Focus

The Transition Economies and the European Union’s Eastward Enlargement

Since 1990, the debate over reforms in the transition countries and the enlargement of the European Union has underlined the importance of reducing income differentials between Eastern and Western Europe. Significant efforts still have to be made everywhere, but there is clearly an increasing divergence in economic fortunes throughout the region. If such trends continue, they will weigh heavily on Europe’s future equilibrium, especially if the more advanced countries are rapidly integrated into the European Union, thus potentially crowding out the rest of the region from the inflow of resources.

The first years of transition saw recessions in the countries of central and Eastern Europe cutting output by 20 to 40%. More recently, some countries have returned to growth, often at over 5%. Furthermore, such growth appears to be self-sustaining as the sharp fiscal cuts of the years 1991-93 are being overcome, and capitalisation is being pursued, while productivity gains remain high and real exchange rates are appreciating rapidly. In contrast, several years of falling output are being followed by slow microeconomic adjustment and strong inflationary pressures in the countries of the Balkans and the Former Soviet Union (FSU). This is weakening their social equilibrium, on which any future growth will be based. These trends may undermine the legitimacy of reforms, as well as the position of the economic and political elites who have defended them.

Indeed, the increasing divergence within post-socialist Europe is likely to put pressure on the continent’s equilibrium. It will also strain the European Union’s regional cooperation policy, and could in the long run affect the conditions of overall convergence. Such a situation results partly from the internal constraints facing the transition economies, on which outside actors have little influence: it is generally observed that countries which can make the best use of foreign aid are those that a priori require least aid. In contrast, financial and technical assistance, as well as trade liberalisation, tend to have a limited impact on economic structures emerging from greater inertia. This is one of the principal reasons why membership of the Union should only be offered to those countries which have proved that they are able to benefit from it. Precipitating integration may otherwise lead to a relaxation of the drive to reform as statism behaviour develops, or may even lead to the crowding out of agents who have already adapted to strong constraints of competitiveness.

Initiatives by the European Union could ‘top-up’ growth of new members, hence exacerbating divergence in the CEECs.

That said, the various initiatives of the European Union may themselves exacerbate divergence, over and above the specific paths taken by the transition countries since 1990. More specifically, if a (likely) ‘first wave’ of enlargement takes place within the next ten years, benefiting the more
advanced countries, they will inevitably have the effect of ‘topping-up’ already fast rates of growth, and will hence accentuate the divergence between the ‘insiders’ and ‘outsiders’. Indeed, the opposite would indicate that integration has failed, at least from an economic point of view. Two effects must therefore be distinguished. First is the autonomous acceleration of new members, whose growth will be topped-up by integration into the Union, as has been the case with Spain and Portugal. Second are the possible rates of a diversion of resources, which would favour ‘insiders’ at the expense of ‘outsiders’, if crowding out were to follow in the wake of the dynamic of independent growth. Access to Union funding (Structural Funds, the Common Agricultural Policy, etc.) should not lead (at least directly) to a redistribution of resources in eastern Europe, as in a zero-sum game.

It must therefore be asked whether a more balanced approach is possible, or whether discrimination between candidates for membership will inevitably lead to a worsening outlook for the less advanced. These are three reasons suggesting a pessimistic answer to this question.

To begin with, there is a strong risk that foreign direct investment will concentrate on the fast members of the Union, due (among other things) to the guarantee of integration within the Single European Market, the rapid convergence of institutions and legal systems, and the prospect of sustained domestic growth. In contrast, countries in the second group will likely only be able to capitalise on their low labour costs, putting them into direct competition with the developing world. This may lead to a quality hierarchy in trade with these countries, rather than the more dynamic and more diversified international trade patterns of the central European economies, based on specialisation.

Integration of the ‘first wave’ of new members is likely to be complex, and risks pushing back the membership of others.

Ultimately, the European Union, having contributed to the success of the first phase of transition reforms, may put off integration of countries that are not able to close the development gap sufficiently themselves. Thus, the internal constraints of transition economies and of the Union may, along with the behaviour of private agents, lead to an over-concentration of resources in a limited number countries, which would in turn be detrimental to the overall equilibrium of the region.

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Private foreign direct investment is likely to concentrate in the ‘first wave’ of new members.

