malaysia	Pearson correlation	0.543*	-0.530*	-0.102	1				
	Sig. (2-tailed)	0.020	0.024	0.688	.				
China	Pearson correlation	0.065	0.930**	0.245	-0.626**	1			
	Sig. (2-tailed)	0.797	0.000	0.327	0.005	.			
Vietnam	Pearson correlation	-0.974**	-0.875*	0.673	-0.602	-0.925**	1		
	Sig. (2-tailed)	0.001	0.023	0.143	0.206	0.008	.		
Philippines	Pearson correlation	0.105	0.631**	0.447	-0.373	0.627**	-0.726	1	
	Sig. (2-tailed)	0.678	0.005	0.063	0.128	0.005	0.102	.	
Thailand	Pearson correlation	0.584*	-0.257	.417	0.609**	-0.403	0.880*	0.137	1
	Sig. (2-tailed)	0.011	0.303	0.085	0.007	0.097	0.021	0.588	.

*Correlation is significant at the 0.05 level (2-tailed)

**Correlation is significant at the 0.01 level (2-tailed)

Source: ADB

Table D.9 Correlations of ASEAN + 3 FDI net inflows^a

		Indonesia	Korea	Laos	Malay	Philippines	China	Singapore	Thailand	Japan ^b	Vietnam
Indonesia	Pearson correlation	1									
	Sig. (2-tailed)	.									
Korea	Pearson correlation	-0.819**	1								
	Sig. (2-tailed)	0.000	.								
Laos	Pearson correlation	0.530*	-0.270	1							
	Sig. (2-tailed)	0.024	0.278	.							
Malaysia	Pearson correlation	0.738**	-0.470*	0.739**	1						
	Sig. (2-tailed)	0.000	0.049	0.000	.						
Philippines	Pearson correlation	-0.192	0.307	0.526*	0.279	1					
	Sig. (2-tailed)	0.445	0.216	0.025	0.262	.					
China	Pearson correlation	-0.167	0.109	0.586*	0.249	0.660**	1				
	Sig. (2-tailed)	0.507	0.667	0.011	0.319	0.003	.				
Singapore	Pearson correlation	-0.333	0.575*	0.189	0.026	0.356	0.296	1			
	Sig. (2-tailed)	0.177	0.013	0.453	0.918	0.147	0.233	.			
Thailand	Pearson correlation	-0.338	0.561*	0.229	0.035	0.544*	0.427	0.414	1		
	Sig. (2-tailed)	0.170	0.016	0.362	0.890	0.020	0.077	0.087	.		
Japan	Pearson correlation	0.035	-0.019	0.370	0.321	0.355	0.478*	0.099	0.137	1	
	Sig. (2-tailed)	0.891	0.939	0.131	0.194	0.149	0.045	0.697	0.588	.	
Vietnam	Pearson correlation	0.141	-0.054	0.822**	0.451	0.649**	0.898**	0.249	0.416	0.399	1
	Sig. (2-tailed)	0.578	0.830	0.000	0.060	0.004	0.000	0.319	0.086	0.101	

^aSource: ADB^bSource: Bank of Japan

**Correlation is significant at the 0.01 level (2-tailed)

is not significantly correlated with other countries. Vietnam is normally negatively correlated with the other members with statistical significance. Singapore is positively correlated with Malaysia and Thailand, but negatively correlated with Vietnam. Indonesia demonstrates a strong, positive correlation to China and the Philippines, at a negative correlation with Malaysia and Vietnam. The unemployment rate between ASEAN + 3 could thus be shaped like this: there is a positive correlation between unemployment in Singapore, Malaysia and Thailand and even more so between China and the Philippines, however the latter two are negatively correlated with the first three.

- FDI net inflows correlations: Table D.9 displays the correlations of FDI net inflows of ASEAN + 3 countries. Indonesia has a strong, negative correlation with Korea, but a very strong positive correlation with Malaysia and Laos. Although negatively related to Indonesia and Malaysia, Korea has positive correlations with Singapore and Thailand. The most significant result is that China, Laos and the Philippines are positively correlated with nearly all other countries.

From the correlations of interest rates, monetary supply growth rates and unemployment rates in ASEAN + 3 countries, we suggest that Singapore, Thailand, Malaysia, the Philippines, Indonesia and China should and could be a group worthy of establishing closer monetary cooperation, including exchange rate policy and a monetary policy coordination framework.

D.7 Conclusion

The economic integration policy in ASEAN + 3 seems to have arrived at very important crossroads. The potential for further trade creation by reducing tariffs in ASEAN-10 is relatively low. Following the EU strategy of establishing a customs union and developing this into a single market is not a choice at all. Instead, ASEAN follows a selective widening strategy, which differs from the European widening process. Whereas new EU member countries are integrated by being members of the EU, China, Japan and Korea integrate separately with ASEAN. Even without tariff reductions between ASEAN and the three East Asian countries and without institutional arrangements between the three countries, China's fast growing economy creates a considerable pull effect on the exports of the other Asian countries. Some countries such as Japan might re-allocate their exports from the US and/or EU to China. In some of the less-industrialized countries, the economic structure is changing rapidly in order to participate in Chinese growth, potentially increasing the risk of a regional bubble economy. One instrument to stabilize this development and prevent contagion effects in case of asymmetric shocks is a more institutionalized, workable and functioning strategy of cooperation in the monetary sector than currently exists under the Chiang Mai Initiative. An overlapping slowdown of growth in China and the USA could create severe economic problems for the ASEAN countries, especially if accompanied by a decline in capital inflows.

This scenario could even result in a new financial crisis, because China's fragile banking system might be vulnerable to some kind of shocks.⁷

On the one hand, the ASEAN + 3 idea of a three-road strategy with free trade flows on each road does not correspond to the current dramatic changes in the direction of trade flows. On the other hand, a region-wide balancing, supporting and complementary monetary strategy comparable to the EMU or EMS II is not on the political agenda. A promising first step toward a monetary strategy in ASEAN + 3 which

- stabilizes the trade-led integration process,
- creates new chances for trade and FDI flows,
- reduces the risk of a bursting Chinese bubble and
- fights against herd behaviour

seems to be the establishment of a sub-regional framework for closer currency cooperation which includes Thailand, Singapore, the Philippines, Indonesia, Malaysia and China.

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⁷The question where and why a new financial crisis in emerging economies could evolve has been recently discussed on a global scale by the World Bank. See Goldstein (2005).

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Chapter E

Financial Market Integration and Growth in the EU

Paul J.J. Welfens and Martin Keim¹

E.1 Introduction

Economic globalization progressed considerably in the 1990s with the opening-up of post-socialist eastern European countries for trade and capital flows as well as with the completion of the single EU market. Part of the single EU15 market introduced in 1993 was the liberalization of services including financial services. With EU eastern enlargement in 2004, there were steps towards an EU25 single market. However, free movement of labour was postponed for most EU15 countries until 2011 (at the latest). In ASEAN countries, financial integration resumed after the 1997/98 crisis, and a broader integration strategy was envisaged. Both the EU and ASEAN are facing economic globalization in the sense that there is a long run increase in the trade of financial services, in foreign direct investment in the banking and insurance sector and a growing influence from global international organizations such as the IMF and the Bank of International Settlements (BIS).

Financial markets are important for economic development for many reasons, including the financing of capital accumulation, innovation and human capital formation. In his survey, Tsuru (2000) points to several channels through which financial markets can affect growth. Competitive financial markets contribute to

- the efficient allocation of capital;
- efficient intermediation so that savings flow to those investment projects with the highest yield;
- a rise in the savings rate (under certain circumstances).

In their empirical analysis, King and Levine (1993) have emphasized that several traits of the financial market contribute to higher growth. For example, liquidity relative to output and the share of private credits in total credits are important for growth; the emphasis on the share of private credits implicitly is an argument that a high share of public credits is not only crowding out private investment in a way

¹ We are grateful to comments from Rolf Langhammer, Kiel Institute for World Economics and Shandre Tangavelu, National University of Singapore. The usual disclaimer applies.

which is neutral to output but that it indeed reduces real income. Levine and Zervos (1998) have pointed out that several variables affect growth of output:

- stock market capitalization, stock market liquidity and the degree of international capital market integration were found to have a positive impact on real output;
- the volatility of stock returns negatively affects output.

Thus empirical findings suggest that international capital market integration – in particular to the extent that it raises stock market capitalization (relative to GDP) – increases stock market liquidity and reduces the volatility of stock returns – will positively contribute to economic development. There is, however, a causality problem in the sense that we cannot exclude that economic growth, which stimulates the development of financial markets, since one may argue that wealth accumulation typically grows faster than output, leading to a situation in which the long run growth of asset accumulation will naturally stimulate the expansion of financial markets and the respective services (Granger causality analysis could shed some light on this, however, the causation could also be an phenomenon of interdependency).

One also cannot be certain that capital market liberalization and regional capital market integration will go along with reduced stock market volatility. To the extent that the US stock market dominates regional stock markets in the EU and Asia, the key issue is the speed and scope of international transmission of US stock market impulses. Moreover, while the US financial market system is the result of an evolutionary market development in which aspects such as stock markets, bonds markets, banks and prudential supervision interact in a useful way, one should expect that financial market institutions in other countries reflect their own specific evolutionary development. Therefore it would be no surprise if temporarily high US stock market volatility causes few problems in the US (or Western) Europe, but this can have rather destabilizing effects in eastern Europe, Asian NICs and other regions.

EU countries have recorded sustained growth since the creation of the single EU market at the end of 1992. However, growth was slower than in the US. This broad comparison obscures the more detailed picture in the Euro zone, namely that medium term growth performance was rather different across countries. As regards the late 1990s, this is particularly the case across member countries of the Euro zone which started on January 1, 1999 when the European Central Bank (ECB) and the European System of Central Banks (ESCB = ECB + national central banks) started. The 11 starter countries of the Euro were a rather heterogeneous group in terms of per capita income and debt-GDP indicators; most starter countries faced considerable unemployment problems in 1999, and the large member countries of the Euro zone still had serious unemployment problems in 2005. By contrast, the non-Euro countries in the EU15 group – UK, Denmark and Sweden – had low unemployment rates. Attributing differential unemployment figures to the Euro is not adequate, however, as several countries in the Euro zone had favourable development in terms of employment and growth. Regional monetary integration does, however, require an adequate degree of wage flexibility and labour mobility.

With financial market integration making considerable progress in the Euro zone, visible for instance through the convergence of nominal interest rates, there was hope that economic growth in the Euro zone would accelerate and unemployment be reduced. This has hardly been the case since growth accelerated mainly in small open economies of the Euro zone while it fell in Germany and Italy. Italy – having a high debt-GDP ratio of close to 110% in the run-up to the start of the Euro – was to benefit from falling nominal and real interest rates as well as from interest rate convergence. Hence Italy should benefit from higher growth, as should Germany provided that domestic policies adopted were growth-enhancing and increasing trade with member countries of the Euro area stimulated growth through higher trade dynamics. From a theoretical perspective, trade creation was to be expected from monetary integration. This holds despite the fact that the Euro area of 11 starter countries (France, Germany, Italy, Austria, Belgium, Netherlands, Luxemburg, Spain, Portugal, Finland, and Ireland) could not be considered as representing an optimum currency area as defined by traditional criteria from the literature. There was considerable economic heterogeneity which led to the creation of cohesion funds for the relatively poor countries, Portugal, Spain, Ireland and Greece, with the latter joining the Euro area in 2001.

Financial market integration was hoped to deliver some of the expected economic benefits through the creation of the Euro and the ECB. Monetary integration creates larger markets allowing for the exploitation of economies of scale and the reduction of transaction costs. If one defines financial market integration through the weighted nominal interest rate convergence – with the relative share of loans across the spectrum of maturities as the weight for that convergence – one could indeed measure financial market integration. As financial market integration might go along with financial market deepening, which amounts to a yield curve with a longer time horizon than before, we have to take into account an additional aspect. Finally, the whole yield curve might be shifted upwards or downwards through monetary integration so that we have at least one additional aspect to be considered. A downward shift, which amounts to reduced costs of capital and in turn should raise the investment output ratio, should increase real income.

The EU's Lisbon Agenda 2010, which put forward the goal of making the EU the most competitive and dynamic knowledge-based economy by 2010 points to the prominence of setting growth goals. Therefore it is important to focus on some of the potential links between information and communication technology and financial markets. From a practical perspective, one may point out that the European Council – here, the heads of governments and presidents of EU member countries – has not raised this topic. Moreover, the European Council has adopted a strange policy goal with the “Lisbon Agenda 2010” in the sense that it has defined a supra-national goal for which the European Commission has hardly any power in laying these foundations. It is the EU member countries which have in principle the means to stimulate economic growth.

The following analysis describes the stages of financial market integration and monetary integration in the EU and presents basic theoretical reflections on financial market integration and about the links between regional financial market

integration and growth. As regards the potential link between financial market dynamics and economic growth, we rely partly on traditional arguments from literature, but we also look at the problem from an endogenous growth perspective. This requires that we:

- look at the level of the growth path, with the neoclassical growth model suggesting that one examine the impact of financial market integration on the savings rate.
- look at the growth rate of output as explained by various elements of financial market integration.

It seems to be rather unclear as to whether regional financial integration in the Euro area has strongly fostered economic growth in the Euro area thus far. Part of the problem is that regional integration effects are superseded by globalization effects on the one hand. On the other hand, policymakers in some EU member countries have adopted economic policies, which did not promote growth and employment. Moreover, interesting effects of financial market integration can also be studied in the context of EU eastern enlargement. From the perspective of accession countries, membership brought with it the advantage of reducing the political risk premium to almost zero so that higher foreign direct investment (FDI) inflows could be anticipated. High FDI inflows could be particularly stimulating for growth if FDI were significant and entering those sectors crucial for economic modernization, including the financial market sector. Banking and insurances are, however, traditionally considered sensitive sectors so that there are considerable impediments for taking over banks or other financial intermediates.

At the bottom line we must ask which policy options could be useful for promoting growth and employment. We find that financial market integration has not yet been completed in the EU and that both national policymakers and the supra-national policy level of the EU could contribute to higher growth. Political interference in goods markets and political obstacles to inward foreign direct investment as well as to outward foreign direct investment are key problems which must be overcome. If the Euro area does not adopt a more coherent set of policy measures, the Euro zone might disintegrate in the long run. The creation of an economic and monetary union in the EU has opened a window of opportunity in Europe, however, it is unclear whether policymakers will come up with consistent policies and the necessary set of reforms to stimulate productivity growth and innovation in the Euro area. Those EU countries which are not yet members of Economic and Monetary Union can be expected to closely watch the dynamics of integration and growth in the Euro area and outside. It also is interesting to focus on issues of future enlargements of the Euro zone which effectively began with German unification in 1990. The negative referenda on the EU constitution – in France and the Netherlands – raise doubts about broad political support for EU deepening and EU widening. It is clear that integration projects normally have the support of broad strata of the population if integration contributes to higher growth and employment. This also reinforces the ability of politicians to pursue EU interests abroad. Thus the question rises as to whether the EU still has a consistent set of goals, strategies

and means. Achieving sustained growth will not, however, be easy in an ageing society, which naturally brings about a decline in long term growth rates of the respective country (McMorrow & Roeger, 2004). Much will depend on the process of financial market integration which in principle could stimulate higher long run growth.

Section E.2 describes financial market integration, while Sect. E.3 looks at theoretical aspects of financial market integration and economic growth. In Sect. E.4, we consider the interplay between globalization forces and regional integration dynamics. Section E.5 concludes with basic policy suggestions.

E.2 Financial Market Integration in the EU

E.2.1 The Integration Process in the EU

Since the end of the World War II, processes of integration within European countries have taken place. This began with the European Coal and Steel Community in 1951, the European Atomic Community in 1957, the Treaty establishing the European Community, also in 1957. In the 1960s, debates arose as to the feasibility of monetary integration as a complement to the higher developed real integration. In the early 1970s, the Werner Plan towards a monetary union failed on one hand due to the dollar crisis in 1971, which led some European countries to choose a floating system instead of a planned fixed currency peg to the US Dollar. On the other hand, the oil price shock(s) had negative impacts on the global economies and thereby on financial markets as well. The European Currency System in 1979 introduced the ECU, an artificial currency unit which allowed the participating countries a small margin of fluctuation ($\pm 2.25\%$) around their central rates. Cooperation of the countries involved led to a closer economic policy of the community members with respect to the use of policies of those countries with more stable economies (Deutsche Bundesbank, 2002).

The financial integration started slowly, namely with the First Banking Directive in 1977, establishing a list of common authorization criteria for a credit institution, and through the Banks' Annual Accounts Directive in 1986, which harmonized the financial disclosures by banks in their annual accounts. Moreover, a few directives for the establishment of insurance companies could be implemented as well as some for listed companies on capital markets such as the harmonization of listing conditions and disclosure requirements (Diereck, 2005).

The Single European Act (1986) provided for the completion of the single market by the end of 1992. The Delors Report (1989) suggested the creation of an Economic and Monetary Union within three steps. In July 1990, this project started for example through the Capital Liberalization Directive issued 1 year earlier, which forced the Community member states to abolish control of cross-border capital movements such as exchange controls. Further characteristics of the EMU will be described later.

The European Community of 1957 is considerably different from that at the beginning of the twenty-first century. The above-mentioned steps towards a common financial union took 30 years of effort, resulting in both progress forward but also steps backward. Besides the integration of programs and contents through the creation of a real single market, the Community increased in size from six members to 25 members. After a Western enlargement with the UK, Denmark and Ireland (1973), two Southern enlargements with Greece (1981), Spain and Portugal (1986) and a Northern Enlargement with Sweden, Finland and Austria (1995), ten new members from Central and Eastern Europe joined the European Union in May 2004. The Eastern enlargement looks to be the most challenging process of integration the union has faced, as former members of the Warsaw Pact have moved away from centrally-planned economies towards market economies through a difficult transition process. The enlargement processes very often brought together well-developed economies and less-developed economies. The group of cohesion countries has developed at different paces. Ireland is no longer a cohesion country; Spain is prospering, while Greece and Portugal still have certain problems. The last enlargement can therefore be regarded as a very ambitious project with the goal of managing quite differently developed economies which also has impacts through and on financial markets as well as on the member states' relations to the EMU. Thus, the European Union can nowadays be divided into three groups:

Eleven Western Countries already joined the Euro area in 1999 (Greece in 2001). Three Western countries have been members of the EU for more than 10 years but have not yet adopted the Euro. The ten new member states of Central and Eastern Europe joined the EU in May 2004 and are obliged to join the EMU as soon as possible.

The step of all member states towards a joint Political European Union is far away and became even more distanced due to the European identification crises marked by the non-acceptance of the elaborated European Union constitution by two referenda in France and the Netherlands.

The single market is one of the most important institutions of the EU (single market programme, 1992). It is based on the four freedoms:

- the free movement of goods;
- the free movement of services;
- the free movement of persons;
- the free movement of capital.

The free movement of services enables companies to establish their enterprises within the whole EU territory (freedom of establishment). There are even special EU legal forms of a company. This is not only interesting for companies but especially for financial intermediaries such as commercial banks, insurance companies, etc.

Together with the free movement of capital, the importance of competition developed a European dimension. An enlarged market allowed investors not only to relocate their businesses abroad but also gave the impact of Foreign Direct Investments a new degree. The control towards new cartel and merger directives

became a new EU competition policy issue. The banking sector certainly experienced lots of changes over the last decades in this respect. On the other hand, the free movement of capital enforces the law of one price (as shown later) (Fig. E.1).

E.2.2 The European Monetary Union

The EMU is unique; there is world wide neither another economic union with a common central bank nor with a currency union. Thus the European Monetary Union is a special case, and its ‘success’ can better be assessed after a longer time in existence. Here we turn to a general discussion of the benefits and potential risks of a monetary union and a brief description of the stages necessary to realize the project ideas.

A monetary union is based on absolutely fixed exchange rates, and there is full capital mobility and free trade in goods and services. A special case of the monetary union is a currency union. This is additionally the case when at least two countries replace their national currencies with a common currency (Visser, 2004).

Benefits of a monetary union are:

- Lower transactions costs: no special fees are needed for converting one currency into another. This leads to cost reductions and efficiency gains in trade and generates higher output. As regards households, this leads to higher savings and consumption, with companies possibly realizing higher investments.

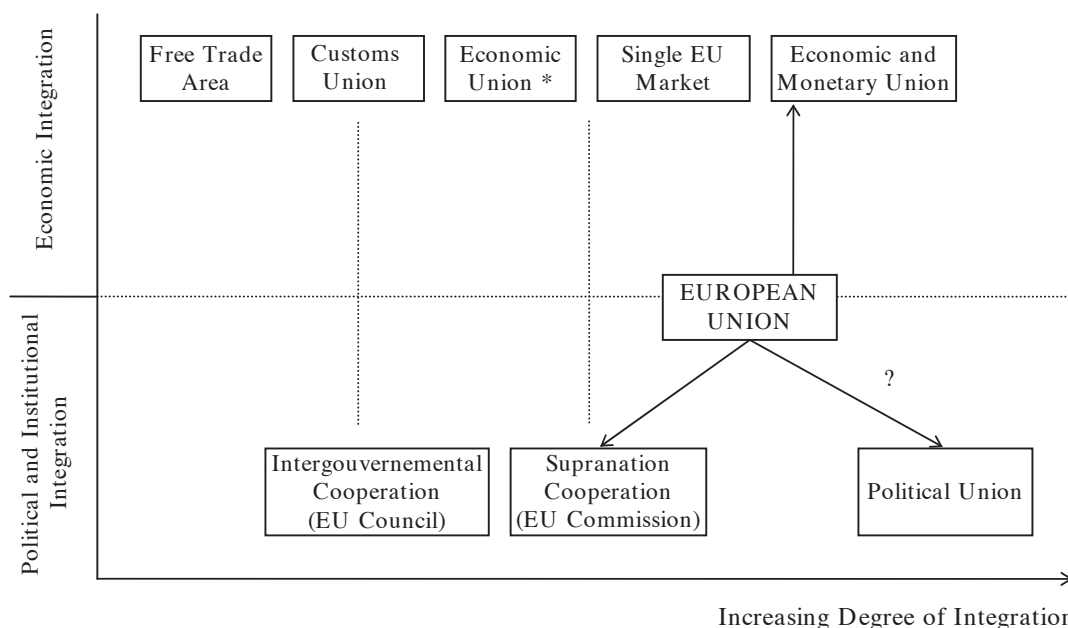


Fig. E.1 Political and economic integration in the European Union (*EU: see common competition policy. Partially based on Platzer, 1992)

- With a uniform unit of account, it is easier to compare prices which leads to better allocation of resources and reduced information asymmetries.
- In the case of the European Union, the Euro can play a more important role in the global currency and bond markets. A stable currency – this is one of the aims of the common European currency – will encourage international business partners to use the Euro as the preferred invoice currency.

Commercial banks within the currency union can use a common international payment system. In the case of the EU, the TARGET or the TARGET II payments system connects the national central banks to a common settlement system.

On the other hand, some potential risks are connected with the establishment of a common monetary area:

- The abandonment of the power of national banks towards an independent supra-national central bank leads to a centralized monetary policy management. This includes the control of the change of the nominal money supply (M) as well as the control of interest rates.
- Lack of differentiation in monetary policy could be a problem for EMU member states if business cycles are not synchronized.
- Absence of national monetary strategies could lead to a greater importance of fiscal policy. It is rather unclear how fiscal policymakers will react to EMU and whether fiscal policies across countries will become better coordinated in the Euro zone than before.
- Individual member countries can no longer rely on the exchange rate instrument as a means of stabilization. The flexibility of participating states over exchange rate management is lost.

E.2.2.1 Three Stages Towards the EMU

The establishment of the EMU required considerable time. In the late 1980s, the Delors-Report gave a roadmap of necessary steps and a timetable for monetary union. The EU largely followed the Delors Report and its three stages.

Stage 1 started on July 1, 1990. The restrictions on the movement of capital between the EU-12 member states were abolished. The task of member states was to arrange their financial policies to achieve the European Council emphasis on maintaining price stability. These policy actions have since been monitored biannually by the ECOFIN council that could consult the member states in necessary. The Treaty on European Union, signed in Maastricht in February 1992, came into force on November 1, 1993.

The European Monetary Institute (EMI) was established in Stage 2, which began on November 1, 1993. Its main tasks were as follows:

- to strengthen central bank cooperation and monetary policy coordination;
- to prepare the establishment of the ESCB;
- to conduct the single monetary policy;

- to prepare for the creation and the distribution of a single currency;
- to elaborate on the new exchange rate mechanism (ERM II) for those countries not joining the Euro on January 1, 1999.

The countries that tried to become members of the newly-created Euro area had to adjust their economic policies to fulfil the Maastricht convergence criteria. The following six convergence criteria of the Treaty establishing the European Community and Article 1 of the protocol on the convergence criteria are relevant in this respect:

- Inflation rate: not more than 1.5% above the average of the three countries with the lowest inflation rate;
- The long run interest rate should not be higher than two points above the three countries with lowest inflation rate;
- The deficit-GDP ratio should not exceed 3% per year (Only in a recession can this limit be exceeded.);
- The debt-GDP ratio should not exceed 60% (This is also part of the Stability and Growth Pact.);
- A stable exchange rate (no devaluation of the currency for at least 2 years);
- The political independence of the national central banks in the respective candidate country must be guaranteed.

In 1998, the first 11 countries were selected, although some of them failed to meet all the convergence criteria. Problems were mostly due to excessive debt levels. Their aim concerning further economic policies had to be to lower these deficits, partly with the help of budget consolidations. In accordance with this, the European Council adopted the Stability and Growth Pact with its regulations on “the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies” and on “speeding up and clarifying the implementation of the excessive deficit procedure”.

Moreover, the conversion rates to the Euro were set as well as the choice of the leading personnel of the new European Central Bank. Overvaluation of the exchange rate would undermine long-term competitiveness and full employment, while undervaluation would also have its problems.

The third and final stage started on January 1, 1999. The creation of the Euro zone with 11 EU countries (Greece joined 2 years later; the UK and Denmark opted-out and Swede also declined participation. The latter two said no by means of a referendum in 2000 and 2003, respectively). The most important issues were the creation of the European System of Central Banks with an independent European Central Bank that effectively replaced the former EMI and the national central banks in the Euro zone. The new currency, the Euro, at first existed only as fiat money; cash was first introduced in 2002. The Euro thus only existed in the form of deposits for non-cash transactions. For several months, there were double price markings in most shops in the member countries of the Euro zone.

E.2.3 The Institutional Framework

E.2.3.1 Stability and Growth Pact

Since the national states and their economic policies have a deeper impact on the economic outcomes of the neighbouring states, the ECB can work more efficiently with its monetary policy when all member states operate under the same target, that is, to avoid excessive deficits and thus high debt levels under a more concrete tailored national fiscal policy.

A specific element of ECB policy was to outline the main strategy of price stability (max. 2% p.a. within the whole EMU territory) within the Treaty establishing the European Community. The stability of the common currency is the other major aim of the EMU. The Stability and Growth Pact, which prolonged the fiscal convergence criteria and was expected to bring about prudent deficit policy of Euro zone member governments – thus avoiding bail out problems (main idea of Germany) – includes criteria and procedures to achieve these goals. It also envisages sanctions for those countries, which violate this pact through extraordinarily high deficits (i.e., a deficit ratio above 3% in periods of no recession) and the neglect of advice by the European Commission on the consolidation of government budgets. A country with an excessive deficit may have to pay a fine of up to $\frac{1}{2}$ percentage point.

In the case of Portugal, these sanctions were applied to some extent, but since the pact was buried when not applied to Germany and France in 2004, its existence and impact is very questionable. The governance of monetary policy is distorted in the EMU, because smaller countries complain that the larger countries, which have violated the pact (Germany and France) have not been adequately punished. This issue also leads to problems with respect to an Eastern enlargement of EMU.

A critical point of Eastern EU Enlargement also concerns the convergence criteria. The application for the first group of countries, which sought to join the EMU was not very strict. The start of EMU had its own problems, suggesting pragmatic EMU enlargement towards eastern European EU accession countries. On the basis of the macroeconomic key figures of 1997 and 1998, all willing EU countries had been accepted to become the first members of the EMU. This process was very crucial since several countries had problems fulfilling the convergence criteria as required (for 2 years). For example, Germany reassessed the value of its gold reserves, which was crucial both from both an economic and legal point-of-view, leading to a debt-GDP ratio under 60% which could only be realized under this circumstance. Many countries such as Belgium and Italy had started with a higher debt-level than 60% (in their cases > 100%) which means that the initially elaborated and set rules were violated even before the EMU had begun. Generally some countries had problems fulfilling the convergence criteria for 2 years, and this was finally neglected. It can be seen that the EMU process (and possibly its enlargement process as well) is more a political process than an economically-based concept. Even the opting-out by the UK, Denmark and Sweden was due to political constraints. The assumption that it may be enough that countries fulfil the convergence criteria for only 2 years is

doubtful; this seems unfeasible due to the question on sustainable financial policies for the big aims of the European Monetary Union. The basis for prudent financial policies of the member states is not given, and the actual discussion on the SGP is based on the lenient management of the initial EMU phase.

E.2.3.2 ESCB and ECB

The ECB is a politically independent institution. Article 105 of the Treaty establishing the European Community states that the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives² of the Community as laid down in Article 2.

The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4. Price stability is defined as a maximum increase of 2% of the Harmonized Index of Consumer Prices (HICP) per year.

The monetary policy of the ECB is based on the two pillars confirmed by the ECB Governing Council in May 2003 (European Central Bank, 2004a):

- on growth of money supply, namely of M3;
- on development of other variables (e.g., exchange rate).

Alternative strategies could be to only rely on M3 development (as the Deutsche Bundesbank did successfully in the period of the DM between 1975 and 1998) or the inflation targeting as applied by the Bank of England.

E.2.3.3 Integration of European Financial Market System

As regards the integration of financial markets in the EU, there have been various reforms over time, in particular (Hartmann et al., 2005):

- Single European Act 1987;
- Liberalization of capital flows 1990;
- Second Banking Directive 1992;
- Financial Services Action Plan (FSAP) 1999–2005;
- Green Paper on financial sector policies 2005–2010.

The FSAP goes hand-in-hand with Lisbon Agenda which aims to lead the EU to become the most competitive and dynamic knowledge-based economy in the world

²These objectives are “a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States”.

by 2010. Integrating the financial markets is a key issue and includes a unified corporate market, open and secure retail markets and the modernization of supervisory rules. The German government announced that 93% of the measures have been already put into practice by the end of 2004 (The Federal Government, 2004). The Green paper on financial sector policies is not supposed to replace the FSAP policies, and the Lamfalussy process continued the integration process of financial markets with its main emphasis on

- “the consolidation progress towards an integrated, open, competitive, and economically efficient European financial market and the removal of the remaining economically significant barriers.
- Fostering a market where financial services and capital can circulate freely at the lowest possible cost throughout the EU – with adequate and effective levels of prudential control, financial stability and a high level of consumer protection.
- the implementation, enforcement and continuation of the evaluation of the existing legislative framework, to deploy rigorously the better regulation agenda for any future initiatives, to enhance supervisory convergence and strengthen European influence in global financial markets” (European Commission, 2005a, p. 3).

E.2.3.4 Macroeconomic Development of the EMU

Generally, EU countries achieved sustained growth. However, non-members of the Euro zone recorded slightly higher growth in the period between 2002 and 2005 than did their participatory counterparts. Especially the larger EMU countries such as Germany, France and Italy experienced low growth rates. In the Euro zone, Austria and the Netherlands which used to share the low inflation policy strategy of the Deutsche Bundesbank in the 1980s and the 1990s had, however, a better growth and employment record than Germany. Smaller countries such as the Northern countries and especially Ireland did much better. Portugal and Greece faced serious deficit problems. Real dynamics are partly linked to financial market integration. As regards the EMU’s aims (Single Market Programme and Full Monetary Integration), we must therefore have a look at the relevant convergence criteria.

The inflation rates converged during the late 1990s. Italy and Spain (after its accession to the EC) were especially successful at lowering their inflation rates and achieving lower real interest rates. The question as to whether membership in the EMU could help in achieving convergence is easily answered in nominal terms. However, different inflation rates across countries of the Euro zone suggest that real interest rates could continue to differ. In 2003 and 2004, the ECB was able to keep the inflation rate at 2% p.a. despite certain concerns on high energy prices (Bank for International Settlements, 2005). After 5 years of unchanged ECB interest rates, the European Central Bank modestly raised interest rates at the end of 2005. As regards the exchange rate relative to the US dollar, 2005 showed a relatively weak Euro which thus corrects the strong appreciation of 2003/2004. There is little doubt that the relatively high interest rates in the US in 2005 contributed to an appreciation of the dollar.

As regards the debt-GDP ratio, it is interesting to see that few EU countries could strongly decrease their debts between 1999 and 2004. However, not only did the two largest countries Germany and France have problems lowering their debt-GDP ratio. Between 2002 and 2004, six out of fifteen countries increased them. The smaller Northern countries and Ireland – as well as Belgium and Italy, which initially had high debt levels – showed a fiscal policy geared toward reducing the debt-GDP ratio (Fig. E.2 and Table E.1).

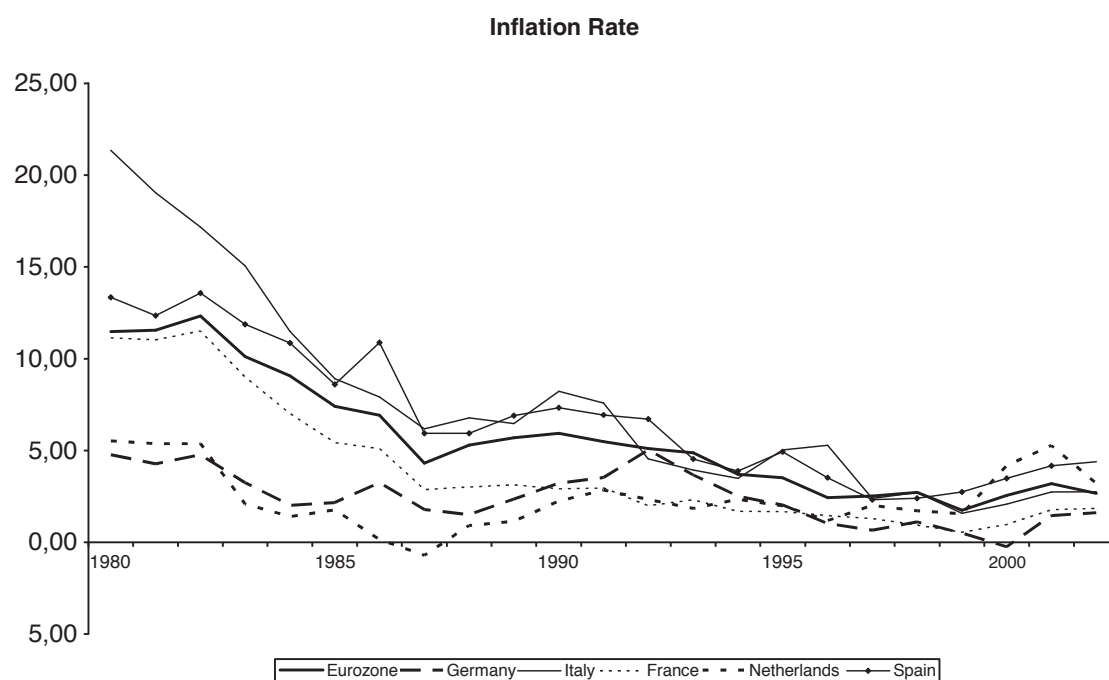


Fig. E.2 Inflation rate development of selected Euro area members (*Source: AMECO Database*)

Table E.1 Gross debts in % of GDP and their changes 2004/1999 in %

	1996	1999	2002	2004	1999–2004
Luxembourg	6.2	6.2	7.5	7.5	21%
Ireland	74.1	52.4	32.6	29.9	–43%
UK	52.6	46.0	38.3	41.6	–10%
Denmark	65.0	52.6	47.2	42.7	–19%
Finland	57.1	47.1	42.5	45.1	–4%
Spain	68.0	63.5	55.0	48.9	–23%
Sweden	76.0	65.5	52.4	51.2	–22%
The Netherlands	75.3	63.8	52.6	55.7	–13%
Portugal	63.6	56.8	58.5	61.9	9%
Austria	63.9	64.9	66.7	65.2	1%
France	57.1	58.6	59.0	65.6	12%
Germany	59.8	61.1	60.9	66.0	8%
Euro area	75.2	72.2	69.5	71.3	–1%
Belgium	128.3	114.4	105.4	95.6	–16%
Italy	122.1	114.9	108.0	105.8	–8%
Greece	111.3	104.4	112.2	110.5	6%

Source: European Central Bank (1999, 2004b)

A potential European economic recession would cause severe problems for EU member states. Despite the positive outlooks for the Northern countries, the Euro area faces structural problems. This is especially the case in Germany, France and Italy, but also in Portugal and Greece. Germany and Italy seem to face particular problems (Table E.2).

Since 1998, all countries considered have had almost the same long term interest rates. This convergence process became more obvious as the EMU's starting date approached, which seemed to have a big influence on the candidate countries (Figs. E.3 and E.4).

Table E.2 Deficit-GDP ratios in % of GDP, 2004–2006

	2004	2005e	2006e
Luxembourg	−1.1	−1.5	−1.9
Ireland	1.3	−0.6	−0.6
UK	−3.2	−3.0	−2.7
Denmark	2.8	2.1	2.2
Finland	2.1	1.7	1.6
Spain	−0.3	0.0	0.1
Sweden	1.4	0.8	0.8
The Netherlands	−2.5	−2.0	−1.6
Portugal	−2.9	−4.9	−4.7
Austria	−1.3	−2.0	−1.7
France	−3.7	−3.0	−3.4
Germany	−3.7	−3.3	−3.8
Euro area	−2.5	−2.6	−2.7
Belgium	0.1	−0.2	−0.6
Italy	−3.0	−3.6	−4.6
Greece	−6.1	−4.5	−4.4

Source: European Central Bank (2004b)

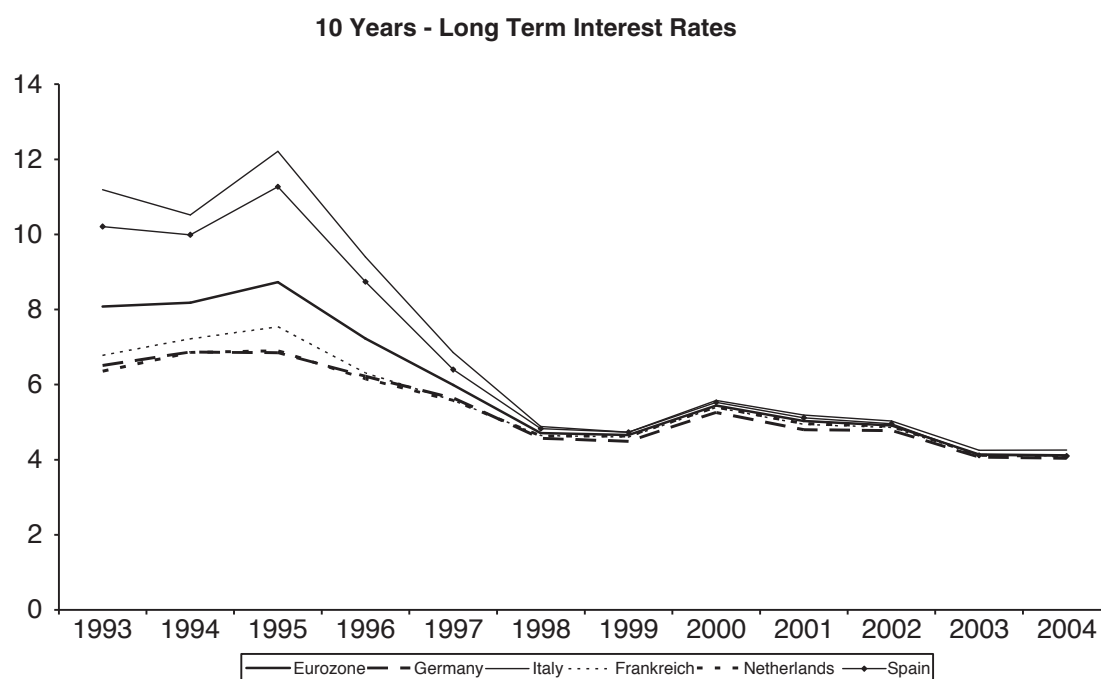


Fig. E.3 Long-term interest rates of the EU countries (Source: AMECO Database)

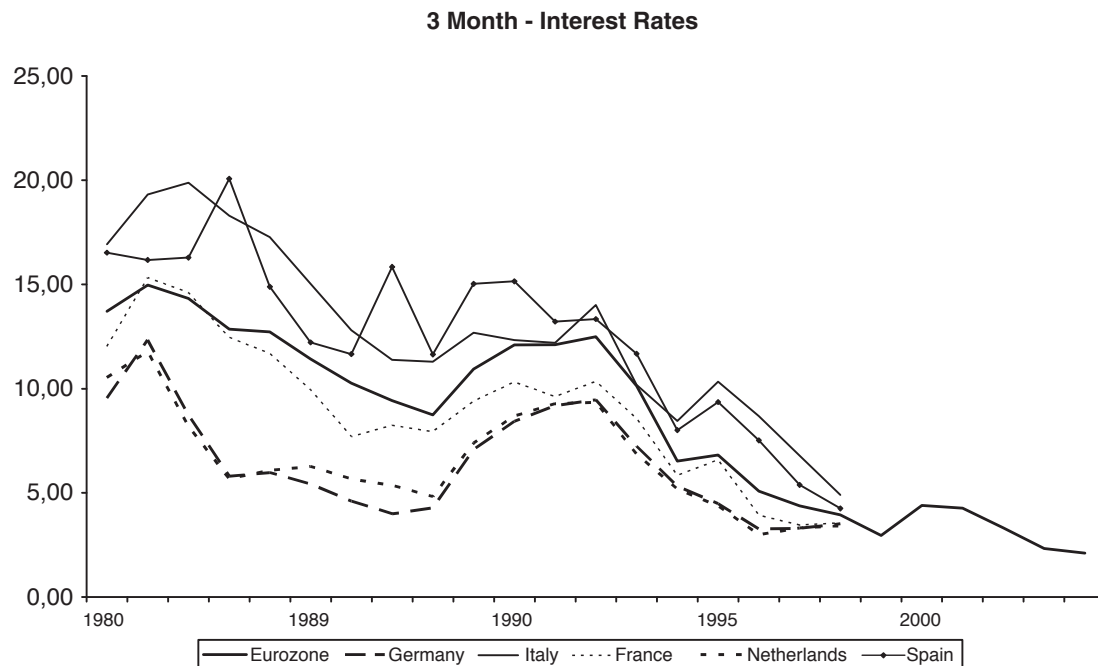


Fig. E.4 Short-term interest rates of the EU countries (*Source: AMECO Database*)

E.2.4 Financial Market Integration

There is not a clear definition for the integration of financial markets in the literature. Therefore we refer in this chapter to the non-discriminatory aspect of integrated financial markets, a key issue of the European single market which means that the following definitions and arguments concerning financial integration be compared with other integration process of other markets. Baele, Ferrando, Hördahl, Krylova, and Monnet (2004, p. 6) emphasize the following three characteristics of integrated financial markets. All market participants:

- “face a single set of rules when they decide to deal with financial products and/or services;
- have equal access to these financial products and/or services and
- are treated equally when they are active in the market”.

Lemmen (1998) distinguishes between a “perfect financial integration”, which means that no barriers exist preventing investors from changing their portfolios instantaneously, and the condition of “no integration”, where barriers do exist. Therefore financial integration is a process referring to the gradual dismantling of capital controls and other institutional barriers affecting the degree of financial integration.

E.2.4.1 Beneficial Effects of Financial Integration

Larger financial markets – cross-border trading enhances efficiency – for which all market participants have the same access to financial products and services lead and/or foster competition among suppliers and demanders of these products

and services. A more efficient allocation of production factors, in particular capital, implies more attractive investment opportunities (Bekaert, Harvey, & Lundblad, 2002; Rousseau, 2002), which again means a higher mobilization of savings (Levine, 1997). Especially less-developed regions offer more interesting investment opportunities, provided that political and economic stability as well as legal reliability are established. This can be expected in the European case in the Central and Eastern European countries. Those countries which opened their markets in the 1990s (together with other attractive location factors) attracted high foreign investments. The remarkable catching-up process corresponds with favourable macroeconomic indicators, and the benefits of financial integration are therefore more attractive in less-developed regions (Gianetti, Guiso, Iappelli, & Pagano, 2002).

