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**Kiel Working Paper No. 892**

**European Integration Deepening and Widening:  
Implications for Asia**

by

Rolf J. Langhammer

November 1998

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## European Integration Deepening and Widening: Implications for Asia

### **ABSTRACT**

*The paper discusses the relevance of past concerns about trade and foreign direct investment diversion to the detriment of Asian suppliers and hosts as a result of EU integration deepening and widening in the nineties. Based on recent empirical evidence, these concerns are rejected. As concerns integration deepening through the Single Market Program (SMP), trade resistance factors on the EU import side can be explained mainly by slow growth in Europe in the first half of the nineties rather than by SMP-induced trade barriers. Concerning integration widening toward Central and Eastern Europe (CEE), higher trade and investment shares of CEE are seen as a process of normalization which materialized earlier than the effects of the Europe Agreements. As trade overlaps between Asian and CEE supply on EU markets are low, the trade diversion fear is not well-founded. The paper also addresses the likely implications of the Single European Currency for Asia. Preliminary findings suggest that short-term implications are small but qualifications have to be made given the insufficient data base concerning the use of European currencies for invoicing, financial transactions, anchor and reserve purposes in Asia.*

JEL Classification: F14, F15

Keywords: Regional integration, trade liberalization,  
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# **EUROPEAN INTEGRATION DEEPENING AND WIDENING: IMPLICATIONS FOR ASIA**

## **I. Introduction: Where EU Integration Effects Come From and How They Are Transmitted to Asia<sup>1</sup>**

EU integration basically comprises two elements, integration deepening and integration widening. The process of integration deepening first aims at the economic union in the real sector, that is borderless movements of persons, physical capital, goods and services with necessary policy harmonisation either through ex ante administrative decisions or ex post market processes. The latter is made possible by mutually recognising national standards and allowing them to compete against each other. Second, integration deepening in the monetary sector is carried out by the European Monetary Union project (EMU) which in its third stage (irreversibly fixing bilateral parities between the national currencies and the Euro) starts on 1 January 1999.

Integration widening is equivalent to the fourth enlargement round (after 1973, 1981/87, 1995) which encompasses the Central and Eastern European countries (CEECs). This process is slotted in various parts of which the first

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<sup>1</sup> Asia in the following is confined to the ASEM countries thus excluding South Asia. The rationale of „splitting Asia“ is not only based on performance criteria as East and Southeast Asia has been the most dynamic region both as a purchaser of EU products and as a competitive supplier on EU markets but also on the fact that the intensity of economic interactions between South Asia and East and Southeast Asia has been low. Thus, the two regions appear as different entities.

comprises those countries chosen by the EU as being most advanced in economic transformation and democratic institution-building. These countries are the Czech Republic, Poland, Hungary, Estonia, Slovenia plus Cyprus the latter being the one of three countries with which the EU concluded Association Agreements in the sixties and seventies (the other two countries being Turkey and Malta). CEECs will have to pass through a long transition period before they are truly part and parcel of the Single Market.

Each of the two major elements has effects on third countries. Integration deepening can impact upon trade, income, investment and hence economic growth in the EU and thereby can influence income-induced and price-induced import demand for goods and services as well as regional patterns of investment of domestic and foreign companies. Such effects can materialise even if the absolute level of border protection remains constant. Third countries' income can additionally be affected via integration-induced terms of trade effects. Finally, integration deepening can also impact upon migration patterns but since migration is restricted and migration costs are often high, this effect will be omitted in the following. The same holds for public funds. With very few exceptions, East and Southeast Asian countries do not belong to the group of major aid recipients. Thus, this is not an important channel of resource flows from Europe to Asia.

Integration effects can be „once and for all“ (static trade and income effects)) without changing savings behaviour investment levels but they can also be labelled dynamic if a larger market carries scale economies and thus influences investment decisions. Integration deepening in the monetary sector carries the most speculative and uncertain effects on third countries via the role of the Euro as invoice currency, reserve currency, anchor currency and as a currency for financial transactions.

The effects of integration widening are traditionally rooted in the customs union literature and thus are summarised under trade creation vs trade diversion. In a dynamic setting, the question of whether investment is diverted from non-member countries to the new members has received even more attention recently, after EU preference margins declined with the lowering of tariffs on an MFN basis. Given that trade costs (defined as costs of bridging economic distance) between the EU and the CEECs are low, changes in access conditions between non-preferred Asia and preferred CEECs can principally trigger diversion effects.