At the same time, the realistic prospects of relatively rapid membership should encourage economic and political agents’ expectations to evolve rapidly, and should hence accelerate the adjustment of behaviour by companies, as well as banks and public administrations. Indeed, such a ‘concentration’ of collective efforts is already be witnessed in central Europe, and will likely raise the present benefits of reform, especially as these are held to be promising made about the near future. By comparison, where such factors are weaker, the legitimacy of the transition risks being eroded, while the temptation to relax reform efforts may rise.

For further information see:
- **Greece: Incomplete EU Membership?**
  A.F. Ceri and J. Spurk
- **A European View of the Transition Economies**
  J. Spurk
  Erasmus University
  Nijmegen, The Netherlands
  1993.
- **A European View of the Transition Economies**
  J. Spurk
  Erasmus University
  Nijmegen, The Netherlands
  1993.
- **The European Direct Investment Committee**
  E. F. Lemée
  CEPR
  London
  1994.

Lastly, a third form of crowding out may follow on from the (currently underestimated) complexity of the enlargement process itself, which could lead to the Union’s collective activities being over-burdened, and to its institutions being submerged with ‘systemic noise’. This might lead to a reduction in the Union’s resources needed to prepare for the second wave of membership, thus possibly pushing it even further into the future. Unless the tangible content of membership is cut, which would be in no-one’s interest, the eastward enlargement of the Union is likely to prove far more complex than the integration of Portugal, Greece or Ireland, countries whose initial economic structures were much closer to those of existing members. In other words, the efforts needed to adapt to the constraints of the Single Market may consume so much time and energy, both in Brussels and in member countries, that this itself will likely push back the launching of the second wave of membership, while stripping it of its credibility.
RESEARCH SUMMARY

The Transmission of Monetary Policy in Europe

In most industrialized countries, central banks' monetary procedures have converged on the control of money market interest rates. However, despite the general use of this instrument, the interaction with the real economy is complex, and monetary policy does not act through a single transmission channel. Instead, several different channels are commonly considered in the economic literature: money, credit, and the exchange rate. The relative importance of these different channels conditions the effectiveness of monetary policy, and it seems likely that they may differ from one country to another, or even from one period to another within the same country. Therefore, a certain monetary stance may have different macroeconomic consequences from one country to another. This issue is especially important within the context of the EMS, where a common monetary policy is implemented, the likely effects of a change in interest rates need to be fairly similar, from one country to another, or at least, unwanted distortions may follow.

This study investigates the effects of monetary policy in the six countries of the European Union for which quarterly national accounts are available, in sufficiently large samples, namely: Austria, Denmark, Finland, France, Germany, Italy, the Netherlands, Spain, and the United Kingdom. It first reviews some key characteristics of the national financial systems, which may lead to divergence in monetary transmission across countries. Subsequently, identified Vector Autoregression Models (VARs) are used for assessing the effect of monetary policy on economic activity. The rate of transmission channels is then addressed, especially in analysing a possible credit channel.

A first source of divergence stems from the way variations in the money market rate, which is set by the central banks, spread to other markets. For instance, a one-percentage-point change in the money market rate does not lead to a similar and instantaneous increase in the lending rate. Thus, the adjustment of bank rates for final borrowers to money market rate variations appears to be particularly slow in France, Denmark, and Finland, but very rapid in the United Kingdom. A second source of divergence comes from the fact that credit information practices vary greatly across Europe. For example, mortgage credits are secured mainly at fixed rates in France and Austria, but are variable in other countries. Ease of access to credit is a third factor which also seems to lead to heterogeneity. This can be seen in the housing credit market, where minimum down-payment conditions range from 5% in the UK, to 40% in Italy. Divergence may also stem from the different degrees of integration, of openness and dependence of the trade balance on exchange rate variations.

Access conditions to mortgage credits and the interest regimes of such credits vary substantially across Europe.

Several methods have been used in the economic literature to evaluate the impact of variations in interest rates. Traditional, national macroeconomic models provide results which are difficult to compare from one country to another, because they are based on different specifications. Multinational macro-economic models do not use such drawbacks, but their results depend largely on the modelling choices made. The VAR models meet these two objections as they are similar across countries, and are generally based on a minimal set of assumptions about the functioning of the economies analyzed. In particular, no constraint is generally imposed on the lag coefficients, but rather on long-term or instantaneous interactions. The VAR models constructed here allow for the effects of an interest rate shock on real activity to be simulated in the six European countries listed above. The money market rate is assumed to be the instrument of monetary policy in each country. In order to facilitate the comparison, the same identifying assumptions are made everywhere. They only restrict the contemporaneous interactions among macroeconomic variables, which are assumed to form a recursive system: monetary authorities are supposed to react contemporaneously to the economic variables that are included in their reaction function. Conversely, monetary policy affects economic variables only with a lag of one quarter.

