GLOBAL REGIONALISM
ECONOMIC AND INSTITUTIONAL CONVERGENCE IN EUROPEAN AND EAST ASIAN REGIONS AND THE NEED FOR NEW GLOBAL GOVERNANCE REGIME

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International Workshop on

GLOBAL REGIONALISM
ECONOMIC AND INSTITUTIONAL CONVERGENCE IN EUROPEAN AND EAST ASIAN REGIONS
AND THE NEED FOR NEW GLOBAL GOVERNANCE REGIMES

CIRCOLO DEGLI SCACCHI

VIA DEL CORSO, 518 - ROME

MONDAY, FEBRUARY 8, 1999

MORNING 9:30-13:15

Introductory Session: ***Global regionalism: trends and perspectives***

Paolo Guerrieri, University "La Sapienza", Rome; IAI, Rome, Italy

Session I: ***Regional integration: economic and institutional convergence***

The experience in Europe

Jacques Pelkmans, CEPS, Bruxelles, Belgium; University of Maastricht, Holland

Discussants:

Bernd Hayo, Zentrum für Europäische Integrationsforschung, University of Bonn, Germany
Motoshige Itoh, University of Tokyo, Japan

Coffee-break

The experience in the East Asia region

Siow Yue Chia, Institute of Southeast Asian Studies, Singapore

Discussants
Axel Borrmann, HWWA, Hamburg, Germany
Rolf J. Langhammer, Kiel Institute of World Economics, University of Kiel, Germany
Salvatore Rossi, Central Bank of Italy, Rome, Italy

Lunch-Buffet

AFTERNOON **14:30-18:00**

Session II: ***Policies and rules at regional and global level***

a) Competition policies at regional and global level

Peter Holmes, University of Sussex, Great Britain

Discussants

Byung-il Choi, Graduate School of International Studies, Seoul, Korea

Piercarlo Padoan, University "La Sapienza", Rome; IAI, Rome, Italy

Coffee-break

b) Trade and investment policies

Bernard Hoekman, The World Bank, Washington, United States

Discussants

Zdenek Drabek, ERAD, WTO, Geneva, Switzerland

Josef T. Yap, Philippine Institute for Development Studies, Manila, Philippine

TUESDAY, FEBRUARY 9, 1999

MORNING **9:30-13:30**

Session III: ***Monetary and financial integration***

Hans-Eckart Scharrer, HWWA, Hamburg, Germany

Discussants

Marcello De Cecco, University "La Sapienza", Rome, Italy
Toru Iwami, University of Tokyo, Japan; LSE, Great Britain

Coffee-break

Session IV: ***Local governments, state and global systems: challenges for a new political and institutional dimensionin Europe and in Asia***

Sergio Arzeni, LEED, OECD, Paris, France

Discussant

Gianni Bonvicini, IAI, Rome; Johns Hopkins University, Bologna, Italy

LIST OF PARTICIPANTS

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DRAFT - NOT FOR QUOTATION

EUROPEAN INTEGRATION, ECONOMIC AND INSTITUTIONAL CONVERGENCE

by

Jaques Pelkmans
CEPS, Brussels and Maastricht University

The experience of the European Union, its Member States and its regions with integration strongly suggests that it has prompted pervasive economic and institutional convergence. At the same time, diversity and heterogeneity among the peoples of the Union is considerable and there are few signs that these characteristics are weakening. Because of these stylised facts it is critical to be careful about the various meanings of 'economic and institutional convergence'. The European experience also shows that the length of the integration period and the level of ambition of the integration agreement(s) matter for convergence.

The structure of the paper follows from these considerations. Section 1 discusses various possible meanings of economic and institutional convergence and selects three of them for the purpose of this paper: convergence of the economic framework of groundrules, of economic liberalisation and regulation, and of economic policies. This is complemented with a brief word on the role of law and institutions. Section 2 distinguishes five successive periods of increasing ambition in European integration since 1950 and attempts to characterise them in terms of the three forms of economic and institutional convergence. It draws five inferences from this overview. Section 3 looks at the other side of the 'acquis', now accomplished. It asks the question what policy discretion Member States still have in the areas covered by acquis. To what extent is 'divergence' in these areas an option? Section 4 attempts to answer the question whether the assignment of public economic functions to the national level – under "subsidiarity" – implies divergence or perhaps still leads to convergence. This is illustrated for five 'national' policies. Section 5 verifies whether economic and institutional convergence can be observed in what traditionally have been "domestic" policy areas where the treaties avoid the (integrative) Community method and call for cooperation (the pillars II and III of the Maastricht treaty), and in those areas where the treaties do not apply (e.g. the typical spending ministries). The paper ends with some remarks for the discussion, especially how this exposition of convergence could be meaningfully juxtaposed to, for instance, the East Asian experience.

1. What is economic and institutional convergence?

Convergence refers to a trend of increasing similarity. The term is generic and can be applied to concepts, (economic) policies, principles and economic performance indicators, but also to, for example, the ranking of a set of priorities. For Tinbergen (_), convergence referred to the mutual approximation of two diametrically opposed economic orders: central planning and the market economy. In the EU economic convergence became Community jargon with the 1974 convergence decision [1]) and received additional weight when the EMS was initiated because 'the credibility of the new system depends on progressive convergence of economic performance [2]). Real economic convergence between poor and rich countries or regions in the EU has become an ever more explicit aim since the start of the Regional Development Fund

[1]) Art. 4 of Council Decision 74/120/EEC of 18 Febr. 1974 speaks of the 'attainment of a high degree of convergence of economic policies of Member States'

[2]) Monetary Ctee report on the EMS, to Council and Commission, 7 Nov. 1978, quoted with Steinherr, 1984, p. 71

(1975) and the insertion of 'economic and social cohesion' in the Single European Act (ratified 1986). In fact, such an aim of convergence was already hidden in the first two aims of the Rome treaty in the terms 'harmonious development of economic activities' and 'balanced expansion' (as 'unbalanced growth' in the 1950s referred to increasing income-per-capita divergence between lagging and advanced economies). Nominal convergence, first interpreted as (downward) convergence of inflation rates of EMS partners, almost became a household term in the 1990s, as shorthand for the non-fiscal entry conditions for monetary union specified in the Maastricht treaty.

For purposes of the present conference, however, nominal and real convergence are less relevant. The idea is to understand and analyse how regional integration systems operate, how they could be compared in a suitable way and whether they might develop incompatibilities with the WTO rules, in words or spirit. For such purposes the following triptych would seem to be more appropriate:

- convergence of the economic framework of ground rules
- convergence of economic liberalisation and regulation
- economic policy convergence

The generic word 'convergence' may, in principle, cover many aspects of those three foci. Applied to the EU, however, it is often far more precise to employ terms such as unification, centralisation, approximation (or, harmonisation, also used in the treaties) and free movement where the "acquis communautaire" is concerned. This will be clarified in the following section. Outside the acquis, convergence of regulation and of policies of Member States presents no conceptual special problems.

Applying convergence to institutions calls for contextual explanation. In an economic perspective institutions may refer to actual political and administrative bodies and procedures, the results of which impact on economic conduct. Not seldomly, especially in economic theory, are the regulatory environment and tax structures stylised as 'institutional. Since economists are interested in markets, private institutions are considered even more important to understand economic processes, be they firms, alliances, associations of companies, consumers, workers, professionals. In a still wider perspective, how markets work (or why they fail) also depends on 'institutional' factors such as property rights, contract law, efficiency and efficacy of the legal system and obligations about transparency. "Soft" institutional aspects matter, too, such as commercial 'culture', ethnic networks and the preference or reluctance to involve the state, the (extended) family or the local communities.

Institutional convergence is therefore elusive and exceedingly hard to measure in a comparative fashion. To apply it to European integration poses additional problems. The EU is rather decentralised, but it does have central institutions and EC law is supreme. A good deal of the acquis is 'directly applicable' – applied directly to companies and consumers, hence, not involving any legal act of a Member State – so that it amounts to centralization. For directives, national laws are necessary but the nature of this legal instrument imposes far-reaching convergence among the relevant national laws. Thus, implementation and enforcement is national, but monitoring by the Commission and – some – possibilities to take private legal action in local courts form very powerful checks against too great diversity or infringement of EC law. Indeed, in terms of the internal market and the more important common policies, it is hard to distinguish the EU from a federation. The only crucial difference is the absence of any EU right to tax or impose social charges.

It is therefore more interesting to study institutional convergence outside the EC acquis. Within the acquis, the question to ask is, rather, what is the optimal degree of (de-)centralisation.

2. Convergence as a function of integrative ambitions

The present section will show how economic and institutional convergence became more extensive over 50 years of European integration. I like to be clear what such a statement does and does not mean. It is often asserted that the Community has become more diverse as it grew from the old EC-Six to today's EU-15. In certain respects – such as disparities of per capita incomes and the roles of governments in the economy – this is undoubtedly correct. However, it is good to realise that the erstwhile EC-Six has, in many ways, 'converged' over time, causing the initial 'divergences' to be forgotten. A few examples may serve as a warning that 'convergence' over long time periods may significantly change countries. Italy and the Netherlands were, in the early 1950s, emigration countries – for Italy, emigration took place within the ECSC, later EEC (and Switzerland) as well as intercontinentally; for the Netherlands, emigration was directed only to other continents. If anything, both countries are now immigration countries. When the EEC started, France was governed by a system of 'indicative planning' and Italy practised a strategy of a 'developmental state' via several giant, state-owned holdings. Yet, these two countries signed a far-reaching and pro-competitive treaty with Germany and Benelux, both more market oriented. Today, the legacies of these 'dirigiste' post-war approaches have virtually disappeared. When the UK joined, its geographical composition of trade was less EC-oriented than the EC Six. Yet, during the two preceding decades, France had already changed from a heavy trade reliance on (former) colonies to an EU-dominated trade patterns. For decades the EU witnessed a rather sharp divide between consensus models of socio-economic policy making (Germany; Netherlands; Denmark; to some extent Belgium) and conflicts models (the UK, France and Italy). And yet the consensus model of the Dutch, with corporatist elements and crowned by the highly influential, tripartite Socio-Economic Council introduced especially by Christian-democrats, differed sharply from the German way, with "Mitbestimmung' but without such a Council, equally under Christian-democratic influence.

Such anecdotal evidence should make one prudent to generalise too quickly about convergence in a non-specified way. The present section only deals with the deepening and widening of the 'acquis communautaire' as this is a well-defined starting point.

Table 1 provides the main elements of deepening and widening in a cumulative fashion over five treaty-based periods. The left column specifies the European Coal & Steel Community (Paris treaty of 1951), the EEC treaty of 1957 (of Rome) and its implementation up until the mid-1980s, the re-write of the Rome treaty (as the Single European Act) and the EC-1992 program following in its wake, the Maastricht treaty on

European Union (in force since Nov. 1993) and the Amsterdam treaty (ratification expected by May 1999). The many elements added in every period are divided over the three forms of convergence distinguished in section 1: of ground rules, of liberalisation & regulation, and of economic policies.

TABLE 1 - How convergence spread with more EU integration

	convergence in ground rules	convergence in liberalisation/ regulation	economic policy convergence
ECSC	o very little (because only sectorally)	o free trade area/sectorally o pro-competitive (anti-trust; state aids) o potentially centralist, yet national discretion large	o adjustment assistance
ROME	o market economy implicit → four freedoms → system of competition o conditional openness → promoting world trade → competitiveness o link to human rights & democracy (Eur. Convention) explicit (Declar. of 1977)	o free product movement o mutual recognition (=limits to divergence) o product regulation (SHEC) via old & new approach + global approach (boost to convergence) o common trade/competition policies o common agricultural policy o failure services & factor market integration o selective other convergence (e.g. environment; equality men/women in labour markets; some structural)	o weak macro economic cooperation until EMS o EMS, exchange rate stabilisation (with loopholes) o ad hoc industrial & technology policy co-operation
SINGLE ACT	o market economy implicit, but four freedoms no longer conditional	o free services movement o mutual recognition in service (=limits to divergence) o service regulation in minimal format (boost to convergence) o free capital movement o free technology movement via regulation of property rights at 2 levels o failure labour market integration	o strengthening EMS for greater macro-economic convergence o structural policies
MAASTRICHT	o subsidiarity o proportionality o open market with free competition o stable prices	o some rhetorical additions to regulatory power (e.g. social protocol) o culture policy must contribute to the 'flowering of cultures of the Member States' (divergence)	o elaborate system of economic policy co-ordination (ALL of EU) o convergence reports (macro +labour

	o sound public finance & monetary conditions o sustainable balance of payments	o strict monetary constitution - centralisation money & mon. policy - central statute ECB - national central banks part of central system (strongly convergent) - identical entry conditions - some constraints of budgetary policies o cooperation in justice & home affairs for free persons movement o co-operation in foreign & security policies	markets), vetted by all MS. o non-compulsory linkage between "ins" and "outs" of EMS o competitiveness & bench marking exercises o privatisation (convergence without obligation)
AMSTERDAM	o area of peace, justice & security o human rights, rule of law & democracy	o new rhetorical additions to EU action (e.g. employment; utilities) o regulation for free persons	o stability pact (stricter convergence of budgetary policies) o employment policies of mutual interest to MS

The Table is cumulative, in the sense that every subsequent treaty period is described only in terms of newly added elements: today's acquis is the addition of all the items in Table 1.

A careful reading of Table 1 suggests several conclusions:

i. EU integration has become more and more demanding in terms of the economic order EU members subscribe to, that is , **there is increasing convergence of economic ground rules**. The sectoral integration of coal and steel under the ECSC was compatible with many variations of what was then called the 'mixed economy', a market economy with considerable state-ownership, the emerging 'welfare state', and other interventionism. And this despite the fact that the ECSC was a potentially 'centralist' free trade area [3]), with a common (though sectoral) competition policy, a ban on subsidies, central 'guidance' on investment, adjustment assistance paid from ECSC levies (on output) and far-reaching powers in case of a so-called 'manifest crisis'.

The Rome treaty is also compatible with different degrees of interventionism in a market economy. Neither the Preamble nor the basic Articles 2 (aims and two broad 'means') and 3 (instruments) contain an explicit reference to what kind of market economy is strived after. Perhaps wisely from a negotiation point of view, the market economy is left implicit and – as Table 1 indicates – one can easily find critical elements of the implicit economic order. But due to sequencing and conditionality problems, Member States retain a great deal of discretion in many aspects. As illustrations, consider Art 222, EEC (property rights are strictly a matter for the Member States, implying that large variations in state ownership are compatible with the EEC), Art 90 (long held to mean that public utilities were, for all practical purposes, not part of the 'common market', a view supported by the EC Court in the 1974 Sacchi case), the controversies over important liberalisation articles which remained long unresolved precisely because 'divergence' would be undermined by liberalisation through free movement [4]), and the enormous problems in state aids (aid to shipbuilding is already mentioned in Art 92, EEC and still not fully resolved 42 years later!), not to speak of the massive interventionism in agriculture [5]). These illustrations point to such divergences in economic regulation and policy that the

[3]) Free trade areas typically shun centralist institutions and anything beyond minimal approximation of regulation and/or trade policy instruments. The new free trade areas of the 1990s, do comprise more regulatory convergence than conventional ones, but they still shun central institutions, let alone interventionism.

[4]) For instance, Art 27 (on-too-weak customs cooperation), Art 30 (banning regulatory barriers), Art 37 (strictly interpreted for state distribution monopolies of ordinary goods, but carefully avoided for gas and electricity utilities), Art 59 (free movement of services) and the common transport policy chapter (where free movement was long blocked by insisting on prior 'harmonisation'). Other examples include Art 67 and 68 (very weak on free capital movements) and the refusal to be consistent on national quotas vis a vis third countries' imports.

[5]) In agriculture, the EEC undertook to centralize very divergent national interventionism in agriculture. Buying off, time and again, these divergencies in a central policy leads to explosive imbalances: from subsidising as much as 5% of EC value added in agriculture in 1970, this rose to 30%(!) a decade ago. Any CAP reform must "undo" this irrational "convergence" by restoring the market role of prices and accepting, perhaps gradually, the resulting adjustment.

Balassa-type common market, suggested implicitly in Art 3, EEC, could, in actual practice, never grow to more than a custom-union-plus, with a few selected common policies. This custom-union-plus is summed up in the 3rd and 4th columns, of the row of the Rome treaty.

Once sequencing and conditionality were largely removed by the Single Act, by a few landmark cases of the EC Court and by the EC-1992 program, the powerful processes of liberalisation and regulation prompted a gradual consensus over six fundamental principles of the economic order for a multi-tier government in a truly single market. They appear in the Maastricht treaty in the "chapeau" and find important micro and macro 'echoes' in the treaty text itself. No doubt the opening up of Central and Eastern Europe influenced this search for consensus as well.

ii. The liberalisation, in terms of free movement, and regulation has gone far. One suspects an interplay with the emerged consensus on the economic order: did the EU liberalisation also prompt a pro-market 'convergence' of national economic philosophies, or, did the latter facilitate EC-1992? It can be argued that the four freedoms have caused such a powerful liberalisation, hence actual and potential competition across the entire single market, that 'national' echoes of further liberalisation and regulatory reform became indispensable for a better market functioning, for business opportunities and for competitiveness and attractiveness for investors. However, there are also good grounds to argue that interventions, a search for equity at the expense of efficiency, protectionism and "jobless growth" under "eurosclerosis" in the early 1980s caused a disenchantment with the mixed economy. Governments all over the Community began to emphasis pro-market, pro-competition, pro-free-trade policies, while cutting unconditional subsidies. Many governments (not least, those with social democrats as prime minister/president) wished to reduce the initial sensitivity for such a U-turn by letting the EC take the lead in the 1985 White Paper and the Single Act. Both perspectives need not be inconsistent.

With the circular strengthening of market-driven policies everywhere in the Union, the convergence could be more easily codified in liberalisation obligations and joint regulation. It also made the societal acceptance of mutual recognition possible. After all, mutual recognition is a radical principle for two reasons: first, it undermines the detailed specifications of existing laws, while (via directive 83/189 and its silent but powerful controls) severely constraining future national product regulation; second, it does help 'divergence' by avoiding uniform EC (product or service) regulation, although the autonomy of being 'divergent' is conditioned by the overriding free-movement obligation. Altogether, the interplay between converging economic philosophies and EC liberalisation had led to impressive results.

The conclusion of 50 years European integration is that **there is far-reaching convergence with respect to the free movements and the related product, service and property rights regulation.** Only with respect to labour markets, social security and social policies is EC regulation patchy and of little importance (except equality of men/women; occupational health/safety; non-discrimination of non-domestic EU workers), hence the economic distortions of the "common" labour market present enormous obstacles due to 'divergence'.

iii. Macro-economic convergence has been very strong in every respect. For all EU Member States the macro economic ground rules are now the same and all are bound by an elaborate system of macro economic policy co-ordination and consultation. In the June 1998 Cardiff European Council this co-ordination was, at least provisionally, extended to what economists would call micro-macro links [6]). In the framework of monetary union [7]), there is currency unification, a single monetary policy (and new, EURO-11- wide payments system and an EURO-11-wide interbank market) and institutional centralisation (the ECB, the ESCB-system), institutional reform (merging the Economic Policy and Monetary Committees; the EURO-11 "Council") and some institutional convergence between national central banks (e.g. all independent, today).

Pressure to have more 'convergence' between Member States on the (close) link between prudential supervision (some have independent supervisors, others assign the central Bank with it) and the lender-of-the-last resort function may well lead to further change. Any significant liquidity operation in Euroland for 'last-resort' cannot be executed without the ECB.

Budgetary convergence has also increased but remained more modest. Member States

have converged around the idea of 'sound public finance', and in particular low budget deficits. The option of joining monetary union (which goes further in budgetary convergence) has exercised a very powerful effect in lowering budget deficits, although countries like the UK and especially Denmark exhibited forceful domestic pressures to cut imbalances. The most spectacular cases are undoubtedly Greece, Italy, Ireland and Finland where, at different points in time, strongly disinflationary measures were pushed through.

In the monetary union the (fiscal) entry conditions have imposed convergence on the deficits side, and - more slowly as this takes time - on the total public debt/GNP ratio side. Once inside Euroland, further budgetary convergence is implied by the ban on monetary financing, the no-bail-out provision and the 1997 Stability Pact (tightening fiscal policy over the business cycle).

Of course this still leaves a great deal of budgetary autonomy (hence, potential divergence) and almost complete tax autonomy outside VAT & excises. To the extent fiscal competition for mobile factors may exercise discipline, corporate taxation would seem to be subject to downward convergence (but from initially very high rates). It is possible that the emerging consensus on 'harmful' tax competition may prompt convergence in savings/capital income taxation and/or tax havens (see further).

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[6]) Commission communication, COM (1999)10/4 adopted on 21st January 1999 on: "Economic reform: report on the functioning of Community product and capital markets" and the later inclusion in the Broad Economic Policy Guidelines.

[7]) It is seldomly realised outside the EU that all Member States have gone to stages I and II of EMU. Stage III is monetary union with the EURO, and a single monetary policy by a single central bank, the ECB.

iv. There are signs that **the deepening and widening of economic integration might be leading to greater economic policy convergence, other than macro.** In the 1990s the emphasis on 'benchmarking' exercises for competitiveness occurred at both levels of government. The EC has a long history of competitiveness concerns, from the considerations in the 1956 Spaak report, via Servan-Schreiber (1967), the technology & (low-growth) - specialisation debate of the early 1980s, to the 1997 competitiveness report of the Commission. The crucial differences are that, this time, the economic policy convergence is 'horizontal', not sectoral; pro-market and hardly interventionist; business-strategy oriented, with an emphasis on best-practice in world markets, rather than based on pre-conceived policy notions; and focussed on good (EU and national, even regional) governance, and minimisation of costs for business.
The Amsterdam treaty comprises a rhetorical section on 'employment' policies. Strenuous efforts are now undertaken to pursue convergence of best-practice employment policies, but there is still a taboo on serious regulatory reform of national labour markets. In fact, these efforts are doomed unless and until genuine liberalisation (and mutual recognition) for the purpose of (relatively) undistorted free movement of workers becomes acceptable. This might well be unacceptable without some degree of centralisation of social policies, which is far-off. Finally there is a convergent trend of privatisation, a clear case of policy emulation within the EU and/or with Central Europe. The convenient convergence of interests of reformers and the budget ministers has surely helped to sustain this trend since the mid-1980s.

v. **The enormous expansion of the 'acquis' as well as its growing technicality in specific areas has prompted innovative institutional developments at the EU level.** As they are an outgrowth of centralisation pressures, the term 'institutional convergence' might not fully reflect the nature and today's results of this process. The Community has always practised "divided governance": (some degree of) centralisation of regulation, and of a few (common) policies, combined with implementation and enforcement at the Member States' level [8]). Essentially, two trend changes can be discerned since the late 1980s.

First, **"divided governance" has come to be much more tightly managed,** because without such tightening implementation and enforcement will occur far too slowly, inaccurately, unevenly or indeed not at all. The naive, legal concept of safeguarding the internal market solely with infringement procedures has clearly been shown to be grossly insufficient. The tightening has been gradually achieved over the last 10 years in view of the sensitivities involved. A non-exhaustive list of measures includes score-tables for all Member States on implementation, 'package-meetings' with Member States on delays or lax enforcement, a pro-active Commission searching for infringements rather than 'waiting' and so-called 'interpretative Notes' on dubious practices. Furthermore, active campaigns (with

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[8]) An exception can be made for the anti-trust part of competition policy (even there, attempts to decentralize the 'policy' function can be oberserved) and for price/income policies of the CAP

business) on the internal market, annual reports and the 1996/97 massive Single market Review were purposefully utilised to narrow the (perceived) discretion of the Member States. Finally, in an interplay with the EC Court, some landmark rulings have also tightened the link between the adoption of a directive and (non-)implementation: domestic law which is inconsistent with the directive, may, in the absence of implementation, be unenforceable, and damage claims due to non-implementation are now possible. An analogue, tough attitude by the Court has been assumed for the (non-) notification of all new product laws or their technical amendments [9]).

Second, the pressure to centralise was often found in highly technical, executive problems. In accordance with 'divided governance', the Commission has traditionally not been involved in executive matters. But this became more and more difficult as integration deepened. **The innovative approach chosen is the establishment of autonomous, yet not fully independent agencies**. Since 1990, ten such agencies have been established, such as the European Environmental Agency (monitoring; technical measurement; modelling; advice), European trade mark office [10]) and European Medicinal Agency. Member States control these agencies together with the Commission. In 1999 a truly independent agency was inaugurated: The European Central Bank. Functional pressures to create more agencies are still strong: the ULTRA (the Union-Level Telecoms Regulatory Authority – see Pelkmans, 1998), one for common air traffic control, one for air transport safety and inspection, and one for food security (where the agency has, at the last moment, been placed 'inside' DG 24, Commission).

This paper is not the place to discuss the agencies and their meaning (see Keleman, 1997; Dehousse, 1997; Majone, 1997; etc.), and the differences with relatively autonomous services inside the Commission (like ECHO, for food aid, etc.) as well as intergovernmental agencies, close to the EU (like the European Patent Office in Munich). It is nevertheless clear that institutions matter once economic integration begins to deepen, and that agencies may have solved some crucial executive issues for the internal market, without undue centralisation.

3. The meaning of the acquis for Member States

When trying to come to grips with 'convergence', and especially in a comparison with other regional integration agreements (RIAs), it should be helpful to clarify the scope for 'divergence' for the Member States in areas falling under today's acquis. Given the wide scope and tremendous detail of the acquis, the following can only sketch what are probably the main items of interest. I shall briefly discuss trade policy in goods, trade policy in services, direct investment, product regulation, services regulation, network industries, (industrial) property rights, social 'standards' and competition policy (in the

[9]) Thus, in mid-1997, the Dutch government found itself in a regulatory crisis, as nearly 400 non-notified laws/decrees, etc. were discovered, after screening. For 4-5 months it was unsure which ones were enforceable and which ones not!

[10]) With the curious name of the Office for Harmonisation, a clear misnomer. Location: Alicante, Spain

wide sense). In selecting these areas the macro-acquis is ignored as it is presumed to be irrelevant in a comparison with any other RIA [11]).

Trade policy in goods

The EU acquis is practically completely centralised. Member States have no longer any discretion in tariffs, quotas, anti-dumping levies, origin rules or technical customs matters (e.g. valuation, customs forms, transit, etc.). Apart from some lingering issues on so-called dual-purpose goods, the 'convergence' boils down to centralisation of rules (and liberalisation) and uniform execution at the national level. Also, "national" VERs have disappeared (the car quotas are in their final year). It is good to illustrate what that means. Occasionally, one still asserts that there are 'liberal' and 'protectionist' Member States in the Union. In terms of the state of liberalisation, and the rules that govern the EU's outer frontiers, such a statement makes no sense. France or Spain is just as liberal as Sweden or the UK. If it refers to discussions in the 113 Ctee or the Council, it means little more than what debates in the US senate between senators from different states would mean.

Trade policy in services

The treaty is very unclear about external trade policy in services. In 1994, when ratification of the Uruguay Round came up, the EC Court was asked its Opinion (94/1). The Court held that cross-border supplies of services fall under EU trade policy (as an exclusive competence). Probably, that aspect of services - requiring free movement - is too radical for WTO negotiations. Services provided via local establishment, or services supplied by a mobile provider or received by a mobile consumer (e.g. a tourist) fall under concurrent powers. An attempt to rewrite Art 113, EC (the basic trade policy article) so as to clarify the issue in the Amsterdam treaty failed. Now that the internal market for services has made great progress and WTO Agreements on financial services and telecoms have been concluded, the concurrent power complication might not mean too much. **In services regulation the EU still allows a degree of divergence (see below) that is bound to be reduced first in the EU itself, after which non-discrimination will limit the discretion of the Member States in WTO, too. However, in road and air transport, concurrent competences do matter still.**
The most important reason is that Member States maintain bilateral treaties with third countries. The problem is a serious one in air transport where e.g. national bilaterals with the US differ greatly in regulatory strictness. This results in distortionary effects on the internal market and differential access to the huge US market. Only centralisation of external air transport negotiations, under an Art 84 Council mandate to the Commission - something Member States were unwilling to do thus far - can remove these distortions, and, in so doing, will imply convergence.

Besides sectoral pressures in the market to converge via more centralisation, also the EC Court exercises pressure: it displayed unusual candor in posing two (weakly

[11]) Thereby, also de-facto currency unions with mini-states (Monaco, San Marino) or between Singapore and Brunei or (in future?) Argentina and the US are ignored.

centralising) conditions to Member States retaining trade policy powers in services: an obligation of the two levels of government to cooperate closely during negotiations, and a 'requirement of unity' in the international representation of the Community.

Direct investment

The EU has always had national treatment (Art. 58, EEC) for foreign investors, irrespective of whether they came from the EU or abroad. State aids to any direct investment (foreign or domestic) fall under an EU effects-based regime, which constrains divergence and indeed a subsidy race considerably, although land prices and tax breaks remain available for national policy discretion. Local contents rules or export performance requirements are forbidden in the EU. **So, altogether there is some, but only modest, divergence in national policies for direct investment.** Indeed, it is today mainly regions which compete to attract direct investment, and their "instruments" mainly include 'one-stop-shopping' for permits and other formalities and 'locational' factors.

However, during the MAI negotiations in the OECD it became apparent that there are nevertheless significant divergences between the Member States if it comes to multilateral "standards" for investment agreements. They matter less for the EU itself and more for developing countries. The issues have to do with social, environmental and other issues as well as with good corporate citizenship, which caused the MAI to be controversial in certain circles.

Product regulation

Product regulation in the EU should always be viewed in conjunction with free movement. **Thus, where free movement is not at issue, there are few pressures for regulation to 'converge'**. It is true, however, that the EU's ban on regulatory barriers reaches far. Such barriers can be pre-empted by so-called 'old'-approach regulation which replaces entirely previous national regulation (hence, unification and 'full' convergence) like in cars, trucks, tractors, metrology, chocolate and certain chemicals. Analogously, they can be removed by new approach regulation with reference to standards, which provide some discretion; in actual practice, however, firms massively adhere to the European standards so that de facto convergence goes very far. Barriers can also be minimised by mutual recognition in combination with proportionality. At first sight this would enable the maintenance of 'divergence' because no (converging) EC directive will be written. And indeed, mutual recognition has allowed many national laws to remain in place, with no or only minor adaptation. But since competitive exposure increases because of free movement, the (extra) costs of restrictive domestic regulation fall on the domestic producers alone. Absent very strong local preferences for such restrictions (say, for 'quality' reasons), competitive disadvantages may eventually cause a reduction in profits or market share. In such cases, regulatory competition should be expected to reduce the regulatory 'burden', and convergence might take place. But this is not a static phenomenon. Every year the 15 Member States, together, draft some 700 product laws, or amendments of them. All of those pass the so-called 83/189 Ctee and many of them will explicitly have to incorporate 'equivalence' or mutual recognition clauses. Also, many actual or potential irregularities are taken out via a painstaking 'detailed-opinion' procedure which forces a stop of national legislative processes, for the relevant draft law, for anything between 3 months and 18 months! **Divergence is obviously greatly constrained this way.**

Services regulation

Also, services regulation in the EU should always be viewed in conjunction with free movement. And similar to product regulation, **there are few pressures for regulation to 'converge' where free movement is not at issue.**

Still, there are important differences with product regulation. First, regulatory approximation in services for the purpose of free movement has gone less far than in goods. In banking this matters, because the exceptional status of the 'general good' clause has been shown to hinder mutual recognition, despite home country control. Other 'host country' regulatory discretion (e.g. matters having relevance for monetary policy and liquidity) have become irrelevant, at least for Euroland. The 'general good' clause has been the subject of much debate, EC Court cases and communications from the Commission. It shows how radical the combination of mutual recognition [12]) , home-country-control and the single "banking passport" (i.e. the license) for free movement actually is. In insurance, considerable residual national regulation has remained, especially for non-life insurance in the mass-risk sector. In road and air transport regulatory approximation has remained modest but little national discretion has remained due to free movement, free establishment and competition policy.

Second, practically all of the services approximation is of the 'new approach' type, with an emphasis on objectives and minimum requirements (here and there, with a reference to standards), not on excessively detailed specifications. Convergence is not seen as essential; what is essential is to remove obstacles for free movement (and indeed free establishment). There is a grey area, here, because, even when the legal 'right' to free movement is guaranteed, many or great divergences between domestic <u>regulatory</u> requirements may increase transaction costs, or otherwise imply entry barriers for non-national entrants. Actual competitive entry may then be inhibited because there are also <u>economic</u> barriers to entry in most services markets. Thus far, in banking and insurance as well as air transport, interpenetration via cross-border services and establishment has taken place but on a still modest scale. Restructuring via domestic mergers, cross-border alliances and rationalization (e.g. of branches) has taken priority in the 1990s. In road transport, a competitive, non-oligopolistic sector with low entry barriers, free cross-border services provision (and cabotage) and free establishment in the form of the build-up of European logistics multinationals and networks has been more pronounced.

A third difference is that the 83/189 procedure does not exist in services. [13]). Fourth, taxation issues in services have a chilling effect on the actual cross-border services provision. In pensions and mortgages the edifice of the internal market is just a facade since the 1992 Bachmann case gave priority to the protection of national tax revenues above free movement. The crux of the matter is tax deductibility (of e.g.

[12]) Especially since the 1992 Säger case, the equivalent of Cassis-de-Dijon for goods

[13]) Other than information services

interest) or temporary tax exemption (for premiums). Fifth, a lack of harmonized accounting rules is more important for certain services (e.g. under the Investment Services directive; and for the internal market for accountancy services, which still suffers from obstacles) than in goods.

Therefore, it would seem that **convergence in services is less far-reaching than in goods. For economic reasons, one should expect this to change only gradually.** Services often require proximity to the customer. Asymmetries of information are considerable which prompts high consumer loyalty, which can be further cemented by clever business strategies. Other barriers to entry (e.g. in air transport) make entry which goes beyond fringe competition difficult and costly.. In other words, the competitive pressures via free movement & free establishment will not be such that regulatory competition will rapidly induce further convergence.

Network industries

Formerly called public utilities ('services publics'), the EU has witnessed a revolution of these anti-competitive fortresses. Dependent on how one's perspective is, one can argue that **convergence (liberalisation) trends have the upper hand,** but also that, **given this trend, one may observe great divergences in the national mix of privatisation, deregulation and reregulation, and in the speeds of regulatory reform.** This complex picture derives from the fact that some countries (UK, Norway, Sweden) initiated radical reforms in the 1980s, while, in the 1990s, the EU initiatives created a minimum degree of convergence as well as a rethink in countries, which at first were resisting the pro-competitive reforms of network industries. In 1999 the picture is as follows:

telecoms services[14]),	fully liberalised considerable regulation and specific anti-trust rules
postal services,	hesitant liberalisation – new reforms being proposed; cross-border distorted
gas/electricity,	slow and partial liberalisation, for the business users only; cross-border not fully free
bus services,	largely liberalised cross-border scheduled
rail services,	little and largely formal liberalisation in freight and passenger; cross-border very problematic
(public) broadcasting,	considerable liberalisation while public TV/radio retains some national protection, if a Member State wants this

This picture suggests that the extent of network industries' liberalisation is strongly correlated with the autonomous changes in technology, and their implications for competitive exposure, hence survival. Where resistance is deep, potential

[14]) Telecoms equipment is in principle fully liberalised, but the 1991 directive comprised a heavy-handed certification & licenses procedure. In Jan. 1999 the Council adopted a new approach directive, replacing the 1991, reducing transaction costs considerably.

competitive pressures due to potential entry are weak (e.g. rail). Combine this with the share of (low-skilled) labour (costs) in output for postal and rail, and the incentives for very high degrees of unionisation, and one understands why convergent liberalisation is only clear in telecoms, and not too problematic in bus services and broadcasting. Elsewhere, a mixture of differentiation in national preferences and strong capture render convergent liberalisation less probable, or relatively slow. Divergences are therefore still fairly conspicuous.

Industrial property rights

Whereas in other RIAs one can hardly expect property rights to be transnational, in the EU the unambiguous assignment of property rights to the Member States (Art. 222, EEC) is a fundamental flaw in the internal market. For decades the free movement of goods (and some) services) could easily be frustrated by the protection of such national rights, even when the ultimate owner (say, a multinational) was the same in both EU countries. Via a series of intricate landmark cases the EC Court has introduced principles which have **reintroduced a kind of conditional free movement.** One principle is the distinction between the existence and the exercise of the right in the internal market; the latter has come to be conditioned quite severely. Another principle, useful for this conditionality, is that of the 'exhaustion of rights' for common patent or trade mark owners.

Because of the case-law the incentives to resist EC-wide property rights regulation have weakened. Despite unanimity requirements, the EU has now

- a common patent application procedures (with some non-EU countries)
- approximated, national trademark law
  - a (parallel) EU trade mark
  - a draft EU patent regulation, but not yet fully adopted
  - copyright & neighbouring right law

With deeper market integration, at least the more disruptive effects of property rights on trade (and hence on competition in such products or services) are likely to be tackled eventually. **Divergences have now less and less meaning.**

Social 'standards'

Another complex situation has arisen in the area of social/labour market regulation and the welfare state. In short, one could say that the EU countries have converged to a very considerable degree in their <u>overall</u> view of social rights, social protection via regulation and social security entitlements and industrial relations; yet this is despite – not, due to – the EU. In the <u>specifics</u> of hiring & firing rules, minimum wages, social security, the importance of collective contracting versus imposition by law, (private & public) pension schemes, etc. Member States have thus far shown little convergence.

Again, once the competitive pressures on labour are taken into account, this is hardly surprising. Europe's labour is relatively immobile for social & cultural reasons, and because of the rigid housing markets (and the tax distortions there). There is relative immobility between regions as well as cross-border, and social systems do not greatly encourage intersectoral mobility either. It is often said that a European labour market does not emerge because of language barriers and socio-cultural differences. Of course, this factor is undeniable and it matters. But it is mistaken to give it too much weight for young workers or new entrants with more skills. It is the national social fortresses which discourage and inhibit practically all residual mobility that otherwise would tend to integrate, on the margin, national labour markets. As a result, workers of country A do not compete with workers of country B, except via the goods and services markets and their company's competitiveness. **This 'splendid insulation' greatly facilitates the much wanted national divergence in the social area.**

Yet, at the same time there is something like a convergent European view on society, based on common values, including basic social rights (the key ILO conventions), a preponderant influence of industrial relations on social regulation and the welfare state, and a collection of social entitlements which exhibit a good deal of overlap between Member States. It is from this more general perspective that the 'social standards' emerge, because they amount to general principles and norms, not to specifics or levels of entitlements.