Since these emerging economies could be regarded as countries with broad investment opportunities at a high risk-high return level, the aspect of foreign involvement in financial markets of countries with a higher developed financial system is also remarkable. This foreign involvement improves the intermediation process and in return lowers the costs and risk specification of investment opportunities (assuming a constant return rate). Of course, risk-averse investors could hedge the risk to some extent; the usage of specialized intermediation partners could generally lower the risk level.

Moreover, innovations of financial products and services from newcomers should be expected from the supply side through the enlargement of financial markets. This is advantageous in the sense that it diversifies investor portfolios. Financial systems which facilitate trading, hedging, diversifying and the pooling of these risks lower the level of uncertainty (Levine, 1997). One can see a reciprocal link between financial development and financial integration. The aspect of higher sovereign credibility is also linked with this issue. One can observe that rating agencies of international investors have steadily upgraded the ratings of the EU countries over the last several decades, especially of the catching-up and cohesion countries.

The openness and the deepening of the financial system should therefore lead to higher economic growth. "Indeed, economic growth and financial development are so intertwined that it is difficult to draw any firm conclusion with respect to causality" (Baele et al., 2004, p. 9). Levine (1997) adds: "While many gaps remain, broad cross-country comparisons, individual country studies, industry-level analyses, and firm-level investigations point in the same direction: the functioning of financial systems is vitally linked to economic growth."

A useful indicator for regional financial market integration is not only nominal interest rate convergence (reflecting the law of one price in financial markets), but also the interest rate spread; as regards the latter, one should expect that margins for standardized products fall. Given the incentives from Basel II to adopt a more differentiated pricing of risk, one should, however, also expect to see a more differentiated set of interest rates. To the extent that financial market integration fosters consolidation in the banking sector, we could witness rising profit rates in the medium term.

E.2.4.2 Potential Risks of Financial Integration

Since the integration of financial markets is not a self-running process, regulation of the monetary policy as well as of legal and institutional design, for example, have to be seriously and carefully considered. The financial system has “to guarantee a smooth and effective transmission of monetary policy” (Baele et al., p. 4). The financial markets within the European Union are regulated quite tightly through numerous directives, treaties and other agreements. The potential risks through the existence of the ESCB have already been discussed above. The consolidation processes over the last decades and those of the future may lead to a lower competition level. This effect cannot be regarded at the moment in all market segments, but generally this problem has to be taken into account (Baele et al., 2004).

Cross-border mergers and the acquisition of foreign banks include not only an expansion towards global banks and toward cost reduction, it could additionally lead to a concentration process with a oligopolistic or even monopolistic market situation (some examples are given in the next section). There is also the danger of an overcentralization of corporate policy in global banks. The credit policy may not work efficiently, since the centrally elaborate credit policies and the needs of local loans differ. This may negatively affect communication between creditors and debtors. It may also lead to problems within research departments which, charged with the task of managing valuable local data, may lose contact to the regions in which the bank operates. Estimations instead of concrete information could lead to distorted suggestions with respect to banking policies.

Another problem might occur when shocks affect a common financial area. The question as to whether all member states would equally react to that shock must be answered. The collapse of the Soviet Union had a considerable negative economic impact on the Finnish economy, since they were large trading partners. The Swedish economy suffered less. The Russian financial crisis in August 1998 affected Russian trading partners such as the Baltic States and other Central and Eastern European countries not only in real terms. The intra-trade of these Eastern countries within the EU is more intensive today than in 1998, but the danger of a potential Russian crisis in the near future might still be harmful to these Eastern countries. Permanent and steadily-rising oil prices or sudden terror attacks may have different impacts on financial markets in EU member states, and a possible contagion effect must seriously be taken into consideration.

Financial stability is more difficult to handle due to the problem of the heterogeneity of the EU financial markets; corresponding figures may be proof of this. The monetary policy of the ECB, which similarly influences all member states, might not be working sufficiently. The ECOFIN council, which elaborates on financial working plans for member states in order to fulfil the Stability and Growth Pact or the convergence criteria, might sometimes be inappropriate. Moreover, the fact that these heterogeneous member states all have the same currency with no direct influence on it is for some countries, especially for the larger as well as the cohesion countries, less helpful. The potential of an appropriate

economic policy through fiscal policy is restricted. Understanding the scope of other issues (e.g., employment policy, dismantling of bureaucracy) takes much time, and the path of implementation into active economic policy has overcome lots of political hurdles.

Generally, this controllability is an enormous task for European institutions, since financial markets interact on an enlarged European environment. The (partly cross-market) effects on consolidation and concentration are challenging for market participants as well as the EU policy makers (i.e., competition policy), as the following section shows and the case of Greece in 2005 proved. Greek policymakers were able to manipulate their budget results for many years to give the semblance of more acceptable budget deficits. Hungary followed a similar course of action with its 'creative accounting' methods. Even Euromoney claimed these countries were "enronizing" their bond markets, alluding to the Enron accounting scandal at the beginning of twenty-first century (Euromoney, 2005).

There is a lack of both legal and economic concepts to ensure that all member states use the same set of accounting rules. Public Private Partnership projects present many opportunities to deal with problems in the field of governmental expenditures (FTD, 2005a).

E.2.5 Effects of Financial Markets in the Euro Area

With the European integration process, different financial markets in the EU are growing closer, both quantitatively (more suppliers and more demanders of financial products) and qualitatively through financial deepening. Their system of interaction within the European institutional framework is globally unique (Fig. E.5).

In this section, we can consider the arguments described above on the effects of financial integration. We have a closer look at the banking sector and very briefly at some stock market indicators, showing some statistics which represent the effects of consolidation, concentration and competition through integration. Table E.3 shows that the number of the monetary institutions within the Euro area has decreased over the 5 years under consideration by 13%, which means that the consolidation process indeed took place from 1998 to 2002. The number of credit institutions decreased even more rapidly, while money market funds gained more importance.

We can observe an ongoing concentration process within the European banking sector. Especially in Spain, Portugal, Greece and Belgium, the five largest banks were able to increase their asset shares tremendously. In only three of the 15 countries – Sweden, Denmark and Finland – could the concentration process be stopped.

The Herfindahl index measures the degree of concentration of the operating banks in the countries, ranging from 0 to 10,000. A value greater than 1,000 signifies moderate concentration, while a value higher than 1,800 points to a highly concentrated market. Nine European banking markets are insignificantly concentrated, while four out of fifteen are moderately concentrated.

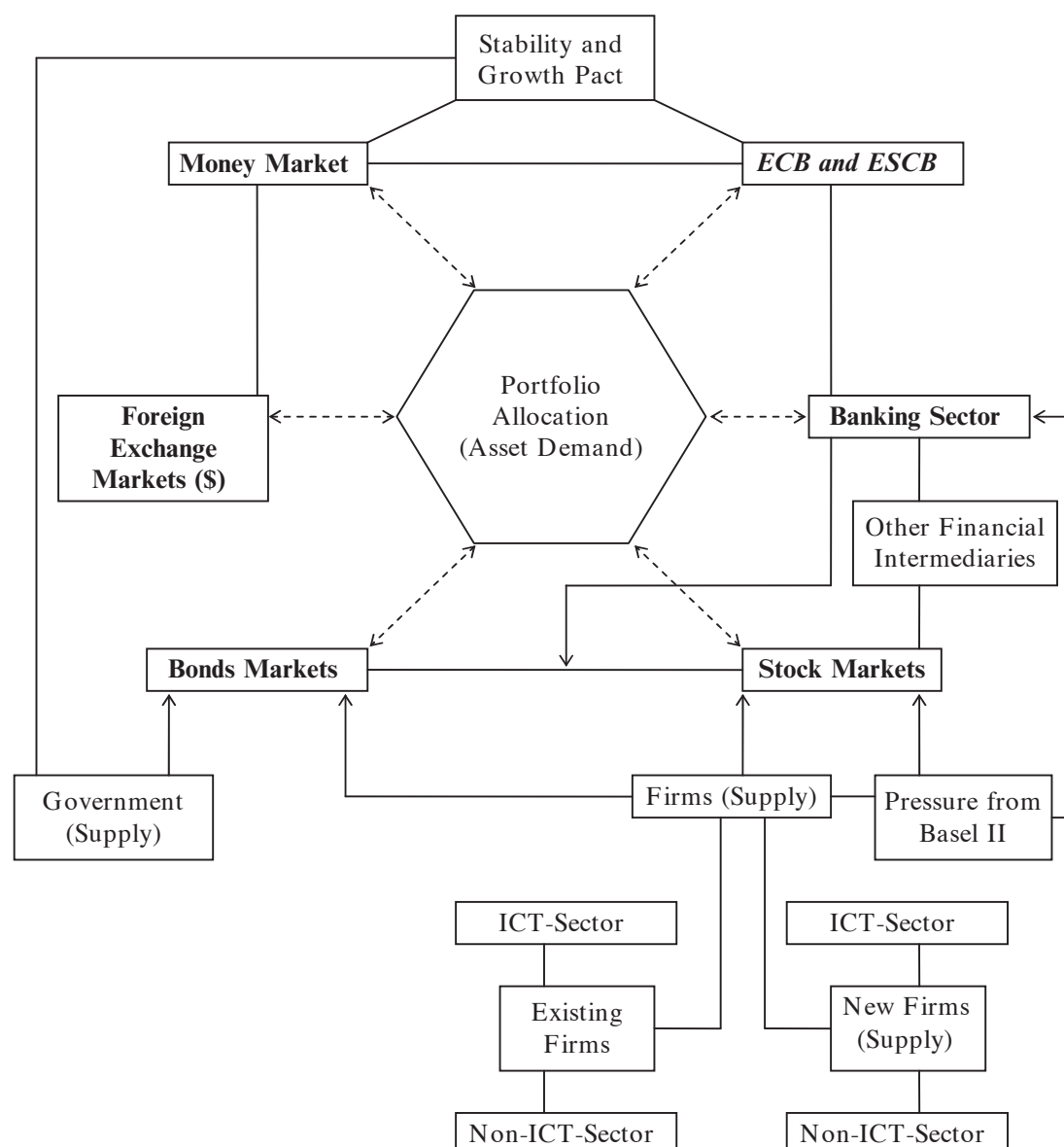


Fig. E.5 The interconnection of the European financial markets

Table E.3 Number of Euro area monetary financial institutions (MFIs)

	1998	2000	2001	2002	1998–2002
Credit institutions	8320	7464	7218	6906	–17%
Money market funds	1516	1604	1631	1620	+7%
Central banks and other institutions	20	20	19	18	
All MFIs	9856	9088	8868	8544	–13%

Source: European Central Bank (2004a)

A number of large mergers and acquisitions in Belgium (e.g., through Fortis) and Finland (e.g., through Nordea) make these markets highly concentrated. In 13 of the 15 countries, the concentration process has been underway for 7 years (Tables E.4 and E.5).

Table E.4 Asset shares of the five largest banks in the EU

Country/year	1997	1998	1999	2000	2001	2002	2003	97–03 index change
Germany	17	19	19	20	20	20	22	+5
Italy	25	25	25	23	29	31	27	+2
Lux.	23	25	26	26	28	30	32	+9
UK	24	25	28	28	29	30	33	+9
Austria	44	42	41	43	45	46	44	0
Ireland	41	40	41	41	43	46	44	+3
Spain	32	35	41	46	45	44	44	+12
France	40	41	43	47	47	45	47	+7
Sweden	58	56	56	57	55	56	54	–4
Portugal	46	45	44	59	60	60	63	+17
Denmark	70	71	71	60	68	68	67	–3
Greece	56	63	67	65	67	67	67	+11
Finland	88	86	86	87	80	79	81	–7
Belgium	54	63	76	75	78	82	83	+29
The Netherlands	79	82	82	81	83	83	84	+5

Source: European Commission (2005b, p. 19)

Table E.5 Herfindahl index for bank's total assets and index change

Country/year	1997	1998	1999	2000	2001	2002	2003	97–03 index change
Germany	114	133	140	151	158	163	173	+59
Italy	201	210	220	190	260	270	240	+39
Luxembourg	210	222	236	242	275	296	315	+105
UK	208	221	250	264	282	307	347	+139
Spain	285	329	441	581	551	529	521	+236
Austria	515	515	511	548	561	618	557	+42
Ireland	500	473	480	486	512	553	562	+62
France	449	485	509	587	606	551	597	+148
Sweden	830	790	790	800	760	800	760	–70
Portugal	577	575	566	986	991	963	1044	+467
Denmark	1431	1442	1499	863	1119	1145	1114	–317
Greece	885	1165	986	1122	1113	1164	1130	+245
The Netherlands	1654	1802	1700	1694	1762	1788	1744	+90
Belgium	699	909	1518	1506	1587	1905	2065	+1366
Finland	2150	2120	1960	2050	2240	2050	2420	+270

Bold figures represent a Herfindahl Index > 1800

Source: European Commission (2005b, p. 20)

E.2.5.1 Developments on Stock Markets

Between 1990 and 2000, the number of listed companies in the European, US and Japanese stock exchanges increased by more than 15%. This trend has declined in all markets of the Triad since 2000, especially in the US. The development of the stock market capitalization process in these regions is even more volatile. The exploding stock bubble, also related to the overperformance of ICT companies as

well as fraudulent company activities and the events of September 11, might be reasons for this abrupt turning point and its deep impacts (Tables E.6 and E.7).

E.2.6 Eastern EMU Enlargement

On May 1, 2004, eight post-socialist countries from Eastern Europe (in addition to Malta and partly Cyprus) acceded to the EU, but not the EMU. The accession countries are expected to join the Euro zone in the medium term. Till then, their monetary and exchange rate policies remain in national hands, but they should conduct policy in accordance with the convergence criteria, generally with the principles of the ESCB. Accession countries are expected to fulfil these as soon as possible. With the adoption of the Copenhagen Criteria and EU membership, the east European accession countries have not only agreed to change their former political and economic system but also to adopt the *acquis communautaire*, which includes switching to the rules of the single market for goods and services (for a transition period without full labour mobility). This naturally also affects financial market developments. With foreign investment from EU15 countries playing a crucial role in most Eastern European accession countries, there is considerable integration of the banking sector in an institutional sense. At the same time, there is some risk for accession countries that the lending policies of foreign banks could often be shaped by headquarters' policies. For example, if the London subsidiary of a major German or French bank is deciding about loans given by the subsidiary in Poland, the countries in eastern Europe might be unable to fully exploit the growth potential in the medium term.

Economic catching-up will be crucial on the road to the Euro since moving closer to the EU12 average income – per capita income in the Euro zone – implies that the Balassa-Samuelson effect will lose significance. This effect basically says that the relative price of nontradables to tradables ($p =: P^N/P^T$) is a positive function

Table E.6 Number of domestic and foreign companies listed on stock markets in the Euro area, the USA and Japan

	1990	1995	1998	2000	2001	2002	1990–2000	2000–2002
Euro area	4276	5106	4546	5516	6357	6271	+29%	+14%
USA	6765	8160	8449	7851	7069	6586	+16%	–16%
Japan	1752	1791	1890	2096	2141	2153	+20%	+3%

Source: European Central Bank (2004a)

Table E.7 Stock market capitalisation of the Euro area, the USA and Japan (% of GDP)

	1990	1995	1998	2000	2001	2002	1990–2000	2000–2002
Euro area	21	28	76	87	72	47	+314%	–46%
USA	53	92	141	153	136	104	+189%	–32%
Japan	90	73	54	67	56	58	–26%	–13%

Source: European Central Bank (2004a)

of per capita income y , since – with b denoting the share of nontradables consumption in overall consumption – the overall price index $P = (P^N)^b (P^T)^{(1-b)}$ and therefore the inflation rate $\pi = \pi^T + (1-b)\pi'$, where π^T and π' represent the inflation rate of tradables prices and the growth rate of the relative price of nontradables, respectively. If one assumes that purchasing power parity holds for tradables in the sense that $P^T = eP^{T*}$ – where e is the exchange rate and P^{T*} the foreign (EU12) price of tradables – the implication of a fixed nominal exchange rate of accession countries would be that $\pi^T = \pi^{T*}$ (where π^{T*} is the inflation rate of tradables in the Euro zone). As long as there is both real convergence and a catching up process, there will be a positive inflation impact from π' – the Balassa-Samuelson effect – which could make it rather difficult to achieve the inflation convergence criterion, an inflation rate which is not higher than the inflation rate on those three countries of the Euro zone with the lowest inflation rate.

Requirements for the new members of the EU eager to enter the Euro zone is that they can join the EMU when they have fulfilled the convergence criteria which includes exchange rate stability for 2 years, in other words, having avoided a deflation. In contrast to Denmark and the UK, the accession countries have no opting-out clause. The following table shows that most of the EMU-accession countries still have problems achieving low inflation rates.

All CEECs can fulfil the criterion of having lower debt-GDP ratios than 60%. The Baltic States are specifically far away from that limit, since their debts accrued during the Soviet period have been completely taken over by Russia. Slovenia has also shown a rather favourable performance. The situation in the other four larger accession countries – especially Hungary – is more critical. At the beginning of the twenty-first century, almost all countries had considerable budget deficits, mostly higher than the critical value of 3% p.a. The need to modernize infrastructure can account for some of the high deficits as well as for the rise of the debt-GDP ratio in accession countries (Table E.8).

Table E.8 Financial convergence criteria of the CEECs, 2004

	HICP inflation ^a	Gross debt- GDP ratio	Deficit ratio	ER changes, 2003–2004
Estonia	3.0	4.9	1.8	CB
Latvia	6.2	14.4	–0.8	3.7%
Lithuania	1.1	19.7	–2.5	CB
Slovenia	3.6	29.4	–1.9	–7.8%
Czech Republic	2.6	37.4	–3.0	–8.0%
Slovakia	7.4	43.6	–3.3	–16.2%
Poland	3.6	43.6	–4.8	–7.6%
Hungary	6.8	57.6	–4.7	CB
Cyprus	1.9	71.9	–4.5	–0.5%
Malta	2.7	75.0	–5.2	0.1%
AC-10	4.0	42.7	–3.9	
Euro area	2.1	71.3	–2.7	

^aBased on harmonized consumer price index; CB = currency board

Source: European Central Bank (2004b)

The CEECs consist of two groups, namely a group of countries slowly moving towards EMU and a second group which is relatively fast and joined the ERM II in 2004. On June 28, 2004, Estonia, Lithuania and Slovenia joined Denmark as the first ‘transition candidates’. Estonia and Lithuania kept their currency board against the Euro, while Slovenia and Denmark use the standard fluctuation band of $\pm 15\%$ and $\pm 2.25\%$, respectively. On April 29, 2005, Cyprus, Malta and Latvia followed, also applying the fluctuation band of $\pm 15\%$ (Table E.9).

Although the strategies described for accession countries are a sign of monetary and financial discipline, the convergence process will probably still take some time. Goldman Sachs (2005) expects the first countries to join already the EMU in 2007, the majority however around 2010. After the Hungarian accounting scandal which once again reveals new dimensions of CEEC fiscal disciplines and catching-up processes, some financial market experts expect Hungary to first enter the Euro area between 2013 and 2016, roughly 10 years after their EU accession (FTD, 2005b).

As regards this accession procedure, there are many issues to ponder including two important strategic aspects:

- Will the enlargement process be managed on a country-by-country basis or in groups of countries? Small countries like Estonia and Latvia will likely never play a huge role in the EMU statistics that affect the value of the Euro. If argued that all the Baltic States could easily join the Euro area, why not Slovenia as well, which offers better real figures than Portugal and Greece. The Czech Republic demonstrates good financial results, but should one ignore Slovakia? The answer to this question may finally be decided due to political reasons.
- Do countries really have to fulfil all criteria? It would not be surprising if the accession countries made this argument, as several EMU-12 countries themselves have at least to some degree failed to fulfil the criteria of the Stability and Growth Pact and formerly the Maastricht Criteria. The larger countries have particularly violated the legal principle of “pacta sunt servanda”, which

Table E.9 The EMU accession strategies of the CEECs

	Monetary policy strategies	Exchange rate regimes
Czech Republic	Inflation target	Managed float
Cyprus ^a	Exchange rate target	Pegged to the Euro
Estonia ^a	Exchange rate target	Currency board
Hungary	Inflation target with an ER constraint	Pegged to the Euro
Latvia ^a	Exchange rate target	Pegged to the Euro (2004: SDR)
Lithuania ^a	Exchange rate target	Currency board
Malta ^a	Exchange rate target	Pegged to basket: Euro, GBP, USD
Poland	Inflation target	Free floating
Slovakia	Inflation targeting plus managed floating	Managed float
Slovenia ^a	Two pillar strategy (as ECB)	Fluctuation band: $\pm 15\%$

Source: European Central Bank (2004b)

^aMembers of ERM II

opens up new aspects of freedom to deal with those agreements and criteria more freely. The institutions that deal with the monetary enlargement should therefore be prepared to elaborate on individual customized strategies for the accession process as well as some scenarios for different outcomes to these criteria over the first years, both for each individual country and for the EMU as a whole.

- The existing and future problems of the accession countries, their increasing debts and the high current account and balance of payments deficits lead to the question of a maximum limit which should not be exceeded, and this should be applicable to the existing EMU-12 countries as well. There is space for further research and the development of possible scenarios to be prepared for the future.

The credibility of the European Union that also affects the Monetary Policy as well as the development of the Euro is at a critical juncture. (It was quite interesting to see that after the two failed referenda and the emerging constitutional and political crisis, the Euro has been quite heavily devaluated.) The stability of the EU as a whole and of the financial markets is no longer a given as was formerly supposed. Extreme shocks such as new financial bubbles or terrorist attacks (i.e., September 11) or even the question of further political enlargements of the EU which might over-extend the EU's capacity (Bulgaria, Croatia, Romania and Turkey) may open the doors to social predicaments that affect financial markets and its participants; in such a situation, the question of the sense of the Euro and the ESCB may once again become prevalent.

The right timing of the next EU and EMU enlargement as well as related strategies must therefore be managed carefully. Further accessions at too rapid a pace could cause serious problems.

E.3 Theory of Financial Market Integration

E.3.1 From Basic Theory to Endogenous Growth Approaches

From an economic perspective, globalization is mainly shaped by intensified trade dynamics, rapid growth of capital flows and the expansion of the digital economy. For a better understanding of the links between financial markets and growth, one should take into account standard theoretical elements as well as some new aspects related to, for example, the role of ICT, which is a critical sector in several ways. As regards ICT, one should note that productivity growth in the US banking sector is strongly influenced by sectoral accumulation of ICT capital, while the productivity impact of ICT in the EU is – for unclear reasons – more modest (Inklaar, O'mahony, & Timmer, 2003). Impediments to intra-EU foreign direct investment in the banking sector could be part of the explanation.

Moreover, it is important to consider the link between financial market development and technological progress. In an economic system with innovating firms,

there is a basic information asymmetry between the innovating firm and the institution financing the respective project (and related investment). Depending on the type of financial system, it is more or less difficult to finance innovation projects, with small and medium-sized firms having particular problems. In a system with universal banks, it is relatively difficult to finance international innovation projects of a firm unless there is a long term relationship between a major bank and the respective firm, with the bank also being active in those markets/countries – and thus getting relevant information – within which the innovating firm has partners. If the innovating medium-sized firm has high profit rates and retained earnings, it can signal credibly to the banking community that it is willing to adequately share risks in the innovation project.

The alternative to bank-financed innovation projects is to rely on stock markets while building up reputation as a successful innovator. This in principle requires taking a firm public. The more technologically advanced the country is, the more it should rely on stock markets as a source of financing innovation and investment projects. International stock market listings can help innovating firms from small countries get broader access to global risk capital. However, listing a European or Asian company in New York is relatively costly. Regional integration of stock markets is thus an alternative for both EU and ASEAN countries. If the respective firm is a newly-created high technology company, it will not immediately be able to rely on stock markets, rather it will need adequate access to venture capital. As regards venture capital, regional integration of venture capital markets could also stimulate both dynamic start ups and long run growth. However, one should not really expect sweeping economic benefits from financial market integration if this is not embedded in a broader concept. The overall economic system consists not only of financial markets, and therefore benefits cannot be fully realized if there are stumbling blocks for growth in other factor markets. Moreover, one should raise the issue as to whether there is a critical minimum degree of financial market integration – say, as defined by full interest convergence across 2/3 of the maturity spectrum (starting with short term markets), and one may well debate whether there is full integration if mortgage markets are not truly integrated, which national regulations often impair.

From a theoretical and empirical perspective, one may state that output Y positively depends on (Welfens & Jungmittag, 1996, 2002, in Audretsch & Welfens) not only on the input of capital, labour and technology (technology input as measured by patents and real expenditures on the import of licenses), but also on the use of telecommunications which is a proxy for the intensity of the diffusion of new technology.

An interesting empirical approach was conducted by Jungmittag (2004), who finds that not only capital, labour and patents are empirically significant for the growth of output for the EU15, but also the degree of high-technology specialization (Ω'). From this perspective, it is not simply technological specialization – emerging in an open economy under the joint pressure of trade, foreign investment and financial market dynamics – which is relevant for growth, rather it is specialization in high technology sectors.

A standard reference in empirical growth analysis is Mankiw, Romer, and Weil (1992) who explain growth of real income by the investment output ratio and human capital. Their approach is, however, somewhat doubtful, since they impose the assumption that the growth rate of technological progress is the same across all countries of the sample which is highly unrealistic. This is important for the link between financial market analysis and growth to the extent that financial market development or financial market integration contributes to technological progress. The Mankiw/Romer/Weil approach – in line with some other studies – points to the relevance of the (net) investment output ratio I/Y . As I/Y times the marginal product of capital $\Delta Y/\Delta K$ is equal to the growth rate of real gross domestic product, one must take into account that I/Y has a trend component and a cyclical component – related to the real interest rate r , the cyclical unemployment rate u^c and expectations about future profits – while the marginal product of capital is determined by capital intensity, technology and human capital.

In the following graph, we can see that output growth rates in the Euro zone went through a cyclical increase in the 5 years after 1995 but have fallen after 2000. The ratio of the long run interest rate to the short term rate increased after a transitory fall after the start of the both Euro zone and the ECB. After 1995, there was a fall in the real interest rate in the Euro zone and most member countries of the Euro zone. The Netherlands and Spain recorded a strong fall in the real interest rate in the 4 years after 1999, while Germany faced a temporary rise in the real interest rate. After a temporary real appreciation in the early years of the Euro zone, the Euro faced a period of real appreciation, which reduced the real and nominal interest rate below the US level for some time. With monetary integration, it is also clear that the rest of the world will benefit considerably from higher capital outflows from the Euro zone. The reason for this is that from an investors' perspective, there are no longer opportunities for currency diversification within the Euro zone. This should have contributed to an early depreciation of the Euro in the starting phase of the ECB and the Euro. There is another long term aspect which is related to the ageing of societies in the EU; ageing should raise the savings rate of the population. However, financial market integration could dampen this development in the Euro zone, since households are likely to face less borrowing constraints in integrated markets.

One should also note that empirical findings and most analyses in the literature suffer from a problem in that one rarely makes a clear distinction between the level of output and the growth rate of output. Within the context of a standard macroeconomic growth model (Jones, 1998) in the steady state, output per capita (y) is given by the following formula if one assumes – with Y denoting output, K capital, L labour and β a parameter in the interval $0,1$ – that the macroeconomic production function is $Y = K^\beta (AL)^{1-\beta}$ and that the growth rate of the population is n , the exogenous growth rate of the Harrod-neutral factor A is a and the depreciation rate on capital is δ (e is the Euler number, s the savings rate, A_0 the initial value of A , t the time index, # for steady state):

$$y \#(t) = A_0 e^{at} \{s/[n + a + \delta]\}^{\beta/(1-\beta)}$$

Taking endogenous growth into account is interesting from a theoretical perspective. If one assumes that the progress rate $a(t)$ is endogenous in the transition to the steady state for the variable real income relative to labour in efficiency units – this is the variable $y^* = Y/[AL]$ – we must ask how financial market integration will affect endogenous growth.

With respect to explaining the progress rate, endogenous growth theory has emphasized the role of human capital (Lucas, 1988), positive external effects from capital accumulation (Romer, 1990), R&D expenditures and innovation (Grossman & Helpman, 1991) and intermediate products – allowing firms the production of a greater variety of final products which stimulates both demand and output growth (Bretschger, 1998; Grossman & Helpman, 1991; Romer, 1990).

One may summarize the link between financial market integration and growth as follows:

- Financial market integration may affect the savings rate s and hence the level of the growth path. In principle it could dampen the savings rate as households face less borrowing constraints (a phenomenon obviously relevant in the Euro zone), but it could also stabilize the savings rate to the extent that the monetary union imposes new constraints on government borrowing (such as the constraints envisaged in the Stability and Growth Pact of the Euro area; as they have not been implemented, however, they are likely to undermine the creditability of the Euro zone and may sooner or later trigger a risk premium on international capital flows into the Euro zone. This particularly reflects doubts about bonds in Italy, Portugal or Greece, which have very high debt-GDP ratios as well as high internal euro area current account deficits).
- Financial market integration can also affect endogenous growth in various ways. Examples of this include facilitating human capital formation (banks facing more competition and becoming more innovative become more willing to engage in university studies financing), influencing the share of firms undertaking innovations (and influencing the type of innovations pursued), encouraging more foreign investors to come – also more MNCs to emerge within the country – and thus to contribute to international technology transfer and increased international outsourcing.

As regards empirical findings, it is obvious that we know little about the links between financial market integration and growth (Fig. E.6).

E.3.2 Monetary Integration, Financial Market Integration, and Welfare Effects

As regards financial market integration in the Euro zone, we clearly can measure this through interest rate convergence. High interest rate countries should converge to the low interest rate of Germany. (In the period of the Deutsche Mark, Germany almost always had the lowest nominal interest rate in the EU.) Thus, a

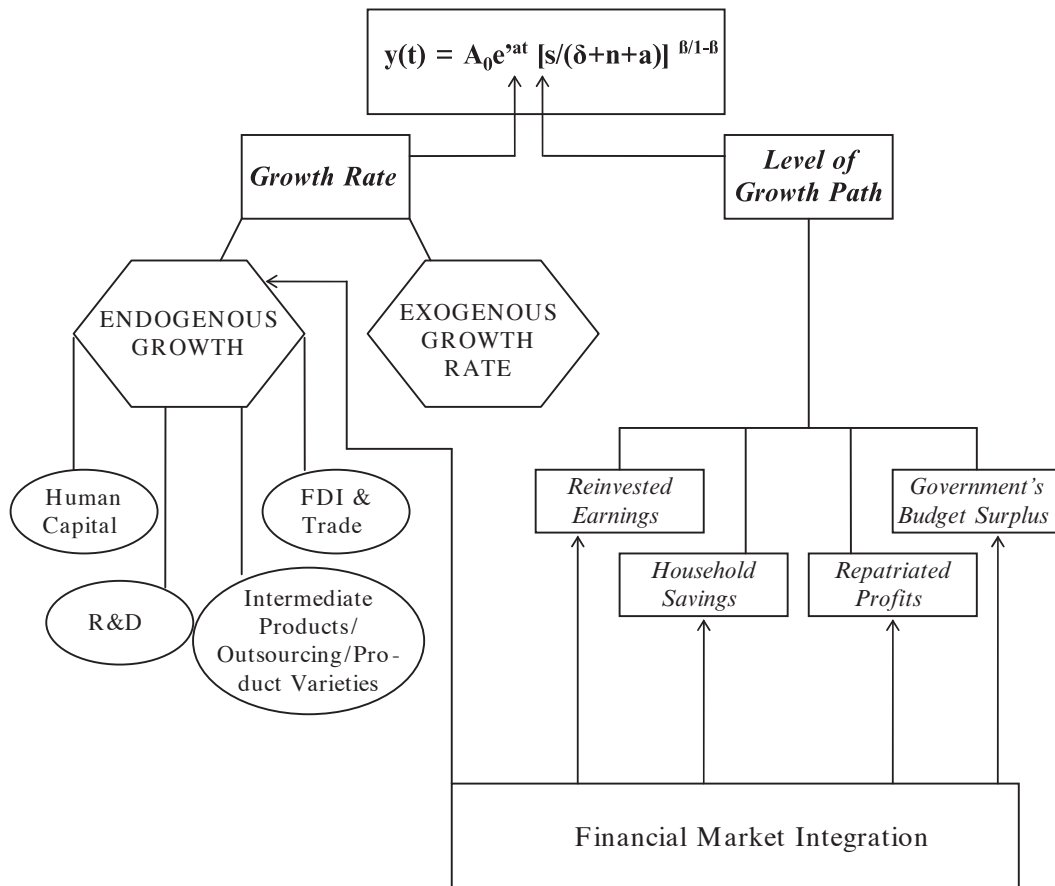


Fig. E.6 Financial market integration and growth

country previously known for high interest rates (e.g., Italy) will experience a fall in the interest rate as the Euro zone starts and also during the run up to the start of the Euro and the ECB. Let us call Germany country I and Italy country II (with starred variables). Italy will have a considerable once-and-for-all welfare gain as the nominal interest rate falls from i_0^* to i_1^* , which is equal to the (unchanged) German interest rate ($i_0 = i_1$). As the real money demand m is a positive function of Y and a negative function of the interest rate, the historically high interest rate country will have a welfare gain equivalent to the area $CDEE'$ (Welfens, 2005). If financial market integration and associated financial innovations bring about a higher substitutability of money and bonds in the country with previously high interest rates, there will be an additional welfare gain since the money demand becomes flatter. These additional gains are equal to the area $AF'E'$. As such, the real money stock $M/P = : m$ in equilibrium would not only rise from m_0^* to m_1^* but to m_2^* (Fig. E.7).

Note that the real money stock can increase in only two ways. First, the new central bank can increase the nominal money supply at a given price level, which implies that the European Central Bank could have considerably increased the money stock in the early years of the Euro zone without inflation effects. (The ECB will have to reduce monetary growth at a later date if inflation is not to

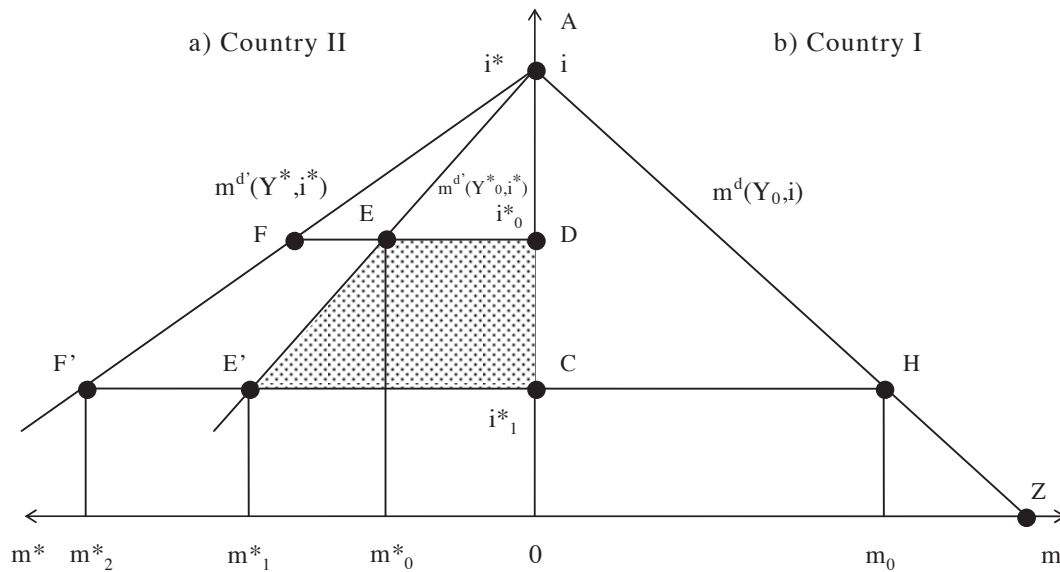
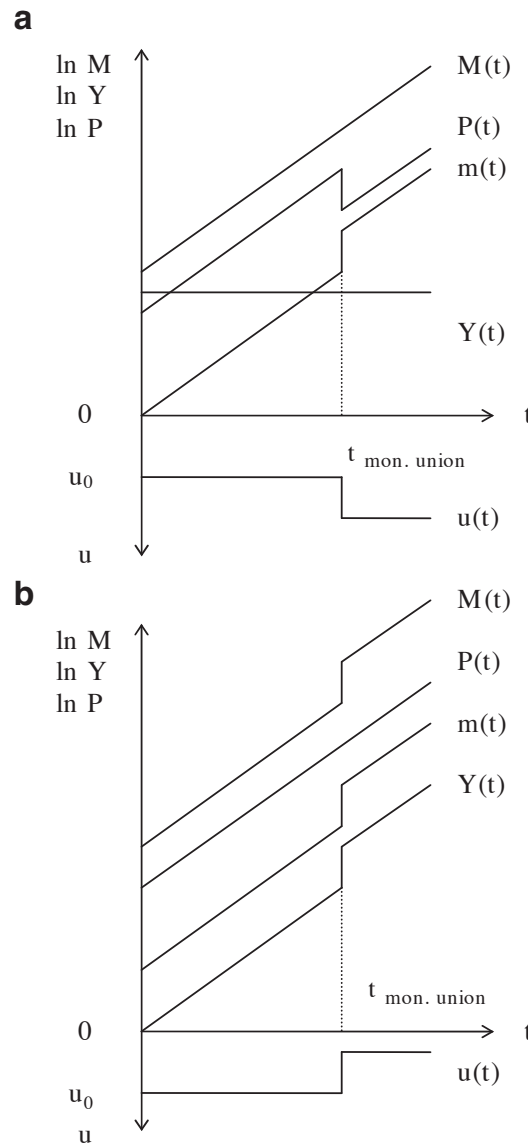


Fig. E.7 Static effects and medium-term effects of monetary union

become a problem.) The associated positive wealth effect should stimulate consumption and investment so that there is a favourable one-off effect on the unemployment rate. The alternative way of raising the real money stock would be a fall of the nominal price level at a given stock of the nominal money stock, which is likely to bring about a rise of unemployment. The two alternative policy options are shown for the simple case of a non-growing economy with constant trend inflation. There will be a one-off increase in real output if the central bank brings about a rise in the real money balances through an expansion in the nominal money supply (b). If the central bank sticks to its pre-monetary union expansion path of the money supply, the monetary union will bring about a one-off rise in unemployment and hence a fall in the equilibrium output level (a) (assuming a given degree of wage flexibility). Hence, a temporary expansionary monetary policy of the ECB is clearly preferable, and it seems that the Euro zone has indeed adopted such a policy – however, obviously not as part of a deliberate strategy. Analysts worried about the allegedly excessive growth in the stock of money simply overlook the analytical aspects discussed here. As regards the empirical analysis of the link between inflation and the growth of the money stock in the Euro zone (hypothetical Euro zone prior to 1999) in the period from 1980 to 2005, one should expect a statistical break around 1999/2000/2001. Of course, it will be difficult to clearly separate the effect identified from the switch to the new monetary regime as well as the ECB (Fig. E.8).

In a more medium term perspective it is quite important to focus on real income development. If due to monetary union output in country II in the monetary union would be lower (Y^*_2) than without monetary union (Y^*_0), there is a welfare loss of $BE_1E_3A^*_2$. In country I monetary union could lead to a rise in real output ($Y_1 > Y_0$) so that for the overall monetary union, the net welfare effect is unclear. There would be a clear welfare gain if output in the monetary union were

Fig. E.8 Monetary union, inflation and unemployment: structural break from switching to monetary union



higher in country I and country II (Y_1^* , Y_1). If country I indeed had a higher real output, the existence of positive spillover effects could then indeed raise output in country I to Y_2 (a similar reasoning applies to the analytical framework of a growing economy). Whether output is raised by the switch to a monetary union is an empirical question and depends – from a theoretical perspective – largely on wage flexibility in the monetary union on the one hand and the degree of financial market innovations on the other. With low or even reduced wage flexibility, increasing price competition in the monetary union is likely to increase the unemployment rate (u) and hence reduce output. A higher degree of financial market innovations – particularly if geared towards venture capital markets, commercial paper markets and stock markets – should stimulate the creation and expansion of new firms, thus leading to increased output. Finally, one should raise the question as to whether the European Central Bank takes opportunities to stimulate output expansion more or less than the average national central banks

in the pre-Euro area into account. Clearly, a central bank should avoid long term inflationary policy since this will not only raise inflation to critical levels but distort managers' attention from product and process innovations toward more innovative liquidity and asset management in order to exploit inflation dynamics. The crucial point here is that this type of financial engineering does nothing to raise consumption output per capita or the quality of consumption goods available (Fig. E.9).

There is one more interesting aspect of monetary union in a dynamic perspective. If per capita income positions differ strongly in the monetary union, there will be considerable differences in the national inflation rate (the price index is composed of tradables and nontradables prices), where differences are on the one hand related mainly to the Balassa Samuelson effect; this means that the relative price of nontradables will rise relative to tradables as per capita income rises. On the other hand, considerable differences in per capita income imply different degrees of intra-industrial trade, which in turn affects the inflation dynamics (Welfens, 2005). A country with high per capita income will have a relatively high share of intra-industrial trade which acts as a disciplinary force on inflation as consumers have a broader choice among domestic and foreign tradables which are close substitutes. This effect is likely to be underestimated in empirical analysis, as a rising share of intra-industrial trade and a rising per capita typically go along with a higher degree of product innovations which will raise prices at face value – but not if improvements in quality are adequately taken into account in the context of hedonic price measurement approaches. By implication, the inflation rate should fall with a rise in per capita income. This perspective is reinforced, if one assumes that stock market capitalization – and stock market turnover – relative to GDP should increase in

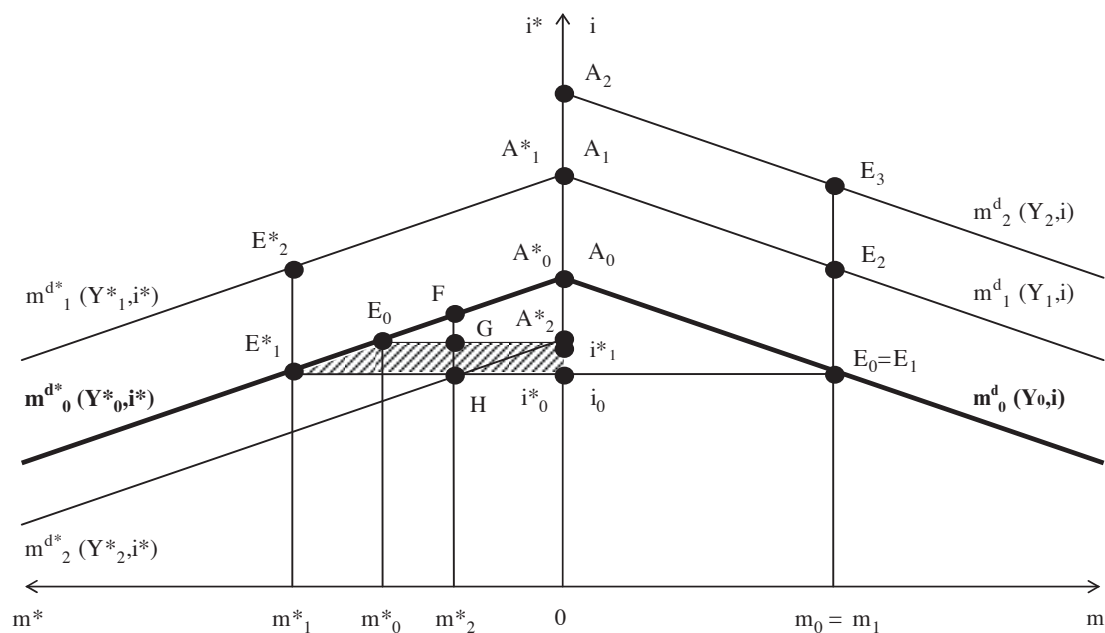


Fig. E.9 Dynamic welfare effects of monetary union

a more innovative economy. As relatively rising stock market turnover absorbs more liquidity, a given growth rate of the money supply should translate into a lower inflation rate – of newly produced goods – in the long run.