For each country the first model includes GDP, the consumer price index, the exchange rate to the Deutsche Mark (or dollar for Germany), and a short term interest rate. The index for international export prices is added for taking into account world price movements.

Simulations show that a restrictive shock is monetary policy leads to a fall in GDP compared to the baseline (see graph). GDP starts falling immediately after the interest rate shock. The negative impact appears to be particularly strong in Germany, and fairly similar in the other countries. The effects on production are generally transitory, and are absorbed progressively over the long term. The maximum impact is spread out over 1 to 2.5 years, depending on the country.

The reaction of macroeconomic variables to monetary policy impulses are generally considered as particularly strong and rapid in the United Kingdom, due to the high inflation of debt on the
short-term bank rate. However, in these simulations, the size and lags of the GDP response differ little in the United Kingdom and in France. One explanation for this paradox may be found in price shifts, which follow the rise in interest rates. This is partly due to the fact that the retail price index in the United Kingdom includes mortgage interest rates. Thus, a rise in interest rates in the United Kingdom tends to increase rather than to decrease inflation. This moderates the rise in the real rate of interest, softening the impact on real activity. The delays in the response of GDP to monetary shocks are largest in Germany, with the maximum impact occurring two and a half years after the shock. GDP trajectories generally depend on the pattern of interest rate shifts after the initial shock, which then become endogenous via the intermediation of the Bundesbank's reaction function. This affects the results of the simulations. For example, as increases or decreases in interest rates are generally carried out very gradually in Germany, they also tend to be more persistent, their impact lasts over a longer time and so is stronger.

Other VAR models have been used to distinguish the effects of the components of final demand and also to assess the importance of the different transmission channels of monetary policy. Contrary to what would be expected for very open economies, the exchange rate channel does not seem to reinforce the impact of monetary policy in most European countries. This may be explained by the fact that most of the countries in the sample are members of the EMS, with the management of exchange rates being carried out jointly with other countries, and hence countervailing variations in exchange rates stemming from monetary policy. Finally, some tests on the countries studied show that the credit channel could be effective in Europe, as credit has a tendency to contract more than money, in the wake of a negative monetary shock. However, more detailed tests by institutional sector, for France and Germany, do not seem to confirm this hypothesis.

Recent empirical work has shown how bank practices vary across countries, even within the European Union. These empirical estimates using identified-VARs show that the main standard effects of monetary policy can be found in most European countries, and that responses and lags are similar across countries. However, the magnitudes may differ. Moreover, different bank practices and regulations across countries lead to some variations in the response of the components of final demand. For instance, in those countries where credit access for households is more restricted (e.g., Italy), monetary policy shocks seem to have less impact on residential investment. This is also true in countries like France, where preferential loans are still significant.

Some differences in the transmission of monetary policy may disappear with monetary union. This will be the case of the exchange rate channel, the intensity of which is linked to the openness of the economy, and also to the degree of commitment by monetary authorities to exchange rate targets. This may now typically constitute a source of divergence among European countries, but will immediately disappear with monetary union. However, other differences reviewed here may persist, at least for several years. Access to credit, for example could ultimately be harmonised, as competition between European retail banks will be boosted by monetary union. But, convergence will take time.

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For further information see:
- The Transmission of Monetary Policy in the European Countries, F. Barban, V. Courbet and B. Moguer, CEPII WORKING-PAPER NO 96/02, FEBRUARY 1996.
- L’Europe en-boucle ou une homogénéisation pour la politique monétaire ?, F. Barban, V. Courbet and B. Moguer, ECONOMIA INTERNATIONAL No 65, 1ST QUARTER 1996.
RESEARCH AGENDA

FISCAL REINFORCEMENT REVISITED

In Europe, the deterioration of public finances and the preparation for monetary union make large-scale fiscal adjustments necessary. Keynesian theory indicates that this will significantly dampen growth. However, recent research suggests that a return to debt sustainability can exert positive effects on private agents' demand, both directly, as it signals that taxes will not have to be raised, and indirectly via a drop in the risk premium on interest rates.