Finally, a deepened and widened Union perhaps may follow different strategies in international fora (such as the WTO) or bi-regional fora (such as ASEM) compared to the old EEC-6 and thus again may affect income, trade and capital flows of Asian countries indirectly.

The paper is organised in a way that these possible repercussions of integration deepening and widening are taken into account for Asia which includes developing Asia and Japan. Section II briefly stylises the state of economic interactions (trade and capital flows) between the EU and Asia by the mid-nineties and the way toward this state. Section III links the state of economic interactions to EU policy measures in order to gauge the responsibility of the EU integration process (basically the Single Market Program (SMP)) for changing bilateral trade and investment patterns. Both measures for integration deepening and widening are considered separately as concerns their likely effects upon Asia.

Section IV takes a forward looking view by speculating about possible future changes in Asian trade and capital transactions due to further EU deepening and widening. Again, this view will differentiate between the real and the monetary sector. Section V concludes on the results.

## **II. Stylised Facts of Europe-Asia Economic Transactions**

### **1. Asian Trade Performance on EU Markets**

The Asian trade performance on EU markets in recent past can be characterised by a slight increase in shares in extra-EU imports from about 25 per cent to 28 per cent between 1988 and 1996. This overall rise hides two opposing trends. The Japanese share decreased by more than 3 percentage points to 9 per cent



whereas developing Asia improved its position by 6 per percentage point to almost 19 per cent (Table 1). Among developing Asia, the share of the four Asian NICs stagnated while those of ASEAN (excluding Singapore) and China rose. Hence, overall the lower-income Asian countries fared better than the higher- income Asian countries which seems to support more the classical inter-industry division of labour between regions with large differences in factor endowment and factor price ratios (the HOS pattern) than the intra-industry division of labour (the Grossman-Helpman pattern). Memo data on the EU export side in Table 1 yield that Asia became a much more dynamic export market for Europe than Asia became for Europe as a sourcing market. This finding underlines previous more detailed analyses on Europe-Asia trade patterns which identify trade resisting factors to be more on the European import side than

Table 1 – Synopsis of European-Asian Trade Relations

	Share in extra-EU 15 imports					
	Asian NICs 4	ASEAN	China	Asia excl. Japan	Japan	Total East and South-east Asia
1988	7.1	3.5	2.0	12.6	12.7	25.3
1990	6.4	4.0	2.6	13.0	11.7	24.7
1992	6.8	5.1	3.9	15.8	12.2	28.0
1994	6.7	6.2	4.7	17.6	10.4	28.0
1996	7.0	6.6	5.2	18.8	9.1	27.9
For comparison:	Share in extra-EU 15 exports					
1988	6.0	3.4	1.8	11.2	5.3	16.5
1996	8.6	6.5	2.4	17.5	5.7	23.2

Source: EU: European Economy, No. 3, 1997: 202-209.

on the European import side than on the Asian import side [Drysedale and Garnaut, 1993; Fukasaku and Martineau, 1996; Langhammer, 1998]. Whether trade-resisting factors during this period can be explained more by growth differentials between rapidly growing Asia and slowly growing Europe than by higher policy-induced barriers in the EU compared to Asia, cannot be answered without in-depth analysis. Yet, the fact that higher-income Asian countries producing relatively capital-intensive items showed a weaker export performance than China and the ASEAN countries supplying more labour-intensive goods supports the hypothesis that unbalanced trade resistance seems to have been caused more by growth differentials than by trade-restricting measures. However, the latter should not be neglected. Effective trade-restricting policy measures in the EU became stronger in more capital-intensive items (cars, electrical equipment, ships, steel) than in clothing and footwear. In fact, there is much evidence that by the end of the eighties, domestic adjustment in labour-intensive products had already been largely accomplished in the EU so that EU tariff protectionism in typical labour-intensive products became more redundant than EU non-tariff protectionism (subsidies, VERs, anti-dumping) in more capital-intensive products.

