Focus

The Competitiveness of Nations

Since the first oil shock and the end of the Bretton Woods system in 1973, the world economy has continuously gone through shocks of all sorts: the fall of the Berlin Wall, the Gulf War, the European Single Market, the Treaties of Maastricht and Amsterdam, the Marrakesh Accords on the creation of the World Trade Organisation etc. are but some of the events of the last decade that have had major consequences on the development of the world economy. Given such a rapidly changing environment, the CEPII has set out to summarise the state of competitiveness between nations.

What are the different concepts of competitiveness?

The concept of competitiveness is very controversial amongst economists. To a large extent, this is due to the ambiguity of the notion itself. Its content varies depending on whether macroeconomic or industrial trends are examined, and whether the short or long term is at issue. The goal of this report is to analyse the competitiveness of nations, looking at these four different aspects.

To begin with, the long term competitiveness of a country may be defined as its capacity to increase the welfare of its inhabitants. The only way to achieve this is to increase the productivity of its production factors. Every nation seeks to combine its physical capital and labour as efficiently as possible. It also strives to improve the quality of human capital through training. A country that manages to improve its efficiency, does not do so at the expense of others. The growth of each country contributes to the progress of the world economy.

In the short term, the macroeconomic competitiveness of a country depends primarily on the evolution of its prices relative to those of its major competitors. These are largely made up of two factors: domestically prices depend on labour costs, and externally they depend on real exchange rate movements. Short term competitiveness is therefore essentially price competitiveness (whereas in the long term prices are meant to reflect conditions in the real world).

Competitiveness is a complex notion, with short and long term, as well as macroeconomic and sectoral dimensions.

From a sectoral point of view, in the long run, the structural competitiveness of a country is measured by its structure of specialisation and the adaptation of its sectoral structure to international demand. In the short term, the competitiveness of an industry expresses itself in rising market shares, which in turn depend on the economic performance of the partner countries and the price competitiveness of rivals.

This report is set out in three parts:
- the first part looks at current major trends, and assesses some of their consequences;
- the second part sets out national competitiveness on the basis of the four dimensions given above, and;
- the third part analyses thoroughly one specific area affecting international competitiveness: the role of FDI.
The issues covered in the report

Four major trends marked the years of 1997 and 1998: the return to growth in western Europe; the financial crisis in Asia; the progress in WTO negotiations on financial services; trade in Information Technology (IT) products and services; and lastly the failure of the negotiations concerning international investment. Of these, the upturn of growth in western Europe has probably been the most important. Measured in constant prices, Europe’s demand for imports expanded by 2.5% in 1996, and by fully 7% in 1997, thus accounting for one third of the rise in international trade. In terms of price competitiveness, the Asian exchange rate crisis and the appreciation of the dollar will be the key features marking 1998 and 1999. Lastly, international negotiations on financial services and the IT products and services sector will have a major long term impact because they will redefine competition in these key sectors.

The Asian crisis is the key factor affecting price competitiveness in 1998-1999.

Most of this first part is dedicated to the Asian crisis, which has struck countries for whom integration into the world economy has been a priority, and which have achieved exceptional economic progress over the last three decades. The present crisis throws into doubt their development "model" which is based on close coordination between the State, banks and companies. The crisis is also a phase of necessary macroeconomic adjustment which has been particulary aggravated by contagion phenomena and the first wave of crisis-resolution strategies put forward by the IMF.

The second part of the report presents a panorama of the long and short term competitiveness of nations. The long term macroeconomic analysis demonstrates clearly the links that exist between investment efforts in physical and human capital and catching up processes, with a reference group of countries (including the richest, over the last 37 years). For most of the period running from 1960 to 1997, only a small minority of countries have caught up with the reference group. The majority of countries have lost ground. Particular attention is then paid to the growth experiences of the five leading industrialised countries, because they represent a sort of technological frontier, a reference in terms of economic efficiency. Their performance is measured in terms of total factor productivity. These trends are analysed by sector, with special attention being given to manufacturing, as well as financial and producer services. Germany, France, Great Britain and Japan demonstrated higher growth rates of labour and total productivity between 1960 and 1993, than did the United States. Nevertheless, Europe’s good productivity performance is not synonymous with an optimal use of labour.

