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CENTRE D'ÉTUDES PROSPECTIVES
ET D'INFORMATIONS INTERNATIONALES

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.

CONTENTS

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 1995, 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.

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Economica
49, rue Héricart
75015 Paris
FRANCE
Tel: 33 (1) 45 78 12 92
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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 endogeneously, 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.

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.

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.

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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FRANCE

CONFERENCE SUMMARIES

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

PARIS, 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 developments 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 policies 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 confidence of foreign investors, could take years. In particular, 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 Steinherr (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 lender-of-last-resort, while at the same time ensuring that such a system would not discourage banks operating in emerging markets from acting prudenty.

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 continents and with respect to the role Europe should play in the international economy, following the creation of the euro.

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THE FRENCH-GERMAN ECONOMIC FORUM

PARIS, 7 JULY 1998

With their European partners, France and Germany are embarking on an unprecedented cooperative venture: a monetary union. The dialogue between French and German officials has been intense for a long time, but economists from both countries rarely discuss 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 French-German Economic Forum. Its purpose is to contribute to policy debates on European policy choices, through the organisation of a series of informal meetings. Since the Forum's creation in July 1997, there have been three meetings. These one-day seminars are opened by a politician, followed by the presentation of two papers covering two topics, and a round-table debate.

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 economists, 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 (presented 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 Economics). 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 Bünger, who highlighted 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 B. 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 remainder of the seminar focused on the implications of a common 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).

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To obtain the papers of the Forum, please contact: Sylvie Hurion, tel: (33) 1 53 68 55 14, or E-mail: HURION@CEPII.FR

Recent Publications

ECONOMIE INTERNATIONALE, QUARTERLY

• No 73, 1st Quarter 1998.

• *'Gérer les risques de contrepartie'*
E. Nicolas

• *'L'effet d'une dépréciation compétitive de l'euro'*
C. Tavéra

• *'Ouverture et productivité à Taiwan'*
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. Berthélemy

• *'Croissance, commerce et localisation'*
J.-L. Guérin

• No 72, 4th Quarter 1997

• *'Modèle de croissance néoclassique et flux de capitaux'*
S. Manzocchi, P. Martin

• *'La crédibilité du mécanisme de change européen à bandes élargies'*
B. Rzepkowski

• *'Endettement et déflation financière au Japon, au Royaume-Uni et en France'*
S. Guichard, B. Mojon

Le débat de politique économique : les fonds de pension

• *'Faut-il des fonds de pension?'*
P. Pestieau

• *'Répartition, capitalisation et sécurité des régimes de retraite'*
E. P. Davis

• *'La sécurité sociale dans les réformes récentes des retraites en Amérique Latine'*
S. Valdés-Prieto

Price:
FF 117 per issue,
FF 440 annual subscription in Europe, and FF 465 outside Europe.
Publisher: la Documentation française

LA LETTRE DU CEPII, MONTHLY

• *'Le désajustement de la balance courante mondiale',*
I. Rabaud
No 170, July-August 1998

• *'Les dix pays candidats et l'Union européenne: L'intégration en marche',*
M. Freudenberg, F. Lemoine
No 169, June 1998

• *'En attendant l'AMI : un bilan des relations entre IDE et commerce',*
L. Fontagné
No 168, May 1998

• *'Le marché du travail britannique vu de France',*
M. Fouquin, S. Jean, A. Sztulman
No 167, April 1998

• *'Le Brésil et la Russie face au risque de crise financière',*
J. Sgard
No 166, March 1998

• *'Productivité du travail dans les transports, les communications et le commerce : une comparaison internationale',*
B. Chane Kune, N. Mulder
No 165, February 1998

• *'Mesurer les inégalités entre nations',*
L. Cadiou, P. Villa
No 164, January 1998

Price:
FF 305 outside France.
Publisher: la Documentation française

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BOOKS BY CEPII RESEARCHERS AND CONFERENCE PROCEEDINGS

• *L'ECONOMIE DU JAPON*
Evelyne Dourille-Feer, 120p., coll. Repères, La Découverte, FF 49.

• *DIFFERENT PATHS TO A MARKET ECONOMY, CHINA AND EUROPEAN ECONOMIES IN TRANSITION*, O. Bouin, F. Coricelli and F. Lemoine, CEPR/CEPII/OECD Development Centre, 1998, 197 p. 195 FF.