Competition policy

In the EU competition policy operates at both levels of government: EU and Member State. At the EU level it is unified, and implementation and, to some extent, enforcement is also centralised. This comprises five areas: anti-collusion (Art. 85), anti-monopoly (Art. 86), merger control, companies with exclusive or special rights (usually, - former – utilities) and state aids approval. Except for state aids, there is scope for national competition policy, but the question is how much. For mergers a clear – though economically arbitrary – set of criteria (based on turnover) determines the division of labour between national and EC merger control: in effect the EU only deals with mergers, including very large companies as partners. For classical anti-trust the Commission has been given a centralist role (e.g. a monopoly on exceptions under Art. 85/3),, and a more relaxed view has begun to be advocated only recently.

The great surprise is actually the very fact that, **today, practically all Member States have an active competition policy, based on rules very clearly structured on the EC articles and principles**. This is a major change from 1957 when only Germany was just introducing its competition law. At a later stage, the entrants coming from EFTA have all introduced national competition law (and Norway and Switzerland as well) with a strongly convergent flavour. Other than for below – EC – threshold mergers, national competition policy may be of some importance for services (e.g. distribution), local anti-competitive aspects of network industries and for anti-competitive side effects of privatisation.

All in all, the overall picture is that **the deepening and widening of the acquis has significantly reduced the potential for divergence for the Member States in these areas.** Another interesting conclusion is that, even where Member States have autonomous options, convergence is observed in some respects, especially when one takes a longer-term perspective.

These conclusions should not be misinterpreted. The remaining diversity in details and style in acquis-areas between the Member States is still rich. But, more often than not, this diversity is neither an obstacle for free movement, nor a distortive element. Where the barriers effect of distortions persist, diversity should be expected to reduce over time.

4. Are 'national' policies under subsidiarity convergent?

In Art. 3B, EC subsidiarity is defined as an assignment principle for powers under concurrent competences, that is, where Member States and the EU level are both competent under EC law. For those categories of competence's, the presumption is that such powers remain at the national level. The accepted justification is that policies should be decided and implemented as closely as possible to the voters so that preferences get best reflected in what governments do and don't. In turn, this is seen as democratic and, under certain assumptions it is efficient (in the sense of satisfaction of preferences). Art. 3B, EC, assigns the powers to the Community level "only if and in so far as the objectives of the proposed actions cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community". Such assignments are subject to the proportionality principle.

The subsidiarity principle was introduced after the Single Act and EC-1992. They prompted a sweeping extension of free movements (undermining regulation and protection at the national level) as well as rapidly spreading centralisation by means of regulation, be it moderated by the new approach, mutual recognition and home country control. One can regard it as a **balanced test of the benefits (scale and – avoiding or promoting – externalities should lead to welfare gains) and costs of centralisation. The latter may be linked, in a fundamental way, with convergence.** Centralisation may – by virtue of free movement without exceptions or because of uniformity of rules or policies – suppress the satisfaction of preferences in regions or countries in many ways. Moreover, there is the lingering fear that centralisation has a ratchet effect – it is hard to undo it. The costs of the ratchet effect could well be that the central decision-makers are not responsive to the regional impact of measures taken or, indeed, of a lack of policies addressing problems of paramount regional interest. This is another way of saying that autonomy and decentralisation express a desire for idiosyncratic policies, hence, the strong likelihood of divergence. Convergence of autonomous national policies and rules may occur on a voluntary basis, too, but one should expect this to happen only when regulatory competition or strong incentives for emulation or benchmarking prevail. Inside the EU, which enjoys very intense economic intercourse and engages in permanent consultation as well as inter-Member States comparison, economic convergence on a voluntary basis may well occur. To provide empirical evidence for this, requires painstaking fact-finding and a suitable framework for analysis and comparison.

To illustrate briefly whether "national" policies under subsidiarity are convergent, it is useful to reflect and ask some questions about five policy areas.

First, national competition policies.

- how autonomies/independent are the agencies executing competition policy, in the Member States?

- does the remit of such agencies include anti-competitive conduct in, say, health, housing, distribution, services of professionals?
  (these sectors are often distorted due to equity-based rules or subsidies or due to self-regulation)
- do (or can) such agencies scrutinise cases of privatisation, which frequently bring with them anti-competitive agreements or effects? Do they do this in co-operation with the Commission (which has become active in this area) and would this be a reason for 'convergence'?
- how do the national merger controls compare?
  (this is key, because the EU thresholds are very high - the US annual total of scrutinised mergers is about 20 times the total of that of the EU Task Force)
- does the one-stop-shopping principle, so crucial for business, force inter-Member States cooperation and convergence in merger control?
- how do national competition authorities and network industry regulators cooperate and/or complement each other? Is this converging because of the liberalising EU-trend in these sectors?

Second, national labour market regulations and industrial relations.
Here, the situation is radically different from competition policy, in that (a) formally concurrent powers are, in fact, almost entirely assigned to the national level, (b) unlike in goods and services, free movement of labour has little actual economic impact on competitive conditions in national labour markets. As noted, the competitive pressures are transmitted via the competitiveness of companies in the goods and services markets. In Euroland, lacking the option of exchange rate realignment, these pressures will further increase as a real appreciation will translate in loss of market share and eventually unemployment. Also, the regulatory and socio-political rigidities in this area, as well as the link with the entitlements in national welfare states, inhibit rapid and sufficient adjustment, and undermine the incentives for intersectoral labour mobility. In turn, this enhances the reliance on the welfare state.

In this policy environment divergence can flourish. Whether such divergence forms the basis for benchmarking and new experiments is unclear. It is here that further research is welcome. A mere comparison of national regulations, policies and social entitlements is, in and by itself, not very illuminating. Moreover, much work has been done in the OECD Jobs Study, and its follow-up, as well as by the Commission and in the literature. What matters is whether new experiments are introduced in Member States, based on learning from best-practice and new ideas, and whether this process is in some meaningful way, convergent. There is some evidence that experiments and change is looked at very defensively, namely, as a threat to accomplishments and social traditions. Thus, in a review of the 10-points OECD Jobs Strategy, Elmeskov (1998) concludes that "only a few (OECD, JP) countries have introduced and sustained policy reforms in a sufficiently wide-ranging and consistent way to achieve such an improvement in labour market performance" (p. 11). Some countries have even moved against the spirit of the proposals.

In a much wider economic perspective, there is also not much empirical economic evidence that globalisation exercises powerful pressures on labour market performance. Recent work on European cases [15]) shows that globalisation is at most a relatively insignificant determinant of unemployment, and that increasing wage disparities of the kind observed in the US do not or hardly occur in Europe.

If these findings are correct, one should expect divergence to be upheld, given powerful vested interests of 'insiders' in the labour markets and given the political incentives for national politicians to focus on the social area as one of the few policies still attracting European voters.

Third, national regional policies.

A plausible hypothesis would be that national regional policies tend to converge. In the non-cohesion EU Member States there is a disenchantment with active regional policies based on large expenditures. Exceptions will of course remain for special areas such as arctic areas in Scandinavia and some mountainous regions. It would seem that the emphasis has shifted to strategies which might - for some relatively poor regions - be co-financed by the EU structural funds, and to attempt to be attractive for (foreign) direct investors via land policies, infrastructure and good governance.

In the cohesion countries, the large funding by the structural funds and the EU cohesion fund, and the benchmarking among regional authorities everywhere, are likely to have brought about a considerable degree of convergence. There is formal discretion to 'diverge' at the national and regional level, but the incentives of EU policies under co-financing (often more than half by Brussels) are simply too strong. One peculiar area are the fiscal concessions. The discretion which was actively used until recently, is increasingly criticised at EU level as 'harmful' i.e. distortive, and this is likely to induce further convergence.

Fourth, privatisation.

Knowing that property rights are strictly a matter of the Member States, state-ownership, and a change to private ownership, must equally be a competence at the national level. Thus, one could argue that privatisation is not a national policy under subsidiarity, but a national power 'tout-court'. Formally, this is correct. However, in an economic perspective, matters look different. EC law and the Commission's role as the 'guardian of the treaty' have developed a dichotomy between the formal question of state-ownership and the conduct or "use" of the state-owned company [16]). In a gradual process since 1980, state-owned companies have been subjected to reporting requirements so as to prevent opaque state aids from remaining undiscovered. Also, Art. 90, EC has come to be interpreted in a pro-competitive fashion. Without dragging the reader into the arcane peculiarities of the interpretation of this Article, it boils down to the burden of proof for the Member State to justify the granting of exclusive or special rights (e.g. because of universal service, with uniform prices). If the justification fails, Art 90/1 applies which states clearly that there is no difference between companies on the basis of (state or private) ownership. In other words, it is exclusive rights, not state-ownership that matters. This implies that governments are forced to rethink the benefits of state-ownership. In the single market few reasons remain. One could be the wish to

[15]) See, for instance, Messerlin, 1995 and the papers in Brenton & Pelkmans, ed.s., 1998

[16]) Similar to the existence/exercise dichotomy for patents and trademarks, referred to earlier (also based on Art 222, EC)

preclude hostile take-overs, or, some precautionary perception to act effectively in the case of a threat to national security (e.g. energy) or of a calamity (e.g. communications).

The upshot has been that, since the mid-1980s recurrent waves of privatisation, initially fuelled by economic policy convictions about efficiency gains, and emulated by selective other Member States, became embedded in a Community framework prohibiting any active 'use' of the ownership for policy. Even infusing extra capital, as (majority or only) owner, came to be scrutinised under state-aids: capitalisation over and above what a private investor could be expected to do, is considered as illegal state aid. Since budget ministers spotted large revenues and the convergent macro-economic stability thinking reduced other possibilities for fiscal policy, privatisation came to be seen as a win-win proposition: more revenue, without higher taxes, more competition (which was 'good' in the new pro-market approach) and the avoidance of intricate problems with Community law. In some sectors, state-ownership was a hindrance for corporate strategies, be it to attract enough equity capital or for the credibility as a partner in mergers (e.g. Renault/Volvo).

Privatisation is therefore a convergent process in the EU, even though, strictly, the EU is neutral with respect to ownership. The remaining divergence relates to aspects such as timing (e.g. compare the UK and Greece), golden shares, sectoral exceptions (e.g. the postal incumbents are only privatised in some EU countries and, for instance, not in the UK), etc.

Fifth, taxation.

The EC has no right to tax. It can only harmonise, and only indirect taxation (Art. 99, EC), unless the proper functioning of the internal market would necessitate (some) harmonisation of other taxes. Any tax directive is subject to unanimity.

The EU constraints on national VAT are considerable and those on excise duties far-reaching. Yet, there are telling 'diversities' such as in car purchase taxes (ranging form 15% to nearly 200%). In corporate taxation the constraints are few and have to do with e.g. consolidation for multinationals. Otherwise, the diversity is perhaps so great and distortive that selective approximation is desirable [17]). The Member States and the Commission have forged a consensus on 'harmful tax competition' in late 1997, especially with respect to tax breaks in corporate taxation and taxation on savings and other income from financial capital. It remains to be seen how far this fledgling 'convergence' will go when it comes to binding constraints.

In fact, therefore, **there is still great scope for tax divergence among Member States**. In income taxation, let alone local taxes (e.g. on property), the EU does not enter in any way. With budgetary discipline for all 15, and the rules and the stability pact in Euroland for the 11, tax discretion is one of the few remaining policy instruments of importance, and it is actively exploited.

[17]) As the CEPS (1992) report and the Ruding Committee (1992) argued almost simultaneously.

5. Is there convergence outside the 'acquis' areas?

It might be useful to verify whether convergence takes place outside 'acquis-areas'. One reason for this to be potentially useful is that, nowadays, many RIAs and loose, cooperative arrangements (e.g. APEC) pledge cooperative endeavours, common projects and other activities in a host of policy areas. The Member States of the EU may well be more comparable with those ventures and groupings, once one focuses on areas outside the acquis.

The range of outside-acquis areas is divided in two parts: (1) areas where the so-called "Community method" (with supreme EC law and EC Court review) does not apply but nonetheless a legal basis for common action and common funding via the EC budget exists, and (2) areas where the treaties simply do not apply. The first group can be found in pillars II and III of the Maastricht treaty (besides a few odd articles in the EC treaty itself). The second group is simply defined as 'everything else'.

5.1. *Intra-EU cooperation and convergence*

In the Maastricht treaty the stringent "Community method', with a high degree of binding, is not always followed. Cooperative approaches, without judicial review by the EC Court, apply to:

- pillar II, on the 'common security and foreign policy co-operation'
- pillar III, on 'justice and home affairs' cooperation with a view to facilitate the free movement of persons and to minimise externalities for other Member States in the cases of refusal of entry for refugees, immigrants, criminals or in case of drugs traffic; co-operation in fighting drugs and crime, etc. is also encouraged and has led to an independent agency called Europol (in the Hague).
- an almost random list of colourful areas which, during the Maastricht negotiations, were not filtered out; this mixed bag shows that 'pet projects' of governments may survive negotiations if there is little to 'trade-off'. The list includes tourism, civil protection(!), energy, health (but solely with respect to the fight against a few diseases such as aids and cancer), development cooperation, education & training and a special species of infrastructure, namely the TransEuropean Networks (TENs). Without further contextual information, this list could just as well refer to intra-ASEAN project cooperation or APEC's 'economic and technical co-operation'.

With respect to convergence, the contrast between pillars II and III is stark. Pillar II has a pre-history of 2 decades in the so-called European Political Cooperation, yet little has been achieved between Maastricht and Amsterdam, or for that matter, before Maastricht. The direct economic consequences of this failure are unclear. Only where pillar II has been effective, can such consequences be seriously explored. The only real success story is the unequivocal and consistent political conditionality for accession candidates in Central Europe as well as for Turkey, Cyprus and Malta. The loud call of the Central European peoples for political support in their struggle to introduce democracy, human rights and the rule of law eventually led to a strong Council resolution in November 1991, and a firm policy stance ever since in the pre-accession process. For countries failing to live up to those fundamental standards (e.g. Slovakia under Meciar; Latvia, before amending its minority laws), the pre-accession process is or is threatened to be delayed. This has immediate consequences for the confidence of foreign investors as well as for EU funding; it may also undermine the lock-in effect of domestic economic reforms under association. However, in Turkey the EU (foreign) policy stance works differently. The EU and Turkey have strongly deepened economic integration with the 1996 "deep" customs-union-plus, while, at the level of political values, a rather conflictuous relationship continues. It is true that Turkey was not admitted to the first group of accession candidates, which has had a negative impact on the domestic resolve for economic reforms.

Pillar III has led to considerable convergence during the decade. The initial reluctance can be ascribed to the enormous discrepancy between the practically unconditional 'free movement of persons' in the Single Act, and the lack of integrative and collaborative tradition among Home Affairs and Justice ministers, including immigration services and the police. The (intergovernmental) Schengen co-operation (as off 1985) and the K-4 committee (after Maastricht) have gone through a learning process. Only after personal networks and a degree of trust had developed, did it become possible to accept that the inefficiencies and ineffectiveness of 'co-operative' approaches in this field could only be overcome by a greater degree of convergence, mutual recognition and centralisation. The Amsterdam treaty provides a legal basis to integrate pillar III into the main text of the EC treaty itself.

The economic consequences are probably (1) a net tightening of immigration [18]) (but at far higher levels than 15-20 years ago), and (2) the free movement of persons with residence permits (now, only in Schengenland, and only for tourism).

The co-operative aspects of the EC treaty can roughly be classified into a group where little more than symbolic action is undertaken (tourism, civil protection), a group where project cooperation and common funding is at stake (health; higher education & training; development co-operation), be it at impressive levels of finance, and a group where the substance of economic cooperation is a complement or substitute for integrative measures (TENs; energy).

The saga of TENs is one of partial success. The main reason is the unwillingness of Member States to centralise, even partially and for cross-border only, the decisions on infrastructure. Whereas Canadian and to some extent US internal economic integration was propelled by federal infrastructure, in the EU infrastructure is a (slow) follower. In the 1990s 'deep' integration has at long last, and only half-heartedly, induced the Member States to internalise spillovers at the EU level, and thereby improve the functioning of the single market.

Energy is more complicated. After the failure of the Euratom treaty and the disenchantment with nuclear power in Europe, and given the irrelevance of EU coal production (too high prices; pollution), one might have expected a common EC framework for an internal energy market, if not a common energy policy. The Maastricht treaty foresaw some such articles in the next review of the treaty but

[18]) A considerable part of asylum seekers in the EU are, in fact, economic immigrants, but it is impossible to ascertain how high the real share is.

Amsterdam has failed to take it up. The very partial liberalisation of gas and electricity and the sensitivities about national security are only two of the reasons why this is not yet possible. Yet, one can observe convergence: the incredible distortions in the coal market have reduced greatly and may disappear once Germany terminates its very high subsidies; atomic energy is on the decrease; the moves to open up the gas/electricity markets is, for European understanding, a remarkable breakthrough.

5.2. *Convergence in 'domestic' policies?*

The typical 'spending' ministries have always remained domestic in the EU. This can be justified by subsidiarity. Reference can be made to education, social security and welfare, housing, infrastructure, health, defence and the activities related to domestic 'law and order' (e.g. police and justice).

With defence spending dependent on NATO - but remember that 4 of 15 EU countries are not a NATO member -, all the other policy areas are truly domestic. They may occasionally emulate best-practice policies elsewhere but this is quite different from incentives to 'converge'. The very fact that these areas use up the bulk of domestic tax revenues and that the policy 'output' may matter in very concrete ways for scores of voters, constitute the basic incentives for domestic approaches, hence a healthy and justifiable divergence.

In the margin, some policies are affected by economic integration. Higher education is affected via the mutual recognition of diplomas and intensive exchange programmes such as Erasmus. Social security and welfare is affected by the (strict) non-discrimination provision for non-domestic EU workers, by the (strict) equality of men and women at work (pension rights, etc!) and by some elements of the EC Social Fund. Infrastructure is affected by EC procurement rules and by TENs, and indirectly by liberalisation of former utilities. Finally, health is affected by the (distorted) functioning of the internal market for medicines, and the recent case-law on the right of patents to move cross-border for health services.

However, this is all marginal, and should not be read as a sign of convergence.

Occasionally, one even finds divergence as a goal of EU policy, caused by the priority of 'domestic' preferences. Examples include resale price maintenance in books (for 'cultural' reasons), the culture clause in the Maastricht treaty (where the EU level should have no policy, except to contribute to the flowering of the cultures of the Member States), the state-aids dilemma in the case of public broadcasting, and the directive on temporary secondment of workers. In the latter directive, the fear that workers from low-wage Member States (say, Portugal) might compete with workers from high-wage workers, under mutual recognition, has led to EU provisions **restricting** free movement. Rather than allowing home-country-control (i.e. Portuguese workers can work elsewhere at any wage and social protection equal to or higher than in Portugal), host-country-control is imposed.

6. Comparing regionalism and their convergence

As shown in this paper, a great deal of economic and institutional convergence in the EU is prompted by the combination of far-reaching liberalisation, under supreme judicial review, and selective centralisation.

This creates a problem of comparability. No RIAs, other than the EEA, have supreme judicial review, or indeed such a radical principle as "free movement". No RIAs have free economic exchange in services, workers (not even in the limited form of the EU), capital and technology (i.e. industrial property rights). No RIAs have a range of common policies, and even trying to find a RIA with a common trade policy (in goods only) is hard. Also, the nature and extent of institutional centralisation in the EU is incomparable to other RIAs.

It is therefore more fruitful to step back and ask the following two questions. First, when studying RIAs and their 'economic and institutional convergence', shouldn't their different methods of economic integration be compared in terms of regional market access and (expected) impact on intra/extra group economic exchange? It is not the task of this paper to conduct such comparisons. Nevertheless, it is noteworthy that the overwhelming majority of RIAs in the world are FTAs; few customs unions have been notified and even fewer really work. A few FTAs (e.g. NAFTA; EEA; Mercosur) have incorporated other elements in very different ways, and they have chosen different forms and ambitions of "judicial" review or (more strict) dispute settlement. Very prudently, AFTA has made (still symbolic) steps in the direction of services and dispute settlement.

Also, the impact on intra/extra trade ratios can be telling. NAFTA, Mercosur and AFTA trade more, or far more, with outsiders than within the group; the EEA is overwhelmingly intra-area oriented. One could perhaps "test" the hypothesis that the smaller this ratio, the less likely that 'economic and institutional convergence' is comparable to that of the EU.

Second, do the RIAs amount to regional experiments for the purpose of WTO negotiations or does WTO serve as a compatibility restraint for what otherwise is internal 'deepening' driven by internal motivations? Again, on this score, the EU would seem to be incomparable with most other RIAs. From an ASEAN perspective, AFTA and APEC differ much less than a legalistic analysis might lead once to suggest (Pelkmans, 1997), precisely because what matters for ASEAN decision-makers and business is global market access and exposure to world - not regional - competition. It is also instructive to remember EC-1992 and the perceptions it gave rise too. The crux of EC-1992 was the removal of the conditionality of 'free movement' as well as qualified majority voting on regulation to overcome market failures. By nature and effect, EC-1992 was radically liberalising. Yet, the rest of the world dubbed it 'Fortress Europe', for the most part because of elements (e.g. agriculture; anti-dumping) which had nothing to do with the Single Act. It is also interesting that the Union's reservations on services liberalisation in the GATT turned into a 'leadership by surprise' by 1990, and this throughout the 1990s. The EU did clearly not pursue internal services liberalisation because Punta del Este was on the horizon!

For analogous reasons the EU attempts to exercise leadership in the WTO in areas where, for internal reasons it feels strong and well-prepared: competition policy, environment, social standards (in the overall normative sense, as discussed), maritime shipping, etc. Some of its even more ambitious agenda could be understood from Sir Leon's abortive proposals, in March 1998, on the New Trans Atlantic Market place, which suggested a "free trade area for services" [19]) and a considerable advance in 'regulatory convergence'. Again, the EU feels relaxed here because it would merely export its internal principles (e.g. mutual recognition, the new approach, the global approach).

It would seem that the connection between regional and multilateral integration is far more critical for other RIAs, perhaps it is even existential.

[19]) ASEAN/AFTA has also utilised this label but it covers essentially the WTO services obligations, no more.

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DRAFT - NOT FOR QUOTATION

REGIONAL INTEGRATION: THE EXPERIENCE IN EAST ASIA

by

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1. Introduction

East Asia for the purpose of this paper encompasses the Northeast Asian economies of Japan, China, Hongkong, South Korea and Taiwan and the ASEAN countries. The region comprises a diversity of countries and territories --- size diversity in terms of land area, population and GNP (Table 1); economic diversity in terms of economic development level, economic system, economic openness, natural resource endowment, degree of industrialisation, and human resource development; political diversity in terms of systems of government and colonial experience; and social diversity in terms of language, ethnicity, religion and culture. Except for Japan, China and Thailand, the East Asian countries had undergone varying periods of colonisation and most had attained political independence only in recent decades. Hence the pre-occupation with nation-building and reluctance to surrender national sovereignty to any regional superstructure.

At present, there is no political vision of a united East Asia or Southeast Asia. Efforts to form an East Asian Economic Grouping (EAEG) have so far failed to take off for both geopolitical and economic reasons. Nonetheless, economic integration through trade and investment flows is growing. However, East Asia's ties with the rest of the world continue to dominate the region's trade.

This paper analyses the proliferation of regional economic groupings and subgroupings in East Asia namely ASEAN/AFTA, APEC, ASEAN growth triangles, Mekong Basin and Greater South China.

2. Modalities of Economic Integration in East Asia - Formation of Regional Trading Arrangements

Economic integration is the process whereby cross-border flows of goods and services and factors of production increased and economies become more inter-linked and inter-dependent. This process can reflect the spontaneous and free play of market forces, or be induced by various types of regional trading arrangements (RTA). The process and pace of integration among a group of economies are influenced and determined by several factors --- economic size and growth; proximity; government policies affecting trade, capital and labour flows; and activities of firms.

Three processes of economic integration have been ongoing in East Asia. First, there is the institutionalised economic integration when a group of countries form a RTA to promote intra-regional trade and investment through liberalisation and facilitation measures. Second, there is the formation and emergence of subregional economic zones such as the ASEAN growth triangles and the Chinese economic area. Third, there is the more pervasive integration of East Asian economies through the market process of trade and capital flows and, to a lesser extent, people flows.

RTAs cover the spectrum from sectoral trading arrangements to free trade areas, customs unions, common markets and economic unions; some focused mainly on intra-regional trade in goods, others extend to trade in services and capital and people flows. RTAs can be distinguished by whether they promote shallow integration or deep integration (Snape 1996). Shallow integration refers to first generation RTAs aimed at reducing barriers to cross-border flows of goods, services and factors among member economies. Deep integration refers to second generation RTAs aimed at the whole spectrum of policies and regulations which directly or indirectly restrict cross-border trade and investment flows. These policies and regulations include those aimed at influencing the level of production of specific goods and services such as excise, value added and commodity taxes and government subsidies; business law regulation and competition policy; health and safety standards; customs documentation and clearance procedures; professional qualifications requirements; legal frameworks; and environmental regulations. The harmonisation of non-border policies and regulations has been pioneered by the EU, particularly with the Single Market, based on the principle of mutual recognition of each other's standards, rather than protracted negotiations to reach common standards.

Countries pursue RTAs increasingly in recent decades for a variety of political and economic reasons. First, partly in response to the growth of regionalism in Western Europe and to disenchantment with the GATT-based multilateral trading system. The conclusion of the Uruguay Round and the establishment of the World Trade Organisation (WTO) with wider supervisory powers has renewed confidence in the multilateral system and enforcement of GATT rules and lessened the pressure for countries to join RTAs. Second, RTAs, through the small membership and concentration of benefits has a comparative advantage in promoting reduction of border barriers in areas where progress at the multilateral level has been slow. Likewise, RTAs can manage more easily the new issues of international trade, that is, those non-border policies and barriers which affect cross-border trade. Third, a country joins an RTA so as to obtain benefits from securing or influencing changes in other countries' policies. For a large country, free trade may not be optimal when it can affect its own terms of trade. However, forming/joining an RTA may avoid retaliatory and counter-retaliatory trade measures. Also, joining an RTA increases a country's bargaining leverage vis-a-vis third countries; in a world of escalating trade barriers, discriminatory treatment and even harassment, countries form/join RTAs to insulate them from these effects. Fourth, joining an RTA may enable a country to buttress its own policies against vested interest and lobby groups and to lock in reforms achieved, as in the case of Mexico joining NAFTA. Fifth, an RTA may confer significant non-economic benefit; for example, ASEAN helps to promote regional peace and security which enables member countries to pursue economic development objectives. Motivations for forming/joining RTAs are almost invariably political for large countries and economic for smaller ones. Pomfret (1996) notes that an RTA is more likely to survive where the large country gains politically and bears low economic cost, while the small country gains economically (as in most GSP schemes, Lome Convention, Caribbean Basin Act, and South Pacific Regional Trade and Economic Cooperation Agreement). The strong political objective helps explain the success of European integration, while its relative absence helps explain the difficulties in establishing RTAs in East Asia.

The proliferation of RTAs has given rise to concern whether they are building blocs or stumbling blocs of multilateralism. By their very nature, RTAs are discriminatory, as they violate the GATT/WTO most-favoured-nation (mfn) principle. The traditional concern of customs union theory is on the direct effects of free trade areas and customs unions on trade and investment flows, with diversion imposing costs on members and non-members. Increasingly, concern is also focused on the effects of RTAs on the world trading system. Lloyd (1996) notes two systemic effects --- first, with growth in number of RTAs and membership expansion of existing ones, RTAs may coalesce from merger of 2 or more RTAs or expansion of membership of an RTA; second, when one country enters into trading arrangements with 2 or more other countries, creating a hub and spoke system which introduces further layers of discrimination.

GATT Article XXIV allows formation of free trade areas and customs unions as exceptions from the mfn principle on the two conditions of liberalisation of trade in all products and no raising of external barriers. In actuality, few RTAs have satisfied these two conditions. Snape (1996) argues that even if these two conditions are met, a network of discriminatory RTAs could still emerge and become a stumbling bloc to the multilateral trading system. An RTA is more likely to complement and facilitate liberal multilateral trade under four conditions --- first, full liberalisation of trade between members in all products if not also in productive factors; second, no raising of external barriers to trade and investment on formation or subsequently, and willingness and capacity to negotiate external barrier reduction; third, homogenous rules of origin and dispute settlement procedures; and finally, openness to new members on conditions similar to those faced by existing members. Lloyd (1996) also suggests some considerations whereby the RTA may be a building bloc --- by making members more competitive and more oriented to international trade and thus reduce protectionist pressures, as in non-tariff measures and in services where GATT/WTO has been less successful in negotiating multilateral reductions; and the costs of negotiating reductions in tariffs and nontariff measures may be lower in RTAs with fewer members and less diverse preferences and cost structures.

RTAs have proliferated in many parts of the world but not in East Asia. The only formal RTA is under ASEAN. Countries in East Asia have pushed for open regionalism under APEC. The fastest growth in intra-East Asian trade and investments has been due to spontaneous regional integration resulting from increasing policy liberalisation and outward orientation of individual economies.

In particular, the open-door policy launched by China in 1979 has led to the sharp increase in intra-regional trade.

ASEAN and AFTA

The Association of Southeast Asian Nations (ASEAN) was formed by the 1967 Bangkok Declaration. By end-1998, ASEAN encompasses all the countries of Southeast Asia, as the founding members of Indonesia, Malaysia, Philippines, Singapore and Thailand were joined by Brunei in 1984, Vietnam in 1996 and Laos and Myanmar in 1997, and agreement was reached in December 1998 to admit Cambodia as soon as possible. The founding fathers had the vision of a one Southeast Asia comprising independent nation states living in peace and harmony. ASEAN was organised for political reasons, although its declared objective was economic cooperation. For the first 25 years (until 1992) the grouping did not behave like a traditional RTA, and official documents avoided the term "integration" and emphasised only "cooperation" as ASEAN political leaders and policy makers refused to consider either a free trade area or customs union. The main benefit of ASEAN to its members was the promotion of regional peace and security, which enabled member countries to unilaterally focus on economic development and enabled the region to become highly attractive to foreign capital. Partial efforts at economic integration took the form of the ASEAN Preferential Trading Agreement (PTA) in 1977 and ASEAN industrial projects in the 1980s. The PTA had cumbersome product-by-product negotiations, low margins of preference, and long exclusion lists which did little to promote intra-ASEAN trade. Likewise, the regional industrial projects failed to contribute to ASEAN industrialisation as countries failed to agree on any regional industrial specialisation and division of labour.

The reluctance of ASEAN to form an RTA prior to 1992 was due to several factors. First, the political leaderships were preoccupied with regional political and security issues as Southeast Asia was the battle ground of the Cold War. Second, the large country differences in level of economic development, industrial competence and commitment to free trade, and thus perceived national benefits and costs, made it difficult to forge consensus on formal economic integration. Third, there was limited economic complementarity, except between Singapore and the other ASEAN countries. The economies have similar resource endowments resulting in production and export of similar primary products, and similar level of industrial competence resulting in production and export of similar labour intensive manufactures to markets outside ASEAN. In more recent years, industrial complementarity is emerging with the growth of production networks and intra-industry and intra-firm trade. Fourth, ASEAN was (and remains) too small to be economically crucial for individual member countries. ASEAN countries were not regional-oriented, with intra-ASEAN trade accounting for less than 20% of the region's total trade, and with high dependence on the advanced industrial countries for markets for primary commodities and labour intensive manufactures and sources of capital equipment and technology. Likewise, sources of foreign investments are largely extra-ASEAN, mainly from the Triad of Japan, USA and EU, and since the late 1980s also from Hongkong and Taiwan.

However, political and economic changes at the national, regional and global levels forced ASEAN to reconsider formal economic integration more seriously. First, political-security issues became less dominant with the end of the Cold War, the return of peace to Indochina, and success over domestic insurgency movements. Second, the more protectionist ASEAN economies of Indonesia, Malaysia, Philippines and Thailand had been undergoing extensive economic reforms to effect new outward looking strategies. Their lowering of tariffs contributed to a convergence of ASEAN tariff levels and, together with improved industrial competence and export competitiveness, contributed to greater acceptability of regional market integration schemes. In any event, influx of foreign direct investment (FDI) and multinational corporations (MNCs) have led to the growth of production networks and regional intra-industry trade. Third, with growing emphasis on export manufacturing and attracting FDI, ASEAN members became more concerned over trade and investment diversion and competition, from emerging trading blocs in Europe and North America, as well as emerging low cost production centres in Eastern Europe, China and Indochina.

In 1992 ASEAN agreed to the formation of the ASEAN Free Trade Area (AFTA) to supersede the PTA. AFTA would provide a dynamic integrated regional market and a wide range of resource endowments and skills, thus increasing ASEAN's industrial and export competitiveness as well as its attraction for FDI; it would also be an insurance against the possible failure of the ongoing Uruguay Round negotiations. The 1992 Agreement provided for the elimination of tariffs and nontariff barriers on trade in goods (except for unprocessed agricultural products) in 15 years (2008). Since then, the liberalisation time frame was shortened to 10 years to 2003; the sectoral coverage was extended to include all goods (but not services); and the temporary exclusion list had to be phased out within 5 years. The rules of origin was set at 40% local and cumulative

ASEAN content. No formal dispute settlement mechanism was established; disputes would be settled bilaterally between authorities of importing and exporting countries, failing which they would be referred to the ASEAN Senior Economic Officials Meeting.

With ASEAN's enlargement to incorporate Vietnam, Laos and Myanmar (and soon Cambodia), each new member was also given a 10-year time frame to complete its AFTA obligations. The enlargement poses both challenges and opportunities as it increases the grouping's political and economic complexity. The new members (CLMV) have different political systems, straining internal cohesion as well as external relations; Vietnam is still a communist country while Myanmar's membership has already led ASEAN to clash with the US and EU. The hitherto ASEAN decision making process by consensus is under strain. Further, the new members are in the midst of transition from command to market economies and still have large and inefficient state owned sectors and enterprises and highly protected industrial sectors. A two-tier ASEAN has emerged as the new members have per capita incomes of US$180-320 (1997), much lower than the founding members' US$1,110-32,940, and requiring considerable development assistance to enable them to catch-up. Enlargement is expected to increase ASEAN's market size and resource diversity and make ASEAN more attractive to foreign direct investment (FDI). Market size as measured by 1997 population increased from 358 million for the ASEAN-6 to 498 million for the ASEAN-10 (including Cambodia), an increase of 25%. However, the CLMV countries have limited effective market size and GDP increased from US$656 billion for the ASEAN-6 to only US$686 billion for the ASEAN-9 (no data available on Myanmar).

The rationale for AFTA goes beyond internal market enlargement. The ASEAN regional market is too small for inward looking regionalism. In 1993, the ASEAN-6 accounted for less than 2% of world output and less than 6% of world trade, as compared to 30.6% and 19.1% respectively for NAFTA and 26.5% and 34.8% respectively for the EU. Further, to the extent that ASEAN will continue to depend heavily on extra-regional sources of capital, technology and expertise, focusing on intra-ASEAN trade liberalisation alone would not significantly reduce ASEAN production costs and improve ASEAN industrial competitiveness. In recognition of this limitation, ASEAN countries are simultaneously reducing trade and investment barriers vis-a-vis the rest of the world. Several ASEAN countries have multilateralised some of their AFTA tariff cuts, while Singapore has completely abolished all tariffs under AFTA way ahead of schedule, and multilateralised them under the Uruguay Round commitments.

The 1992 AFTA document had no provisions for services or investment. A Framework Agreement on Services has been reached in 1998 providing for negotiations in air transport, maritime transport, telecommunications, tourism, business services, construction, and financial services. Liberalisation of these services will enable ASEAN countries to provide more efficient services domestically, and thus reduce the cost of doing business, as well as to become competitive service exporters. A Framework Agreement on Investment has also been reached, with the target of an ASEAN Investment Area (AIA) by year 2010. In addition, ASEAN is also exploring economic cooperation with other RTAs.

The currency and financial crisis which erupted in Thailand in July 1997 and spread rapidly to engulf Indonesia, Malaysia, Philippines and South Korea, and to a lesser extent the other East Asian economies, has placed a severe test on the regional grouping. Given the severity of the crisis, regional self-help was limited and the crisis countries turned individually for help to the IMF, World Bank, ADB, and the high-income OECD countries, particularly Japan. Efforts to adopt a regional currency for ASEAN's trade transactions fell through, and bilateral schemes were adopted instead. Member countries agreed to the establishment of a regional surveillance mechanism, to be established at the ASEAN Secretariat with technical help from the ADB. In spite of severe economic recession and much reduced import capacity, member countries have so far resisted pressures to slow down the schedule of trade liberalisation under AFTA and are accelerating efforts to liberalise and facilitate FDI under AIA.

APEC Forum

The Asia-Pacific Economic Cooperation (APEC) Forum provides an alternative to multilateralism and RTAs. APEC was launched in November 1989 as an intergovernmental forum. From an initial membership covering US, Canada, Japan, Australia, New Zealand, ASEAN countries and South Korea, membership has grown rapidly as more and more Pacific Rim countries have applied to join. APEC drew its rationale from the growing economic interdependence and community of interests among Pacific Rim countries. This facilitates consensus-building on many global and regional issues, and speaking with a united voice increases the influence and leverage of the Pacific Rim in world affairs. At the same time, APEC provides a forum to manage the increasingly complex economic relationships of member countries and to resolve the inevitable bilateral disagreements and disputes.

