LA LETTRE DU CEPII

No 274 — January 2008

CENTRE D'ETUDES PROSPECTIVES ET D'INFORMATIONS INTERNATIONALES

La lettre du CEPII: A chronicle of globalization

1978-2008, CEPII is thirty years old! For La Lettre du CEPII, its four-page, monthly publication, it is an opportunity to look back over the thousands of pages published since its first issue.

La *Lettre du CEPII* appeared for the first time in May 1979. It came out eight times a year until 1993. It then switched to monthly publication and became more based on the research done by CEPII. Looking back over these 273 issues, we can, of course, see that the themes and approaches which are CEPII's hallmark are continuously present. But we can also see changes. Changes in tone — more "prescriptive" during the 1980s, more "positive" afterwards. Changes in topics (the sector analyses, predominant in the early years, later disappear in the *Lettre*) as well as in models used. The medium term global macroeconomic projections included in many letters in the early 1990's are later abandoned. Conversely, long term economic prospects and their demographic component continue to be explored.[1]

The evolution of the themes is, of course, mostly guided by the world economy. This is why a kind of chronicle of globalization unfolds with each ensuing issue. After the "grey years" of the socialist economies in Europe, many letters are devoted to the transition period, then to membership of the European Union by Central and Eastern European countries. The internal changes in the "newly industrialised countries" and later in the "large emerging countries" and their competitive pressure on world markets are extensively discussed. Services, long considered non-tradable, come within the scope of globalisation... and within that of CEPII's research. True, the world is not yet "flat"; there are still frontiers, but today we are a long way from the separate worlds that economists studied thirty years ago.

With its *Lettre*, CEPII seeks to show up the structural transformations of the world economy and throw light on the tensions caused by them. The crises - oil crises, the debt crisis in the 1980s, banking crises, the Asian financial crisis... — activate the use of CEPII's expertise to elucidate current affairs and propose a discussion of their medium-term implications in the real economy and in the field of regulation. The letters on international financial architecture[2] are a meaningful illustration of this.

Here we have selected three topics for this "*Lettre des Lettres*": international trade, exchange rates and European integration, on which a large part of CEPII's work and *letters* have concentrated. We intend to draw out the main messages, note their modulations over time, and identify correspondences across time.

International trade

Tools for analysis

The first letters devoted to international trade demonstrate the efforts made to set up analytical concepts and tools. The theme of specialisation first appears in

1. They are studied using the Ingenue model, in particular. See the April and November 2001 issues of La Lettre.
2. See March and October 2000, July-August 2002, May 2003, January and April 2005 in particular.

September 1979, though the definition of a first indicator that measures specialisation independently from trade balances. The focus then is on the dynamic aspect of specialisation (countries can build their comparative advantages) and on the distinction between its "intensity"" and "quality", the latter depending on adaptation to demand (December 1983). Furthermore, in terms of changes in trading performance, an effort is made to distinguish between what is due to initial positions and what comes from later developments (December 1980).[3]

In April 1987, an innovative typology is proposed in *La Lettre* that makes a distinction between one-way trade (a product is either exported or imported), vertical two-way trade (a product is both exported and imported but at different levels of quality) and two way trade in similar products, or horizontal two-way trade. The latter (37% of French trade in manufactured items in 1982), which seems to contradict the theory of international specialisation, can be explained by the demand for variety and by the diversity of firms' supply. In imperfect competition, high performing companies are able to export products for which the country has no comparative advantage. The non-uniform nature of firms is most recently touched on in the September and October 2007 letters.

This typology, subsequently refined by differentiation of quality ranges (February 1997) is widely used today. It led CEPII to build, alongside the CHELEM database used since 1978, a new harmonised bilateral flow database, BACI, detailing the trading volumes and values for some 5,000 products.

To throw light on the trade negotiations launched by the WTO, in 2001 the CEPII built a computable general equilibrium model for simulating the interaction of markets for goods, services and production factors, in quantities and prices, that covers the whole world and gives details on the major trading partners in the negotiations: the MIRAGE model. As negotiations are taking place at the very detailed level of tariff lines, the model had to be linked to a detailed, exhaustive, bilateral database on obstacles to trade. To this end, the MAcMap database was developed jointly by CEPII and the International Trade Centre.[4]

These tools are extensively used at CEPII to analyse international trade main issues that are the subject of many issues of *La Lettre du CEPII*.