• *EMPLOYMENT AND EMU,*
Conference proceedings of the first French-German Economic Forum, 2-4 July 1997, Paris, CEPII and Zentrum für Europäische Integrationsforschung, Bonn, *ZEI Policy Paper* B97-02.

• *L'EUROPE APRÈS L'EURO : STRATÉGIES POUR LA CROISSANCE ET L'EMPLOI,* Conference proceedings of "l'Europe après l'euro", organised by L. Fabius, J. Lang, Elie Cohen and the CEPII, collection Les Documents d'information, Assemblée nationale, March 1998,139 p., 40 FF.

CEPII WORKING PAPERS

• *'La politique monétaire et la crise japonaise'*
S. Guichard
No 98-06

• *'La régionalisation du commerce international: une évaluation par les intensités relatives bilatérales'*
M, Freudenberg, G. Gaulier, D. Ünal Kesenci
No 98-05

• *'Pegging the CEEC's Currencies to the Euro',*
A. Bénassy-Quéré, A. Lahrèche-Révil
No 98-04

• *'The International Role of the Euro',*
A. Bénassy-Quéré, B. Mojon, A.-D. Schor
No 98-03

• *'EMU and Transatlantic Exchange Rate Stability',*
A. Bénassy-Quéré, B. Mojon
No 98-02

• *'Programme de travail 1998'*
No 98-01

The full text of Working Papers are available on the CEPII's web-site: http://www.cepii.fr

Events: Conferences, Seminars and Meetings

- **Product Quality, Labour Productivity and Trade (CEPR)**
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. Dourille-Feer (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**
J. Sgard (CEPII) C. de Boissieu (University of Paris I)
26 February

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

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

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

- **Chinese Reforms in Industry and Finance, 1994-1998**
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)
26 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 Groeninger joined the CEPII as an information technologist in May.

Forthcoming

- The CEPII, CEFI, DREE, Caisse des Dépôts et Consignations and the *Revue Economique* are organising a joint workshop on "Central European Countries' integration into the European Union" on the 15-16 September in Prague.
- On 23 September the CEPII's report entitled "Competitivité des nations" (The Competitiveness of Nations) is being presented at a meeting in Paris. For further information contact Valérie Colombel tel: (33) 1 53 68 55 24, E-mail: colombel@cepii.fr

To mark its 20th Anniversary, the CEPII is organising a conference entitled: "The World Economy: 1978-1998-2018" - Paris, 21 October 1998.

Opening by M. Bourdin (President of Planning Delegation, French Senate) and D.Strauss-Khan, (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. Courtis (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. Brender (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. Berthélemy (Director of the CEPII), J.-L. Beffa, (CEO of Saint-Gobain), J. Pisani-Ferry, (Advisor to the Minister for Economic Affairs)

Concluding remarks by R. Barre (former French Prime Minister)

* to be confirmed

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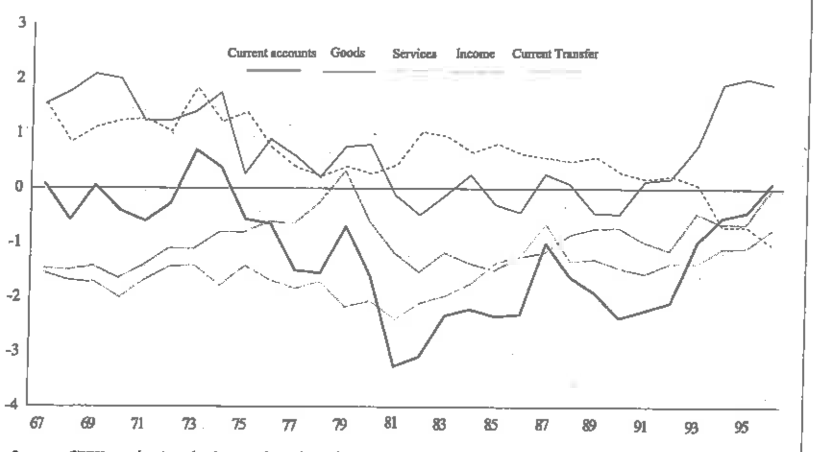
CHELEM DATABASE

The World's Current Account Discrepancy



Source: CEPII, author's calculations based on the CHELEM database.

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,
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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

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