Only a small number of countries have been able to catch up with the rich nations over the last four decades.

Attention is subsequently given to the link between growth patterns in world trade and the catching up process of certain countries. The expansion of trade is very unequal across product categories: trade in primary products is regressing, whereas trade in electrical and electronic goods, in cars and in processed chemicals is growing rapidly. The latter now account for more than half of world trade. Furthermore, it is to be noted that countries catching up are those which are exporting goods whose share in world trade is growing fastest. In contrast, countries falling behind tend to be specialised in goods with weak international demand growth.

The analysis of short term competitiveness demonstrates that the dollar’s appreciation and the yen’s weakness, since July 1995, have had a greater impact on trends in price competitiveness than have labour cost movements. Europe is favoured by the intermediate position of its currencies, which means that competitive losses due to the fall in Asian currencies are offset by gains against the dollar, the currency of the world’s most dynamic economy since 1993. However, the size of American deficits, the seriousness of the Asian crisis and the creation of the euro could undermine this favourable configuration.

The third and final part of the report is dedicated to an analysis of the links between foreign direct investment and trade, which is discussed in the following article.

Michel Fouquin (project leader)
E-mail: FOQUIN@CEPII.FR
Isabelle Bensidoun, Laurence Boone, Lionel Fontagné, Michael Freutenberg
Colette Hersog, Nanno Mueler, Laurence Nayman and Deniz Ünal-Kesenci

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Economica
49, rue Héricart
75015 Paris
FRANCE
Tel: 33 (1) 45 78 12 92
Fax: 33 (1) 45 73 05 67
**RESEARCH SUMMARY**

- Is Foreign Direct Investment a Substitute for Trade?

Traditional theory suggests that trade and foreign direct investment (FDI) are substitutes. Recent theoretical and empirical analysis indicates that this relationship is far more complicated. Indeed, there is good evidence to show that FDI may actually stimulate exports. But, depending on the country in question, such investment can also increase imports to the home country, suggesting that FDI is used not only to enter foreign markets but is part of production relocation strategies as well. Hence, the net trade effects of FDI are varied.

The traditional analysis of foreign involvement generally refers to trade and FDI as alternative strategies. New economic models of trade and FDI, however, allow for multinational firms to develop endogenously, following a process of integration. In these models, the decision to invest abroad is the result of a combination of intangible assets (firm-specific advantages) and the location advantages of foreign countries. Weak economies of scale at the plant level, combined with sizeable fixed costs at the firm-level, or with high trade barriers, promote the multinationalisation of firms. The so-called "convergence hypothesis" thus identifies the following mechanism: as countries converge multinational firms emerge and displace trade, while intra-industry trade expands simultaneously.

But such substitution may be questioned:

i) when multinationals compete in multiple foreign markets;

ii) when uncertainty is taken into account;

iii) when foreign investment is a strategic barrier to entry. From an empirical point of view, time series data on trade and FDI flows indicate that these two modes of internationalisation are clearly complements.

This debate is linked to competitiveness: if FDI displaces trade, then exports should be replaced by local sales in foreign markets, which are then detrimental to the domestic industry of the investor. In contrast, if trade and FDI are confirmed as complements, investing abroad might lead to greater competitiveness in foreign markets, which is beneficial to the exports for the investing country. But FDI may also boost imports from the subsidiary to the home country, as a result of relocation strategies.

FDI can be measured by flows or by stocks, affecting the results with regard to trade creation. Using the most disaggregated data collected so far (for France), the positive relationship between trade and FDI flows is validated. Outward FDI is associated with additional exports and imports, in the industry considered, *vis-à-vis* the country hosting investment. But since the former increases more than the latter, investment abroad is associated with a trade surplus. Conversely, inward investment is associated with a trade deficit in the host country.

The impact of FDI on trade is much higher when spillovers between sectors are accounted for.

Disaggregated data have been used to validate the complementarity between trade and FDI flows.

These complex relationships have never been addressed in the literature in a systematic manner, using data for a wide range of countries that is broken down by sector, country and trading partner. The matching of trade and FDI makes it possible to control for determinants which promote both trade and FDI, such as market size, per capita income or regional integration, or conversely for economies of scale having the opposite impact on both forms of internationalisation.