The gains of openness

According to traditional international trade theory, the gains from openness come from economic specialisation. However, in a dynamic setting or under imperfect competition, these gains are not systematic. Several letters deal with this problem, on the basis of empirical research, attempting to define which specialisations will foster growth (April 1996); observing that the poor countries left behind in this catch-up process have a specialisation profile that is ill-suited to international demand (September 1998); asking questions about how the opening up of countries in the South could be included under WTO multilateral rules without the constraints of trade liberalisation overriding development goals (July 1999, October 2001).

Many letters deal with the link between the performance of economies and how they are integrated on the international scene. For example, the September 1981 issue of *La Lettre* compares Korean and Mexican development strategies. Through a combination of export promotion and import substitution, at that time, Korea is building up an integrated industrial fabric throughout the metal industry, as it had already done in the textile industry. This strategy proves more effective than that followed by Mexico whose export-oriented border area industries have little effect on raising the standard of its industry as a whole. Twenty years later, CEPII is pondering the dualism of the Chinese industry and its consequences on the country's economic catch-up process (June 2002). In the long term, the dichotomy caused by the accelerated development of export industries should be reduced with the opening up of the internal market after China joins the WTO (April 2000 letter). The Chinese authorities are now trying to redirect an outward looking, wide-ranging growth system, whose negative effects are highlighted in the March 2006 letter: an increase in inequality and a serious deterioration in its terms of trade.

The competition from the South

The question of competition from Southern countries comes to the forefront of public debates once again in the 1990's. "Should we be afraid of the South?" asks the October 1993 issue of *La Lettre*, which explains that, overall, the emergence of new competitors does not raise

3. A rigorous method for distinguishing the effects of acquired positions and performance is presented in the February 2004 issue of La Lettre.
4. The April 2002 letter provides a brief description of MIRAGE and MAcMap. See also the discussions on the measurement of trade protection (November 2000) and the overview of world trade protection, drawn up from the most recent version of MAcMap, in the May 2007 letter.

a problem of external balance but of reallocation of jobs across sectors. The effect of globalization on labour markets quickly becomes a subject of both theoretical and empirical controversy. What is the impact of competition from Southern countries on jobs and wages? How can this be measured and distinguished from the impact of technical progress? The September 1997 letter shows that an increase in imports modifies production conditions: it accelerates gains in productivity, all the more so if imports come from poor countries. A quarter of the apparent labour productivity gains observed in the French industry between 1977 and 1993 can be explained by the development of trade (15% by trade with the South). The overall impact of these gains in productivity on employment depends on the economy's capacity to transform them into new jobs.

The analysis of competition from Southern countries quickly focuses on China. Already in 1995 (May), the letter stresses that the way the Chinese economy is developing internationally makes the country the world's workshop. This term is used again ten years later (May 2005) to describe China, which has become a global trade power integrated into the Asian production system. This integration with Asia hides the fact that Europe plays a leading role in Chinese imports directed to the domestic market; consistently, Europe is in a good position if Chinese growth is to be refocused on domestic consumption. The CEPII analyses also show, in January 1996 (and March 2006), that Europe is far from powerless against Asian (and Chinese) competition, thanks to its substantial advantages in all top-of-the-range products.

French foreign trade

Already in December 1988, the *Lettre* points out that "Foreign trade is still the French economy's weak point". Two explanations are put forward: the geographical pattern of exports and the low level of sector specialisation. It is also noted that it is exports, more than imports, which determine the development of the industrial balance. Some fifteen years later, exports are once again the main suspect for the rising gap between German and French trade balances (October 2005). Geography is one element involved: French exporters are faced with slightly less brisk demand than their German competitors. But it is, above all, the less efficient response of the French commercial offering to this demand which may explain the different performance by the two countries.

Firm-level data analysis sheds further light on French trade (October 2007). Scarcely one thousand firms (generally the best performers in terms of productivity and employment) account for two thirds of French exports. However, export growth is due less to firms already present in foreign markets than to new exporters. Public policy should concentrate on fostering the expansion of the exporters' "club".

The Doha round

The creation of the WTO in 1995 led CEPII to devote several letters[5] to the next round of negotiations. One of the most important was the growing power, within the organisation, of emerging countries and several developing countries. In fact, the United States and Europe underestimated their role and the Doha round, launched in 2001, was to fail two years later in Cancún (September 2003).