E.4 Integration of Financial Markets in the Euro Zone and Global Dynamics

In both the EU and ASEAN, there is an increasing overlap of regional integration and economic globalization. As regards regional financial market integration, we expect interest rate convergence and actually a fall in the nominal and real interest rate if financial market integration is embedded in a stability-oriented monetary union of countries with a similar per capita income. We also expect maturity deepening in bonds markets and should witness volume growth of bond emissions in the integrated bonds market where economies of scale in intermediation will be easier to exploit than before. All this contributes to lower interest rates. At the same time (see the following figure), there are international impulses possibly leading to higher interest rates. Globalization pressure implies that required rates of return are on the increase in EU and ASEAN stock markets. In particular, banks come under pressure to generate higher profit rates which will – along with the pressure from the BIS's Basel II package requiring more risk-differentiated credit pricing of banks – reduce the growth rate of loans. Medium-sized firms in Europe and Asia facing problems as bank credits become more expensive will consider therefore the option to finance investment and innovation through the bond market with greater interest. (Governments in Europe have not done much to encourage SMES to take this route, and the ECB as well as the BIS have done much to downplay the impact of Basel II).

Finally, there are increasing global innovation dynamics in OECD countries and Newly Industrialized Countries on the one hand and an expansion of the ICT sector largely based on the use of modern computers and software on the other. The latter is particularly poor collateral from a banker's perspective, which implies that countries with a strong reliance on a universal banking system have disadvantages in financing the expansion of ICT. This could be a major problem in continental EU countries which heavily rely on universal banking and are obviously lagging behind in ICT expansion relative to the US and the UK (as well as to Sweden and Finland). A rising role of global innovation dynamics and of ICT require a greater role of venture capital financing and a relative expansion in the role of stock markets. The latter is, however, not without risks, as there are considerable overshooting problems in stock markets and foreign exchange markets. The standard DORNBUSCH overshooting problem from exchange rate markets can indeed have mirror effects in the stock market, and both markets are interdependent as has been shown in the empirical analysis by Welfens and Borbély (2004) (Fig. E.10).

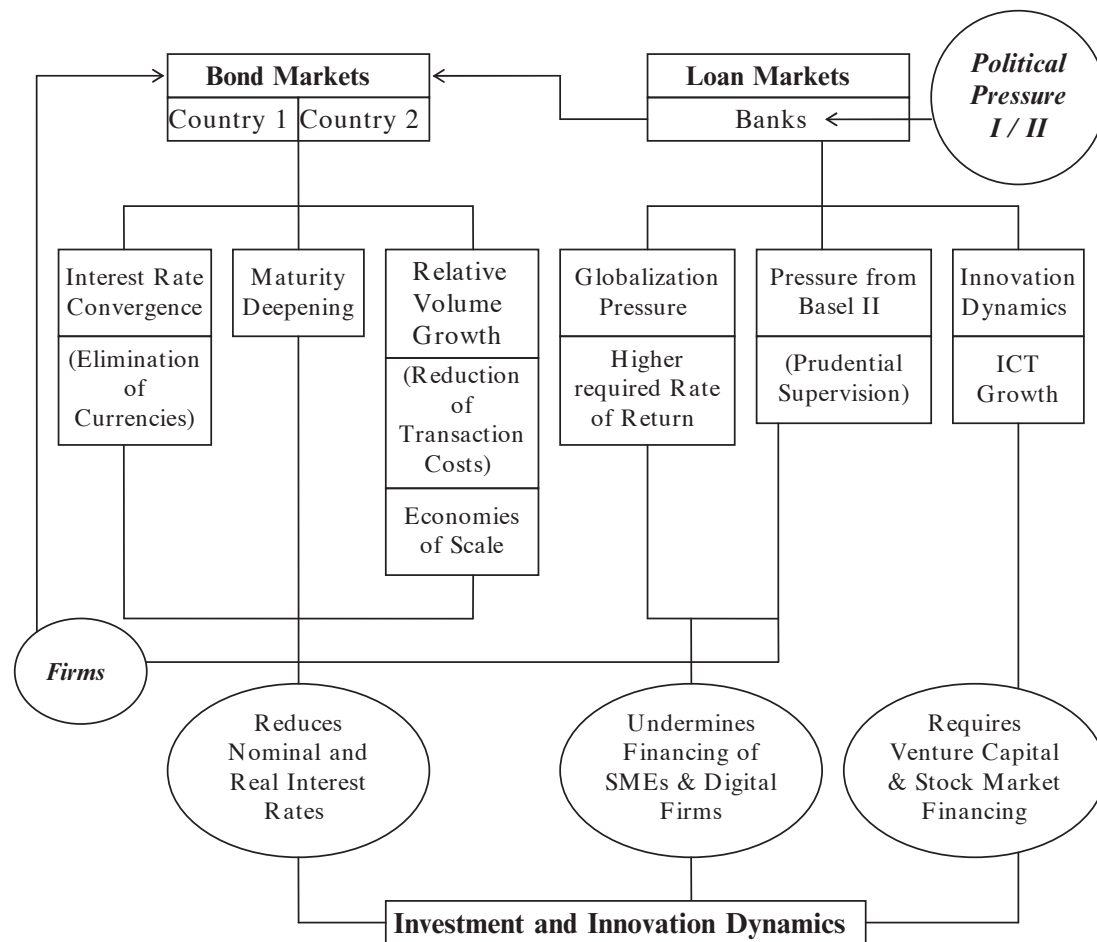


Fig. E.10 Integration of financial markets and globalization

E.5 US Financial Market Crisis

In January 2006, one of the authors was sitting in a Café at Dupont Circle in Washington DC and discussed some of the strange developments in US mortgage markets with a colleague from Georgetown University. There also were doubts about banks whose financial innovations focussed on turning B-rated bonds into A-rated bonds. The colleague took his time to explain in some detail key aspects of financial market innovations in mortgage markets in the US. We both agreed that there were unsound practices in real estate financing and the only disagreement was about the point at which the bubble in the US would burst. This all suggests that experts and bankers were quite aware – 2–3 years before the onset of the subprime crisis in summer 2007 – about key problems which aggressive banks and hedge funds in the US and Europe were creating behind the buzzword of financial innovation. Certainly, not all innovation stood for excessive risk, but it is obvious that the quality of market signals and the clarity of balance-sheet reports were impaired through some of the new approaches of the financial sector.

The new issue of the *Journal International Economics and Economic Policy* offers in its Forum contributions by Goodhart (2008), Welfens (2008), Wolf (2008) and Mullineux (2008) on the International Banking Crisis. Goodhart (2008) has emphasized that risk premia were unusually low in 2005/2006. The main emphasis in the contribution of Welfens (2008) is on the role of excessive required rates of return of banks – the new standard of 30% set by Wall Street Banks and British banks since the late 1990s is unrealistic and dangerous since a government bond interest rate of 4% suggests that bankers aim at projects whose average risk premium is close to 26% (if we consider aspects leverage the figure is slightly smaller). Turning back to sustainable rates of return will not be possible without new tax legislation which makes long-term profit maximization more attractive and punishes excessive risk-taking of banks which often create negative national or international spillover effects in the context of the casino-capitalism. One certainly should not turn towards overregulation of banks and also not broadly undermine financial innovation, but better regulation for banks, hedge funds (often being subsidiaries of banks eager to effectively avoid regulation) and private equity funds is urgently needed – above all in the US and in the UK.

The Eurozone – and the Euro – could be the big winner of the biggest US banking crisis since 1945. As regards the FED's aggressive reduction of interest rates, one may raise doubts that expansionary monetary policy and fiscal policy can be an adequate substitute to the structural reforms which are really needed in the US and some EU countries. The fact that almost all Spanish banks came out of the US subprime crisis without major problems can largely be attributed to the rather conservative banking regulation of Spain's central bank which require banks eager to set up special investment vehicles and push off-balance sheet activities to come up for those with the same equity requirements than for standard lending arrangements within the balance of the bank. Considering the IMF article IV reporting on the US in 2007 – which was quite uncritical – one should call on the IMF to take the task of policy surveillance more serious and not to paint artificial gold plates on a shaky US banking system; impartial and critical reporting indeed is needed, and the IMF failed here in 2006/2007.

A special problem concerns the collapse of the interbank market in the US, the UK and the euro zone over several months in 2007/2008. The banks' overloaded multi-layer securitization business – following the idea of originate and distribute risks across many shoulders – has created so much intransparency in financial markets that we now face a classical market-for-lemons problem in such markets. To restore confidence and thus an effective working of such markets requires strict measures: OECD countries should introduce severe penalties on mis-ratings (e.g., certain WestLB securities were rated as triple AAA by Moody's and by Fitch in 2005, although by all means never more than a B rating would have been adequate; Moody's gave some lukewarm explanation for this mistake in spring 2008, Fitch continued the over-rating for several days more until major newspapers had run the story). The governments of the Eurozone or the EU should help launch a new European rating agency – as a private-public partnership – so that more competition in the rating business would result. A special team of neutral controllers,

possibly organized by the Bank of International Settlements and the OECD or the IMF should go through the balances of all major banks and those whose evaluation brings favourable news about the quality of both assets and risk management should have preferred access to central bank liquidity.

In the election year 2008, the US FED is likely to linger on with its opaque policy of massive interest rate cuts. However, already the massive interest rate cuts of the FED in January 2008 went along with a rise of the long term interest rate so that higher inflation expectations are obvious. Moreover, the real interest rate in the US is negative in 2008 and this is going to cause new problems through creating incentives for overindebtedness and also by dampening the private savings rate which – considering the high current account deficit-GDR ratio – already may be considered as much too low. The standard models of the FED and the OECD are somewhat inconsistent in the sense that there hardly is a future penalty in terms of future output losses or inflation/welfare losses if the real interest rate falls below zero. In real life such penalty is, however, quite likely to occur and results partly from the misallocation which occurs if the real interest rate is over an extended period much below the real output growth rate. In a normal economy, the real interest rate must be identical to the growth rate of real income in the long run. It is also clear that the massive dollar devaluation which has occurred imposes part of the adjustment costs on major holders of high stocks of foreign reserves denominated in US dollars. Japan, the Republic of Korea and Taiwan thus are effectively contributing part of their respective gross national product to the US where obviously government expects such generous behaviour as the price for the US military protection. Of course, this argument does not hold for China where the structure of reserves is likely to be adjusted in favour of the euro. A massive nominal and real appreciation of the Euro will undermine export growth of the Eurozone; at the same time investors from the euro area can obtain US firms and more generally firms in the dollar area at a discount. The biggest winner, however, will be banks and sovereign wealth funds from Singapore, China and some Arab countries.

As regards prudential supervision, weaknesses in the EU should be carefully considered. The proposals of the EU calling for group-based supervision (with groups of countries being involved in the supervision of major international banks) are impractical. If resistance of the British government against a more integrated EU supervision system should continue, countries of the euro zone would be wise to adopt their own integrated system. With Iceland facing the heat of hedge funds' speculation against the currency there will be second thoughts in Iceland as to whether joining the EU and the Eurozone would be a superior alternative to standing alone with a national currency. The fallout of the US banking crisis on the British financial system – likely to be much higher than for the euro zone – could also trigger a new discussion about the Euro in the UK in the long run. EU countries would be wise to help the US in sorting out the mess in financial markets.

Concerning the reform proposals of the US Minister of Finance, Mr. Paulson, one may raise some doubts about the need to shift more responsibility in prudential supervision to the US central bank (there the responsible person had emphasized

for years that minimal regulation for banks and financial markets would be desirable in any case). Better financial regulation should be quite important for the US for four reasons:

- Many people rely on financial market products for their retirement (while the average savings rate of private households was zero in 2007 one should not overlook that median age households have a positive savings rate).
- The stability of financial markets is a key requirement for maintaining the status of the dollar as a global reserve currency and to attract high capital inflows.
- Stable banks and resilient financial markets may be considered one pillar for sustainable financing of investment and innovation projects which are crucial for economic development and economic growth.
- Instability of banks and financial markets in the US will have negative international spillover effects which could heavily undermine the stability of the world economy in a world with global financial markets. Massive depreciations of assets in the US (and Europe) are likely to dampen consumption and investment on the one hand, while there could be – depending on central bank behaviour – massive changes in the nominal and real effective dollar exchange rates on the other.

As massive recapitalization of banks in the US, Switzerland, the UK and some euro area countries is necessary, the influence of sovereign wealth funds, including those from Singapore, China and certain Arab countries will gain importance. The economic weights in the world economy could be shifted away from OECD countries.

E.6 Policy Conclusions

We can draw a number of policy conclusions from our analysis above. Financial market integration and economic growth are characterized by a number of interesting links on which one should shed more light through empirical analysis.

If one considers the interdependencies of the overall economic system, it is not very realistic to expect major benefits from financial market integration if there are blockades to structural change in labour markets. The high unemployment rate in the Euro area represents a blocking factor in this respect. For example, while raising factor productivity and the yield on investment might well require outsourcing in many sectors, the resistance of trade unions in countries with high unemployment is likely to slow down such outsourcing in some countries of the Euro zone (also compared to the US). Uniform minimum wages – without regional differentiation – in France and Italy as well as certain social security elements in Germany seem to be crucial problems for the labour market in the Euro zone. At the same time, one should take into account that more integrated financial markets – in a period of global financial market liberalization as enshrined in GATS – could be subject to larger shocks and more extreme bubble problems than was previously the case. To the

extent that stock market bubble problems are related to short-sighted speculations, it is worthwhile to consider strong tax incentives for long term investment while short-term yields could be taxed more heavily. Such a development is unlikely to happen unless OECD countries agree upon some joint framework in this respect.

In the Euro zone, the governments in Germany, France and Italy should carefully consider their serious and long-lasting unemployment problems. Financial market integration will be a complementary measure towards full employment if this integration stimulates the creation of new firms and encourages investment and innovation in existing firms as well. The latter will, however, not come easily. Governments have many possibilities – including tax policies – to stimulate the expansion of venture capital markets and to encourage the growth of stock markets. Moreover, social security reforms should be done in such a way as to give stock markets a greater role. However, one should not overemphasize the expansion of this pillar for savings toward retirement, since stock markets are quite volatile. An important problem in the Euro zone is the Commission's emphasis that state-owned savings banks in several member states (including Germany) should no longer earn privileged backing by government, since this would not allow for the establishment of a level playing field with private banks. To some extent this is a valid argument, but at the same time it is not really clever for government to throw away the economic benefit of a triple-A rating from which state-owned banks can benefit. Given the rather limited engagement of private banks in start-up financing, one may instead argue that state-owned banks should not only enjoy a privilege with respect to capital costs but also have special obligations in the field of local venture capital financing; such banks should also have an information advantage in this respect. One might well consider allowing private banks to acquire a majority stake in local and regional state-owned banks. However, there could indeed be reasons to require that government keep a certain minority stake in certain regions (say, below 1/3 of overall capital).

It seems quite important that governments in the Euro zone remove barriers to foreign direct investment since there can be no truly integrated financial market if the convergence of capital costs is not facilitated by broad FDI activities. Moreover, there might be FDI diversion effects in the context of EU eastern enlargement and Euro area enlargement toward Eastern Europe. It also seems adequate to encourage foreign investors from outside the Euro zone to invest more in the EU. This, however, requires that the Stability and Growth Pact in the EU truly be respected, which is not the case thus far; one might have to adopt a new Pact. Higher FDI inflows into the Euro zone also depend on a consistent and growth-enhancing policy of the European Central Bank. It is not clear whether the ECB really exploits opportunities to stimulate growth and employment. International confidence in the Euro would benefit from a more consistent framework in prudential supervision in the Euro area. Once the first crisis hits the financial markets in the Euro zone, national governments – which in many member countries are strongly involved in supervision – and the ECB as well as some national central banks involved in supervision will finally want to cooperate (or to cooperate more than in the first 7 years of the Euro period). Yet this cooperation will then come at a premium price.

Governments in member countries of the Euro zone should commission studies to highlight not only the problems in venture capital financing but also to better understand the problems of ICT financing. It is naturally a challenge for the universal banking system to finance investment and in particular innovation in an increasingly digital world. The risk that benefits from an innovation will not accrue to the ICT investor but rather diffuse to other countries is only one problem; the lack of collateral in the digital services sector is another.

One can only hope that the Euro zone will proceed slowly with an eastern enlargement of the Euro area. There is still considerable need for exchange rate flexibility in eastern European accession countries. However, at the same time the ECB should carefully analyse the dynamics of financial market development and growth in Eastern Europe, and prudential supervision agencies in the euro area and in accession countries would be wise to cooperate. If there is ever a crisis in Poland its neighbour, Euro country (or Germany) cannot be indifferent to such negative dynamics.

At the bottom line, one may hope that financial market integration in Europe can contribute to both higher growth and a higher level of the growth path. There are many interesting issues for both theoretical and empirical analysis. The necessary bridging between real economics and monetary economics is an enormous challenge, as there has been a long tradition that most researchers in their respective fields have worked in splendid isolation for many years. Our contribution thus is only a modest step towards building such a bridge.

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Chapter F

Toward East Asian Economic Integration: Classification of the ASEAN + 3 Economies Using Fuzzy Clustering Approach

Noer Azam Achsani and Hermanto Siregar

F.1 Introduction

Facing globalization, many regions tend to integrate their economy in order to have a better bargaining position in comparison to other regions such as the EU, NAFTA and East Asian countries. The history of East Asian Economic integration itself began on 8 August 1967 with the establishment of the Association of Southeast Asian Nations, or ASEAN, in Bangkok, its aims and purposes being to:

1. accelerate the economic growth, social progress and cultural development in the region through joint endeavours in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian nations, and
2. promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries in the region and adherence to the principles of the United Nations Charter.

ASEAN initially had five Member Countries, namely Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Brunei Darussalam joined on 8 January 1984, Vietnam on 28 July 1995, Laos and Myanmar on 23 July 1997, and Cambodia on 30 April 1999. The Association represents the collective will of the nations to bind themselves together in friendship and cooperation, and through joint efforts and sacrifices to secure the blessings of peace, freedom, and prosperity for their peoples and their posterity (The ASEAN Declaration, Bangkok, 8 August 1967).

When ASEAN was established, trade among the Member Countries was insignificant. Estimates for between 1967 and the early 1970s show that the share of intra-ASEAN trade from the total trade of the Member Countries was between 12% and 15%. Thus some of the earliest economic cooperation schemes of ASEAN were aimed at addressing this situation. One of these was the Preferential Trading Arrangement (PTA) of 1977, which accorded tariff preferences for trade among ASEAN economies. Ten years later, an Enhanced PTA Program was adopted at the Third ASEAN Summit in Manila further increasing intra-ASEAN trade.

The Framework Agreement on Enhancing Economic Cooperation was adopted at the Fourth ASEAN Summit in Singapore in 1992, which included the launching

of a scheme toward an ASEAN Free Trade Area or AFTA. The strategic objective of AFTA is to increase the ASEAN region's competitive advantage as a single production unit. The elimination of tariff and non-tariff barriers among the member countries is expected to promote greater economic efficiency, productivity, and competitiveness. The Fifth ASEAN Summit held in Bangkok in 1995 adopted the Agenda for Greater Economic Integration, which included the acceleration of the timetable for the realization of AFTA from the original 15-year timeframe to 10 years.

In 1997, the ASEAN leaders adopted the ASEAN Vision 2020, which called for ASEAN Partnership in Dynamic Development aimed at forging closer economic integration within the region. The vision statement also resolved to create a stable, prosperous and highly competitive ASEAN Economic Region, in which there is a free flow of goods, services, investments, capital, and equitable economic development as well as reduced poverty and socio-economic disparities. The Hanoi Plan of Action, adopted in 1998, serves as the first in a series of plans of action leading up to the realization of the ASEAN vision.

In addition to trade and investment liberalization, regional economic integration is being pursued through the development of Trans-ASEAN transportation network consisting of major inter-state highway and railway networks, principal ports and sea lanes for maritime traffic, inland waterway transport, and major civil aviation links. ASEAN is promoting the interoperability and interconnectivity of the national telecommunications equipment and services. Trans-ASEAN energy networks, which consist of the ASEAN Power Grid and the Trans-ASEAN Gas Pipeline Projects, are also being developed.

ASEAN cooperation has resulted in greater regional integration. Within 3 years from the launching of AFTA, exports among ASEAN countries grew from US \$43.26 billion in 1993 to almost US \$80 billion in 1996, an average yearly growth rate of 28.3%. In the process, the share of intra-regional trade from ASEAN's total trade rose from 20% to almost 25%. Tourists from ASEAN countries themselves have been representing an increasingly important share of tourism in the region. Of the 28.6 million tourist arrivals in ASEAN during 1996, 11.2 million or almost 40% came from within ASEAN itself.

The success story of the EU in establishing a single market in 1999 have motivated the ASEAN region to further integrate their economy. During the ASEAN Summit in Bali in October 2003, all ASEAN members agreed to establish a so-called "ASEAN Economic Community (AEC)" as the realization and final goal of economic integration as outlined in the ASEAN Vision 2020. It rearticulates its aims to create a stable, prosperous and highly competitive ASEAN economic region in which there is a free flow of goods, services, investment and a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities. The AEC plans to establish ASEAN as single market and production base, turning the diversity that characterizes the region into opportunities for complementing business, making the ASEAN a more dynamic and stronger segment of the global supply chain.

Success in integrating all ASEAN countries (Indonesia, Malaysia, Singapore, Thailand, Philippines, Brunei Darussalam, Vietnam, Myanmar, Cambodia, and Laos

Peoples Democratic Republic) means integrating a region which has a population of about 549 million, a total area of 4.5 million square kilometres, a combined gross domestic product of US \$800 billion, and a total trade of US \$1047 billion (as of 2004). This will have a great impact on the region, not only economically but with respect to other aspects as well.

Furthermore, Mr. Osamu Watanabe (the Director of JETRO Japan) said that the single market should include not only ASEAN countries, but ASEAN + 3 (Japan, South Korea and China). This would lead to a markedly greater impact, since it would result in a huge market with a population of more than 3 billion people. Currently, ASEAN already has even closer cooperation with the three countries, that is, ASEAN-China Free Trade Area, Comprehensive Economic Partnership between ASEAN-Japan, and Korea.

Keeping this development in mind, it is interesting to assess whether the ASEAN + 3 economies may be seen as a single major entity or actually as a number of significantly different clusters. If they still consist of a number of markedly different clusters, it may reflect that economic conditions, and hence economic interests, are divergent among the economies. Knowing composition of the clusters may therefore be important in identifying common economic interests of groups of the countries. Classifying the ASEAN + 3 based on a scientific approach is the objective of this study.

F.2 Classification of ASEAN + 3: A Fuzzy Clustering Approach

Traditionally research suggests that dynamics toward a convergent point of economic agents are mainly determined by structural and institutional settings. More recent research, especially that using experimental approach such as List (2004), suggests that market composition also has important influences on convergence tendencies. Our study mainly concerns this line of market composition. Classifying or clustering is a means to study market or regional composition.

There are many approaches to classifying the ASEAN + 3 countries. An approach which has not yet been utilized is the fuzzy clustering approach, which basically minimizes the variance or dissimilarity within members of a cluster. We used the macroeconomic data from 10 ASEAN Asian countries (i.e., Indonesia, Malaysia, Singapore, Thailand, the Philippines, Brunei Darussalam, Vietnam, Myanmar, Cambodia, and Laos) in addition to three other East Asian countries, namely Japan, China and South Korea.

The data are collected from the official website of ASEAN (www.aseansec.org) covering the period from 1990 to 2001. Using the fuzzy C-Means method, all the countries are classified into some “economic clusters” based on the Maastricht Treaty Criterion of the EU (i.e., Debt/GDP ratio, Budget Deficit/GDP Ratio, Exchange rates stability (against US \$), and long term interest rates). In order to see the impact of Asian Crisis 1997 the data are divided into two time periods, before and after the crisis.

F.2.1 Fuzzy Clustering

Ruspini (1969) introduced a notion of fuzzy partition to describe the cluster structure of a data set and suggested an algorithm to compute the optimum fuzzy partition. Dunn (1973) generalized the minimum-variance clustering procedure and Bezdek (1981) generalized Dunn's approach to obtain an infinite family of algorithms known as Fuzzy C-Means (FCM). He generalized the fuzzy objective function by introducing the weighting exponent m , $1 \leq m < \infty$;

$$J_m(U, V) = \sum_{k=1}^n \sum_{i=1}^c (u_{ik})^m d^2(x_k, v_i), \quad (1)$$

where $X = \{x_1, x_2, \dots, x_n\} \subset R^p$ is a subset of the real p -dimensional vector space R^p consisted of n observations. U is a randomly fuzzy partition matrix of X into c parts, v_i is the cluster centres in R^p , $d(x_k, v_i) = \|x_k - v_i\| = \sqrt{(x_k - v_i)^T (x_k - v_i)}$ is an inner product induced norm on R^p , u_{ik} is referred to as the grade of membership or belonging of x_i to the cluster i . The grade of memberships satisfies the following constraints:

$$0 \leq u_{ik} \leq 1, \text{ for } 1 \leq i \leq c, 1 \leq k \leq n, \quad (2)$$

$$0 < \sum_{k=1}^n u_{ik} < n, \text{ for } 1 \leq i \leq c, \quad (3)$$

$$\sum_{i=1}^c u_{ik} = 1, \text{ for } 1 \leq k \leq n. \quad (4)$$

The FCM uses an iterative optimization of the objective function, based on the weighted similarity measure between x_i and the cluster centre v_i .

The FCM algorithm computes partition matrix U and the clusters prototypes in order to derive fuzzy models from these matrices. Steps of fuzzy C-means algorithm can be found for example in Hellendorn and Driankov (1997). We used the XploRe statistical software for our computational tasks.

F.3 Empirical Results

The results are presented in Figs. F.1 and F.2 and Table F.1. Empirical observations lead us to classify the countries into 3 or 4 clusters, both before and after the crisis. In Figs. F.1 and F.2, the graphs show the "memberships values" of each country corresponding to each cluster, whereas a summary of the results is presented in Table F.1.

It can be seen from the above figures and table that there is a relatively consistent classification as follows:

1. Singapore, Japan, Korea and China.
2. Malaysia-Vietnam-Thailand.
3. Indonesia-Filipina.

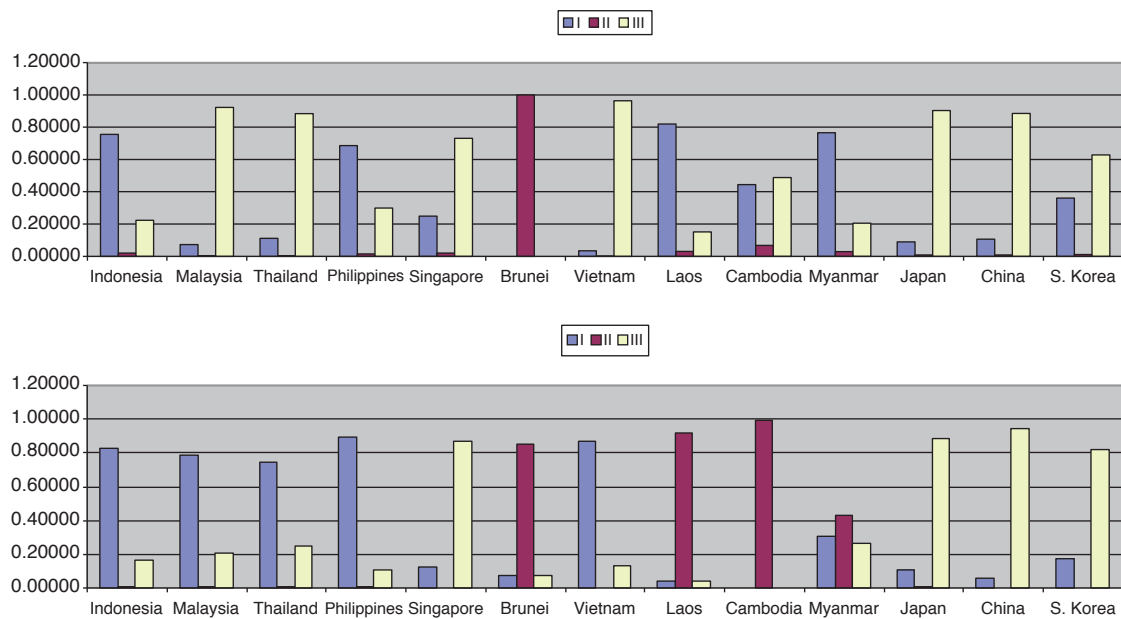


Fig. F.1 Results (membership values) of the fuzzy-clustering in three clusters, before (*above*) and after (*below*) the Asian Crisis

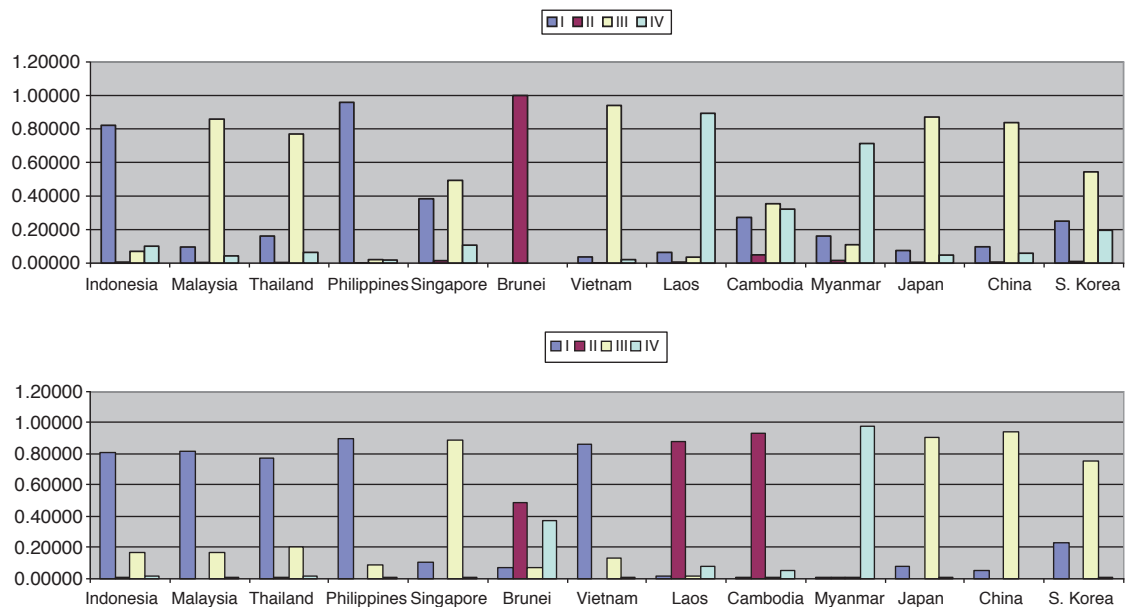


Fig. F.2 Results (membership values) of the fuzzy-clustering in four clusters, before (*above*) and after (*below*) the Asian Crisis

4. Myanmar, Cambodia, Laos Peoples Democratic Republic.
5. Brunei.

This classification seems to be consistent over time (before and after the crisis), and it is also similar with the real economic situation in the region during the last 10 years. Cluster I is the “big economy” in the region, consisting of Singapore, Japan, South Korea, and China. Singapore, Japan, and South Korea are the richest countries in the region, which may function as a source of investment for the region. As for China, though not as rich as these countries, it is the most promising

Table F.1 Summary of the classification

Country	3 Clusters		4 Clusters	
	Before the crisis	After the crisis	Before the crisis	After the crisis
Indonesia	1	1	1	1
Malaysia	3	1	3	1
Thailand	3	1	3	1
Philippines	1	1	1	1
Singapore	3	3	3	3
Brunei	2	2	2	2
Vietnam	3	1	3	1
Laos	1	2	4	2
Cambodia	1 (3)	2	3 (4)	2
Myanmar	1	2	4	4
Japan	3	3	3	3
China	3	3	3	3
S. Korea	3	3	3	3

country in the world. China has maintained consistent economic development over the last decade and also benefited from the highest foreign direct investment.

Cluster II consists of Thailand, Malaysia and Vietnam. Thailand and Malaysia are two of the so-called the new industrialized countries. Their economies have remained relatively stable over the last decade and they also experienced only a small impact from the Asian crisis. In only a few years, both of them recovered successfully from the crisis. On the other hand, Vietnam is not as developed as Thailand and Malaysia, but has also had consistent economic progress during this period. The Asian crisis brought about merely a small impact on its economy, and it is becoming a major foreign direct investment destination next to China in the region (UNCTAD, 2003).

Cluster III consists of Indonesia and the Philippines. Both countries were actually also included in the “new Asian tiger”. After the onset of the crisis, however, these countries have faced many problems in their economy, including persistent poverty, high unemployment rate, and infrastructure bottleneck. These economies has not recovered as of yet.

Cluster IV consists of the “less-developed countries” in the region (i.e., Myanmar, Cambodia, and Laos). All of them are the newest members of the ASEAN. Cluster V has only one member, Brunei Darussalam. Although it is a relatively affluent country, Brunei is very small in terms of area or population and as such has a limited economic impact on the region. For this reason, Brunei may be compared to the Luxemburg in the EU.

F.4 Policy Implications

The above classification can be related to some economic phenomena occurring in the last 2 years. First, there is a phenomenon that many investors, mainly Japanese, ceased their investment in Indonesia (e.g., Sony, Nike, Aiwa), and relocated their

area of interest to Vietnam, Malaysia, and China. This movement across clusters (from cluster III to cluster II and I) may have affected individual economic performance (e.g., slow export growth in Indonesia relative to that in Vietnam, Malaysia, and China) but might not be affecting the region's economic performance. Being bounded in the ASEAN + 3 agreement, this would force Indonesia to undertake economic reform seriously, including overcoming infrastructure or supply-side bottlenecks in order to attract investors' interest and to increase competitiveness of its export products. More detailed unilateral measures such as relaxed limitations on foreign equity ownership, liberalized sectoral restrictions, streamlined approval procedures, granted incentives and investment guarantees, seem to be important for Indonesia as well as the Philippines and members of cluster IV.

Second, Mr. Goh Cok Tong (whose country is a member of cluster I) and Mr Thaksin Sinawatra (from a cluster II country) suggested that the ASEAN single market should be developed soon. In line with this, Mr Watanabe suggested that Japan, South Korea and China (the other members of cluster I) should also be included in the single market. These five countries may be seen as "leaders" in the region's economy. In order for the ASEAN + 3 to function effectively, their initiatives should consider problems faced by the other economies. As warned by Yamazawa (1992) as well as other scholars, the benefits of such development would not be evenly distributed among members, but accrued mainly to the most advanced members in the group. One way to avoid this is to provide a kind of investment assistance, for instance by assigning some industries to each member nation, or to simply help the lagging countries (members of clusters III and IV) in developing the aforementioned unilateral measures.

Appendix 1

Membership values of each country as the result of fuzzy classification into 3 clusters

Country	Before the crisis			After the crisis		
	I	II	III	I	II	III
Indonesia	0.76	0.02	0.22	0.83	0.01	0.16
Malaysia	0.07	0.00	0.92	0.78	0.00	0.21
Thailand	0.11	0.00	0.88	0.75	0.01	0.25
Philippines	0.69	0.01	0.30	0.89	0.00	0.11
Singapore	0.25	0.02	0.73	0.13	0.00	0.87
Brunei	0.00	1.00	0.00	0.07	0.85	0.07
Vietnam	0.04	0.00	0.96	0.87	0.00	0.13
Laos	0.82	0.03	0.15	0.04	0.92	0.04
Cambodia	0.45	0.07	0.49	0.00	0.99	0.00
Myanmar	0.77	0.03	0.21	0.30	0.43	0.27
Japan	0.09	0.01	0.90	0.11	0.00	0.89
China	0.11	0.01	0.89	0.06	0.00	0.94
S. Korea	0.36	0.01	0.63	0.17	0.00	0.82

Note: The highest membership values for the corresponding countries are in bold type

Appendix 2

Membership values of each country as the result of fuzzy classification into 4 clusters

Country	Before the crisis				After the crisis			
	I	II	III	IV	I	II	III	IV
Indonesia	0.82	0.01	0.07	0.10	0.81	0.01	0.17	0.02
Malaysia	0.10	0.00	0.86	0.04	0.81	0.00	0.17	0.01
Thailand	0.16	0.00	0.77	0.06	0.78	0.00	0.20	0.01
Philippines	0.96	0.00	0.02	0.02	0.90	0.00	0.09	0.01
Singapore	0.38	0.02	0.49	0.11	0.10	0.00	0.89	0.01
Brunei	0.00	1.00	0.00	0.00	0.07	0.49	0.07	0.37
Vietnam	0.04	0.00	0.94	0.02	0.86	0.00	0.13	0.01
Laos	0.06	0.01	0.04	0.89	0.02	0.88	0.02	0.08
Cambodia	0.27	0.05	0.35	0.32	0.01	0.93	0.01	0.05
Myanmar	0.16	0.02	0.11	0.71	0.01	0.01	0.01	0.98
Japan	0.07	0.01	0.87	0.05	0.08	0.00	0.91	0.01
China	0.10	0.01	0.84	0.06	0.05	0.00	0.94	0.00
S. Korea	0.25	0.01	0.54	0.20	0.23	0.00	0.76	0.01

Note: The highest membership values for the corresponding countries are in bold type

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Chapter G

Further Evidence of the Impact of Foreign Bank Presence in Thailand

Chantal Herberholz¹

G.1 Motivation

For foreign investors, market access through locally incorporated banks in Thailand used to be limited to the acquisition of stakes in existing banks not exceeding 24.99% of paid-up registered capital with no new commercial bank licenses having been issued between 1978 and 1996 (Traisorat, 2000, p. 7). Since 1997, however, foreign majority shareholdings have been permitted for a period of 10 years on a case-by-case basis (Bank of Thailand, 1997, p. 25). After 10 years, foreign investors are not allowed to purchase additional shares unless foreign shareholdings amount to less than 49% of total shares. As market access through the establishment of branches remained heavily restricted, further liberalising foreign equity investment in locally incorporated banks following the outbreak of the Thai financial crisis has given foreign banks the opportunity to compete on an almost level playing field for the first time. Four locally incorporated banks have subsequently been acquired by foreign banks in 1998 and 1999, respectively.² Two of these so-called hybrid banks, however, have already been resold since then: one to a domestically-owned bank, the other to a foreign-owned bank incorporated in Thailand.³ The merger and privatisation of two state-owned banks remain pending.⁴ Although the latest Financial Sector Master Plan as approved by the Cabinet on 6 January 2004 (FSMP) introduces a new licensing system for domestic as well as foreign banks, it does not

¹ This paper was written in preparation of Chapter III (The Foreign Bank Effect on Value Creation in Commercial Banks Incorporated in Thailand) of the author's dissertation titled *The Impact of Foreign Entry on the Thai Commercial Banking Sector – Revisited*, Ph.D. Programme in Economics, Faculty of Economics, Chulalongkorn University; Dissertation Adviser: Assoc. Prof. Sothitorn Mallikamas, Ph.D., Dean.

² Refer to 1 for a graphical representation of the scale of foreign entry into the Thai commercial banking sector over the period 1997:2 to 2004:4.

³ The Development Bank of Singapore sold its majority stake in the DBS Thai Danu Bank to the Thai Military Bank in 2004 and the two institutions were subsequently merged. Also in 2004, ABN Amro Bank sold its majority stake in the Bank of Asia to the UOB Radanasin Bank. The two entities were merged to create United Overseas Bank (Thai) (Srisukkasem, *The Nation*, 15 March 2005; *The Nation*, 9 September 2005a; *Bangkok Post*, 29 November 2005)

⁴ The institutions in question are BankThai and Siam City Bank (Banchongduang, 2004)

address the temporary regulations regarding foreign equity participation in locally incorporated banks.

Against this background and in light of the negotiations of free trade agreements such as the proposed bilateral Thai-US Free Trade Agreement, which may include the provision of financial services (Na Thalang & Pongvutitham, 2005; Chantanusornsiri, 2005), this chapter aims at (1) analysing if foreign-owned banks incorporated in Thailand differ from domestically-owned banks incorporated in Thailand and (2) examining the effect of foreign bank presence on commercial banks incorporated in Thailand in terms of the performance measures net interest margins, non-interest income (scaled by total assets), operating margins, personnel expenses (scaled by total assets) and return on assets, given that liberalisation of market access generally proceeds on the premise that foreign entry is beneficial for the host country (see, e.g., Claessens, Demirgüç-Kunt & Huizinga, 2000, p. 117).

The chapter is organised as follows. Section G.2 reviews prior research on bank efficiency spillovers associated with foreign entry. The structure of the Thai banking sector is briefly described in Sect. G.3. Section G.4 discusses the methodology, and Sect. G.5 presents data sources and some descriptive statistics. The estimation results as well as an assessment thereof are presented in Sect. G.6, and Sect. G.7 offers concluding remarks.

G.2 Prior Research

Existing literature on foreign bank entry primarily deals with efficiency comparisons of domestic and foreign banks as well as analyses of competitive pressures exerted by foreign banks and their impact on financial sector efficiency. Although most early studies are focused on developed countries, particularly the US, studies have recently been extended to developing countries, with results differing between developed and developing countries. Most studies reviewed point to an improvement in financial sector efficiency. Regarding research methodology, empirical studies follow either the approach introduced by Claessens, Demirgüç-Kunt, and Huizinga (1998), focusing on traditional accounting-based performance measures such as net-interest margins, operating margins, and returns on equity or assets to proxy competition and efficiency, or apply efficient frontier estimation methods⁵ to conduct efficiency comparisons between domestic and foreign banks and to analyse the impact of foreign entry on domestic banking sectors.⁶

⁵See, for example, Berger, Deyoung, Genay, and Udell (2000); Sturm and Williams (2002) and Bonin, Hasan, and Wachtel (2003).

⁶Claessens and Laeven (2003), however, relate a competitiveness measure (based on the Panzar and Rosse methodology) to indicators of countries' banking system structures (including foreign bank penetration) and regulatory regimes.

In the above-mentioned pioneering study, Claessens et al. (1998) examine how foreign bank entry affects the operation of domestic banks, using bank-level and macroeconomic data for 80 countries over the period from 1988 to 1995. Efficiency comparisons between foreign and domestic banks reveal that foreign banks achieve higher (lower) profitability and net interest margins than domestic banks in developing (developed) countries, confirming the results in Demirgüç-Kunt & Huizinga (1997, p. 19). A larger foreign ownership share of banks is found to reduce profitability and overhead costs (scaled by total assets) of domestic banks, which suggests that foreign bank entry improves the functioning and efficiency of national banking markets. These findings are supported by Claessens and Glaessner (1998), who study the relationships between the openness of eight Asian financial markets and institutional quality, financial sector fragility, and costs of financial services provision. Their empirical results indicate that a negative relationship between net margins and the share of foreign banks exists as well as between net margins and overhead costs (scaled by the volume of business) and the openness indicator for banking services. However, the authors find a positive relationship between profitability and foreign bank presence, and the fact that increased foreign bank presence goes together with greater profitability and lower net margins suggests that openness encourages banks to reduce costs and diversify their income by relying to a greater extent on fee-based income. Lensink and Hermes (2003) extend the methodology developed by Claessens et al. (1998) and examine whether the short-run relationship between foreign bank entry and domestic bank behaviour depends on the level of economic development, using bank-level data for 48 countries over the period from 1990 to 1996. They find that at lower levels of economic development, foreign bank entry is associated with increasing costs and margins for domestic banks in the short-run, while at higher levels of development costs, margins and profits are either not or are negatively associated with foreign bank entry. The authors conclude that at lower levels of economic development, spillover effects of banking techniques and practices initially trigger an increase in costs, which leads to an increase in margins since domestic banks continue to enjoy market power.