The impact of FDI on trade is much higher when spillovers between sectors are accounted for, even if the global trade surplus remains comparable with that estimated at the "industry of investment" level.

At a slightly more aggregated level, a comparison between France and the US highlights that the net trade surplus is roughly identical, even though US investment abroad demonstrates much stronger effects of complementarity. As expected, the impact on trade is much weaker when inward FDI into the US is accounted for, given the difference in domestic market sizes. Pooling the data for 14 declaring countries with 15 partners, in one sector from 1984 to 1993, highlights the asymmetry between the trade surplus associated with outward FDI flows and the trade deficit associated with inward FDI.

More generally, log-linear export equations can be estimated at the aggregate level and used to assess the trade creation effect associated with bilateral FDI. The model integrates country and "fixed-time" effects, and is estimated for 21 OECD countries over 1980-94. It includes determinants of bilateral trade, such as the relative sizes and income levels of the trading countries, and their geographic distance, as well as inward and outward FDI. The trade creation effects associated with bilateral FDI are presented in the table below. On the whole, complementarity dominates. The largest rise in exports occurs for: Japan and the United States.
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Note: i = exporting country; j = importing country. Example: the exports of Japan to the USA amount to US$ 78 billion. In the absence of bilateral FDI, ceteris paribus, the exports would have been only US$ 34 billion. The trade creation effect on Japanese exports to the USA due to bilateral FDI flows (between Japan and the United States) therefore equals: (78-34)/78 = 149%.

(bilateral, FDI flows between Japan and the United States create a 149% increase in Japanese exports to the US); Canada and the US (bilateral FDI boosts US exports to Canada by 86% increase in exports); as well as the United Kingdom and the US (bilateral FDI creates a 101% increase in exports). Negative amounts in the table correspond to net disinvestments which lower exports.

For the US, FDI stocks are associated with greater imports than exports, and hence a net trade deficit.

As for FDI stocks, the results are more contested. Estimates are made for France with respect to 57 partners and 35 sectors, from 1989 to 1994, which are controlled for economies of scale and transportation costs. Inter alia, outward FDI is clearly complementary to French bilateral exports, but displaces French imports. For 1994, the estimates indicate that more than $10 billion of net exports are associated with the French involvement abroad. In contrast, inward FDI is a complement for both French exports and imports.

Turning to the US, the complementarity between outward FDI stocks and bilateral trade is confirmed at the industry level. Each $1 of the US FDI stock abroad is associated with 70 cents additional bilateral exports. But what is more striking is the fact that US imports are boosted too (by $1.3), possibly as a result of the relocation of activities abroad. Thus, in contrast to France, US foreign assets are associated with a net trade deficit.

As for foreign assets in the US, they have a net substitution effect on trade. Each $1 of inward FDI leads to a 16-cent cut in US imports from the investor's country. At the same time, the 10-cent cut in US exports is the result of a lack of competitiveness of US industries which are concerned by foreign FDI. Foreign investors in the US are above all motivated by entry into this huge national market: they substitute local sales for previous exports by the parent.

In short, the evidence on the relationship between FDI and trade appears to be quite mixed, contradicting the established idea of a simple substitution between the two.

_Lionel Fontagné and Michaël Pajot  
E-mail: FONTAGNE@CEPII.FR  
and PAJOT@CEPII.FR_  

_for further information see:_

- "How Foreign Direct Investment Affects International Trade and Competitiveness," L. Fontagné and M. Pajot, 
  _CEPII WORKING PAPER_, No. 97-17, Nov. 1997.

- "Investissement Direct Et Commerce International : Le Cas Français," L. Fontagné and M. Pajot, 

  _DSTI/EAS/IND/WP9(00)5_, OECD, 1996._


CONFERENCE SUMMARIES

ASIA AND EUROPE:
WHAT IS THE JOINT OUTLOOK IN THE WAKE
OF THE FINANCIAL CRISIS?