Another major issue concerned the impact of multilateral liberalisation on the least developed countries. The Mirage simulations significantly tempered the optimism of most assessments: some countries of the South, particularly in sub-Saharan Africa would be penalised by the erosion of their preferential margins and, as net importers of agricultural products, by the rise in world prices (July-August 2004).

Mirage was also used to balance the gains expected by the main countries against the cost of the concessions necessary to reach a compromise. The stumbling blocks encountered by the round can then be understood (February 2006, June 2006 and January 2007).

Finally, the *Lettre* stressed the key role of large emerging countries: for Northern countries, greater opening up of these high-growth economies would make their concessions in the agricultural sector more acceptable; for the less advanced countries, full opening up of emerging markets (like that agreed to by many OECD countries) would restore the benefit of preferential margins wiped out by multilateral opening up of markets.

Whilst multilateral negotiations were becoming bogged down, since the early 2000's there has been an explosion of preferential "regional" agreements (United States-Morocco, China-Chile, *etc.*), often very different from the mid-1980's kind (single European Market, NAFTA). Several letters[6]. pointed out their dangers: increasing complexity of trade policies, exclusion of certain countries due to their geographical or political positions, unequal power relationships, less incentive for the main countries to

5. January 1995, August and November 1999 and October 2001.
6. September 2003, January 2007.

resume a multilateral approach, and so on. Still, the March 2007 letter, which was devoted to economic integration in East Asia, pointed out that the regional agreements that have burgeoned in Asia look less like discriminatory preferential agreements than a means of strengthening cooperation between neighbouring countries sharing common interests.

Exchange rates

In September 1980, when the dollar was very weak (the equivalent of 1.63 euros!), the ninth *Lettre du CEPII* asserts that "the exchange rate has once again become an economic weapon". The letter shows that the dollar is under-valued against many currencies (with the notable exception of the yen) in terms of purchasing power parity, but also in terms of a standard incorporating levels of development (Balassa-Samuelson effect). The effect of this under-valuation is "to export unemployment from the United States to other western economies". Since 1973, the dollar has been floating and the United States has taken advantage of this to relinquish its international monetary responsibility.

The next two letters, in 1983 (April) and 1986 (September), react to the dramatic rise in the dollar (until 1985), then to its fall. Naturally, these letters try to understand these changes. But, just as previously, the tone is above all prescriptive, based on a measurement of the equilibrium exchange rates and recommending consultative management of parities. Then come six years (1987-1992) without any major upward or downward trend in the dollar exchange rate; the *Lettre* then turns its attention to the European monetary system and German monetary unification.

Starting from 1993, the theme of the international monetary system makes a strong comeback, with twelve *Lettres* in thirteen years. As in the 1980s, the approach is mainly prescriptive: equilibrium exchange rates, effectiveness of foreign exchange interventions with, in the 2000's, a widening of the approach giving Asian exchange rate policies, in particular Chinese, a key role. Nevertheless the tone becomes more circumspect. The April 1993 *Lettre* puts the G7's success in stabilising parities into perspective. The October 1994 issue goes further, noting the international monetary system's inability to prevent "long-term distortions of real exchange rates", the instability of nominal exchange rates and, already, the accumulation of large current account imbalances. It lists the three challenges that the international monetary system would have to meet: the spread of capital market liberalisation, the development of regional monetary agreements and the rise of emerging economies. It suggests that international coordination should no longer focus on exchange rates but, upstream, on the principles of macroeconomic policy. It calls for the reactivation of IMF multilateral monitoring of exchange rate policies, particularly those of emerging economies.[7] Fifteen years later, it can be seen that the three challenges have not been dealt evenly by the international monetary system: monetary cooperation has made little progress at either the international or the regional level -Euro being a major exception; emerging countries have set themselves up as key powers; and the IMF has in fact reintroduced multilateral monitoring of exchange rate policies, associating advanced and emerging countries.