Over a longer period, a comparison between the absorptive capacity of the three major trading partners (EU, US, Japan) vis-à-vis Asian supply can shed more light on the relative openness of EU markets. Estimates of ex-post average propensities of import demand of the three partners draw a fairly positive picture of the EU (Table 2). During 1974-1990, that is the period between the first oil price shock and the collapse of socialist Europe, the EU propensities vis-à-vis developing Asian supply (3.2) slightly exceeded the US propensity (3.0) and were widely ahead of the Japanese propensity (0.9). As concerns the propensity for the first half of the nineties, the EU propensity (4.9) was even much higher than that of the US (2.4) but smaller than that of Japan. The reason is that prior to 1974, the US was already a major export market for Asia whereas the EU

Table 2 – Ex-Post Propensities<sup>a</sup> of Import Demand of Major Asian Trading Partners vis-à-vis Asian Supply, 1974-1995

Exporting region	Imports of			
		US	EU-15	Japan
Developing Asia (incl. China)	1974-90	3.0	3.2	0.9
	1990-95	2.4	4.9	5.6
Japan	1974-90	3.7	4.9	—
	1990-95	1.2	0.3	—
<sup>a</sup> Defined as the ratio between average growth of nominal Asian (Japanese) exports deflated with the Asian (Japanese) GDP deflator and average real GDP growth of importing regions. For Europe, growth rates of G-4 (Germany, Italy, France, UK) is taken as the yardstick for economic growth of the EU.				

Source: Own calculations from UN Monthly Bulletin of Statistics, various issues. – World Bank, Global Economic Prospects and the Developing Countries, 1997.

emerged as a new market after the mid-seventies. The Japanese market became open at a much later stage only. The same holds true for the propensity toward the Japanese supply. It was not until the nineties that the US showed a higher average import propensity toward Japanese products than the EU. It cannot be excluded that apart from trade policies and growth differentials also exchange rate volatility between the European currencies, the Yen and the Dollar may have influenced such differences and changes in propensities. These findings do not contradict the hypothesis mentioned above that trade-resisting factors were stronger on the EU import side than on the Asian import side. Probably, Asian average import toward Europe were even higher than those of the EU toward Asia. In general, the estimates do not place the EU behind the US as concerns import propensities. Overall, it is important to note that in spite of strongly reduced economic growth in Europe in the first half of the nineties import demand toward Asian products was not curtailed but was maintained especially toward products from lower-income Asian countries.

A particular concern in Asia after 1989 has been growing competition with CEECs on EU markets. This concern has been rooted in low economic distance between the EU and the CEECs, traditional trade links from the pre-war period, complementarity in resource endowment and, consequently, relatively low labour costs compared to Western Europe. In fact, gravity models reveal

that the „normal“ pre-war intensity of trade between Western and Eastern Europe became rapidly re-established long before the full impact of the bilateral free trade agreements (Europe Agreements) materialised [Piazolo, 1997]. Yet, given widely unchanged EU agricultural protection against CEECs and contingent protection measures against so-called „sensitive“ industrial products, the rise of CEECs share in extra-EU imports (including the successor states of the former USSR) was not spectacular (from 10.1 per cent in 1990 to 11.3 per cent in 1996).

More important for East Asia is the question of substitutability between its supply and that of CEECs in order to assess how strongly the two regions compete with their exports on EU markets. A suitable indicator is the Finger-Kreinin trade overlap index. Based on estimating overlaps between the developing Asia supply and the supply of individual CEECs (at the 4-digit HS level), one can conclude that overlaps scaled for the range 0-100 have been relatively small (up to 36) without a clear trend until 1996 (Table 3). While East and Southeast Asia reduced the share of typical labour-intensive products in its exports to the EU, for instance textiles from 20 per cent to 13 per cent between 1988 and 1995, CEECs either showed an increase or kept shares of labour-intensive products largely constant. In future, it is more likely that the relatively strong human capital endowment in the advanced CEECs and their accession to the EU will lead to more rapidly rising wages for both skilled and – as a complementary factor – also unskilled labour than we can expect for the more

unskilled labour-abundant Asian economies. This would suggest trade overlaps not to rise.