Although trans-Pacific rather than global in focus, APEC differs from RTAs by seeking to avoid discriminatory options, focusing on trade liberalisation measures which can be pursued in a non-discriminatory manner. Because market access under APEC is intended to be non-discriminatory wherever possible, the effects are likely to be less trade diverting than those of a traditional RTA. APEC pursues "open regionalism", open in the sense of not discriminating against the rest of the world; its primary policy focus is economic; and it has coordinated decision making based on consensus, rather than seeking to impose any supranational authority on members. APEC's role is to provide public goods to facilitate development through private sector initiatives, that is to promote efficiency and compatibility of transport and communication infrastructure, harmonisation or mutual recognition of standards, regulations and administrative procedures, and elimination of tariffs and nontariff barriers to promote competition.

At the Bogor Summit in 1994, APEC agreed to push for free trade in the Asia Pacific by year 2010 for developed countries and year 2020 for developing countries. Action plans were drawn up at the Osaka (1995) and Manila (1996) summits. APEC action plans have three dimensions --- trade liberalisation and facilitation, investment liberalisation and facilitation, and economic and technical cooperation. The Vancouver (1997) and Kuala Lumpur (1998) summits focused on early voluntary sectoral liberalisation schemes.

3. Modalities of Economic Integration in East Asia - Formation of Subregional Economic Zones (Srezs)

Subregional economic zones (SREZs) are also known as growth triangles (ASEAN terminology). The SREZ encompasses geographically contiguous areas of neighbouring countries, with the economic integration process involving flows of goods, investments and people.

Chia and Lee (1993) have distinguished three variants of SREZs in East Asia. First, the metropolitan spillover, from Singapore and Hongkong into cross-border hinterlands. After a sustained period of rapid economic growth resulting in rising costs and land and labour shortages, development in the city-state of Singapore spilled over into neighbouring Johor (southern Malaysia) and Riau (western Indonesia), while development in the city-state of Hongkong spilled over into neighbouring Guangdong and Fujian provinces of China. Metropolitan spillovers into the hinterland are a common phenomenon in all countries. What distinguishes the spillovers of Singapore and Hongkong are that they are city states and regional trading, financial, transportation and telecommunications hubs and the spillovers are cross-border. Flows of goods, services, capital and people are facilitated by geographical proximity, economic complementarity, and an accommodating policy environment. The second type of SREZs are geographically proximate areas with common ethnicity and culture where traditional cross-border economic exchanges were restricted and then revived with the onset and ending of the Cold War. The transition of socialist command economies to capitalist market economies and the desire of border areas to accelerate economic growth have pushed them to cooperate to exploit economic complementarities and scale and agglomeration benefits. This type of SREZ is typified by the baht economic zone, Yellow Sea Rim and Japan Sea Rim economic zones. The third type of SREZ has the joint development of natural resources and infrastructure. Development projects which can be multi-country in scope include transportation and communication networks and forestry, mineral, energy and water resources. Joint development can facilitate funding by external funding agencies, reduce the financial burden and improve efficiency of projects by exploiting economies of scale and agglomeration. Countries can also cooperate on projects so as to minimise disputes over ownership and utilisation of common resources such as a major river, and improve environmental management. This type of SREZ is typified by the Mekong Basin project.

Factors in the emergence of SREZs in East Asia in the past two decades may be attributed to political and policy changes, growing economic complementarity and traditional geographical and cultural proximity. First, dramatic political developments and policy changes in the past two decades led to the tumbling of political and policy barriers. For the latter, the market-oriented economies in ASEAN undertook economic reforms to liberalise, deregulate and privatise their economies to improve productive efficiency and competitiveness, resulting in a more favourable policy stance towards foreign trade and foreign investment. For the Indochina countries, the end of war and political conflicts and major domestic political changes and economic reforms have also resulted in more outward looking economies and greater receptivity towards foreign trade and foreign investment. In Northeast Asia, the dramatic political developments have removed or reduced conflicts and tensions and the barriers to cross-border trade and investment flows (except in the Korean peninsula). Geopolitical realignments give new emphasis to regionalism. Also, governments of these countries now face the imperatives of economic development and are more prepared to cooperate to improve their investment climate through infrastructural development, improvements in industrial efficiency and access to markets.

Second, economic linkages between politically separate areas are enhanced by complementarity in factor endowment and technological capability, which enable locational specialisation, economies of scale and agglomeration. Cross border investment flows take place because land and undeveloped natural resources are immobile, while government policies continue to restrict labour mobility. Third, with the falling of political and policy barriers, traditional geographical and cultural proximity re-asserts itself to facilitate flows. Localities tend to trade and do business with their neighbours because of lower transport, communications and other transaction costs. Proximity also saves time, an important consideration when the market is constantly changing and delivery schedules are tight and firms practice just-in-time inventories. For investment decisions, small and medium enterprises find proximity reduces information and other transaction costs; this is particularly so when investors have to operate in a different political, bureaucratic and legal environment, with unfamiliar and non-transparent rules and regulations, and deal with local business partners with different business and financial accounting practices. Geographically proximate areas often, but not always, share a common ethnicity, culture, language and kinship which help reduce information costs and cultural misunderstandings.

The SREZ as a transnational phenomenon poses challenges in inter-country as well as intra-country relations (Chia 1994). First, cross-border relations among constituent areas of the SREZ of the metropolitan spillover model are akin to the core-periphery relations within a country with the additional complication of being cross-border, with sensitivities of foreign ownership and control added onto the political, social and distributional sensitivities. Second, the SREZ impacts on relations between the central government and the provincial/local authorities and on relations between provinces/local authorities. The SREZ creates a centrifugal force which draws the periphery away from the national core, and may undermine central authority and national cohesion. The growing economic clout of the provincial/local authorities may lead to demands for greater provincial/local autonomy in policy and in collection and use of tax revenues, thus eroding the political authority and revenue base of the central government, as in China. Also, the SREZ may increase rivalry among provinces/local areas for investment funds from the central government and the foreign and domestic private investors. The development resources allocated by the central government to the SREZ may be at the expense of other provinces/local areas and raises the issue of equitable resource allocation. Investment diversion also takes place if the SREZ increases its attraction of foreign investment at the expense of other regions of the country. To the extent that provincial/local authorities in southern coastal China have to find their own financial resources for much of the infrastructural development, and foreign investors have been actively involved, the rivalries for central government funds have been lessened but rivalries for private funding have intensified.

Third, as some parts of the country pulls ahead in economic development while other parts are left behind, the issue of widening disparities in development and in incomes become more serious. In China, the growing disparity in level of development and standard of living between the southern coastal provinces and the inland provinces have led the central government to take corrective actions for development policies and to encourage the inland and northeast regions to seek their own linkages with the southern coastal provinces and with neighbouring countries.

The RTA and SREZ are alternative modalities of regional economic integration in East Asia, with different merits. First, the SREZ operates on a much smaller scale than an RTA, so that its impact is smaller and localised, unless a country has a series of SREZs. Second, the SREZ is a more flexible arrangement than the RTA and can more readily accommodate subregions at different stages of economic development and with different economic and political systems. For example, a formal FTA incorporating China, Hongkong and Taiwan is at present not politically feasible, but the SREZ flourishes. Further, just as it is easier to push for an RTA rather than to complete a new WTO round because it is smaller and focused among countries with common interests, so it is easier to push for the SREZ because it is smaller and focused among local regions with common interests. Third, the SREZ focuses directly on trade and investment facilitation to produce for the global market, while the RTA focuses on liberalisation of intra-regional flows of goods and services. Fourth, the SREZ can be used to advantage to develop subregions within a country, particularly the less developed peripheral areas, by linking them with foreign growth poles. Fifth, the SREZ is less perceived as a zero or negative sum game as domestic enterprises are not threatened by more competitive goods from other member countries and as domestic and foreign enterprises work in partnership in joint ventures to develop natural resources, to engage in production networks, or to develop different parts of the value chain. Non-members are also not excluded, as they can participate in the SREZ through the investment process.

ASEAN Growth Triangles (GTs)

ASEAN has created growth triangles (GT) as a complementary mode of regional economic cooperation to its PTA and AFTA, based on the principle of participation by some but not all member countries and focusing on investment cooperation rather than market integration. The GT aims at enhancing investment attractions by pooling resources and combining the competitive advantages of their geographically contiguous localities, exploits the economies of scale and of clustering and specialisation according to comparative advantage, and facilitates establishment of production and distribution networks and development of infrastructure. The GTs are not left completely to private sector development, as governments facilitate trade and investment by providing the appropriate policy framework, promoting infrastructure development and promoting foreign investment involvement.

Three GTs involving ASEAN member countries have been established, with Indonesia and Malaysia involved in all three, and Brunei, Singapore, Philippines and Thailand involved in one each. The southern IMS-GT (Indonesia-Malaysia-Singapore, formerly known as Sijori) is the pioneering GT and initially comprises the three contiguous areas of Indonesia's Riau islands, Malaysia's southern state of Johor and the city-state of Singapore; the geographical scope has since been extended, covering an area of 23 thousand sq km and population of over 5 million people. The southern GT is an example of a metropolitan spillover. With an extended hinterland, Singapore is able to relocate its non-competitive labour and land intensive industries and tourism facilities and restructure its economy into higher value added activities and reinforce its role as a regional service hub. By cooperating with Singapore, Johor and the Riau islands have benefited from increased investments from Singapore businesses as well as MNCs based in Singapore, and have ready access to Singapore's efficient transportation, telecommunications, financial and commercial infrastructure. Labour in the metropolitan core worry about industrial hollowing-out and job losses with the relocation of industries, while SMEs worry about the loss of business when their corporate customers relocate cross-border and they have difficulties in maintaining business links. In the periphery areas, there are social problems arising from massive influx of foreign investors and tourists and people from other parts of the country, putting pressure on the local infrastructure and social services, and contributing to rising prices, traffic congestion and environmental pollution.

The northern IMT-GT (Indonesia-Malaysia-Thailand) encompasses contiguous areas of west Indonesia, north Malaysia, and south Thailand, covering an area of 180 thousand sq km and a population of about 22 million. The eastern BIMP-EAGA (Brunei-Indonesia-Malaysia-Philippines-East ASEAN Growth Area) encompasses Brunei, east Indonesia, east Malaysia and south Philippines, extending over an area of 700 thousand sq km and a population of over 24 million. These two GTs represent the geographically proximate areas with common interest overlapping with the joint development of natural resources and infrastructure. These GTs have no major growth centre (equivalent to Singapore) and have similar factor endowments and level of economic and industrial development. In addition, these two GTs are more geographically dispersed and lack integrating transportation and telecommunications infrastructure which could reduce the economic distance and transaction costs. Economic cooperation focuses more on joint development of infrastructure, natural resources and tourism. For common resources straddling land and sea borders, joint development help minimise ownership disputes and improve environmental management. The central challenge in the development of the two GTs is mobilising the financial resources required for infrastructure-related development and demonstrating the commercial viability of various projects.

Greater Mekong Subregion (GMS)

Subregional economic cooperation has extended to cover ASEAN and non-ASEAN countries, as in the Greater Mekong Subregion (GMS) in continental Southeast Asia. The Mekong River and its tributaries are important water resources for the riparian areas of Cambodia, Yunnan (China's southwest province), Laos, Myanmar, Thailand and Vietnam. Exploiting the resources of the Mekong Basin to generate power, increase food production, and provide water transport requires enormous investment and technical resources beyond the capability of the low-income riparian countries. A Mekong Committee comprising Cambodia, Laos, Thailand and Vietnam was first established in 1957 under the United Nations initiative to coordinate the development of the lower Mekong Basin and to seek funding from international and regional agencies and donor countries. Subsequent political developments in the subregion undermined the project. The return of peace to Indochina led to the formation of GMS under the initiative of the Asian Development Bank. The areas of GMS form a natural economic territory, with shared interests in the development of agriculture, forestry, fishery, energy, and water transport and in environmental management and also have common ethnic and cultural links. The subregion suffers from low per capita incomes, poor infrastructure and severe shortages of financial and technical resources. The main objective of GMS is to facilitate economic cooperation, with a focus on jointly developing natural resources and infrastructure by exploiting geopolitical and economic interests and geographical proximity. Apart from the ADB, there is also an ASEAN initiative and other overlapping initiatives, necessity some degree of coordination.

Other emerging "growth triangles" in Southeast Asia are the subregion encompassing the border areas of Cambodia, Myanmar, Laos and Thailand (baht zone), and that between Subic Bay (northern Philippines) and Kaoshiung (southern Taiwan).

Greater South China Economic Zone (GSC)

The economic subregion of Greater South China (GSC) encompasses the contiguous economies of Hongkong (and Macau), Taiwan, and China's coastal southern provinces of Guangdong and Fujian. Unlike the ASEAN growth triangles where the economic integration process is partly government-led, the economic integration of GSC has been largely market-driven, although the policy framework in facilitating economic linkages has also been crucial in its development and success. Prior to 1979 economic relations between Hongkong and China were limited, while that between Taiwan and China were forbidden. In 1979, as part of its new open door policy, China created 4 special economic zones for the introduction of foreign capital, with 3 located in Guangdong (Shenzhen, Zhuhai and Shantou) and 1 in Fujian (Xiamen). The creation of these special economic zones by the PRC government in coastal south China on the one hand and the economic restructuring of Hongkong and Taiwan on the other, have precipitated the economic integration of Hongkong and the special economic zones, which later extended to other parts of the Pearl River Delta in Guangdong. To a lesser extent, economic linkages were also forged between Taiwan and Guangdong and Fujian provinces.

The degree of economic integration of Hongkong and Taiwan with coastal south China is reflected in the extensive bilateral/trilateral trade and investment flows. The large and growing trade and investment flows reflect the forces of geographical proximity, cultural and linguistic affinity, and economic complementarity, and despite lack of political and diplomatic relations and the ban on direct contacts between Taiwan and China. Guangdong is adjacent to Hongkong and easily accessible by land transport, while Taiwan faces Guangdong and Fujian cross the Taiwan Straits and readily accessible by sea. People of Hongkong originate from and speak the same Chinese dialect as Guangdong, while people of Taiwan originate from and speak the same Chinese dialect as Fujian. Hongkong and Taiwan have abundant investment capital and entrepreneurial and managerial resources, with land and labour shortages and rising costs pushing investments outwards. Hongkong is also a financial centre and entrepot, providing ready access to financing, trade services and links with the world. Fujian and Guangdong have more land and a population of over 100 million which provides a large pool of low wage labour and large potential consumer market. China and Hongkong are each other's most important trading partner and investor. Hongkong is the leading investor in coastal south China and its entrepot thrives on trade with and for China. Growth of bilateral trade has been stimulated by outward processing whereby Hongkong manufacturers contract or subcontract their production to Guangdong and Fujian. Hongkong investments reportedly employ some 3 million workers in coastal south China, which is several times the size of the Hongkong industrial workforce, which has shrunk to less than 400,000. China has also invested heavily in Hongkong and such investments have escalated in recent years. The extent of China-Taiwan trade and investment flows are harder to estimate, but the rapid growth of Taiwan investments in China have led to Taiwan government concerns over national security.

4. Market Integration in East Asia

Intra-East Asian Trade Flows

Key features of East Asian trade in the past two decades (until the outbreak of the regional financial crisis in July 1997) are its rapid growth, changing composition with growing intra-industry trade and FDI-trade linkage, triangular and unbalanced trade pattern, and rapid growth of intra-regional trade. First, East Asian trade grew rapidly in the 1980s and early 1990s, reflecting rapid economic growth and pursuit of outward oriented economic policies. For the market economies of the Asian NIEs and ASEAN, major economic reforms undertaken from the mid-1980s led to the switch from import substitution to export manufacturing and falling trade tariffs and nontariff barriers and more FDI inflows. For the command economies, China spearheaded the transition to a market economy with its open door policy and economic reforms from 1979, followed closely by the command economies in Indochina. Trade/GDP ratios have risen for most countries and the region has some of most trade-oriented economies in world. The role of Singapore and Hongkong as entrepots for Southeast Asia and China respectively have facilitated the region's trade with the world.

Second, the composition of East Asian trade shows rising shares of trade in manufactures and in services in response to changing production structures and emphasis on export manufacturing, depressed commodity and energy prices, and liberalisation of imports of manufactures and services. As a growing number of the region's developing countries are being drawn into export manufacturing, production networks have emerged, together with a pecking order of industrial competence. Intra-industry trade has grown with regional component sourcing and differentiated manufactures. Intra-firm trade has also grown with greater penetration of FDI and globalisation strategies of MNCs, both between parent and affiliates and between affiliates in the region.

Third, East Asia has large trade surpluses with the world, due to surpluses accumulated by Japan, China and Taiwan. In 1997, exports from the East Asian countries (Japan, China, Hongkong, Macau, South Korea, Taiwan and ASEAN-10) amounted to US$1,407.6 billion and imports amounted to $1,340.2 billion, giving a surplus of $67.4 billion. Japan has a persistent trade surplus which grew continuously to peak at $121.1 billion in 1994 but declined to US$82.4 billion in 1997; its trade surpluses with US and EU have given rise to serious trade frictions in past decade. Japan's trade surplus with Asian NIEs have overtaken its surplus with US and EC, while its trade with ASEAN is more balanced and its trade with China is in deficit. China's trade surplus has also grown, reaching $40.8 billion by 1997, mainly with Hongkong, US and EU.

Fourth, a triangular trade pattern emerged, with East Asian developing economies importing capital goods, intermediate inputs and components from Japan to produce manufactures for US and EU markets; the pattern is most evident for Asian NIEs but also emerging for China and ASEAN. Huge and growing trade deficit with Japan financed by trade surpluses with US and EU. 2 main factors contributed to triangular trade and huge trade imbalances --- sourcing of capital and high tech goods from Japan reflect latter's technological edge in some products, geographical proximity, and FDI and foreign aid links; and the rapid growth of export manufacturing in East Asian developing countries targeted at markets in US and Europe.

Notwithstanding the general absence of RTAs in East Asia (except AFTA), trade within East Asia has grown faster than the region's trade with the world. The share of intra-regional trade in East Asia's total trade rose from 37.6% in 1985 to 50.1% in 1997, while East Asia's share of world trade rose from 17.7% to 24.0% in the same period. The rapid growth of intra-East Asian trade has several explanations. First, the economic dynamism of East Asia, with incomes, investment demand and consumption demand growing faster than the world. Second, policy reforms aimed at deregulation and liberalisation of region's economies provided strong impetus to intra-regional trade and investment; in particular, intra-regional trade has been boosted by China's open door policy and market-oriented reforms and use of Hongkong as its entrepot. China-Hongkong trade grew dramatically, as the latter resumed its historical role as China's entrepot; demand for its entrepot services boosted by the ban imposed by Taiwan and South Korea on direct trade with China, and growth of China exports of manufactures which require more intermediation services. China-Hongkong trade also surged with massive Hongkong investments in processing operations in Guangdong. In 1997, the bilateral trade accounted for 15.6% of China's total trade and 36.4% of Hongkong's total trade. Third, intra-regional trade was also given impetus as major East Asian exporters sought new markets within the region to reduce dependence on US and Western Europe so as to defuse trade frictions. Shift in direction of exports was especially noticeable in recent years for Hongkong, South Korea and Taiwan. Fourth, currency realignments after the Plaza Accord of September 1985 shifted comparative advantage and led to relocation of manufacturing within East Asia and growth of FDI-linked trade.

Intra-regional trade increasing comprises manufactures, reflecting the flying geese pattern. For Japan, in 1950s-1960s it had a strong comparative advantage in labour intensive and standard technological products such as textiles and clothing and these products dominated its export structure. With rising wages, this advantage was lost by the 1970s and new advantage gained in skill and techno-intensive products and quality consumer goods. Japan supplied Asian NIEs and ASEAN with capital goods and intermediate goods which enabled them to produce labour intensive manufactures for export. For the Asian NIEs, in the 1970s and early 1980s they emerged as major exporters of labour intensive manufactures. However, with full employment pushing up wage costs and with growing industrial competence and capital resources, production and export shifted to chemicals, petrochemicals, basic metals, motor vehicles and electrical/electronic products and components, while industrial raw materials and intermediate goods began to feature more prominently in import structures. The Asian NIEs market their manufactures largely in North America and Western Europe and source their capital goods and intermediate goods largely from Japan, giving rise to triangular trade. For ASEAN-4 and China, as latecomers they emulated the export manufacturing strategy of the Asian NIEs, and their export structures increasingly shifted from traditional primary products and petroleum towards manufactures, with the transformation accelerated by depressed commodity and petroleum markets of the mid-1980s. Exports of manufactures shifted from resource-based products such as processed food, beverages, wood products towards textiles and clothing, chemicals, basic metals, machinery and electronics, with main markets in North America and Western Europe but sourcing of capital and intermediate goods largely from within the region. The composition of trade among East Asian economies has gradually shifted from vertical exchange between primary products and manufactures to more of an exchange between manufactures.

The share of intra-ASEAN trade in ASEAN's total trade has not shown significant change. In 1997, trade among the ASEAN-6 amounted to 20.7% of these countries total trade, as compared to 19.7% in 1985. Intra-ASEAN trade accounted for over half the trade of Cambodia and Laos, over a quarter of the trade of Brunei, Myanmar and Singapore and less than 15% of the trade of Indonesia and Philippines. Of intra-ASEAN trade (ASEAN-10) amounting to US$162.3 billion in 1997, Singapore accounted for 44%, followed by Malaysia with 24%. Singapore's pivotal role is due to its entrepot and petroleum refining activities and complementarity of its economy with the rest of ASEAN. Entrepot trade in manufactures grew rapidly in 1980s as neighbouring countries use Singapore's intermediation services to import and export primary products and manufactures. Manufactures accounted for 80% of Singapore's entrepot exports, mainly of machinery and equipment, parts and components, textiles and clothing. Singapore domestic exports to ASEAN comprise mainly of petroleum products, and electrical/electronic products.

East Asia's trade continued to grow steadily until 1995; growth decelerated to 2.5% in 1996 and 3.5% in 1997. Since then, the region's total trade and intra-regional trade have been seriously affected by the regional financial crisis which erupted in July 1997 and which deepened into an economic crisis in 1998. For 1997, exports grew by 5.6% and imports by only 1.3%; sharp deceleration in both exports and imports were evident in the later part of 1997 and continuing into 1998; for Japan, Korea and Thailand, absolute declines were already evident in imports for 1997. In order for East Asian countries to revive their trade and economies, their main trading partners need to absorb more of their exports. In particular, Japanese economic recovery is vital to stabilisation of East Asian developing economies.

Intra-East Asian FDI Flows

Key features of East Asian FDI flows in the past two decades (until outbreak of regional financial crisis) are the emergence of Japan and Asian NIEs as major foreign investors and the rapid growth of intra-East Asian investments.

Japanese firms and Asian NIE firms increasingly undertook outward direct investments after the mid-1980s. They were motivated by a combination of home country push factors, host country pull factors and firm-specific factors. First, sustained economic growth led to rising costs and erosion of competitiveness and profits, and pressures to relocate land and labour intensive industries to foreign locations while domestic resources shift towards higher value added activities. Second, strong economic and trade performances led to improved balance of payments, currency appreciation and foreign exchange decontrols; in particular, the Plaza Accord of September 1985 triggered a wave of Japanese outward FDI, while currency appreciation was also a factor in pushing Asian NIEs to invest outward. Third, market access became a growing issue in the 1980s.

Investments in US and Western Europe were to overcome trade restrictions and frictions and exploit opportunities of the Single Market and NAFTA. Also Asian NIE investors sought GSP benefits and MFA quotas in East Asian developing countries. Rapid growth of East Asia itself and economic liberalisation and deregulation in several countries also made many of these markets more attractive to FDI. Fourth, Asian NIEs also invested abroad to access technology by tapping into innovations emanating from high tech industries and laboratories in advanced industrial countries to complement domestic R&D efforts and diversify country, market and product risks. The restructuring process led firms to invest abroad to diversify out of mature industries/sectors in the home market. For Hongkong investors, there was also the search for political economic security with reversion to Chinese sovereignty in July 1997. Outward investments take the form of greenfield investments in production facilities, as well as mergers and acquisitions, portfolio investments and real estate investments. Finally, Japanese corporations invested abroad to pursue globalisation strategies.

Japanese outward FDI flows (notification basis) peaked in 1989. The decline in subsequent years reflected several developments. First, the burst of Japan's bubble economy and prolonged recession adversely affected corporate balance sheets and financial capacity to undertake new investments. Sharp fall in stock and real estate prices increased the non-performing loans (NPLs) of banks and reduced ability to meet BIS capital-adequacy-ratios. Second, investments in North America and Western Europe were discouraged by poor sales and earnings of Japanese affiliates due to recessions, while real estate investments have turned sour as prices plummeted and rising yen led to heavy foreign exchange losses. Also investments in the European Single Market tapered off. The slowdown in Japanese investments in East Asia were milder due to the continuing regional economic boom and proximity and lower transaction costs for outward investments by Japanese SMEs.

East Asian developing economies are favoured destinations for FDI. First, the region has abundant natural resources, including petroleum and gas. Singapore and Hongkong have strategic geographical locations and are regional service hubs. Second, for FDI targeted at host markets, China has a huge market and thus has attracted the second largest amount of FDI in the world (after the US); for the other economies, domestic markets have expanded with rapid economic growth and rising incomes, population growth, and increasingly integrated markets. Third, for FDI in export manufacturing, locational advantages of host countries are abundant low wage labour and free labour markets, and availability of industrial estates and EPZs with well-developed infrastructure. Foot-loose export manufacturing is attracted by physical infrastructure, institutional support, low restrictions and performance requirements, low tax regimes, abundant low wage labour and skilled manpower and supporting supplier networks for more sophisticated industries. Fourth, although economic fundamentals are crucial, favourable FDI policies improve the overall investment environment. The past decade has witnessed dramatic policy changes in favour of FDI in several East Asian developing economies ---- establishment of investment promotion centres providing a range of services; relaxation of foreign ownership restrictions; economic reforms including deregulation, privatisation, trade and investment liberalisation so as to stimulate economic growth; provision of industrial estates and parks and export processing zones with various industrial facilities; generous fiscal incentives and rollback of performance requirements; and political and social stability.

Emergence of Japan and Asian NIEs as major investors and economic and policy developments in East Asia led to the rapid growth of intra-East Asian investments. By the early 1990s, the traditional dominant role of Western investors were being gradually overtaken by investors from Japan and Asian NIEs in Southeast Asia and China (except for Singapore where Triad investors continue to dominate). Investments from western countries slowed because of their sluggish home economic performance and some diversion of investor interests to the European Single Market and NAFTA. The major investment flows within East Asia were from Japan to ASEAN and Asian NiEs and from Asian NIEs to ASEAN. Smaller flows were from Japan and Asian NIEs to China, with Hongkong playing pivotal investment and intermediary roles; a substantial proportion of Hongkong investments in China originates from third countries, most notably Taiwan. There are also sizeable China investments in Hongkong. Unlike Hongkong's extensive investments in China, Singapore's investments in the ASEAN hinterland have been much more modest, although intra-ASEAN investments are mainly from Singapore to Malaysia and Indonesia.

According to the World Investment Report (1998), global FDI flows in 1997 appeared unaffected by the East Asian financial crisis, registering a growth of 19% to $400 billion. The 5 crisis economies of Indonesia, Malaysia, Philippines, Thailand and South Korea saw their combined FDI inflows almost unchanged from the 1996 level. China continued to attract a record level of $45 billion in FDI inflows in 1997, although the growth rate tapered to only 11% as against an annual average of 145% during 1992-93. The Report expects FDI inflows into China to decelerate further in 1998-99, reflecting slower economic growth, excess capacity in several industries due to overinvestment and weaker demand, sharp wage increases in coastal south China and sharp currency depreciations in South Korea and Southeast Asia eroding China's cost competitiveness.

With the regional financial crisis, intra-regional investments have declined, as many of the region's corporations grapple with mounting debts and other difficulties. In contrast, European and American MNCs are now taking a more active interest in the region and merger and acquisition activities are growing in response to the large number of the region's corporations seeking recapitalisation and injections of foreign capital and as asset prices have dropped drastically in foreign currency terms.

5. Prospects for Economic Integration in East Asia

As the East Asian region, and more particularly the crisis economies of Indonesia, Malaysia, Philippines, Thailand and South Korea, grapple with the problems raised by the crisis which erupted upon the region in July 1997 and which saw no significant recovery by end-1998, new initiatives in regional economic integration have taken a back seat.

The deepening of economic integration in ASEAN and East Asia has been adversely affected by ASEAN's enlargement to embrace the CLMV transitional economies and by the regional financial and economic crisis. For ASEAN, enlargemnent is not yet completed, as the December 1998 decision to admit Cambodia will only be implemented conditional on improvements in Cambodia's internal politics. ASEAN enlargement to encompass the CLMV countries has led to greater diversity of political systems and styles and economic systems and levels, thus putting a severe strain on the ASEAN process of decision-making by consensus and principle of non-interference in domestic affairs of members, and pushinging back the deadline for the completion of

AFTA. ASEAN needs to re-examine its decision-making process and formalise its dispute settlement mechanism. Enlargement, more particularly the membership of Myanmar, has also made it more difficult for ASEAN to work together with the US and EU.

The regional financial and economic crisis has impacted negatively on all ASEAN countries to varying degrees. Singapore is less affected because it has very strong economic and financial fundamentals, while the CLMV countries are less affected because they do not have open capital accounts. ASEAN as a regional grouping has not been effective in helping its members overcome the crisis. There has been limited financial cooperation. Individually and collectively, ASEAN countries did not have adequate financial resources to counter the speculation by international hedge funds and to bail out economies, financial institutions and business enterprises. Limited financial assistance was offered to the crisis countries on a bilateral basis. A proposal to conduct ASEAN trade using a regional currency and reduce dependence on the US dollar was considered not feasible and pursued only on a bilateral basis. The proposal for ASEAN to establish a regional surveillance and monitoring mechanism also hit a snag and it was eventually agreed that the mechanism would be established at the ASEAN Secretariat in Jakarta, with technical assistance from ADB. The crisis has highlighted the need for ASEAN to move towards closer financial cooperation, so that a crisis of such a dimension will not recur. Beyond the crisis, ASEAN needs to be more effective as an economic grouping. It is too small in market size and capital and technological resources and need to cooperate with other RTAs so as to access larger markets and larger pools of capital and technology. Increasingly, the ASEAN growth triangles will develop under the umbrella of AFTA, the Framework Agreement on Services and the AIA.

In Northeast Asia, a Greater China Economic Area encompassing China, Hongkong, Macau and Taiwan is a growing reality. Hongkong reverted to Chinese sovereignty under the "one country, two systems" in July 1997 and Macau will follow suit by end-1999. China is actively wooing Taiwan with the same formula and cross-Straits relations are rapidly improving. A Greater China Economic Area will result in an integrated market of 1.3 billion people and combine the entrepreneurial, managerial and financial resources of Hongkong and Taiwan with the vast human resources of China.

Will an East Asian grouping emerge? The case for an EAEC seems stronger than before. The regional crisis has shown the slowness if not reluctance of North America and Western Europe to come to East Asia's rescue, preferring to defer to the IMF. Would the regional crisis has spread so wide and become so deep if earlier and concerted rescue efforts were mounted? An EAEC would provide the institutional mechanism for information gathering and sharing and early warning signals, and hasten cooperative efforts to prevent a regional contagion. An East Asian RTA would facilitate bloc-to-bloc negotiations with an expanded EU and an expanded NAFTA.

What will happen to APEC? It is much larger than ASEAN in membership, population, market size, and capital and technological resources, as it includes some of the largest countries and economies in the world, notably the US, China and Japan. However, APEC is not an RTA as its trade and investment liberalisation and facilitation action plans are entirely voluntary and non-binding. It remains to be seen how effective voluntarism will be and APEC may have to move towards some binding agreements and progress from the level of commitment to the level of implementation.

As both ASEAN and APEC struggle with their forms of economic integration, they will be watching developments in the EU very closely and drawing lessons.

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Table 1: East Asia - Key Indicators

	Population	Land area	GNP 1997		GNP per capita 1997		Foreign trade 1997 $million		
	1997 million	000 sq km	$billion	ppp-adj $bill.	$	ppp-adj $	Total	Exports	Imports
Japan	126	377	4772.3	2950.7	37850	23400	759713	421067	338646
China	1227	9326	1055.4	4382.5	860	3570	325080	182917	142163
Hongkong	7	1	164.4	159.6	25280	24540	396493	187870	208623
Macao							4453	2138	2315
South Korea	46	99	485.2	621.1	10550	13500	280659	136111	144548
Taiwan	21	36	285.8(96)	na	13310(96)	na	236557	122097	114460
Brunei	0.3	5	7.2	na	25090	na	6321	2375	3946
Indonesia	200	1812	221.9	690.7	1110	3450	95195	52179	43016
Malaysia	21	329	98.2	229.3	4680	10920	159013	78750	80263
Philippines	73	298	89.3	269.2	1220	3670	76943	28510	48433
Singapore	3	1	101.8	89.6	32940	29000	257842	125302	132540
Thailand	61	511	169.6	399.3	2800	6590	120393	57518	62875
Cambodia	11	177	3.2	na	300	na	1738	624	1114
Laos	5	231	1.9	6.3	400	1290	601	192	409
Myanmar	47	658	na	na	na	na	3853	1178	2675
Vietnam	77	325	24.5	128.3	320	1670	22887	8722	14165

Sources: World Bank, World Development Report 1998/99; Asian Development Bank, Key Indicators 1997.

Table 2: East Asia - Trade Matrix (Exports+ Imports), 1985

	World	Japan	China	Hongkong	Macao	S. Korea	Taiwan	NE Asia	Brunei	Indonesia	Malaysia	Philippines	Singapore	Thailand	Cambodia	Laos	Myanmar	Vietnam	SE Asia	Asean-6	CLMV	East Asia
US$million:																						
World	3703100	300137	69020	53599	1805	46517	5195	522993	3527	27448	29724	119	12896	15729	30	67	984	929	133183	131173	2010	656176
Japan	307705		19124	7338	61	11303	8484	46310	1997	12383	6531	28	5500	3082	2	13	221	216	32143	31691	452	78453
China	69809	21269		11910	300	0	0	33479	3	454	384	11	2304	379	2	10	78	0	4025	3936	90	37504
Hongkong	59883	8127	15425		651	1609	3398	29210	12	490	396	0	2298	505	0	1	33	156	4411	4221	190	33621
Macao	1683	97	226	506		7	34	870	0	0	1	1	5	2	0	0	0	0	9	9	0	879
South Korea	61347	12103	0	2011	1		530	14645	229	865	1684	2	758	296	0	0	25	0	4249	4224	25	18894
Taiwan	51915	8484	0	3398	34	530		12446	119	645	673	9	1263	402	0	0	0	0	3371	3371	0	15817
NE Asia	652342	50080	34775	25163	1047	13449	12416	136960	2360	14837	9668.8	31	12128	4666	4	24	357	372	48208	47451	757	185168
Brunei	3540	1917	12	10	0	0	119	2058		10	49	5	403	330	0	0	0	0	807	807	0	2865
Indonesia	28872	11238	333	400	0	861	615	13477	1		129	2	2465	129	0	0	5	11	2962	2946	16	16439
Malaysia	27709	6617	161+25	416	0	1182	673	8888	32	205		3	4939	962	1	0	39	15	6791	6736	55	15679
Philippines	9965	1624	371	396	0	289	219	2949	15	208	564		377	139	0	0	0	1	1304	1303	1	4253
Singapore	49049	6634	2601	1947	10	704	1213	13169	536	2465	7275	3		1493	15	0	125	191	12516	12185	331	25675
Thailand	16382	3402	494	396	1	319	412	5013	345	104	902	3	1255		0	21	49	1	2789	2718	71	7801
Cambodia	32	2	2	0	0	0	0	4	0	0	1	)	15	0		0	0	0	16	16	0	20
Laos	71	14	9	1	0	0	0	24	0	0	0	)	13	23	0		0	0	35	35	0	59
Myanmar	585	136	13	29	0	16	0	194	0	21	14	)	46	4	0	0		1	87	85	1	281
Vietnam	952	225	0	152	0	0	0	377	0	11	13	!	199	1	0	0	2		226	225	2	604
SE Asia	137168	31808	3934	3747	11	3371	332	46143	929	3024	8946	13	9710	3080	16	21	219	221	27533	27056	477	73676
Asean-6	135518	31432	3911	3565	11	3355	332	45544	929	2992	8918	13	9438	3053	16	21	218	219	27169	26695	474	72713
CLMV	1641	377	23	182	0	16	0	599	0	32	28	}	272	28	0	0	2	1	364	361	3	963
East Asia	689500	81888	38609	28910	1058	16820	1588	183103	3289	17861	18615	5?	1838	7747	20	45	576	593	75741	74507	1234	258844
Percent distribution:																						
World	100.00	8.11	1.86	1.45	0.05	1.26	1.0	14.12	0.10	0.74	0.80	0	1.16	0.42	0.00	0.00	0.03	0.03	3.60	3.54	0.05	17.72
Japan	100.00		6.22	2.38	0.02	3.67	2.6	15.05	0.65	4.02	2.12	0	1.79	1.00	0.00	0.00	0.07	0.07	10.45	10.30	0.15	25.50
China	100.00	30.47		17.06	0.43	0.00	0.0	47.96	0.00	0.65	0.55	0	3.30	0.54	0.00	0.01	0.11	0.00	5.77	5.64	0.13	53.72
Hongkong	100.00	13.57	25.76		1.09	2.69	5.7	48.78	0.02	0.82	0.66	0	3.84	0.84	0.00	0.00	0.06	0.26	7.37	7.05	0.32	56.14
Macao	100.00	5.77	13.42	30.08		0.42	2.1	51.69	0.00	0.00	0.05	0	0.27	0.14	0.00	0.00	0.00	0.00	0.52	0.52	0.00	52.22
South Korea	100.00	19.73	0.00	3.28	0.00		0.86	23.87	0.37	1.41	2.75	0	1.24	0.48	0.00	0.00	0.04	0.00	6.93	6.89	0.04	30.80
Taiwan	100.00	16.34	0.00	6.55	0.07	1.02		23.97	0.23	1.24	1.30	0	2.43	0.77	0.00	0.00	0.00	0.00	6.49	6.49	0.00	30.47
NE Asia	100.00	9.07	6.30	4.56	0.19	2.43	2.25	24.80	0.43	2.69	1.76	0.	2.20	0.84	0.00	0.00	0.06	0.07	8.73	8.59	0.14	33.52
Brunei	100.00	54.15	0.34	0.29	0.00	0.00	3.7	58.15		0.27	1.37	0.	1.39	9.32	0.00	0.00	0.00	0.00	22.79	22.79	0.00	80.94
Indonesia	100.00	38.92	1.15	1.39	0.00	2.98	2.3	46.68	0.00		0.45	0.	8.54	0.45	0.00	0.00	0.02	0.04	10.26	10.20	0.06	56.94
Malaysia	100.00	23.88	0.00	1.50	0.00	4.27	2.4	32.08	0.12	0.74		2.	7.82	3.47	0.06	0.00	0.14	0.05	24.61	24.31	0.20	56.58
Philippines	100.00	16.30	3.73	3.97	0.00	2.90	2.7	29.59	0.15	2.08	5.66		3.78	1.39	0.00	0.00	0.00	0.01	13.09	13.07	0.01	42.68
Singapore	100.00	13.53	5.30	3.97	0.02	1.44	2.5	26.83	1.09	5.03	14.83	0.		3.04	0.03	0.00	0.25	0.39	25.62	24.84	0.67	52.35
Thailand	100.00	20.76	3.01	2.42	0.00	1.95	2.6	30.60	2.11	0.64	5.50	0.	7.66		0.00	0.13	0.30	0.01	17.02	16.59	0.43	47.62
Cambodia	100.00	6.25	6.25	0.00	0.00	0.00	0.0	12.50	0.00	0.00	3.13	0.	6.88	0.00		0.00	0.00	0.00	50.00	50.00	0.00	62.50
Laos	100.00	19.97	12.17	1.08	0.00	0.00	0.0	33.23	0.00	0.00	0.01	0.	7.61	32.13	0.00		0.00	0.14	49.92	49.77	0.14	83.14
Myanmar	100.00	23.17	2.16	5.03	0.00	2.79	0.0	33.14	0.00	3.63	2.40	0.	7.85	0.67	0.00	0.00		0.23	14.78	14.56	0.23	47.92
Vietnam	100.00	23.62	0.00	15.99	0.00	0.00	0.0	39.61	0.00	1.16	1.35	0.	0.86	0.08	0.00	0.01	0.16		23.77	23.60	0.17	63.38
SE Asia	100.00	23.19	2.80	2.73	0.01	2.46	2.4	33.64	0.68	2.20	6.52	1.	7.08	2.25	0.01	0.02	0.16	0.16	20.07	19.73	0.35	53.72
Asean-6	100.00	23.19	2.81	2.63	0.01	2.48	2.4	33.61	0.69	2.21	6.58	1.	6.96	2.25	0.01	0.02	0.16	0.16	20.05	19.70	0.35	53.66
CLMV	100.00	22.96	1.42	11.12	0.00	1.00	0.0	36.50	0.00	1.96	1.70	0.	6.58	1.68	0.00	0.01	0.09	0.09	22.20	22.02	0.19	58.70
East Asia	100.00	11.88	5.60	4.19	0.15	2.44	2.3	26.56	0.48	2.59	2.70	0.	3.17	1.12	0.00	0.01	0.08	0.09	10.98	10.81	0.18	37.54

Source: IMF, Direction of Trade Statistics Yearbook.