This project (conducted with researchers at INSET) examines the empirical evidence by selecting all large-scale fiscal adjustments, both expan- sionary and contractionary, in the OECD since the mid-1970s. It suggests that the output cost of fiscal reinforcement may not be proportional to the size of the adjustment effort, as is generally assumed in standard macroeconomic models. Yet the 'painless adjustment' thesis is by no means prevalent, even though a number of countries have been able to control their public finances at relatively low cost.

The project investigates the reasons for such divergences, including: the situation of public finances when the adjustment is undertaken, the accompanying monetary policy; the extent and composition of the fiscal effort, as well as the size and openness to foreign trade of the country. Furthermore, research will test for possible selection bias as costly adjustments may be interrupted because of their dampening effects on the economy. Finally, consumption and investment behavior of private agents are tested econometrically, to show any irregularities during the periods of adjustment.

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TRADE AND EMPLOYMENT: A GENERAL EQUILIBRIUM MODEL

The growing role played by a certain number of emerging countries has greatly affected international trade in manufacturing product over the last twenty years. This phenomenon is likely to be accentuated by the rapid growth of these BRICs (Brazil, Russia, India, China). The present study sets out to analyse the future impact of this phenomenon on European labour markets.

Simulations rely on a comparable general equilibrium model, comprising the European Community, a rest-of-the-world zone, and the emerging countries. These are characterized by wealth levels clearly below the OECD average, along with a rising share of world trade. Their economies are broken down into thirteen sectors, of which eleven are in manufacturing. Three production factors are also used, namely: capital, skilled labour and unskilled labour. Goods are also differentiated, using various levels of quality, but goods produced by emerging countries are of a similar nature to those produced in the developed countries. Given economies of scale, oligopolistic competition between Cournot takes place in manufacturing sectors. Depending on the sector, adjustment to market variations occurs via the number of firms present and their size.

The reference scenario put forward here is based on a doubling of the relative size of the emerging countries. This shock has a positive impact on Europe's welfare, though the benefits are distributed unequally. Real wages for skilled labour rise by 0.6%, and real returns on capital increase by 0.1%. By comparison, real wages for unskilled labour fall by 0.1%.

The main conclusion is that the scale of these effects is small. This reflects the strength of mechanisms which screen the impact of the growth in the emerging countries, including: product differentiation, sector entry barriers, general equilibrium constraints, and long-term trade balances.

Further research is presently based on generating more detailed data at a sectoral level and by labour sector, rendering the effects of international competition more endogenous in the production function, and, using a more realistic description of the labour markets, especially concerning employment-wage elasticity.

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JAPANESE FOREIGN INVESTMENT IN ASIA

The relocation of Japanese industrial production in Asia was triggered by the massive appreciation of the yen in 1985 (crisis2), and accelerated further in 1983 as the Japanese currency continued to rise. This project examines whether these trends may or may not lead to a long-term deindustrialization of the archipelago. The project shows how Japanese, overseas industrial production has developed rapidly, though for a long time Japan lagged behind the other major industrialised countries in this area.

Trade and foreign direct investment flows between Japan and the rest of Asia are examined, in order to highlight the way the trade cycle has developed in this region. This cycle is linked to the different phases in the maturity of foreign direct investment: to begin with, Japanese export-oriented businesses and component parts were stimulated strongly. This was followed by exports of increasingly sophisticated components. The last phase in the cycle concerns the importation of finished goods, produced in Japanese-made components and parts, goods which compete or replace domestic production in Japan. To prevent an unfavourable, boomerang effect from squeezing out production and employment in parent companies, during the final phase of the cycle, the latter have to shift their production upstream and into new areas.

Far from weakening Japan's industrial fabric, the rapid relocation of production may, on the contrary, act as a catalyst for overhauling capacity, giving rise to new activities, at least until such time as the industry.