Although indicative, cross-country studies cannot be considered supportive evidence for any particular country. The following country-case studies based on the methodology developed by Claessens et al. (1998), however, support the general findings of the cross-country studies. Using bank-level and macroeconomic data for the period from 1980 to 1997, Denizir (2000) finds that foreign bank entry into the Turkish banking market has the effect of reducing overhead costs (scaled by total assets) in the domestic banking system, thereby increasing efficiency and resource utilisation. Moreover, foreign banks enhance competition and reduce domestic bank profitability. Similarly, Barajas, Steiner, and Salazar (2000); Pastor, Pérez, and Quesada (2000); and Clarke, Cull, D'amato, and Molinari (1999), with their country case studies on financial sectors in Colombia, Spain and Argentina, respectively, provide further evidence for the beneficial impact of foreign bank entry on the efficiency of domestic banking markets. An analysis of the impact of foreign bank entry on the Thai domestic banking sector, using bank-level data for twenty consecutive calendar quarters from the second quarter 1997 onwards

(Herberholz, 2002), gives supportive evidence that (1) foreign-owned banks incorporated in Thailand are more efficient than their domestically-owned counterparts in terms of profitability, and (2) that foreign bank entry reduces net interest margins and profitability in the domestic banking system thus contributing to greater efficiency in the sector.⁷

Whereas the above line of research focuses on a microeconomic perspective, other lines of research on the effects of foreign bank entry focus on a macroeconomic perspective. A number of studies analyse the effect of financial sector openness on economic growth, and the studies reviewed indicate a positive relationship.⁸ Other studies are concerned with the impact of foreign bank entry on credit supply and the stability of the domestic banking sector, with evidence to date being rather ambiguous.⁹

G.3 Structure of the Thai Banking Sector¹⁰

Until recently, the Thai banking sector was comprised of commercial banks, representative offices of banks incorporated abroad, restricted banks and international banking facilities, with commercial banks having been separated into full commercial banks and branches of banks incorporated abroad. Although branches of banks incorporated abroad have been allowed to undertake the business of commercial banking (Bank of Thailand, n.d.a, p. 5), they have been exposed to substantial operating and other restrictions such as a limitation to a maximum of three branches, with automatic teller machines being regarded as a branch (Dobson & Jacquet, 1998, p. 42; Bank of Thailand, 1996, p. 53). Representative offices of banks incorporated abroad on the other hand are restricted to non-income generating activities. The restricted bank license has only recently been introduced and permits the operation of commercial banking business in general, while placing certain restrictions on the scope of activities (Fitch Ratings Ltd., 1999). Since its introduction it has only been granted to one bank, namely Thanachart Bank in 2002. International banking facilities are offshore banking facilities, and the license

⁷Note that the asset share of foreign-owned banks incorporated in Thailand turned out to be positively related to overhead expenses over total assets, being interpreted as an indicator of the pressures exerted on domestic banks to restructure their operations initially leading to higher overhead expenses (Herberholz, 2002, p. 190).

⁸See, for example, Demirgüç-Kunt, Levine, and Min (1998) as well as Eschenbach and Francois (2000).

⁹See, for example, Weller and Scher (1999); Dages, Goldberg, and Kinney (2000); Crystal, Dages, and Goldberg (2001) and Arena, Reinhart, and Vazquez (2003).

¹⁰The Thai banking sector has experienced substantial regulatory and institutional changes since the beginning of the 1990s when the first round of financial liberalisation started. Refer to Bank of Thailand (1996, p. 35, 1999, pp. 45–63); Dobson and Jacquet, 1998, pp. 310–312; Williams and Intarachote, n.d., pp. 3–5).

allows for the conduct of international banking business only (Bank of Thailand, n.d.a, pp. 39–46, 1999, p. 50). While the commercial banking system in December 1997 consisted of 15 commercial banks incorporated in Thailand and 20 branches of banks incorporated abroad, it was comprised of 12 commercial banks incorporated in Thailand and 18 branches of banks incorporated abroad in December 2004. The largest three commercial banks have traditionally dominated the commercial banking sector, with a combined market share of 41% in terms of assets in December 1997 and 46% in terms of assets in December 2004, reflecting the high degree of concentration prevalent in the sector. As reported by Disyatat and Nakornthab (2003, pp. 5–6), Thailand's financial structure has remained bank-based following the 1997 financial crisis. The latest FSMP proposed a complete overhaul of the licensing system and introduced a single presence policy. Only two types of licenses are issued to deposit-taking financial institutions incorporated in Thailand under the FSMP, namely the commercial bank license and the retail bank license, with the latter carrying lower capital requirements and restricting the scope of activities. Since the provisions may require applicants for a license to merge with other financial institutions, further consolidation of the sector is to be expected. Thus far, three new commercial bank licenses and four retail bank licenses have been issued to existing finance companies under the new regulations to upgrade their operations.¹¹ Turning to foreign banks, commercial banking in Thailand actually commenced with the establishment of a branch of a foreign bank, namely the Hongkong and Shanghai Banking Corporation in 1888 (Fitch Ratings Ltd., 1998, p. 13), and foreign banks played a significant role until World War II when most foreign banks were closed, resulting in a shift from a foreign-bank dominated system to a domestic-bank dominated system (Traisorat, 2000, pp. 6–7). After World War II, foreign banks resumed their operations and new foreign and domestic banks were set up. In the late 1970s, however, entry became highly restrictive. No new commercial banking license was granted between 1978 and 1996 (Traisorat, 2000, p. 7). Seven foreign banks were granted licenses to operate branches in Thailand in November 1996 as part of GATS obligations (Bangkok Bank, n.d.a, p. 3). Prior to November 1997, foreign participation in locally incorporated banks was limited to 24.99% of paid-up registered capital or 24.99% of directorship positions (Bank of Thailand, n.d.a, p. 4). In the wake of the financial crisis, the ceiling on foreign ownership of domestic banks has been temporarily raised to 100% on a case-by-case basis as mentioned above to facilitate restructuring of the financial sector. This led to a relatively intense period of foreign entry as can be seen in A. 1. In addition, foreign participation in four domestically-owned private commercial banks incorporated in Thailand, namely Bangkok Bank, Kasikorn Bank, Siam Commercial Bank, and Bank of Ayudhya, has reached up to 49% (Posayananda, Nakornthab, & Jittamai, 2005, p. 37). Most of these domestically-owned private

¹¹ Tisco Finance, Asia Credit and Kiatnakin Finance have been granted commercial bank licenses, whereas AIG Finance (Thailand), Land and Houses Credit Foncier, GE Money (Thailand) and Thai Keha Credit Foncier have been granted retail bank licenses (*The Nation*, 2005b). Tisco Bank and Kiatnakin Bank started operations on 1 July 2005 and 3 October 2005 respectively.

banks incorporated in Thailand, however, have placed internal restrictions on shareholdings to retain control.

The FSMP has introduced two types of foreign bank licenses, namely subsidiaries of foreign banks (scope of business: commercial banking; branches: one branch inside Bangkok and metropolitan areas and three branches outside; minimum registered and paid-up capital: THB four billion) and full branches of foreign banks (scope of business: commercial banking; branches: none; minimum capital requirement: THB three billion) (Bank of Thailand, 2004, pp. 5–6). Hybrid banks are not addressed by the FSMP, which indicates that they continue to be considered Thai banks operating under special regulations, rather than foreign banks despite their ownership structure. The new single presence policy also applies to foreign banks, and the Standard Chartered Bank, for example, has already integrated its Standard Chartered Bank Bangkok Branch into its Standard Chartered Nakornthon Bank, renaming the new entity Standard Chartered Bank (Thai) on 1 October 2005 (Bangkok Post, 6 September 2005). To date, Société Générale International Banking Facility and UFJ International Banking Facility have been granted full branch licenses, whereas the International Commercial Bank of China has been granted a subsidiary license (Bank of Thailand, n.d.b, p. 37).

G.4 Methodology

To analyse differences between domestically-owned and foreign-owned commercial banks incorporated in Thailand and to examine the impact of foreign bank presence on commercial banks incorporated in Thailand in terms of traditional, accounting-based performance measures, two sets of regressions are estimated following the approach used by Claessens et al. (1998, pp. 13–14) and Denizer (2000, pp. 11–13). Since we are dealing with few specific cross-sections, a fixed-effects model is chosen, with the intercept being allowed to vary over cross-section units.¹²

1st set of regressions (panel I):

$$DV_{it} = \alpha_i + \beta_1 FO_{it} + \beta_2 FS_t + \beta' CV_{it} + \varepsilon_{it}$$

2nd set of regressions (panel II):

$$DV_{it} = \alpha_i + \beta_1 FS_t + \beta' CV_{it} + \varepsilon_{it},$$

DV_{it} denotes the dependent variable for bank i at time t , FO_{it} the foreign ownership dummy variable for bank i at time t and FS_t the measure of foreign bank

¹²If, however, the null hypothesis of no individual effects cannot be rejected, a constant coefficient model is used, with all parameters, including the intercept, assumed constant in both the cross-section and time dimensions.

presence at time t . CV_{it} contains a number of regressors, which seem to perform robustly in the literature¹³ to control for other factors. α_i are the individual effects, β_1, β_2, β' unknown parameters, and ε_{it} is an error term. Variable definitions are given in Table G.1 below.

Table G.1 Variable definitions and independent variables

Variable definitions ¹⁴	
Alternative dependent variables ¹⁵ (proxies for efficiency of bank intermediation and indicators of the degree of competition)	
NIM	Net interest margin, which is defined as net interest income over total assets
NII	Ratio of non-interest income and total assets
ROA	Return on assets, which is defined as net income (excluding extraordinary items) over total assets
OEA	Operating margin, which is the ratio of overhead (i.e., non-interest) expenses and total assets
PEA	Ratio of personnel expenses and total assets
Independent variables ¹⁶	
FO	Foreign ownership dummy variable which takes the value of one if at least 50% of the bank's shares are foreign-owned, with the 50% threshold being chosen to ensure foreign control
Alternative measures of foreign bank presence ¹⁷	
FMS	Ratio of assets of foreign banks (where foreign banks refer to foreign-owned banks incorporated in Thailand) and assets of total commercial banks
FMSA	Ratio of assets of foreign banks (where foreign banks refer to foreign-owned banks incorporated in Thailand and branches of banks incorporated abroad) and assets of total commercial banks
FNS	Ratio of the number of foreign banks (where foreign banks refer to foreign-owned banks incorporated in Thailand) and the number of total commercial banks
FNSA	Ratio of the number of foreign banks (where foreign banks refer to foreign-owned banks incorporated in Thailand and branches of banks incorporated abroad) and the number of total commercial banks

¹³ Note, however, that none of the studies reviewed uses SFICM as independent variable.

¹⁴ All variables are expressed in percent except the dummy variables.

¹⁵ Note that return on equity is not used in this study due to substantial adjustments in equity levels over the period in question. For the same reason – despite regulatory minimum capital requirements – the equity-to-assets ratio is not included as a control variable.

¹⁶ A variable to control for market consolidation such as the concentration ratio of the three largest commercial banks incorporated in Thailand is not included since it does not seem to materially affect the estimation results.

¹⁷ As noted by Claessens et al. (1998, pp. 6–7), the number share of foreign banks is the appropriate measure if foreign banks have an impact upon entry rather than after having gained size, in which case the asset share would be appropriate. Note that Mathieson and Roldós (2001, p. 27) use the following measure of foreign bank participation: the ratio of the sum across all banks of the assets of each bank multiplied by the percentage of equity held by foreigners to total bank assets. Data on the percentage of equity held by foreigners in Thai banks is, however, not available on a quarterly basis.

Table G.1 Variable definitions and independent variables

SOI	State ownership dummy variable, which takes the value of one if at least 50% of its shares are owned by the government; used to account for differences in business motives and goals
LA	Ratio of liquid assets and total assets; aimed at capturing the decline in the propensity to lend following the 1997 financial crisis ¹⁸
NPLCR	Non-performing loan coverage ratio, which is defined as loan loss reserves over non-performing loans; aimed at capturing bank health
DA	Ratio of customer deposits and total assets; used to capture funding patterns
OEA	Operating margin; used in regressions with NIM and NII as dependent variables, since overheads are assumed to be passed on to consumers as reported by Claessens et al. (1998, p. 19)
INT	Nominal interest rate; used to account for changes in monetary policy
SFICM	Growth rate of the sum of outstanding loans of specialised financial institutions (SFI) ¹⁹ and new issuance of securities; aimed at accounting for the increasing importance of SFI in financing government projects as well as the increasing importance of capital markets

Using a panel of 8 domestically-owned and 4 foreign-owned banks incorporated in Thailand, the first set of regressions is used to examine (1) whether foreign ownership matters in the determination of the dependent variable, controlling for other factors and (2) how foreign bank presence affects Thai commercial banks in terms of traditional, accounting-based performance measures controlling for other factors.

Regarding the latter question, a negative relationship between the measure of foreign bank presence and the net interest margin, non-interest income over total assets, operating margin, personnel expenses over total assets and return on assets could suggest that increases in foreign bank presence increase contestability²⁰, thus improving the efficiency of financial intermediation. More explicitly, increases in foreign bank penetration are expected to reduce net interest margins (in the sense of the gap between what the ultimate saver receives and what the ultimate investor has to pay for funds), to lower operating margins and personnel expenses (indicating more efficient organisational structures) and to reduce non-interest income and return on assets (in the sense of a reduction of excessive profits associated with oligopolistic markets).

Regarding the first question, while increases in contestability may lower net interest margins, non-interest income over total assets, operating margins, personnel

¹⁸ Note that in some cases increases in interbank and money market items stem from compensation (in the form of promissory notes guaranteed by the FIDF) received for the transfer of non-performing assets under certain profit/loss sharing and/or yield maintenance schemes. (Herberholz, 2002, p. 185)

¹⁹ These SFI are the Government Savings Bank, the Government Housing Bank, the Bank for Agriculture and Agricultural Cooperatives, Export-Import Bank of Thailand and the Small and Medium Enterprise Development Bank of Thailand.

²⁰ The theory of industrial organisation shows that the threat of entry, having an immediate impact on the franchise value of banks (Hellmann, Murdock, & Stiglitz, 2000, p. 14), can be more important than actual market structure.

expenses over total assets and return on assets in commercial banks incorporated in Thailand, new and better strategies and technologies employed by foreign-owned commercial banks incorporated in Thailand as well as their presumed funding advantage may earn higher net interest margins, non-interest income over total assets and return on assets, which would signal the potential of restructuring through sales of domestic banks to foreign banks. The foreign ownership dummy variable is expected to be negatively related to the operating margin, and the ratio of personnel expenses over total assets as foreign-owned banks incorporated in Thailand are expected to introduce more sophisticated managerial structures and operational processes outweighing any informational disadvantages they may have such as less information on customers, business conditions and policy changes (Claessens et al. 1998, p. 10).

The second set of regressions uses a panel of 8 domestically-owned banks incorporated in Thailand and is aimed at examining how foreign bank presence affects Thai domestic commercial banks in terms of the dependent variables controlling for other factors.

Summarising, the following hypotheses are tested²¹:

1st set of regressions (panel I):

$H_0: \beta_1 = 0, \beta_2 = 0$, and $H_A: \beta_1 > 0$ ($H_A: \beta_1 < 0$ in the case of OEA or PEA being the independent variable), $H_A: \beta_2 < 0$

2nd set of regressions (panel II):

$H_0: \beta_1 = 0$, and $H_A: \beta_1 < 0$.

G.5 Data Sources and Descriptive Statistics

Quarterly, bank-level data for 12 commercial banks incorporated in Thailand for the period from 1997:2 to 2004:4 have been compiled from the STOCK EXCHANGE OF THAILAND's Listed Company Info, R-SIMS and I-SIMS information systems.²² Commercial banks included are (1) five domestically-owned private banks incorporated in Thailand (Bangkok Bank, Bank of Ayudhya, Siam Commercial Bank, Kasikorn Bank (previously Thai Farmers Bank), TMB Bank (previously Thai Military Bank), (2) three state-owned banks incorporated in Thailand (BankThai created through the amalgamation of Union Bank of Bangkok, Krung Thai Thanakit, and 12 financial companies in 1998), Krung Thai Bank, Siam City Bank (merged with Bangkok Metropolitan Bank in 2002), and (3) four foreign-owned banks incorporated in Thailand [(Bank of Asia ABN Amro Bank until 2004, now United

²¹ Where H_0 denotes the null hypothesis and H_A the alternative hypothesis.

²² Note, that information on non-performing loans was not disclosed by all banks in 1997 and the first quarter of 1998. For these missing data, either data from Fitch Ratings Ltd. (1998, p. 22), or data averaged across prior and following periods were used to create balanced panels.

Overseas Bank, Thai)], DBS Thai Danu Bank (Development Bank of Singapore until 2004; merged with Thai Military Bank), Standard Chartered Bank (Thai) (previously Standard Chartered Nakornthon Bank; Standard Chartered Bank), United Overseas Bank (Thai) (previously UOB Radanasin Bank; the former Laem Thong Bank was renamed Radanasin Bank in 1998; United Overseas Bank). (Herberholz, 2002, p. 185) A ranking of commercial banks incorporated in Thailand by assets is given in A. 2. All remaining data have been obtained from the Bank of Thailand. Whereas other studies use unconsolidated financial statements to ensure consistency, both consolidated and unconsolidated accounts are used in this study to ensure the inclusion of subsidiary asset management corporations set up to manage bad assets, with unconsolidated financial statements only being referred to if consolidated financial statements are not available.

Appendix A.3 shows average values of performance measures for foreign-owned and domestically-owned banks incorporated in Thailand, and differences between foreign-owned and domestically-owned banks incorporated in Thailand are visible. On average, foreign-owned banks incorporated in Thailand earned higher net interest margins than their domestically-owned counterparts (0.53% vs 0.34%) and performed better in terms of non-interest income (scaled by total assets) and return on assets (0.28% vs 0.26% and -0.39% vs -0.55% , respectively). However, foreign-owned banks incorporated in Thailand incurred higher operating margins and personnel expenses (scaled by total assets) (0.83% vs 0.60% and 0.275 vs 0.17%, respectively) on average than domestically-owned banks incorporated in Thailand.

G.6 Estimation Results

The estimation results are summarised in A.4–A.7.

G.6.1 *First Set of Regressions*

With respect to the first set of regressions, the results show that the asset share of foreign-owned commercial banks incorporated in Thailand (FMS) is significantly related to the net interest margin,²³ personnel expenses (scaled by total assets) and return on assets and enters with the expected negative sign, which supports the findings in the literature (see e.g., Claessens et al. 1998, p. 14) and Denizer (2000, pp. 15–16), who inter alia report that increases in the share of foreign banks (number share in the former case and number and asset share in the latter case) lead to lower operating margins and a return on assets of domestic banks as well as Barajas et al. (2000, p. 377), who in addition find that foreign entry also lowers net interest

²³ R^2 , however, is extremely low.

margins. The foreign penetration measure is insignificant with respect to non-interest income (scaled by total assets) and the operating margin and enters with an unexpected positive sign, which in the former case might reflect a shift from traditional banking transactions to more sophisticated and innovative activities. In the latter case, pressures exerted on commercial banks incorporated in Thailand to restructure operations initially lead to higher overhead expenses as suggested in Herberholz (2002, p. 189). The foreign ownership dummy variable is significantly and positively related to non-interest income (scaled by total assets) as well as return on assets, giving supportive evidence to the literature (see, e.g., Denizer, 2000, pp. 15–16), who *inter alia* finds that foreign ownership is significantly and positively related to return on assets, but it is insignificant with respect to the net interest margin and the operating margin, where it enters with the expected sign. Contrary to expectations, the foreign ownership dummy variable is significantly and positively related to personnel expenses over total assets, which may reflect early retirement schemes as well as pay-outs to encourage staff departures (Herberholz, 2002, p. 194), also indicating however that foreign-owned banks incorporated in Thailand have sought to recruit highly-qualified personnel.²⁴ These results suggest that foreign-owned banks incorporated in Thailand are more efficient than their domestically-owned counterparts in terms of non-interest income (scaled by total assets) and return on assets. Hence, there seems to be scope for further enhancing banking sector efficiency through sales of majority stakes in domestic banks to foreign investors.

Turning to control variables, the state ownership dummy variable turns out to be insignificant with respect to all performance measures; its sign, however, perhaps indicates that the advantages associated with government interference (e.g., funding advantages due to stronger support ratings) outweigh its disadvantages (e.g., government-imposed lending policies and government-directed absorptions of insolvent banks). The coefficient of the ratio of liquid assets to total assets enters with a significant and negative sign with respect to non-interest income (scaled by total assets), which reflects that liquid assets typically do not earn fee-income. The results also show a negative relationship between liquid assets and personnel expenses (all scaled by total assets), reflecting that holding a liquid assets portfolio is one of the most basic banking transactions and consequently not labour-intensive. Surprisingly, the non-performing loan coverage ratio is insignificant with respect to all performance measures. Moreover, the variable enters with an unexpected negative sign with respect to net interest margins. Banks with higher non-performing loan coverage ratios tend to be more risk averse, which should result in lower funding costs due to lower prospective bankruptcy costs. The negative sign with respect to return on assets may reflect the need for substantial loan loss provisionings following the 1997 financial crisis. The significant and positive coefficient of the variable deposits

²⁴Note that Chantapong (2005, p. 20) also finds that unit labour costs of foreign-owned banks incorporated in Thailand (referred to as merged banks) were higher than those of their domestically-owned counterparts after the financial crisis, however, the author furthermore finds that unit labour costs of branches of banks incorporated abroad were lower than those of domestic banks.

over total assets with respect to the operating margin and personnel expenses (scaled by total assets) as well as its negative association with return on assets indicates that a large branch network, which has been pivotal for attracting deposits, carries high maintenance and salary expenses. Its negative relationship with the net interest margin is surprising, given that customer deposits are commonly considered a relatively cheap source of funds compared to acquiring funds from the interbank or capital markets, since a large branch network gives banks access to customers in areas with little competition for deposits, with interest paid on these deposits correspondingly being lower as argued by Demirgüç-Kunt and Huizinga (1998, p. 18). The operating margin turns out to be insignificant with respect to the net interest margin as well as non-interest income over total assets. The coefficient of the nominal interest rate is significant with respect to personnel expenses over total assets and return on assets and enters with a negative sign, the latter indicating that banks had more interest rate sensitive liabilities than assets. The results further show a positive association between the growth rate of the sum of lending by specialised financial institutions and the issuance of securities and personnel expenses (scaled by total assets), which may reflect increasing competition in recruiting qualified personnel as reported by Posayananda et al. (2005, p. 42). This argument gains further support by its negative association with return on assets.

Using a broad foreign penetration measure (FMSA), which includes assets of branches of banks incorporated abroad, results in the foreign ownership dummy variable being significant with respect to the net interest margin only, which may reflect that branches of banks incorporated abroad and banks incorporated in Thailand neither compete in the same lines of business nor on a level playing field, although some branches of banks incorporated abroad have expanded their activities beyond the wholesale segment (the most noteworthy example being Citibank)²⁵ (Herberholz, 2002, p. 189). Its coefficient enters with the expected positive sign; however, the R^2 is again extremely low. The coefficient of the broad foreign penetration measure turns out to be significantly and negatively related to the ratio of personnel expenses and total assets as well as return on assets, confirming the results above. Among the control variables, the state ownership dummy variable turns out to be positively associated with return to assets, perhaps indicating that the advantages of government interference outweigh its disadvantages as suggested above. The liquid assets over total assets ratio is significantly and positively related to return on assets, which might be due to liquid assets typically being of high quality, carrying low interest but hardly requiring loan loss provisionings. The non-performing loan coverage ratio is negatively related to return on assets, which may reflect the impact of loan loss provisionings in the wake of the financial crisis as mentioned above. The significant and positive association between the ratio of deposits over total assets, and the operating margin as well as personnel expenses over total assets again reflect the high maintenance and salary expenses of a large branch network necessary for attracting deposits. Its negative association with the net

²⁵Note that only few studies distinguish between different types of foreign banks (for example Montgomery, 2003 and Haber & Musacchio, 2005).

interest margin again is counterintuitive. The operating margin as well as the nominal interest rate turn out to be insignificant. Again, the growth rate of the sum of lending by specialised financial institutions and the issuance of securities are highly significant and positively related to the operating margin as well as personnel expenses over total assets and negatively related to return on assets.

Using the number share of foreign-owned commercial banks incorporated in Thailand (FNS) reveals a significant relationship with personnel expenses over total assets only, and the coefficient enters with the expected negative sign. The foreign ownership dummy variable turns out to be insignificant with respect to all performance measures except for the net interest margin, where its coefficient enters with the expected positive sign.²⁶ Among the control variables, the coefficients of the state ownership dummy variable as well as the ratio of liquid assets over total assets are again significant and positive with respect to return on assets. As expected, the ratio of deposits to total assets is positively related to the operating margin as well as the ratio of personnel expenses over total assets, but negatively associated with net interest margins, the latter being counterintuitive. Also in accordance with the results above, the growth rate of the sum of lending by specialised financial institutions and the issuance of securities are highly significant and positively related to operating margins and personnel expenses over total assets and negatively related to return on assets.

These results are confirmed once branches of foreign banks incorporated abroad are included in the measure of foreign bank penetration (FNSA). The share of foreign banks in the system turns out to be significant with respect to personnel expenses over total assets only and enters with the expected negative sign. The coefficient of the foreign ownership dummy variable, however, turns out to be significant with respect to the net interest margin,²⁷ non-interest income over total assets, personnel expenses over total assets as well as return on assets and enters with a positive sign, thus confirming the findings reported above. Among the control variables, the liquid assets over total assets ratio is of statistical significance, and its coefficient enters with the expected negative sign with respect to non-interest income and personnel expenses (all scaled by total assets). The significant and positive relationship between the ratio of deposits over total assets and operating margins as well as the significant and negative relationship between deposits over total assets and return on assets again reflect the high maintenance and salary expenses associated with a large branch network. Its negative association with the net interest margin is again surprising. The nominal interest rate is only of statistical significance with respect to personnel expenses over total assets and enters with a negative sign. The growth rate of the sum of lending by specialised financial institutions and the issuance of securities is significant and positively related to personnel expenses over total assets and negatively related to return on assets, which is consistent with the findings above. The remaining control variables turn out to be insignificant.

The empirical findings with respect to the first set of regressions indicate that foreign bank entry leads to greater efficiency in commercial banks incorporated in

²⁶ Note that R^2 is again extremely low.

²⁷ Again, R^2 is extremely low.

Thailand. The negative relationships between the asset share of foreign banks in the system and net interest margins, personnel expenses as a percentage of total assets as well as return on assets reflect greater contestability in the sector, with positive welfare implications for depositors and borrowers. Decreases in net interest margins reflect a narrowing of the gap between what the ultimate saver receives and what the ultimate investor has to pay for funds, decreases in personnel expenses over total assets perhaps efforts taken to address overstaffing problems prevalent in the sector and to introduce sophisticated operational structures and processes (Herberholz, 2002, p. 194),²⁸ whereas decreases in return on assets indicate the elimination of excessive profits associated with oligopolistic markets. The results further show that foreign ownership has some impact on the dependent variables. Foreign-owned banks incorporated in Thailand appear to earn higher net interest margins, non-interest income (scaled by total assets) and return on assets and incurred higher personnel expenses, perhaps reflecting early retirement schemes as well as pay-outs to encourage staff departures and suggesting that foreign-owned banks incorporated in Thailand have sought to attract highly qualified personnel. The results further suggest that the size of foreign banks matters rather than their number, which is not consistent with the findings in Claessens et al. (1998, p. 18), for example.

G.6.2 Second Set of Regressions

Focusing on domestically-owned banks incorporated in Thailand, the results with respect to the second set of regressions show that the asset share of foreign-owned commercial banks incorporated in Thailand (FMS) is significantly related to net interest margins, personnel expenses over total assets and return on assets. As expected, increases in the asset share of foreign-owned banks incorporated in Thailand reduce net interest margins, personnel expenses over total assets and return on assets in domestically-owned commercial banks incorporated in Thailand. The asset share of foreign-owned commercial banks incorporated in Thailand again enters with an unexpected positive, but insignificant coefficient with respect to non-interest income over total assets and the operating margin.

Turning to control variables, the results show that the state ownership dummy variable, the operating margin as well as the non-performing loan coverage ratio are not of statistical significance. The liquid assets over total assets ratio enters with a significant negative coefficient with respect to non-interest income over total assets, again reflecting that liquid assets generally do not earn fee income. The variable deposits over total assets is significantly and positively related to operating margins. This result again reflects the expenses of a branch network necessary for attracting customer deposits. As expected, the growth rate of the sum of lending by special-

²⁸ It is noteworthy that the number of employees of banks incorporated in Thailand decreased from 124,088 as of December 1996 to 85,958 as of December 2004. (Bangkok Bank, n.d.b, n.d.a)

ised financial institutions and the issuance of securities are significantly and negatively related to return on assets. The nominal interest rate enters with a significant and positive coefficient with respect to operating margins, but with a significant and negative coefficient with respect to personnel expenses over total assets.

Once branches of banks incorporated abroad are included in the definition of foreign banks, the coefficient of the asset share of foreign banks in the system (FMSA) turns out to be significant with respect to personnel expenses over total assets only and enters with a negative sign.²⁹ Again, the results may reflect the fact that branches of banks incorporated abroad and banks incorporated in Thailand neither compete in the same lines of business nor on a level playing field. Among the control variables, the state ownership dummy variable, the liquid assets over total assets ratio, the operating margin as well as the nominal interest rate turn out to be statistically insignificant. The non-performing loan coverage ratio, however, is negatively associated with return on assets. The ratio of deposits over total assets is significant and positively related to personnel expenses over total assets as expected, but negatively to net interest margins, which again is counterintuitive. The growth rate of the sum of lending by specialised financial institutions and the issuance of securities are again significant and positively related to personnel expenses over total assets and negatively related to return on assets.

The number share of foreign-owned banks incorporated in Thailand (FNS) is significantly and negatively related to personnel expenses over total assets, but positively related to the operating margin³⁰. The latter may reflect pressures exerted on domestically-owned banks incorporated in Thailand to restructure their operations. Among the control variables, the coefficient of the non-performing loan coverage ratio is significant and enters with a negative sign with respect to return on assets. The variable deposits over total assets turns out to be of statistical significance with respect to personnel expenses over total assets and the coefficient enters with the expected positive sign. The growth rate of the sum of lending by specialised financial institutions and the issuance of securities are positively associated with personnel expenses over total assets and negatively with return on assets.

Once branches of banks incorporated abroad are included in the number share of foreign banks in the system (FNSA), it turns out to be significantly associated with personnel expenses over total assets as well as return on assets. Whereas in the former case the coefficient of the foreign penetration measure enters with the expected negative sign, it enters with an unexpected positive sign with respect to return on assets,³¹ which again underlines that branches of banks incorporated abroad and banks incorporated in Thailand neither compete in the same lines of

²⁹ Note that a positive and significant relationship between the asset share of foreign-owned banks incorporated in Thailand and operating margins is reported in Herberholz (2002, p. 205). The afore-mentioned study covers the period 1997:2 to 2002:1.

³⁰ Note, however, the extremely low R^2 .

³¹ See Claessens and Glaessner (1998) who interpret their finding, that increased foreign bank presence leads to greater profitability and lower net margins, to mean that openness encourages banks to reduce costs and diversify their income by relying to a greater extent on fee-based income.

business nor on a level playing field. Among the control variables, the variable liquid assets over total assets is significantly and negatively associated with non-interest income over total assets as expected. Its negative association with return on assets, however, is contrary to the findings in 6.1 and its positive association with operating margins counterintuitive. The deposits over total assets ratio is significant with respect to the variable net interest margin, and its coefficient again enters with an unexpected negative sign. Its coefficient enters, however, with an expected positive sign with respect to the operating margin. Neither the state ownership dummy variable, the non-performing loan coverage ratio nor the operating margin turns out to be of statistical significance. Again, the growth rate of the sum of lending by specialised financial institutions and the issuance of securities are negatively related to return on assets. The nominal interest rate is significant with respect to personnel expenses over total assets and enters with a negative sign.

The empirical findings with respect to the second set of regressions indicate that foreign bank entry has also led to greater efficiency in domestically-owned commercial banks incorporated in Thailand, although not all relationships are clear. The negative relationship between the asset share of foreign-owned banks incorporated in Thailand and net interest margins, personnel expenses (scaled by total assets) as well as return on assets reflects greater contestability in the domestic commercial banking sector. Again, the results show that the size of foreign banks rather than their number matters, which is not consistent with the findings in Claessens et al. (1998, p. 18). In light of the results obtained from running the first set of regressions, foreign bank presence appears to have an impact on both, foreign-owned and domestically-owned banks incorporated in Thailand.

G.7 Conclusion

This study provides further evidence on how hybrid banks – majority controlled by foreign banks –, which have had the opportunity to compete with domestically-owned banks incorporated in Thailand on an almost level playing field since 1997, operate differently from their domestically-owned counterparts in terms of the traditional, accounting-based performance measures net interest margin, non-interest income over total assets, operating margin, personnel expenses over total assets as well as return on assets. Using the asset share of foreign-owned commercial banks incorporated in Thailand (FMS) as a foreign penetration measure, the empirical results obtained show that non-interest income over total assets and return on assets of foreign-owned banks incorporated in Thailand were on average higher than those of their domestically-owned counterparts, reflecting higher productive efficiency. However, foreign-owned banks incorporated in Thailand incurred on average higher personnel expenses over total assets *inter alia*, reflecting their efforts to attract highly qualified personnel. Using a broad measure of the number share of foreign banks in the system (FNSA) not only confirms these results, but suggests that net interests margins of foreign-owned banks

incorporated in Thailand were on average higher as well. However, these relationships are not confirmed once a broad measure of the asset share of foreign banks (FMSA) or the number share of foreign banks in the system (FNS) is used as a control variable, with the exception that the foreign ownership dummy variable enters with a significant positive coefficient with respect to the net interest margin in both regressions.

The literature provides empirical evidence that foreign bank entry can render national banking markets more competitive and force banks to operate more efficiently. This study provides further evidence for the beneficial impact of foreign bank presence in the case of Thailand. The main finding is that the asset share of foreign banks in Thailand is significantly related to net interest margins, personnel expenses (scaled by total assets) and return on assets. Increases in the asset share of foreign banks in the system are found to reduce net interest margins, personnel expenses (scaled by total assets) and return on assets, both in foreign-owned and domestically-owned commercial banks incorporated in Thailand. Using the number share of foreign banks in the system confirms these results for the performance measure personnel expenses over total assets, but the results with respect to return on assets are not clear. The results suggest that the asset share of foreign banks, rather than their number share, matters.

The rather ambiguous results obtained from the efficiency comparison of foreign-owned and domestically-owned banks incorporated in Thailand combined with the results indicating a beneficial effect of foreign bank presence on the efficiency of Thai commercial banks, may imply that not only actual behaviour of foreign banks, but also potential increases in foreign bank presence, are of importance.

To summarise, the results obtained in this study may support the notion that market access should further be liberalised in the future, especially regarding the provisions with respect to foreign equity participation. However, the results are obtained using data over a relatively short period of time and for a relatively small number of cross-sections and should thus be interpreted cautiously. Furthermore, traditional, accounting-based performance measures may be inappropriate indicators of the competitiveness of a banking system as well as inappropriate proxies for efficiency (Herberholz, 2005a, 2005b). In addition to this, not only have specialised financial institutions and capital markets expanded their activities, but other nonbank financial institutions (especially credit card companies in the case of Thailand), which have experienced foreign entry as well, have also had an impact on the degree of competition in the banking system and should thus be taken into consideration.³² Apart from these issues, the present study addresses only bank efficiency spillovers associated with foreign bank entry. Future research should also address other areas affected by foreign bank presence such as the impact on credit supply and the stability of the financial system.³³ To obtain further insights, attempts should also be made to quantify effects that have thus far been treated as not quantifiable.³⁴

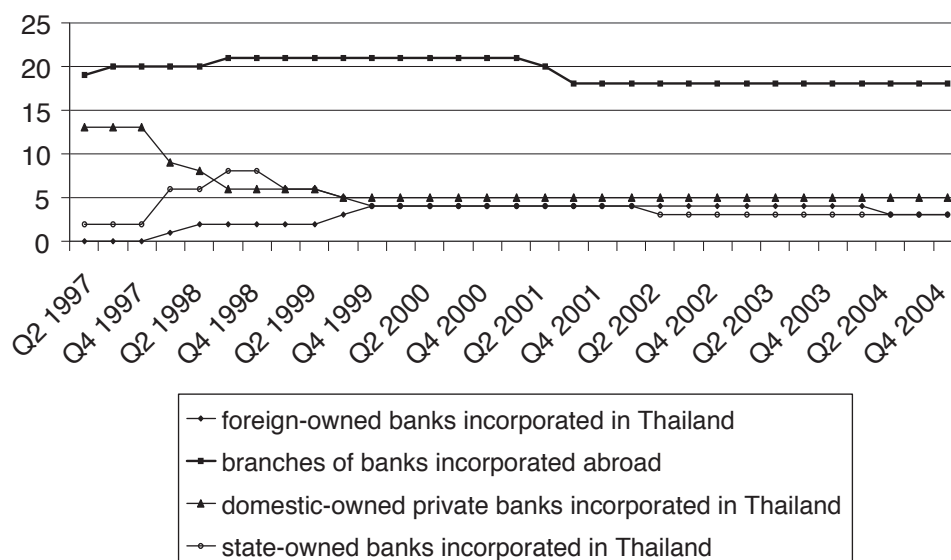
³² Quarterly data are not available for the period in question.

³³ Refer to Herberholz (2005a) for a detailed discussion.

³⁴ See 33.

Appendices

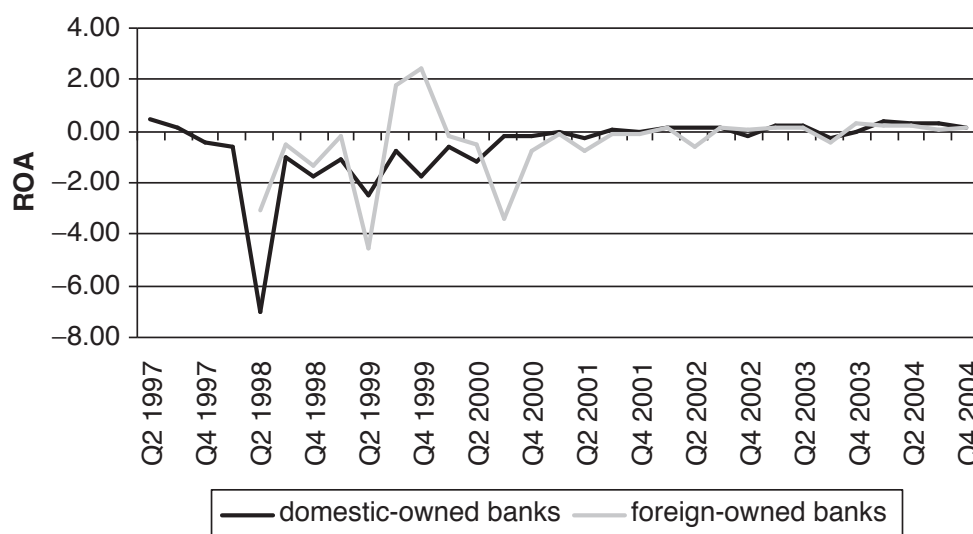
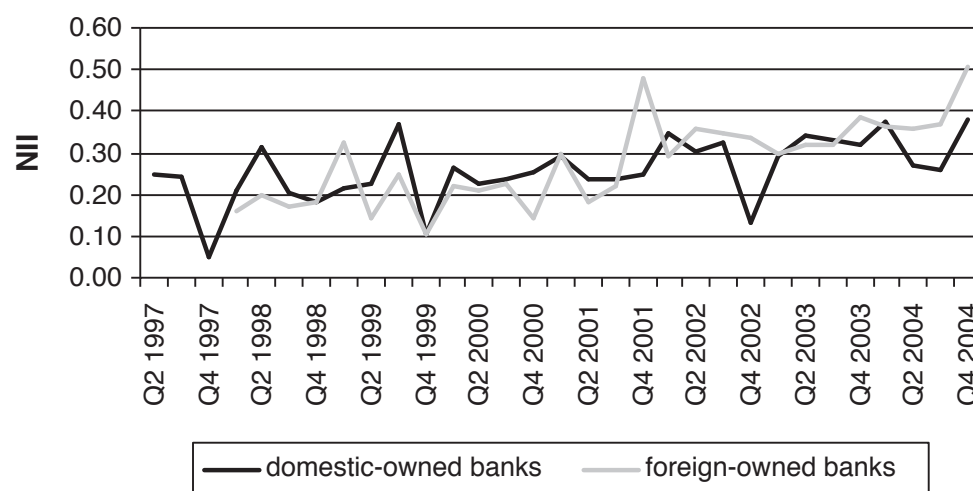
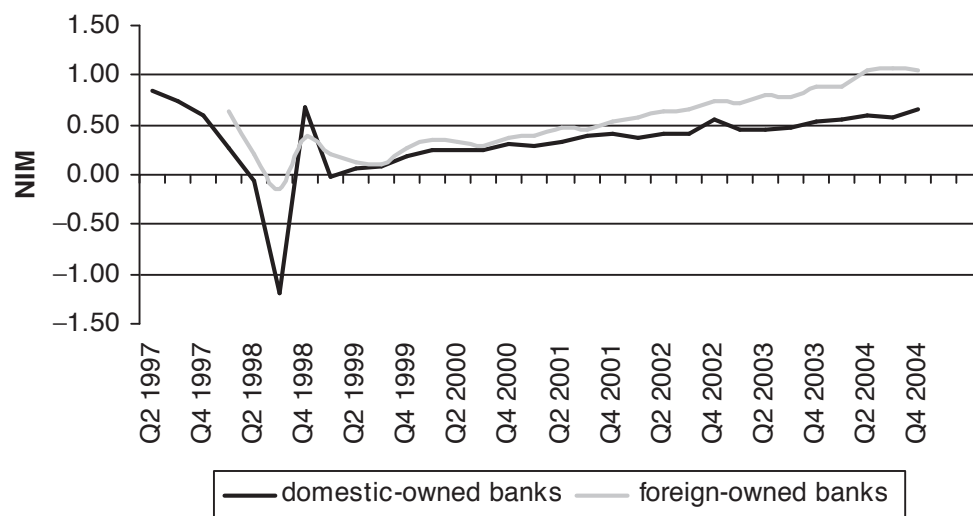
1 Number of Commercial Banks Incorporated in Thailand

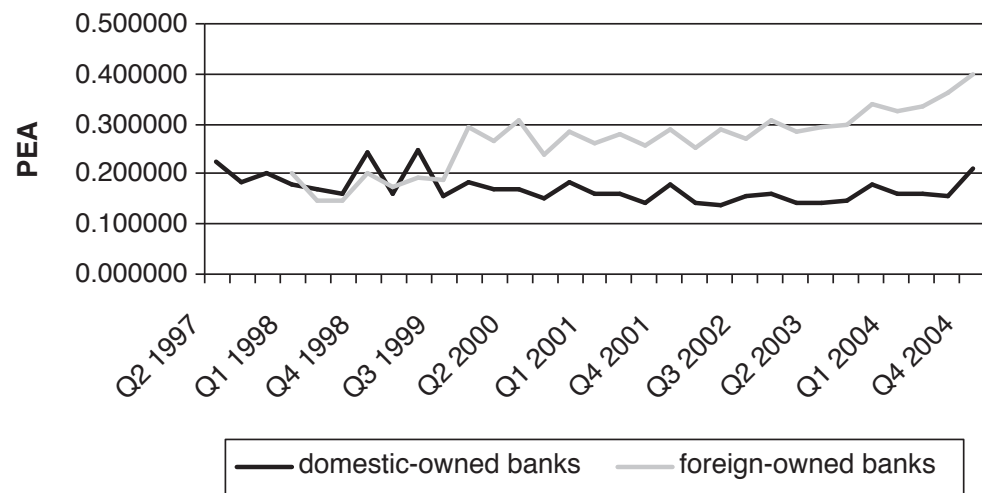
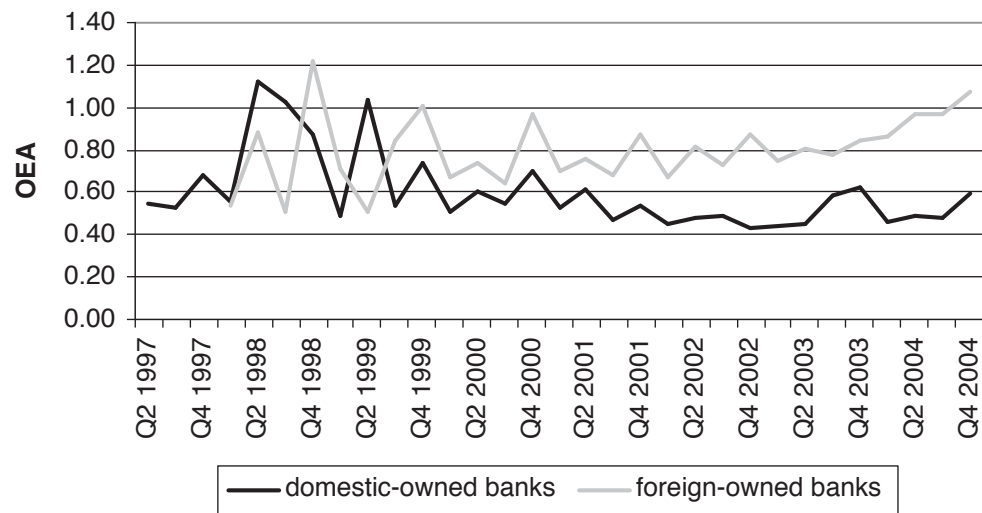