Table 3 – Trade Overlaps<sup>a</sup>: Central and Eastern Europe vs. East and Southeast Asia, 1989-1993 (percentage points)

	Food products			Non-food products		
	(HS 01-24)			(HS 25-99)		
	1989	1993	1996	1989	1993	1996
Poland	16.8	23.3	24.0	29.4	31.2	31.1
Hungary	17.1	19.5	20.8	30.6	36.0	36.3
Czechoslovakia	12.5	21.1 <sup>b</sup>	–	25.5	31.1 <sup>b</sup>	–
Czech. Republic	–	22.4	19.7	–	33.6	33.8
Slovakia	–	16.1	16.0	–	27.0	26.0
Bulgaria	16.9	20.8	24.2	25.0	32.3	26.8
Romania	11.9	17.3	21.9	23.0	29.9	27.3

<sup>a</sup>The overlap index is calculated by computing the percentage share of each product in total food or non-food EU imports from each country. This gives two values (percentage shares), one from each country, for every product group. The index is defined as the sum, over all food or non-food product groups, of the smaller of the two values. Figures are based on 4-digit commodity groupings of the Harmonised System (HS). Asian countries include Thailand, Malaysia, Singapore, Indonesia, the Philippines, China, Taiwan, Hong Kong, and South Korea. – <sup>b</sup>1992.

Source: Eurostat (various issues). – Own calculations.

## 2. Foreign Direct Investment

Compared to the intensity of trade links between East and Southeast Asia and the EU and compared to the growth record of Asia, European FDI in Asia has always been surprisingly low. It seems that European companies have a clear preference of exports over FDI. Given severe data bottlenecks as concerns EU

outward FDI figures instead of individual EU countries' figures, any firm conclusion is flawed by incompleteness, incomparability, and ageing database. Stock data for the three major EU countries (France, Germany, UK) which are reported to account for about 80 per cent of FDI in Asia suggest the developing Asia share in total EU FDI to have even declined between 1985 and 1993. According to these data, the share has shrunk from 4.4 per cent to 3.8 per cent (Table 4). Viewed from the host country side, the EU ranked third with about 13 per cent of total FDI stock in developing Asia in 1993 (US: 14 per cent, Japan 21 per cent; European Economy [1997: 231]). More recent data support the view that the mid-nineties have become a turning point. Langhammer [1998: 240] reports 1994 figures for individual EU member states (based on OECD data) which approach US levels. Even more recent German stock data [Deutsche Bundesbank, 1998] yield that by end 1996 developing Asia accounted for 5.5 per cent of total German extra-EU FDI. Investment in Japan accounted for 4.5 per cent. Still, however, these are small amounts compared to traditionally high German investment in Latin America (Brazil: 6.5 per cent in 1996) or in the three leading CEECs (Czech Republic, Poland, Hungary: 6.3 per cent). Whether the investment diversion argument can be supported from the rapid rise of investment in CEECs will be discussed below.

Table 4 – Share of Developing Asia in French, German and UK FDI Stock in the World, by Industry 1985 and 1993 (in per cent)

	1985	1993
Printing sector	6.0	7.1
Manufacturing	3.4	3.7
of which		
Food products	6.6	2.4
Textile, leather, clothing	0.5	1.5
Chemicals	4.2	7.4
Electrical equipment	3.1	3.0
Motor vehicles	0.8	0.5
Other transport equipment	11.8	2.0
Tertiary sector	4.3	2.8
of which		
Construction	8.6	0
Transport & storage	31.4	0.9
Finance, insurance	6.2	2.4
Other services	2.6	3.4
All sectors	4.4	3.8

Source: See Table 1: 227.

### 3. Bank Lending

Neither FDI nor bank lending are resource flows which are directly influenced by EU integration policies. Indirectly, however, these policies may have impacted upon capital account transactions. As concerns FDI, trade facilitation and liberalisation could be expected to induce export-oriented FDI to engage in EU partner countries provided that the domestic policy framework was appropriate. With respect to bank lending, liberalisation of banking services within the EU under the SMP has triggered a wave of mergers and acquisitions and has deepened European financial markets. Preparations for the EMU project were also instrumental to remove market segmentation in Europe. It is therefore no surprise that the Single Market helped European banks to become more global.



Interestingly, it is Asia which has become Europe's major global playing field. Between end-1995 and end-1997 European banks increased their share in total international bank lending to Asia from 38.6 per cent to 47.1 per cent and accounted for almost two thirds of incremental bank lending to Asia during this period (BIS 1998). The same share in incremental lending can be observed with respect to lending to all developing countries. Following the BIS data, German banks took the lead in European lending to Asia followed by UK and French banks. More than half of the increase in the Asian exposure of German banks in the first half of 1997 was accounted for by Malaysia and China and by the end of June 1997 German banks had the highest level of European exposure to South Korea and Thailand while still well below Japanese banks.