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  L. Forges (CEPII, Université de Paris I), M. Freudenberg (CEPII),
  H. Lassalle-Durández (Université de Paris I), D. Unal-Esen of (CEPII)
  13 January

- Flexible Integration Towards a More Effective and Democratic Europe
  N. Boyer (CEPEAEP, CNRS, EHESS),
  M. Delaun (CES), M. Delauney (Université libre de Bruxelles, EGBEE, CEPRE),
  J. Floris, F. Camba (CEPII),
  G. Talmoral (Université compossible dans une économie de marché)
  19 January

- The International Debt Strategy: Past and Future
  W. S. Cline (IFRI, Washington), J. Sgard (CEPII)
  19 March

- The Path to Local Industrial Development in Germany: How Long Will It Be?
  S. L. Opescher (IFR, Munich)
  14 March

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  J. Williamson (IFRI, Washington)
  26 March

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  E. Borel (CEPII, Brussels),
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  M. Fugas (CEPII), A. Meiri (CEDELS)
  27 March

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  S. Cline (IFRI, Washington), J. Fugas (CEPII),
  A. Meiri (CEDELS)
  27 March

- Foreign Direct Investment to China: The Future of the World Economy
  C. D. White (CEPII, Brussels),
  J. Sgard (CEPII, Brussels),
  L. Dorembach (INSF, CEPII),
  A. Meiri (CEDELS)
  26 April

- The World Economic Outlook: Globalization and the Future of the G7
  (Jointly organized with the World Bank) J. D. C. Charles (World Bank, Washington),
  C. D. White (CEPII, Brussels),
  L. Dorembach (INSF, CEPII)
  16 May

News in Brief

- A high-level seminar was jointly organised in Paris in May, by the
  CEPII and the Foundation for
  Advanced Information and
  Research (FAIR, Tokyo). The
  seminar brought together leading
  officials from France and Japan,
  Ministers of Finance, central
  banks, and major banks. The topics
  addressed included: France and
  EMU, financial adjustment in
  Japan, the international role of
  the yen, as well as the relations
  between monetary policy and interna-
  tional trade.

- In April, Anton Brander (former
  Director) and Jean Pras-Ferry (the
  present Director of the CEPII)
  participated in a meeting organised
  by the Caisse Argentino para la
  Financiación Internacional (CARI),
  for the launching of Argentina's
  new model 'Economia Mundial
  1990-2000: el imperativo de
  crecimiento'. The meeting was
  organised under the initiative of
  Carlos Menem, President of
  Argentina. The meeting was
  attended by senior representatives
  of the Bank, International Monetary
  Fund, the World Bank, and the
  Organisation for Economic Co-
  operation and Development.

Forthcoming

- The CEPII is undertaking a joint
  study with Prof. Stephen Smith
  (University of London) on the
  consequences of a change in
  VAT systems in the EU. This study
  has been commissioned by the
  French Senate, and is to be completed
  by the end of 1996.

- A seminar is being jointly organised
  by the CEPII and DELTA
  (EHESS, IAE, and CNRS) on the
  fiscal aspects of the single market in Europe. It will
  take place in Paris, 12 September,
  and will examine the
  consequences of a change in
  VAT systems in the EU. This study
  has been commissioned by the
  French Senate, and is to be completed
  by the end of 1996.
The rapid growth of trade has been one of the most prominent transformations of the world economy since World War II. CHELEM data show that the volume of international trade grew fourfold between 1967 and 1993, whereas world output rose by a factor of 2.4, and population by 1.6. As a result, the share of trade in world GDP almost doubled during this period.

The graph presents the relative importance of America, Asia and Europe-Africa (Europe including the Former Soviet Union, Africa and Middle East) in world population, output, trade and in foreign direct investment (both inward and outward FDI). If the distribution of the world's population has changed little between 1967 and 1993 with more than half of humanity living in Asia, the centres of gravity for the other indicators have shifted noticeably. In fact, Asia doubled its share in world trade (from 12% to 25%) and in output (10% to 22%), and almost quadrupled its share in FDI (6% to 22%). The rapid displacement of these centres towards Asia, and the persistent disparity with the distribution of the world population suggest that this is a natural catching-up phenomenon, which will continue into the future as Asia's economic weight converges with its demographic weight.

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1. World production (GDP) is calculated in 1990 purchasing power parity (CEPPI, database CHELEM) and world trade in real terms (CEPPI, database CHELEM) is deflated by unit values (CATT).

CHELEM DATABASE

Asia's Rise in the World Economy

Evolution of the Centres of Gravity of World Population, Output, Trade and FDI between 1967 and 1993

Source: CEPPI, authors calculations based on the database CHELEM.

- Trade and FDI figures base exclude humanitarian flows. Every observation (point) indicates its distance from the three regions. The closer a point is to a given region, the more important that region's share in the world total. Therefore, Asia's increasing share in world trade, output and FDI enrolments is a natural shift of the three areas of gravity of these variables downwards to the right.