PARKS 11 AND 12 MAY 1998

The Asia-Europe Foundation (ASEF)
and the CEPII organised this conference to create a
dialogue between European and Asian economists concerning
the common outlook of the two continents, following the
financial crisis which struck Asia in 1997. Though it is
still too early to talk about the "aftermath" of the crisis, it is
useful to draw some conclusions concerning the first deve-
lopments of the monetary and financial turmoil and to
reflect on better solutions for the future of the region and
for its relations with Europe. To stimulate such thinking,
the ASEF and the CEPII brought together approximately 20
top-level, Asian and European economists, who are
amongst the foremost experts on these issues. They were
drawn from international organisations (the Asian
Development Bank, the World Bank, the European
Investment Bank, the Bank of International Settlements
and the OECD), as well as from the international financial
community and academia.

The objective of the conference was
also to clarify the measures that have already been implemented,
and the progress which is still to be made
both in Asia and Europe, as well as at the level of the
international organisations. The role of the austerity
policies implemented with the help of the International
Monetary Fund was discussed, especially by Professor
Yung Chul Park (President of the Korean Institute of
Finance), for whom deflationary fiscal and monetary poli-
cies are necessary to restore the confidence of foreign
investors. Yet he also stressed that if there is no massive
inflow of liquidity, then the restructuring of banks and
companies, which alone is able to generate the confi-
dence of foreign investors, could take years. In particu-
lar, the lack of credit facilities for international trade
would be highly damaging. The need for massive and
immediate liquidity inflows was stressed by numerous
participants from the countries affected by the crisis, but
was also underlined by Alfred Steinher (Chief Economist
at the European Investment Bank).

The architecture of the globalised,
international financial system, which has undergone a
new crisis due to events in Asia, was also examined.
Numerous participants stressed the unpredictable nature
of crises: the self-fulfilling nature of expectations held by
financial markets which amplify capital movements, in
a manner that is not connected to the fundamentals. It is
therefore necessary to create barriers to avoid chain-
reaction panics. From this point of view, discussion took
place on the importance of having a leader-of-last-resort,
while at the same time ensuring that such a system
would not discourage banks operating in emerging mar-
ketso from acting prudently.

The ASEF and the CEPII have
the intention of collaborating in the future, in order to stimulate
different initiatives in the debate between Asian and
European economists, from the point of view of reinforcing
the economic and financial links between the two con-
Inents and with respect to the role Europe should play in the
international economy, following the creation of the euro.

Jean-Claude Berthelot
E-mail: berthelot@cephi.fr

THE FRENCH-GERMAN
ECONOMIC FORUM

PARKS 7 JULY 1998

With their European partners,
France and Germany are embarking on an unprecedented
coopeative venture: a monetary union. The dialogue be-
 tween French and German officials has been intense for a
long time, but economists from both countries rarely dis-
cuss their vision of the functioning of the monetary union
and the implications for both economies. To meet this
need, Jean Pisani-Ferry (former Director of the CEPII)
and Jürgen von Hagen (Director of the Zentrum für
Europäische Integrationsforschung-Bonn) decided to
launch a forum of discussion between economists of these
two countries: the Frenc-German Economic Forum.
Its purpose is to contribute to policy debates on European
policy choices, through the organisation of a series of infor-
mal meetings. Since the Forum's creation in July 1997,
there have been three meetings.

The first meeting, in July 1997, was
opened by the French Minister for Economics and
Finance, Dominique Strauss-Kahn, who emphasised the
necessity of dialogue among French and German econo-
mists, especially as the scope for cooperation in terms of
economic policy is likely to widen in the future. The two
papers of this meeting were on the Stability Pact (presen-
ted by P. Artus, Caisse des Dépôts et Consignations) and
the need for an Employment Pact for EMU (by K.-W.
Schatz, Kiel Institute for World Economies). The ensuing
debate went beyond these questions and covered the need
for EMU to have a central institution to counterbalance,
and act as a partner, to the European System of Central
Banks. Indeed, the issue of cooperation on a large range
of economic policies was stressed.

The second meeting in January
1998 was opened by the German Secretary of State to the
Ministry of Economic Affairs, Klaus Bünker, who high-
lighted the fact that the euro was now a reality and that
the US monetary authorities are concerned about it, not
only because of its impact on trans-Atlantic economic
relations, but also because of its impact on the world
financial system as a whole. The question of the potential
role of the euro as a rival to the US dollar (with a paper
by A. Bénassy-Quéré and E. Mojon, CEPII), and the need
for an exchange rate policy (paper by J.M. Neumann,
University of Bonn) were hotly debated.