A closer look to German short-term bank claims toward Asian countries, however, reveals that European banks have not only been late-coming but also early-leaving. Between June 1997 (shortly before the outbreak of the Thai crisis) and September 1997, German banks reduced their short-term claims toward Thailand by one third. Whether such „last in-first out“ behaviour significantly differs from that of Japanese or US banks is open to scrutiny. Yet, if a high degree of risk aversion should really be found typical for European banks and if because of European banks being later-comers this risk perception should have been ex ante unknown to risk-prone Asian debtors, the mismatch of risk perception in European lender-Asian borrower relationship can have introduced additional volatility and vulnerability in short-term lending.

### **III. Can Past Europe-Asia Trade and Investment Patterns be Explained by EU Integration Policies?**

#### **1. The Trade Diversion Issue**

For many years, Asian concerns against European integration have centred on the general assumption that discriminatory integration policies would impede Asian exporter's access to the EU. This assumption had two facets.<sup>2</sup>

First, the SMP was feared to favour domestic producers in perfectly competitive markets over external imports as a result of declining internal trade costs (abandoning inner border controls, harmonisation of indirect taxation and technical standards, mutual recognition of national well-established regulations). For products under imperfect competition and increasing scale economies, the larger market would give rise to concentration processes and again push cost efficiency of EU products. In both cases, domestic producers would gain in competitiveness even if the absolute level of external protection would remain constant. In few products where prior to the Single Market still nationally different protection levels prevailed and where the Single Market required harmonisation of these levels (for instance, in cars, sensitive textiles, bananas) Asian exporters had specific concerns. They feared that the formerly relatively open large national markets (such as Germany in the abovementioned products)

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<sup>2</sup> In the following, the special case of the clearly discriminatory EU Common Agricultural Policy with its implications for special Asian exporters, such as Thai cassava exporters, is not taken into consideration. Nor is competition between Asian non-preferred and ACP preferred exporters of tropical agricultural products on EU markets addressed. These

would surrender to demands of protection raised by the formerly relatively closed smaller national markets (such as the Mediterranean EU member markets) and that the net result of harmonised external policies would be worse for Asia than the prior-Single Market situation of different national policies.

This first facet is not the classical Vinerian trade diversion case. This case underlies the second facet. In this facet, integration widening toward third countries, in particular toward CEECs, is feared to divert trade from low-cost Asian suppliers to high-cost CEECs suppliers.

To start with the first facet, during the early nineties, there has been an extensive theoretical and empirical discussion on the implications of the Single Market for extra-EU trade. As concerns Asia, different assumptions and estimates on price elasticities led to large variety of findings for different countries, regions and sectors. In a survey article, Hallett [1994] critically discusses partial equilibrium analyses by Davenport [1990] , Davenport and Page [1990], Langhammer [1990], Matthews and McAleese [1990], Page [1991], Nicolaides [1990] and Stevens [1990].

Findings range from optimistic scenarios [Langhammer] with trade and income gains for EU external trading partners to pessimistic scenarios [Davenport and Page] with trade diversion exceeding so-called external trade creation (income-induced higher EU demand for external imports). The former

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traditional issues were analysed in detail in various articles in a volume edited by

result is based on high ex-post income elasticities of EU demand for products supplied by fast growing exporters of manufactures (basically comprising the Asian exporters) so that external trade creation would outweigh trade diversion by a factor of 4. The latter result assumes higher substitution elasticities between EU supply and third country supply thus leading trade diversion to outweigh trade creation. What all studies have in common is that in perfectly competitive markets (probably the bulk of Asian supply in manufactures) the static trade effects are small in terms of GDP (less than a percentage point). Second, effects of harmonising quotas in few sensitive items could not be assessed given the uncertainties on the outcome of political bargaining between the more open traders in the EU, on the one hand, and the more restrictive traders on the other hand. Third, terms of trade gains arising from lower import prices of net importers of capital goods outside the EU due to enhanced competitiveness of EU suppliers should be taken into account. For developing Asia being in a position of a net importer, this would be a gain.