Table 3: East Asia - Trade Matrix (Exports + Imports), 1997

	World	Japan	China	Hongkong	Macao	S. Korea	Taiwan	NE Asia	Brunei	Indonesia	Malaysia	Philippines	Singapore	Thailand	Cambodia	Laos	Myanmar	Vietnam	SE Asia	Asean-6	CLMV	East Asia
US$million:																						
World	11153800	769091	452310	246529	5336	248261	239145	**1960672**	5900	98833	194405	71417	202786	120486	2153	816	3538	20665	**72089**	**693827**	**27172**	**2681671**
Japan	759713		63519	29505	117	40703	40033	**173877**	1556	24795	25896	13708	26139	24183	71	50	310	3460	**12016**	**113277**	**3891**	**294045**
China	325080	60810		50795	765	24021	19634	**156225**	33	4518	4406	1661	8706	3507	121	29	643	1436	**2506**	**22831**	**2229**	**181285**
Hongkong	396493	40045	144171		1750	12259	20817	**219042**	25	2586	6630	3478	15162	5235	104	11	122	900	**3425**	**33116**	**1137**	**253295**
Macao	4453	186	746	905		47	242	**2126**	1	6	18	7	41	18	0	0	0	0	**91**	**91**	**0**	**2217**
South Korea	280659	42620	23577	12594	0		7021	**85812**	0	7632	7637	3308	8191	3526	0	0	0	1607	**3190**	**31294**	**1607**	**117713**
Taiwan	236557	40033	19634	20817	242	7021		**87947**	87	3626	7184	3721	11176	4426	98	4	88	1787	**3219**	**31220**	**1977**	**120144**
NE Asia	**2002955**	**183694**	**251847**	**114616**	**2874**	**84051**	**87947**	**726029**	**1702**	**43163**	**61771**	**25883**	**69415**	**40895**	**394**	**94**	**1163**	**9190**	**243670**	**232829**	**10841**	**968699**
Brunei	6321	1443	37	27	1	0	87	**1695**		43	321	4	1726	155	0	0	0	0	**2249**	**2249**	**0**	**3844**
Indonesia	95195	21875	4030	2236	0	6260	3626	**38027**	40		2499	877	6473	1817	54	0	144	514	**1241**	**11706**	**712**	**50445**
Malaysia	159013	27280	4149	6267	8	6695	7184	**51583**	296	2725		2123	27309	5922	114	2	423	482	**3939**	**39376**	**1021**	**90979**
Philippines	76943	14122	1766	3583	7	3504	3721	**26703**	3	873	2153		5044	1267	1	0	52	319	**971**	**9340**	**372**	**36416**
Singapore	257842	32122	9722	14663	71	9107	11176	**76860.7**	1607	6473	41820	4929		12597	479	36	879	2208	**71021**	**67426**	**3602**	**147889**
Thailand	120393	24898	4004	4225	22	3265	4426	**40840**	156	2261	5502	1246	9553		391	438	0	716	**20281**	**18718**	**1545**	**61103**
Cambodia	1738	90	103	80	0	52	98	**423**	0	16	71	1	189	330		0	0	265	**87**	**607**	**265**	**1295**
Laos	601	17	5	10	1	4	4	**41**	0	0	1	0	1	371	0		0	25	**39**	**373**	**25**	**439**
Myanmar	3853	322	694	124	0	0	88	**1228**	0	154	455	0	934	0	0	0		0	**1543**	**1543**	**0**	**2771**
Vietnam	22887	3390	1511	939	7	1767	1787	**9401**	0	538	500	315	2325	754	0	23	0		**4461**	**4432**	**23**	**13856**
SE Asia	**744786**	**125569**	**26021**	**32154**	**117**	**30654**	**32197**	**246702**	**2102**	**13083**	**63322**	**9495**	**63564**	**23213**	**1038**	**499**	**1498**	**4529**	**162334**	**154769**	**7566**	**409036**
Asean-6	**715707**	**121740**	**23708**	**31001**	**109**	**28831**	**30220**	**236609**	**2102**	**12376**	**62295**	**9179**	**60105**	**21758**	**1038**	**476**	**1498**	**4239**	**165066**	**147814**	**7252**	**390675**
CLMV	**29079**	**3819**	**2313**	**1153**	**8**	**1823**	**1977**	**11093**	**0**	**708**	**1027**	**316**	**3449**	**1455**	**0**	**23**	**0**	**290**	**7261**	**5955**	**313**	**18361**
East Asia	**2747741**	**309253**	**277868**	**145770**	**2991**	**114705**	**120144**	**971731**	**3804**	**56246**	**106093**	**35378**	**122969**	**64108**	**1433**	**693**	**2661**	**13719**	**406004**	**387698**	**18406**	**1377735**
Percent distribution:																						
World	100.00	6.90	4.06	2.21	0.05	2.23	2.14	**17.58**	0.05	0.89	1.74	0.64	1.82	1.08	0.02	0.01	0.03	0.19	**6.46**	**6.22**	**0.24**	**24.04**
Japan	100.00		8.36	3.88	0.02	5.36	5.27	**22.89**	0.20	3.26	3.41	1.80	3.44	3.18	0.01	0.01	0.04	0.46	**15.8**	**15.31**	**0.51**	**38.70**
China	100.00	18.71		15.63	0.24	7.39	6.10	**48.06**	0.01	1.39	1.36	0.51	2.68	1.08	0.04	0.01	0.20	0.44	**7.71**	**7.02**	**0.69**	**55.77**
Hongkong	100.00	10.10	36.36		0.44	3.09	5.25	**55.24**	0.01	0.65	1.67	0.88	3.82	1.32	0.03	0.00	0.03	0.23	**8.64**	**8.35**	**0.29**	**63.88**
Macao	100.00	4.18	16.75	20.32		1.06	5.43	**47.74**	0.02	0.13	0.40	0.16	0.92	0.40	0.00	0.00	0.00	0.00	**2.04**	**2.04**	**0.00**	**49.79**
South Korea	100.00	15.19	8.40	4.49	0.00		2.50	**30.58**	0.00	2.72	2.72	1.18	2.92	1.26	0.00	0.00	0.00	0.57	**11.37**	**10.79**	**0.57**	**41.94**
Taiwan	100.00	16.92	8.38	8.60	0.10	2.97		**37.18**	0.04	1.53	3.04	1.57	4.72	1.87	0.04	0.00	0.04	0.76	**13.61**	**12.77**	**0.84**	**50.79**
NE Asia	**100.00**	**9.17**	**12.57**	**5.72**	**0.14**	**4.20**	**4.39**	**36.20**	**0.08**	**2.15**	**2.58**	**1.29**	**3.47**	**2.04**	**0.02**	**0.00**	**0.06**	**0.46**	**12.17**	**11.62**	**0.54**	**48.36**
Brunei	100.00	22.83	0.59	0.43	0.02	0.00	1.38	**26.23**		0.68	5.08	0.06	27.31	2.45	0.00	0.00	0.00	0.00	**35.61**	**35.58**	**0.00**	**60.81**
Indonesia	100.00	22.98	4.23	2.35	0.00	6.58	3.81	**39.95**	0.04		2.63	0.92	6.80	1.91	0.06	0.00	0.15	0.54	**13.04**	**12.30**	**0.75**	**52.99**
Malaysia	100.00	17.16	2.61	3.94	0.01	4.21	4.52	**32.44**	0.19	1.71		1.34	17.17	3.72	0.07	0.00	0.27	0.30	**24.73**	**24.13**	**0.64**	**57.21**
Philippines	100.00	18.35	2.30	4.66	0.01	4.55	4.84	**34.70**	0.00	1.13	2.80		6.56	1.65	0.00	0.00	0.07	0.41	**12.62**	**12.14**	**0.48**	**47.33**
Singapore	100.00	12.46	3.77	5.69	0.03	3.53	4.33	**29.81**	0.62	2.51	16.22	1.91		4.89	0.19	0.01	0.34	0.86	**27.55**	**26.15**	**1.40**	**57.36**
Thailand	100.00	20.68	3.33	3.51	0.02	2.71	3.68	**33.92**	0.13	1.88	4.57	1.03	7.93		0.32	0.36	0.00	0.59	**16.85**	**15.55**	**1.28**	**50.75**
Cambodia	100.00	5.18	5.93	4.60	0.00	2.99	5.64	**24.34**	0.00	0.92	4.09	0.06	10.87	18.99		0.00	0.00	15.25	**50.17**	**34.93**	**15.25**	**74.51**
Laos	100.00	2.83	0.83	1.66	0.17	0.67	0.67	**6.82**	0.00	0.00	0.17	0.00	0.17	61.73	0.00		0.00	4.16	**66.22**	**62.06**	**4.16**	**73.04**
Myanmar	100.00	8.36	18.01	3.22	0.00	0.00	2.28	**31.87**	0.00	4.00	11.81	0.00	24.24	0.00	0.00	0.00		0.00	**40.05**	**40.05**	**0.00**	**71.92**
Vietnam	100.00	14.81	6.60	4.10	0.03	7.72	7.81	**41.08**	0.00	2.35	2.18	1.38	10.16	3.29	0.00	0.10	0.00		**19.47**	**19.36**	**0.10**	**60.64**
SE Asia	**100.00**	**16.86**	**3.49**	**4.32**	**0.02**	**4.12**	**4.32**	**33.12**	**0.28**	**1.76**	**7.16**	**1.27**	**7.19**	**3.12**	**0.14**	**0.07**	**0.20**	**0.61**	**21.81**	**20.78**	**1.02**	**54.92**
Asean-6	**100.00**	**17.01**	**3.31**	**4.33**	**0.02**	**4.03**	**4.22**	**32.92**	**0.29**	**1.73**	**7.31**	**1.28**	**7.00**	**3.04**	**0.15**	**0.07**	**0.21**	**0.59**	**21.67**	**20.65**	**1.01**	**54.59**
CLMV	**100.00**	**13.13**	**7.95**	**3.97**	**0.03**	**6.27**	**6.80**	**38.15**	**0.00**	**2.43**	**3.53**	**1.09**	**11.86**	**5.00**	**0.00**	**0.08**	**0.00**	**1.00**	**24.91**	**23.82**	**1.08**	**63.14**
East Asia	**100.00**	**11.25**	**10.11**	**5.34**	**0.11**	**4.17**	**4.37**	**35.36**	**0.14**	**2.05**	**3.82**	**1.29**	**4.48**	**2.33**	**0.05**	**0.02**	**0.10**	**0.50**	**14.73**	**14.11**	**0.67**	**50.14**

Source: IMF, Direction of Trade Statistics Yearbook

Table 4: East Asia - Exports and Imports, 1995-1997

	1997			1996			1995		
	Total	Exports	Imports	Total	Exports	Imports	Total	Exports	Imports
US$million:									
World	11153800	5527900	5625900	10680900	5289800	5391100	10223800	5074200	5149600
Japan	759713	421067	338646	760750	411242	349508	778942	443005	335937
China	325080	182917	142163	290042	151093	138949	280955	148892	132063
Hongkong	396493	187870	208623	379077	180526	198551	366310	173546	192764
Macao	4453	2138	2315	4126	2149	1977	4038	1989	2049
South Korea	280659	136111	144548	280896	130526	150370	260518	125365	135153
Taiwan	236557	122097	114460	217677	115991	101686	215485	111833	103652
NE Asia	**2002955**	**1052200**	**950755**	**1932568**	**991527**	**941041**	**1906248**	**1004630**	**901618**
Brunei	6321	2375	3946	7075	2374	4701	5621	2108	3513
Indonesia	95195	52179	43016	92878	49914	42964	84207	43982	40225
Malaysia	159013	78750	80263	156668	78246	78422	151336	73722	77614
Philippines	76943	28510	48433	52299	20543	31756	45653	17371	28282
Singapore	257842	125302	132540	256819	125126	131693	242581	118187	124394
Thailand	120393	57518	62875	129079	55743	73336	130892	57200	73692
Cambodia	1738	624	1114	1945	301	1644	1914	352	1562
Laos	601	192	409	1011	321	690	900	311	589
Myanmar	3853	1178	2675	3704	1189	2515	3416	1180	2236
Vietnam	22887	8722	14165	21075	7156	13919	17526	5723	11803
SE Asia	**744786**	**355350**	**389436**	**722653**	**340913**	**381640**	**684046**	**320136**	**363910**
Asean-6	**715707**	**344634**	**371073**	**694818**	**331946**	**362872**	**660290**	**312570**	**347720**
CLMV	**29079**	**10716**	**18363**	**27736**	**8967**	**18768**	**23756**	**7568**	**16190**
East Asia	**2747741**	**1407550**	**1340191**	**2655121**	**1332440**	**1322681**	**2590294**	**1324766**	**1265528**
Percent distribution:									
World	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Japan	6.81	7.62	6.02	7.12	7.77	6.48	7.62	8.73	6.52
China	2.91	3.31	2.53	2.72	2.86	2.58	2.75	2.93	2.56
Hongkong	3.55	3.40	3.71	3.55	3.41	3.68	3.58	3.42	3.74
Macao	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04
South Korea	2.52	2.46	2.57	2.63	2.47	2.79	2.55	2.47	2.62
Taiwan	2.12	2.21	2.03	2.04	2.19	1.89	2.11	2.20	2.01
NE Asia	17.96	19.03	16.90	18.09	18.74	17.46	18.65	19.80	17.51
Brunei	0.06	0.04	0.07	0.07	0.04	0.09	0.05	0.04	0.07
Indonesia	0.85	0.94	0.76	0.87	0.94	0.80	0.82	0.87	0.78
Malaysia	1.43	1.42	1.43	1.47	1.48	1.45	1.48	1.45	1.51
Philippines	0.69	0.52	0.86	0.49	0.39	0.59	0.45	0.34	0.55
Singapore	2.31	2.27	2.36	2.40	2.37	2.44	2.37	2.33	2.42
Thailand	1.08	1.04	1.12	1.21	1.05	1.36	1.28	1.13	1.43
Cambodia	0.02	0.01	0.02	0.02	0.01	0.03	0.02	0.01	0.03
Laos	0.01	0.00	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Myanmar	0.03	0.02	0.05	0.03	0.02	0.05	0.03	0.02	0.04
Vietnam	0.21	0.16	0.25	0.20	0.14	0.26	0.17	0.11	0.23
SE Asia	**6.68**	**6.43**	**6.92**	**6.76**	**6.44**	**7.08**	**6.69**	**6.31**	**7.07**
Asean-6	**6.42**	**6.23**	**6.60**	**6.51**	**6.28**	**6.73**	**6.46**	**6.16**	**6.75**
CLMV	**0.26**	**0.19**	**0.33**	**0.26**	**0.17**	**0.35**	**0.23**	**0.15**	**0.31**
East Asia	**24.64**	**25.46**	**23.82**	**24.86**	**25.19**	**24.53**	**25.34**	**26.11**	**24.58**

Source: IMF, Direction of Trade Statistics Yearbook.

Table 5: East Asia - Matrix of Inward Foreign Direct Investment Stock, 1980 and 1992

Recipient Regions/ Countries		Investing Regions/Countries Japan	China	NIES-4	Hong Kong	Singapore	South Korea	Taiwan	ASEAN-4	Indonesia	Malaysia	Philippines	Thailand	East Asia	North Amer.	EU	World
Japan	1980		0.00	3.09	2.45	0.00	0.00	0.63	0.00	0.00	0.00	0.00	0.00	3.09	56.68	13.27	100.00
	1992		0.03	2.73	2.28	0.16	0.14	0.15	0.03	0.03	..	..	..	2.79	46.26	20.12	100.00
China	1980	16.11		49.38	48.86	0.52	0.00	0.00	0.62	0.01	0.00	0.16	0.45	66.10	18.74	8.41	100.00
	1992	11.89		66.38	60.96	1.10	0.32	4.00	0.73	0.07	0.08	0.11	0.47	79.00	9.69	4.27	100.00
NIES-4	1980	20.44	0.17	9.53	7.03	2.27	0.04	0.19	4.36	0.28	2.75	1.14	0.19	34.50	32.14	26.10	100.00
	1992	31.81	0.69	7.89	4.57	3.00	0.05	0.27	3.22	0.11	1.71	0.77	0.64	43.62	26.73	19.01	100.00
Hong Kong	1980	21.55	0.48	1.78		1.67	0.03	0.08	0.32	0.00	0.02	0.18	0.12	24.13	41.53	34.23	100.00
	1992	40.38	1.87	6.88		6.51	0.36	0.01	1.05	0.03	0.01	0.28	0.73	50.18	32.85	19.53	100.00
Singapore	1980	11.71	0.00	12.56	12.12		0.00	0.44	7.08	0.64	6.11	0.10	0.24	31.35	22.46	33.12	100.00
	1992	23.27	0.20	6.53	6.11		-0.22	0.64	5.21	0.11	3.92	0.27	0.91	35.21	21.17	23.09	100.00
South Korea	1980	56.07	0.00	2.08	2.05	0.00		0.03	0.00	0.00	0.00	0.00	0.00	58.15	25.54	6.63	100.00
	1992	43.17	0.06	2.45	1.67	0.65		0.13	0.01	..	..	0.01	..	45.68	26.45	20.41	100.00
Taiwan	1980	18.56	0.00	21.80	12.54	8.92	0.14		8.66	0.25	2.56	5.50	0.35	48.82	36.81	6.36	100.00
	1992	28.97	..	15.30	10.77	4.43	0.11		4.50	0.32	0.92	3.03	0.23	48.77	27.91	8.86	100.00
ASEAN-4	1980	28.62	0.00	20.63	9.79	10.57	0.07	0.21	0.59	0.02	0.22	0.25	0.11	49.85	11.43	15.60	100.00
	1992	22.55	0.13	25.65	7.99	5.39	3.77	8.50	1.23	0.82	0.18	0.06	0.16	49.57	8.86	12.23	100.00
Indonesia	1980	37.50	0.00	12.95	11.50	1.46	0.00	0.00	0.78		0.28	0.44	0.07	51.24	4.85	9.22	100.00
	1992	20.74	..	22.54	8.31	3.27	4.70	6.25	0.38		0.21	0.02	0.15	43.66	4.36	10.69	100.00
Malaysia	1980	17.56	0.00	36.42	8.18	27.68	0.06	0.50	0.27	0.04		0.01	0.23	54.25	6.75	26.62	100.00
	1992	21.57	0.51	34.07	3.25	10.40	3.31	17.11	4.13	3.64		0.20	0.29	60.28	9.54	17.94	100.00
Philippines	1980	16.79	0.00	5.39	4.31	0.41	0.46	0.21	0.03	0.00	0.03		0.00	22.21	58.54	8.91	100.00
	1992	21.04	..	10.05	6.58	0.95	1.61	0.90	0.29	..	0.29		..	31.38	48.75	10.53	100.00
Thailand	1980	28.86	0.00	16.07	10.69	4.79	0.30	0.30	1.39	0.04	1.07	0.27		46.32	35.36	15.90	100.00
	1992	34.02	0.17	31.21	15.39	8.50	0.54	6.77	0.56	0.14	0.37	0.06		65.96	17.54	10.24	100.00
East Asia	1980	23.67	0.07	16.26	9.99	5.99	0.05	0.23	2.02	0.12	1.18	0.57	0.15	42.02	23.51	19.17	100.00
	1992	22.97	0.29	23.21	14.14	3.38	1.59	4.11	1.72	0.38	0.68	0.31	0.35	48.19	19.08	14.21	100.00
North America	1980	3.93	0.00	0.14	0.13	0.06	-0.09	0.04	0.07	0.00	0.01	0.05	0.00	4.14	41.48	39.47	100.00
	1992	18.13	0.03	1.20	0.67	0.17	0.15	0.21	0.09	0.03	0.02	0.01	0.03	19.45	23.14	44.34	100.00
EU	1980	2.09	0.00	0.07	0.01	0.00	0.05	0.00	0.00	0.00	0.00	0.00	0.00	2.16	40.08	36.18	100.00
	1992	4.08	0.02	0.30	0.18	0.04	0.06	0.02	0.01	..	..	..	..	4.41	24.99	48.60	100.00
World	1980	0.67	0.40	3.25	1.14	1.20	0.29	0.61	4.00	2.07	1.37	0.29	0.27	8.31	32.72	35.70	100.00
	1992	1.40	1.98	4.57	1.48	1.79	0.44	0.86	5.30	3.28	1.17	0.21	0.65	13.25	29.75	37.64	100.00

Source: APEC, Foreign Direct Investment and APEC Economic Integration, 1995.

Table 6: East Asia - Matrix of Outward Direct Investment Stock, 1980 and 1992

Investing Regions/ Countries		Recipient Regions/Countries: Japan	China	NIES-4	Hong Kong	Singapore	South Korea	Taiwan	ASEAN -4	Indonesia	Malaysia	Philippines	Thailand	East Asia	North Amer.	EU	World
Japan	1980		..	9.69	3.00	2.56	3.12	1.01	16.67	12.12	1.78	1.69	1.09	26.37	29.09	10.70	100.00
	1992		1.16	7.09	2.98	2.03	1.20	0.89	7.00	3.73	1.25	0.50	1.52	15.24	44.42	18.30	100.00
China	1980	1.92		24.60	24.50	0.10	..	..	0.40	..	0.40	..	..	26.92	48.99	1.92	100.00
	1992	0.68		58.62	51.57	6.59	0.45	..	13.14	..	11.05	..	2.09	72.43	16.86	10.66	100.00
NIES-4	1980	1.48	16.70	21.69	1.75	12.71	0.52	6.71	44.71	21.72	18.78	1.48	2.73	84.58	5.46	2.00	100.00
	1992	1.21	36.94	9.89	3.04	3.46	0.29	3.10	22.13	10.21	6.60	1.09	4.22	70.17	13.67	4.02	100.00
Hong Kong	1980	1.79	21.11	24.84		15.86	0.65	8.33	42.60	25.95	12.15	1.35	3.15	90.34	4.66	0.52	100.00
	1992	1.45	54.87	9.48		4.96	0.33	4.19	19.22	12.35	1.73	0.62	4.51	85.01	9.03	3.15	100.00
Singapore	1980	..	..	11.61	10.64		..	0.77	64.16	2.30	60.08	1.15	0.64	75.77	1.91	3.06	100.00
	1992	0.43	1.59	19.54	17.20		0.37	1.97	27.10	1.85	22.08	0.60	2.58	48.66	9.14	7.21	100.00
South Korea	1980	1.23	..	1.69	0.87	0.82		..	20.36	17.90	0.05	1.07	1.33	23.27	16.78	29.67	100.00
	1992	1.88	6.44	2.62	1.83	0.58		0.20	22.98	15.15	3.23	2.38	2.23	33.91	37.57	6.64	100.00
Taiwan	1980	0.99	..	11.25	3.85	7.01	0.39		26.46	8.88	3.06	9.77	4.74	38.70	43.44	0.10	100.00
	1992	0.31	0.00	1.75	0.07	1.63	0.06		33.72	5.21	17.03	4.30	7.18	35.78	33.52	1.82	100.00
ASEAN-4	1980	..	0.35	73.21	1.95	44.11	..	27.15	10.30	7.92	0.32	0.05	2.01	83.86	11.39	0.20	100.00
	1992	0.21	1.97	42.46	4.94	25.87	0.02	11.64	18.51	2.75	14.42	0.20	1.15	63.17	9.82	20.43	100.00
Indonesia	1980	..	0.23	92.12	..	76.58	..	15.54	6.08		4.95	..	1.13	98.42	-2.25	1.13	100.00
	1992	0.38	1.08	4.15	0.38	1.57	..	2.20	35.22		34.52	..	0.70	40.83	6.98	49.22	100.00
Malaysia	1980	..	..	81.18	0.22	66.74	..	14.21	7.92	5.21		0.08	2.63	89.10	3.43	..	100.00
	1992	..	1.41	71.48	0.13	64.16	0.02	7.18	8.96	6.20		0.56	2.20	81.85	5.11	0.33	100.00
Philippines	1980	..	0.98	57.58	3.23	1.90	..	52.46	15.52	14.19	0.18		1.16	74.09	25.63	0.28	100.00
	1992	..	5.01	77.02	9.22	10.46	0.07	57.27	7.56	1.69	5.07		0.80	89.60	7.82	2.49	100.00
Thailand	1980	..	..	50.58	45.55	5.03	..	..	..	..	..	..		50.58	45.78	2.71	100.00
	1992	0.57	2.91	42.54	29.41	12.83	..	0.30	4.14	3.02	1.11	0.01		50.16	36.03	5.37	100.00
East Asia	1980	0.18	2.03	12.43	2.88	4.60	2.73	2.21	19.91	13.18	3.81	1.62	1.30	34.56	25.92	9.42	100.00
	1992	0.18	6.20	8.07	3.12	2.55	1.05	1.34	9.29	4.62	2.20	0.58	1.90	23.74	39.58	16.30	100.00
North America	1980	2.60	..	1.81	0.87	0.5	0.24	0.21	1.70	0.74	0.27	0.54	0.15	6.12	26.93	34.65	100.00
	1992	4.91	0.09	4.05	1.60	1.43	0.50	0.52	1.97	0.87	0.29	0.30	0.51	11.02	22.69	38.25	100.00
EU	1980	0.77	0.06	3.71	1.06	2.62	0.02	0.02	0.92	0.11	0.71	0.04	0.06	5.46	32.98	31.80	100.00
	1992	1.22	0.06	1.75	0.70	0.92	0.09	0.04	0.64	0.13	0.32	0.06	0.13	3.68	27.58	47.67	100.00
World	1980	7.42	0.02	1.05	0.83	0.16	0.04	0.02	0.17	0.01	0.10	0.06	..	8.66	49.40	33.51	100.00
	1992	18.69	0.05	3.12	2.05	0.52	0.27	0.27	0.29	0.12	0.10	0.04	0.03	22.15	28.25	38.65	100.00

Source: APEC, Foreign Direct Investment and APEC Economic Integration, 1995.

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ECONOMIC AND INSTITUTIONAL CONVERGENCE IN EUROPEAN AND EAST ASIAN REGIONS AND THE NEED FOR NEW GLOBAL GOVERNANCE REGIMES

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DRAFT - NOT FOR QUOTATION

THE REGULATION OF COMPETITION AND COMPETITION POLICY AT THE REGIONAL AND GLOBAL LEVEL

by

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1. Introduction

There is an essential ambiguity in the debate about trade and competition. There are two related but logically distinct concerns, on the one had the need to discipline powerful private transnational firms or groups who may abuse their power, and on the other a desire by firms to ensure that national competition laws should not be applied in away that restricts market access. Underlying this tension is that fact that many of the market access discussions in all contexts are driven firms who want to regulate governments, and not just the other way round.

In other words the trade and competition agenda is both about the extent to which differences in national competition regimes may cause distortions to *trade* and also the extent to which inadequacies in national or regional systems (including their trade policies) may distort *competition*. In fact the current interest in the trade and competition issue derives very much from a perception that defects and gaps in competition law and its application can sustain private barriers to market entry and even create new disadvantages for new entrants by subjecting them to more onerous conditions.

The paper will focus on Regional Integration in Europe and its lessons for the rest of the world but it is necessary to now to treat the EU or strictly the EC as a single entity for most purposes and look at its regional integration arragments with the rest of Europe, notable the Europe Agreements with the Central and Eastern Europe Countries (CEECs). This is because they constitute the most far reaching attempt to link trade and competition policy between jurisdictions in a context *where no supranational enforcement body exists.* The issue of the possible trade off between anti-dumping and competition rules has been particularly alive in this area.

One of the justifications of anti-dumping is that is able to deal with predatory behaviour in international markets that national competition laws cannot handle, if only for evidential reasons. Our theoretical work suggests that this is indeed a possibility. Our work shows that there are a number of sectors, including airlines, telecommunications, chemicals and perhaps cars where lack of concertation of trade and competition policies and of competition policies between jurisdictions does pose problems.

The basic theme of the paper is that a good case can be made that the issue of competition policy should from a normative point of view be addressed at the WTO level. A strong case can be made that there are some barriers to free competition in world markets that are not being adequately addressed by existing national and regional and regional competition, rules, for example a failure to control export cartels. On the other hand there has been resistance since the 1940s to addressing these problems, and the economic and bureaucratic interests that militate against advance in this area are still with us. There have been changes in the line up of interests as the agenda has been explicitly linked to market access rather than consumer welfare, and this seems to have been reflected in the recent WTO discussions. Clearly any radical moves are ruled out, for the moment but given that the control of anti-competitive behaviour appears already in some parts of the WTO constitution, (notably the GATS) it is not unreasonable to expect this to be extended but it is not at all clear how this could or should be done.

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2. Market Access Vs Competition?

At one level it is paradoxical that there should be calls for action to promote international competition in a period when globalisation of markets seems to be doing just that on an unprecedented scale. Two of the central explanations suggest another paradox. On the one hand pressure for international rules on competition are driven by a liberal imperative to go the last mile towards economic efficiency and in particular to stop large powerful global firms depriving us of the benefits of liberalisation. On the other side we have a "market access" agenda, driven in some cases by large powerful firms themselves seeking to challenge any rules which might keep them out of certain markets. The first agenda calls for a common coalition of governments throughout the world to unite and collectively discipline their own firms. The other agenda implies regional coalitions of firms and governments in confrontation with each other, notably the US administration and business uniting to prevent allegedly lax enforcement of competition law in Japan harming US firms. In the first agenda consumers everywhere are the prospective beneficiaries; in the second it is producer interests at stake. Fears about the "market access" agenda include worries that countries might feel there was added legitimisation for the use of measures such as the US Article 301 where an allegation could be made of "the toleration by a foreign government of systematic anti-competitive activities by firms or among private firms in the foreign country that have the effect of restricting, on a basis that is inconsistent with commercial considerations, access of goods."

Several commentators (eg Marsden 1997) have pointed out the tension between rules which require economic efficiency to be maintained and rules which are directed at ensuring the opening of markets and have implied that a market access driven set of rules on competition would risk forcing countries to outlaw practices which were perfectly efficient but which had the effect of excluding foreigners. It has in fact long been a criticism by US writers of EC competition law (eg Rosenthal in Hufbauer 1990) that the stress on market integration for its own sake within the EC, especially as it developed in the 1960s on vertical restraints made no economic sense. A more optimistic reconciliation however can be derived from the experience of GATT itself. Krugman (1991) argues in an entertaining satire that while the mercantilist spirit of the original GATT in which trade liberalisation is deemed to be a "concession" to other parties rather than something to be recommended, nevertheless the reciprocity approach led to just about everyone did what was in their own interests even if they announce that they had only done so grudgingly to placate the foreigners.

It would seem that the distinction between the liberalisation and the market access agendas may explain some of the frictions in the trade and competition debates between officials specialising in trade and those specialising in competition. The former are mainly concerned with promotion of exports, the latter in principle with the pursuit of efficiency.

As a first approximation freer entry into foreign markets is likely to bring more competition and more competition is likely to bring more efficiency. But there are weak links in this chain. There is for example no firm agreement on what vertical restraints are pro or anti-competitive. The US has just protested against New Zealand's decision to remove restrictions on parallel imports, an approach that would be mandatory inside the EU!

3. Historical Developments

The Havana Charter, constitution of the aborted ITO in Paragraph 1 of Article 46 would have required that:
'each Member shall take appropriate measures and shall cooperate with the Organization to prevent on the part of private or public commercial enterprises, business practices which restrain competition limit access to markets, or foster monopolistic control' (quoted in Bergstorm, 1993)

What was contemplated was a set of rules binding on ITO member states which would have required regulation to curtail the rights of firms to act in an anti-competitive way, (see Jackson).

Ironically, the Rome Treaty of 1957 did not go as far as this. It imposed no requirements on member states to prevent anti-competitive behaviour. What it did was to declare illegal such behaviour where it could distort trade between the member states. There was no requirement on member states to have any sort of competition law, but EEC law would automatically supersede any national law or legal lacunae that gave rise to cross-border trade distortions.

What was required however was that differences in domestic competition conditions should not be allowed to distort trade between member states. The notion of undistorted trade as a yardstick is no firmer than that of perfect competition and yet it is clear that what is intended is that purely local monopolies could be tolerated, eg taxi services in a single town, but that any exclusionary practices harming market access from firms in other member states is illegal, or the use of profits from one closed market to engage in any form of predatory or quasi-predatory behaviour in other markets, (as for example the Commission established in the Akzo case).

At the start, in this view, the competition rules of the Rome Treaty were not primarily a set of competition rules for a single European Market - as this did not exist. They were at least as much a set of trade rules preventing differences in competition law and enforcement between member states – and other discrepancies - from creating grievances on market access grounds. Through the principle of direct effect and the powers given to the Commission these rules did impinge directly on firms, but they were not universally directed at all anti-competitive behaviour, just that which could affect trade.

The enforcement of these competition rules over the years was one of the most important element, but far from the only one in creating what for most goods and services has become a single European Market. The function of Articles 85 & 86 etc has thus begun to take on a different role. They have come to be a large part of the internal anti-trust regime.

On this reading of the evolution of EU competition law it would be a mistake to project the nature of the EU as it now stands as a quasi-state or internal market on to the world market as whole, but there are surely lessons for the world economy from the evolutionary development of the system. It is clear that experience within the EC has led the European Commission, and perhaps with less conviction the member states, to believe that the important integrating force of EC competition policy shows the potential of this approach for the wider trading system. The emergence of the Commission as a key player speaking for the EC and its member states on these issues is clearly a significant factor on the debates.

In this note we shall draw on EC experience to ask what anti-competitive distortions can exist at a cross border level, what gaps there may be in existing national/regional rules and enforcement and whether we could imagine any sort of global regime that could better achieve the declared aims of trade policy and competition policy.

The 1996 WTO Ministerial meetings agreed to establish a working group for discussions on the issue. Such discussions have been taking place for a long time especially in the OECD, without clear conclusions, and it is evident that there are many hurdles to be overcome before a consensus is reached that any form of negotiations should take place, let alone what any form agreement might take.

4. Issues In The Current Debate

These initiatives have coincided with a more general debate on the desirability of an international agreement on competition policy. The case for action at an international level is based on the following arguments:

(a) the internationalisation of industry through FDI and intra-industry trade increasingly renders national concepts of competition policy problematic (as for instance shown by the difficulties of defining 'relevant' markets);

(b) progress on the removal of public restraints on trade through consecutive trade rounds means that private restraints *and the way these are regulated* have become potentially more important;

(c) there are more competition authorities in the world dealing with anti-competitive practices, and above all mergers, and the risk of conflict is increasing;

(d) increasing criticism is being devoted to the anti-competitive implications of some aspects of trade policy;

(e) international rules and jurisprudence on the trade/competition interface are in any case expanding, e.g. in the GATS, TRIPs, and Kodak-Fuji so there is a need to consolidate .

There is, however, much scepticism. Why not just let it be solved by voluntary cooperation between authorities and market forces to promote entry. Is there a real problem at all? And even if there is, could any form of agreement improve the situation.

Many experts concede that in theory there could be international anti-competitive behaviour that is not being adequately dealt with under present rules but they insist that before any negotiation is justified:

1. real cases must be identified;
2. it needs to be shown that new rules would help.