2 Ranking of Commercial Banks Incorporated in Thailand in Terms of Assets (As of 31 December 2004)

Rank	Bank	Total assets (in THB)	Market share in terms of assets (commercial banking sector; in %)
1.	Bangkok Bank (BBL)	1,407,347,461,000	19.35
2.	Krung Thai Bank (KTB)	1,148,903,401,000	15.80
3.	Kasikombank (KBANK)	824,551,748,000	11.34
4.	Siam Commercial Bank (SCB)	764,893,575,000	10.52
5.	Thai Military Bank (TMB)	670,132,081,000	9.22
6.	Bank of Ayudhya (BAY)	575,355,636,000	7.91
7.	Siam City Bank (SCIB)	472,444,051,000	6.50
8.	BankThai (BT)	231,833,185,000	3.19
9.	Bank of Asia (BOA)	163,862,303,000	2.25
10.	Standard Chartered Nakornthon Bank (SCNB)	63,643,454,000	0.88
11.	UOB Radanas in Bank (UOBR)	53,005,015,000	0.73

3 Average Values of Performance Measures for Foreign-owned and Domestically-owned Banks





4 Estimation Results: First Set of Regressions (Panel I)

	NIM ^a - CC		NII - FE		OEA - FE		PEA - FE		ROA - FE	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
FMS	-0,160577	-2.10010**	0,007513	0,829137	0,001667	0,071502	-0,017506	-3.74387***	-0,541570	-1.86631*
SOI	0,107016	0,410063	0,057556	0,992872	-0,283893	-1,152127	-0,010390	-0,564276	2,683548	1,399897
LA	0,000087	0,014734	-0,002497	-3.24122***	0,000741	0,315455	-0,000698	-3.61136***	0,033262	1.231114
NPLCR	-0,000013	-1,138376	-0,000002	-0,446697	-0,0000002	-0,009901	-0,000001	-0,410791	-0,000064	-0,666219
DA	-0,019040	-1.85516*	-0,000755	-0,344478	0,020522	2.17526**	0,002360	2.095292**	-0,102245	-1.85951*
OEA	0,456541	1,354657	-0,006170	-0,234770						
INT	-0,007569	-0,148936	-0,001094	-0,431334	0,013565	1,284821	-0,003120	-3.11550***	-0,180686	-1.97509**
SFICM	0,005958	1,639503	-0,000116	-0,174417	0,003072	1,429475	0,000635	2.29034**	-0,024346	-2.99667***
FO	0,083297	1,589894	0,139989	3.11664***	-0,049464	-0,203714	0,094520	3.50914***	3,272062	2.00667**
R²	0,073430		0,212973		0,178400		0,612863		0,202680	
FSTAT	2.764920***		4.262021***		3.611332***		26.32884***		4.227779***	
	NIM ^a - CC		NII ^a - CC		OEA ^a - CC		PEA ^a - CC		ROA ^a - CC	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
FNSA	-0,032980	-1.305410	0,007596	0,564009	-0,004603	-0,141179	-0,011332	-3.02412***	-0,533576	-1.70010*
SOI	0,114426	0,431041	0,013312	0,346609	-0,083686	-1,150829	-0,001470	-0,153241	0,821428	1.71157*
LA	-0,001081	-0,177544	-0,001755	-0,707618	0,004104	0,664567	-0,000683	-1,145541	0,122428	1.76294*
NPLCR	-0,000014	-1,158349	-0,000004	-1,138867	0,000018	1,470906	0,000002	1,078879	-0,000200	-1.69388*
DA	-0,023591	-2.20257**	0,002039	0,847142	0,018126	1.97802**	0,005380	2.47101**	-0,184593	-1.539258
OEA	0,454720	1,354146	0,000827	0,042172						
INT	-0,003004	-0,059934	0,003974	0,772706	-0,000750	-0,048164	-0,000199	-0,112427	-0,048562	-0,362596
SFICM	0,005669	1,587778	-0,000614	-1,165729	0,003924	2.32613**	0,000790	4.15398***	-0,026870	-3.10442***
FO	0,095567	1.80939*	0,016522	0,642210	-0,071203	-0,867032	0,002346	0,235207	0,363142	0.753732
R²	0,068768		0,016803		0,073167		0,259912		0,169624	
FSTAT	2.576426***		0,596244		3.108382***		13.82813***		8.043271***	

*, **, *** indicate significance levels of 10, 5 and 1%, respectively

CC denotes the constant coefficient model and FE the fixed effects model. Regarding the latter, the individual effects are not reported

All regressions are estimated with heteroskedasticity-consistent standard errors

^aDependent and independent variables in first differences (except dummy variables) to correct for unit root problem

5 Estimation Results: First Set of Regressions (Panel I)

	NIM ^a - CC		NII ^a - CC		OEA ^a - CC		PEA ^a - CC		ROA ¹ - CC	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
FNS	-0.019540	-0.429739	0.010623	0.569871	0.008453	0.174592	-0.009752	-1.78075*	-0.275826	-0.976745
SOI	0.120211	0.452194	0.012264	0.315123	-0.082346	-1.136675	0.000341	0.034974	0.915641	1.83272*
LA	-0.001182	-0.197996	-0.001809	-0.725690	0.003949	0.662442	-0.000678	-1.037528	0.120352	1.69194*
NPLCR	-0.000012	-1.001476	-0.000005	-1.309968	0.000018	1.493467	0.000002	1.495356	-0.000165	-1.501477
DA	-0.022153	-1.96279**	0.001500	0.590862	0.017944	1.80651*	0.005985	2.86354***	-0.162424	-1.456481
OEA	0.455724	1.354267	0.000432	0.021986						
INT	-0.006593	-0.131879	0.004641	1.060685	-0.001542	-0.107149	-0.001353	-0.786478	-0.107700	-0.865524
SFICM	0.005669	1.584982	-0.000599	-1.107011	0.003952	2.38202**	0.000784	4.16547***	-0.026723	-3.06312***
FO	0.101121	1.909247*	0.015787	0.607847	-0.069422	-0.848908	0.003954	0.396873	0.455529	0.923090
R²	0.068344		0.017820		0.073315		0.254940		0.157313	
FSTAT	2.559379***		0.632986		3.115152***		13.47307***		7.35053***	
	NIM ^a - CC		NII - FE		OEA - FE		PEA - FE		ROA - FE	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
FNSA	-0.033222	-0.860995	0.003022	0.979521	-0.017694	-1.595207	-0.004020	-2.02795**	0.005501	0.088689
SOI	0.118394	0.443310	0.065795	1.051258	-0.278293	-1.125810	-0.028775	-1.624421	2.087119	1.156748
LA	-0.001179	-0.202634	-0.002434	-3.19954***	0.000760	0.324000	-0.000849	-4.46926***	0.028556	1.091168
NPLCR	-0.000011	-0.985026	-0.000002	-0.528578	0.000001	0.077516	-2.26E-07	-0.144950	-0.000062	-0.648386
DA	-0.022795	-2.12105**	-0.000625	-0.301681	0.022161	2.29402**	0.001687	1.555358	-0.134385	-2.01318**
OEA	0.455416	1.355372	-0.003957	-0.150186						
INT	-0.009184	-0.179021	-0.000308	-0.104762	0.000117	0.010895	-0.002778	-1.95218*	-0.073726	-0.926461
SFICM	0.005163	1.439802	-0.000041	-0.060461	0.002626	1.248785	0.000520	2.02593**	-0.024612	-2.86061***
FO	0.094341	1.79292*	0.140570	2.99850***	0.015510	0.064510	0.082736	2.96885***	2.448859	1.68325*
R²	0.069302		0.213480		0.188762		0.596293		0.174011	
FSTAT	2.597905***		4.274921***		3.8699***		24.5656***		3.503785***	

*, **, *** indicate significance levels of 10, 5 and 1%, respectively

CC denotes the constant coefficient model and FE the fixed effects model. Regarding the latter, the individual effects are not reported

All regressions are estimated with heteroskedasticity-consistent standard errors

^aDependent and independent variables in first differences (except dummy variables) to correct for unit root problem

6 Estimation Results: Second Set of Regressions (Panel II)

	NIM ^a - CC		NII - FE		OEA - FE		PEA - FE		ROA - FE	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
FMS	-0.218488	-1.69492*	0.007877	0.770023	0.023354	1.127530	-0.014062	-3.17536***	-0.297659	-2.29127**
SOI	0.083716	0.333769	0.075536	0.945858	-0.196377	-0.653157	-0.018563	-0.78404	2.237593	0.955506
LA	0.004965	0.800812	-0.003050	-2.70935***	0.005042	1.418015	0.000204	0.517198	-0.007078	-0.787187
NPLCR	-0.000028	-1.228676	-0.000001	-0.378866	-0.000006	-0.413948	-0.000002	-1.583609	-0.000020	-0.459658
DA	-0.031743	-1.454088	-0.002673	-0.888815	0.022347	1.94832*	0.002473	1.612256	-0.041607	-0.657585
OEA	1.214316	1.499132	-0.009307	-0.255706						
SFICM	0.008892	1.627296	-0.000299	-0.330349	0.001747	0.763583	0.000515	1.597174	-0.016163	-2.208690**
INT	-0.010800	-0.138257	-0.001436	-0.443857	0.026810	2.34351**	-0.001187	-1.73205*	-0.103730	-1.638276
R²	0.156163		0.211724		0.208465		0.299968		0.173713	
FSTAT	5.343702***		4.154208***		4.383192***		7.131569***		3.498875***	
	NIM ^a - CC		NII ^a - CC		OEA ^a - CC		PEA ^a - CC		ROA ^a - CC	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
FNSA	-0.027131	-0.603413	0.031108	1.852214	0.014946	0.520710	-0.010181	-3.24898***	-0.201384	-1.015307
SOI	0.091030	0.357204	0.008130	0.229187	-0.051137	-0.811193	0.001453	0.158928	0.282829	0.955938
LA	0.004768	0.743140	-0.005413	-2.081816	0.004683	1.475083	0.000119	0.258407	0.013915	0.514981
NPLCR	-0.000027	-1.211874	-0.000002	-0.413010	0.000016	1.413245	0.000001	0.959791	-0.000085	-1.69696*
DA	-0.036939	-1.64993*	-0.001708	-0.474106	0.013479	1.252805	0.006383	1.95611*	-0.059527	-0.596105
OEA	1.166100	1.469779	0.008215	0.305002						
SFICM	0.008890	1.623784	-0.000835	-1.184909	0.002050	1.345988	0.000534	2.69201***	-0.018778	-3.02603***
INT	-0.004588	-0.060817	-0.000312	-0.048228	-0.002027	-0.097735	-0.001255	-0.578754	-0.014741	-0.117485
R²	0.147798		0.044014		0.052131		0.257663		0.076272	
FSTAT	5.007792***		1.329432		1.822780		11.50377***		2.736599***	

*, **, *** indicate significance levels of 10, 5 and 1%, respectively

CC denotes the constant coefficient model and FE the fixed effects model. Regarding the latter, the individual effects are not reported.

All regressions are estimated with heteroskedasticity-consistent standard errors.

^aDependent and independent variables in first differences (except dummy variables) to correct for unit root problem.

7 Estimation Results: Second Set of Regressions (panel II)

	NIM ^a - CC		NII ^a - CC		OEA ^a - CC		PEA ^a - CC		ROA ^a - CC	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
FNS	-0.041745	-0.744525	0.013267	0.755475	0.046866	2.25079**	-0.006274	-1.89447*	-0.224851	-1.592762
SOI	0.092675	0.362875	0.004959	0.135530	-0.050317	-0.800403	0.002344	0.252919	0.294756	0.980601
LA	0.004045	0.697244	-0.004676	-1.932384	0.005064	1.578604	-0.000120	-0.243534	0.009100	0.346412
NPLCR	-0.000025	-1.158600	-0.000004	-1.027204	0.000014	1.341243	0.000002	1.427653	-0.000070	-1.64689*
DA	-0.035500	-1.559223	-0.002099	-0.564789	0.011602	1.105625	0.006601	2.04676**	-0.051055	-0.532870
OEA	1.179048	1.464344	0.006042	0.216326						
SFICM	0.008706	1.599634	-0.000835	-1.142647	0.002265	1.495938	0.000526	2.64486***	-0.019491	-3.16759***
INT	-0.007756	-0.100738	0.003624	0.640612	-0.000490	-0.025294	-0.002526	-1.202858	-0.039008	-0.328917
R²	0.148519		0.031160		0.067199		0.247724		0.081401	
FSTAT	5.036504***		0.928677		2.387607**		10.91394***		2.936922***	
	NIM ^a - CC		NII - FE		OEA - FE		PEA - FE		ROA - FE	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
FNSA	-0.072005	-1.285057	0.005940	1.438560	-0.022343	-1.559146	-0.005767	-2.01341**	0.068838	1.70812*
SOI	0.089017	0.348020	0.077587	0.906922	-0.123723	-0.417617	-0.028193	-1.246069	1.694861	0.747906
LA	0.003359	0.584532	-0.002893	-2.85746***	0.005830	1.71331*	-0.000188	-0.581944	-0.016194	-1.81120*
NPLCR	-0.000023	-1.099648	-0.000002	-0.476460	-0.000006	-0.402774	-0.000001	-1.021958	-0.000016	-0.417509
DA	-0.037442	-1.65464*	-0.003340	-1.072931	0.027364	2.14621**	0.002512	1.521626	-0.071178	-0.996594
OEA	1.182992	1.485581	-0.000333	-0.009168						
SFICM	0.007643	1.425518	-0.000134	-0.144291	0.001180	0.492670	0.000325	1.275542	-0.014906	-2.14852**
INT	-0.013241	-0.168721	0.001315	0.333700	0.005692	0.612672	-0.002841	-1.76661*	0.003996	0.073258
R²	0.151400		0.215780		0.226647		0.303679		0.153733	
FSTAT	5.151637***		4.255688***		4.877532***		7.258273***		3.023353***	

*, **, *** indicate significance levels of 10, 5 and 1%, respectively.

CC denotes the constant coefficient model and FE the fixed effects model. Regarding the latter, the individual effects are not reported.

All regressions are estimated with heteroskedasticity-consistent standard errors.

^aDependent and independent variables in first differences (except dummy variables) to correct for unit root problem.

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Chapter H

ASEAN and India: A Mutually Strengthening Paradigm/Vision

G.R. Krishnamurthy

H.1 ASEAN and India

India is an awakened power in Asia. Thanks to its British heritage, now, it is a great knowledge-power. It has the third largest volume of technically trained manpower in the world. India produces 2.5 million graduates and diploma holders every year through its more than 300 universities and 15,000 colleges. Among these are the IIT's and IIM's, which produce the world class technocrats, scientists and managers. With a literate population of 500 million to back up the millions of technically trained graduates, the country is poised for a tremendous technological growth, particularly in Information Technology and Bio-technology.

With the launching of new economic policy in 1991, the processes of liberalization, privatization and globalization (LPG) have not only taken deep roots in the country but also contributed to the tremendous growth of the economy in the past 15 years. Controls were eliminated, regulations were minimized, and license permit raj has been dismantled!

As a result, growth increased to 7.5% a year in the mid 1990s; exchange reserves went up from 1 billion to 20 billion. Inflation came down from 13% to 6% by early 1990s. Of course, India was 15 years behind the liberalization programme of the Deng's revolution in China in December 1978; India learned to specialize in the knowledge industries of tomorrow. Hundreds of entrepreneurial professionals have come into existence in twenty-first century India and there are now more than 500 software companies in Bangalore, which has become the silicon valley of India. Infosys, one of the country's software companies, has seen an increase in capital to around US \$15 billion within a decade from its starting capital of US \$500. Similarly, Azim Premji had become the third richest man in the world with the market capitalization of his software company crossing US \$46 billion, or around 11% of India's GDP (Gurcharan Das, 2001). McKinsey projects that the Information Technology industry alone may provide one million jobs with about US \$50 billion in revenues by 2010. Thus, India is now on the march, even if its pace was slow in the later part of the twentieth century.

With the declaration of the new economic policy (NEP) and with the background of the hundreds of public sector companies during the Nehruvian period, which

provided millions of secure jobs to Indians, India now has the largest middle class population in the world. Though official estimates put them at around 250 million, many other reliable studies estimate the size of the middle class at ~350 million. In other words, this is the consumer population. They are in a position and ready to consume anything and everything from kitchen goods to toiletries, FMCGCs, from scooters to automobiles. Strangely enough, India's rural situation has changed so drastically over the last 3–4 decades that the rural markets in many affluent agrarian pockets are consuming as much as the urban middle class!

Thus, India offers perhaps the third largest market for consumption next only to the US and European markets in the scope and volume of business.

In addition to the comfortably consuming population of 350 million, the country has one of the largest networks of transport in railways, land routes and shipways. It has a well-developed infrastructure. Though power generation in India is yet to be accelerated, all other infrastructural facilities are in place to complement any foreign business investment. In short, India is poised with the right climate for a steady and fast growth (as East Asian tigers did some years before).

It is in this context that ASEAN in general, and some of the ASEAN countries in particular, may prefer to have mutually strengthening business collaborations and trade agreements with India. India is in a unique position to offer her knowledge services in Information Technology and bio-technology to these countries at rates which are at least as competitive as those of other regional competitors.

It should be mentioned here that software exports have been growing at 60% a year over the past few years in India. They are expected to increase to US \$50 billion by 2008. Out of 19 top global software companies, 12 were Indian companies. More than 400 portals have been launched every month over the last few years, backed by scores of venture capital funds. Likewise, McKinsey projects that remote services in India could become a US \$500 billion. business, employing 1–2 million Indians in the coming 2 years (Gurcharan Das, 2001). Thus, India is going through a silent information revolution through e-mail, chat rooms, browsing and e-commerce, in addition to software services. The 20 million Diaspora Indians spread all over the world are contributing to this internet revolution.

It is in this context and scenario that individual ASEAN countries could profit from mutually-enriching business collaboration with India in information technology.

Of course, here we should note that China is a great power in Asia. Its manufacturing prowess is something colossal. With a roaring export engine, China – like the US – in a quota-free world is a great driving force for the global economy.

China already has some sort of special relationship with ASEAN countries in the form of ASEAN + 3 relationship (with China, Japan and Republic of Korea). Yet ASEAN countries, particularly some of them in certain areas (e.g., textiles) cannot compete with China.

China is currently the largest exporter of textiles and clothing, with a market share of 17–18% of the world. China's ability to compete in textiles is going to affect many countries including Cambodia, Bangladesh and India and even some of the ASEAN countries.

The South East Asian Economies have been particularly affected by China since their financial crises in 1997, when many investments in manufacturing within these countries were lost to China. Even Japan and Taiwan have experienced huge job losses due to imports from and migration of products to China. China's accession to the WTO will accelerate the reconfiguration and realignment of many sources of investments, imports and exports on a large scale in the years to come. It is in this context that the collaboration of ASEAN countries with India, particularly in information technology and biotechnology areas, will be more advantageous and mutually strengthening.

H.2 India and ASEAN: A Business Vision

India is not currently a major threat to any of the ASEAN countries. Its relative importance can be compared with that of China who exported around US \$593 billion of goods in 2004 to the US, while India's exported hardly US \$10 billion. Similarly, Indian exports in textiles are hardly 3.5% of world trade, whereas China commands around 17% (in 2004) of the market and Chinese leather and footwear exports to the US amount to about US \$14.5 billion while India's exports are hardly half a billion..

However, Indian textile industry is gearing up to face the competition and function in the WTO era. Though India currently has only about 4% of exports in textiles and garments, it is estimated to grow to between 10% and 15% a year over next 5 years. The projection for Indian textile exports is about 20–25% annually in the coming decade. India thus has an advantage in which the government is trying to come to the rescue of textile industry through the pragmatic labour legislation and dismantling of S.S.I. reservations. If the Indian government could offer 70% subsidies to its exporters, as does China, the Indian textile industries would certainly compete with the Chinese in the coming 10 years.

Moreover, the latest warning from the US to China with threatened tariffs and taxes of 27.5% on Chinese exports to the US (unless the Yuan is revalued) will be a great advantage to Indian industrial exports, particularly textiles. Most probably, the EU may join the US in exerting pressure on the Chinese to appreciate the Yuan.

In view of the above realities, ASEAN's business deals with India will be much more advantageous than with the Chinese – whether in textiles, footwear or electrical machinery and equipment, not to speak of collaboration in Information Technology and Bio-technology. In this context, India could see great gains in competition even in textile trade in comparison to other countries with a government driven export lead approach! India could also increase its exports even in electronic goods and machinery.

Thus, it is a good time for ASEAN to explore various avenues of business and trade collaborations with partners in the South Asian Association for Regional Cooperation (SAARC), particularly with India. After all, India accounts for 75% of SAPTA's (SAARC Preferential Trading Arrangement) gross domestic product

and 80% of its population. Thus, mutually strengthening business relationships between ASEAN and India will have positive spill over effect on the SAARC countries as a whole.

H.3 Singapore Model of Co-operation

On 29th June 2005, India and Singapore signed a historic economic pact, the *Comprehensive Economic Co-operation Agreement (CECA)*. (*The Hindu* dated 29 and 30 June 2005). Although it is called economic co-operative agreement, the CECA pact goes beyond a free trade agreement. It is the a comprehensive bilateral understanding between the two countries for it includes clauses relating to visa and air transport liberalization. It is an integrated package, comprising trade in goods and services, agreement on investments, mutual recognition-agreement in services and co-operation, agreements in science and technology, customs, education, e-commerce, intellectual property and the media. According to Prime Minister Manmohan's vision, Singapore is going to be India's gateway to South-East and East Asia.

In fact, India as a nation and the Indian Government are committed to moving forward to sign a CECA with all ASEAN countries. The Indian Government expects a large flow of investment from Singapore and through Singapore. The CECA will pave the way for vast increases in bilateral trade from US \$8 billion at present to a US \$50 billion by 2010. Likewise, according to Assocham study, investments from ASEAN countries are expected to increase to US \$10 billion by 2015. The most important areas of Singapore's investment in India would be airports, ports, urban infrastructure and the like.

In addition to this, there is a tremendous scope for investment ventures in biotechnology health care as well as in food processing, entertainment and tourism.

Turning to IT, more than 300 Indian companies have already set up software development operations in Singapore. More than 1500 Indian IT companies have bases in Singapore. Thus, Singapore will witness the fastest growth in IT and allied services, including R & D, S & T, IPR management and manufacturing, all-in-all, in 22 areas.

In fact Singapore's trade with India has grown faster than any other country – at about 50% – while it was only around 33% with China last year. Prime Minister Lee expressed his admiration for India's world class technology and management institutions in Education. He believes that the scope is vast for Singapore's investment in India. Additionally, Lee said that Singapore would be very happy to have an Indian presence in its science and technology sector, including the defence related S & T segment. Moreover as the Indian economy continues to strengthen, her interests in business with South East Asia will continue to grow. Of course, neither India nor China can take the place of America as a market in East Asia.

Prime Minister Lee was very keen on having the East Asian Summit (EAS) in December 2005 not only include ASEAN + 3 but also India. In the near future, he hopes that India-ASEAN will have FTA. The huge manufacturing base of India will

be a great strength for ASEAN countries, for they have great trading interface with the global markets.

Other ASEAN countries may follow the Singapore pattern of economic collaboration and co-operation with India in near future.

Based on this pact, Dr. Manmohan Singh, the Indian Prime Minister, suggested a trade and economic relations committee (TERC) for initiating negotiations for India-ASEAN CECA.

It should be noted here that Thailand and India had already signed a bilateral agreement much earlier than the Singapore pact. Both Thailand and Singapore account for 35% of Indian imports from 45% of her exports to ASEAN. Thus other ASEAN countries may soon follow in signing bilateral agreements with India.

Indo-ASEAN FTA were the subject of negotiations in September 2006 between India and ASEAN. Issues like ROO (Rules of Origin) and CTH (Change in Tariff Heading) will be streamlined.

Hence, it is in this context of India's fast growth and her confidence in signing bilateral agreements and regional pacts with many countries and blocks that two key points should be mentioned:

- The Carnegie Report (in a book: "India, as a new global power", by the analyst ASHLEY TELLIS) (Outlook, 2005) observes that India will have the fourth most capable concentration of power by 2015.
- It will be among the 5 major economies in 25–30 years. Now, to the India-ASEAN Summit.

H.4 ASEAN and India Summit

In this context, the ASEAN and India summit which took place on 30 November 2004 in Laos was a great beginning in India's relations with ASEAN.

On that day, India and ASEAN signed the accord on partnership for peace progress and shared prosperity by the Indian prime minister and representatives of the ASEAN. Asian Development Bank (ADB) president, Tado Chino described the step as another milestone in Asia's market driven integration. This accord is designed to pave the way for the India-ASEAN Regional Trade and Investment Area (RTIA) agreement. Based on this pact, both sides are expected to boost their bilateral trade to US \$30 billion by 2007 from the current US \$13 billion. The RTIA will include FTA in goods, services and investment.

This agreement forms the core of a push by ASEAN toward greater integration with larger economies in the Asian pacific region. As a result, India's exports to Asia and Oceania countries grew tremendously by a phenomenal 42%, while its growth to the US was 24% and around 23% to EU during the year 2004.

There is an unmistakable glow in India's image and performance among ASEAN countries. As a result, out of the total India's trade worth US \$114 billion, more than 8.5% exports went to ASEAN countries. Here it is also to be noted that

India and ASEAN have many complementarities between their economic structures. For instance, 50% of India's GDP comes from services (to say that it is economy of services) while more than 26% from industry and 22.5% from agriculture. India's overall growth rate registered at 24% during 2004, exceeding the target of 16%. Overall GDP growth for India is projected at 6.5–7.5% in 2005 by comparison with an estimated world growth rate of about 2.6%. Despite this, China's growth rate is equally impressive, if not faster. Its growth lies in the manufacturing sector, while India's growth lies in service sector. Thus, India's exports and services to ASEAN countries will be mutually strengthening.

The economies of China and India have been growing twice as fast as the rest of the world over the past two decades, thus resulting in their projected 40% share in world trade, which in turn matches their population percentage. (40% of the world) by 2010 (Morgan Stanley Report).

Even before the ASEAN and India summit took place, Indian business corporations had widespread interests in ASEAN countries. The TATA group recently got two big acquisitions in East Asia by acquiring South Korea's Daewoo truck making company and TATA steel buying out Singapore's NAT steel. In turn, South Korean companies operate in India in the electronic, automobile and information technology sector. Ballarpur industries, Dena Bank, Bharati Tele Ventures have been listed in the Singapore stock exchange. Infosys has already entered Singapore. Thailand had received 100 applications from Indian industries investing projects worth US \$700 million. In Malaysia, Godrej industries invested quite early in 1968. Mahindras entered China to produce tractors, while Sundaram Fasteners became the first Indian engineering company to establish a manufacturing unit in China. Similarly, Aditya Birla group was one of the pioneers creating and investing in around 20 world class companies, many of them in South East Asia. Their manufacturing ranges from textiles to acrylic fibre, from rayon to polyester, from industrial chemicals to viscose and from fatty acids to palm oil. Over 10000 employees of the company are citizens of South East Asian nations.

The latest news is that TATA motors is going to invest alongside Thai Rung Union Car (TRU)/PLC to produce pick up trucks and also 600 CC vehicles in Thailand.

Turning to Malaysia, bilateral trade with India expanded from US \$2.5 billion to almost double that amount between 2001 and 2002. India's exports to the Philippines, another ASEAN country, amounted to US \$207 million. Indonesia has always enjoyed a balance of trade surplus with India. Its exports to India amounted to US \$2.41 billion. between 2003 and 2004.

In this context, it should be mentioned that India's patent regime has been liberalized. This is likely to help with large scale FDIs in the bio-tech parks of India at Hyderabad, Pune and Bangalore. In fact, India could become the centre for production of bulk drugs and vaccines for mass diseases. The Indian government envisages 100% FDI in the field of bio-tech. There could be more collaborations from the US and EU blocks with Indian bio-tech, pharmaceuticals and enzymes companies, which in turn will lead to a spill-over effect in all of Asia, particularly in ASEAN countries.

In this context, it is noteworthy that the EU is likely to participate in “SWAP currency arrangements” with ASEAN (as Japan and Korea are already doing) (DR. MIRANDA S. GOELTOM, Senior Deputy Governor, Bank Indonesia). Dr. Miranda contends that this arrangement will help with financial system stability. With the launching of the “New Asia strategy in 1994 by the EU, ASEAN became the corner stone of the EU’s dialogue” (RIYADO SUPARNO, *The Jakarta Post*, Kuala Lumpur, July 19, 2005).

According to Thierry Rommel, Head of the EU commission delegation to Malaysia, the dialogue is underway to launch the trans-regional EU-ASEAN trade initiative, which may eventually lead to the establishment of FTA (Free Trade Agreement) between EU and ASEAN. For this, both EU and ASEAN are attempting to focus on complementarities to make their co-operation effective and sustainable.

As a result, Europe is the third largest trading partner of ASEAN, accounting for 12.4% of the total trade of five core ASEAN members in 2004. Unlike FTAs signed by Japan and the US with individual ASEAN countries, Rommel argues that the EU would have deeper FTAs, focusing not only on the reduction of tariffs, but also on the removal of non-tariff barriers between the EU and ASEAN.

H.5 ASEAN and China

China is an Asian marathon. As has been already stated, its manufacturing strength and prowess are colossal. China already has some relationship with ASEAN in the form of the ASEAN plus 3-dialogue relationship/mechanism.

As regards its manufacturing strength, Chinese exports amounted to US \$97 billion in textiles in the year 2004, while the whole global textile trade was estimated at US \$395 billion; it is around 17–18% of the whole global textile trade. More importantly, global textile trade is projected to reach US \$600 billion by 2010, while China’s share is estimated to hover around 35%. The US, for instance, imports 85% of its clothing needs, while the EU imports 60–70%.

The European Union (of 25 members) with its 450 million population now has the world’s greatest GDP status. More than this, it is the largest trading block, which is likely to import more and more clothing. A substantial part of it is expected to come from China.

Not only in textiles but even in many other Fast Moving Consumer Goods (FMCGs) and finished products, China’s exports rank above that of any other country except the US and the EU. For instance, it produces 30% of the world’s air conditioners and TVs, 50% of the cameras, 25% of the washing machines as well as 80% of all toys sold in the US and 40% of microwaves sold in Europe (Leggett & Wonacott, 2002). Of course, China is the fourth largest producer of industrial goods next to the US, Japan and Germany. It is one of the world’s largest producers of copper, aluminium and steel.

H.6 Implications for ASEAN

H.6.1 What Are the Business Implications of All These to ASEAN Countries?

After the financial crisis of 1997, the economies of South East Asia have seen investments in mass manufacturing going north to China.

Firms like Nike lowered their manufacturing scale in Indonesia while increasing production in its factory in China. Thailand's toy companies have been badly hit by Chinese competition. South Korea, being afraid of China in manufacturing, is looking at Information Technology. Strangely, over eighty US-based corporations recently announced their intention to move production to China (Bronfenbrenner, 2001).

This may result in ~35,000 job losses in the US. To aggravate the imbalance in trade between the US and China, prices of Chinese clothing and shoes have dropped by 30% over the past decade. In addition to this, Chinese exports to the US also include hi-tech goods. Strangely enough, the US has a larger trade deficit with China than with any other country. In fact, such imports are likely to increase with the entry of China into the WTO.

Even in Singapore, there are some job losses due to Chinese competition. As an antidote to this, Singapore is planning the "launch-pad" policy for some of the Chinese companies to help these companies globalize and locate their research and development activities in Singapore!

In Japan, large manufacturers like NEC, Canon and Honda have relocated their operations to China and are exporting products back to Japan. China is likely to benefit at the expense of some of the ASEAN countries, including India, Cambodia and Bangladesh in textiles.

The biggest losers among ASEAN will be those countries which compete directly with China in certain products. For example, Indonesia and China compete in 83% of their product lines, while Japan competes in only 16%. In fact, Indonesia, Malaysia and Thailand and the Philippines are at a comparative labour cost disadvantage with China. Hence, their job losses cannot be offset by growth in exports to China or elsewhere.

In a quota-free world, China's exports are going to be more harmful to many slow growth countries including some of the ASEAN countries.

H.6.2 Reasons for Chinas' Leap in Exports

One of the main reasons for the leap in Chinese exports are the unevenly and artificially-protected exchange rates between the US \$ and the Chinese Yuan, one dollar pegged at 8.28 Yuans. This rate literally remained the same for more than a decade, while all other currencies including India's appreciated between 15% and

40% against the dollar in the last few years. As the Yuan remained artificially weak (preferred to be weak by the Chinese), Chinese goods became relatively cheaper and cheaper, swamping the world markets including the US and EU. Frighteningly, with the China's entry into WTO, China could afford to drop prices even farther by 30%, particularly in industries like textiles. Thus, there is no question of any country competing with China, including the ASEAN countries! This advantage ceases when the revised exchange value between US \$ and Yuan comes into effect.

Second, one of the most important reasons for the low price of Chinese goods particularly in textiles (70%) involves subsidies offered to exporters by China. This advantage will be offset when the Chinese government ceases, or at least decreases, these subsidies according to WTO norms.

It is in this scenario that any business relationship or trade agreement between India and ASEAN countries will be more advantageous and mutually strengthening (than with China).

In the world of business groups and trading blocks and within the WTO, collaboration between rapidly-developing and well-developed ASEAN countries with India will be a great advantage for both.

Of course, the US leading NAFTA with a population of more than 360 million people, the EU bolstering 450 million people within its borders, and China with a consuming population of 50% in her country are the powerful manufacturing and consuming blocks.

China must be understood differently in the processes of sourcing and marketing!

At last, India with 350 million in its consuming population as well as a vast service economy and manufacturing base could be a great market for ASEAN and vice versa.

Now, India is beginning to look east while many ASEAN countries are looking towards India. India, which used to look west for trade, education and tourism, has now begun to change its direction, focusing more on the east and its regional neighbours. This directional shift in India's policy has resulted in Asia becoming its largest trading partner, surpassing both the US and the EU.

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Chapter I

The Outward Investment of China: Causes and Consequences

Sompop Manarungsan

This chapter focuses on a key issue for the global economy, Chinese economic development by examining a range of key indicators.

First, it is clear that China is becoming very active in the area of research and development, as China acquires access to R&D from several sources through its R&D imports. Many countries around the world compete in supplying R&D products to developing countries, and China is easily profiting from these imports. Last year alone, China obtained about US \$60 billion in direct foreign investment. Moreover, China also develops its own R&D through research institutes and academies. Therefore, the growth of R&D in China is very rapid.

China also enjoys a secure standing in marketing management, because it produces many products which are supplied on both local and international markets. China is currently developing its range of brand names to give it brand recognition in domestic and international markets using a dual-track approach. Where it can it has developed indigenous brands but where it would be difficult for China to compete with a pre-existing brand it has sought to acquire selected pre-existing brand names. An example of this is TCL, one of the greatest economic giants in China. TCL acquired Thomson from France and uses its well-known brands such as RCA. Similarly, one of the famous computer producers in China, Lenovo, recently acquired IBM's computer division and can use its trusted name for at least five consecutive years. Thus, this strategy of brand name promotion has led to an internationalisation of Chinese brand names and international access via the purchase of international brands.

China is eagerly seeking continued international capital growth. High capital inflows from around the globe have followed, particularly from developed countries entering China enabling it to develop its own financial sector and capital market. At the same time, foreign direct investment in Chinese enterprises is another key source of capital for a thriving China.

The next key factor influencing China's economic potential is its efficiency in international networking infrastructure. Such networking is very important, especially in an increasingly globalised world. China now has an internal and external networking mechanism supported by a high degree of infrastructure throughout the country. As such, most of cities in China are linked by very good roads and airways.

Nowadays transportation in China is very efficient, and this will lead to greater networking capabilities through the country.

At the provincial level, China was formerly separated into semi-autonomous regions, each province big enough to be its own country. By now, however, the central government of China has promoted linkages at the provincial level. At the same time, every province in China must initiate change to fall in line with requirements set out by the WTO. Thus every province must revise its regulation and laws to deal with WTO rules. The homogenisation of administration in China is being hastened, providing even greater chances for the internal integration of China. Not only is the provincial level of significance, but the international level is also very important, and China's external networking is growing very rapidly within the global economy as well.

If we turn to the development strategy, it is quite different from that of other countries. Some countries use single track development; others use dual track development. China on the other hand uses a 'total-track' development strategy, allowing it to develop both a labour and capital intensive, knowledge- and service-based economy with various forms of development. This total development strategy involves not only inward direct investment, but also outward direct investment. It is probable that China's outward direct investment will continue to grow over the coming years, as China must utilize its increasing foreign reserves derived from the growth in international sales. By the end of 2004, the foreign reserve of China increased to about US \$600 billion, and by the end of June 2005, the foreign reserve of China was estimated at US \$700 billion. It has a considerable incentive to use these foreign reserves for foreign asset investment abroad, as a failure to do so would place considerable pressure on the value of the Yuan.

Looking at China's real estate market, a high degree of investment opportunities can be found throughout the country and industry continues to invest in the real-estate sector, despite the increasingly high property prices in cities such as Shanghai. The increase in foreign reserves is also reflected in a surplus money supply in China. In fact, the money supply increased by about 16% in the first half of 2005, and much of this is in liquidised assets. This in turn is reflected in the price of non-tradables and may lead to some problems such as a speculative bubble effect in the future. To sustain development, it is necessary to recycle some part of foreign exchange outside the country, to take some of the pressure off the money supply. This also has the effect of reducing the inflation rate in China, or more correctly the relative price of non-tradables to tradables. Investing money overseas additionally presents the opportunity of attracting further foreign investment within China itself. We can also observe a diversification in Chinese investment. If China were to merely focus on one particular area of investment, this might lead to a reduction in the efficiency of other potential areas of investment. Moreover, investing in real estate and financial sectors provides China with a more efficient globalisation management. The two sectors therefore play an important role for Chinese investment abroad. With outward direct investment, China also increases its chances for gaining access to materials, particularly basic commodities which guarantee more sustainable development. China is reliant upon basic commodities such as oil, iron and steel, so that its

industrial development can move forward. More, overseas direct investment (ODI) also provides China more opportunities for improving marketing management, as real estate alone is not sustainable. China has already agreed to a free trade agreement (FTA) with ASEAN. If China has more ODI, it will bring more efficiency in FTA.

A rift can now be seen in the relations between China and the US. China is presenting more challenges for the US, not only with respect to security issues but at the economic level as well. For example, China currently competes with the US at energy seeking. Confrontations between China and the United States can also be found in the financial sector. With respect to R&D, you can see that the US is one of the primary countries selling R&D in the world, because the US cannot compete in or produce consumer products at the same level of cost-efficiency as in developing countries. As a result, the US now faces high account deficits. Similarly, China is becoming more challenging in R&D development as well as in brand-building and servicing.

In summary, China now employs state-intervention capitalism to manage its market economy, and the US has moved toward a more politically intervened capitalism.

Chapter J

Reflections on the EU Constitutional Crisis

Franz Knipping

Please let me start with a joke. Recently in Brussels an American met with a European official, and the two discussed future perspectives of the United States on the one hand, and the European Union on the other. “You know”, said the visitor, “we as Americans can be very confident in the future. We have a good President, we have Johnny Cash, we have Bob Hope, and we have Stevie Wonder”. His European counterpart grew depressed. “Too bad”, he said, “we do not even have a president of the European Union, and we have no cash, no hope, and I know of no wonder”.

The joke reflects very nicely the European mood after the negative referenda on the Constitutional Treaty in France (29 May 2005) and the Netherlands (1 June 2005), followed only 2 weeks later by the failure of the European Council to agree on the Budgetary Forecast for the 7-year period from 2007 to 2013. There was embarrassment and shock, and even talk about an approaching end of the European integration dream and of the sustainability of the Euro as the common currency. And the brave positive referendum of little Luxemburg could not really change the situation.

What had happened in Europe, and what does it mean? Please let me advance some reflections and group them under three points: What exactly has been rejected with the French and Dutch referenda, why has it been rejected, and what should be done after the rejection?

J.1 What has been Rejected?

The object of the rejection bears a dubious name: Constitutional Treaty. This was in fact a Treaty, not a Constitution. Without the ambitious denomination, which raised fears that Europe would become a strange kind of superstate, the text would probably have fared better. It was the result of the deliberations of a European Convention directed by former French President Giscard d’Estaing, and it was too long and too complicated, a text of 448 articles with many annexes which not only the average citizens, but even many deputies did not really know

and certainly did not fully understand. The information policy of the Governments was more than negligent. Only when the danger of rejection became imminent was there some last-minute effort of information and explanation for the French and the Dutch.

The text in itself was not so bad, however. It had in view a number of structural reforms of the European Union which most observers deem absolutely necessary to make the Union fit for functioning with its current 25 Member States. Let me briefly summarize, under five headings, the main reform provisions in the Constitutional Treaty.

1. More efficiency of European institutions: creation of a longer-term Presidency of the European Council for up to 5 years, creation of the position of European Minister for Foreign Affairs, extension of the competencies of the President of the European Commission, further extension of the competencies of the European Court of Justice.
2. More efficient decision-making and voting procedures: in the Council of Ministers reduction of voting by unanimity in favour of majority voting requiring a double majority, 55% of the Member States and 65% of the population of the Union; simplification of the procedures to take decisions by majority instead of unanimity.
3. More democratic legitimacy: strengthening of the competencies of the European Parliament, especially of its powers for legislative co-decision with the Council of Ministers with respect to budgetary decisions and the election of the President of the Commission; more competencies of national parliaments to control the action of the European Commission, among them the competency to stop Commission proposals by one-third of the national parliaments; public meetings of the Council of Ministers; right of petition for one million European voters to ask the Commission to initiate certain legislative proposals.
4. More transparency: merger of the various European treaties into a single document and abolishment of the complicated three-pillar structure of the Maastricht Treaty; clearing up of the distribution of competencies between Union and Member States according to the principle of subsidiarity; giving the European Union a legal personality and thus enabling it to sign international treaties; integration of the Charter of Fundamental Rights into the Constitutional Treaty.
5. New perspectives of evolution: enforced cooperation allowing a group of Member States to advance more rapidly towards integration than the others (e.g., in security and defence matters or for common economic policies in the Euro zone).

Thus, on the whole, the Constitutional Treaty has convincing elements. The text indeed contains a number of provisions aimed at increasing efficiency and transparency, improving the EU's democratic nature and its orientation toward the future, thereby helping it come to terms with the interests and needs of 25 or more Member States. In principle, this comprehensive Treaty should therefore have been respected and appreciated by the European citizens.

J.2 Why It has been Rejected?

If it has nevertheless been rejected by the French and Dutch – and has in fact covertly been rejected by the people in other Member States – there must be important reasons for this. It is essential for future progress of the European project that these reasons be drawn to light and analyzed. Some discussions have started, but conclusions diverge and consequences are not in sight. I think the answer comes out of a complex interrelation of three sets of motivations.

To begin with, there is the current general situation of European societies, or more precisely, of most societies of the old Western European Community. These are pervaded with a general mood of *malaise*, made out of diffuse fears caused by economic and job crises, dwindling social security systems, demographic decline, and uncontrolled migration. After their unique economic successes of the past decades, Western European societies are now ill-prepared for global competition which was on the increase in the 1990s after the end of the Cold War. Only very hesitatingly did they start to realize the consequences. And they feel that globally-induced competition is heightened by the enlargement of the European Union with so many neighbouring Eastern European countries which are economically still far behind and can produce more cheaply.

This leads directly to a second set of motivations. The *malaise* in Western European societies is attributed, consciously or not, at least in part to the action of the European Union seated in Brussels. In fact, it cannot be denied that a plethora of European regulations intervene on the economic, social, legal and cultural life of the Member States on a daily basis. Nevertheless, it is also evident that under the impact of the revolutionary changes of the early 1990s in Eastern Europe, the European decision-makers have given up the proven method of the first four decades of integration: the rhythm of organic, patient, step-by-step evolution. Instead they have sped up the process into a new era of over-ambition and impatience, adding to their aims of Currency and Political Unions the goals of Common Foreign Policies and Common Security and Defense Policies, the decision to integrate all Eastern European countries at one time without really paying attention to their maturity for integration, and to open up still further – and without setting limits – the gates towards enlargement and immigration. There is also the feeling of negative effects of the Euro on prices and fiscal stability. It seems clear that given the ailing economic and social situation, Western European citizens are more and more stressed by the European influences on domestic developments. Particularly, trust in the competence of the leaders is fading away.