International monetary coordination must rely on common understanding of "normal" or "equilibrium" exchange rates. The *Lettre* regularly reports on CEPII's research in this field, highlighting, respectively, the uncertainty surrounding calculations of equilibrium exchange rates (June 1995), the extent of exchange rate adjustments necessary to correct worldwide imbalances (July-August 2003), the need to take account of regional interaction in assessing exchange rate distortions (for example, the under-valuing of the yuan, reveals an under-valuing of the whole East Asia region against key currencies, see the October 2003) and, finally, the need for a multilateral approach to exchange rate distortions (October 2004).[8] Coordination also relies on the existence of effective policy instruments. On this point, the *Lettre* emphasises the ineffectiveness of foreign exchange interventions when they are inconsistent with actual or anticipated monetary policy (September 1999, January 2004).

The period 1999-2007 starts with a strong depreciation of the euro against the dollar, followed by a spectacular rise. This volatility of the euro comes as no surprise to CEPII, whose April 1997 *Lettre* anticipated greater instability of the euro-dollar exchange rate. Above all, this letter tempered the then widespread opinion that the euro would be a strong currency against the dollar. In fact, the disappearance of European currencies was to lead European savers wanting to diversify their portfolios to invest outside of the monetary union. The weakness of the euro in 1999-2000, which took the markets by surprise[9],

7. Exchange-rate policies of emerging countries are often discussed in *La Lettre du CEPII* from 1994 onwards, in terms of regime choice (March 1995, June 2000, September 2001) or case studies (Mexico in April 1995, China in April 1999 and May 2004 and Argentina in February and December 2002).
8. This work on equilibrium exchange rates are also applied to the question of entry parities in the euro area (November 2002), see below page 5.
9. See "Everyone can make mistakes", September 2002.

can be explained by this diversification mechanism, together with the disappointing performance of the euro area's economy, as stated in the September 2000 letter. In its conclusion, it mentions the risk of an "upward overshooting, which it would perhaps be difficult to combat due to the potentially divergent interests of the players in European economic policy". As a matter of fact, the very strong appreciation of the euro since 2001 and, even more so, since 2006, has not created sufficient consensus in Europe to foster an exchange rate policy.

Finally, the dollar depreciation since 2001 was of no surprise to the *letter's* successive contributors. However, they questionned its relation with the rise in oil prices. In the last, the appetite of oil exporting countries for assets denominated in dollars traditionally explained the positive effect of oil price rises on the dollar. The November 2005 letter suggests that a new and negative causal link to operating, from the dollar to oil, could have been established via Asian exchange rate policies and their impact on world oil demand: a depreciating dollar favors chinese export expansion and therefore its oil demand.

European integration

European integration appears in La *Lettre du CEPII* in 1986, with the common agricultural policy, and further in 1992 and 1993, at the time of the European Monetary System crisis. From 1995 onwards, the Centre has published more than two *Lettres* a year on European subjects, on average.

The single market

Ten years after the Single European Act came into force, the February 1997 newsletter shows that the most pessimistic scenarios have proved misplaced. They anticipated inter-industry specialisation of European countries, accentuating their differences with the risk of making the single monetary policy ill-designed. In fact, specialisation has developed within industries, along quality ranges. However, the most optimistic expectations have also proved wrong: the December 2001 letter shows that the European market is not really unified. In the late 1990's, the "border effect", which limits trade when a border has to be crossed, is still there. Several complementary explanations are put forward: exchange-rate volatility, consumer preferences and social and business networks.[10]

If there is one field where the single market remains still to be created, to a great extent, it is services. Two letters published in 2006 (January and April) explain the gains that could be expected from liberalisation of the different modes of trading services in Europe and emphasise the importance of business services as the most dynamic sub-sector. As for the manufacturing industry in its time, this liberalisation should lead to a geographic reconfiguration of service activities in Europe with, at the end of the day, gains in efficiency but also corresponding adjustment costs.

Enlargement

In June 1993, the Copenhagen Summit laid down the membership criteria for future members of the European Union. In September 1994, the *Lettre* notes that Central European countries are more and more different, in terms of export capacities, from the Balkans. In June 1998, it observes that only the former has developed intra-industry trade with Western Europe. This differentiation justifies the choice of an enlargement in several waves, while the development of specialisation dissipates the fears of very strong competitive pressure on certain industries in Western Europe. The April 2003 letter, which shows simulations performed with the MIRAGE model, confirm the latter point of view: in industry, the shock of enlargement should materialise more through the complex effects of market integration than through the mere opening up of the economies.