For sceptics there are a number of steps that must be made in an argument.
Are there restrictive business practices with a significant cross border dimension?
Are these adequately dealt with by national/regional rules?
If not could they be dealt with by voluntary agreements?
If not is this because the rules or their enforcement are inadequate or because governments choose not to act?
If the former could we actually imagine drawing up a set of rules that would have the desired effect?
If the latter could we see governments accepting an obligation to act?

Thus it would not be enough to identify a global cartel or monopoly; we also need to show that it could not be dealt with current instruments *and* that it could be dealt with under some rules likely to be acceptable. The true sceptic would insist that in addition to demonstrating the benefits of any new arrangement we need to compare them with the costs. As in so many economic or legal debates the conclusion one comes to will depend very heavily on burden of proof arguments.

The various outcomes can be seen from examples. We can identify lots of cross border practices which could be dealt with by current rules if governments wished to do so. Most countries permit export cartels which have negative impacts in other countries, but they could legislate against them. Most countries consider mergers only in terms of the impact on competition in their own markets.

5. Are International Agreements Needed?

Economic theoretical arguments

As usual economic theory cannot tell us very much that is definitive. The one thing it can do however is to caution us against assuming that there are simple answers.
It would have been common in the 1980s to argue that modern industrial economics showed that we could rely on free entry to solve all problems of monopoly and competition and that the only exception to this was when government regulation got in the way. So if we have anti-competitive markets we need to argue for the removal of whatever government regulations prevent new entry eroding the dominant position: the last thing we want is more government interference in the process of competition. This view of competition in general which was applied to international trade as well had its apotheosis in the Chicago Doctrine as applied by the US Supreme Court and in the writings of Judge Bork. It was refined to a higher intellectual plane in the theory of contestable markets which quite correctly argued that under a very extreme set of assumptions (notably the absence of sunk costs) any market however concentrated

would reproduce the optimal outcome of perfect competition. Many writers in this school simply did not address the question of whether such conditions were satisfied on real life. And more recent theory (eg Sutton) have shown quite clearly that very different conclusions emerge if these assumptions are not satisfied. In landmark decision the US Supreme Court threw out a case brought under US anti-trust law (Zenith vs Matsushita) alleging that international anti-competitive behaviour had occurred in the CTV market. A 5:4 majority threw the case out on summary judgement arguing that the allegations made simply could not possibly be true and that evidence accumulated in Japan that they were true should not be examined.

In our view this case highlights many key issues (see Belderbos and Holmes) including the question of where the burden of proof lies.

The Chicago approach strongly claimed that not only would high price monopolies pretty soon be driven out of business by new entry they argued that low price "predatory" behaviour could never be profitable. Hence of course the argument that anti-dumping policy was not needed to deal with risks of "unfair" competition of this kind. More recent work based on game theory reverses the thrust of the Chicago conclusion without however giving us clear guidance for policy. The work of Milgrom and Roberts and of Tirole has thrown up numerous examples of "strategic" behaviour where firms undertake actions which would not be optimal unless they were able to induce other firms to react in a way that reduced those firms' profits. These examples become very relevant when we have markets that are linked but not perfectly integrated as in the case of international trade where profits gained in one market can be used to "predate" in another under some circumstances. Our work on Zenith Matsushita suggests that there can be cases of market share predation that have nothing to do with monopolisation, though they may be inefficient and actually harm consumers. The theory leaves us in a dilemma from a practical point of view as in most of the instances the information required to differentiate malign strategic behaviour from normal competition is almost impossible to establish.

One clear argument that does emerge however seems to be that if you are to find out for example whether very frequent launches of new products are really just designed to drive a rival (who may not have a profitable home market to sustain this) out of business, you would need to have evidence of the intentions of the firms. In the AKZO case the firms were operating inside the EU and DG IV could obtain authenticated documentation. In the Zenith-Matsushita case the Supreme Court took a post-modernist approach to the evidence gathered by the Japan Fair Trade Commission: what to the ordinary observer looked like strong documentary evidence was dismissed as mere "texts".

If there are cross border issues we do have some arguments for international co-operation. The question is surely what form should this take, eg *ad hoc* voluntary exchanges or bilateral agreements or multi-lateral rules? Bliss (1996) cautions against using multilateral rules to bind domestic choices and yet there is clearly some scope at minimum for international rules to make it easier for competition authorities everywhere to do what they all wish t do and for trade authorities perhaps to do less of what they so often do "because others are." The latest WTO analysis (WTO 1997) notes that where there are existing agreement they do not always provide for full exchange of information or mutual recognition of judgements.

This is relevant for the issue of export cartels. UK, EU, US and Japanese cartel laws all exempt cartels that only affect export markets. The US Webb-Pomerene law is written in such a way as to openly admit a mercantilist logic.

Cartels and restrictive agreements

With globalisation of the economy it is clear that if cartels are to work they must be transnational. We shall refer below to a number of sectoral examples below.
We know that the prevalence of such arrangements is less than it was but there is clear evidence that some still exist.

It is interesting to wonder what the implication of the Uruguay Round are here: industry to industry agreements have been made illegal under the GATT 1994 Safeguards agreement. At least one major arrangement of this kind existed till very recently (the UK-Japan car deal 1977-91).
We may well ask whether the WTO code is likely to be self-enforcing or whether there is not a need for an international agreement among competition authorities to ensure that the trade rules are scrupulously respected?
The US, whilst opposed to a firm multilateral régime, has recently proposed in the OECD that there should be a voluntary agreement to ban cartels, but this appears to go no further than a commitment by all countries to enforce

Mergers

This is clearly one of the most urgent issues for consideration and we will use it to lead into other areas. Global mergers are increasing, so too are the numbers of competition offices able to take a stance on each one. Though Whish and Wood argued that there was no immediate need for action we have seen increasing numbers of cases where confrontation has taken place, notably between the EU and US over Boeing-MDD.

There is here a clear double agenda. On the one hand the spread of global firms and strategic alliances does raise the question of whether there should not be increased vigilance against the emergence of dominant global suppliers whose position could become unshakeable. In global industries merger of producers based in one territory clearly affects market structure in others where they sell and would otherwise be actual or potential competitors. The mere fact that there are cross border effects is not by itself enough to prove that existing arrangements are inadequate. There is nothing to stop anti-trust authorities from making agreements with each other and it could be argued that there is always a joint interest in an efficient outcome. The simplest argument for institutionalised international co-operation of some kind is that the transactions costs make it unrealistic to suppose that optimal bargains could be achieved through *ad hoc* discussions. But why not leave anti-trust authorities to make bilateral agreement, voluntarily agreed but binding once made, as in the EU-US case? Does the Boeing-MDD case show that confusion and contradiction can always be averted?

Surely, however there are substantial asymmetries. There are many small countries whose promise to police the consequences of mergers by their firms for the US or the EU would not of much interest.

But then why would the EU or the US have any interest in any global deal that covers mergers? Even Commissioner Van Miert has observed that no formal set of rules could really have been invoked to settle a major political dispute.

The other side of the agenda provides grounds for negotiations. Though Wood and Whish considered the problem to be small, there are more frequent examples of mergers being held up and uncertainties being created by complexity of multiple jurisdiction. The most notable current case concerns ICI's attempts to divest certain basic chemical activities notably Tioxide in markets where a multiplicity of competition authorities are all involved because of the market power of potential acquirers.

Some scope for agreement is called for, obviously not a world-wide merger authority, but some agreement on procedures and which might conceivably extend to rules on what factors should at least be taken into consideration.

The Europe Agreements provide an interesting case here. The actual text of the Europe Agreements require the CEECs (Poland Hungary etc) to ensure that their competition law is applied in such a way as not to distort trade between them and the member states. Some commentators have read this as constituting a demand that these countries somehow devise national competition codes which transpose EU law in precise detail. The 1995 White Paper can be read as requiring this. For reasons indicated above and in Estrin and Holmes (chs.1,2 and 3) this is inappropriate legally and is not in fact required by the agreements. Some observers have commented on the fact that the White Paper states that the CEECs may wish to include an efficiency defence in their merger rules though the EU does not and wondered about this inconsistency. We would we see this as highlighting the fact that even the most far reaching cross-border competition régime does have to lay down common substantive criteria. It leaves the countries in question free to set their own rules, with their own priorities about the trade-off between consumers and producers, so long as *trade* is not distorted. Thus while outside the EU CEECs are free to include an efficiency defence in their merger rules, so long as the result is not to distort trade. Indeed once in the EU as member states this will still be true. So even if there was a global agreement of any kind on merger criteria it would be strange if it were to go so far as to rule on the acceptability of an "efficiency defence. Different problems arise in the case of "social" justifications for decisions on mergers. One reading of the Rome Treaty would suggest that the Commission is obliged to take "Cohesion" into account in all decisions, including competition (Frazer 1997). This would imply the right to ban a merger which might lead to plant closures in disadvantaged regions, as well as the right to allow a competition reducing merger that would keep them open. Many would oppose such a policy but it is hard to see why the global system should outlaw it, and yet if one does start negotiating over merger rules, there will be those who argue that it there is a distortion if "our" firms cannot take over "theirs".

The nature of the tension between efficiency and competition policy is often very complex. In this context "distorted trade" is to be understood in the EC sense, in effect as "limited". This is fine in the context of the Europe agreements, and internally within the EU, but as Philip Marsden has pointed out, there are some circumstances in which additional trade could be inefficient. Clearly any WTO agreement, whether on mergers or any other form of behaviour or structure to curtail activities that distort or restrict trade could contain wording that does not excessively push the market access agenda. One's instincts would be to trust the negotiators who are in any case wary of commitments, to impose a fairly tough burden of proof on any complainant to prove that a targeted activity was truly a distortion. "It made it harder for us to sell there" ought not to be enough.

UNCTAD 1997 argues strongly that LDCs should in fact open their economies generally to inward investment including take-overs, and argues that old-fashioned hostility to MNCs should be merely replaced by an effective guarantee form competition policy, but this is not quite the same as a requirement for one type of merger rule as compared to another.

6. The Europe Agreements and Other Regional Agreements

We have already commented on the specific character of the Europe Agreements. The one element in their competition provisions that is potentially a model for the wider world is that they commit the CEECs to ensure that their competition régimes in all aspects covered by the Rome Treaty shall ensure trade between them and the EU is not distorted. The wording of the Europe Agreements declares incompatible with the agreement etc in the partner country or the Community which distorts or threatens to distort trade. There has been much discussion of what the CEECs have to do to implement the deal. Less so of the EU: it appears to create an obligation on DG IV to ensure that nothing within the EU adversely distorts trade. Private restrictions on imports are already covered, but while the Rome Treaty gives the EC the power to control import cartels, it does not appear to cover export cartels or predation, and yet the Europe Agreement creates asymmetrical obligation.
The Europe Agreements are a very special case. The provide for

Anti-dumping and Competition Law in regional agreements
Here again the Europe Agreements provide some insights. If anti-dumping were indeed aimed at outlawing the same practices as competition law we should indeed expect the full implementation of the Agreements to lead to an end to the need for anti-dumping.

Instead the White Paper of 1995 para 6.5 says 'once satisfactory implementation of competition and state aids policies (by the associated countries) *has been achieved, together with the wider application of other parts of Community law linked to the internal market*, the Union *could* decide to *reduce* progressively the application of commercial defence instruments for industrial products from the countries concerned'.

This gives us the clue to the fact that in the mind of its users anti-dumping laws are designed to protect producers against any allegedly "unfair" asymmetric advantage in other markets which create some form of "sanctuary". This extends well beyond the idea that there might be a protected home market due to monopolistic restrictions. Any difference in regulatory régimes can be an excuse for anti-dumping. Anti-dumping is in this sense following the logic of countervailing duties, which are less contested by free traders, even though a case can be made that the main burden of excessive aids falls on the state giving them.

We see this in the EEA Agreement which provides that:

The application of Article 26 of the Agreement (the suspension of anti-dumping policy and countervailing duties) *is limited to the areas covered by the provisions of the Agreement and in which the Community acquis is fully integrated into the Agreement.*

Hence the ability to use anti-dumping in the Norwegian Salmon case: the common fisheries policy does not apply in the EEA so anti-dumping could be invoked.

A survey by Hoekman (1997) shows the tenuous character of the link between anti-dumping reform and competition harmonisation in other regional agreements: The ANZCERTA gets rid of anti-dumping between Australia and NZ, on the basis of totally free trade, anti-subsidy rules – and no obligatory harmonisation of competition rules. In other regional integration schemes we see no systematic link between competition harmonisation and ending anti-dumping: mostly neither occurs but in the Canada-Chile arrangement there is suppression of AD but no competition policy harmonisation. Mercosur has begun cooperation on competition policy but still keeps anti-dumping.

It would be desirable to take competition issues into account in anti-dumping decisions but when we look at the aims of the instruments we see they are really quite different. Anti-dumping is based on the perceived need to remedy any alleged asymmetry of conditions, which might include concealed state aids, price controls on inputs, export bans on inputs.

As an example of this we can note that Polish officials complain that if there 1,000 producers of wooden pallets in Poland they cannot possibly be engaging in predatory dumping in the EC. This is quite true but as Commission officials respond, if the price of wood is in some sense artificially low in Poland there could be an argument for anti-dumping duties in the logic of the system.

It would indeed be preferable for anti-dumping decisions to reflect on whether there really was a danger of monopolisation in the market, but this is not what they are about.

The anti-dumping story does of course remind us that between markets which are only partially integrated. It *is* possible that where firms in partially open markets are competing in fully open ones that some form of strategic behaviour could occur that is detrimental to economic efficiency. The possibility of cross subsidies of this kind are much greater between segmented national markets than they are in within domestic or fully integrated markets.

The anti-dumping instrument does not ask if this is occurring: it infers that it could be happening if the imprecise test of a dumping margin is satisfied. This test is obviously too crude but we can make a case that the evidential requirements of competition rules may well be very hard to satisfy in most cases as the Zenith Matsushita saga showed. Where evidence of actions with cross border effects can be found, national authorities may be able to act, but we may wonder about the implications of the Advocate General's opinion in the Woodpulp case which seems to echo Zenith Matsushita and imply that where *any* pro-competitive explanation exists it must be accepted in preference to an anti-competitive one. This seems to generate a burden of proof problem that will be particularly hard to surmount in cross border cases, as indeed Woodpulp was.

In fact as the AKZO case showed, such cases are always very complex and are likely to involve interaction across product markets as well as geographically. The case against Microsoft is clearly based on the idea that it can finance aggressively competitive pricing in sectors where it faces entry on the back of profits in areas where it has market power.

How realistic is it to think that such cases are widespread? Commission officials argue that since they regularly uncover cartel even within the EU, there must be many more undiscovered cases in the wider world. We know that allegations have been made within the EU airline and chemical industries (AKZO) of exclusionary practices based on the partial integration of EC markets. These can be policed by the existence of an overarching competition agency, DG IV, but no such agency exists for the world economy.

It is not at all clear that we can project experience of EU trade and competition law upwards to the world or sideways to Asia. EU competition law exists as it does, not to harmonise national measures but to create an overarching framework for a common market, in which the parties agree to enter into a process of "Deep Integration" (Lawrence 1996) going beyond removing border based obstacles. E.Fox (1998) argues that relatively modest steps are needed to ensure that competition policy is not run in such a way as to act as a barrier to trade. The EU's aims go far beyond this. For regional integration schemes which have lesser ambitions the need to have common competition rules is clearly less, though every economy individually is likely to benefit from de-monopolisation. Asian economies with different concepts of competition to each other are less likely to find an EU style model congenial.

We might raise the question of whether uncoordinated régimes are likely to lead to a race to the bottom to attract inward investment. Gatsios and Holmes (1998) however argue that in general this is an unlikely outcome of regulatory competition (albeit not impossible) since the main impact of any policy is in fact always going to be on the infra-marginal domestic firms.

7. LDCs And International Competition Policy

As relatively weak players, developing countries could expect more often to be the victims rather than the perpetrators of global anti-competitive behaviour. They must balance the benefits of any possible future WTO-based regime controlling abusive behaviour by multinationals against the costs of compliance and the penalties for non-compliance.

The WTO discussions are continuing: the *process* aid to be as important than the immediate *product.* Developing countries should play a less passive role to use the discussions as a learning exercise. Countries engaged in major privatisation exercises should reflect on how to avoid creating abusive monopolies that will then be hard to discipline.

Developing countries also need to be kept aware of parallel negotiations at the OECD, since agreements often come as a *fait accompli* to the WTO. But there are major pitfalls for the unwary. A priority of the developed countries is to enforce tougher global anti-trust rules; but more specifically to combat private barriers for to entry for their exports into emerging markets, whilst resisting any attempt to discipline their trade policy.

LDCs need to be wary of the risk of being required to adopt a specific model of competition law which may be administratively impossible to sustain, and in particular they need to be wary of specific forms of competition rule being demanded to satisfy the interests of pressure groups for example who want to prevent countries from allowing parallel imports or who want to restrict the ability to control abuse of intellectual property rights.

The TRIPs agreement is very vague in *allowing* countries to regulate abuses of IPR but it does not require them to do so. Any suggestion of measures which placed such an obligation on home countries to do this would be likely to provoke suggestions that host countries rules be circumscribed. The issue of exhaustion of IPR is linked to the ability of private firms to use these to segment regional markets for their own products which may or may not matter depending on whither there is a horizontal dimension.

The case can be made for allowing firms to set up exclusive marketing arrangements and a case can be made against this. It is hard however to make a case for imposing global rules on whether parallel imports are to be allowed.

The TRIPS agreement has resulted in at least one curious paradox. It is reported in the FT (Jan.8th 1999) that Hong Kong's vigorous enforcement of intellectual property rules has led to the exclusion of low price "grey imports" for this market and allegations of abuse of dominance, which the Hong Kong Government has in general insisted is impossible in such an open market as Hong Kong. (Of course inter-brand competition is not directly affected by this). The DG of the government's IP department acknowledges that the current state of the law poses a problem for free trade (and frees speech as books and films can be kept out) but says their job is to protect authors and artists while "Someone else must protect the others", but HK has no competition law to do this

Within the EU Competition law does this, balancing the upholding of IP against the need to stop abuse. The EU position paper to the WTO on this subject illustrates the tensions. Regarding abnormally high prices of products subject to IPRs, it notes:
"In general, abnormally high prices originate from an impediment, either strategic or of a regulatory nature, to enter the market. In such circumstances the problem can usually best be addressed by intervening against possibly unjustified barriers to entry. Only in exceptional circumstances should abnormally high prices be considered as an abuse in themselves" EC 1998.

This is a statement of policy in the EU, and the question arises whether any move towards pressing countries to ensure their firms did not abuse control of IPRs where they did generate dominance could avoid imposing a single view on how this was to be done. (It is worth remarking that within the EU the member states have been reluctant to cede authority to Community institutions on IPR, and perhaps the TRIPs agreement at the WTO was seen as a slightly softer substitute for hard intra-EC law.)

8. What Does the Wto Offer Now?

The GATS agreement Articles VIII and IX, and above all the Telcoms annexe and its associated "Reference Paper" do enjoin member states to prevent anti-competitive behaviour. It is clear that the intention of this is not to provide consumers of internationally traded services with more protection against abuse than consumers of goods. It is to ensure that in partially opened markets a supplier retaining some elements of dominance in part of the market should not be able to use it to prevent entry in other parts of the market. Being unfair: it is OK for consumers to be exploited in the closed part of the market so long as this profit is kept by shareholders or wasted in excess costs, but rents must no be used to cross subsidise against entry in open segments. Clearly new entry anywhere is likely to be good for consumers rather than bad. The issue is driven by service provided and where *export* interests prevailed as in telecoms provisions were stronger than in airlines for example where all but a handful of airlines wanted to hold on to some of their access barriers.

The nearest equivalents in the GATT are article XXIII and, paradoxically anti-dumping. Anti-dumping fits into this framework because it is designed to stop a firm taking advantage of an alleged asymmetrical advantage in its home market to cross subsidise abroad. The GATS rules are to stop a firm practising "dumping" type prices in part of its home market. There are indeed those who would like to see anti-dumping extended to services – and the European Commission has in some documents suggested this!

Article XXIII provides for access to dispute settlement:

" *If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of*

(a) the failure of another contracting party to carry out its obligations under this Agreement, or

(b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or

(c) the existence of any other situation.. "

This is not as comprehensive as the Rome Treaty's ban on trade restrictions or measures of equivalent effect, but the spirit is the same. A state has a case to answer if it agrees to a "trade concession" and then introduces a measure which "nullifies or impairs" the liberalisation measure.

The US and the EU have for a long time been arguing that Japanese distribution arrangements do not allow new goods suppliers to find outlets, and this anti-competitive behaviour is tolerated by the Japanese government.

In the recent case Kodak persuaded the US government to bring a complaint (it has to be state to state) against Japan, arguing that Fuji's single brand control of wholesale distribution of film, had government support, and so kept Kodak out. The WTO panel seemed to accept that the US (ie Kodak's) complaints might be breaches of the rules if indeed the complaints were true; it accepted that a distributional monopoly upheld by administrative measures could in principle be illegal. However it concluded that on the basis of the facts as it interpreted them, there was nothing apparently out of the ordinary going on in this market:

"single-brand wholesale distribution is the common market structure -- indeed the norm -- in most major national film markets, including the US market. While the United States

responds that the US market structure was the result of private and not governmental actions, it is unclear why the same economic forces acting in the United States would not also exist in Japan." (decision *p.421)*

It really is not clear what would happen if there were a stronger but disputable case.

9. What Scope Exists for Stronger Rules to Emerge, and What Form Might They Take?

There are formidable obstacles to major innovations within the WTO. Its rules are addressed to member states: any move to enhance the rights of firms or consumers would represent a big change in principles, thought aborted MAI moved in this direction.

A system of compulsory exchange of confidential material on anti-competitive action with cross-border impact would be strongly resisted by firms. And there is little incentive for industrial countries to exchange information with developing countries, whose firms are rarely in a position to commit abuses that harm industrial country consumers.

Moreover, the industrial and developing countries differ about the key elements to be included in any package.

Developing countries would benefit most from obligations on all countries to discipline possible anti-competitive abuses by multinational corporations.

The industrial countries want to use international competition policy as a way of assuring market access for their firms.

The problem is that the agenda is dominated by *market access* rather than *international anti-trust issues*. This has been carried into the discussions on international competition policy where the main issues debated have concerned the extent to which competition law is enforced in such as way as to allow local monopolies and cartels to exclude imports. Japan is not the only target; the USA has also criticised New Zealand and South Africa

While trade officials from exporting countries seek to enlist competition authorities in importing countries to assist in opening markets, the wider community of competition officials is reluctant to be drawn into the business of export promotion, and within the EU there is a resistance to the Commission taking over wholly a matter which is still shared with member states.

Some Asian countries, led most vocally by Hong Kong, are arguing that the issue should be the effect of trade policy on competition, not the reverse. Industrial country trade policies are said to diminish competition, in particular through the use of anti-dumping actions and Voluntary Export Restraints. Hong Kong Officials argue strongly that the openness and lack of interventionism in their economy means that there is no room for

There is some movement concerning cartels. The USA proposed in 1997 a voluntary agreement in the context of the OECD aimed at world-wide price fixing or market sharing arrangements. This would commit members to prosecute 'hard-core cartels' that operate across more than one market. Developing countries, which are vulnerable to bid rigging, might welcome a more binding agreement. But the US proposal would only 'recommend' the enforcement of existing laws, and most countries exempt export cartels from their competition law if there is no knock-on effect in the home market. And any restrictions on industrial country export marketing arrangements could also lead to pressure on arrangements designed to bolster commodity prices.

There is an odd paradox. The WTO WG Report suggests that on many issues there is a degree of consensus about best practice and certainly a general will to engage in extending voluntary cooperation among competition authorities, but above all in the US (and in some other competition authorities) it seems that there is a gut fear of entering into anything more than the most limited of bilateral commitments in case a Pandora's box is opened and the "trade guys" get their hands on competition policy, (as we noted within the EU there is a tension between member states and Commission).

It seems very likely that there will be a gradual extension of the bilateral cooperation etc and that eventually this could lead to the need for some form of broader codification. One might also imagine the development of jurisprudence that might eventually need to be codified on what sort of measures would be considered acceptable under Article XXIII. In the first instance it is very hard to see anything more than a symbolic and presumably non-justiciable commitment by WTO members to introduce some form of competition policy (not necessarily a law). To this could be added a green box of types of rule that everyone would agree should never be subject to challenge.

It seems extremely unrealistic at present to suppose that there can be any moves towards convergence of substantive rules; the US has made its opposition to this clear in the OECD, but perhaps the most fruitful approach would be a gradual extension of bilateral cooperation, voluntary at first, that would have the effect of revealing the gaps that need to be filled. Regional initiatives have a major part to play in this.

One hears that the idea of a full blown Millenium Round in which Trade and Competition would be a major part is being opposed by the US, though clearly any negotiations that take place will have to involve linkages of some sort. In the present world economic climate where accusations of "unfair trade" are likely to flourish there is perhaps an increasing political attraction for countries to demonstrate that their economies are not "sanctuary markets" from which unfair trade takes place. The link between anti-dumping in Europe and competition policy in other regions is not therefore irrelevant.

10. Conclusions

We believe that *prima facie* evidence exists of significant cross border anti-competitive behaviour that is not adequately addressed at present. What is harder to *prove* of course is that is that international co-operation could overcome all of the practical and political economy problems that account for this.

This overview suggests that there is scope for something beyond the present system of voluntary co-operation between authorities. Such co-operation is most likely in a regional context where a culture exists of co-operation that goes beyond the legal limits of comity.

One potential disadvantages of the more radical schemes eg of Scherer and the DIAC group should not be allowed to hide the advantages of what the much more modest proposals by authors such as Eleanor Fox.

As time goes by people may wish to go further, but at the very minimum an alignment of the GATT with the most ambitious element of GATS would not be unreasonable. The Reference paper on Telecoms actually goes much further than anything in any other part of the world trading system, and it seems quite possible that we will see a patchwork of agreements developing as the need arises.

It is indeed hard to prove that there actually *are* global anti-competitive practices that need to be addressed – in the absence of a régime that ensures investigation - but we would argue that an *a priori* case does exist. If we can and need to address the issue in the Telecoms sector, it seems very likely that it is both possible and desirable elsewhere. One might suggested that the GATT should contain an article:

"Members recognise that certain business practices of goods suppliers may restrain competition and thereby restrict trade in goods. Each member shall, at the request of any other member, enter into consultations with a view to eliminating such practices."

As the WTO's latest report shows there are many very modest steps that could be achieved without the bugbear of a global authority, or the excessive sacrifice of national sovereignty. The Europe Agreements are clearly beyond the outer limit of what is imaginable for now, but even they would permit more flexibility than the CEECs have chosen to exercise. To return to our original dichotomy between the "international trust-busting" and "market access" agendas, there are a number of proposals (information sharing etc) where there is an overlap between the two sets of interests and where we might be able to hope for some progress by leveraging one set of interests on the other.

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Appendix some sectoral examples

Here we present a summary of some of the work that has been carried out at te Sussex European Institute on particular markets. One could have selected other markets. In the global cement industry Dumez and Jeunemaitre show how all intra-regional competition issues are inseparably linked to the global market. It is alleged that firms collude to keep up prices and to co-ordinate investment and then arrange dumping in other markets. The EU has recently been faced with simultaneous competition investigations of this industry and anti-dumping complaints by it. In steel Wolff argues that cartels still exist. Ahmed (1995) has investigated the activities of Nitrex allegedly acting as a fertiliser export cartel.

GLOBAL COMPETITION ISSUES IN THE CHEMICAL INDUSTRY

The history of the chemical industry is rich in attempts at international restrictive practices. Major markets (North America, Europe and Asia) were divided up among the major producers in the US, Europe and Japan. On occasions these cartels received tacit government support, partly for political reasons and partly because the high ratio of fixed to variable costs is said to risk creating "destructive competition." More recent cases of international collusion have occurred in the EU in several sectors including polyethylene and soda ash. In both of these cases, there is strong evidence to suggest that the use of anti-dumping policy actually facilitated collusion in the EU by creating barriers to entry.

'National' regulation of international competition

The soda ash case demonstrates an extremely complex regime of governance that has been at times contradictory. The US soda ash producers have been allowed to set up an export cartel under the 1918 Webb-Pomerene Act while the Japanese producers were successful in maintaining an import cartel (possibly due to poor enforcement of the Japanese Anti-Monopoly Law (AML). European producers were not offered exemptions under EU competition law, and DGIV investigations in the early 1990s exposed a long-standing cartel whereby ICI (Brunner Mond) (UK) and Solvay (Belgium) agreed not to sell in each other's markets. The imposition of anti-dumping duties against US producers may well have facilitated collusion, (as Patrick Messerlin suggests occurred for polyethylene), and perhaps for the European and Japanese producers to 'pacify' the US export threat, they have purchased capacity in the US export cartel. Pugel (1986) alleges that the Japanese import cartel received MITI approval even if the AML outlawed import cartels. Y.Akbar University of Sussex and European Business School.

REGULATION AND COMPETITION IN INTERNATIONAL AVIATION

Competition issues in international aviation

Competition has long been an issue in international aviation because of the collusion among flag carriers within the framework of the International Air Transport Association (IATA). The effectiveness of this cartel declined in the 1970s due to increased competition from new entrants, particularly charter carriers. Recently, however, new competition policy issues have become economically and politically salient as a consequence of two related, but distinct, trends. The first is the liberalisation of country-to-country air service agreements (ASAs). The second, is the dynamic increase in strategic alliances between airlines.

These developments are linked. Market liberalisation has increased competitive pressures, encouraging airlines to seek new ways of responding, including entering alliances. In addition, the US and other governments have made conclusion of 'open skies' agreements a precondition for granting immunity from competition rules to alliances involving airlines from the partner country.

'National' regulation of international competition

In the absence of international rules on competition, it has been up to national authorities to intervene. The US has tended to be the most active, although the European Commission has become more assertive. Both authorities investigated IATA, but neither acted, and both have intervened on alliances, but none have been refused immunity, although some conditions have been imposed, a decision on the BA-American alliance is outstanding, and the Commission is reviewing others.

Efforts to coordinate the two sides' regulation of competition generally are framed by a 1991 agreement. Although it extends to civil aviation, its effective application is impeded by the limitations of EU competition law with regard to external aviation and the disparities in the allocation of bureaucratic competences. Efforts to put cooperation on competition issues on a firmer footing as part of a proposed transatlantic Common Aviation Area are blocked by other considerations.

International competition is thus governed by the unilateral application of two sets of different competition rules. The discrepancy between increasingly integrated international markets and segmented competition regime might present three problems:

1) weak application of competition rules might permit the emergence of dominant operators;
2) without effective competition rules, predatory pricing might be used to drive out competitors;
3) differences in 'domestic' competition regimes might give some carriers an unfair advantage.

Prospects for an international competition regime

Maintaining the status quo in competition policy while liberalising market access would jeopardise the potential benefits and might even result in a net loss of welfare. The unilateral application of national competition rules to international aviation creates uncertainty for operators and friction between regulators. In addition, there are cases of alleged cross-border abuse of dominant positions. While the EU framework may be adequate for intra-EU cases, the Laker case suggests a more general problem.

A central obstacle to the conclusion of and effective working of a multilateral competition regime is that it would cut across the bilateral ASAs governing other forms of market access and would break the political link between liberalisation of bilateral ASAs and anti-trust immunity. Consequently, the record of liberalising air transport multilaterally has been poor. The GATS air transport regime is very limited and excludes market access. While competition policy concerns might trigger renewed efforts as part of the GATS Review in 2000, significant progress is unlikely without a major shift away from bilateralism.

One way of squaring the circle between multilateral competition rules and bilateral ASAs might be to agree at the multilateral level common principles and enforcement mechanisms to be incorporated into bilateral agreements. An EU-US aviation competition regime, if concluded, might serve to pilot such an approach and might *de facto* represent a global competition regime.

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ENERGY

The energy sector is very diverse but historical and recent experience suggests that there are international competition issues to address. Historically we have seen strong tendencies towards cartelisation in the coal market domestically, and in the oil and uranium markets internationally. The evolution of those markets has changed the incentives to cartelise over time; most obviously in the varying success of efforts amongst oil producers over the last thirty years (OPEC's effectiveness in the 1970s was relatively shortlived though recent developments indicate renewed efforts amongst oil producers to control output in a bid to raise prices). Recent developments in utility industries - where traditionally the monopoly has been guaranteed by law - have moved these industries in the direction of more competition. Yet the interplay between competitive and monopolistic components of the market, and the degree of competition possible highlights competition policy questions.

Competition policy is beginning to figure in regional energy regimes, notably in the EU where it has been used to unravel state monopolies in the oil sector and to monitor cooperation and consolidation in all energy markets. The EU has been in the vanguard of attempts to liberalise energy utility markets in Europe and, if telecoms and transport sectors are a guide, competition policy will play an important role post liberalisation in "levelling the playing field".

Given the territorial limitations of most network energy markets the scope for global competition policy might be questioned. Moreover, the provisions of the GATT have effectively excluded energy from its purview in the past. Nonetheless the European Energy Charter Treaty, which spans Western and Eastern Europe and the CIS and which Japan and the US might sign in the future, offers a much wider forum. While the effectiveness of this regime as a mechanism of international competition policy provisions is questionable (given the weak provisions relating to competition policy), it may provide the basis for a more comprehensive arrangement in the future.

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CARS

The global competition issue facing this industry is currently the massive merger between Mercedes and Chrysler, but the trade and competition interface in this sector goes back much further. EU jurisprudence is replete with examples of practices by firms to restrain the intensity of cross border competition.

The Commission's enforcement of competition law in this area, however, has been subordinate to trade policy perspectives. A classic example is the UK-Japan Industry to Industry VER of 1977-1991. When Consumer groups complained of its apparent violation of Article 85, DG IV declined to investigate citing trade policy reasons. The Court of First Instance actually annulled the letter notifying a refusal to investigate. This led to no further action, indicating the problem where competition authorities have the power but not the will to intervene in trade related cases.

There have been several other case in this area, eg Peugeot, Automec, Asia Motors. Most of which arise from the way the Commissin has sought to use the block exemption on selective and exclusive distribution to reinforce trade policy. the Commission has been somewhat ambiguous in its approach, sometimes disciplining manufacturers, sometimes resisting pressures to act against them.

The new WTO Safeguards Code will finally ban all Industry to Industry agreement.

An interesting question is whether we can say the Article XIX agreementt reduces the need for an international agreement to ensure that all countries police their existing bans on private VERs because the WTO will enforce this- or alternatively whether on the contrary full compliance requires firmer agreement that competition policy will not be bent to facilitate trade restrictions?

P.Holmes & Y.Akbar

COMPETITION AND REGULATION IN INTERNATIONAL TELECOMS

International competition issues in telecommunications have, for practical purposes, arisen only recently with the extensive liberalisation of the industry. International telecoms has been traditionally organised bilaterally between national monopoly operators under the aegis of the International Telecommunications Union. Governments were content with this arrangement, which served to raise revenue for subsidised domestic telephone service. The system is now under severe pressure due to liberalisation and technical change. Now that domestic markets are being opened up to competition, both market access and antitrust issues arise at the international level.

Telecoms is something of a special case since, arguably, there already exists a multilateral international competition policy agreement in all but name: the 1996 WTO Telecoms accord. This commits signatories to open domestic telecoms markets, thus (on paper) guaranteeing foreign carriers' rights of establishment. It also deals with certain antitrust issues, most notably the potential abuse of dominant position arising from control of bottleneck facilities. The Reference Paper, which sets out regulatory principles, refers explicitly to the essential facilities doctrine in this context. It also, for example, addresses related antitrust issues, such as the potential for operators to cross-subsidise activities in competitive segments of one market with revenues from areas where they retain monopoly power and profits.

The approach, then, is to agree on broad regulatory principles, contravention of which could be addressed ex post in WTO dispute settlement. However, the (3 page) WTO Reference Paper pales in comparison with, for instance, the 1996 US Telecommunications Act or the EU's 1998 full liberalisation package, which themselves leave many details unresolved. Thus, one issue is whether further development of the WTO rules would be needed to deal effectively with some of these tricky issues. There appears to be a *prima facie* case for going beyond voluntary cooperation, since the particular structure of telecommunications means that the negative effects of abuse of dominance do spill over frontiers, and some countries may have strong disincentives to liberalise unilaterally.

For instance, retaining a national telecoms monopoly means substantial (hard currency) profits from incoming international traffic. Liberalisation abroad only adds to these profits, since competition there leads to falling call charges, stimulating demand for calls to the monopoly market. Thus liberalisation in the US in effect transferred some of the rents from international traffic from US operators to foreign operators. Even with rapidly shifting technology and market structure, this central issue of access to bottleneck resources remains relevant. Access on reasonable terms to local networks remains a key issue (not least in the US); in the MCI/Worldcom case more recently, control of the international Internet backbone has been a major issue.

It would certainly seem difficult to deal with these issues in a multilateral framework in much more detail than does the current WTO accord, not least because there remain quite legitimate differences of opinion on the appropriate nature of competition and regulation in telecoms. On the other hand, this probably means that fears over the potential for rigid international rules that might disallow efficiency-enhancing competitive restrictions are not in practice well-founded in the case of telecoms.

This brings us to a final issue which is not addressed in the WTO framework: international strategic alliances. There has in recent years been a proliferation of cross-border joint ventures and mergers in telecoms in recent years. While there is some concern over possible anti-competitive effects, the issue here is that alliances must be cleared by a number of domestic competition authorities. Cooperation among these authorities, or even a one-stop shop arrangement, could improve decisions and reduce the costs incurred by the firms concerned in gaining clearance.

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DRAFT - NOT FOR QUOTATION

MULTILATERAL DISCIPLINES FOR INVESTMENT-RELATED POLICIES?*

by

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1. Introduction

The value of sales by foreign affiliates of multinational firms now exceeds global exports of goods and services (UNCTAD, 1996). The observed growth in foreign direct investment (FDI) is a consequence of many changes in the world economy. For example, services are becoming more important in GDP as activities are outsourced and the information technology revolution creates markets for an ever expanding set of new services. Often such services cannot be traded, or suppliers must have a physical presence in a market in order to compete efficiently. Falling costs of communication have also eased the constraints on global rationalization of production, leading to ever greater geographic specialization and splicing of the production (value added) chain.