The result is, thirdly, discontent and protest. European citizens begin to refuse accepting burdens in the name of European Integration and instead tend to stand up against Europe, or more precisely against European leaders who seem to live and decide far away from the hopes and fears of the citizens in their daily environment, and who do this with sometimes provocative arrogance. The expression of distance and protest may vary, but its hard common core is the feeling of a lack of possibilities to participate in the European process: the democratic deficit. I think this is the crux

of the current constitutional crisis. The challenge of the democratic deficit is not a new phenomenon, but it is now becoming a problem and an imposing political force.

The crisis has deep roots. A look into the history of European integration shows that the democratic deficit was one of the constitutive characters of the construction of Europe right from the start, and it has accompanied all 55 years of its integration history. The grandiose results of Western European unification – lasting peace, stable and prosperous economies, high social standards, a European voice in the world – have all been achieved in the quasi-absence of substantial participation of the European citizens. European integration has primarily thus far been the result of the activity of elites, of executive power and will, not of aspirations at the grass-roots level. The visions of the venerable Fathers of Europe led by Jean Monnet have essentially generated technocratic structures, rules and institutions within which democratic participation has remained of secondary importance. Part of the blame certainly goes to the stumbling effects caused by the ever-present competition among the Member States. Historians have even suggested that after World War II, “Europe” was essentially not the way out of the ruins but the way to refresh the individual national sovereignties.

High on the European agenda at all events were always political compromises between governments, not democratic legitimation and nearness to European citizens. Compromises are intrinsically the outcome of controversial negotiations mostly behind the scenes, which make the political process so complex and intransparent that even experts have difficulties following developments, let alone the people, bypassed as it is and therefore disinterested. In 1956 and 1957, the negotiation and signing of the Treaties of Rome were not affairs of the people. Decades later, Jacques Delors admitted in 1992 that the Maastricht Treaty had been made “in the indifference of the people.” There was, as was certainly the case in Germany, very little public discussion about the merits of the Euro as a common currency, about the ambitious Eastern enlargement, and about the Constitutional Treaty.

It is true that from time to time some measures have been taken to give life to a “Europe of the Citizens”. The introduction of general elections to the European Parliament is the most notable one. Other examples exist, such as successive extensions of the competencies of the Parliament, the introduction of the European passport, European citizenship, and generalized local and European voting rights. Seen as a whole, however, these were limited measures which remain far from assuring broad democratic participation in the European process. The Heads of State and Government as well as the European Commissioners continue to behave like absolute monarchs with regard to the future of Europe, not really controlled in this respect by the various Parliaments.

It is also true that the people have by and large tolerated this state of affairs for more than five decades, so that we may even ask what is the reason for this public tolerance, for the “permissive consensus” towards the European unification process. The answer is clearly that the people have thus far profited from European integration. Europe was fundamentally associated with economic prosperity, with liberties, with peace and security, and it moved on without much stress. Europe was seen as a convenient framework for a better life.

Sadly enough, this perception has now changed. Prosperity and welfare seem endangered for most parts of the population. Moreover, with the end of the Cold War most people no longer are concerned with security questions. The new speed and ruthlessness of European policy-making, without any indication of limits and finalities, produce stress. A poll taken in the Member States shortly before the referenda in France and the Netherlands and published in the Eurobarometer revealed that a considerable majority of citizens of the “old Europe” would not object to dissolution of the European Union. The negative outcome of the referenda shows that citizens do not want to remain passive any longer, but declare themselves actively dissatisfied with the mere “appeasement” of the people by their Governments.

There were some forebodings: the negative Danish referendum on the Maastricht Treaty in 1992 which had to be repeated, the near-failure of the French referendum the same year, the rejection of the Treaty of Nice by the Irish in 2001. The recent French and Dutch referenda seem to prove that the democratic deficit has arrived on top of the European political agenda. Europe is at a turning point. If this diagnosis is correct, an extended and fundamental reflection is indeed needed, because the “business as usual” reflex seems as pointless as the “back to the roots” slogan.

J.3 What Should Be Done?

Much public comment and advice have been advanced in the meantime to show ways out of the current European crisis. May I please end my analysis with some personal conclusions?

1. It must be fully recognized and accepted by European leaders that they are confronted with a serious loss of confidence in the European project, that the Constitutional Treaty as such has definitely failed and that hard work is needed to open up new orientations based on the confidence of the citizens.
2. Even if the Constitutional Treaty as such is dead, its contents deserve and need attention. Ways should be found to bring its useful reform provisions into existence, through a renegotiation of the Constitutional Treaty, by amendments to the Treaty of Nice, or with special regulations. Yet future basic documents should be shorter and simpler in nature.
3. The role of the parliamentary bodies in the European structure must be reconsidered, on the European as well as on the national levels. Parliaments, and not bureaucracies, should have the central role in the realisation of the principle of subsidiarity, with the EU assuming only those functions which cannot be performed by the nation states or the regions.
4. Europe certainly needs a slowing-down and reorganization of the enlargement process. To regain the confidence of the citizens, there is no better way to do this than to declare an immediate moratorium on enlargement. There can be no question that with regard to future accessions, the political and economic criteria must be at least strictly observed if not fundamentally reconsidered.

5. European decision-makers must give up their habits of proclaiming unrealistic objectives and making appearances seem like realities: economic growth (e.g., the “Lisbon Process”), currency stability, social standards, the consequences of competition, the financing of development in Eastern Europe, European international power. Some humility and a greater sense of service for the people would certainly be appreciated. The analogy of the bicycle that cannot rest for a while must be scrapped.
6. The negative referenda in France and the Netherlands certainly do not mean the end of the European project. It must and it will go on, because it remains the best assurance for peace, values, economic prosperity and social welfare. Despite this, Europe needs a new vision, new courage, a new sincerity and a clarification of its borders, its identity and its finalities.

After all, I believe that with due carefulness, the European project always has its chances and will soon return to more flourishing times, perhaps with a European President, more cash, new hope, and perhaps even some wonder?

Chapter K

European Community Law and WTO Regulations: The Direct Effect-Doctrine Revisited

Alexander Proelß

According to Article XI(1) of the Agreement Establishing the World Trade Organization of 14 April 1994 (33 *ILM* 1144 [1994], hereinafter WTO agreement), the European Communities “shall become original Members of the WTO”. At the time of entry into force of the WTO agreement on 1 January 1995, it was hoped that the accession of the European Community – the European Atomic Energy Community does not bear any relevance with regard to the subject at hand – would constitute an end to decades of not only academic controversy on the status of the General Agreement on Tariffs and Trades concluded in 1947 (55 *UNTS* 187, hereinafter GATT 1947) within the European Community legal system and on the question whether and to what extent the European Community was bound to the provisions of international trade law. From now on, the Community would not only be the first international organization to become a founding member of the WTO, but would also be in the position to speak with one voice in the context of international trade issues.

The expectations of those days, however, were not met in the following years. Whereas it was not surprising that the European Community, like any other WTO member, was (and still is) occasionally found guilty of being in breach of world trade rules by WTO panels – lastly in April 2005 regarding Community subsidies for sugar production (cf. WT/DS265/AB/R, WT/DS266/AB/R and WT/DS283/AB/R, Report of the Appellate Body of 28 April 2005; as of November 2005, proceedings initiated against the European Community are still pending in six cases; in four other cases, only consultations have been requested) – it *was* surprising at first sight that the European Court of Justice (hereinafter ECJ), being the competent organ under the Treaty Establishing the European Community (hereinafter EC) to “ensure that in the interpretation and application of this Treaty the law is observed” (Article 220[1] EC), did not change its negative approach in respect of the question of whether WTO regulations and panel reports have direct effect within the Community legal order. Against this background, suggesting that recent jurisprudence of the Court has not settled but rather re-raised the matter of EC compliance with WTO regulations does not seem to be completely implausible. It is the legal reasons for the frictions between European law on the one hand and international trade law on the other which will be dealt with in the following.

K.1 The European Community as an Actor in International Trade Law

It should be taken into account that already in 1964, the ECJ stated that “by contrast with ordinary international treaties, the EEC treaty has created its own legal system which, on the entry into force of the treaty, became an integral part of the legal systems of the Member States and which their courts are bound to apply. By creating a community of unlimited duration, having its own institutions, its own personality, its own legal capacity and capacity of representation on the international plane and, more particularly, real powers stemming from a limitation of sovereignty or a transfer of powers from the states to the community, the Member States have limited their sovereign rights, albeit within limited fields, and thus have created a body of law which binds both their nationals and themselves” (Case 6/64, *Flaminio Costa v. E.N.E.L.*, [1964] ECR 585, at 601). It has been concluded from this famous ruling that European Community law constitutes an autonomous (“supranational”) legal system situated “between” national and international law. In respect of international trade law, the Community was not conferred sovereign rights regarding, *inter alia*, the creation of a common commercial policy (cf. Articles 131–134 EC; for a general list of the Community’s fields of action see Article 3 EC; for an overview on the history of the common commercial policy cf. the article by A. Crozier in this volume), but was also assigned the power to conclude bilateral or multilateral agreements (cf. Article 310 EC). However, the legal consequences of the Community’s participation in such agreements and its role as an actor in international trade affairs are still far from being clear.

In this regard, it should be noted that one major result deriving from the autonomy of Community law is the need for clear differentiation between the legal positions under the terms of public international law on the one hand and under Community law on the other. As regards public international law, in case the Community is willing to accede to an agreement, it is to be observed first whether the agreement in question allows for the accession of international organizations at all. As this was not given with regard to GATT 1947, the Community was not able to become a formal member under the terms of public international law. From the perspective of Community law, however, the ECJ held in 1983 that “as regards the fulfilment of the commitments laid down in GATT, the Community has been substituted for the Member States with effect from 1 July 1968” (Joint Cases 267–269/81, *Amministrazione delle Finanze dello Stato v. Società Petrolifera Italiana SpA (SPI) and SpA Michelin Italiana (SAMI)*, [1983] ECR 801, para. 19).

But how was this possible? The answer delivered by Court is: “Since the entry into force of the EEC Treaty and more particularly, since the setting up of the common external tariff, the transfer of powers which has occurred in the relations between Member States and the Community has been put into concrete form in different ways within the framework of the general agreement and has been recognized by the other contracting parties” (Joint Cases 21–24/72, *International Fruit Company NV and Others v. Produktschap voor Groenten en Fruit*, [1972] ECR 1219, para. 16). Thus, although the Community did not and could not become a

party to GATT 1947, “it appears that, in so far as under the EEC Treaty the Community has assumed the powers previously exercised by Member States in the area governed by the general agreement, the provisions of that agreement have the effect of binding the Community” (*International Fruit Company NV and Others v. Produktschap voor Groenten en Fruit*, [1972] ECR 1219, para. 18).

When the WTO was finally established in 1995, the fact that the European Community became a regular member to the organization under the terms of public international law was expected to have a positive input on the legal certainty and political accountability of the Community’s role as an actor in international trade issues. However, already the process of accession to the WTO gave rise to legal disputes, once again from the *intra*-Community perspective. While the Commission argued that issues governed by the WTO agreement fell exclusively into the Community’s sphere of competence and that, therefore, the agreement was to be concluded solely by the Community, the Member States insisted on their participation. As no compromise could be achieved, the ECJ, upon request of the Commission, delivered a legal opinion stating that “the Member States, whether acting individually or collectively, only lose their right to assume obligations with non-member countries as and when common rules which could be affected by those obligations come into being. Only in so far as common rules have been established at internal level does the external competence of the Community become exclusive” (Opinion 1/94, [1994] ECR I-5267, para. 77). Since this was not given in respect of *all* aspects of international trade law governed by the WTO legal corpus, the Court reasoned that the Member States and the Community were insofar jointly competent. Thus, the WTO agreement, which contains the provisions of GATT 1947, the provisions of the General Agreement on Tariffs and Services (33 *ILM* 44 [1944], hereinafter GATS) and those of the Agreement on Trade-Related Aspects of Intellectual Property Rights (33 *ILM* 1197 [1994], hereinafter TRIPS) in its Annex 1, had to be concluded by both the Member States *and* the Community under the terms of a mixed agreement (cf. Proelß, 2005, pp. 251 *et seqq.*).

K.2 The Doctrine of Direct Effect in Community Law: Theoretical Basis and Practical Implications

Taking a closer look at the legal character of international trade law, WTO regulations, as any other rule of public international law, generally have to be transferred into national law in order to unfold legal consequences (cf. Article 24 of the Vienna Convention on the Law of Treaties [1155 *UNTS* 331], hereinafter VCLT). Therefore, compliance with the rules of international trade law largely depends on the status attributed to them by the legal systems of world trade actors. With regard to the European Community, however, the nature of obligations arising from both WTO regulations and rulings of the WTO panels belongs to the most debated questions in the context of Community membership to the WTO (cf., e.g., Cottier, 1998, pp. 325 *et seqq.*; Senti, 2002, pp. 111 *et seqq.*; Tancredi, 2004, pp. 933 *et seqq.*). The problem

at hand is generally discussed under the terms of the doctrine of direct effect. But what does this legal concept refer to? In order to answer this question, a closer look at the jurisprudence of the ECJ is inevitable.

Since 1972 the Court has held in several decisions that not with standing Article 300(7) EC, according to which “agreements concluded under the conditions set out in this Article shall be binding on the institutions of the Community and on the Member States”, an international agreement concluded by the Community forms an *integral part of Community law* – and may thus be assessed to review the legality of a Community act under Article 234 EC – only in case the rules of the agreement in question are *unconditional* (cf., e.g., Case 9/73, *Carl Schlüter v. Hauptzollamt Lörrach*, [1973] ECR 1135, para. 27). In the view of the Court, this was not given in respect of GATT 1947 due to the fact that “this agreement which, according to its preamble, is based on the principle of negotiations undertaken on the basis of reciprocal and mutually advantageous arrangements, is characterized by the great flexibility of its provisions, in particular those conferring the possibility of derogation, the measures to be taken when confronted with exceptional difficulties and the settlement of conflicts between the contracting parties” (Joint Cases 21–24/72, *International Fruit Company NV and others v. Produktschap voor Groenten en Fruit*, [1972] ECR 1219, para. 21). As GATT 1947 did, therefore, not constitute an integral part of Community law *stricto sensu*, the Court denied its jurisdiction to give preliminary rulings concerning the interpretation of that agreement. Despite the fact that, according to the Court, the Community was bound to the provisions of GATT 1947, the ECJ considers the unconditional and inflexible character of international agreements concluded by the Community as a precondition to invoke them to review the legality of a Community act. Where this is not given, the accession of the Community is legally relevant under Article 300(7) EC only insofar, as “the primacy of international agreements concluded by the Community over provisions of secondary Community legislation means that such provisions must, so far as is possible, be interpreted in a manner that is consistent with those agreements” (ECJ, Case C-61/94, *Commission v. Germany*, [1996] ECR I-3989, para. 52; see also Weiß, 2005, p. 281).

From this jurisprudence most writers have drawn the conclusion that the ECJ regards the provisions of GATT 1947 of being unable to produce direct effects (see only Hilf & Schorkopf, 2000, p. 75). According to this interpretation, by implicitly invoking the direct effect-doctrine, the Court allegedly applied its ruling from its notorious decision in “van Gend & Loos” (Case 26/62, *NV Algemene Transport-en Expeditie Onderneming van Gend & Loos v. Netherlands Inland Revenue Administration*, [1963] ECR 1 *et seqq.*), which dealt, *inter alia*, with the question whether *individuals* may rely directly on a provision of Community law before their national courts. As this depends on the clear and unconditional character of the provisions concerned (*ibid*, at 13), the comparability to the situation at hand in terms and premises seems to be obvious, yet only at first sight.

A closer observation of the jurisprudence of the ECJ reveals that the Court did at last *not* refer to the same concept in respect of GATT 1947. This was already clarified in the Court’s judgment “International Fruit Company” of 1972 (Joint

Cases 21–24/72, *International Fruit Company NV and others v. Produktschap voor Groenten en Fruit*, [1972] ECR 1219), where it emphasized: “Before invalidity can be relied upon *before a national court*, that provision of international law must also be capable of conferring rights *on citizens of the Community* which they can invoke before the Courts” (*International Fruit Company NV and others v. Produktschap voor Groenten en Fruit*, [1972] ECR 1219, para. 8). Thus, two different significances of the direct effect-doctrine have to be distinguished: In case the Court is called upon to analyse whether an international agreement such as GATT 1947 has become integral part of Community law under Article 300(7) EC and may, therefore, be considered to review the legality of a Community act, the decisive question seems to be whether the rules of the agreement in question are *self-executing* (cf. Klein, 1988, pp. 8 *et seqq.*; Ott, 1997, p. 75 *et seq.*; Schroeder & Selmayr, 1998, p. 345 *et seq.*; Tancredi, 2004, pp. 941, 943). Only in case the Court has to decide whether *individuals* may rely upon the provisions of an international agreement *before their national courts*, the prerequisites of the “Van Gend & Loos” jurisprudence have to be fulfilled additionally (cf. Case 104/81, *Hauptzollamt Mainz v. C.A. Kupferberg & Cie KG a.A.*, [1982] ECR 3641, para. 22 *et seq.*; Case 12/86, *Meryem Demirel v. Stadt Schwäbisch Gmünd*, [1987] ECR 3719, para. 14; Case C-265/03, *Igor Simutenkov v. Ministerio de Educación y Cultura, Real Federación Española de Fútbol*, not yet published, paras. 21 *et seqq.*). To set the record straight, in such a situation it should no longer be spoken of “direct effect” but rather of “direct applicability” (cf. Case 12/86, *Meryem Demirel v. Stadt Schwäbisch Gmünd*, [1987] ECR 3719, para. 14. Recent jurisprudence of the Court is, however, rather imprecise on this point; cf. Case C-377/98, *Netherlands v. Parliament and Council*, [2001] ECR I-7079, para. 54; Case C-265/03, *Igor Simutenkov v. Ministerio de Educación y Cultura, Real Federación Española de Fútbol*, not yet published, paras. 21, 29; Case C-374/03, *Gaye Gürol v. Bezirksregierung Köln*, not yet published, para. 20). In the “Nakajima” case (Case 69/89, *Nakajima All Precision Co. Ltd v. Council*, [1991] ECR I-2069, para. 28), the Court then expressly distinguished between the two situations (cf. also Case 148/78, *Criminal proceedings against Tullio Ratti*, [1979] ECR 1629, para. 19; Case C-377/98, *Netherlands v. Parliament and Council*, [2001] ECR I-7079, para. 54).

But what are the consequences of the differentiation between direct effect and direct applicability? While the question whether the norms of an international agreement are self-executing and are, therefore, able to produce direct effect depends on the fact whether the norms in question have to be implemented on the national level (see Bleckmann, 1970, pp. 49 *et seqq.*; Vázquez, 1995, pp. 695 *et seqq.*), direct applicability deals with the possibility for individuals to rely directly upon a provision of Community law before a national court. This is not always the case regarding norms which are self-executing (cf. Klein, 1988, p. 11). The different character of the two concepts also becomes manifest when taking into account the applicable methods of interpretation. In case the ECJ has to analyse possible direct effects of an agreement concluded by the Community in the context of Article 300(7) EC, the Court impliedly falls back on methods of interpretation laid

down in the VCLT, that is, public international law (cf. Case 87/75, *Conceria Daniele Bresciani v. Amministrazione Italiana delle Finanze*, [1976] ECR 129, para. 16; Case C-280/93, *Germany v. Council*, [1994] ECR I-4973, paras. 105 *et seq.*; Case C-149/96, *Portugal v. Council*, [1999] ECR I-8395, paras. 41 *et seq.*; see also Weiß, 2005, p. 283). On the other hand, if an individual relies on a norm of an international agreement concluded by the Community, its direct applicability is to be assessed within the autonomous framework of Community law (cf. ECJ, Case 104/81, *Hauptzollamt Mainz v. C.A. Kupferberg & Cie KG a.A.*, [1982] ECR 3641, para. 22 *et seq.*; Case 12/86, *Meryem Demirel v. Stadt Schwäbisch Gmünd*, [1987] ECR 3719, para. 14; Case C-280/93, *Germany v. Council*, [1994] ECR I-4973, para. 110).

Viewed from this point of origin, albeit dissenting opinions in literature, it is submitted that the Court's jurisprudence in respect of the nature of obligations arising from GATT 1947 was in every way acceptable (*contra* Siebold, 2003, p. 258 *et seq.*). Apart from the fact that the Community did not and could not become a member to GATT 1947, the provisions of the agreement were not able to produce direct effects for the very simple reason that they were not self-executing. This conclusion is not only supported by the fact that in order to produce legal consequences, national implementation of GATT 1947 was inevitable. Also, the great flexibility of the provisions concerned and the non-binding character of decisions of the dispute settlement mechanism were to be taken into account. Thus, accusing the ECJ of having committed a denial of justice by refusing to assign direct effects to the norms of GATT 1947 is misleading, for the jurisdiction of the Court is restricted to the observation of lawful interpretation and application of *Community* law. Due to its lacking self-executing character, however, GATT 1947 did not become an integral part of Community law under Article 300(7) EC insofar as the jurisdiction of the ECJ was not given. But do these submissions still apply in the light of the Community's formal membership to the WTO?

K.3 Direct Effect of WTO Regulations

According to the majority of writers, the jurisprudence of the ECJ regarding GATT 1947 cannot be upheld in respect of the WTO agreement for the following three reasons (see, e.g., the Advocate General's Opinion in Case 53/96, *Hermès International (a partnership limited by shares) v. FHT Marketing Choice BV*, [1998] ECR I-3603, para. 29; cf. also Hilpold, 1999, pp. 258 *et seq.*; Schroeder & Selmayr, 1998, p. 348; Siebold, 2003, pp. 262 *et seq.*): First, the Community formally acceded to the WTO agreement, thereby becoming a party to its annexes including the revised GATT 1947, now labelled GATT 1994, automatically. Secondly, from the perspective of Community law, the WTO agreement was concluded under Article 300 EC. Therefore, *prima facie* it is difficult to see why Article 300(7) EC, under which the WTO agreement including its annexes would form an integral part of Community law, should not be applicable. If this reasoning

would have been correct, the legality of the notorious Community regulation concerning the common organization of the market in bananas (No. 404/93), for example, could have been verified against the parameters of international trade law. Thirdly, reference is made to the revised WTO dispute settlement system. This system does not only incorporate the dispute settlement mechanism from GATT 1947, but also provides for the establishment of an appellate body in order to guarantee the compulsory character of the entire WTO legal system. According to Article 17(14) of annex 2 to the WTO agreement dealing with rules and procedures governing the settlement of disputes, “[a]n Appellate Body report shall be adopted by the DSB and *unconditionally accepted by the parties to the dispute* unless the DSB decides by consensus not to adopt the Appellate Body report within 30 days following its circulation to the Members” (italics added). In addition, pursuant to Article XVI(4) of the WTO agreement, “[e]ach member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements”. As the ECJ explicitly acknowledged in 1991 that binding decisions of an international court shall be respected by the Community and its organs given that the Community is a member to the statute of the respective court (cf. Opinion 1/91, [1991] ECR I-6079, para. 39), it seems that contrary to GATT 1947, the norms of the WTO agreement including its annexes are naturally self-executing.

Surprisingly enough, the ECJ did not follow this approach, but rather re-emphasized the missing direct effect of GATT 1994 and the WTO dispute settlement system, thereby provoking harsh reactions in legal writings. The Court was not only accused of giving an erroneous interpretation of the dispute settlement rules of the WTO complex, but also of misinterpreting the intra-Community effects of international agreements concluded by the Community under Article 300 EC. It was already in 1994, when the case of the Community regulation concerning the common organization of the market in bananas (Case C-280/93, *Germany v. Council*, [1994] ECR I-4973) and subsequent Community policy regarding its refusal to effectively implement the – in the eyes of the Community adverse – ruling of a WTO panel (WT/DS38/R, EEC-Import Regime for Bananas, Report of the Panel of 11.2.1994) led some commentators to the conclusion that the EC had finally gone bananas itself (cf. Breuss, Griller, & Vranes, 2003; Trachtman, 1999, pp. 655 *et seqq.*). But is such criticism justified?

It seems that an answer to the negative could be based on the preamble of Council Decision 94/800/EC concerning the conclusion on behalf of the European Community, as regards matters within its competence, of the agreements reached in the Uruguay Round multilateral negotiations ([1994] OJ L 336, pp. 1 *et seqq.*). In this document, the Council expressly stated that the WTO agreement including its annexes may not be interpreted in a manner which would enable the judicial organs of the Community and the Member States to *directly apply its provisions*. Should this statement constitute a valid reservation to the WTO agreement, the legal consequences of the latter would have been modified. However, according to public international law, reservations formulated in the course of accession to a treaty are valid unless the reservation is prohibited in the treaty (cf. Article 19 lit. a VCLT). As exactly this is given pursuant to Article XVI(5) WTO agreement (“No reservations

may be made in respect of any provision of this Agreement. Reservations in respect of any of the provisions of the Multilateral Trade Agreements may only be made to the extent provided for in those Agreements.”), and since neither GATT 1994 nor GATS contain any provision providing for the possibility of making reservations – Article 72 TRIPS only rules that “[r]eservations may not be entered in respect of any of the provisions of this Agreement without the consent of the other Members” – Council Decision 94/800/EC is irrelevant with regard to the question at hand (Siebold, 2003, pp. 266 *et seqq.*). Thus, an answer may only be given based on a closer observation of the respective rulings.

Concerning this matter, the stage was set in the famous decision in *Portugal versus Council of 1999* (Case C-149/96, *Portugal v. Council*, [1999] ECR I-8395). First, it is important to note that in its judgment the Court expressly referred to the relevant methods of interpretation deriving from public international law by stating that the WTO agreement has to be “interpreted in the light of its subject-matter and purpose” (*Portugal v. Council*, [1999], para. 35). It follows from this that the Court dealt with the question at hand, that is, whether WTO regulations are self-executing. I did not address the problem of direct applicability. Then, in the decisive section of its ruling, the Court held that “[w]hile it is true that the WTO agreements [...] differ significantly from the provisions of GATT 1947, in particular by reason of the strengthening of the system of safeguards and the mechanism for resolving disputes, the system resulting from those agreements nevertheless accords considerable importance to negotiation between the parties. [para. 36] [e.g.], Article 22(2) [of the understanding on rules and procedures governing the settlement of disputes] provides that if the member concerned fails to fulfil its obligation to implement the said recommendations and rulings within a reasonable period of time, it is, if so requested, and on the expiry of a reasonable period at the latest, to enter into negotiations with any party having invoked the dispute settlement procedures, with a view to finding mutually acceptable compensation. [para. 39] Consequently, to require the judicial organs to refrain from applying the rules of domestic law which are inconsistent with the WTO agreements would have the consequence of depriving the legislative or executive organs of the contracting parties of the possibility afforded by Article 22 of that memorandum of entering into negotiated arrangements even on a temporary basis. [para. 40].” The Court further emphasized that like GATT 1947, the WTO agreement mentions in its preamble that it is founded on the principle of negotiations with a view to entering into reciprocal and mutually advantageous arrangements (para. 42). Since in the Court’s view, therefore, WTO regulations are neither unconditional nor self-executing, they do not form an integral part of Community law under Article 300(7) EC, inasmuch as they may not be invoked in order to challenge the legality of a Community act under Article 234 EC.

When blaming the ECJ for its allegedly false interpretation of WTO regulations, it should, first of all, not be ignored that also WTO panels base their rulings on the assumption that GATT/WTO provisions do only produce *indirect* effects. In its decision in *United States-Sections 301–310 of the Trade Act of 1974* (WT/DS152/R), a WTO panel held that “[w]hen evaluating the conformity of national law with WTO obligations in accordance with Article XVI(4) of the WTO Agreement account must

be taken of the wide-ranging diversity in the legal systems of the Members. Conformity can be ensured in different ways in different legal systems. It is the end result that counts, not the manner in which it is achieved. Only by understanding and respecting the specificities of each Member's legal system, can a correct evaluation of conformity be established" (para. 7.24). In accordance with relevant US and Japanese adjudication (cf. the references given by Tancredi, 2004, p. 952 *et seq.*), the panel concludes: "Under the doctrine of direct effect, which has been found to exist most notably in the legal order of the EC but also in certain free trade area agreements, obligations addressed to States are construed as creating legally enforceable rights and obligations for individuals. Neither the GATT nor the WTO has so far been interpreted by GATT/WTO institutions as a legal order producing direct effect" (Tancredi, 2004, para. 7.72). Thus, suggesting that the norms of the WTO complex are not by themselves self-executing, stands to reason.

Indeed, the Court in its recent *van Parys* ruling of March 2005 (Case C-377/02, not yet published) repeated that "to accept that the Community Courts have the direct responsibility for ensuring that Community law complies with the WTO rules would deprive the Community's legislative or executive bodies of the discretion which the equivalent bodies of the Community's commercial partners enjoy. It is not in dispute that some of the contracting parties, which are amongst the most important commercial partners of the Community, have concluded from the subject-matter and purpose of the WTO agreements that they are not among the rules applicable by their courts when reviewing the legality of their rules of domestic law. Such lack of reciprocity, if admitted, would risk introducing an anomaly in the application of the WTO rules" (para. 53). Thus, viewed from the intra-Community perspective, the problem of direct effect rather seems to be a matter of balance of power among the Community organs than one of compliance with WTO regulations (see Tancredi, 2004, p. 942).

As a matter of logic, since the WTO agreement itself may not be relied upon in order to review the lawfulness of a Community act due to its missing direct effect, this submission applies *a fortiori* in respect of the decisions of the WTO Dispute Settlement Body (hereinafter DSB), being the competent organ pursuant to Articles 2(1) and 16 to adopt the reports drawn up by WTO panels. Albeit the fact that the applicability of Article 300(7) EC to decisions of international courts or dispute settlement organs seems highly doubtful anyway, a closer examination reveals that the character of WTO panel decisions is in no way different to the former situation under GATT 1947. When Article 3(7) of the WTO Understanding on Rules and Procedures of Governing the Settlement of Disputes provides that "[i]n the absence of a mutually agreed solution, the first objective of the dispute settlement mechanism is usually to secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any of the covered agreements", this provision explicitly leaves room for negotiations of the parties to the dispute. This is supported by Article 22(2) ruling that if the party to the dispute concerned fails to enforce recommendations and decisions of the DSB within a reasonable period of time, "it is to enter into negotiations with any party having invoked the dispute settlement procedures with a view to agreeing compensation. If no satisfactory compensation

has been agreed within 20 days after the expiry of the reasonable period, the complainant may request authorization from the DSB to suspend, in respect of that member, the application of concessions or other obligations under the WTO agreements". Furthermore, by saying that "[a] solution mutually acceptable to the parties to a dispute and consistent with the covered agreements is clearly to be preferred", the understanding acknowledges the existence of a *scope of manoeuvre* which may be utilized by way of negotiations of the parties to the dispute (cf. Tancredi, 2004, pp. 945 *et seqq.*). Even in case an agreement concluded between the parties to the dispute is WTO-incompatible, this does not render the agreement invalid but only illegal under public international law (cf. Article 53 VCLT). Against this background, and since also WTO panels have repeatedly emphasized the need to respect the wide-ranging diversity in the legal systems of the WTO Members, it is hardly possible to argue for the self-executing character of WTO norms and/or DSB decisions. From the perspective of public international law, this submission is finally supported by the fact that a Swiss proposal made in the course of the negotiations of the WTO agreement to confer direct effects to the provisions of revised international trade law, was explicitly rejected and finally abandoned. Thus, the ECJ, in dismissing its jurisdiction to interpret and examine WTO regulations within the scope of the Community legal order, deserves full affirmation.

K.4 Conclusions

The preceding comments have shown that the European Community's not at all irreproachable reputation as a subject of the WTO legal system lacks justification as far as the missing direct effect of WTO regulations is concerned. Whereas it is true that the Community refused to effectively implement rulings of WTO panels in a number of well-publicized cases, no major difference may be determined in comparison to other economically powerful members to the WTO. As one author has recently shown, the change from GATT to WTO has not only increased the level of compliance with the outcomes of dispute settlement procedures, but also enhanced the importance of international trade law arguments in the European Community's political process (Princen, 2004, pp. 555 *et seqq.*, at 571). Therefore, the missing direct effect of WTO norms in the Community legal order is no special feature of supranationality. Rather, it results from the fact that at least in practice, state parties to the WTO have insisted on the existence of a *scope of manoeuvre* for negotiations which dominates the formal approach of the dispute settlement system. In failing to prevent its members from agreeing not to fully observe its rules in their relations, the case of the WTO is, after all, no exception on the international plane.

Secondly, the legal consequences of the denial of direct effect with regard to WTO regulations should not be overestimated. In this respect, reference is to be made to the fact that on the one hand, the ECJ follows a rather trade law-friendly approach by acknowledging two exceptions to the rule established in its jurisprudence: In case the Community intends to implement a particular WTO obligation, or in the event that a Community measure expressly refers to the corresponding

provisions of the WTO agreement, Article 234 EC applies irrespective of whether the provision concerned bears any direct effect by itself (cf. Case 69/89, *Nakajima All Precision Co. Ltd v. Council*, [1991] ECR I-2069, para. 31; Case 70/87, *Fédération de l'industrie de l'huilerie de la CEE (Fediol) v. Commission*, [1989] ECR 1781, paras. 19 *et seqq.*). On the other hand, individuals may challenge violations of WTO obligations by other WTO members in accordance with Council Regulation (EC) No. 3286/94 of 22 December 1994 laying down Community procedures in the field of the common commercial policy in order to ensure the exercise of the Community's rights under international trade rules ([1994] OJ L 349, pp. 71 *et seqq.*). Hence, the denial of direct effect by the ECJ does not result in legal uncertainty in an era of "EU and ASEAN Facing Economic Globalization".

K.5 Cases Before the European Court of Justice

Case 26/62, *NV Algemene Transport-en Expeditie Onderneming van Gend & Loos v. Netherlands Inland Revenue Administration*, [1963] ECR 1.

Case 6/64, Judgment of 15/07/1964, *Flaminio Costa v. E.N.E.L.*, [1964] ECR 585.

Joint Cases 21–24/72, *International Fruit Company NV and others v. Produktschap voor Groenten en Fruit*, [1972] ECR 1219.

Case 9/73, *Carl Schlüter v. Hauptzollamt Lörrach*, [1973] ECR 1135.

Case 87/75, *Conceria Daniele Bresciani v. Amministrazione Italiana delle Finanze*, [1976] ECR 129.

Case 148/78, Criminal proceedings against Tullio Ratti, [1979] ECR 1629.

Case 104/81, *Hauptzollamt Mainz v. C.A. Kupferberg & Cie KG a.A.*, [1982] ECR 3641.

Joint Cases 267–269/81, *Amministrazione delle Finanze dello Stato v. Società Petrolifera Italiana SpA (SPI) and SpA Michelin Italiana (SAMI)*, [1983] ECR 801.

Case 12/86, *Meryem Demirel v. Stadt Schwäbisch Gmünd*, [1987] ECR 3719.

Case 70/87, *Fédération de l'industrie de l'huilerie de la CEE (Fediol) v. Commission*, [1989] ECR 1781.

Case 69/89, *Nakajima All Precision Co. Ltd v. Council*, [1991] ECR I-2069.

Opinion 1/91, [1991] ECR I-6079.

Case C-280/93, *Germany v. Council*, [1994] ECR I-4973.

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Case 53/96, *Hermès International (a partnership limited by shares) v. FHT Marketing Choice BV*, [1998] ECR I-3603.

Case C-149/96, *Portugal v. Council*, [1999] ECR I-8395.

Case C-377/98, *Netherlands v. Parliament and Council*, [2001] ECR I-7079.

Case C-377/02, *Léon Van Parys NV v. Belgisch Interventie-en Restitutiebureau (BIRB)*, not yet published.

Case C-265/03, *Igor Simutenkov v. Ministerio de Educación y Cultura, Real Federación Española de Fútbol*, not yet published.

Case C-374/03, *Gaye Gürol v. Bezirksregierung Köln*, not yet published.

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Chapter L

Outsourcing and Offshoring Strategies of Multinational Companies in Asia

Norbert Koubek, Stephan Weinert, and Kirsten Meyer

Offshoring to Asia has become an important strategy for many western companies to enhance competitive advantage. So far the majority of articles have focused exclusively on a specific topic such as offshoring strategies or typical offshoring locations. Yet little has been written about the interrelation of strategic aspects and regional considerations on the one hand and adequate underlying theoretical aspects on the other. Thus, this chapter tries to combine all three issues to provide a comprehensive picture of today's offshoring activities.

L.1 Offshoring Strategies as Market Entry Alternatives

When analysing the literature as to how a company can expand its operations across international borders, a rich set of market entry strategies can be found such as exporting, licensing, franchizing, contract manufacturing, joint ventures, strategic alliances, mergers, acquisitions, and subsidiaries, to name just a few (Bruns, 2003, pp. 95–124; Keegan & Schlegelmilch, 2001, pp. 269–301; Kutschker & Schmid, 2004, pp. 820–899). Less well-covered but increasingly important forms of market entry strategies are the so-called “offshoring strategies”. Consequently, we will introduce them in greater detail in this section. Before this is done, though, it is essential to explain first what the term “offshoring” means.

“Offshoring” can be classified as a sub-category of outsourcing. When speaking of “outsourcing”, we generally refer to the externalization of activities, previously performed in-house, to a third party. The third party in this context is usually an outsourcing vendor. The third party can be, however, also part of the outsourcing organization, such as a subsidiary for instance. What differentiates offshoring from outsourcing is the international dimension. Outsourcing can take place purely in a national context. When speaking of offshoring, though, the third party is located in a foreign country.

The international dimension separates offshoring from outsourcing fairly well. What is more problematic is to separate it from other terms frequently mentioned in the literature, namely “international outsourcing” and “global outsourcing”. All three terms – offshoring, international outsourcing and global outsourcing – have the crossing of international borders in common. As a consequence, some writers

apply the term “offshoring” only in a specific context, for example when referring to externalizing activities to a third party located in a low cost country (Erber & Sayed-Ahmed, 2005, p. 100; Schaaf, 2004, p. 3). This allows for the separation of offshoring from the other two terms. Such a view can also be backed up by various surveys showing that most offshoring takes place particularly in relation to low cost countries such as China, India or most of the other Asian countries. Nevertheless, such a view must be seen critically. It is a fact that the primary motive for most companies engaged in offshoring is taking advantage of lower costs in foreign countries. Exceptions to this motivation nevertheless exist, and they should not be ignored. Singapore with one of the highest per capita income levels in the world, for example, is hardly a low cost country. Yet it is among the most attractive offshoring locations (A.T. Kearney, 2004). As a result of these findings, we define offshoring as the externalization of various tasks previously performed in-house to third parties located abroad, mostly in low cost countries.

Moreover, some authors differentiate between offshoring and what is known as “nearshoring”. The difference between the two is the geographical distance between the outsourcing organization and the third party. If the third party is from a country close in proximity, the term “nearshoring” is applied. Mexico, for instance, is a nearshoring destination for US companies as is the Czech Republic for German companies. If the third party is farther away, the term “offshoring” is used instead (Erber & Sayed-Ahmed, 2005, p. 100). In the course of this article, we will not distinguish between the two, but refer to both as “offshoring”. The reason for this is that the main drivers responsible for the rise of both off- and nearshoring are broadly the same.

Knowing now what offshoring means, we will introduce the main offshoring strategies – offshore outsourcing and captive offshoring – which are also shown in Fig. L.1.

The first main offshoring strategy is called “offshore outsourcing”. It can be defined as the externalization of various tasks to outsourcing vendors located in a foreign country. An example here is the Bank of America’s decision to outsource its software development to Infosys in India (UNCTAD, 2004, p. 148). It can be assumed that offshore outsourcing will grow extensively in the future. The reason for this is the rise of numerous offshoring vendors, which compete with increasing success on the world information technology (IT) market, including the

Outsourcing	Onshore outsourcing	Offshore outsourcing
	Internal domestic provision	Captive offshoring
Own provision		
	National	International

Fig. L.1 Main offshoring strategies
Source: Schaaf (2004, p. 3)

Indian companies TCS, Wipro, Infosys or Satyam. Although they are still small in comparison to the already-established players such as IBM, EDS or Siemens Business Services, their annual growth rates are remarkable. Infosys, for instance, grew by 37% from 2001 to 2002 (Deloitte & Touch, 2003, p. 12). Given India's skills in IT and the growing global demand for IT solutions, additional offshore outsourcing deals will most likely expand rapidly in the years to come.

The second main offshoring strategy is known as "captive offshoring". Here, the third party belongs to the inter-firm network of the outsourcing organization located in a foreign country. Typical examples are the IT service centres of Infineon in Dublin or of DHL in Prague as well as British Telecom's call centres in Bangalore and Hyderabad (UNCTAD, 2004, p. 148).

What fundamentally distinguishes captive offshoring from offshore outsourcing is the extent of control over the third party. When outsourcing to an external vendor, transaction costs mainly in the forms of search, negotiation and monitoring costs occur. It can be assumed that these costs are higher compared to a captive offshoring strategy due to greater information asymmetry between the outsourcing organization and the external vendor (assuming that the vendor may behave opportunistically). On the contrary, when outsourcing to a unit of the inter-firm network, the extent of direct control is higher. This, in turn, minimizes opportunism and consequently monitoring costs.

According to research by Deutsche Bank Research, the captive model clearly dominates offshoring strategies. It currently accounts for two-thirds of total global outsourcing volume (Schaaf, 2004, p. 3), and 61.4% of all organizations covered in a recent survey state that they prefer it over all other offshoring alternatives (Schaaf & Weber, 2005, p. 11). Reasons for this clear domination are probably the aforementioned higher control aspect and the relatively new emergence of highly skilled outsourcing vendors in emergent countries.

L.2 The Extent of Offshoring

Although wide consensus exists that offshoring has increasingly gained in importance and in scale, it is difficult to determine its exact extent. A main reason for this is the lack of official statistics. Many governmental institutions in industrialized countries have data on this. Such information, however, is often non-existing in many emerging countries or imprecise. The lack of a commonly agreed-upon offshoring definition is likewise problematic. Service offshoring, for instance, falls into the category of cross-border trade. When offshoring takes the form of captive offshoring, however, statistics on foreign direct investment (FDI) need to be analysed (Schaaf, 2004, p. 4). As a result, a valid statistical database does not exist. We can nevertheless direct our attention to various pieces of data to provide a better picture of the situation.

According to Deutsche Bank Research, the global volume of the offshoring market was estimated to be between US \$10bn and US \$50bn in 2003. Future growth rates of up to 20% are expected annually (Schaaf, 2004, p. 4). This will not only be a growth in quantity but also in quality. Looking at a recent survey covering more than 570

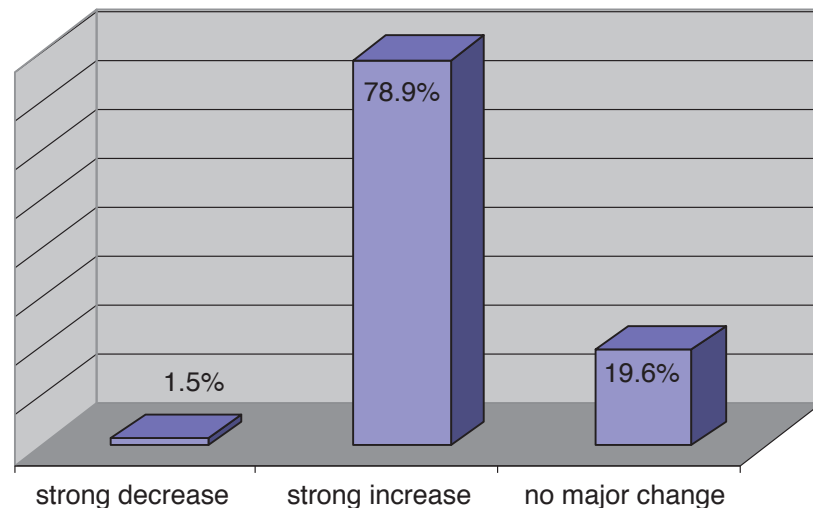


Fig. L.2 Expected development of the value of offshored services

Source: Schaaf and Weber (2005, p. 10)

companies in the German-speaking region in this context, nearly 80% of managers believe that the value of offshored services will grow significantly as shown in Fig. L.2.

Other indicators for the growth of offshoring can be found in the context of labour market research. For instance, 400,000 US business-processing jobs had been relocated by July 2003. This number is likely to rise to around 3.3 m by 2015 (Agrawal & Farrell, 2003, p. 37). Deloitte Research (2003, p. 2) estimates that two million jobs in the financial service sector alone will be moved abroad.