The third meeting took place on the
7 July 1998, in Paris, and was opened by Jacques Delors,
who put forward what he thought were the key points for
a successful EMU. He contrasted economic policies that
could be common to the euro-zone, with those that
should remain under national sovereignty. The remain-
der of the seminar focused on the implications of a com-
mon currency for labour markets in the euro-area (a
paper by K.-H. Paqué, University of Magdeburg), and the
question of tax competition in a common currency area
(paper by J. Le Cacheux, OFCE).

Laurence Boone
E-mail: boone@cephi.fr

To obtain the papers of the Forum, please contact:
Sylvie Hurion, tel: (55) 1 55 68 55 14, or E-mail:
hurion@cephi.fr
Recent Publications

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- ‘L’effet d’une dépréciation compétitive de l’euro’
  C. Tavéra
- ‘Ouverture et productivité à Taïwan’
  S. Dessus
- ‘Le partage de la valeur ajoutée’
  A. Sylvain
  Workshops:
  - ‘L’Asie et l’Europe : quelles perspectives communes après la crise financière ?’
    J.-C. Berthélémy
  - ‘Croissance, commerce et localisation’
    J.-L. Guérin
  - No 72, 4th Quarter 1997
  - ‘Modèle de croissance néoclassique et flux de capitaux’
    S. Manzoechi, P. Martin
  - ‘La crédibilité du mécanisme de change européen à bandes étroites’
    B. Rzepkowski
  - ‘Endettement et déficit financier au Japon, au Royaume-Uni et en France’
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  FF 440 annual subscription in Europe, and FF 465 outside Europe.
  Publisher: la Documentation française

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  Publisher: la Documentation française
  Available from the web-site of the CEPII, one month after publication: http://www.cepii.fr

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- Product Quality, Labour
  Productivity and Trade (CEPII)
  O. Cortes (CEPII), L. Fontagné (CEPII), University of Paris I), M. Freudenberg (CEPII), S. Jean (CEPII)
  22-23 January

- The Macroeconomic Situation in Japan and the Financial Crisis
  E. Dourville-Fer (CEPII), S. Guichard (CEPII), C. Meyer (University of Paris I), M. Aglietta (CEPII), University of Paris X
  23 January

- The Dangers of the Financial Crisis in Brazil
  I. Sarré (CEPII), C. de Boisjoly (University of Paris I)
  26 February

- The Financial Crisis in Korea: From the Miracle to the Collapse
  Yang Chul Park (Korea Institute of Finance)
  26 March

- Presentation of the 1998 World Bank, Global Development Finance Report
  U. Dadush (World Bank)
  Discussants: E. Ismaelewicz (Le Monde), M. Aglietta (CEPII, University of Paris X), J.-C. Berthélémy (CEPII), T. Desjardins (BNP), X. Musca (Ministry of Economics, Finance, and Industry)
  2 April

- France's Position in the High-Techology Trade
  L. Fontagné (CEPII, University of Paris I), M. Freudenberg (CEPII), Deniz Unal-Kesenci (CEPII), T. Hatzhichromoglou (discussant, OECD)
  5 May

  B. Naughton (University of California, EHESS), F. Lemoine (discussant, CEPII)
  6 May

- Asia and Europe: What is the Joint Outlook in the Wake of the Financial Crisis?
  For details, see page 5
  11 and 12 May

- Disintegration of the Former Soviet Union
  S. Djankov (World Bank)
  25 May

- Privatisation in China
  Wing Thye Woo (University of California, Davis), F. Lemoine (discussant, CEPII)
  24 June

News in Brief

- Michael Freudenberg left the CEPII, in June 1998, to join the Directorate for Science, Technology, and Industry of the OECD. He has been replaced as editor of The CEPII Newsletter by Nanno Mulder. Marie-Pierre Mol, Secretary-General of the CIREM, left the CEPII in July, and Laurent Col left in March. We wish them all the best for the future.
- Julien Talbot, was seconded to the CEPII from the INSEE, in February, to manage the Centre's electronic databases and the web-site.
- Lionel Groening joined the CEPII as an information technologist in May.

Forthcoming

- The CEPII, CEFL, DREE, Caisse des Dépôts et Consignations and the Revue Économique are organizing a joint workshop on 'Central European Countries' integration into the European Union' on the 15-16 September in Prague.
- On 25 September the CEPII's report entitled "Competitivité des nations" (The Competitiveness of Nations) is being presented at a meeting in Paris.