However, changes in the economic environment have not been purely market driven; there has been a substantial change in the policy environment as well. Perceptions about multinational firms and their effects on host countries have undergone a transformation. Most countries are now quite eager to attract FDI; many (including some industrialized countries at both the central and local government level), offer fiscal and financial incentives to attract FDI. Another measure of the desire to attract FDI is the proliferation of bilateral investment treaties (BITs) between countries. As of Jan 1, 1997, there existed a total of 1330 BITs compared to some 400 at the beginning of 1990 (UNCTAD, 1997). During 1996 alone, 180 BITs were signed: one every other day.

On the other hand, many countries impose additional requirements on the conduct of multinationals. For example, they may be subject to local content requirements, export requirements, technology transfer requirements etc. The schizophrenic nature of the overall policy environment reflects the guarded optimism with which many countries continue to view the entry of multinational firms into their territory. Such firms would prefer not to be subject to discriminatory entry and conduct constraints and are supporters of efforts to discipline the ability of governments to do so. They are also concerned that mechanisms exist to provide compensation in cases of expropriation or nationalization. These are major motivations for the negotiation of BITs, regional integration agreements (RIAs) and the recent attempt to conclude a multilateral agreement on investment (MAI) under OECD auspices.

This paper asks (i) what are the main issues confronting developing countries in the area of investment policies; (ii) whether international cooperation could help solve these problems; (iii) if so, how bilateral or regional agreements compare to a global, nondiscriminatory set of disciplines; and (iv) whether there is a strong case for developing countries to support the creation of a multilateral agreement on investment.

In the case of trade policy, the rationale for engaging in reciprocal negotiations and concluding trade agreements is straightforward. While free trade (or low and uniform protection through tariffs if revenue considerations predominate) is optimal for countries that cannot affect their terms of trade, political economy constraints may impede a government from attaining this outcome. Reciprocal negotiations can help mobilize interest groups, especially exporters, to oppose efforts by import-competing industries to retain protection. In the process, a country not only reaps the gains from liberalization at home, but also gets better access to foreign markets. Does a similar rationale apply to investment policies?

Three sets of potential gains from cooperation can be identified. The first is that policies may be in place that prevent entry by foreign firms that are detrimental to society: producer rents are less than consumer losses but local incumbents capturing the rents are able to block FDI liberalization. Note that such rents cannot be very high in tradable industries as long as a liberal trade policy stance is pursued, as foreign firms can contest the market through exports. Thus, such a situation that is more likely to prevail in nontradable industries or sectors subject to significant regulation (e.g., licensing requirements): i.e., in service sectors. Alternatively, investment policies that are detrimental to the welfare of the country may be imposed: foreign entry may be allowed but investors are subjected to performance requirements that raise production costs. In both cases, one must ask how international investment agreements could help solve the underlying political economy problem.

A second set of circumstances is conceptually more straightforward. National policies may be detrimental to other countries (negative spillovers), or lead to an inefficient noncooperative outcome for the world as a whole (e.g., a prisoner's dilemma). If so, in principle there are gains from cooperation. Here the question is whether there exists a non-empty negotiation set, which depends in part on whether an effective (i.e., enforceable) agreement can be designed. Finally, governments may be pursuing all the "right" policies to attract FDI, but there may be no significant "supply response" because of a history of policy reversals. If investors are risk averse, they may then continue to avoid the country altogether, impose large risk premia, not transfer "sensitive" technologies, etc. In such a setting an international agreement may serve as a mechanism through which governments make irrevocable commitments and lock in policy reversals, thereby anchoring expectations of investors.

We start this paper with a brief discussion of policies that restrict FDI and summarize existing WTO rules and disciplines (Section 2). We then examine the economic rationale for financial and fiscal incentives designed to lure in multinationals and conclude that there does not exist a strong argument for the use of fiscal and financial incentives (Section 3). Given that the use of such incentives may lead to tax competition, a MAI that outlaws location subsidies might be beneficial. However, attempts to discipline subsidies may be easily circumvented unless the focus centers on the complete set of policy instruments that governments can use to influence investment decisions and market structures more generally, independent of residency status. These include not just location subsidies, but also production and operating subsidies, competition policies, environmental regulation and technical standards, R&D regimes, procurement regimes, etc.

A number of RIAs have included liberalization of FDI (Section 4). Such agreements illustrate that even if a right of establishment in included, substantial scope tends to remain for governments to restrict access to markets and/or to engage in competition for FDI. Many RIAs do not go much further than the WTO in key areas such as market access for services. At the same time they create potential locational distortions by encouraging investment in "hub" countries and may discriminate against FDI originating in non-members. A MAI could reduce (ideally eliminate) such discrimination, and is therefore preferable to RIAs. However, little evidence exists regarding the prevalence and impact of any discrimination. As this is a problem that is likely to be most prevalent in service industries, attention should focus on efforts to liberalize access to service markets.

We conclude that stand-alone agreements on FDI are unlikely to generate large gains for developing countries (Section 5). Countries that are serious about attracting FDI can implement the appropriate policy mix unilaterally. Conversely, countries such as China have demonstrated that they can attract FDI without committing to the types of disciplines likely to figure on the agenda of a MAI. Many countries will find it difficult to attract FDI in manufacturing even with all the "right" policies in place. The key need therefore is to continue the process of multilateral trade liberalization, focusing attention as far as investment (establishment) policies are concerned on services markets.

2. Restrictive Policies toward FDI

Policies toward FDI exhibit considerable variation over time and space. In countries that historically emphasized import substituting industrialization such as most of Africa, Latin America, and Southeast Asia, FDI was typically not allowed or multinational firms had to operate under severe restrictions. Even in countries where technology acquisition was a major concern of governments, multinationals were rarely permitted to operate wholly owned subsidiaries. For example, Japan, Korea, and Taiwan imposed restrictions on FDI at various points in time,[1] even though foreign trade was viewed positively.

In recent years, government policies toward FDI have been liberalized across the world. For example, of the eighty two policy changes made with respect to FDI policies by thirty five countries in 1991, eighty were in the direction of greater liberalization (UNCTAD, 1992). This trend reflects an increasing awareness on the part of many governments that multinational firms play an important role in economic development by serving as conduits of superior technology as well as management techniques. Such a realization stems partly from the success of countries such as Singapore, Thailand, and Malaysia that rely heavily on FDI.

However, while there has been a global trend toward liberalization with respect to FDI, many countries—both industrialized and developing—impose performance yardsticks on multinationals. Examples include equity ownership limits, licensing regimes, foreign exchange restrictions, and export or local content requirements. Collectively, these are referred to as trade-related investment measures (TRIMs). In other words, the perception seems to be that while FDI is a good thing, the conduct of multinational firms may have to be subjected to certain regulations and restrictions in order to maximize benefits for the host

[1] Ozawa (1974) provides a detailed account of the Japanese experience. The Ministry of International Trade and Investment (MITI) restricted FDI until 1970, and never greatly liberalizing it, and even insisted that foreign firms share their technology with local firms as a precondition for doing business in Japan. A similar story can be told about South Korea's experience.

country – assuming such indeed is the motivation behind the various TRIMs instituted by host countries. While it is quite likely that like other forms of protectionist measures, TRIMs reflect the underlying political economy of the host country, it is nevertheless worthwhile to ask if there is a case that can be made for such policies on purely welfare grounds (i.e. the aggregate welfare of the host country).

In the neoclassical world of perfect markets, investment measures are bound to be distortionary whereas in a world of imperfect competition or one in which there exist other distortions, such measures may have some beneficial aspects. An early analysis of domestic content requirements as well as content preferences in a model of perfect competition is found in Grossman (1981). The basic point of this paper is that content protection raises the price of domestic inputs, by requiring multinationals to use more of them, and thus benefit input suppliers at the expense of final goods producers. However, multinationals are pervasive in oligopolistic industries and can have significant market power. Thus, examining the effect of TRIMs under conditions of imperfect competition is important. Analyses of content protection and export performance requirements are available in Richardson (1991; 1993) and Rodrik (1987). Once one grants the second best setting under which TRIMs are typically implemented, their negative effects are somewhat mitigated.[2] It is well known in general that policy intervention in oligopolistic markets can improve local welfare by altering the distribution of product market rents between domestic and foreign firms. Nevertheless, even if policies are used as tools for transferring rents, they are bound to be second-best tools, at least strictly from an economic viewpoint.

Existing evidence shows that investment measures tend to be concentrated in specific industries with automotive, chemical, and petrochemical and computer industries leading the list (UNCTAD, 1996). Furthermore, local content requirements are most important in the auto industry whereas export requirements are more important in the computer industry. In chemicals and petrochemicals, both local content requirements and export requirements are employed extensively.

In many cases, surveys show that investment measures make firms do what they would have done anyway, except that they may do it sooner as a result of constraints or incentives imposed. For example, a TRIM that requires firms to export is inconsequential if firms were going to export even in the absence of such a requirement. Thus, the actual effect of investment measures may be quite small. The US Department of Commerce's survey of 1977 and 1982 indicate that only six percent of all the overseas affiliates of US firms thought themselves to be affected by TRIMs, although a far greater percentage operated in sectors where such TRIMs existed. In other words, the constraints imposed by TRIMs often fail to bind (UNCTAD, 1991).

The empirical evidence notwithstanding, the issue was put on the Uruguay Round agenda. An Agreement on TRIMs was negotiated that prohibits measures that are inconsistent with the GATT national treatment principle (Art. III) and the prohibition on the use of quantitative restrictions (Art. XI). The TRIMs agreement includes a list of prohibited

[2] As is well known, in the presence of pre-existing distortions, introducing another distortion, say in the form of a content protection scheme, can raise welfare.

measures (local content, trade-balancing, foreign exchange-balancing and domestic sales requirements), requires that all policies not in conformity with the agreement be notified within 90 days of entry into force of the agreement, and that they be eliminated within two, five or seven years, for industrialized, developing and least developed countries, respectively. The latter two groups may request extension of these transition periods. The agreement is to be reviewed in the year 2000 at which time it may be complemented by provisions on competition and investment policy.

Although the TRIMs agreement is widely held to be relatively weak, as all it does is to re-iterate that the GATT national treatment principle and the prohibition of quantitative restrictions apply to policies intended to foster investment. Notably, the agreement does not address export performance requirements, nor does it affect FDI in services, which is covered by the GATS. Notwithstanding its limited reach, the GATT has been a constraint on countries using TRIMs such as local content requirements, and can be expected to become a more serious source of discipline in future as transition periods expire.

So far there have been only a few disputes brought before GATT/WTO panels in this area, the most notable of which are a case brought against Canada's Foreign Investment Review Act (FIRA) by the US in 1984, and a more recent case brought by the EU, Japan and the US against provisions of the National Car Program introduced by Indonesia in 1996. In the FIRA case the panel found that written undertakings submitted by foreign investors to the government regarding sourcing of inputs and export objectives to be a violation of national treatment, as it implied discrimination against importing inputs. The Indonesia case also revolved around local content measures. Under the contested program, the government granted "National Car" company status to Indonesian companies that met specified criteria as to ownership of facilities, use of trademarks, and technology. National Cars companies were required to meet increasing local content requirements over a three year period; if so, they benefited from exemption from the prevailing luxury tax on sales of cars and exemption from import duties on parts and components. "National Cars" manufactured in a foreign country by Indonesian nationals and which fulfilled the local content requirements prescribed by the Minister of Industry and Trade were also exempt from import duties and luxury tax. Such imported National Cars were deemed to comply with the 20 per cent local content requirement for the end of the first production year if the value of "counter-purchased" Indonesian parts and components accounted for at least 25 per cent of the value of the imported cars (WTO, 1998b). The panel found that this program violated the TRIMS Agreement (national treatment).

More disputes may arise under the TRIMs agreement once the transition periods for full compliance on the part of developing countries have expired (a major reason Indonesia was "targeted" was that the policy measures were introduced after the entry into force of the TRIMs agreement--a number of countries apply similar policies but are sheltered by the transition period). This should help ensure that markets are contestable through trade flows. However, much will depend on the incentives for multinationals to bring complaints. Insofar as they are incumbents that have invested and incurred the costs of whatever policies are applied, they may be loath to upset the existing status quo if this is profitable.

In many cases complaints are more likely to be brought by "outsiders" with an interest in exporting into formerly protected markets.

3. Policies to Promote FDI

Economic theory dictates that when domestic distortions and externalities from FDI are both absent, the optimal FDI policy ought to be no policy at all -- i.e. governments should allow for unfettered market transactions. Thus, a role for policies promoting FDI requires domestic distortions or market failures. Since multinational firms typically arise in oligopolistic industries, a possible example of a domestic distortion is the presence of imperfect competition in the host economy. Suppose, following Glass and Saggi (1998b), one imagines an economy with an oligopolistic sector (manufacturing) and a numeraire sector (agriculture). Inward FDI into the manufacturing sector generates increased demand for skilled labor, which benefits skilled workers through raising wages in the host country but consequently damages the profits of host firms (positive due to imperfect competition). The tension between wages and profits implies that government policies toward FDI benefit one group at the expense of the other. Developing countries usually have small or non-existent local firms in industries that are dominated by multinationals since brand names, R&D, and reputation are of central importance in such industries and these assets are rarely available to developing country firms. Furthermore, in many small open economies, a substantial fraction of the ownership of firms may belong to other countries. Thus, if the economic environment of a country is such that profits of local firms are unimportant either because local industries are extremely underdeveloped (so that national income comprises mostly of wage earnings) or because local profits do not accrue to domestic agents, the country is likely to take a favorable view of inward FDI. In such countries, the loss in profits incurred due to the increased entry of multinationals is small relative to the gain accruing to workers. Similarly, one can imagine other domestic distortions that may create a role for policy toward FDI, although such policies need not be first best.

A second possible rationale for inducing FDI has to do with technology spillovers. Developing countries hope not only to import modern foreign technologies via FDI but also to generate technological spillovers for local firms thereby making more efficient use of existing resources.[3] There exists a large literature that tries to determine whether or not host countries enjoy `spillovers' (positive externalities) from FDI (Blomstrom and Kokko, 1997, provide an excellent overview). The central difficulty is that spillovers, by their very nature, often do not leave a paper trail -- they are externalities that the market fails to take into account. Nevertheless, it is useful to ask what are the potential channels through which spillovers from FDI may arise so as to identify possible policy options. In the following discussion, we restrict attention to those effects of FDI that may be classified as externalities. For example, increased competition will generally result from FDI but this is

[3] The usage of the word 'spillovers' is somewhat unfortunate since productivity improvements are unlikely to be costless and automatic.

not typically understood to be an externality. At a general level, the literature suggests the following potential channels of spillovers:

- Demonstration Effects – local firms may adopt technologies introduced by the multinational through imitation or reverse-engineering.
- Labor Turnover – workers trained by the multinational may transfer important information to local firms or may start their own firms leading to diffusion of technology.
- Linkages – derived demand by multinationals may lead to local provision of services or inputs that can also be used by local firms.

In its simplest form, the demonstration effect argument states that the close proximity to multinational firms may lead to efficiency gains by local firms who may modify their own production methods upon exposure to the superior technology of multinationals. The main point here is that in the absence of FDI, adoption of certain technologies may simply be infeasible because local firms lack the necessary information. In other words, it is simply too costly for local firms to acquire the required information for adopting new technologies if they are not first introduced in the local economy by multinationals (and hence demonstrated to succeed in the local environment). Hence, geographical proximity is a vital part of this argument. The main insight of the demonstration effect argument is that FDI may expand the set of technologies available to local firms. One must be careful, however since a mere expansion in choices need not imply externalities, especially if incentives for adoption are also affected by FDI. Even if one can argue that FDI increases the incentives for adoption, it is not necessarily the case that this implies that FDI generates positive externalities. FDI may expand choices but it generally also increases competition. The net effect on the incentives for adopting new technologies may be ambiguous. However, if competition reinforces the incentives for adoption, FDI may indeed spur local incentives.[4] Some empirical support for this prediction is found by Blomström, Kokko and Zejan (1994).

Faster adoption of new technologies by local firms due to inward FDI does not necessarily constitute a spillover for the local economy. Multinationals will face more severe competition as a result of upgrading by local firms. Foreseeing the consequences of technology transfer, multinationals may alter the very terms of their original technology transfer. For example, a multinational firm may choose to transfer technologies of lower quality when there is a risk of leakage or adoption of the technology by local firms. While

[4] In a recent paper, Glass and Saggi (1998a) examine the question of spillovers in a dynamic general equilibrium product cycle model. In their North-South model, the demonstration/proximity argument is formalized as follows: Southern firms can imitate multinationals located in the South at a lower cost than they can imitate firms located in the North. However, as they point out – multinational firms are also stronger competitors than firms that produce only in the North since they produce in the same low wage location as potential imitators. Their model delivers the surprising result that a faster flow of FDI need not increase technology transfer to the South since imitation focussing on firms located in the North slows down with a hastening of imitation targeting multinationals. See also Das (1987) and Wang and Blomström (1992) for an alternative dynamic model of technology transfer from a parent company to its subsidiary. In their model, investment in learning activities by the domestic firm provides a competitive spur for technology transfer.

an expansion in the set of possibilities, along with the competitive spur of FDI, may lead local firms to make adoption decisions that they would not make in the absence of FDI, such an effect need not imply the existence of externalities.

As is often the case with such difficult issues, the evidence is mixed. Using industry level data, Blomström and Persson (1983), found that domestic labor productivity is positively influenced by foreign presence in an industry, as measured by the foreign share of industry employment. On the other hand, more recent studies using firm level data are not supportive of the spillover hypothesis: Aitken, Hanson, and Harrison (1997) and Haddad and Harrison (1993) actually find that foreign investment has a negative effect on the performance of domestically owned firms. One needs to be cautious in interpreting this finding. Case-study evidence is strongly suggestive of spillovers (see Schive, 1990) and a more complete econometric study would require a more dynamic approach: it is very unlikely that significant improvements in the productivity of local firms can be realized without costly investments that yield payoffs in the future.

The type of FDI may also matter importantly. Djankov and Hoekman (1998) find that foreign investment has a negative spillover effect on firms in Czech industry that do not have foreign partnerships. This effect is relatively large and statistically significant. However, if joint ventures are excluded and the focus of attention is restricted to the impact of majority-owned foreign affiliates (i.e., FDI) on all other firms in an industry (including joint ventures), the magnitude of the negative effect becomes much smaller and loses statistical significance. This result illustrates that the initial negative spillover result may not be robust and that tests for spillovers with the methodology used here (and in the literature more generally) require some assurance that in distinguishing between two subsets of firms in an industry on the basis of whether or not there is majority foreign ownership (or more generally foreign linkages of some kind) one is not ignoring other important determinants of the performance of firms. One such determinant likely to be important is the technological effort of firms. Survey questionnaires reveal that joint venture firms invested significantly more in training and new technologies than pure "domestic" firms. It may be that the technological ability and effort expended by many of the firms without foreign partners is too low to be able to absorb spillovers when they occur, or that the firms with foreign linkages have absorbed a significant share of the available stock of labor with requisite skills.

While direct imitation and reverse-engineering have been extensively studied as channels of inter-firm technology diffusion, the role of labor turnover has been neglected. Labor turnover differs from these channels because knowledge embodied in workers moves across firms only through the physical movement of workers. Empirical evidence regarding the magnitude of labor turnover from multinationals to local firms is mixed. For example, while a study of Kenyan industries by Gershenberg (1987) finds limited evidence of labor turnover from multinationals to local Kenyan firms, several other studies do document substantial labor turnover from multinational to local firms. UNCTAD (1992) discusses the case of Bangladesh's garment industry in some detail. Desh—the first Bangladeshi firm to manufacture and export garments—was supplied with technology and credit by Korea's Daewoo. Eventually, 115 of the 130 initial workers left Desh to set up their own, or to join other newly established, garment companies. The remarkable speed with which the former Desh workers transmitted their know-how to other factories is a good example of the role labor turnover can play in technology diffusion.[5]

Pack (1997) also discusses evidence documenting the role of labor turnover in disseminating technologies of multinationals to local firms in Taiwan. For example, in the mid 1980s, almost fifty percent of all engineers and some sixty percent of all skilled workers that left multinational affiliates in Taiwan joined local firms. The figures reported in the Gershenberg study of Kenyan industry are less assuring: of the ninety one job shifts studied, only sixteen percent involved turnover from multinationals to local firms. This difference may reflect the fact that in countries such as South Korea and Taiwan, local competitors are less disadvantaged relative to their counterparts than in many African economies, thereby making labor turnover possible. Thus, the ability of local firms to absorb the technologies introduced by multinationals may be a key determinant of whether or not labor turnover occurs as a means of technology transfer in equilibrium.[6] This is the argument advanced in Glass and Saggi (1998c). The rationale of their model is as follows. Since superior technology is one of the key intangible assets that permit multinationals to successfully compete with local firms, multinationals have an incentive to limit diffusion of their technology to local rivals. An effective method of limiting technology diffusion is to curtail labor turnover by offering higher wages than local rivals. Thus, if multinationals are observed paying higher wages than local firms, the wage premiums paid by a multinational can provide a rough estimate of the value it places on the knowledge it transfers to its workers. The more interesting point is that such a premium may either exceed or fall short of the benefit the local economy would enjoy if the multinational were to sit back and allow its workers to leave.

Many recent studies document that multinationals pay higher wages than local firms. Using data from Mexico, Venezuela, and United States, Aitken, Harrison, and Lipsey (1995) show that higher levels of foreign investment are associated with higher wages in all three countries. Note that if the multinational must raise wages in order to restrict technology transfer to local firms and given that the wage premium has no necessary relation to the social value of the knowledge embodied in workers, technology transfer is not necessarily optimal for the local economy. Thus, policies designed to encourage technology transfer do not always raise welfare of the recipient country.

Consider finally the argument that multinationals generate externalities through backward and forward linkages. In this context, Rodriguez Clare (1996) makes the important point that multinationals improve welfare only if they generate linkages over and beyond those generated by local firms they displace. Thus, merely documenting extensive linkages between multinational and local suppliers or buyers is insufficient to argue that net external benefits accrue to the local economy as a result of FDI.

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[5] Bloom (1992) reports that substantial spillover effects were created in South Korea when production managers left foreign firms to join local ones.

[6] In the case of Desh, the technology being transmitted was quite simple and local absorptive capacity would have been adequate.

Markusen and Venables (1999) have argued that the entry of multinationals might help resolve a coordination failure in the host economy. By creating demand for intermediate goods, entry by multinationals encourages there production. Consequently, local firms gain access to hitherto unavailable inputs since these are not produced in the absence of the demand generated by multinationals. Such an argument is probably most relevant for the least developed countries that have very little industrial activity of their own. Countries like India and Brazil that have adequate indigenous industry are unlikely to enjoy substantial linkage effects of the kind discussed by Markusen and Venables.

To recapitulate, an economic rationale for providing fiscal and financial incentives to FDI might exist in the presence of domestic distortions or positive externalities from FDI. The empirical evidence regarding the latter has not been clear cut but part of the difficulty lies in the very nature of externalities. Furthermore, a true evaluation of the extent to which there are spillovers from FDI requires a dynamic study since immediate productivity improvements in local firms are unlikely. Nevertheless, suppose one accepts the notion that there indeed exist solid economic grounds for promoting inward FDI via incentives. Even so, the case for incentives must contend with the real problem that arises once the existence of other countries with a similar interest is recognized. Suppose two potential host countries foresee positive externalities from an investment project that is being considered by a multinational firm. The two potential hosts could easily find themselves in a bidding war for attracting FDI that is to the detriment of both parties. Thus, even in the presence of externalities, a policy of offering incentives to multinational firms seems counter-productive.

Yet another damaging criticism of a policy of offering incentives to inward FDI comes from direct empirical evidence on this issue. Most studies (Morck and Yeung 1991, and Wheeler and Mody, 1992) fail to find any significant impact of such incentives on FDI, once the other more important determinants of FDI are taken into account. This line of research implies that determinants of FDI are much more fundamental than incentives; the available evidence suggests the latter basically end up as transfers to multinationals. However, this conclusion has been contested by a number of countries in the WTO Working Group on Trade and Investment (WTO, 1998). Representatives from these countries (who are not identified in the reports of the Group) remain unconvinced by the evidence. For example, Loree and Guisinger (1995) find that investment incentives do have a positive effect. In part the differences of opinion may reflect measurement difficulties, as it may be difficult to separate fiscal and/or financial incentives from more general policies that promote business activity. That the latter matter a lot is uncontested. In a recent empirical analysis of the effect of state policies on the location of manufacturing, Holmes (1998) finds that the share of manufacturing in employment in states with pro-business regulatory environments increases by one third compared to a bordering state without such policies. This result is noteworthy not only in indicating that state policies appear to matter, but also in suggesting that differences across states are relatively stable. The measure of policy chosen (whether a state had a law banning requirements that all employees of a firm join a union) has not changed significantly since 1958; in the last two decades only two states passed such laws; while none repealed them.

4. The Regional Integration Experience

The extent to which market access barriers are removed and the reach of the national treatment principle as circumscribed in a trade agreement are important determinants of the magnitude of liberalization (integration) that is pursued by governments. In the case of the WTO, national treatment does not apply to investment policies. It is often claimed that RIAs can and do go further, allowing governments to abolish market access barriers (e.g., by granting the right of establishment) and performance requirements. Clearly the RIA experience is relevant in assessing the need for and payoffs associated with a possible MAI. A first question to ask is what RIAs have in fact achieved to date over and above what countries have been willing to do unilaterally or through the WTO.

Some RIAs have extended the reach of national treatment to investment, in the process abolishing performance criteria and related policies such as local content and trade balancing requirements. Examples include the EU, where freedom of investment is a basic principle, NAFTA, and various association agreements the EU has concluded with Central and Eastern Europe neighbors. Other RIAs with investment liberalization provisions include Mercosur, the G3 (which is closely modeled on NAFTA), and the Canada-Chile FTA. Agreements vary in the extent to which barriers to entry are removed; with the exception of the EU, most RIAs tend to maintain restrictions on market access and entry by foreign firms.

Services Liberalization: A Litmus Test

A key indicator of the "seriousness" of RIAs is the extent to which they go beyond the WTO in liberalizing market access restrictions and subject governments to disciplines regarding the use of incentives and performance requirements. As far as market access is concerned, a litmus test from an investment point of view is what is done in nontradable sectors, i.e., many services. As mentioned earlier, tradables can be supplied through trade: in these sectors the focus of negotiations should first and foremost be on elimination of trade barriers. What have RIAs achieved in liberalizing access to service markets?

In the EU, there is full freedom to provide services, with the exception of transportation services for which the primacy of national policies was recognized until a common EC-wide regime was established. Little progress was made to do so, with the result that intra-EC competition in transportation services remained limited. In the financial services sector, Article 61 of the Treaty of Rome stated that liberalization was to be effected in step with the progressive liberalization of capital movements-in the absence of progress on the latter, the former was also constrained. Liberalization of the medical and pharmaceutical professions was made contingent upon the harmonization of licensing and certification requirements. Despite rulings by the European Court of Justice in the mid-1970s that, as of the end of the transitional period (1970), all other services in principle were tradable, differences in national regulations proved to be major barriers to market access.

Much of the Single Market program aimed at integrating EU services markets, and many of the Directives that were issues by the Commission related to specific service industries. For example, the second Coordinating Banking Directive made home countries responsible for prudential supervision (e.g. setting and enforcing liquidity and solvency standards), subject to the requirements of other EC Directives that establish minimum standards in this regard, thereby allowing any credit institution authorized in a Member State to establish branches and provide banking services anywhere in the EU (the so-called single passport). Directives were also developed dealing with investment services, mutual funds, insurance, road and air transport, telecommunications (broadcasting as well as value-added services), professional services (accounting, legal and medical), and the mutual recognition of diplomas related to pharmacy and higher education related to 'regulated' professions.

The NAFTA has comprehensive coverage of services activities, and liberalizes both cross-border trade and investment in services. It includes several sector-specific trade liberalizing rules and/or timetables (for financial, telecommunications and transportation services) and establishes work programs on standards harmonization for land transportation (bus, truck and rail services) and telecommunications equipment. A negative list approach is taken towards determining sectoral coverage. All non-conforming measures at both the national and sub-national levels not scheduled within prescribed time limits automatically become null and void. Although Mexico lodged the largest absolute number of reservations, it also undertook significant liberalization commitments in a large number of service sectors. Most transportation modes-land, maritime and some air services, telecommunications, and financial services are included. Mexico agreed to open up financial markets to international competition over a six-year period, during which market share limits-both aggregate and firm-specific-apply. Thereafter, temporary safeguard provisions may be invoked in banking and securities, but not beyond January 2007, and only if prescribed foreign market shares reach their upper limits.

Services were included in the Australia-New Zealand Closer Economic Relations (CER) trade agreement in 1988. All service sectors were covered except "sensitive" ones such as basic telecommunications, broadcasting, air transport, maritime cabotage and postal services.[7] In 1992 Australia removed its reservations relating to banking and government preferences for Australian companies in construction, engineering and general consultancy. New Zealand removed its reservations for radio and television broadcasting, short-wave and satellite broadcasting, stevedoring and part of the reservation relating to airways services. Subsequently, the two governments agreed to integrate their aviation markets through conclusion of a bilateral agreement.

CER does not include a right of establishment; FDI remains subject to review policies in each country. The common trans-Tasman labor market obviates the need for provisions on temporary entry and the removal of citizenship and/or permanent residency requirements associated with the licensing of service providers found in the NAFTA. The agreement only

[7] Moreover, Australia reserved restrictions on establishment of foreign-owned banking branches, subsidiaries or representative offices, as well as legislative limits on shareholdings in Australian banks. Also excluded were Federal government procurement preferences for construction, engineering and general consultancy and Australian State preferences for basic health and third-party insurance.

contained "best efforts" language regarding licensing and certification requirements, which was all that was feasible given the sovereignty of Australian states with respect to numerous licensing and certification matters. In a 1992 review of the CER New Zealand and Australia committed themselves to exploring the potential benefits of concluding a trans-Tasman agreement applying mutual recognition principles to Australian and New Zealand regulatory standards for goods *and* occupations. As noted above, negotiations were concluded in 1997.

No specific commitments are made in the Euro-Mediterranean agreements (EMAs) on liberalization of cross-border supply of services (i.e., trade), nor is there a right of establishment. Liberalization in these areas are an objective that is to be pursued in the future. The EMA simply refers to the obligations of each Party under the General Agreement on Trade in Services (GATS). These do not imply much, if any, liberalization (Hoekman and Primo Braga, 1997). Mediterranean countries made very limited commitments under the GATS, subjecting some 6 percent of their service sectors to the national treatment and market access principles, as compared to 26 percent for the EU.[8]

Other RIAs vary in their coverage of services. In the case of ANDEAN, CACM, and SADC, little services liberalization has occurred. In SACU and CARICOM certain service sectors have been integrated more for historic than for deliberate policy reasons. In CARICOM national treatment applies to banking, health, education, tourism and transport services, and many of these services are provided jointly. The G3 is similar to NAFTA, although sectoral coverage is less (e.g., transport remains the subject of negotiation). In MERCOSUR, free circulation of services is a long term objective to be achieved by 2007. Progress towards liberalizing service markets has been slow, with members still engaged in a process of negotiating a framework agreement for liberalization in this sector. ASEAN members have until recently restricted services liberalization to the GATS. In 1997 they agreed to attain full liberalization (on a preferential basis in most services by 2020.

With the exception of the EU, in practice it appears that the multilateral GATS process is either leading liberalization of services, or that GATS commitments of RIA members do not differ significantly from RIA commitments. RIAs also do little to effectively constrain the ability of governments to provide incentives for FDI. The most far-reaching RIAs are those involving the EU as a partner. They seek to apply common disciplines in areas such as antitrust, state aids, and state monopolies; indeed, increasingly what appears to be required by the EU is the full adoption of the EC's internal market rules and the adoption of *national* legislation that is consistent with EC norms. But the periodic disputes regarding the use of incentives by local governments to attract FDI illustrate that even these far-reaching disciplines are insufficient defuse tensions. Moreover, recurring claims of "social dumping" reveal that even far-reaching disciplines on subsidies will not be enough to constrain the ability of governments to adopt the regulatory regimes they believe will be most conducive to stimulating investment, be it foreign or domestic.

[8] The share of the service sector where commitments were made--even if not guaranteeing national treatment and market access also differed substantially. The EU scheduled 57 percent of its services; the Middle East and North African Members of the WTO only 16 percent.

5. Towards a WTO-based MAI?

Starting in 1995, the OECD initiated talks to create a Multilateral Agreement on Investment (MAI) that would further liberalize investment and establish binding dispute settlement procedures. Investment has also been proposed as a subject for future WTO negotiations. A recent WTO report on investment in the global economy concludes that:

"WTO members are confronted with a basic policy choice: Do they continue to approach the FDI issue as they have until now, that is bilaterally, regionally and plurilaterally, and on an ad hoc basis through sectoral and other specific WTO agreements; or do they seek to integrate such arrangements into a comprehensive and global framework that recognizes the close linkages between trade and investment, assures the compatibility of investment and trade rules and, most of all, takes into account in a balanced way the interests of all the members of the WTO--developed, developing and least developed alike. Only a multilateral negotiation in the WTO, when appropriate, can provide such a global and balanced framework" (WTO, 1996, p. 59).

With the demise of the OECD-based efforts to negotiate a MAI, it appears that the WTO is the only game in town for those seeking to negotiate general rules on FDI. In this connection RIAs are a second-best instrument, as they may distort the pattern of FDI flows, either by discriminating against investors located in non-members, or by creating incentives for FDI from any source to locate in a specific country. The latter can arise in so-called "hub and spoke" free trade agreements, where a country has a series of bilateral FTAs, but the various partner countries do not have FTAs with each other. In such situations investors may choose to locate in the "hub" country simply because this gives them access to all the "spoke" countries, not because it is the optimal location on economic fundamentals.

Given the possible distortions created by RIAs, if an agreement is to be pursued, this is clearly best done in a multilateral setting like the WTO. A number of WTO agreements already embody or imply disciplines on investment-related policies (see WTO 1996 for a review). A central question, however, is whether the net gains of negotiating an *effective* MAI under WTO auspices are large enough. Returning to the key issues identified in the Introduction, what would a MAI do for developing countries in terms of fostering "good" FDI-related policies; in terms of generating better access to foreign markets; and in terms of addressing the potential for negative spillovers due to lack of international cooperation?

Most FDI takes place between high-income countries that have similar factor endowments. The fact that these flows of FDI occurred in the absence of any MAI raises questions regarding the relevance of such an agreement. It could be argued that FDI flows would have been still higher if there existed a MAI. Furthermore, the policy environment across the developed world is on the whole more uniform than it is across developing countries. Thus, the value of implementing common rules governing FDI is potentially higher for developing countries. FDI flows into such countries have increased substantially in the last decade; they now attract some thirty percent of the total (UNCTAD, 1996). It is worth recalling here that what matters in terms of attracting FDI is political stability, geography, an efficient infrastructure, adequate human capital, and liberal trade policies. An investment treaty will do little to attract FDI if these fundamental requirements are not in place. On the other hand, when such conditions do exist, a country's policy with respect to trade and FDI does not seem to be pivotal. Consider China for example – it has been the biggest recipient of FDI in recent years and it is not even a member of the WTO, let alone subject to international disciplines on investment policies. Large countries such as China will be able to continue attract FDI even if they do not join the MAI and continue to pursue policies that violate national treatment. Of course, the cost of foreign capital may rise at the margin, but it is worth recalling that China attracted some $130 billion in FDI during 1985-95, the fourth highest in absolute value after the United States, United Kingdom and France (UNCTAD, 1996).

From a national perspective, a MAI may help countries that seek FDI as a signaling device or instrument through which the perceived credibility of a set of policies intended to foster FDI can be enhanced. However, much of what might be embodied in a MAI can be pursued and implemented by a government unilaterally.[9] Indeed, many countries that are looking for FDI already have done so. For example, great weight was put upon the fact that the OECD effort to negotiate a MAI would include strong enforcement provisions including investor-State arbitration, and the OECD draft agreement required Parties to accept arbitration of disputes under the ICSID, ICC, or UNCITRAL rules,[10] depending on the preferences of the investor (see Baldi, 1996). But any country already has the option of doing this. Indeed, countries that are "in the market" for credibility can use the existing WTO disciplines as well to schedule market access opening policies for services (including granting of the right of establishment), and can also lock in low tariff regimes by binding these under GATT rules. There is still huge scope for developing countries to use the existing WTO as a credibility enhancing instrument if government wish to do so—the coverage of services commitments is very limited, and tariff bindings for merchandise imports are often significantly higher than applied rates.

An important question is whether a MAI can help to reduce or offset the political impediments that constrain adopting better policies. To do so, the process of negotiating the MAI must allow issues to be brought to the table that are of sufficient interest to domestic constituencies for them to invest resources to fight for a more liberal FDI regime. Clearly necessary conditions for a government to go down this path is that there are restrictive policies that have proven impossible to eliminate unilaterally, and that there are issue linkages that can break the deadlock. The RIA experience suggests that as far as developing countries are concerned it may not be easy to devise such an agreement; the

[9] Developing countries may for example use the facilities of the Multilateral Investment Guarantee Agency (MIGA), pass legislation that allows investors to invoke the arbitration services of the International Center for Settlement of Investment Disputes (ICSID) and commits the government to abide by such arbitration decisions, negotiate bilateral investment treaties with the major home countries of FDI, etc.

[10] International Center for the Settlement of Investment Disputes (operating under World Bank auspices); the International Chamber of Commerce (which has a Court of Arbitration); and the United Nations Committee on International Trade Law, respectively.

OECD experience illustrates that limiting attention to investment policies only is a recipe for failure—the agenda needs to be broader to allow tradeoffs and issue linkages.

Increasing access to foreign markets through FDI does not appear to be a priority issue for most developing countries. Here again the question will be what they can gain in other areas from making commitments regarding FDI policies. This is an important issue, and should be the subject of careful analysis by each government.