Furthermore, various cases in the daily media show that offshoring – in particular, captive offshoring – is on the rise. Infineon, for example, has established a service centre in Hungary responsible for carrying out corporate accounting tasks. DHL, a leading logistics company, recently established an offshore data processing centre in the Czech Republic. Unisys, an American IT company, plans to establish new centres in Eastern Europe and China. In like manner, Siemens and SAP have built up centres in India particularly responsible for software programming.

As a result, we can conclude from this section that a precise quantification of offshoring is difficult to make. What can nonetheless be said with certainty is that offshoring is already shaping today's global business and is likely to do so even more in the future.

L.3 Concepts of Globalization and Offshoring

As already mentioned, new forms of corporate strategies have been developed in the course of globalization to react appropriately to business opportunities and challenges. Offshoring strategies outlined in Sect. L.1 are increasingly important in this respect. To understand them better and to point to potential future developments especially in the context of Asia, it seems necessary to analyse them from different theoretical points of view. Thus, Sects. L.3.1–L.3.4 will discuss offshoring

in relation to the Triad model, the core competency concept and the value chain analysis. Furthermore, offshoring will be discussed in relation to the relocated activity (i.e., goods or services).

L.3.1 The Triad Model and Globalization

Ohmae developed the Triad model in the 1980s, which splits the world economy into three major regions (Ohmae, 1985). According to the economic reality at that time, these three regions were the USA, Western Europe and Japan. The other countries or country groups were then more or less attached to these regional centres of gravitation. Forces of globalization led to the development of enterprises with strong competitive positions in all three Triad regions. Preconditions for this development were the general homogenization of demand (despite possible cultural and national differences), resource potential and market knowledge as well as the emergence of a global information and communication infrastructure (Perlitz, 2004, pp. 122–129).

Over time, political and economic conditions have changed quite dramatically. This is especially the case due to the dissolution of the Eastern Block and the leadership of the Soviet Union, the global economic opening of China and to economic and social developments in East Asia, South East Asia and South Asia as well as to the constitution of the North American and Pan-American economic zones (the North American Free Trade Area, NAFTA and the Free Trade Area of the Americas, FTAA). As a consequence, the three original Triad regions have changed. Looking at it from an offshoring perspective, this change is quite significant as illustrated in Fig. L.3. Each of the original three regions now has lucrative nearshoring locations in its ‘neighbourhood’. For instance, Mexico has become



Fig. L.3 Triad model and globalization

an increasingly important nearshoring location for the US; the new EU member states for Western Europe; China, India and ASEAN countries for Japan and other western companies.

When considering the economical and political improvements in many emerging countries, it is hardly surprising that a growing number of multinational corporations (MNCs) now increasingly relocate parts of their value chains to these regions. The main beneficiaries of this trend are China when it comes to the relocation of production and India when relocation of services takes place. Member states of the ASEAN group also benefit from this process, as will be shown in more detail later on.

L.3.2 Core Competencies and Offshoring

At the beginning of the 1990s, Prahalad and Hamel developed the core competence concept, which deals with the optimal utilization of company resources on a national as well as an international level. According to this concept, enterprises carry out only those activities themselves for which they have a designated competence in comparison to others. All functional areas are to be included here, and it is therefore essential to take into account that: “Core competencies are the collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies” (Prahalad & Hamel, 1990, p. 82). With particular regard to the further development of technologies and production as well as the opening up of new markets, core competencies are the benchmark: “Core competencies constitute the focus for strategy at the corporate level” (Gottfredson, Puryear, & Phillips, 2005, pp. 133–139; Prahalad & Hamel, 1990, p. 91) (Fig. L.4).

The classical core competence concept receives a clear enlargement through international integration, networking through EDI systems and the global standardization of company activities.

When transferring functions to offshoring locations, companies sometimes have competencies at their disposal, which can better be utilized in the new markets than in their old mature markets. The ability for mass production, for example, is actually no longer applicable in most high wage economies, but by offshoring to a low-cost region this competence can lead to enhanced competitive advantage.

The international possibilities of offshoring can be deployed within a company as well as by acquiring competencies from third party providers. Each case will require a precise individual solution though: “Every outsourcing decision with all its pending questions is a result of strategic principle considerations. The ultimate goal, almost always, is concentrating on core competencies” (Kern, 2002, p. 23, translated from the German language).

In conclusion, it can be said that offshoring certainly has the potential to boost competitiveness. In order to take advantage of this potential, however, competencies

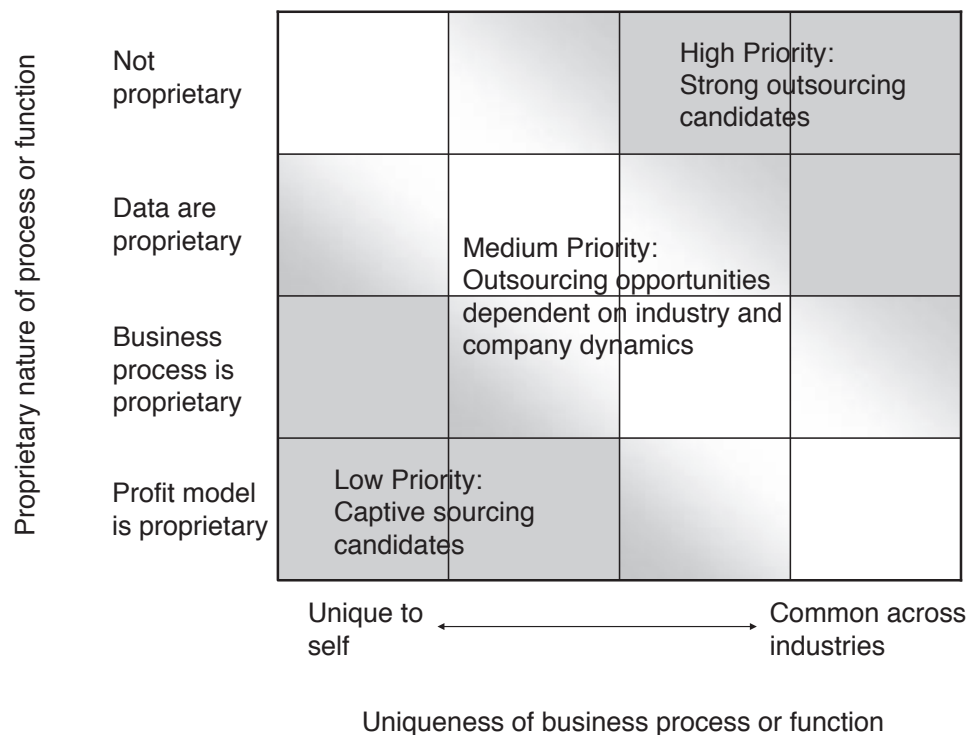


Fig. L.4 What should be outsourced

Source: Gottfredson et al. (2005, p. 138)

and company resources must be fully utilized irrespective of where they come from, internally or externally from offshoring vendors.

L.3.3 The Value Chain Concept and Offshoring

The value chain concept, published by Michael Porter in the 1980s, divides all company activities necessary to produce and sell goods into single activities. These activities can broadly be grouped into two main categories, primary and secondary activities (Porter, 1980). Theoretically, these activities can be located at a single location, at several locations, between several companies at one location, or between several companies at several locations (Kutschker & Schmid, 2004, pp. 321–331; Porter, 1986, pp. 17–68). Thus, a variety of options exists as also shown in Fig. L.5.

By applying the offshoring concept, companies have the possibility to transfer parts of their production to those locations which are most appropriate according to organizational goals. This can be done within the company as well as through the integration of third party offshoring vendors. Apart from the production of goods, an increasing proportion of value added currently originates from services as well.

Value chain activities are increasingly directed at attractive regions, especially those of Asia, because these regions often perform well economically and provide access to a large pool of potential customers as well as to motivated and skilled labour.

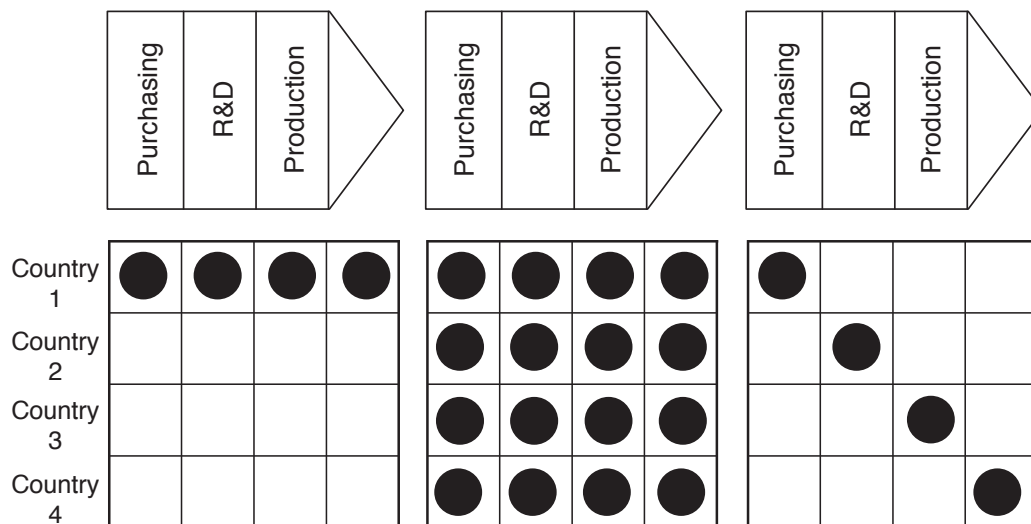


Fig. L.5 Basic options of the international value chain
 Source: Ringlstetter and Skrobarczyk (1994, p. 343)

L.3.4 The Relationship Between Goods and Services, Commodities and Specialities, and Offshoring

In the beginning, offshoring strategies sought to relocate low value-added goods and services. The offshoring of mass production or simple highly standardized services especially took place. These low value added goods and services can be categorized as “commodities” (Kutschker & Schmid, 2004, pp. 343–347).

Today, the relocation of higher value added goods and services abroad is also possible depending on the economic and political situation as well as on the educational infrastructure of the offshoring country. It seems that these factors lay the foundation for shifting more and more higher value-added goods and services – also known as “specialities” – to offshoring locations, particularly in the Asian region. For instance, the relocation of R&D activities or customized software programming can now be seen (Brainard & Litan, 2004, pp. 3–7; UNCTAD & Roland Berger, 2004).

On the basis of what has thus been said, it becomes clear that offshoring is a highly-complex phenomenon. To better understand this, it is necessary to classify its different types and to analyse offshoring on the basis of different adequate theoretical concepts. Putting this all together, we can draw a two-dimensional matrix as illustrated in Fig. L.6. One dimension shows the different offshoring activities, namely goods and services with their sub-classifications commodities and specialities. The other dimension lists the theoretical concepts outlined before, namely the Triad model, the core competencies concept and the value chain.

In general, it can be said that independent of the theoretical concept to which we refer, the offshoring of commodity goods dominated early relocation practices followed by the offshoring of commodity services. Currently, specialities are increasingly relocated to emerging countries driven by improvements in the local

<div>Offshoring activities</div> <div>Globalization concept</div>	Goods		Services	
	Commodities	Specialities	Commodities	Specialities
TriadModel				
Core Competencies Concept				
Value Chain Analysis				

Fig. L.6 The offshore activity matrix

infrastructure, skilled labour and the considerably lower costs than is found in most industrialized economies.

L.4 Trends in Production and Service Offshoring

In the last section we briefly mentioned that it seems feasible to distinguish between the offshoring of goods and the offshoring of services, further sub-classifying these categories. Furthermore, it could be seen that certain trends in offshoring goods and services exist. We will now take a closer look at these trends from an evolutionary point of view.

As mentioned before, offshoring is not an entirely new phenomenon. It began in the 1980s with both the offshoring of production as well as offshoring services. Looking first at offshoring production, Farrell (2004, p. 82) reports that European, US and Japanese companies began to set up plants within low cost countries in the 1980s. These plants were responsible for the production of goods, which were then to be exported to their home markets. Most of these goods can be regarded as rather simple low value-added goods like apparel, toys and cheap consumer electronics (Palvia, 2003, p. 1). In Sect. L.3, we referred to them as “commodities”. During this time, the degree of FDI was limited. The political and economic situation in many low-cost countries restricted the expansion of western MNCs and, consequently, FDI on a greater scale. With the end of the Cold War, more and

more economies ended their isolationist policies and started to attract Western and Japanese companies. The first came from industries such as consumer electronics in the 1990s. Component production and final assembly in particular were increasingly relocated (Farrell, 2004, p. 84). Today, offshoring production has gone even further. In addition to a continuous relocation of labour-intensive activities, offshoring in high-skilled industries, or “specialities” as we refer to them, is growing rapidly. German carmakers such as Audi, for instance, have offshored their entire production of certain models to Eastern Europe. A study by KPMG in the European car industry revealed that while most production today is still carried out in the EU15 zone – 75% of the respondents said they produce 32% or more in this region – this figure is expected to drop to 19% within the next 3 years. The main beneficiaries of this trend are China in particular, accounting for roughly 20% of all manufacturing investments; Eastern Europe with 13%; and India along with the Asia-Pacific region with 10% (KPMG, 2004, p. 5). It thus seems that production will increasingly be carried out in offshoring countries and not in the former home markets of the European car manufacturers.

Service offshoring started roughly in the same period as the offshoring of production. The first services offshored can be classified as being rather simple in nature. A parallel can be seen here to the early days of relocating production. One of the first companies following a service offshoring strategy was the Australian IT company SPI Technologies. SPI hired workers in the Philippines in the 1980s for converting paper based texts into digital formats, simple but expensive work in western countries (Willebbrock, 2004, p. 66). Today, offshoring labour-intensive services continues, but a trend toward the relocation of much more complex activities – specialities – requiring expert knowledge such as high-skilled jobs in software development, manufacturing design, and pharmaceutical research is also underway (Farrell, 2004, p. 84).

The breakthrough of service offshoring is still to come. Certain restrictions exist making service offshoring either impossible or unreasonable. According to Bardhan and Kroll (2004, p. 4), only those services with the following attributes are affected:

- No face-to-face customer servicing requirements
- High information content
- Work-process telecommutable and Internet enabled
- High-wage differential with similar occupation in destination country
- Low set-up barriers
- Low social-networking requirements

In addition, it has been stressed that certain services should not be offshored, although they technically could. Strategically important services as well as services requiring specialized business knowledge are better kept in-house (A. T. Kearney, 2004, p. 4). The dangers associated with losing competitive advantage when transferring these services obviously exceed the benefits that could be reaped through their offshoring.

All of these aspects limit service offshoring. Not surprisingly, it is still considerably small compared to offshoring of production. When analysing the world's service

Table L.1 Plans of MNCs in the IT industry and related areas for expanding their offshoring activities in India

Company	No. of employees	Employees in India	Plans for Indian office(s)
Accenture	65,000	3,500	8,000 by Aug. 2004
Adobe Systems	3,250	185	250 in 6 months
Cadence	5,000	315	Doubling in 4 years
Cap Gemini	56,500	800	2,000 by Dec. 2004
Covansys	4,556	2,000	2,800 in 1 year
CSC	92,000	1,200	4,800 by 2004
EDS	138,000	300	2,400 by 2005
i2	2,800	1,000	Actively recruiting
IBM Global Services	150,000	3,100	10,000 in 3 years
Intel	79,200	950	3,000 by 2005
Keane	5,819	623	2,000 by end 2003
Logica-CMG	24,000	350	1,000 by end 2004
Microsoft	55,000	200	500 in 3 years
Oracle	40,000	3,159	6,000 in 1 year
Texas Instruments	34,400	900	1,500 by March 2006
Xansa	5,583	1,200	6,000 in a few years

Adapted from Roach (2004, pp. 90–92)

output entering international trade, for instance, the results show that although the share of services in the GDP of leading economies has steadily risen over the past four decades, only one-tenth of world service output actually enters international trade. In contrast, world trade is dominated by the manufactured goods, being responsible for nearly 50% (UNCTAD, 2004, p. 97). However, statistics also show that FDI in services is on the rise, and service-related FDI in emerging economies can be regarded as an indicator for captive offshoring operations. Numerous MNCs such as SAP, IBM or Siemens have already set up service centres in emerging countries; many others plan to significantly expand their local presence as shown in Table L.1.

In conclusion, it can be said that both the offshoring of goods as well as the offshoring of services has a rather long tradition. Furthermore, both forms will continue to exist and will probably expand in the future as high value-added activities are increasingly relocated abroad. Lastly, the highest potential in offshoring is in the service sector. The increasing digitalization of services and the combination of low costs and well-qualified people in many emerging countries pave the way for further offshoring. Its biggest wave, it seems, is still to come.

L.5 Empirical Evidence

The following part will provide empirical data based on FDI figures and trade flow data as an attempt to explain offshoring strategies as a market entry alternative and to support the theoretical concepts outlined in Sect. L.3. As there is no precise information available

on offshoring, data on FDI can be used as an indicator for captive offshoring strategies, whereas trade flow figures indicate offshore outsourcing tendencies in general.

As indicated before, offshore outsourcing strategies are increasingly directed at low-cost emerging economies (or newly-industrializing countries as they are also often called). We will now analyse which factors are predominantly responsible for the popularity of certain regions in Asia.

L.5.1 Offshoring Destinations India and China

The A.T. Kearney (2004) Offshore Location Attractiveness Index, which “measures the viability of countries as offshore destinations based on their financial structure, people skills and availability and business environment”, shows that Asian countries dominating the first ten places of the ranking. (For a detailed explanation on the methodology, see A. T. Kearney, 2004, p. 5.) In the overall ranking, India is by far the most attractive location for offshoring. Its share of global offshoring volume is estimated to lie between 70% to 90% (Schaaf, 2004, p. 8). According to a study by Deutsch Bank Research, India’s economy will grow at about 6% on average over the next 10–15 years, ranking number 1 out of 34 developed and newly emerging nations. Closely following India in this ranking are three other countries from the Asian region, Malaysia in second place with an average growth rate of about 5.4%, followed by China with ~5.2%. Thailand, which will probably grow on average by 4.4%, ranks number 4 (Asuncion-Mund, 2005, p. 3). The UNCTAD World Investment Report 2004 (UNCTAD, 2004, p. 51) states that economies with high growth rates – for instance India, China or members of ASEAN – receive more FDI flows. Combined with the fact that China and Malaysia are ranked number 2 and 3 in the A. T. Kearny index, respectively, this shows their attractiveness as offshoring locations in general and as captive offshoring regions in particular (A. T. Kearney, 2004, p. 2).

Reasons for India’s enormous growth rates and its attractiveness as an offshoring location are numerous. With 1.1 bn people, India is the world’s most populous region after China and has a large labour pool due to its demographic development (Asuncion-Mund, 2005, pp. 3–4). Nevertheless, India’s per capita income is still only half that of China (Heuer, 2004, p. 112). Although India is a preferred offshoring location especially because of low wages, it also builds its success on factors such as highly qualified specialists with good English skills and on its experience as an offshoring destination in general (Asuncion-Mund, 2005, pp. 3–4; A.T. Kearney, 2004, p. 3). According to the IMD worldwide competitiveness yearbook from 2004, India leads second only to Denmark in the availability of skilled labour (Asuncion-Mund, 2005, p. 5). Another reason for India’s current strength originates from growing investor confidence leading to increasing FDI (UNCTAD, 2005, p. 52).

In total, FDI to Asia was valued at US \$105 bn in 2004. Figure L.7 illustrates which countries benefited the most from such investments. Here, East Asia clearly

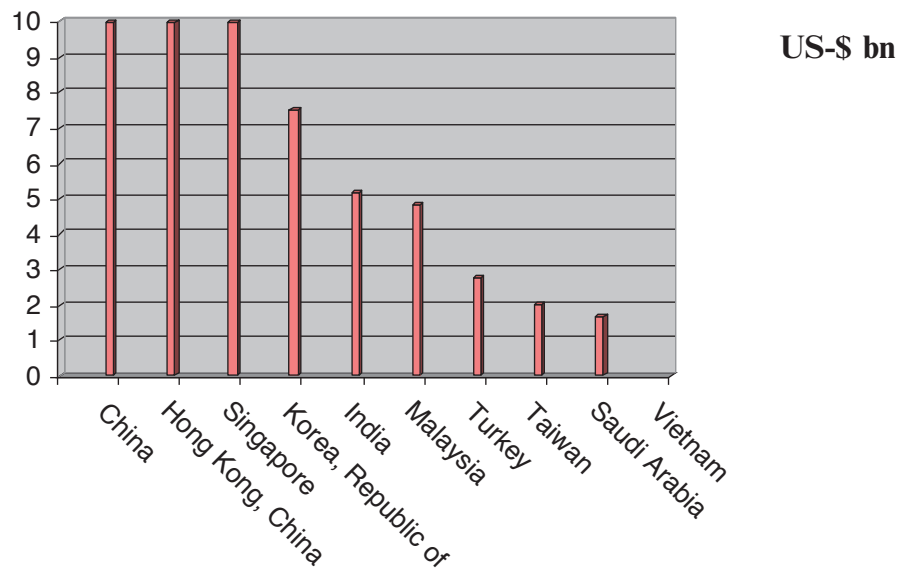


Fig. L.7 FDI flows to the Asian region in 2004
Source: UNCTAD (2005, p. 52)

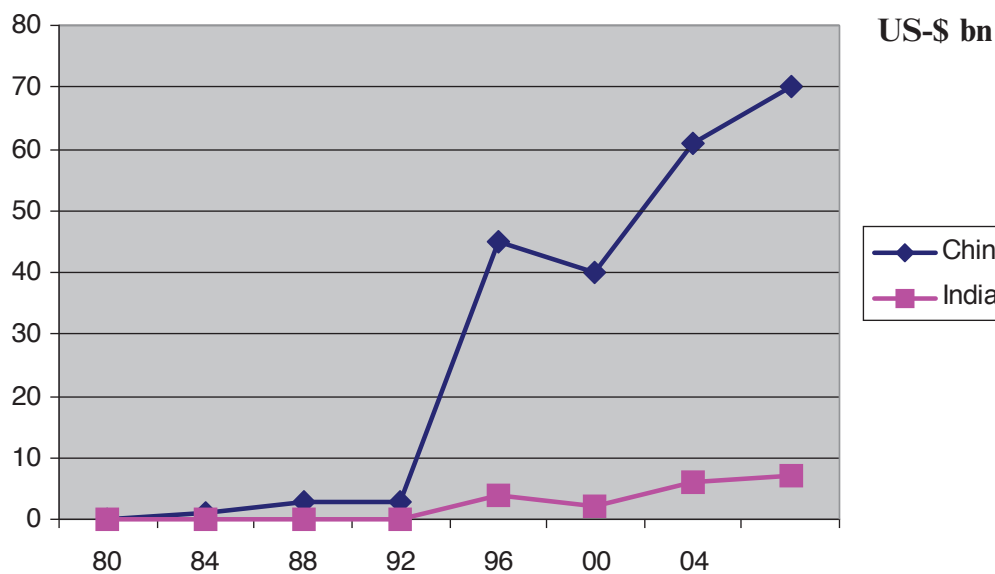


Fig. L.8 FDI flows to China and India
Source: Heymann (2005, p. 7)

dominates. The figures also implicitly show which countries seem to be preferred as captive offshoring locations.

The graphs show that while both China and India are popular offshoring locations, the former attracts significantly more FDI than India. However, India is regarded as a better offshoring location for certain activities, especially IT services. Nevertheless, a striking gap in FDI between China and India has developed since the early 1990s as is illustrated below in Fig. L.8.

L.5.2 Offshoring Destinations in the ASEAN Region

Referring once again to the A. T. Kearny index, there are three countries from ASEAN which are among the top 10 most attractive offshoring locations: Malaysia (3), Singapore (5) and the Philippines (6). Additionally, Thailand (13) and Vietnam (20) are among the 25 most attractive offshoring regions (A. T. Kearney, 2004, p. 2). Their attractiveness as offshoring and FDI locations is based on high economic growth with GDP growth having been extremely strong in Singapore, Malaysia and Thailand. The economies of the Philippines and Indonesia, on the other hand, have been growing more gradually. Although their growth rates were more than 4%, both countries remain susceptible for economic shocks (Walter, 2004, p. 2). While Thailand is ranked 13 in the overall rating, it ranks in at number 4 on financial structure attractiveness behind the top three players as other members of the ASEAN region: India, Vietnam and the Philippines (A.T. Kearney, 2004, pp. 2, 13).

According to the IMD Yearbook from 2004, many countries from the ASEAN region can rely on highly qualified specialists. In this regard, Singapore and the Philippines even rank before the US and Germany, and Malaysia has already caught up to Germany (Asuncion-Mund, 2005, p. 5). The availability of skilled labour is probably one of the reasons why Malaysia is expected to challenge India's position as an offshoring location in the near future, although it will probably never become the leading location due to its modest market size and existing problems of piracy (A.T. Kearney, 2004, p. 8).

As the third and fifth set of boxes in Fig. L.9 shows, Asia has also been an attractive region according to the flow of trade. In 2004, trade flows worth €249 bn came from Europe while €245 bn from North America. Moreover, both Triad regions are

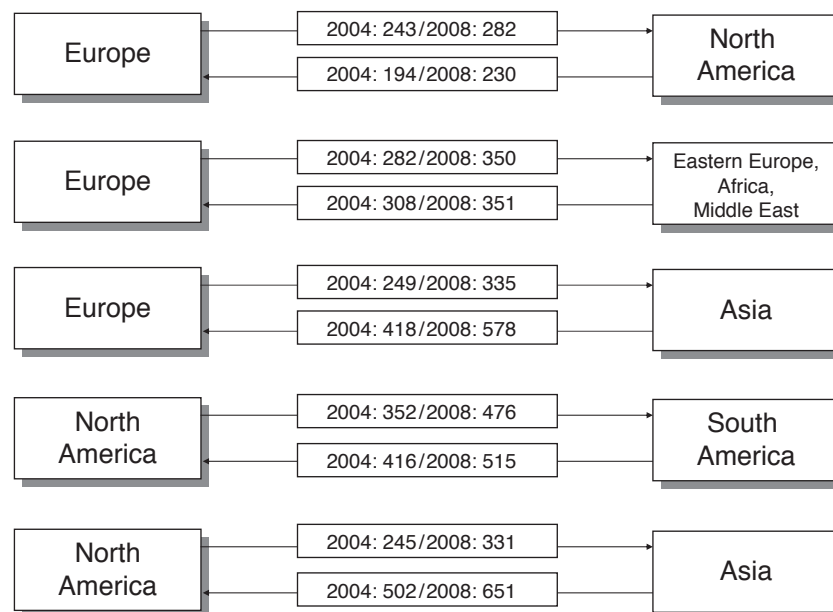


Fig. L.9 Large trade flows: exchange of goods in 2004 and 2008 (estimated) in €bn
Source: Bündler (2005, p. V36)

expected to increase their trade flows to Asia through 2008, Europe with an increase of €335 bn and North America with an increase of €331 bn. Trade flows from Asia to Triad regions are also increasing. Inflows to North America from Asia, for example, were twice as much (€502 bn in 2004) as the reciprocal flow from North America to Asia and are expected to grow even more by 2008 (€651 bn). Additionally, Europe will receive more trade flows from Asia, up from €418 bn in 2004 to €578 bn in 2008. Although it is difficult to draw a conclusion on offshore outsourcing based on these figures, the growing involvement and integration of these regions nevertheless indicates that companies are increasingly pursuing offshore outsourcing strategies directed at the Asian regions (Bünder, 2005, p. V36).

L.5.3 Offshoring Destinations in the Triad Region

Referring to Fig. L.9 again, it can be assumed that offshore outsourcing strategies also play an increasingly important role within the Triad region. Although no regional distinction is made within Europe, for instance between Western and Eastern Europe, increasing trade flows between North America, Europe and Asia can be seen as an indicator for the positive development of offshore outsourcing. Trade flows from North America to Europe, for example, are expected to grow from €194 bn in 2004 to €230 bn in 2008 (Bünder, 2005, p. V36).

As another indicator for offshore outsourcing strategies, we can look to data on intra-firm trade between parent companies and their affiliates. The share of intra-firm trade of selected services for the United States, for example, gradually increased from 1997 to 2002 for imports as well as for exports (UNCTAD, 2004, p. 128).

While trade flows within these regions generally increased, FDI inflows into developed countries – again an indicator for captive offshoring – including the three traditional Triad regions Japan, the US and the EU, experienced an overall reduction from US \$442 bn to US \$380 bn from 2003 to 2004. While investment in North America nearly doubled in 2004, FDI within the EU declined by 36% to US \$216 bn. This is probably due to the late economic downturn.¹ The US received the largest flows of FDI worldwide, amounting to US \$96 bn in 2004, followed by the United Kingdom whose inflows increased from US \$20 bn to US \$78 bn due to growing inflows from the US. Japan also enjoyed a rise in levels of FDI by 24% (US \$7.8 bn), a trend, which will probably continue as Japan's economy, grows and the Japanese government pursues structural improvements (UNCTAD, 2005, pp. 81–91). The country nevertheless faces a growing public debt, which amounted to 163% of GDP by the end of 2004 (Walter, 2004, p. 3).

¹ A distinction must be made here between the EU-15 and the ten new EU member states (from Central and Eastern Europe). While the EU-15 experienced a decline in FDI inflows of 40 percent to US \$ 196 bn in 2004, flows within the ten EU-accession states grew by 69% to US \$ 20 bn in 2004 (UNCTAD, 2005, pp. 81–84).

FDI flows to the US are favoured due to its above-average economic development as well as predicted positive population growth up to 2020. Europe and Japan, on the other hand, face negative population growth rates (Heymann, 2005, pp. 1–2). Yet after years of recession in the 1990s, Japan has begun to rebuild its competitiveness. Unit labour costs have decreased since 1997 and are still decreasing by 4.5% per year. Since 2003, more than 30,000 jobs have been created per month (Koll, 2005, p. 14), and GDP is growing (Walter, 2004, p. 2). One of Japan's biggest challenges now is to remain competitive against China. Japanese managers realize that being present in China is absolutely essential. As a manufacturing location, China is of significance mostly with respect to labour-intensive components, especially as it still fails to widely respect intellectual property. Toyota, for example, develops and manufactures its Lexus model in Japan and only imports certain body parts from China (Koll, 2005, p. 14).

Still, industrialized or developed economies have been experiencing a competitive disadvantage due to their relatively high labour unit costs for many years now. Even within the Triad region, there are quite substantial differences between unit labour costs; this can be seen in Fig. L.10. Wage restraints in many Western countries nevertheless showed a positive effect on the economy, as unit labour costs hardly increased whereas unit labour costs in Eastern Europe are still likely to expand significantly over the next several years (Heymann, 2005, pp. 11–12).

Comparing inward FDI performance with the actual potential of some Triad countries for the period from 2000 to 2002 reveals that certain factors must be taken into account when looking at FDI inflows. Indonesia, for example, has suffered from economic shocks and is thus rated as an 'under-performer'. China, the Czech Republic and Singapore on the other hand can be labelled 'front-runners' due to their high FDI potential and good performance. As two traditional members of the Triad region, Japan and the US perform below their potential, showing low FDI performance despite high FDI potential as is also the case for Poland, Thailand

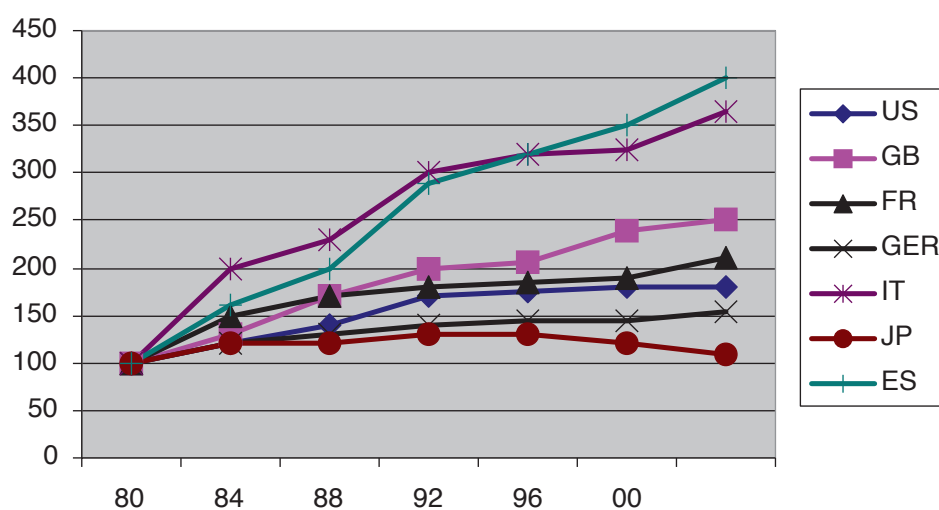


Fig. L.10 Unit labour costs in industrialized countries (1980 = 100)

Source: Heymann (2005, p. 12)

and the Philippines (UNCTAD, 2005, p. 25). This classification can help companies when selecting possible outsourcing locations.

In conclusion, it can be said that the US, EU-15 and Japan are likely to remain important industrial centres in the future, particularly as labour costs play only a minor role in capital intensive sectors (e.g., the final assembly of car production). In many industries, transport costs also exceed the value of goods. As transportation costs are likely to grow due to increasing energy prices, the proximity of sales markets becomes even more relevant (Heymann, 2005, pp. 9–10). For example, the shipping of cars from India to Europe attracts additional freight costs of about US \$300–US \$400. This may, of course, be offset by export incentives offered by the Indian government (Oburai, 2004, pp. 9–10).

What also favours the Triad region is the availability of excellent human resource talent. The former EU region, for example, will remain competitive in many traditional sectors, as it can rely on greater productivity, superior technical skills as well as leading and driving innovations in industries such as automotive, aviation and mechanical engineering (Heymann, 2005, p. 11).

L.6 Conclusion

Offshoring has become increasingly important in today's global business. To understand its complexity better and to provide managers with new ideas on how to utilize its potentials, we have analysed offshoring strategies from various theoretical perspectives. All of them – the Triad model, the core competence concept and the value chain analysis – provide useful insights and thus help to shed light on certain aspects of the offshoring phenomenon. Furthermore, we link these theoretical insights with empirical data. Various indicators reveal that offshoring leads to a convergence of different economic regions. The relocation of value chain activities from industrialized to emerging economies paves the way for more international trade between the East and the West. Western MNCs doing business in these regions appear to be benefiting the most from such relocation, as are specific countries such as China and India. However, the ASEAN countries also demonstrate high potential in this respect and are quickly catching up. They could indeed become the preferred offshoring locations of tomorrow.

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Chapter M

Regional Economic Integration, Mergers and FDI: Welfare and Policy Implications for ASEAN

Toby Kendall and Cillian Ryan

M.1 Introduction

As East Asia follows Europe and other regions by deepening regional economic integration, an important consideration is the likely effect on competition and ownership of production in the region. Traditional analysis of preferential trade agreements (PTAs) focuses on trade creation and trade diversion effects, with no consideration of changes in market structure. Panagariya (1999) argues that ASEAN members are unlikely to gain from these traditional effects, due to their relatively small market sizes and low levels of intra-regional trade. However, PTAs have also tended to be accompanied by increased production by firms from outside the region, attempting to take advantage of a larger internal market by avoiding tariffs on non-member countries, and any analysis of the welfare implications of a PTA should take such effects into account. This chapter draws on previous theoretical work by the authors and presents a theoretical framework for analysing the effects of a PTA on both greenfield FDI and mergers and acquisitions, and considers the implications for ASEAN members' welfare and competition policy.

Increasingly governments are looking to regional trade agreements as a means of promoting domestic industry in the belief that bigger markets will enable domestic firms to grow and prosper. While some literature has studied the effects of such integration in monopolistic industries where economies of scale are prevalent, the impact of regional agreements in oligopolistic industries is less well understood.¹ This chapter focuses on the strategic aspects of such trade agreements in the context of a Cournot model and considers the influence of regional integration on the incentives of foreign firms to export, to engage in greenfield FDI or to merge with domestic firms. We show that, contrary to government intentions, such agreements are likely to increase foreign participation in the customs union at the expense of domestic and union partner firms. This may take the form of increased greenfield

¹Collie (1997) and Yi (1996) both consider the effects of trade blocs in oligopolistic markets, but neither of these papers considers changes in market structure as a result of economic integration. Horn and Levinsohn (2001) consider the effects of multilateral, but not preferential, trade liberalisation on mergers.

investment or takeovers of domestic firms by foreign predators even in situations where a potential domestic predator has the superior technology. However, consumer welfare unambiguously rises as a result of the union formation.

Regional integration agreements have tended to be accompanied by increased production by foreign firms in the integrating region (see Dunning, 1993, for a survey). Previous papers by Motta and Norman (1996) and Norman and Motta (1993) have explained the increase in FDI which has accompanied many regional integration agreements by showing that regional integration offers a large tariff-free market to firms located in the region, hence increasing the relative profitability of FDI compared to exporting. However these papers have concentrated purely on greenfield investment, whereas Table M.1 below highlights the importance of international mergers and acquisitions in total investment, while Table M.2 emphasises the striking increase in the proportion of investment in the EU made up of mergers and acquisitions as integration has deepened. These tables suggest that any analysis of FDI needs to include acquisitions alongside greenfield FDI.

Table M.1 FDI inflows (Percentage of GDP, weighted averages)

	Gross FDI inflows		
	Total	Greenfield	Mergers & acquisition
Industrial countries			
1987–89	1.07%	0.25%	0.82%
1990–94	0.82%	0.29%	0.53%
1995–99	1.88%	0.33%	1.55%
Developing countries			
1987–89	0.97%	0.87%	0.10%
1990–94	1.59%	1.28%	0.32%
1995–99	2.95%	2.01%	0.94%

Source: Calderón, Loayza, and Servén (2002)

Table M.2 Ratio of inward mergers and acquisitions to FDI inflows (Percent)²

	1988–93	1994	1995	1996	1997	1998	1999	1994–99
OECD total	68.8	73.3	76.7	82.7	85.4	97.9	106.1	92.9
Europe	56.2	67.7	65.0	75.0	88.0	83.2	116.6	89.6
UK	85.9	135.5	178.4	127.2	139.0	150.9	161.9	152.3
France	42.0	104.7	32.7	67.1	87.7	80.1	64.4	70.5
Germany	120.7	62.6	62.3	181.9	107.1	95.0	175.8	121.5
United States	93.9	105.9	93.9	83.4	81.6	118.3	91.8	97.0

Source: OECD (2001, p. 47)

²Due to differences in the way the series are calculated, the values for mergers and acquisitions are often more than 100% of the corresponding values for FDI inflows. Details of how these series are calculated can be found in OECD (2001, p. 19).

Table M.3 Inward mergers and acquisitions and total FDI inflows to ASEAN 6³

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total FDI (US \$million)	27091	28553	32264	20859	26517	22440	18481	12336	16946
M&A (US \$million)	3515	2593	5829	7360	8881	5746	12872	4627	4184
Ratio M& A /FDI (%)	12.97	9.08	18.07	35.29	33.49	25.61	69.65	37.51	24.69

Source: Constructed by authors using data from UNCTAD online FDI database

Table M.3 gives figures for total FDI and mergers and acquisitions in six ASEAN members.⁴ While the proportion of investment in the form of mergers and acquisitions is much lower than for Europe and no clear trend is present, it is still clear that mergers and acquisitions account for a significant part of total investment in the region.

Most previous analyses of strategic behaviour in oligopolistic markets have tended to focus on the narrow strategy of taking over (and closing) existing firms to raise profit through the reduction of industry supply or alternatively FDI solely as a means of tariff jumping. However, additional strategies such as licensing, divisionalisation and divestiture (see Baye, Crocker & Ju, 1996) also exist and, in the context of PTA formation, it is not immediately clear which strategy will necessarily be chosen by firms.⁵ Two possibilities need to be considered: the traditional merger model, where the foreign predator firm purchases the domestic target and (acting as a joint-plant profit maximiser) shuts down the target, which we term a *market concentrating merger*; and the alternative strategic option of operating the target as a separate division or franchise with the technology of the acquiring firm (as in Ryan, 2005), which we term a *technology transfer merger*. We contrast these possibilities with that of a foreign firm continuing to export from its existing base or investing directly (greenfield FDI) in the customs union. In the case of greenfield FDI we analyse the possibility that the foreign firm can invest in the union either by establishing a new overseas division or by relocating its original foreign operations into the union. Incentives for greenfield FDI, like those for mergers, are affected by the removal of tariffs between union partners. The possibility of supplying both partner countries, tariff-free, from a single plant in one of these countries increases the incentive to establish a plant in the domestic (or union-partner) country; however, the creation of a new plant, rather than the acquisition of an existing one, increases competition in the domestic market.⁶

³Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

⁴Brunei-Darussalam, Cambodia, Laos and Myanmar are excluded due to lack of available data on mergers and acquisitions.

⁵This chapter does not set out a full general equilibrium model of divisionalisation as in Baye et al. (1996) as its application in this context, where there are more than two firms and differential marginal costs, results in intractable solutions.

⁶With the number of firms in the market endogenous, greenfield FDI would be likely to lead to more firms exiting the industry than a merger.

This chapter draws on the analysis of Kendall and Ryan (2001), where we showed that the acquiring firm, or new investor, will always prefer to continue operating two plants. Here we concentrate on the effects of changes in intra-union tariffs, showing that such regional initiatives are likely to favour foreign predators over (possibly) more efficient domestic market leaders due to the external tariff jumping motive. Both mergers and greenfield investment become more profitable, relative to exporting, for the foreign firm as a result of regional integration. Hence customs union formation is likely to result in more foreign-owned plants within the union.

The chapter proceeds as follows. Section M.2 sets out the various stages of the game from the perspective of an individual firm and analyses incentives to merge or engage in greenfield FDI in the absence of tariffs. Section M.3 introduces tariffs into the model and considers the influence of intra-union tariff reductions on the incentives of domestic, union-partner and foreign based firms. Section M.4 considers the welfare effects of regional integration and possible implications for competition policy, focussing on the case of ASEAN, as well as considering generalisations to and extensions of our results. Finally, Sect. M.5 concludes.

M.2 The Model

This section presents a simplified framework for analysing international mergers and FDI. A more complete analysis of the model is contained in Kendall and Ryan (2001). Other theoretical extensions are considered in Ryan and Kendall (2005) and the issues addressed in that paper are discussed in Sect. M.4 below.

The model is a simple partial equilibrium model of international oligopoly with the following features: the world is composed of three countries; the home country, a union partner country (whose variables are denoted by u) and a foreign country (whose variables are denoted by an asterisk). We assume that each country has a small number of firms (n , n^u and n^* respectively, each greater than or equal to 3) producing a homogeneous product, while all three markets are segmented with each firm selling in all markets.⁷ We assume that each firm faces constant marginal costs, marginal costs differ across firms, in each country firms are ranked such that $c_k > c_j$ ($c_k^* > c_j^*$) ($c_k^u > c_j^u$) if $k > j$, and there are no fixed costs. In addition we assume that a firm selling into a market other than its home market faces a constant additional per-unit cost t^u or t^* , due to a tariff and/or transport cost.

The focus in this chapter is primarily on the options facing foreign firms, and they play a three-stage game as set out in diagram 1. In stage one they decide whether they wish to only export directly, to set up a new plant or to acquire a union-based firm (the target). If the firm decides to establish a presence in the

⁷The assumption that there are at least three firms producing in each market is to rule out possible monopoly effects after a merger.