Opening by M. Bourdin (President of Planning Delegation, French Senate) and D. Strauss-Kahn, (Minister of Economic Affairs and Finance).

Morning Session: 'The Mutations of the World Economy over the Last 20 Years'
   Chairman: F. Mer, (CEO of Usinor and Chairman of the CEPII's Board)
   Speakers: M. Albert, (member of the Banque de France's Monetary Policy Council), J. de Larosière* (Inspector of Finance, former president of the EBRD), K. Courti (Chief Economist, Deutsche Bank Capital Markets), M. Aglietta (Scientific Advisor to the CEPII, Professor at the University of Paris X-Nanterre), Y. Berthelot (Executive Secretary of the UN Economic Commission);
   A. Bréder (Director of Economic Studies at the CPR), H. Martre (Chairman of the CIREM), and C. Sautter (Minister of the Budget)

Afternoon Session: 'The Challenges of the Next 20 Years',
   Chairman: J.-M. Charpin (Director of the French Planning Agency),
   Introduction by J.D. Wolfensohn (President, The World Bank)
   Speakers: Mrs. J.R. Shelton (Deputy Secretary-General of the OECD),
   T. Atkinson, (Professor at the University of Oxford), R.
   Blackhurst, (Professor, School of International Studies, Geneva), P.
   Artus, (Director of Economic and Finance Studies at the Caisse des Dépôts),
   J.-C. Berthélémy (Director of the CEPII), J.-L. Biffa, (CEO of Saint-
   Gobain), J. Pisani-Ferry, (Advisor to the Minister for Economic Affairs)
   Concluding remarks by B. Barre (former French Prime Minister)

* to be confirmed

For further information contact
Valérie Colombel
Tel: (33) 1 55 68 55 24,
E-mail: colombel@cepii.fr
In the CHELEM - Balance of Payments database, the world's current account balance is estimated by the sum of the current transactions of the IMF member countries, ten non-members and international organisations. In principle, global debits equal global credits in each operation: goods and services trade, current transfers, and income transactions. In practice, the world's current account balance showed a minor discrepancy in 1996, corresponding to US$ 5 billion or 0.1% of the average of global debits and credits (referred to as global current transactions below). This small asymmetry is unique in the period 1967-95, and hides large discrepancies at the disaggregated level which almost cancel out (see Figure).

The world trade in goods, after ten years of near-equilibrium, shows a growing positive asymmetry (1.9% of global current transactions in 1996) which mainly originates from the introduction of the single market in Europe in 1993. As a result of the new accounting system for intra-European trade, based on declarations by companies instead of customs, the discrepancy of the trade balance of the intra-EU trade reached US$ 55 billion in 1996, e.g. 0.8% of current transactions. For the world trade in services, the negative asymmetry (-0.8% of current transactions in 1996) is mainly explained by "open registry" fleets, whose services are declared only by importers and not by exporters. The current transfers' positive discrepancy turned negative after 1993 and reached -1.0% of the current operations in 1996; a trend largely explained by the introduction of new accounting methods by the IMF, which moved the registration of workers' remittances from the current to the capital account. Finally, the usual negative discrepancy of world income transactions is due to the financial flows of offshore banks, which are better registered by borrowers than by the lenders. In 1996, the exceptional near-equilibrium in income transactions contributed to the small, overall discrepancy of the current account.

Isabelle Rabaud, RABAUD@CEPII.FR

The CHELEM (Harmonised Accounts on Trade and the World Economy) database provides harmonised, long term data on trade, economic growth and population, stretching back to 1967 and to 1960 for some series. The database breaks down the global economy into 53 countries/geographic regions, and 71 product categories. Also included are data on PPPs and exchange rates. The database is bilingual (French-English), 'user friendly', and is available on CD-ROM. For further information please contact Colette Herzog at the CEPII, tel: (33) 1 53 68 55 27, or E-mail: Herzog@cepii.fr

CEPII
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CEPII - 9, rue Georges Pitard, 75740 Paris Cedex 15, France tel: (33) 1 53 68 55 00 fax: (33) 1 53 68 55 03
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