Finally, turning to the systemic issue (international spillovers), perhaps the strongest argument in favor of a MAI is that it may help avoid mutually destructive policies from the viewpoint of developing countries eager to attract FDI via the use of incentives. In our view, to be effective in this regard a MAI would need to be very comprehensive. It would need to cover investment incentives, taxation, performance requirements, and deal with the discrimination that is created by RIAs. If an agreement is not comprehensive, countries can side-step the disciplines through the use of other policies, including their competition policies. The GATT/WTO negotiating and implementation history illustrates that subsidy disciplines are very hard to obtain, and are easily circumvented. Even RIAs such as the EU—which go much further than the WTO in this area—have encountered recurrent difficulties associated with government policies intended to attract FDI. NAFTA does not even try to tackle this issue. The recent report issued by the WTO Working Group on investment (WTO, 1998) illustrates that there are widely divergent views on the efficacy and need of incentives. The report also fails to indicate there is any consensus regarding the existence of a compelling case that there are large benefits to be obtained for the trading system (and for individual WTO members) through the establishment of multilateral disciplines on investment-related policies.

6. Concluding Remarks

Competing for FDI via incentives and imposing performance requirements on foreign investors are dubious policies for developing countries. The evidence indicates that fundamental factors such as infrastructure, geography, a labor force with appropriate skills, secure property rights, an effective legal regime and political stability are much stronger determinants of FDI. In principle, a major potential rationale for a multilateral investment agreement is that it can help avoid wasteful competition for FDI. This would be especially beneficial to developing countries since resources are scarce in such countries. However, it is difficult to see how any MAI could impose effective disciplines on the use of incentives. Both the regional and the GATT/WTO experience with disciplining subsidies does not suggest there is great cause for optimism in this regard.

Rationales for a MAI that rest on the role international agreements can play as credibility enhancing instruments are also not compelling, as governments have not used available instruments to anything close to the full extent possible, and many of the dimensions of a MAI that have been touted in this connection can be employed through unilateral decisions to use existing institutional mechanisms to reduce uncertainty.

Negotiating a MAI may prove useful in arriving at a "grand bargain" that extends beyond liberalization and binding of investment regimes. This is an issue that must be considered carefully, as there may be significant scope for obtaining large returns in other areas as a quid pro quo for participating in a MAI. Indeed, for developing countries the gains associated with international agreements in other areas are likely to far outweigh anything that could emerge from a MAI alone.

In our view priority should be given to the pursuit of "classic" trade liberalization to ensure markets for tradable goods are contestable through exports. This should include efforts to liberalize access to service markets on a nondiscriminatory basis, an area where establishment (FDI) is often crucial. Further nondiscriminatory liberalization of trade barriers for goods and services will also help reduce possible locational distortions for FDI resulting from RIAs. Given that there is already in place a General Agreement on Trade in Services under the WTO that includes establishment as a mode of supply on which commitments can be made, there does not appear to be a compelling case for seeking to negotiate a stand-alone investment agreement.

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MONETARY REGIONALISM IN EUROPE AND THE INTERNATIONAL MONETARY SYSTEM

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Among the salient features of regional economic integration in the European Union (EU) are the institutional arrangements in the fields of money and international finance, including the early attempts at co-ordinating exchange-rate policy. Since the early 1970s various schemes have been developed to form not only a trade area but also a monetary entity in Europe and to de-couple the intra-European economic relations from the vagaries of the fluctuations of the US dollar. Starting with the European "snake" this led to the exchange-rate mechanism (ERM) of the European Monetary System (EMS) and finally to the all-comprehensive European economic and monetary union (EMU) which entered its third stage on 1 January 1999. The euro, the single European currency, is about to establish itself as a strong second pillar in the international monetary arena alongside and in competition with the US dollar, and thus to change the mode of global monetary governance.

In contrast to the European approach, trade integration in the East Asia and the Pacific has not been associated with regional monetary arrangements. Instead, most countries in the region have maintained strong unilateral links between their currencies and the US dollar. The yen has been unable to establish itself as a regional currency - if this ever has been the aim of the Japanese authorities.

What were the economic and political driving forces of monetary integration in Europe? What can be learnt from the operation of the EMS? What is the outlook for future global monetary governance in the light of the regional development in Europe? These are questions to be addressed in the following.

Prologue: Regional monetary reintegration as a stimulus to monetary multilateralism - the case of the EPU

The legal and institutional foundations for the monetary and financial reintegration of the world economy after the end of World War II were laid in Bretton Woods on 23 April 1944 with the agreements on the International Monetary Fund (IMF) and the World Bank (IBRD). The multilaterally agreed rules of the IMF on the fixing and adjustment of exchange rates and on facilities for financial support in case of balance-of-payments deficits were certainly a necessary condition for the reconstruction of a stable international monetary system. Yet, in all the post-war period throughout the 1950s the IMF proved unable to play an active role in this respect.

Rather, the driving force was the regional institutional framework provided in Europe by the Organisation for European Economic Co-operation (OEEC) and its monetary angle, the European Payments Union (EPU), with the support of the United States. The EPU, a scheme for the consolidation and multilateralisation of bilateral balances and their settlement, turned out to be highly successful in overcoming the bilateralism in trade and trade financing then prevalent in Europe and was in fact instrumental in paving the way for an early reintegration of the European economies.[1] It was this success which allowled the participating countries in 1958-59 to make their currencies convertible. Only then was the IMF able to assume its duties (Borrmann et al. 1995, 49f.; Gros and Thygesen 1992, 8f.).

[1] For an account of the working of the EPU see Kaplan and Schleiminger (1989); Gros and Thygesen (1992), 4ff.

This early example is of little use in dealing with today's problems. However, it may serve as a reminder that regional monetary schemes can indeed pave the way to multilateral monetary co-operation. Moreover, it demonstrates that the roots of monetary integration in Europe date back as far as fifty years. To be sure, economic conditions - and therefore priorities of economic policy - after World War II were much different in East Asia. Europe had already been highly industrialised before the War, whereas the Asian economies were still at an early stage of their development. Their trade links were with industrialised countries rather than among each other. This holds also for Japan which then could be considered an emerging economy at best. Priority was therefore on economic development and access to the markets of industrialised countries rather than on regional trade liberalisation and - to that end - regional monetary co-operation.

1. Background: Features of European institutional integration

The political and economic driving forces of European Economic and Monetary Union and its forerunners, in particular the European Monetary System and its exchange-rate mechanism (ERM), can only be understood against the background of the dynamic process of regional economic integration that took place in Europe since the early 1950s. The European Economic Community (EEC) - now: European Union (EU) - started as a club of six on 1 January 1958. From its beginning it stood out for a set of distinct elements unparalleled by any other integration scheme worldwide, making it a union sui generis (Borrmann et al., 1995, 51):

- The Community is a truly political venture, created with the objectives to "establish the foundations of an ever closer union among the European peoples" and "to strengthen the safeguards of peace and liberty"[2]; to permanently overcome the century-old discord and hostility between France and Germany; and to allow Western European nations, by joining their forces, to bring their common interests to bear vis-à-vis the (then) superpowers United States and Soviet Union.[3]
- With the constitution of five "basic freedoms" - freedom of movement for goods, services, workers, and capital, and right of establishment - the Union's scope extends far beyond a mere free trade area (abolition of internal duties) or a customs union (common external tariff) for (industrial) goods.
- In order to give these freedoms material substance, they are underpinned by an active policy of approximation (harmonisation) and/or mutual recognition of national laws, administrative rules, regulations and procedures.
- From the start, the Union disposed over genuine policy competences in the fields of trade, agricultural, transport[4], and competition policies. Over time, these competences have been both strengthened and extended to a growing number of other policy domains. This implies that member countries have ceded their own

[2] See Preamble to the EC Treaty.

[3] On the motives for European integration see, e.g., Feldstein (1997); Weidenfeld (1992), 11f.; Harbrecht (1984), 10ff.; Schneider (1977), 321ff.

[4] The EC was unable to agree on a common transport policy until the late-1980s.

national rule-setting authority fully or partially to the Union level.[5] Authority for macroeconomic policy (with the exceptions recently generated under EMU) has been assigned to the national level. However, under Article 103 of the EC Treaty member countries shall consider their policies "as a matter of common interest" and coordinate them with their partners.

- The EC disposes over its own budget, amounting to 1.2 per cent of Community GDP, and since 1970 over own financial resources to cover the expenditures.
- As a measure of solidarity between the wealthier and the less wealthy member countries and regions, the Union has set up a scheme of sizeable financial transfers for structural and social programmes.
- More recently, the EU has extended its scope of activity beyond the innate field of economics to cover areas of interior as well as foreign and security policies.
- Last but not least the Union is characterized by a highly developed, supranational institutional structure of Commission, Council, Parliament and Court of Justice with far-reaching legislative, administrative and judicial competences, and with majority voting as the common decision-making procedure.
- Not all of these elements are of direct relevance to monetary and financial policies. Yet, the sum of them demonstrates the unique nature of the European Union and provides the basis for the institutional and political dynamics which finally led to EMU.

2. Dynamics of the European integration process

There is no straight route from the foundation of the EEC in 1958 to the EMS in 1978 and to EMU in 1999. The integration process has repeatedly been subject to severe crises, and its direction was often less than clear. With hindsight, the dynamics of European integration can be "explained" by a number of driving forces. The following factors stand out:

- The dialectic process of EC widening and deepening: Every round of new accessions to the EC was preceded by a process of deepening to prevent the "acquis communautaire" from being eroded by the new members. The first round of 1973 produced the system of "own resources" which put the financing of the common agricultural policy on a sound footing. The second round of 1986 was preceded by approval of the Internal Market Programme and the Single European Act. Passage of the Maastricht Agreement paved the way for the third round in 1995. The next round will be subject to agreement on the Agenda 2000 and possibly to further institutional reform, too.
- The inherent "logic" of the integration process, as put forward by (neo-) functionalist integration theory: Partial or sectoral steps to deeper integration serve as catalysts for yet further deepening (e.g., the Common Agricultural Policy and, more recently, the Single European Market have been stimuli for monetary

[5] The latest - and most far-reaching - instance is monetary and exchange-rate policy under EMU. The latest - and most far-reaching - instance is monetary and exchange-rate policy under EMU.

integration), and economic integration is a driving force to political union.[6] In political practice, often the argument has played a role that any standstill of integration will provoke reversal.

- Increasing market integration: Increasing regional integration of the goods markets has generated pressures to shield intra-European trade relations from external shocks (e.g., exchange-rate disturbances), but also to complement the free flow of goods by the integration and liberalisation of the services and capital markets.
- The role of the European Commission: The Commission has considered itself not just the "guardian of the Treaty" but has consistently pushed to enlarge the competences of the EC and thereby its own power and influence.
- The French-German "tandem": In a mode of "cooperative rivalry" the two countries have regarded themselves the joint "engine" of European integration. While their perceived political and economic interests have not in all instances been identical, this has generally not prevented them from providing leadership to the Union. This joint leadership has been a major condition for the advancement of the integration process so far.
- External challenges: Major changes in international political and economic conditions have repeatedly triggered joint European policy responses pushing forward the integration process. Among those challenges were: shifts in the dollar policy of the United States, the perception of a "technological gap", the oil price shocks, the trade rounds of the GATT/WTO, the collapse of the Soviet empire, crises and war in former Yugoslavia, and rising international migration into the EU. Often it has been the desire to build a counterbalance to the United States which produced initiatives for a further deepening of the Community.

3. Integration in Europe and Asia: Elements of a comparison

With its political objectives, its supranational organisation and the scope of its activities the European Union far exceeds any regional scheme in Asia or other parts of the world. In fact, institutional schemes have only played a peripheral role in the process of regional and international integration of the Asian economies. ASEAN has been dormant for the first twenty-five years of its existence and made its first effective steps with the creation of AFTA in 1992. Japan, South-Korea, China, Hongkong and Taiwan are linked among another and with ASEAN/AFTA only under the wide umbrella of APEC which covers also the United States, Canada and some Latin American contries. Trade integration in Pacific Asia has largely been market driven within the multilateral framework of GATT/WTO.

Lack of active leadership did perhaps play a role in this outcome. For historical reasons, Japan has been unable to perform this leadership on its own (much as Germany would have been unable to assume this function in Europe). Major differences in size

[6] This analytical and political approach has long been established in continental Europe. The European Coal and Steel Community in 1951, the (abortive) attempt at a European Defence Community in 1952, Euratom and the European Economic Community in 1957 were all conceived as moves to lay the foundations for a lasting, peaceful (Western) European order.

and in levels of development between Japan and the other economies of the region, but also unresolved political liabilities from the past, have prevented a "tandem" solution comparable to the French-German alliance in Europe.

More decisive than missing regional leadership has probably been the fact that, because of the late entry of most Asian countries into the world economy, trade integration in the region started rather late and at a time, when progress in multilateral liberalisation had already greatly reduced the incentive to enter into ambitious regional integration schemes (Table 1b). Nor did the obvious success of the market-driven approach to integration and economic development give occasion to such an incentive. The loose schemes of ASEAN/AFTA and APEC seem to fit the Asian economies fairly well. This lack of a regional institutional superstructure, and its reasons, may at least partly explain why monetary integration schemes did not evolve in East Asia. It remains to be seen whether the serious regional contagion effects experienced in the recent financial crisis will give rise to a joint approach to financial and monetary management. Can the EMS serve as a model?

4. European exchange-rate management: Snake and EMS

In the 1960s, the integration process in the EC - at that stage mainly related to the trade of goods and the setting-up of the common agricultural policy - progressed under the roof of the Bretton Woods system of fixed exchange rates. Trade performance was impressive: Between 1958 and 1969 intra-EEC trade increased by a factor of 5.3 (from US$ 6.9 bn to US$ 36.5 bn), more than twice the rate of expansion experienced with the rest of the world (2.5). As a result, the share of intra-EEC exports in total exports of the Community countries rose from 30.1 to 48.2 per cent. In the process, the EEC rose to become the most important export region for all member countries, requiring special policy attention.[7]

The limits of the Bretton Woods system became obvious at the end of that decade: The United States ran high public-sector deficits to finance the Vietnam war, coupled with current-account deficits, and thereby exposed the rest of the world to imported inflation. The attempt of the German authorities to insulate the country from the monetary trends in the United States led to increasing market pressure on the deutschemark which had to be revalued by 9.3 per cent in 1969. The attempt of the French authorities to convert "excess" dollars into gold led to the closure of the American "gold window" ("Nixon shock") in 1971 and finally resulted in the collapse of the Bretton Woods system.

[7] Cf. Scharrer (1971).

Table 1: Regional Trade Integration of the EU and East Asia, 1970, 1980, 1990
in per cent of total exports

a) European Exports to Selected Regions

		Western Europe[1]	of which EU (EEC)	USA	World[2]
EU (9)	1970	66	50	8	100
EU (12)	1980	67	56	6	100
EU (15)	1990	72	66	7	100

b) East Asia[3] Exports to Selected Regions

		East Asia[3]	of which Japan	USA	World[2]
East Asia	1970	27	7	28	100
	1980	33	10	22	100
	1990	37	8	27	100
Japan	1970	19		32	100
	1980	23		25	100
	1990	26		33	100

[1] Including Turkey and Cyprus.
[2] Excluding Taiwan.
[3] Japan, P.R. China, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Thailand;
excluding Taiwan.

Source: Own calculations based on IMF, Direction of Trade Statistics.

5. "Werner" plan of EMU and snake

As early as 1969, at the end of the "transition period" to the Common Market, the European Heads of State and Government, at their Summit in The Hague, had committed themselves to transform the Community into an Economic and Monetary Union. A major motive, besides the "need" to find a "new goal" for the EC, was the concern triggered by the revaluation of the deutschemark and a preceding devaluation of the French franc (1968), that market integration in the EC might suffer from repeated currency realignments and that the common agricultural policy based on a system of price support might be upset. Moreover, there was a great degree of political frustration about the "exploitation" by the United States. As it soon turned out, time was not yet ripe for this ambitious undertaking which was based, under the "Werner Plan", on a rather loose concept which barely concealed the political differences.[8]

The systemic shift to floating exchange rates in 1973 increased this concern. The joint float ("snake")[9], an instrument devised under the "Werner" strategy and a forerunner of the ERM, appeared to offer a solution by shielding the internal exchange-relations from the gyrations of the US dollar. However, in the face of highly divergent ("asymmetric") national policy responses to the first oil price shock, the United Kingdom, Italy and finally France had to withdraw and the snake slimmed down to become a narrow "DM bloc", with Germany, Belgium, Denmark, Luxembourg, the Netherlands and Norway remaining.

EMS and ERM Stage I

A new, and this time more successful move for regional monetary integration was started by a joint Giscard-Schmidt initiative at the Bremen Summit in 1978. Even though Europe and the world economy were at the brink of the second oil price hike conditions for success were better this time. Indeed, all parties were interested in a success. Germany suffered from "real" appreciations of the deutschemark against major European trade partners under the impact of the US dollar policy of "benign neglect". France had experienced a sharp acceleration of its rate of inflation and hoped to "import" price level stability by pegging the Franc to the deutschemark. Moreover, design of a "new" system offered France (and Italy) a face-saving return to the joint float, a political interest that was shared by the German government. Politically, the EMS was an attempt to "de-couple" the European economy from the US dollar and to establish a monetary counterweight to the United States, an objective shared by most member countries.[10]

The design of the system was such as to satisfy all participants:

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[8] Cf. Scharrer (1973).

[9] The "snake" started to operate already on 24 April 1972 within the wider band of currency fluctuations against the US dollar. Initial members were Belgium, France, Germany, Italy, Luxemburg and the Netherlands, with the United Kingdom, Denmark and - as an associate member - Norway joining soon thereafter.

[10] For a deeper discussion of the motives and objectives see Gros and Thygesen (1992, 35ff.).

- The "stability bias" of the system, a major German and Dutch objective, was obtained by the "parity grid", with fluctuation margins of $\pm$ 2.25 per cent around bilateral central rates, and an "asymmetric" obligation of the weak-currency countries to settle intervention balances in foreign assets (rather than their own domestic currency). In principle and also de facto interventions were (largely) undertaken in Community currencies.
- Weak-currency countries had access to generous lines of credit at preferential interest rates under three financing facilities (only one of which, the Very-Short-Term Facility, was constantly used in the end). They also benefitted from the provision that liabilities under these facilities were denominated in ECU, reducing their financial burden in case of a devaluation of their own currency.
- For new entrants, and in particular Italy, a "temporary" wider band for currency fluctuations of $\pm$ 6 per cent around the central rate was established. Participation in EMS, and especially in the exchange-rate mechanism, was voluntary (British request).
- A "divergence indicator" promised to offer a "fair" sharing of the adjustment obligations between hard and weak currency countries.
- "At the centre of the system" was the ECU, a basket unit of account named after the ancient French gold coin (écu), which was to serve as denominator (numéraire) and means of settlement in the "official" circuit (rather than the US dollar or any member currency) and exhibit a "European identity". The ECU got some prominence as a unit of account for international bonds.
- The European Monetary Cooperation Fund (EMCF/FECOM), set up in 1973, gave the system a (symbolic) institutional backing. Actual decisions were taken by the participating central banks and the EC Council (Finance Ministers/ECOFIN).

In a formal sense, the EMS was established outside the legislative and institutional framework of the EC by an agreement among the central banks of EC member countries. Only side aspects which were not crucial to the functioning of the system were covered by Community legislation. Yet, as mentioned above, the EMS owed its creation to the political initiative of the European Council (Summit), and there can be no doubt that the EC provided indispensable backing for its functioning and survival in view of considerable market tensions and economic policy conflicts.

In the first ten years or so of its existence (stage I), the working of the EMS was characterized by a sufficient degree of elasticity to account for differences in economic and inflation performance among member countries. Eleven currency realignments took place in the course of which the deutschemark was revalued by an average 40.4 per cent vis-ą-vis the other EMS currencies (excluding the Spanish peseta), with major variations from currency to currency.[11] In the same period the deutschemark fluctuated against the dollar in a range between 1.58 (31/12/87) and 3.47 DM/dollar (26/02/85); the record low was registered on 19/04/95 with 1.36.

[11] See Gros and Thygesen (1992, 68). Cumulative revaluations against individual currencies amonunted to (in per cent): Belgium/Luxembourg franc: 31.2, Danish krone: 35.2, French franc: 45.2, Dutch guilder: 4.0. Irish punt: 41.4, Italian lira: 57.7.

In the course of these events the deutschemark and the Bundesbank gradually evolved as the monetary (policy) anchors of the system. The German currency became the chief currency for interventions both at the margins and within the band ("intramarginal interventions"). This prompted other EMS member central banks to build up deutschemark reserves. More important for the performance of the system was that a number of central banks, in an effort to stabilize the exchange rate of their currency against the deutschemark and to take full benefit from the low German inflation rate, started to "mirror" the monetary policy of the Bundesbank. This gradually paved the way for permanently stable exchange rates of the members of the "core" group[12]: For them, the (modest) realignment of 12 January 1987 turned out to be the last one.[13] Even if not all EU member countries were then able to follow suit, the growing economic (policy) convergence made it possible to revitalize the project of European economic and monetary union.

6. EMS and ERM stage II

In the second half of its existence the EMS became subject to a major shake-up which not only changed its design decisively. There also emerged a sharp split between the "core" group and the European "periphery": In the fall of 1992 a number of countries from the latter group came under heavy market pressure to devalue their currencies. Various factors came together bringing about a profound change in market sentiment: A major "real" revaluation of the currencies concerned, due to sticky exchange rates against high and protracted inflation differentials vis-ą-vis the "core"; an extremely tight German monetary policy in the aftermath of German unification; unsynchronized national business cycles; and the narrow outcome of the French referendum on EMU which put the project into doubt. Besides, contagion effects applied, seizing all currencies beyond the narrow "core" - and to some extent even the French franc, a "core" currency. As a result, between mid-1992 and mid-1995 the Italian lira, the Spanish peseta, the Portuguese escudo, the Pound Sterling, the Swedish krona and the Finnish markka depreciated by 11 (FIM) to 35 (ITL) per cent against the deutschemark.

In addition, the band of currency fluctuations of the ERM had to be widened sharply from $\pm$ 2.25 to $\pm$ 15 per cent in order to stop "safe betting" against the monetary authorities. From a systemic point of view this meant that the ERM was "softened" to become a target zone system. After this forced departure it is highly unlikely that the previous order of narrow margins with obligatory interventions could ever be restored - in Europe or elsewhere. As it turned out, the exchange rates of the "core" currencies stayed largely within the previous bounds, due to an excellent inflation performance of the countries in question, continued economic and monetary policy convergence, but also - at times of crises - strong bilateral commitments to defend the central rates. Moreover, the goal of EMU added credibility to these policy efforts. This was

[12] Austrian schilling, Belgium/Luxembourg franc, Danish krone, French Franc, German mark, Dutch guilder.

[13] The Austrian schilling had been firmly pegged to the deutschemark already since [19xx], the Dutch guilder since 1983.

underlined by the early convergence of short and long-term interest rates of the "core" candidate countries at or near the German/Dutch level.[14]

For certain industries in the "core", among them notably the automobile industry, the massive drop of some "peripheral" currencies produced heavy problems since they had to adjust their export and selling prices sharply to the domestic price level in the countries concerned. This also led to greater regional price discrimination in Europe, to reimports and investigations of the European Commission into the pricing behaviour of firms. Large currency depreciations brought about charges of exchange-rate "dumping" and beggar-thy-neighbour policies which for some time appeared to threaten the very existence of the Single European Market. These charges were unfounded and the macroeconomic damages, temporary as they were, in the end proved lower than expected. Since the spring of 1995, exchange rates of the periphery countries have recovered, making good part of their previous losses. With the emerging prospect of a "wide" EMU of eleven members, covering the countries of the Southern EU periphery, exchange-rate expectations stabilized, currency fluctuations subsided and the interest-rate differential narrowed.

7. Some lessons

On balance it appears that for the first decade of its existence - and for the "core" group also beyond - the EMS with its cornerstone, the exchange-rate mechanism, has contributed to a more steady development of intra-EC exchange rates. This holds even though fluctuations of the US dollar against the deutschemark "ruled into" intra-ERM exchange relations from time to time. Volatility of exchange rates was reduced ( ). Monetary and to some extent fiscal policy convergence have been both a cause and an effect of this outcome. Central to the result was the credible commitment of the Bundesbank to price level stability, even if the Bank was not at all times successful in achieving this goal, coupled with the growing readiness of ERM countries to peg their currencies to the German monetary anchor. At the same time, intra-ERM exchange rates have not been immune from divergent developments in economic fundamentals in Europe, including cyclical differences. Until the late 1980s, real appreciations of weak currencies were periodically cushioned by adjustments of nominal exchange rates, even if governments deliberately aimed at maintaining some external pressure on the price level. Compared to the de facto rigidity of many "floating" Asian currencies, the EMS - formally a fixed exchange-rate system - was definitely more flexible, at least in the first years of its existence.

All currency realignments were, however, forced upon governments by market pressure. The notion that adjustments should be managed under an agreed Community procedure by "enlightened" governments was never translated into practice. In the late 1980s/early 1990s market signals became politically biased by strong market sentiment that in view of the EMU process any further adjustment of central rates had to be ruled

[14] The economic relevance of the commitment to EMU is demonstrated by the fact that the interest rates for the Danish krone stayed persistently above the rates for the Belgium franc, in spite of a superior Danish convergence record.

out. This gave support to a growing misalignment of currencies which in the end came to burst in the summer of 1992 when market participants revised their judgment under the impact of new information. The ensuing sharp overshooting of exchange rates and the resultant competitive distortions and frictions were much in line with recent regional experience in Asia (Japan, China, Taiwan versus the rest of East Asia) and in Latin America (Brazil versus Argentina).

The lessons are the same, too: Narrow nominal exchange-rate targets maintained over a medium-term period may seriously misguide market participants, lead to allocative distortions and finally give rise to sudden and sharp revisions of exchange rates with the tendency to major overshooting. This may disrupt regional (and world) trade and economic integration and produce international policy friction. As a rule, therefore, monetary authorities should refrain from committing themselves to a given exchange-rate level over the medium term. Exchange-rate targeting has worked in the small and rather homogeneous European "core" group because it was supported by lasting economic convergence and credible acceptance of a strong regional anchor to national monetary policy. The medium-term effect of wide target ranges remains to be seen; it appears that their chances for success depend crucially not only on the width of the band but on their flexible adjustment to differences in national economic performance.

The ERM countries were in principle prepared to have their currencies float against the US dollar in line with the deutschemark. Unlike the practice in Asia, German monetary authorities had no implicit or explicit target for the dollar exchange rate of their currency. Indeed, the "Nixon shock" of 1971 and the turn to floating in 1973 were greeted as opportunities to conduct an independent monetary policy, and the authorities were always mindful not to loose that independence. This did not mean that the Bundesbank which in Germany was in charge of exchange-rate policy took an attitude of "benign neglect" to the dollar rate. The Bank would engage in maintaining "orderly market conditions", and at times of extreme dollar strength or weakness it would seek to turn the trend by an appropriate interest rates policy, exchange-market interventions and/or policy declarations. On the whole this relaxed attitude to the dollar rate helped to avoid the rise of biased market expectations.

Fluctuations of the dollar had but a limited impact on intra-European trade. Most of this trade was denominated in the currency of the exporting or the importing country, with the deutschemark occasionally serving as a vehicle currency. Well-functioning spot and forward markets for all European currencies, ample non-dollar trade-financing facilities offered by domestic banks and the (non-dollar) Euromarkets, and the willingness of foreign traders to "de-couple" from the US dollar were conditions for this type of regional integration to succeed. This greatly reduced the incentive of the authorities to engage in stabilizing the dollar rate. In the course of European monetary integration the deutschemark gradually grew into the (limited) role of a vehicle currency for trade between Europe and the rest of the world (   ), thereby lessening the need for non-European market participants to refer to the US dollar.

The building up of deutschemark reserves by the central banks of other EMS members contributed to making the German currency an international reserve currency with a share in total world reserves of 15.9 per cent in 1995 (Bergsten 1997).[15] This is about equal to its share in private international assets of 15.5 per cent (Frenkel and Goldstein 1998, McCauley 1997). The role of the deutschemark as the European monetary anchor also helped to promote its use as a European and international vehicle currency in foreign-exchange trading, rivaling the US dollar in that function. According to a survey conducted by the Bank for International Settlements in May 1995, 19 per cent of total foreign exchange market turnover was in deutschemark (US dollar 42, Yen 12 per cent). Indeed, development of the international monetary system into a "triad" structure was reinforced by European monetary regionalism. In contrast to the yen, the deutschemark was no longer just the currency of a major national economy (as it used to be in the 1960s and 1970s), but a "proxy" for the European economy at large or the group of countries participating in the ERM.

The ECU was unable to assume that position. As a basket unit of account it lacked the support of a strong central bank. With the patronage of some member governments and the European Investment Bank the ECU succeeded, however, in establishing itself as a store of value and accounting instrument in the international loan and bond markets, and temporarily equalled the deutschemark in that capacity. The monetary turmoils of 1992/93 gave a fatal blow to that use: Between 1990 and 1996 the share of the ECU in the denomination of international bank credits and of bond issues fell down from 8.7 to 0.2 per cent, and from 8.1 to 0.7 per cent, respectively; for euromarket deposits it diminished from 4.5 to 2.7 per cent (Ochel 1998). Information costs of assessing the future value of the large currency basket had turned too high for both borrowers and lenders. Only with EMU coming in sight was the ECU able to recover some ground: The Maastricht Treaty established an identity of the (last) value of the ECU and the (first) value of the Euro.

8. Full-scale monetary integration: European Economic and Monetary Union

The project of economic and monetary union, initiated in early 1988 with the memoranda by Balladur, Amato, Genscher and Stoltenberg[16] was in line with the "logic" of integration: In the mid-1980s the EU had started its Single Market programme, to be realized by the end of 1992 and intended to create a truly integrated market of a continental scale. Important elements of this project were the complete and irreversable dismantling of the remaining capital controls and the creation of a European financial market. This challenged the proper functioning of the ERM and seemed to demand a new approach to monetary integration. Beyond this immediate concern there was the more general perception that in order to fully realize the benefits of the Single Market, comparable in economic size to the United States, a major item was missing: the single currency.

[15] One third of this (US$ 68.8 bn) was accounted for by the deutschemark holdings of EU central banks (Masson and Turtleboom 1997).

[16] Reprinted in Krägenau and Wetter (1993). See also Gros and Thygesen (1992, 311ff.)

9. National interests in EMU

Economic interests and objectives notwithstanding, political motives did play a highly important, and perhaps the overriding, role in the establishment of EMU. EMU and the euro were regarded as crucial elements on the road to a further deepening of the EU and strengthening the "European identity" and economic weight in a world of competing regions. The vision that EMU will consolidate the rapprochement of European nations, make the process of European unification irreversible and serve as a catalyst to political union was underlying Chancellor Kohl's statement that EMU was "a matter of war and peace".[17]

As with the EMS, important driving forces for EMU were the national interests. From a German political perspective, and in particular the perspective of Chancellor Kohl, the further strengthening of the ties with the members of the European Union - and above all with France - by a single currency and joint monetary decision-making was seen as an (additional) insurance against the temptations of a German see-saw policy which in the past had always turned out to Germany's disadvantage, as well as against the risk of German isolation in Europe. Moreover, the deutschemark's role as the anchor of the European Monetary System and the Bundesbank's role as the "key" central bank in Europe had repeatedly given rise to political friction - notwithstanding the fact that these roles were "earned" on the markets and politically "ratified" by the voluntary policy decisions of Germany's partners to peg their currencies to the deutschemark. Merging the Bundesbank with other central banks in the European System of Central Banks can be interpreted as an attempt to reduce that friction and thereby to gain more room for manoeuvre in other European and foreign policy areas - while at the same time transferring the Bundesbank model to the European level through strict and binding provisions of the Maastricht Agreement and safeguarding fiscal discipline by the provisions of Article 104c of the EC Treaty and the Stability (and Growth) Pact.[18]

The political interests of the other member countries of the European Union in EMU were generally different from the German interests and policy objectives, though by no means identical. Many feared that, without EMU, a re-unified Germany might emerge as the political and economic centre of gravity in an enlarged European Union and that the deutschemark would establish itself as "the" European currency. In this scenario, France, Italy, Spain and others found themselves "marginalised" and without effective economic and political influence (Giavazzi 1996). "Breaking the control of the deutschemark over the European economy" was (and is) therefore for many the very essence of EMU, as Ireland's Prime Minister bluntly pointed out when taking over the presidency of the European Council in [199x].[19]

In a more positive sense, member countries of the exchange-rate mechanism of the EMS which in the past had maintained strong links with the deutschemark, "shadowing" German monetary policy in order to keep their exchange rate stable vis-ą-vis the German currency, were demanding an equal say in the formulation of a "European" monetary policy which was guided by German domestic considerations

[17] For a critical view see Feldstein (1997).
[18] This and the following four paragraphs build heavily on Scharrer (1997).
[19]

alone. A situation in which monetary policy in large parts of the EU was de facto defined by the Bundesbank was considered to be in contradiction to the very political philosophy of the EU as a community of equals.

The economic arguments in favour of EMU were put forward by the European Commission (1990) in their study "One Market, One Money". In principle, they apply to all countries alike and need not be repeated. In addition, each member country had (and has) its own economic interest in EMU. Germany, an open economy with an export-to-GDP ratio of 25 per cent[20], had suffered from recurrent nominal and real appreciations of the deutschemark against the currencies of its European trade partners with which [57] per cent of Germany's foreign trade is conducted. Between 1989 and 1995 the deutschemark appreciated by 19 per cent against other EU currencies (31 per cent against the US dollar). Transformation of the EU into a single-currency area was considered to be conducive to strengthening Germany's position both as an export-oriented economy and as a European investment location. The latter had been impaired not only by high labour costs but by the expectation of business investors that the deutschemark would appreciate further in the medium term. Insistence on the convergence criteria reflected the German interest in an economic environment conducive to the continuation of the course of price-level stability set by the Bundesbank.

Some of Germany's partners in the EU, especially in the Southern league (including France), were driven by the motive that a European central bank governed by a pan-European policy board could be relied upon to pursue a less "rigid" monetary policy than the Bundesbank. A higher rate of money growth, with lower short-term interest rates, was (and is) seen by many as a means to stimulate GDP growth and employment - even though the poor European employment performance is mainly due to supply-side deficiencies. At the same time, countries suffering from internal and external credibility problems expected to overcome that credibility gap by their partication in EMU. For some, EMU membership is a substitute for domestic political and institutional reform which could not be carried through in the face of strong internal opposition.[21] These countries also wished to gain from the elimination of the interest-rate premium vis-ą-vis the deutschemark which had raised their nominal short-term interest rates by up to six percentage points (in Greece even ten points), and their long-term rates by up to four percentage points (in Greece nine points) above the level in the "core" area. Their cost of macroeconomic stabilisation and notably of budget consolidation would thereby be reduced.

From the beginning of the negotiations on EMU, France showed a particular interest in the external dimension of the venture. EMU was seen as a means to end American dominance of the international monetary system and economic "exploitation" of Europe by the United States. The French notion of "exploitation" is ambiguous, however. It may either mean that a weak dollar impairs European exports and leads to an export of European jobs to the US or, that a strong dollar "forces" Europe (and the rest of the world) to finance the US current account deficit. Central to the theme is the

[20] National accounts definition.

[21] The most important element of the reform, the granting of independence to the central bank, in principle could have been done by each country on its own. Yet it proved to be feasible only in the context of EMU.

idea that the United States, because of the leading position of the dollar as an international reserve, finance and trade currency disposes over some disproportionate monetary "power" which it deliberately uses to carry its political and economic self-interest. EMU and the Euro are seen as instruments to check that power.

10. Institutional elements of EMU

Negotiations on the institutional structure of EMU and the conditions for participation were finalized with the adoption of the Maastricht Treaty (an amendment to the EC Treaty) and the relevant protocols, above all the Protocol on the Statute of the European System of Central Banks and of the European Central Bank,[22] at the Maastricht Summit on 9-10 December 1991.[23] The main institutional elements and provisions are:

- A European Economic and Monetary Union will be created among all member countries of the EU that meet the criteria for participation ("convergence criteria"). Exceptions apply to the United Kingdom and Denmark.
- The Euro will be the single currency of EMU.
- The Euro will be managed by the System of European Central Banks (ESCB), composed of the European Central Bank (ECB) and the national central banks of participating countries. It disposes over the necessary policy competences and instruments to perform its functions (with the possible exception of exchange-rate policy, see below).
- The ESCB is bound to the primary objective to maintain price stability. Without prejudice to this objective the ESCB shall support the general economic policies in the Community.
- The ESCB will be governed, and all monetary policy decisions will be taken, by the Governing Council, comprising the members of the Executive Board of the ECB and the governors of the national central banks.
- In the performance of their functions, the ESCB, its member institutions and the members of their decision-making bodies are guaranteed political independence.
- The ECB and national central banks are prohibited from extending any credits to public authorities.
- The Community and member countries shall not be liable for the financial commitments of another EU member state or its bodies ("no bail-out").
- Member governments shall avoid "excessive deficits" (including excessive indebtedness) as defined in the Treaty. A procedure for the surveillance of member countries, including graduated penalties in the case of non-compliance, is provided for. The Stability and Growth Pact gives additional substance to these provisions.
- Competence for exchange-rate policy is split between the EC Council and the ESCB. The EC Council may, by unanimous vote, conclude formal agreements on an exchange-rate system for the Euro in relation to non-Community currencies. In the absence of such a system it may, by a qualified majority, formulate general orientations for exchange-rate policy. They shall be without prejudice to the primary

[22] Reprinted in Krägenau and Wetter (1993) and, in English, in Gros and Thygesen (1992).

[23] The final version of the text was formally signed on 7 February 1992.

objective of the ESCB to maintain price stability. The ECB and the national central banks may acquire and sell spot and forward all types of foreign exchange assets an precious metals on the initiative of the ESCB. They hold and manage these assets.

- The Council shall, by a qualified majority, decide the arrangements for the negotiation and conclusion of agreements concerning monetary or foreign exchange regime matters. These agreements shall be binding also on the ESCB. Furthermore, it shall decide, by the same majority, on the EC position at international level as regards issues of particular relevance to EMU and, by unanimous vote, on its representation. The ECB and the national central banks may establish relations with foreign central banks and financial institutions and, where appropriate, with international organisations. They may conduct all types of banking transations, including borrowing and lending operations, with third countries and international organisations.