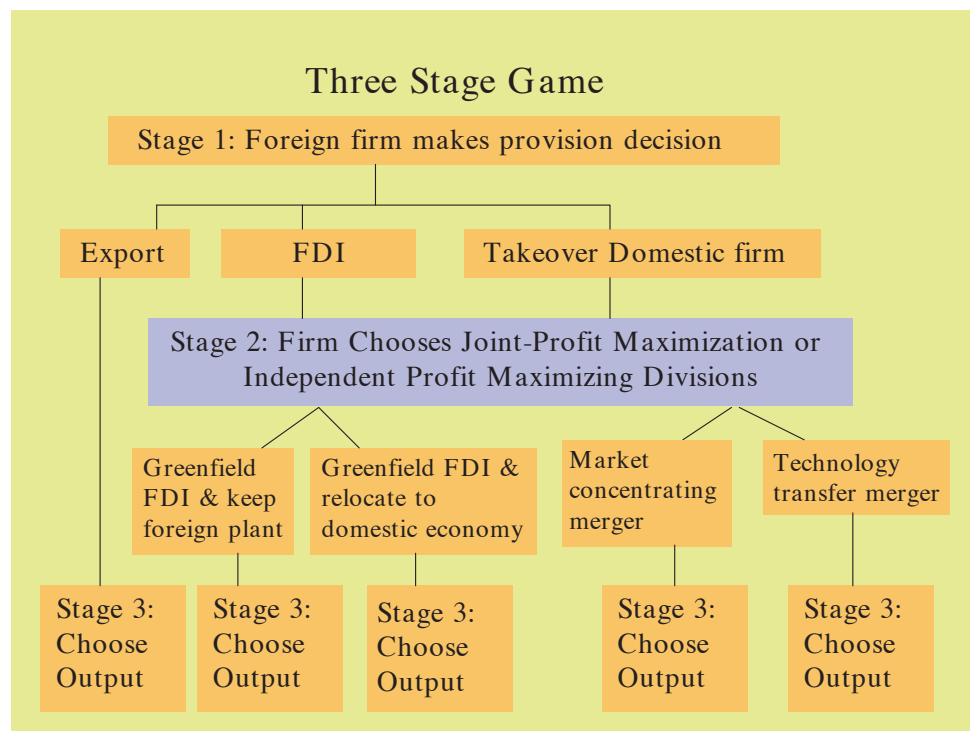


Fig. M.1 The game tree

domestic market then in stage two it decides whether to operate the target (using their superior technology) or its new subsidiary as an independent division, while continuing to sell from the parent plant, or to maximise joint-plant profits, which will in effect lead to shutting down the less efficient plant or foreign parent.⁸ This second stage is not explicitly analysed in this chapter; Kendall and Ryan (2001) showed that the dominant strategy is always to operate both plants and analysis and proofs from that paper apply directly here. However we emphasise here that the assumption made in most of the Cournot merger literature (such as Salant, Switzer, & Reynolds, 1983) (Fig. M.1).

Falvey (1998) and Falvey and Nathananan (2002) that the acquiring firm closes down the less efficient target is allowed for in this model but never chosen. That is, technology transfer mergers will always be preferred to market concentrating mergers.

In stage three the firms, and any independent divisions, decide their appropriate level of output in each market via Cournot competition. The numbers of independent firms and divisions depend on decisions made in previous stages of the game. The game is solved in the usual way by means of backward induction, starting with stage three, the final-stage output game.

⁸It is assumed that a more efficient firm can exploit its full cost advantage when producing at any location. The implications of relaxing this assumption are discussed in Sect. M.4; for full analysis of cases where only part of this cost advantage can be transferred to acquired plants, see Ryan and Kendall (2005).

M.2.1 Stage 3: The Final-Stage Output Game

In this stage we solve for the output for each firm or division, given the total number of firms and divisions (whether located in the home, union-partner or foreign country) serving each market. In this section we assume no tariffs or trade costs are present; when they are introduced in Sect. M.3, they enter the equations analogously to an additional marginal cost for the firms that face them.

Demands in the three markets are given by:

$$\begin{aligned} D &= A - p \\ D^u &= A - p^u \\ D^* &= A - p^* \end{aligned} \quad (\text{M.1})$$

where A is a positive constant and p , p^u and p^* are domestic, union-partner and foreign prices respectively.⁹ Market clearing requires that

$$\begin{aligned} D &= H + H^u + H^* \\ D^u &= U + U^u + U^* \\ D^* &= F + F^u + F^* \end{aligned} \quad (\text{M.2})$$

where H , H^u and H^* are the total sales of the home, union-partner and foreign producers respectively to the home market, that is,

$$H = \sum_{j=1}^n h_j, H^u = \sum_{j=1^u}^{n^u} h_j^u \text{ and } H^* = \sum_{j=1^*}^{n^*} h_j^*,$$

where there are n , n^u and n^* home, union-partner and foreign firms and divisions respectively, setting outputs for the home market of h_j , h_j^u and h_j^* . Similarly, F , F^u and F^* are the total home, union-partner and foreign firm's sales to the foreign market defined as

$$F = \sum_{j=1}^n f_j, F^u = \sum_{j=1^u}^{n^u} f_j^u \text{ and } F^* = \sum_{j=1^*}^{n^*} f_j^*$$

respectively and U , U^u and U^* are the total home, union-partner and foreign firm's sales to the union-partner market defined as

$$U = \sum_{j=1}^n u_j, U^u = \sum_{j=1^u}^{n^u} u_j^u \text{ and } U^* = \sum_{j=1^*}^{n^*} u_j^*.$$

⁹Note that in this section, with zero tariffs, prices will be equal in each market, as will the output of each firm and total demand in each country. However the three markets are viewed separately here as prices and quantities will differ in Sect. M.3 below, when tariffs are set.

The profit maximisation problem for a representative plant i , with constant marginal cost c_i , is

$$\begin{aligned} & \text{Max } (p - c_i)h_i + (p^u - c_i)u_i + (p^* - c_i - t^*)f_i \\ & \equiv \text{Max } \left\{ \left[A - \sum h_j - \sum h_j^u - \sum h_j^* - c_i \right] h_i + \right. \\ & \quad \left[A - \sum u_j - \sum u_j^u - \sum u_j^* - c_i \right] u_i + \\ & \quad \left. \left[A - \sum f_j - \sum f_j^u - \sum f_j^* - c_i \right] f_i \right\} \end{aligned}$$

yielding first-order conditions:

$$\begin{aligned} (p - c_i) &= h_i \\ (p^u - c_i) &= u_i \\ (p^* - c_i) &= f_i \end{aligned} \tag{M.3}$$

Substituting Eqs. (M.3) and their union-partner and foreign equivalents into Eqs. (M.1) and (M.2) and rearranging yields

$$p = \frac{A + C + C^u + C^*}{n + n^u + n^* + 1} = \frac{A + C + C^u + C^*}{N + 1} \tag{M.4}$$

where

$$C = \sum_{j=1}^n c_j, C^u = \sum_{j=1^u}^{n^u} c_j^u, C^* = \sum_{j=1^*}^{n^*} c_j^*,$$

and $N = n + n^u + n^*$. Output of plant i is therefore:

$$h_i = h_i^u = h_i^* = \frac{A + C + C^u + C^* - (N + 1)c_i}{N + 1} \tag{M.5}$$

Symmetric expressions are obtained for outputs of other firms in the home market and prices and outputs in the other markets.

M.2.2 Stage 1: The Choice Between Merger, Greenfield FDI and Exporting

For purposes of exposition, we will initially assume that each firm is a single-plant concern exporting to markets outside its home country and then examine its options should it decide to merge or establish a new plant. As mentioned previously, any firm that chooses to acquire or establish a new plant will operate two plants

independently. The analysis in this section assumes no trade costs; these will be added in Sect. M.3.

M.2.2.1 Mergers in Stage 1

In this case it is assumed either that the technically superior firm, j , licences its superior technology to the target single-plant firm, k , or that j acquires k but allows it to continue in operation as an independent franchise or division using the superior technology available to firm j . For simplicity, we assume that the profit from the joint operation accrues to the purchasing firm.¹⁰ The new market equilibrium is thus derived on the assumption that there are still effectively n firms in each market, with two having the same technology. We will see below that output rises, market price falls, profits and market share of the non-merging firms fall, and consumer surplus rises in each of the markets. Consumers and the merging firms (and in particular, the predator firm) gain. Hence, unlike in most Cournot merger literature, this merger is pro-competitive and unambiguously improves overall efficiency.

To illustrate the above, we consider the effect of a merger between (home) firm j and (home) firm k where $c_k > c_j$. The effect on the equilibrium price in the home market is (denoting the new level by \hat{p}):

$$\hat{p} = \frac{A + C + C'' + C^* - c_k + c_j}{N + 1} = p - \frac{[c_k - c_j]}{N + 1} < p \quad (\text{M.6})$$

since $c_k > c_j$. For notational convenience we write this as $\hat{p} = p - R < p$, where

$$R = \frac{c_k - c_j}{N + 1}$$

Similarly, the output of the newly merged firm (taking the two plants together) is:

$$2\hat{h}_j = \hat{h}_j + \hat{h}_k = h_j + h_k + (N - 1)R \quad (\text{M.7})$$

while each individual plant sets output \hat{h}_j , where

$$\begin{aligned} \hat{h}_j &= h_j - R < h_j \\ \hat{h}_j &= h_k + NR > h_k \end{aligned} \quad (\text{M.8})$$

Thus, while the output of the original production plant falls ($h_j > \hat{h}_j$), the total production of the merged firm rises,

¹⁰As we will see the most cost-efficient firm will always have the incentive to bid the most for the target, and in principle we could have a Nash bargaining game over the price but this complication would add nothing to the exposition.

$2\hat{h}_j > h_i + h_k$. By contrast, the outputs of all the home and foreign rival firms (r) fall since,

$$\begin{aligned}\hat{h}_r &= \frac{A + C + C^u + C^* - (N+1)c_r - (c_k - c_j)}{N+1} = h_r - R < h_r \\ \hat{h}_r^* &= \frac{A + C + C^u + C^* - (N+1)c_r^* - (c_k - c_j)}{N+1} h_r^* - R < h_r^*\end{aligned}\quad (\text{M.9})$$

However, exports rise: since

$$\hat{p}^* p^*,$$

$$\hat{D}^* = \hat{F} + \hat{F}^* + \hat{F}^u > F + F^* + F^u \text{ and } \hat{F}^* = \sum \hat{f}_i^* < F^*,$$

\hat{F} must have risen overall with

$$(\hat{f}_j + \hat{f}_k) > (f_j + f_k) \text{ and } (\hat{f}_j < f_j) \text{ and } (\hat{f}_k < f_k)$$

The effect on the union-partner is similar.

For this merger to take place the post-merger profits from merging and operating as independent divisions, franchises or licensees must be positive. The profit resulting from the merger in this case is given by:

$$\begin{aligned}\Delta\pi^M &= 2(\hat{p} - c_j)\hat{h}_j - (\hat{p} - c_j)h_j - (p - c_k)h_k + 2(\hat{p}^u - c_j)\hat{u}_j - (\hat{p}^u - c_j)u_{j_k} \\ &\quad - (p^u - c_k)u + 2(\hat{p}^* - c_1)\hat{f} - (p^* - c_1)f_1 - (p^* - c_n)f_k\end{aligned}$$

Using (8), $\hat{h}_j = h_j - R$ and $\hat{h}_k = h_k - NR$, and similar expressions for \hat{u}_j , \hat{u}_j , \hat{f}_j and \hat{f}_k , substitution yields:

$$\Delta\pi^{MC} = 3(N^2 - 2N - 1)R^2 + 2(N - 1)(h_k + u_k + f_k)R \quad (\text{M.10})$$

which is strictly positive, for N greater than 3 at least, and

$$\left. \frac{\partial \pi}{\partial N} \right|_0, \left. \frac{\partial \pi}{\partial (c_k - c_j)} \right|_0, \left. \frac{\partial \pi}{\partial h_k} \right|_0$$

We note that merger profits depend on the *ex ante* absolute cost difference between two merging firms $c_k - c_j$, and thus, *ceteris paribus*, the potential post-merger profits are largest for a merger between the most efficient and the least efficient firm, firms 1 and n respectively. Hence, the most efficient firm is in a position to outbid all others if a merger is profitable and it alone may have multiple divisions, franchises or licensees.

In the case of a merger where the firm opts to merge with a less efficient competitor and operate each plant independently it is important to note that profits

are always positive in this framework. While this would indicate that this path would always be chosen it obviously creates problems in establishing the number of firms in the final equilibrium.

The explanation for this problem is as follows. The use of the superior technology by the target firm reduces the price for all producers and thus the predator's profits fall *ceteris paribus*. However, because it has sold the technology to the target company, the predator gets any profit increase the target enjoys as a consequence of the latter's increase in market share. The larger the increase in the target's production, the greater the chance of a successful merger. Once again as the number of firms declines, and as $c_k - c_j$ gets smaller, a merger will become less attractive. However these profits are always positive in the absence of any other countervailing cost, at least when demand is linear.

Hence, some cost associated with the merger is required to place a lower bound on merger profits and hence determine an internal equilibrium. This might be the merger cost itself (lawyers' fees which might rise as n falls and the firm's size increases); the costs of negotiating and monitoring licence agreements; the cost of implementing the superior technology (presumably a one-off fixed investment cost); or even the cost of an investigation by the equivalent of a Monopolies and Mergers Commission. We hence assume there is a fixed cost of a merger, M , attributable to any or all of the above reasons.

M.2.2.2 Greenfield FDI in Stage 1

We now consider whether there is an incentive for a firm to establish a new plant overseas while continuing to export from its existing plant.¹¹ This would increase the number of firms/plants selling in each market by one, thus raising competition and reducing price by more than a merger. Hence this strategy can only be optimal if the cost of establishing a new firm, denoted Φ , is lower than that of acquiring an existing firm, the sum of the pre-merger profits of the target and the merger cost M .

In the case where foreign firm i chooses to engage in FDI and continue exporting from its existing base, expressions analogous to Eqs. (M.4) and (M.5) can be determined for prices in the three markets and outputs of each firm:

$$\tilde{p} = \tilde{p}'' = \tilde{p}^* = \frac{A + C + C'' + C^* + c_i}{N + 2} \quad (\text{M.11})$$

$$\tilde{h}_j = \tilde{u}_j = \tilde{f}_j = \frac{A + C + C'' + C^* + c_i - (N + 2)c_j}{N + 2} \quad (\text{M.12})$$

¹¹With no transport costs or tariffs, this is effectively just setting up a new division with the location of no importance. However in the next section, when tariffs are introduced, the location of the plant becomes crucial.

The increase in profits (after the payment of the fixed set-up cost) from this strategy is given by:

$$\Delta\pi^{FC} = 3\left[2\tilde{h}_i^2\right] - \Phi = 3\frac{2N+3}{(N+2)^2}(h_k + (N+1)R)^2 - \Phi \quad (\text{M.13})$$

M.2.2.3 Stage 1: Export Versus Merger Versus Greenfield FDI

We now compare the two strategies of the previous subsections with each other and consider whether the profits associated with the dominant outcome is greater than the fixed cost (Φ or M) to determine the outcome of Stage 1. If not the firm simply continues to export to the domestic market from its foreign plant.

Assuming symmetry in the three markets, profits earned by firm i under merger and greenfield investment can now be compared. Under symmetry, profits earned in each market are the same, while a firm that sets up a foreign plant incurs fixed cost Φ and/or faces merger costs M . The relevant profit terms are given in Eqs. (M.10) and (M.13) above.

If neither of these terms is positive the firm will choose to export to the domestic and union market from the foreign plant. If both are positive then we need to check whether greenfield investment or merger is the dominant strategy. The relevant condition is as follows:

$$\begin{aligned} \pi^{MC} - \pi^{FC} = & 3\left[N^4 - 14N^2 - 16 - 5\right]R^2 - 6(2N^2 + 5N + 3)R \\ & + 6(N-1)Rh_k - 3(2N+3)h_k^2 + (N+2)^2(\Phi - M) > 0 \end{aligned}$$

The inequality above leads directly to the following proposition:

Proposition 1: In the absence of tariffs, a firm is more likely to choose merger than greenfield FDI the greater is the cost advantage of the predator relative to the target and the lower is the fixed cost associated with a merger as opposed to that of establishing a new plant.

Proof: From the expression above,

$$\frac{\partial(\pi^{MC} - \pi^{FC})}{\partial R} = 6\left[N^4 - 14N^2 - 16 - 5\right]R - 6(2N^2 + 5N + 3) + 6(N-1)h_k > 0$$

$$\frac{\partial(\pi^{MC} - \pi^{FC})}{\partial \Phi} = (N+2)^2 > 0 \text{ and } \frac{\partial(\pi^{MC} - \pi^{FC})}{\partial M} = -(N+2)^2 < 0$$

The intuition behind Proposition 1 is clear. When merger costs are high, greenfield investment is more profitable when it involves a low fixed cost, while acquiring a domestic firm is cheaper when that firm has relatively high costs and is consequently less profitable.

For any given set of tariff settings (to be discussed in more detail below), there will obviously be some initial equilibrium involving a dominant firm with one or more plants and a set of competing firms where the firm is just indifferent between a take-over, establishing a new independent subsidiary or remaining autonomous. The remainder of the chapter focuses on the effects of tariffs on merger and investment activity in the context of this framework. In particular, we are interested in changes in the incentive to merge or engage in greenfield FDI as a consequence of relaxing these trade impediments.

M.3 Tariffs and Regional Integration

We start this section by introducing tariffs into the model above. We consider the cases of mergers and greenfield FDI separately, in each case first looking at the effects of tariffs on the equations derived in Sect. M.2 and then analysing the effects of regional integration, modelled as a reciprocal reduction in trade costs by partner countries. We use the general term PTA throughout to emphasise that our results, which consider the effects of reductions in intra-union tariffs alone, apply to both customs unions such as the EU and free trade areas such as the ASEAN FTA. Changes to the external tariff structure are beyond the scope of our analysis here, which we believe to be reasonable as our main focus in this chapter is on the ASEAN FTA, and as free trade areas do not require changes to their members external tariff structure.

What happens if we impose a tariff, t'' , on imports into the home market by firms from the potential PTA, and t^* on foreign firms located outside the potential union? This is equivalent to an increase in the marginal cost faced by union-partner and foreign firms, and hence these tariffs now appear in all the relevant equations above. For simplicity and to obtain analytical results, we assume some symmetry in tariff setting. Specifically, we assume that any pair of countries that do not belong to the same PTA set the same tariff rate, t^* , on each others' imports. The only deviations from this tariff rate are between the two potential partner countries, who set tariffs on imports from each other at the equal rate t'' . Note that we do not impose a zero tariff within the union, but we do assume $t'' \leq t^*$. This assumption allows us two advantages: first, we do not require a PTA to involve zero trade costs, which could be either due to the partners not moving completely to free trade or due to some other trade cost such as a transport cost; and second, we can consider marginal reductions in tariffs that can be thought of as representing progressive moves (rather than a jump) to free trade, in line with the experience of ASEAN.

M.3.1 Tariffs and Merger Activity

This section begins by setting out general expressions for prices and outputs in the presence of the tariff structure outlined above. We start by examining the basic

output and price equations before detailing the effects on merger profits. The tariff inclusive price in the home economy is:

$$p_t = \frac{A + C + \sum_{n^*} (c_j^* + t^*) + \sum_{n''} (c_j'' + t'')}{N + 1} \quad (\text{M.14})$$

$$= p + \frac{n^* t^* + n'' t''}{N + 1} > p$$

A domestic firm's sales to the domestic market rise (in the following equations, a superscript t signifies outputs when tariffs are imposed),

$$h_i^t = \frac{A + C + C^* + C'' + n^* t^* + n'' t'' - (N + 1)c_i}{N + 1} = h_i + \frac{n^* t^* + n'' t''}{N + 1} \quad (\text{M.15})$$

while a foreign firm's sales to the domestic market fall,

$$h_{i^*}^t = \frac{A + C + C^* + C'' + n^* t^* + n'' t'' - (N + 1)(c_{i^*} + t^*)}{N + 1} \quad (\text{M.16})$$

$$h_{i^*}^t + \frac{n'' t'' - (n + n'' + 1)t^*}{N + 1}$$

and for a firm in the potential partner country, u ,

$$h_{i^u}^t = h_{i^u} + \frac{n^* t^* - (n + n^* + 1)t''}{N + 1} \quad (\text{M.17})$$

As can be seen from Eq. (M.16), the sales of each foreign firm to the domestic market are raised by the effect of the tariff t'' against the other country, u , on the domestic price, but reduced by the influence of the t^* on its own sales. Obviously for the potential union partner, we can see from Eq. (M.17) that for some values of $t^* > t''$ sales could actually be higher than under free trade as a consequence of the home country's decision to impose or raise tariff t^* .

The effects of regional integration on two types of merger are now considered: a merger between two firms in the same country and the acquisition of a domestic firm by a foreign (non-partner) firm. The derivation of the results is in Appendix 1, here we concentrate on an intuitive explanation.

The main result is summarised in Proposition 2:

Proposition 2: The formation of a PTA and consequent reduction in tariffs increases the likelihood of a domestic firm being taken over. The most profitable takeover will, *ceteris paribus*, involve acquisition by a foreign firm.

Proof: See Appendix 1.

The reason for this result is that the reduction in regional-bilateral tariffs reduces regional production costs and effectively increases the potential sales and profitability of any firm producing within the region. However, the increase in profitability

is greater for more efficient firms, hence increasing the profitability of acquisition, at least with our assumption of complete technology transfer.¹² Additionally, the tariff-jumping motive for acquisition by a firm from outside the region increases, as profits fall for firms producing outside the region at the same time as rising for those producing inside. The net result is a greater increase in the profitability of acquisition by a foreign firm and, given domestic and foreign potential predators with the same costs, the foreign firm will be willing to pay more. This has clear policy implications, which are discussed in Sect. M.4 below.

M.3.2 Tariffs and Greenfield FDI

We again begin by considering the general tariff structure, before going on to consider the effects of PTA formation. In the expressions for outputs that follow, the numbers of domestic, union-partner and foreign plants are given in parentheses. This is done for clarity because greenfield FDI affects the number of plants in each location.

$$\begin{aligned} h_i^t(n+1, n^u, n^*) &= \frac{A + (C + c_i) + C^u + C^* + n^u t^u + n^* t^* - (N+2)c_i}{N+2} \\ &= \frac{N+1}{N+2} h_i^t \end{aligned} \quad (\text{M.18})$$

$$\begin{aligned} h_i^t(n+1, n^u, n^*) &= \frac{N+1}{N+2} h_i^t \frac{N+1}{N+2} \left(h_i + \frac{n^* t^{u*} + n^u t^u}{N+1} \right) \\ &= \frac{N+1}{N+2} h_i + \frac{n^* t^{u*} + n^u t^u}{N+2} \end{aligned} \quad (\text{M.19})$$

$$\begin{aligned} h_{i^*}^t(n+1, n^u, n^*) &= \frac{A + (C + c_i) + C^u + C^* + n^u t^u - (n + n^u + 2)t^* - (N+2)c_i}{N+2} \\ &= \frac{N+1}{N+2} h_{i^*}^t - \frac{t^*}{N+2} \end{aligned} \quad (\text{M.20})$$

$$\begin{aligned} h_{i^*}^t(n+1, n^u, n^*) &= \frac{N+1}{N+2} h_{i^*}^t - \frac{t^*}{N+2} \\ &= \frac{N+1}{N+2} \left(h_{i^*}^t - \frac{(n + n^u + 2)t^*}{N+2} \right) \end{aligned} \quad (\text{M.21})$$

¹²For discussion of the case when technology transfer is not complete, see Sect. M.4 below.

Similar expressions to (Eqs. M.18–M.21) can be found for outputs in the union-partner and foreign markets. Using these, we consider the effects of regional integration on the incentives for greenfield FDI. Formal derivations are contained in Appendix 2.

The effect of regional integration on the profitability of greenfield FDI relative to exporting is generally uncertain. This reflects the complex effects of a change in t'' on the profits of a multi-plant firm. Considering a fall in the intra-union tariff first on profits earned in the union-partner, the plant located in the domestic country will experience an increase in output and profits, while the plant in the foreign country will experience a fall in output and profits. In the domestic country, each of these plants will sell less and earn lower profits as union-partner firms gain market share. Although a fall in t'' will also reduce profits for a single-plant firm located in the foreign country, the effects on output and price will be less when there is one fewer firm in the market. Hence a fall in the intra-union tariff could increase or reduce the relative profitability of FC over exporting.

However, a stronger result can be obtained considering levels of t'' around zero, leading to the following proposition:

Proposition 3: A marginal reduction in the intra-union tariff to zero increases the incentive for a foreign firm to engage in greenfield FDI.

Proof: See Appendix 2.

Propositions 2 and 3 both suggest that regional integration is likely to increase foreign ownership in the region. The following section considers the welfare and policy implications of this.

M.4 Welfare and Policy Implications for ASEAN

As ASEAN continues moves towards deeper regional integration, there has been some concern over the potentially adverse effects of greater foreign ownership. Thanadsillapakul (2004) argues that ASEAN-level competition law and policy are important to “enhance regional economic strength and ensure that the regional market open to non-ASEAN trade and investment would prevent powerful trans-national corporations from entirely dominating the regional economy”. The author does, however, note that any competition policy should put the interests of the region’s consumers first. While recognising that applying a theoretical model directly to such a real-world case has its limitations, we now consider our model’s implications for consumer welfare and for competition policy. We then proceed to discuss how robust these implications are to generalising and relaxing some of our stronger theoretical assumptions.

In the framework set out in this chapter, both mergers and greenfield FDI as a consequence of regional integration appear to have clear benefits for consumers. Unlike in the traditional Cournot merger case, mergers do not result in a reduction in the number of producers selling in a market; instead, they replace an inefficient

producer with a more efficient one, leading to higher total output and lower prices for consumers. Greenfield FDI has even clearer benefits, as a new efficient producer enters the market without any firm leaving. Thus the total number of firms increases and the rise in output sold and fall in prices will be greater than with a merger.

This suggests at first glance that there is no need for competition policy aimed at restricting foreign ownership to accompany regional integration from the viewpoint of the region's consumers. This would seem to run counter to the conventional wisdom that greater concentration in the ownership of production is anti-competitive and damaging to consumers. The crucial difference from the conventional market-concentrating merger literature in this chapter is that firms choose an organisational structure that effectively allows them to run two independent plants after acquisition. Thus, the newly acquired domestic subsidiary will effectively compete against the union or foreign parent's imported product in the market. This may seem counter-intuitive but it must be remembered that this is an oligopolistic market and such a strategy squeezes their market rivals even more, and thus this strategy is equivalent to a commitment to capacity. Firms allowed this possibility will always choose to do so, leading to increased, rather than reduced, competition after the acquisition.

Rather than thinking of this type of strategy as a purely abstract theoretical possibility, we can call on European examples to show that mergers or acquisitions often lead to divisions of a single firm competing against each other. These sorts of mergers are represented by, for example, the Volkswagen/Audi group take over of Skoda and Seat. Post merger, these firms continued in operation as independent entities even though, in virtually all sectors of the market, at least two of the marques compete against each other with near identical products.¹³ https://ex1.bham.ac.uk/exchange/kendallt/Inbox/_ftn1

Similarly, Coca Cola licences European subsidiaries to produce its drink from concentrate, and while these licences have prescribed national, and even regional, boundaries, in practice competition between these independent subsidiaries is rife.¹⁴ There are also examples in the high-technology sector of manufacturers licensing their technology to producers who then compete against them downstream for contracts.¹⁵ Other relevant examples are provided by BMW's purchase of Rover, Grand Met's merger with Guinness (and latterly Seagram), and many of the the 1980s mergers where corporate raiders and cash-rich tobacco and oil companies purchased a wide range of disparate firms, on the grounds that they were bringing superior management techniques to other industries. Thus, arguably, the sorts

¹³In each sub group there are at least two competing models from each division in European Markets. For example, there are versions of the VW Sharan and Seat Alhambra, Audi A6 and VW Passat, and Skoda Octavia and VW Golf where even cosmetic differences are difficult to detect.

¹⁴Recently, when there was found to be a contamination fault with a batch of Coke in Belgium, the extent of parallel trade in syrup by licensees was such that Coke could not identify the source.

¹⁵For example, Ericsson and Motorola license production of phone system components to firms who subsequently compete against them in contract bids.

of mergers studied here represent a significant proportion of all the takeover and merger activity of the last two decades. While not all of these mergers have attracted the attention of competition authorities, because technology transfer is frequently at the heart of the merger incentive, this chapter suggests that despite the inherent difficulties with measuring cost implications of mergers, competition authorities must give significantly more weight to the possibility of cost and efficiency gains.

The examples above from Europe, together with our theoretical analysis, suggest that deeper regional integration in East Asia could bring about a wave of mergers and acquisitions that have pro-competitive effects. The creation of a regionally integrated market will make both mergers and greenfield FDI more profitable, and hence more likely, compared to exporting and thus will increase gains to consumers within the region. It follows that any competition policy that has the interests of consumers at its heart should in general be sympathetic to both greenfield FDI and acquisitions by efficient foreign firms.

However, this is not to say that there is no role for competition policy alongside PTAs. The effects of regional integration on the profitability of acquisition by domestic and foreign firms are asymmetric, as explained in Sect. M.3. Consider the case of three firms, based in Thailand, Malaysia and the EU, competing to take over a less efficient Thai firm. Regional integration will affect the incentives faced by these firms. Crucially, regional integration differs from global reductions in tariffs in that it affects partner and non-partner countries differently. A global tariff reduction means that the incentives for an EU firm and a Malaysian firm will be affected equally. In fact, a global reduction in tariffs to zero would ensure that any takeover would involve the most efficient firm as the acquirer, regardless of location. However, regional integration has differential effects, especially when considering a marginal fall in the union tariff, which stays above zero. This will have the least effect on the Thai potential predator, which already has a presence in the Thai market. The Malaysian firm will have a greater incentive to acquire the inefficient firm as, although it already has a presence in the region, there would still be some tariff-jumping effect if it had a presence in Thailand as well. The gains from having tariff-free access to both markets outweigh the gains to the Thai potential predator from having an extra presence in its local market.

However, the firm with the greatest incentive to make the acquisition is the European firm, as it has a greater (relative) tariff-jumping motive. Prior to any acquisition, the Malaysian firms will be capturing more of the Thai market (and *vice versa*) but by locating in the region, the European firm can gain a larger market share. Regional integration increases this effect as a plant in Thailand has improved access to the Malaysian market and hence becomes a more profitable base for supplying the entire region. Thus, regional integration in the ASEAN region will provide a strong incentive for European firms to locate in that market.

It follows that, when the three potential predators have equal costs, the European firm will have the greatest incentive to make the acquisition. More worryingly, for some range of cost differences a less efficient European firm would outbid a more efficient potential predator in the ASEAN region. In addition, the fact that technology gains associated with a merger may be only marginal, or that a regional firm may

be taken over by a less-efficient tariff-jumping firm, raises the possibility of welfare losses and hence a clear role for competition policy. These factors would limit the potential welfare gains from regional integration: consumers would gain less as the predator would not be the firm with the lowest costs, and consumers might even lose if production costs rise on aggregate, while profits that would otherwise be earned by a firm within the region will instead leave the region. Hence, we argue that the most important role of competition policy in the ASEAN region is to prevent such cases and to limit acquisitions of firms in the region by firms from the rest of the world, when they could instead be acquired by equally or more efficient firms located in the region. Unfortunately, for any regulator, the decision on whether to allow a merger or not is likely to depend crucially on the extent of any improvement in productivity associated with a transfer of either technological or managerial advantage, something which has been notoriously difficult to measure. If the advantage is due to managerial practices it might be a reasonable prior to argue that these are culturally more exportable within rather than between regions, on the other hand much of the productivity improvements in the EU automotive industry owe a debt to the importation of Japanese managerial practices in the 1980s and early 1990s.

Furthermore, while our model has assumed perfectly transferable technology, clearly this is likely to be a major issue in practice.¹⁶ In the analysis above we assumed that, post-merger, the less efficient firm, j , employs the technology of the more efficient firm,

$$i, \tilde{c}_j = c_i, \text{ where } \tilde{c}_j \text{ indicates the target's post-merger marginal cost.}$$

Thus, the abolition of a regional tariff made an intra-regional merger (where the most efficient partner firm acquires the least efficient home firm) more attractive. We thus have the case of a (new) more efficient division displacing sales by less efficient home producers. So since overall output rises, aggregate cost are lower and the price falls, aggregate welfare unambiguously rises.

However, in practice technology may not be perfectly transferable, for example, where a production advantage was due more to culturally-determined managerial and work practices rather than pure technology. Suppose instead that $\tilde{c}_j = c_i + \delta(c_j - c_i)$ where $\delta \in (0,1)$ is a measure of the transferability of technology (where $\delta = 0$ indicates free transfer and $\delta = 1$ indicates that technology transfer is not possible). In this case it could be that the intra-region merger with the least-efficient domestic firm might result in only a marginal improvement in its costs and hence its increased output merely displaces the output of more efficient producers (some subset of the other home and partner firms). In this case we are in a world akin to that analysed by Lahiri and Ono (1988), who showed that marginal improvements in the technology of the weakest firm in an oligopolistic market displace some output of more efficient firms, and if production costs increase in aggregate this will result in higher prices and reduced consumer welfare.

¹⁶The issue of imperfectly transferable technology is dealt with theoretically in Ryan and Kendall (2005), alongside the case of differentiated products discussed below.

One other caveat should be mentioned. The formal analysis thus far has assumed a homogenous good, when perhaps many of the markets we think of as oligopolistic (automobiles, electrical products) involve (slightly) differentiated products. In Ryan and Kendall (2005) we study a differentiated goods version of the model and the key difference is that in this case a market-concentrating merger merely involves exploiting joint monopoly power (over the differentiated aspect of the market) rather than a shut-down of the target. However, in this richer version of the model the bulk of the results above continue to stand, with one important caveat. As the market becomes more concentrated, at some point a predator will switch from running the newly acquired firm as a distinct division to running all divisions as an integrated, market-concentrating firm. In these circumstances the concerns about potential welfare losses associated with globalisation or regionalisation identified in the homogenous market-concentrating literature (see, e.g., Long & Vousden, 1995) arise. Thus, a regional competition-regulator will have the additional task of evaluating when an additional merger may induce a predator to switch behaviour from what is effectively a competition-enhancing strategy to a market-concentrating strategy.

Although it is somewhat beyond the scope of the model analysed in this chapter, it is worth noting that similar issues might occur relating to the establishment of new plants. We have not directly considered divisionalisation by domestic firms in our model, with only foreign firms allowed to set up a new plant. However, the analysis of mergers suggests a similar story here. Integration of the ASEAN economies will create greater incentives for firms from outside the region to establish a new plant than for those based in the region. Hence a new plant might be established by a European firm rather than by an equally or more efficient Thai firm. Again, this could prevent the full benefits of integration from being experienced by ASEAN members.

To summarise, evaluating the effects of changes in intra-union tariffs leads to the conclusion that such regional initiatives are likely to favour foreign predators over (possibly) more efficient domestic market leaders due to the external tariff-jumping motive. Both mergers and greenfield FDI become more profitable, relative to exporting, for the foreign firm as a result of regional integration. Hence, customs union formation is likely to result in more foreign-owned plants within the union. This suggests that, in the absence of competition policy to regulate ownership by foreign firms, the full potential welfare benefits of ASEAN economic integration might not be accrued.

M.5 Conclusions

This chapter has presented a model in which foreign firms choose between exporting, greenfield FDI and acquiring a domestic firm as means of supplying the domestic market and considered the implications for welfare and competition policy for ASEAN members. A foreign firm that chooses to either merge with a

domestic firm or set up a new plant will also continue to export from its original base. Merger is more likely to be preferred to greenfield investment when there is a larger cost difference between the predator and the target and when the fixed cost of establishing a new plant is high relative to the fixed cost of merging. Regional integration will make both mergers and greenfield FDI more profitable and hence more likely compared to exporting and hence will increase gains to consumers within the region.

Evaluating the effects of changes in intra-union tariffs leads to the conclusion that such regional initiatives are likely to favour foreign predators over (possibly) more efficient domestic market leaders due to the external tariff-jumping motive. Both mergers and greenfield FDI become more profitable, relative to exporting, for the foreign firm as a result of regional integration. Hence customs union formation is likely to result in more foreign-owned plants within the union.

The results in this chapter have clear policy implications. While regional integration has definite benefits for consumers, the firms most likely to benefit are those from outside the customs union. Any takeovers of domestic firms are more likely to be by foreign predators, while more inward investment will be attracted. This will reduce the market share and profitability of domestic firms. Hence, while regional integration is often advocated as a way of promoting domestic and union-partner firms, our model suggests that the opposite might be true.

At the same time, the main consumer gains from regional integration could come from the increased presence of efficient foreign firms within the region. This suggests that ASEAN competition policy needs to balance the gains for consumers with the distorted incentives for foreign firms to produce in the region.

Appendix 1: Regional Integration and Mergers

Case A: Merger Between Home Firms 1 and n

$$\begin{aligned}\Delta\pi &= \tilde{h}_1^{t^2} - h_1^{t^2} + \tilde{h}_n^{t^2} - h_n^{t^2} + \hat{u}_1^{t^2} - u_1^{t^2} + \hat{u}_n^{t^2} - u_n^{t^2} + \hat{f}_1^{t^2} - f_1^{t^2} + \hat{f}_n^{t^2} - f_n^{t^2} - M \\ &= [h_1^t - R]^2 - h_1^{t^2} + [h_n^t + NR]^2 - h_n^{t^2} + \hat{u}_1^{t^2} - u_1^{t^2} + \hat{u}_n^{t^2} - u_n^{t^2} \\ &\quad + \hat{f}_1^{t^2} - f_1^{t^2} + \hat{f}_n^{t^2} - f_n^{t^2} - M\end{aligned}$$

Using the following substitutions, where $R = \frac{c_n - c_1}{N+1}$:

$$h_1^t = h_1 + (N+1)R + \frac{n^* t^* + n^u t^u}{N+1}; h_n^t = h_n + \frac{n^* t^* + n^u t^u}{N+1},$$

$$u_1^t = u_1 + (N+1)R + \frac{n^* t^* - (n + n^* + 1)t^u}{N+1}; h_n^t = h_n + \frac{n^* t^* - (n + n^* + 1)t^u}{N+1}$$

$$\text{and } f_i^{t^*} = f_i + (N+1)R - \frac{(n+1)t^*}{N+1};$$

$$f_n^{t^*} = f_n - \frac{(n+1)t^*}{N+1}$$

we get:

$$\begin{aligned} \Delta\pi &= 3(N^2 - 2N - 1)R^2 \\ &+ 2 \left\{ (N-1)(h_n + u_n + f_n) + [(2n^* - n - 1)t^* + (n'' - n - n^* - 1)t''] \right\} \frac{(N-1)}{N+1} \Big\} R - M \end{aligned}$$

$$d\Delta\pi / dt^* = (2n^* - n - 1) \left\{ \frac{N-1}{N+1} \right\} R$$

which under symmetry of n and n^* is positive. That is, a rise in the general level of external tariffs makes a merger more profitable as it increases the price, sales and profits in both the home and partner country for both firms and hence increases the benefits from passing on the superior technology.

The effect of a decrease in the intra-union tariff on profitability is given by

$$d\Delta\pi / dt'' = (n'' - n - n^* - 1) \left\{ \frac{N-1}{N+1} \right\} R$$

and the derivative is negative if the two union countries are symmetric. Thus, under symmetry mergers become more attractive as the internal barriers are removed. If the partner is large however, (i.e., $n'' > n$) then the profitability of a purely domestic merger may decline as tariffs fall since the rise in its share of the domestic market exceeds the domestic firm's increased share of the partner market.¹⁷

Case B: Merger Between Foreign Firm 1 and Home Firm n

Now we consider an international-union merger where a foreign predator takes over a target firm where both union countries impose a symmetric tariff and the foreign country is outside the Union. Home country has tariff t^* and t'' against foreign countries and union countries respectively and facing tariffs t^* and t'' in the reciprocal market.

¹⁷This is of course taking the number of firms as exogenous, whereas in future research they could be determined endogenously.

$$\Delta\pi = \hat{h}_{1*}^{t^2} - h_{1*}^{t^2} + \hat{h}_n^{t^2} - h_n^{t^2} + \hat{u}_{1*}^{t^2} - u_{1*}^{t^2} + \hat{u}_n^{t^2} - u_n^{t^2} + \hat{f}_{1*}^{t^2} - f_{1*}^{t^2} + \hat{f}_n^{t^2} - f_n^{t^2} - M$$

Using the following substitutions, where $R = \frac{c_n - c_1}{N+1}$:

$$h_{1*}^t + \frac{n^u t^u - (n + n^u + 1)t^*}{N+1}; h_n^t = h_n + \frac{n^* t^* + n^u t^u}{N+1},$$

$$h_{1*}^t = u_{n*} + (N+1)R + \frac{n^u t^u - (n + n^u + 1)t^*}{N+1}$$

$$h_n^t = h_n + \frac{n^* t^* - (n + n^* + 1)t^u}{N+1}$$

and $f_i^{t^*} = f_i + (N+1)R + \frac{(n + n^u)t^*}{N+1}$;

$$f_n^{t^*} = f_n - \frac{(n+1)t^*}{N+1}$$

We get:

$$\Delta\pi = 3(N^2 - 2N - 1)R^2 + 2(N-1)(h_n + u_n + f_n)R + \left[\{N(2n^* - n - 1) + n + n^u + 2\}t^* + \{N(n^u - n - n^* - 1) - 2n^u\}t^u \right] \frac{2R}{N+1} - M$$

$$d\Delta\pi / dt^* = \left[\{N(2n^* - n - 1) + n + n^u + 2\} \right] \frac{2R}{N+1}$$

Under the assumption of symmetry, this derivative is positive and merger profitability rises as the external tariff rises (tariff jumping a).

$$d\Delta\pi / dt^u = \left[\{N(n^u - n - n^* - 1) - 2n^u\} \right] \frac{2R}{N+1}$$

Under the assumption of symmetry, this derivative is negative and merger profitability rises as the internal tariff is lowered. The key question now is whether the merger is more attractive for the internal or external predator. To answer this, the profitability of takeovers by domestic and foreign firms must be compared. The following expression gives this difference:

$$\begin{aligned} & \left\{ \left[\{N(2n^* - n - 1) + n + n^u + 2\}t^* + \{N(n^u - n - n^* - 1) - 2n^u\}t^u \right] \right. \\ & \quad \left. - \left[(2n^* - n - 1)t^* + (n^u - n - n^* - 1)t^u \right] (N-1) \right\} \frac{2R}{N+1} \\ & = \left[\{n^u + 2n^* + 1\}t^* + \{3n^u - n - n^* - 1\}t^u \right] \frac{2R}{N+1} \end{aligned}$$

Under symmetry and for $n > 1$, this is positive so the external firm will bid more.

Appendix 2: Regional Integration and Greenfield FDI

Exporting versus Greenfield FDI

This appendix considers the foreign firm's choice between exporting and setting up a plant in the domestic and/or union partner countries while continuing to produce in the foreign country. Comparing profits earned by the foreign plant in all three markets to profits earned by the two plants with greenfield FDI, the following condition is derived:

$$\begin{aligned} \pi^{FC} > \pi^{EX} \Rightarrow & 3(N^2 - 2)H^2 + 2(N + 1)^2 H[-(n^* + 1)t'' + (n^* - 1)t^*] \\ & - 2(2N + 3)[(n'' + n)t'' - (n + n'' + 1)t^*] \\ & + (N + 1)^2 (t'')^2 [2(n'')^2 + 2n''n^* + 2n'' + (n^*)^2 + 2n^* + 1] \\ & - (2N + 3)(t'')^2 [(n'')^2 + n^2] + (N + 1)^2 (t^*)^2 [3(n^*)^2 + 2n^* + 1] \\ & - (2N + 3)(t^*)^2 [3(n + n'')^2 + 4(n + n'') + 1] - 2(N + 1)^2 t''t^* [(n^* + 1)n^*] \\ & + 2(2N + 3)t''t^* [(n + n'')(n + n'' + 1)] - (N + 1)^2 (N + 2)^2 \Phi > 0 \end{aligned}$$

It is immediately and intuitively clear that an increase in the cost of setting up a new plant, Φ , will make greenfield investment less likely. More interesting is the effect of a change in the intra-union tariff. To analyse this, the partial derivative with respect to t'' is taken, yielding the following expression:

$$\begin{aligned} & -2(N + 1)^2 (n^* + 1)H - 2(2N + 3)(n'' + n)H \\ & + 2(N + 1)^2 [2(n'')^2 + 2n''n^* + 2n'' + (n^*)^2 + 2n^* + 1]t'' - 2(2N + 3)[(n'')^2 + n^2]t'' \\ & - 2(N + 1)^2 (n^* + 1)n^*t^* + 2(2N + 3)(n + n'')(n + n'' + 1)t^* \end{aligned}$$

The sign of the above expression is uncertain. This reflects the complex effects of a change in t'' on the profits of a multi-plant firm, as discussed in Sect. M.3.

However, a stronger result can be obtained considering levels of t'' around zero, leading to Proposition 3.

Proof of Proposition 3: Evaluating the expression above at $t'' = 0$ gives:

$$-2(N + 1)^2 (n^* + 1)(H - n^*t^*) - 2(2N + 3)(n'' + n)[H - (n + n'' + 1)t^*]$$

This expression is definitely negative, meaning that a reduction in the intra-union tariff from a low level to zero will always raise the relative profitability of greenfield FDI compared to exporting.

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