Joining the European Union implies adopting the single currency eventually. To do this, the new members must comply with the Maastricht nominal criteria and, in particular, participate in European Exchange-Rate Mechanism (ERM-2) for two years at least. The November 2002 letter underlines the risks of the stabilisation of exchange rates coming into conflict with the catching-up process. From this point of view, there is a divergence between small applicants, which confirm their eagerness to adopt the euro (Slovenia adopted it on 1st January 2007), and large countries, less inclined to give up exchange-rate flexibility (April 2004).

In parallel, the *Lettre* discusses the conditions for success of the "membership challenge", stressing the requirements of the "political contract" that the European Union enters into with its new members (July-August 2000). At the time of the start of the Barcelona process (1995), several letters are also devoted to the Mediterranean countries (which, with the opening up to Central and Eastern

10. On this topic, see also the May 2000 letter, which deals with tax obstacles in the car industry, and that of July-August 2002 on the national nature of contract guaranteeing institutions. The February 2007 letter, devoted to firms' location choices, also stresses these network effects.

European countries, have lost their privileged position as EU neighbours) and the Europe-Mediterranean free trade project.[11] In 2004, the *letter* again raises the question, in terms of Turkey, of the virtuous circle of integration and the ability to accelerate the convergence of much less developed countries (September and December 2004).

Tax competition

The December 1999 issue of *La Lettre du CEPII* evaluates the impact of a reduction of one percentage point in the corporate income tax rate on inward foreign direct investment to be about 4%. This means that there is a strong temptation for governments to "race to the bottom" in terms of tax rates, with the risk that the financing of public goods be transferred to labour and consumption, which are less mobile tax bases than is capital. The July-August 2001 letter goes further in noting that, on tax issues, the European Union is structurally divided along three lines: country size, single currency membership and distance to the centre of the European Union. With the 2004 enlargement, it was to be feared that tax competition would increase: corporate tax rates were almost systematically lower in the new member states (March 2004). The letter points out that tax incentives are justified in these peripheral countries. However, given their relatively heavy taxation on labour, these incentives would be more likely to attract paper profits than real activities. Then, Western member states should, on the one hand, worry about the conditions for new Member States to catch up, and on the other hand, consider enhanced cooperation on tax issues seriously. In this mindset, the June 2005 letter, which notes the regular lowering of corporate income tax rates in both old and new member states, deplores the fact that the European Union, with its lack of tax coordination, remains a collection of "small" countries incapable of raising taxes on capital.

Fiscal policies

The single currency has given Member State fiscal policies a more important place. The December 1996 letter notes that, faced with a recession, the procedures stipulated in the stability pact would only be tenable if the Union's monetary policy was significantly more expansionist than it had been in the past. A few years later, the ECB's policy was to prove relatively expansionist but... nevertheless several Member States failed to comply with the pact! Three *Lettres* were then devoted to the pact, with, in particular, a criticism of the "exceptional circumstances" included in the initial formulation (November 2004). These circumstances are so exceptional that no country has ever been able to avail itself of them. Finally, two letters published in July-August 2005 and April 2007 bitterly note the hollowing out of "discretionary" fiscal policies (*i.e.* excluding "automatic stabilisers"). However, the second letter highlights a counter-cyclical monetary policy in the euro area. It also notes that looking at the fiscal balance, even when cyclically-adjusted, gives only very imperfect information on the fiscal stance. For example, French and German balances have developed in quite a similar manner since the euro was set up, while their fiscal revenues and expenditures were moving in very different directions.

On the whole, the letters dealing with European issues call for greater consistency between the different coordination schemes (stability pact, tax coordination and the Lisbon strategy) and between Member States, while pleading in favour of continued opening up of markets, especially in the field of services.

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11. July 1993, December 1994, June 1996, November 1997.

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PUBLISHER:
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Director of the CEPII

CHIEF EDITOR:
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DISTRIBUTION:
La Documentation française.

SUBSCRIPTION only to the original, French version.
(11 issues per year)
France 48.50 € VAT
Europe 50.10 € VAT
DOM-TOM (NET, econ. air mail)
49,10 € NET
Other countries (NET, econ. air mail)
50.10 € NET

Please send your orders to:
La Documentation française,
124, rue Henri Barbusse
93308 Aubervilliers Cedex
Tél. : 33 (0)1 40.15.70.00

WEB site: **www.cepii.fr**
ISSN 0243-1947

CCP n° 1462 AD
1st Quarter 2008
January 2008

Imp. ROBERT-PARIS
Imprimé en France