After the decision of the European Council on [ ] May 1998 to enter into EMU with eleven member countries[24], the European Central Bank was established on 1 June 1999. It started operating, within the framework of the European System of Central Banks (ESCB), on 1 January 1999. The initial base interest rate was set at three per cent. On the international arena the euro started strong: The market exchange rate for the dollar was determined at 1.16 dollar/euro on the first trading day (04/01/99).

11. EMU and the international monetary system

Transition from the EMS to EMU implies transition from a "soft", decentralized and contestable monetary integration scheme to a "hard", centralized and irrevocable regional organisation. The impact of the far-reaching European decision on the structure and working of the international monetary system cannot be fully appraised at this point of time. Yet, some trends are likely. They have an influence on Asia, too.

First, in a rather general sense, the European "weight" in the international monetary system will be strengthened. Creation of a monetary entity comparable in economic size to the United States, with a single currency and a single decision-making monetary authority, the ESCB, means a quantum jump from the previous monetary organisation grouped around a "medium-sized" national currency, the deutschemark. At the same time, EMU is still far from being fully comparable to the United States. It is made up of integrated but politically independent states with different economic institutions and philosophies which retain, inter alia, their fiscal authority and continue to pursue their own national economic and political interest.

Secondly: In view of the institutional precautions taken in the Treaty, including the plain policy assignment given to the ESCB, EMU is in a good position to become a region with a low and relatively stable rate of inflation. This should encourage business investment and reduce volatility on the financial markets. Investment should also benefit from the creation of a large economic area without the risk of intra-regional

[24] Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

competitive distortions produced by exchange-rate fluctuations and misalignments. Whether Europe will be able to exploit its chances for growth and employment will, however, crucially depend on its readiness to carry through structural reform against the opposition of organized interest groups.

Thirdly, EMU will turn into a highly integrated financial region with a wide and deep financial market, offering private and public investors and borrowers a great choice of financing options at attractive conditions. With the euro as the single currency of the EMU area the fragmentation of the national financial markets in Europe will be overcome.[25] However, the euro financial market will be more than simply the aggregate of existing national markets. It will offer a wider spectrum of financial instruments and deeper, i.e. more liquid, and less volatile secondary markets. After an adjustment period it will therefore rival the US market in both scale and scope.[26] National stock and bond market indices have already been overtaken by European indices like the Euro STOXX which allow the investor to evaluate the performance of his investment in a regional perspective. The euro money market had a good start thanks to the large-scale payments system TARGET operated by the ESCB.

These developments offer new investment and borrowing alternatives to private and public financial agents world-wide. Business enterprises, financial institutions and monetary authorities, in Asia as in other regions of the world, should be able to take benefit from this possibility to diversify their portfolios into a currency of equal standing with the US dollar. As far as private assets are concerned, Henning (1997), Bergsten (1997) and Ochel (1998) have estimated portfolio shifts from the US dollar into the euro of US$ 350-700 bn, depending on the assumptions. Total asset shifts, including official foreign-exchange reserves, have been estimated at US$ 600-800 bn (Ochel 1998).

Whether this will lead to an appreciation of the euro against the dollar is highly dependent on the time path. It is fair to assume that the restructuring of portfolios will be spread over a considerable period of time since investors will wish to assess the future performance of the new currency in the light of experience. Moreover, the present interest-rate differencial in favour of the US dollar reduces the incentive to switch funds to the euro market. The exchange-rate effect is also dependent on the future growth of euro lending to international borrowers which would involve money outflows. The future strength of the euro will also crucially depend on the economic performance of the EMU region.

Fourthly, the role of the euro as a reserve currency must be seen against this background. The foreign exchange holdings of monetary authorities are but a subgroup of total international assets. The short-term effect of EMU is that international reserves decline by the amount of intra-EC deutschemark holdings. By the same token, the share of the US dollar will increase in the short run. This effect will be reversed or over-compensated when foreign monetary authorities restructure part of their reserves into euro. Compared to the previous financial markets for deutschemark and other national European currencies the euro financial market offers the advantage of being both wider

[25] On the transformation of national financial markets into a euro market see, e.g., Kotz (1998); Deutsch and Siedenberg (1998).

[26] For a comparison of the present market volumes of the US and aggregate European financial markets see, e.g., Bergsten (1997), Ochel (1998), Schröder (1998).

and deeper (i.e. more liquid). This should serve as an incentive to step up investment in Europe. However, the euro market is lacking a strong large-scale borrower comparable to the US Treasury. Instead, several national treasuries offer a variety of financial instruments, with relatively thin markets. With that, Europe is certainly at a competitive disadvantage relative to the US financial market. This disadvantage is of some importance especially as far as official reserve holdings are concerned.

Fifth, the euro financial market is lacking both a central authority for the prudential supervision of financial institutions and markets and a clear assignment of the lender of last resort. Both functions are presently decentralized and assigned to national authorities. Under the Single Market programme the full liberalisation of capital movements was achieved. Moreover, common regulatory standards for the operation of financial institutions (banks, investment banks, brokers, insurance companies etc.) were established and the rules for their prudential supervision were harmonised. The Second Banking Directive of 1989 introduced the Single Banking License ("European Passport") under which banks were allowed to operate throughout the Community by offering cross-border financial services and establishing branches. Under the principle of home country control constituted with that Directive supervision of branches within the EC was assigned to the authority of the home country of the parent company. Subsidiaries remain subject to the supervision of the host country. This solution served its purpose when cross-border activities were limited. EMU has given a strong incentive to banks to widen their regional scope in Europe, by expanding their subsidiaries and acquiring local banks. This calls for a more centralized supervision of the group activities, to complement (or substitute for) national control of the group members. The same applies in principle to the function of a lender of last resort. For the time being the EC does not appear fit to deal with region-wide financial crises.

Sixth, for foreign - including Asian - enterprises operating in the EMU11 (through production or trade subsidiaries) or doing trade with EMU countries, European transition to the Euro offers the perspective of saving transaction costs. Cash management in Europe can be rationalized, the cost of hedging against exchange-rate risk will diminish, charges for money transfers will be lower, information costs can be saved. The expected internal stability of the euro will reduce the volatility of inflation and thereby enhance investment planning. The same effect should be expected from the creation of a single-currency area of continental scale. This will also assist foreign investors in organizing an efficient, integrated European production, logistics, and distribution network cutting across national boundaries. Inasmuch as EMU is stimulating EC growth and investment this should seen as also benefitting, rather than giving rise to concern to,[27] the rest of the world.

Seventh, the euro is likely to assume the role of a pivot currency for a wider, inofficial "euro zone" including non-participating EU countries, economies in central and eastern Europe, Russia and other CIS countries, the Mediterranean and the countries of the franc zone in Africa[28] (CFA franc and Comorian franc); all of them economies

[27] Concern has been expressed, e.g., by Korean enterprises suspecting an augmentation of competitiveness of their European competitors (N.N., 1999). This concern is unfounded since a speeding up of European production and income growth will also increase demand for foreign products.

[28] Member countries of the West Arican Economic and Monetary Union (UEMOA) and of the Central African Economic and Monetary Community (CEMAC), Comoros.

with strong trade and financial relations with EMU11 and the EU at large. It is true, the new formal ERM2 devised for EU countries not (yet) members of EMU may be of but limited relevance; only Denmark (with a "band" of $\pm$2.25 per cent) and Greece ($\pm$ 15 per cent) have declared their participation in the scheme, with the United Kingdom and Sweden abstaining. Nevertheless, the euro will gain a strong market position as the preferred transactions currency of private agents in intra-regional trade and finance.[29] This development will probably be enhanced by the voluntary unilateral pegging of some currencies to the euro, even if the peg is not fixed but adjustable over time. In certain CEEC countries the euro will substitute for the deutschemark as the monetary anchor and/or domestic store of value, unit of account and means of payment. In others, like Russia, it may partly displace the dollar.

As a consequence, the euro will increasingly be used as a vehicle currency in trade, financial and exchange-market transactions between private and official agents of the "euro zone" and parties in third countries, including Asia. Again, relative to the pre-EMU situation, this development will help to save transactions costs, it will "economize" on the use of currencies and thereby promote international market integration.

Eighth, what will be the impact of the rise of the euro for the operation of the international monetary and financial system? To begin with, the number of (major) currencies will be reduced. This "rationalization effect" should promote the efficiency of the system even though an Asian counterpart of comparable "weight" is missing. The effect on exchange rates is difficult to assess. To the extent that both the US and EMU will continue to pursue a path of economic, monetary and financial stability, the bilateral euro-dollar exchange rate should not be subject to major fluctuations. The presence of a strong socio-economic "competitor" across the Atlantic coupled with a highly sensitive indicator of relative performance, the bilateral exchange rate, should serve as an incentive to economic and monetary policy-makers in both EMU and the United States to proceed on that path. Yet, success cannot be taken for granted. Economic performance of EMU is the result of the independent action of eleven national governments and of organized national interest groups, only loosely coordinated by a single monetary policy, the rules of the EC Treaty and of the Stability and Growth Pact on fiscal soundness, and a formal but soft process of economic policy cooperation in the EU council (ECOFIN).

With the start of EMU and under the impression of the recent financial and monetary turmoils in Asia, Russia and Latin America, the international exchange-rate regime has become an issue of discussion. Some European and Japanese policy-makers are in favour of a more stable exchange-rate structure, to be achieved mainly by means of target zones, however defined. This move is heavily opposed by US policy-makers, and also the European Central Bank has voiced strong reservations.[30] Indeed, various arguments speak against this approach. To begin with, the sharp currency depreciations in the course of this decade have been the consequence of preceding stickiness of exchange rates in the face of underlying economic maladjustments and heavy structural deficiencies. Not less, but more exchange-rate flexibility is therefore warranted.

[29] For instance, at the London stock exchange and from mid-1999 also at the Copenhagen exchange major stocks will be quoted in euro.

[30] See, e.g., Duisenberg (1999a).

Moreover, with the entry into EMU and the adoption of a single European currency there is now even less need than before to stabilize the bilateral exchange rate against the US dollar, since dollar fluctuations are no longer able to disrupt the European exchange-rate structure. The European economy is now much more "closed" than before. Finally, target zones cannot live up to their promises. If they are wide - and fluctuations of the deutschemark against the dollar in the 1990s have been within the proposed range of thirty per cent (± 15 per cent)[31] - they are rather meaningless. If they are narrow, and are defended by exchange-market interventions, they are an invitation to currency speculation and may undermine the primary objective of monetary policy, price level stabilisation. Only if the ESCB would be prepared to target its internal monetary policy to the exchange rate of the dollar - rather than to the EMU price level, as stipulated by the EC Treaty - would there be a chance that exchange-rate targeting could succeed. It is quite appropriate, then, that "the eurosystem in its monetary strategy deliberately does not specify a target for the exchange rate of the euro" (Duisenberg 1999b).

The European Council, at its meeting in Luxembourg in December 1997, has agreed that it will formulate orientations for exchange-rate policy only under extraordinary circumstances, as for instance in the case of clear exchange-rate distortions. This line appears reasonable, it should be maintained.

More important than "progress" on joint exchange-rate management appears progress on internationally coordinated approaches to prudential supervision of financial institutions and markets, including supervision of hedge funds and/or bank lending to these institutions. It is in this area that the EU, the US and Japan should seek a closer cooperation.

Ninth, not too much should be expected from economic policy cooperation and coordination at the G-7 level. As mentioned above, the EC Treaty (Article 109 par. 4) foresees that the Council shall decide by a qualified majority "on the position of the Community at international level as regards issues of particular relevance to economic and monetary union." Representation of the Community must then be determined unanimously. It is conceivable that as a rule EU and EMU will be represented by the ECB in matters of (internal) monetary policy and by the EU presidency and/or the European Commission as far as economic issues are concerned. In some instances, e.g. exchange-rate policy or the proper mix of monetary, fiscal and structural policies, both bodies should be involved. The actual role and competence of the Presidency (and/or Commission) in the international negotiating process remains to be seen. Past experience demonstrates that in matters concerning, e.g., international fiscal coordination member countries insist on their national competence, in accordance with the provisions of the EC Treaty. The negotiating authority of the EC "spokesperson" is therefore likely to be limited. The same holds for issues concerning the future international monetary and financial "architecture". The G-7 will therefore continue to be relevant.

As to the representation of EMU at the International Fund, the IMF's Articles of Agreement extend membership only to countries. The euro area is thus not able to appoint a Governor or an Executive Director to the IMF. On 22 December 1998 the IMF

[31] For a (notional) central rate of 1,60 DM/dollar the margins are at 1.36 and 1.84, respectively.

granted observer status to the ECB under which the ECB will be invited to participate in Executive Board meetings on IMF surveillance over the monetary and exchange rate policies of EMU and over the policies of individual EMU member countries as well as on a wide spectrum of other issues of mutual interest to the IMF and the ECB (IMF 1999). This means that EMU is now represented in the IMF by one central bank (with observer status) and eleven governments. Adoption of a single currency in EMU will also require adaptation of IMF surveillance over member countries of EMU to include discussions with the ECB and, as far as exchange-rate policy of the EC Council is concerned, with ECOFIN (Deppler 1998).

The gradual growing of the euro into becoming a world currency should strengthen the European position in the Fund even though the European "voice" remains split. It remains to be seen whether the EU will be able to present own initiatives and common views on issues at hand. This would be a condition for rolling back the strong US influence on the IMF.

Tenth, the implications of monetary integration in Europe for East Asia are far from clear-cut. From the foregoing discussion it should be obvious that neither the EMS model nor the regional monetary anchor function of the deutschemark can be easily "exported" to Asia. This is even more true for the transition to economic and monetary union. At the same time, with further increasing regional market integration in Asia and a lessening of economic ties with the United States, and taking into account recent economic experience, a reorientation of Asian exchange-rate policy appears warranted. Transition to EMU and introduction of the euro offer new opportunities and choices for Asian business enterprises and monetary authorities. Economic performance in Asia will certainly not suffer from these institutional innovations which should therefore not be viewed as a menace but rather as a challenge. The Yen will not automatically gain (nor lose) from this development. Certainly it cannot be considered an attractive investment alternative for European central banks to place their previous deutschemark holdings. They owed their existence to the mechanics and incentives of the EMS. Whether the tri-polar structure of the international monetary system will receive support from EMU or whether the Japan's position will be eroded in the process depends crucially on Japan's own economic performance.

Is there a trend to further regional monetary integration? The recent financial and monetary crises have led to a reconsideration of previous approaches to exchange-rate management. In Latin America schemes of an even stricter pegging to the US dollar - by pegging internal monetary policy to a currency board - receive increasing attention. On the other extreme, the unpegging of exchange rates and their free floating appear a viable option. The intermediate solutions of the past have demonstrated their severe limitations and shortcomings.

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DRAFT - NOT FOR QUOTATION

LOCAL AND REGIONAL GOVERNANCE AND GLOBALISATION - LOGIC, TRENDS AND CHALLENGES IN EUROPE

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1. Introduction

International economic integration, often termed "globalisation", presents opportunities and challenges. Major benefits will accrue to countries which engage successfully in the globalising economy. However, certain aspects of globalisation threaten the simultaneous achievement of economic growth and social stability. The opening sections of this paper describe globalisation, its causes, its impact on labour markets and local economies, and some of its policy implications for national governments. Subsequent sections detail local programmes and policies which can help to ameliorate economic and social tensions associated with globalisation while exploiting the opportunities which globalisation creates. Emphasis is placed on what can be achieved through local measures that is unlikely to be attained by centralised initiatives. The final section addresses the reasons why coordination between local and central levels is often required.

2. Globalisation and its causes

Since the end of the second world war the world economy has experienced an ongoing process of globalisation of economic activities. This process has accelerated in recent years. The liberalisation of international and domestic trading environments, the growth in foreign direct investment, simultaneous and rapid technological change, and the emergence of new forms of inter-firm co-operation have all contributed to an increasingly integrated international system of production and trade.

Technological change in transport and communications has also accelerated globalisation. It is only over the last three decades for example that air freight has become significant for trade. The growth of air freight has assisted the geographic dispersion of individual industrial processes. Containerisation and the emergence of bulk carriers, supertankers and other forms of specialised shipping have also fostered trade. Similarly, technological change has been a cause of the growth of trade in services, and developments in telecommunications have encouraged the international manufacture and sourcing of industrial goods by multinational firms. Developments in international commercial law and the evolution of capital markets have also underpinned trade expansion, while the end of the Cold War served to accelerate international economic integration and draw public attention to globalisation.

3. Why should policymakers think globally ?

The potential gains from globalisation are many. Under an open trade policy competition can enhance allocative efficiency, effect structural change in industry and other sectors of the economy, encourage the adoption of improved processes, increase the use of superior imported inputs in production and afford scale economies. Globalisation also provides consumers with access to wider ranges of cheaper goods. Indeed, even elementary models of trade illustrate the economic benefits which accrue as nations sell what they are relatively efficient at producing and purchase what other countries produce with relatively greater efficiency.

However, there is quite widespread concern in OECD countries about the social and economic costs of enlarged flows of trade and investment. However, policymakers in fact have little realistic alternative to globalisation. A retreat into protectionism and re-regulation would simply entail a new distribution of such costs, not their disappearance. Protectionism would also involve losing the benefits of globalisation enunciated above. Furthermore, the technological changes which have spurred economic integration are irreversible. In short, with a view to raising average standards of income and well-being policymakers must accept globalisation, seeking to maximise its benefits and minimise its costs.

4. Globalisation and local communities

Increased international economic integration has major implications for local economies. These stem from the fact that internationally mobile factors have less incentive to invest in the prosperity of local communities than in the past. Of course, many companies have an interest in the economic well-being of their immediate environments. However, if faced with adverse local economic change, globalisation has made it easier for firms simply to outsource or relocate. Indeed, the locational behaviour of large companies has proved one of the most newsworthy features of globalisation. The enhanced ability to move out of areas in decline can add to the cumulative nature of local economic deterioration.

The link between globalisation and local development raises important issues of social cohesion. Social cohesion also has significant economic ramifications as social capital -- the complex of institutions, customs and relationships of trust conducive to co-operation -- is increasingly viewed as a key ingredient in economic success. An environment characterised by impermanence, weak commitment or socio-economic distress will not facilitate the accumulation of social capital. Furthermore, it has been observed that stocks of social capital tend to accumulate and decline in a self-reinforcing manner. As a public good, there is a role for public authorities in nurturing social capital, while the appropriate level of intervention in this sphere is predominantly local.

Globalisation also augments competition. This adds to pressure for specialisation, creates uncertainties and shortens product life cycles. Consequently, globalisation may increase inter-dependence among firms and create incentives for various forms of inter-firm collaboration (this collaboration is often local, but can also be national or even international). There is a range of services and policies which public authorities can consider in order to foster inter-firm collaboration. Many of these are best designed and implemented at the local level. And social capital is a valuable asset in attempting to realise such inter-firm collaboration.

5. Globalisation and labour markets

This section outlines the routes by which trade and investment flows influence OECD labour markets. The intention is not to review the growing literature on the quantitative impact of such flows, the conclusions of which remain uncertain.

Across the OECD there has been a decline in demand for low-skilled labour. This decline has been attributed both to trade (with countries possessing a comparative advantage in low-skilled labour) and to labour-displacing technological change. In fact, trade and technological change are likely to be intertwined as some producers change production processes in the face of import competition from developing-countries.

Rodrik (1997) describes the effects on labour markets of increases in the elasticity of demand for labour arising from trade and the mobility of capital (this elasticity reflects the extent to which employers can respond to changes in wages by purchasing imports or investing elsewhere). As trade and capital mobility grow this elasticity increases. In other words, in any given location or industry labour becomes more substitutable. This is true whether economic integration occurs with developed or developing countries. Rodrik shows how an increase in this elasticity causes: a greater share of nonwage costs to be born by labour (as capital can relocate if made to shoulder an unwelcome portion of these costs); increased volatility in earnings and hours worked; and a reduction in the bargaining power of labour vis-à-vis employers. Some authors have also pointed out that increased competition in product markets may reduce the rents accruing to labour in industries which were previously imperfectly competitive (Borjas and Ramey 1995).

6. Some economic and policy implications of globalisation for the State

Globalisation, and its concomitant of economic liberalisation, limit the number of responses open to policymakers. For example, raising revenue by taxing capital is problematic if capital can relocate easily. The adoption of a single European currency will entail the surrender of national exchange rate policy altogether, and a considerable circumscription of monetary policy. The European Court of Justice has considered the use of fiscal policy to reinvigorate economically depressed regions to constitute unfair competition. In a like manner, trade liberalisation obviously makes tariff policy redundant, while emerging debates on trade -- in such areas as environmental standards and competition policy -- may lead to further uniformity in policy. Indeed, as Rodrik states "Gone are the days when trade policy negotiations were chiefly about interference with trade at the border - tariffs and non-tariff barriers. The central trade issues of the future are 'deep integration', involving policies inside the borders, and how to manage it."

A reduction in the degree of policy freedom need not be negative. In the present context governments surrender policy choices voluntarily as part of the trade-off involved in realising the greater benefits of economic integration (although governments do not wish to forego the ability to tax capital). However, many of the problems addressed by the now outmoded policies remain, while, as discussed above, new economic and social tensions have emerged. Policymakers are still expected to contribute solutions. Indeed, policy inaction may be politically untenable. These considerations give rise to the following question:

Given the implications of globalisation for social cohesion, the difficulties of taxing capital and the generally reduced scope for policy from central authorities, can actions at the local level help provide an effective and efficient policy response to some of the changes brought about by globalisation ?

Various of the problems associated with globalisation may in fact require solutions at the national or even international level. For instance, it is difficult to see an effective response to the issue of taxing capital that does not involve inter-governmental agreement. However, local initiatives of different sorts should complement centrally conceived and implemented policies and programmes. Some important social and economic objectives can only be achieved through local action. And many national programmes can gain in effectiveness and efficiency from a degree of local autonomy in design and implementation. Locally-based programmes can increase the resilience of the local economy by fostering entrepreneurship, providing key business support services, developing linkages with outside investments, and increasing the density of economic and social linkages within an area.

7. Acting locally

The remainder of this paper focuses on how institutions at the local and regional level in Europe are adapting to the challenges of globalisation. It makes an assessement of the role of local and regional policies in meeting the key forces of globalisation. It then outlines how decentralisation trends are being played out in practice firstly at the level of individual European countries and secondly within the context of the European Union. Finally, some key challenges are identified for the development of effective local and regional governance in Europe.

Creating linkages with foreign direct investments

The social problems associated with footloose direct investment were referred to above. However, if local firms are able to establish supplier linkages with foreign direct investments in a particular area then the multiplier effects on the local economy will be increased. The foreign investment may also become less footloose. How strong either of these effects is will vary according to a range of factors (the type and volume of inputs supplied, the technical specificity of the inputs, the importance of other factors determining location, etc.). The Welsh Development Agency (WDA) is an example of a regional development body that has explicitly sought to match the purchasing needs of outside investments with the supply capacity of local SMEs. The WDA has also established supplier associations, partly to increase learning among local firms in those disciplines and practices required to meet the exacting standards of key customers. The Plato programme in Belgium and Ireland further illustrates how co-operation between large and small businesses at the local level can enable small entrepreneurs to obtain guidance from management experts. Clearly, the local embedding of outside investment is also advanced by providing the range of services, infrastructure, qualified workers, etc. on which the success of business typically relies.

8. The logic for local and regional governance

Impacts of globalisation

Globalisation and new technologies are associated with new markets and increasing competition involving almost all localities and regions in a process of restructuring. Different territories have been affected in different ways. Old industrial regions and regions dependent on traditional agriculture have tended to suffer whereas high technology complexes or flexibly specialised industrial districts have experienced growth. A key challenge for Europe is to facilitate local adjustment, particularly in the areas that have been most adversely affected, and to reinforce economic and social cohesion.

The often-cited paradox of globalisation is that whilst transport and communications improvements, increasingly footloose capital and more open markets would appear to make differences between territories less important in determining economic well-being, in fact a range of intangible factors make territory matter more, not less. Thus Porter (1998) argues that:

"the enduring competitive advantages in a global economy lie increasingly in local things - knowledge, relationships, motivation - that distant rivals cannot match."

Porter focuses our attention on the competitive advantages generated in industrial clusters, or geographic concentrations of interconnected companies and institutions in a particular field. Clusters encompass an array of linked industries and other entities important to competition, for example suppliers of specialised inputs and infrastructure, sophisticated customers, manufacturers of complementary products, companies in industries related by skills, technologies or common inputs and governmental and other institutions that provide specialised training, education, information research and technical support. The success of firms in many industrial clusters demonstrates the strong influence of the quality of the local business environment. It also raises the question of how to support economic development in areas that do not possess thriving clusters.

Globalisation has been associated with an increased competition between territories and the emergence of very high concentrations of unemployment in certain regions and localities of Europe, putting social cohesion under strain. As shown in Table 1, there are wide regional variations in unemployment rates within every European country. Moreover, OECD time series data on the evolution of regional disparities over the past two decades suggests that has been no general tendency for structural convergence among regions in Europe. In other words, those regions that had relatively low incomes and high unemployment at the beginning of the 1980s have tended to remain so.

Table 1: Regional variations in unemployment rates in the European Union, April 1995

Country	Highest unemployment region	Rate (%)	Lowest unemployment region	Rate (%)	Average rate (%)
European Union 15					10.7
Belgium	Hainaut	15.9	Vlaams Brabant and West Vlaanderen	5.3	9.4
Denmark	-	-	-	-	7.1
Germany	Magdeburg	18.6	Oberbayern	4.1	8.2
Greece	□□□□□□□ □□□□□□□ □□□	13.2	K□□□□	4.1	9.1
Spain	Andalucia	33.3	Navarra	12.6	22.7
France	Nord Pas de Calais	15.3	Alsace	7.1	11.2
Ireland	-	-	-	-	14.3
Italy	Sardegna	20.8	Trentino-Alto Adige	3.9	12.0
Luxembourg	-	-	-	-	2.7
Netherlands	Groningen	9.6	Utrecht	6.1	7.3
Austria	-	-	-	-	-
Portugal	Alentejo	11.4	Centro	3.9	7.1
Finland	Ita-Suomi	21.7	Aland	6.2	18.1
United Kingdom	Northern Ireland	13.0	East Anglia	6.7	8.8

Source: Eurostat (1997) Regions Statistical Yearbook 1996

The value added of the bottom-up approach

One of the reasons for the increased involvement of local and regional agencies or governments in economic development activities in Europe has been that national macroeconomic policies and investment incentives to attract mobile firms appear to have achieved little in terms of enabling the restructuring required in local socio-economies. Instead it is now widely accepted that policies designed and delivered at the regional and local levels are also required in order to support locally-based entrepreneurship and the performance of local clusters of firms based on improving the quality of their regional environment, for example in terms of physical infrastructure, business support services, labour supply and the technological base. Many declining and stagnant areas have relatively weak support structures in these respects.

Recent work by the OECD (1998) has looked closely at the factors influencing the intensity of entrepreneurship and shown that government policies designed and implemented at the regional level can have an important impact. Key policy measures include the provision of appropriately tailored advice and information services, the promotion of collaboration and networking between firms, the establishment of business incubators, improvements to the flow of finance to firms, improved skills formation and technology transfer mechanisms such as science parks. In delivering this type of support there has been a major shift to decentralise policies from the central to the regional level, founded on the belief that regional authorities are best placed to develop differentiated policies that build on the strengths and address the weaknesses of their areas.

Strengthening of local and regional institutions in Europe has also reflected the objective of improving governance and subsidiarity and providing new opportunities for democratic participation by moving authority closer to people. Local involvement can most effectively be achieved when new partnerships are built between regional government, businesses, professional bodies, the voluntary sector, public agencies and local people. Together these partnerships can develop a shared view of what needs to be done for the well-being of their areas and, by being in touch with local concerns and needs, they can build community support for that agenda. This also helps to mobilise new actors and to bring their competences and resources to bear in designing and delivering services within partnerships formed at the regional level. In this way the leverage of public expenditure can be enhanced and new resources can be brought forward. OECD (1996) showed how in the case of Ireland the establishment of local partnerships has helped to address issues of social exclusion in a more flexible, decentralised and participative way. Decentralised government can therefore be more responsive to local people and give them the powers and opportunities to contribute to the prosperity of their own communities.

A critical characteristic of regional and local development policies is the flexibility allowed in designing policies that meet local needs based on a locally agreed strategy. The nature of economic problems and opportunities varies between different local areas and therefore it is a mistake to try to homogenise the policy response.

9. Decentralisation trends in Europe

Decentralisation in European countries

Decentralisation has been carried out in some form by most European countries during the last 20 years, including a territorialisation of policies in the area of economic development and employment (OECD, 1997). Decentralisation processes have been particularly strong in France and Spain and regions were also reinforced in Belgium when the new constitution was drawn up in that country. More recently, Britain has moved towards devolving political power in Scotland and Wales, and modernising governance in England by promoting a mayor and assembly for Greater London and new Regional Development Agencies. Germany has had powerful regional government since the war, and there is ongoing debate about whether to decentralise further.

France: After a long history of strong centralisation in Paris, in recent years we have seen the gradual emergence of the regions. Regionalisation began in France in 1955 with the division of the country into 22 'programme regions' responsible for orientating public investments through the National Plan. The regions then gained in authority through legislation in 1972 and 1982. The regional councils have been set up with the function of elaborating regional development plans, supporting economic development, training and education. They administer two French regional policy grants and are also empowered to finance or guarantee loans, provide industrial sites and arrange business advice. While there has been some genuine decentralisation of government functions in France, central government maintains tight control of regional finances.

Spain: Following the end of the Franco regime Spain has put strong emphasis on decentralisation to its regions. The national territory is broken down into 17 autonomous communities set up between 1979 and 1983. Each has its own institutions: a legislative assembly, a cabinet and a supreme court of justice. In 1993 and 1994, the central government devolved more powers and responsibilities to the regions. The powers of the autonomous communities now cover 22 fields, including regional development and economic development. Their financing is a joint responsibility through a taxation system established in October 1993, reflecting a form of fiscal federalism with transfer of funds to the autonomous communities.

Belgium: Over the past decade the institutional and administrative trend in Belgium has been for the decentralisation of powers, the regionalisation of the territory and the federalisation of the regions: there is now a federal Belgium with three socio-economic regions (Brussels, Flanders and Wallonia). In 1980, the management and funding of regional policy was transferred to Flanders and Wallonia. In 1988, these two regions also became responsible for industrial policy. In the same year, the Brussels region was also given specific regional status. The central government no longer intervenes in the formulation of regional policy objectives or strategies.

United Kingdom: The United Kingdom is currently undertaking a large scale programme of devolution of powers towards regions. In 1999 a new Parliament will be set up in Scotland, new Assemblies will be set up in Wales and Northern Ireland and a Mayor and Assembly will be established for London. Alongside these significant changes are being made within England, with nine development agencies being set up in England's regions. These Regional Development Agencies will have the task of improving the economic performance of the regions. They have five overarching purposes; to promote economic development and regeneration, to promote business efficiency, investment and competitiveness, to promote employment, to enhance the development and application of skills and to contribute to the achievement of sustainable development.

Germany: In the Federal Republic of Germany, the post-war Constitution has created a broad decentralisation of power. As a result, regional development was mainly entrusted to the regional authority of the eleven Lander (states/administrative regions). Following reunification, five Lander were set up in the former East Germany. Regional development is a responsibility shared between the federal government and the 16 Lander. The powers of the Lander include, among others, various aspects of regional development and regional economic policy. Each Land develops its own course of action within the limits of the programme. These activities are funded equally by the federal government and the Lander.

One important element of decentralisation has been increased public spending and tax responsibilities at local and regional level. Table 2 illustrates the scale of decentralisation of public spending indicated through data on local government spending as a proportion of total government spending and the scale of decentralisation of tax responsibilities is indicated through data on local taxes as a proportion of total taxes. Combined spending by regional and local authorities varies considerably between countries, from between 10% of all government spending in Greece to 67% in Switzerland. In Italy it is approximately 25%. These discrepancies in the ratio of decentralisation of public spending indicate differences between European countries in the distribution of responsibilities between different levels of government. The significant scale of regional spending in some countries demonstrates that high levels of decentralisation are achievable.

The figures on decentralisation of taxes also show a very considerable degree of variation, with local taxes representing less than 10% of total taxes in Greece, Portugal, Belgium, the United Kingdom, Ireland and the Netherlands, compared with more than 40% in Sweden, Germany and Switzerland. In some cases there is a significant discrepancy between local tax revenues and local spending, for example in the United Kingdom, Ireland and Italy. In these countries local spending is highly dependent on transfers from central government and the scope for central controls on local spending are clearly greater.

Table 2: Decentralisation of taxes and spending in European countries, 1995

Country	Decentralisation of spending (Local government spending as % of total government spending)	Decentralisation of taxes (Local taxes as % of total taxes)
Greece	10	3
Portugal	15	9
Belgium	16	8
Iceland	22	20
UK	24	0
Italy	25	11
Ireland	28	3
Norway	28	26
France	29	19
Spain	30	20
Netherlands	32	5
Finland	36	34
Austria	37	31
Denmark	42	32
Sweden	44	41
Germany	57	48

Source: OECD, National Accounts

The local and regional dimension in European Union policies

One of the most fundamental trends in European Union policies has been the drive towards increased integration. The Single European Act of 1987 set in motion the process of establishment of the Single European Market and the 1991 Maastrict Treaty on European Union set out the process of achieving full economic and monetary union. At the beginning of 1999, a single currency area was established in 11 of the European Union countries.

Along with the more general forces of globalisation, economic integration within the European Union is likely to increase the exposure of regions and local areas to international competition and structural change. The European Union has therefore reinforced policies to promote economic and social cohesion. Thus, the Maastrict Treaty established economic and social cohesion as a Community pillar and set up an additional new Cohesion Fund for Member States with below 90% of European average GNP that are moving towards economic and monetary union. The latest 'Agenda 2000' proposals for restructuring of European Union policies in the light of enlargement of the Union to countries in Eastern and Central Europe confirm the importance of social and economic cohesion.

The European Union is putting great emphasis on regional and local structures to deliver bottom-up restructuring to achieve economic and social cohesion objectives. Thus in 1988 the Structural Funds were reformed in order to implement local development programmes in partnership with local and regional authorities. The Maastrict Treaty reinforced the concept of subsidiarity, or the sharing of decision-making between different levels of government, recognising the role of national, regional and local government authorities in deciding policies in appropriate areas. A Committee of the Regions was also established to review and comment on the policy proposals of the Commission. This is a visible recognition of the importance of the region in helping to shape European policies.

The European Commission has therefore been an important catalyst in the development of bottom-up economic development policies. In addition to the reform of the Structural Funds, encouraging as wide a range as possible of local actors in the design and monitoring of Community programmes, various Community Initiatives also seek to develop the capacity of local partners to work together. Amongst the most important are the LEADER programme which supports networking between local actors operating development policies in rural areas and the Territorial Pacts for employment drawn up between the European Union, local authorities and the private sector. Some 89 Territorial Pacts are now being supported by the European Union, built around the idea of extending cooperation between local and regional authorities, businesses, trade unions, chambers of commerce, higher education authorities and other local bodies. These Commission schemes play an important role in developing partnership and local capacity throughout the European Union.

10. Key challenges for effective regional and local governance

Local and regional development is an important activity that can help restructure local economies and meet social and community objectives in ways that cannot be achieved by policies designed at national or international levels. It has an important role in improving regional competitiveness, improving governance and local participation and mobilising resources for economic and social development. Europe should seek to reinforce this process of moving towards a territorialisation of policies and decentralising appropriate activities to the regional and local levels. However, there are certain challenges that must still be addressed in order to secure effective local and regional development approaches in Europe.

Finding an appropriate balance between different levels of governance: The benefits of decentralisation are closely tied to the capacity of regional partners to deliver policies that reflect regional conditions and it is important that regions are given enough autonomy to achieve this. At the same time governments should not simply decentralise all activities to local or regional level. Central government has important roles in coordinating policies and ensuring a fair distribution of resources. For example, decentralisation can exacerbate geographical disparities in policy provision unless there are systems in place to support regions with a weaker tax base with financial transfers. Furthermore, it is important to avoid a multiplication of functions between different levels of government with associated increases in public expenditure and reductions in efficiency. Decentralisation should therefore be viewed as part of a democratic process that divides powers and allows governments at different levels to be independent but coordinated within an overall framework.

Professional management: Increased power and expenditure at the regional and local levels must be accompanied by professional management. This requires professionally qualified staff, clear rules for attaching spending to objectives and output targets and the introduction of performance monitoring and evaluation across the network delivering services. There has been a tendency in the past for local and regional governments to manage by procedures, with the result that innovation has been stifled and performance impaired. Instead local governments and partnerships need to become more professional and qualified and in particular to manage by results and objectives rather than by procedures. It is the development of a coherent local strategy and the mobilisation of people and resources around it that makes local and regional initiatives effective. This requires committed and qualified local and regional development staff.

Need for monitoring, evaluation and information exchange: There is also a need for an increasing sophistication of local and regional development policy itself. Monitoring, evaluation and information exchange allows areas to benefit from policy innovations elsewhere and to refine and improve their own procedures.

11. The need for co-ordination between central and local authorities

Issues of decentralisation and subsidiarity are complex, and the institutional arrangements adopted must vary from one State to another. A country's history, polity, unitary or federal system of government, economic and social homogeneity will all affect the degree of autonomy best accorded to local and regional bodies as well as the choice of issues to which that autonomy should apply. However, there are generic reasons why centralised co-ordination and/or implementation may be necessary: If local policies have important effects on the welfare of other localities then inefficient resource allocation (from a national standpoint) may occur in the absence of central control; if policies entail economies of scale then they might best be implemented centrally; central co-ordination provides a degree of economic insurance because recessions and growth in different regions within a country are often not perfectly correlated; and centralised policy is required on equity grounds. This is because redistributive policies at the local level may become financially unsustainable owing to the movement of wealthy groups out of redistributive areas and the movement of poorer groups towards such areas. Discussion of the appropriate balance between centralised and decentralised action -- which will also depend on the public function in question -- goes beyond the scope of this paper. It suffices to say that, as this paper has attempted to show, local initiatives must complement central programmes for the response to globalisation to be most effective.

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