As concerns Asia in particular, Page [1992] notes gains for commodity-exporting ASEAN countries because of positive external trade creation and lack of EU domestic substitutes. On the other hand, Asian exporters of manufactures would lose because of trade diversion not being outweighed by positive terms of trade effects. Kreinin and Plummer [1992] join the „pessimistic“ view by

arguing that Asian manufacturers would have to incur a decline in export prices in order to cope with EU Mediterranean competitors who would enjoy tariff savings because of being full member states. This view was questioned by Langhammer [1994] in a detailed analysis of the Taiwanese export performance. He states that NIEs with a strong element of product innovation and up-grading including high service components would not have to fear trade diversion.

Finally, with respect to post-1992 effects, Verbiest and Tang [1991] in an ADB study on the medium-term effects of EU-1992 find increasing external trade creation over six years of SMP implementation, the magnitude for individual countries being dependent on the degree of trade intensity with the EU.

Evaluating the 1990-1995 access conditions of Asian suppliers on EU markets, there is more support for the optimistic view though the counterfactual is difficult to specify and though the dramatic shocks of the collapse of the Soviet bloc plus the post-German reunification boom in Europe and the subsequent recession have made a reliable stock-taking almost impossible. What is certain is that the harmonisation of national quotas did not prove to be a major disadvantage to Asia since parallel commitments of phasing out quotas made in the multilateral trade negotiations have widely contained the trade-restricting potential of quotas. Except for the special case of quotas on Japanese cars which expire at end-1999, the MFA quotas which are to be phased out under the UR,

and few quotas against an allegedly state-trading economy like China, quotas are no longer an important trade policy issue in manufacturing.<sup>3</sup>

The second facet, the possible extent of Asian losses in trading with the EU due to CEECs having free access to the EU, has been analysed by Horne [1995] and Horne and Huang [1996]. In the first paper, Horne [1995] applies different approaches of measuring factor endowments in CEECs and Asia and finds the former region (excluding the former Soviet Union) closely located to non-NIE East Asia in the Leamer Triangle of natural resources, unskilled labour and capital [Anderson, 1991]. Using measures of trade intensity, complementarity and trade bias (the latter being a measure of the relative strength of trade resistances), he finds CEECs and non-NIE East Asia to directly compete for export markets in unskilled labour-intensive goods. From this finding, there is a short way to identify trade diversion in case of privileged access of CEECs to the EU. Welfare losses as a result of trade diversion have been found to vary according to the degree of trade discrimination [Horne, Huang, 1996]. In a static CGE model, such losses are assessed to be the largest for Asia if CEECs and the EU would mutually concede free trade thus giving also EU producers on CEEC markets privileged access against Asian competitors (and not only CEEC producers privileged access against Asian competitors on EU markets). They are the lowest if free trade between EU and

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<sup>3</sup> Tariff quotas under the Generalised System of Preferences (GSP) are not considered here since the GSP is not part of negotiable trade policy but a substitute of non-negotiable aid

CEECs would also imply that tariffs on CEEC imports from non-EU countries are removed as well. Between the two cases, the case of non-reciprocal unilateral removal of EU tariff barriers against imports from Eastern Europe is located. In terms of trade volumes, the decline of Asian exports to the EU is a small fraction of a percentage point.

The study does not take external liberalisation of the EU into account which runs parallel to integration widening. Since implementation of the Uruguay Round commitments is pursued simultaneously to implementing the free trade agreement between EU and CEECs and since both EU and CEECs are WTO Contracting Parties, the trade diversion effects are overstated. What is also neglected is the impact of integration widening on the changes of the price of non-tradables in CEECs. Within the process of removing trade barriers between CEECs and the EU, CEECs' exchange rates have been subject to real appreciation since prices of non-tradables (basically labour) rose faster than prices of tradables subject to international competition and since former non-tradables became tradables. Such exchange rate changes were basically driven by capital account rather than by current account transactions. Foreign risk capital inflows in Poland, Hungary and Czech Republic have favoured the use of the complementary factor, skilled labour, and have via wage bargaining also driven the price of unskilled labour upward. This has partly eroded price

competitiveness which CEECs owed to discriminatory trade policies. In short, it is questionable whether a traditional static analysis of discriminatory trade policies comes to realistic results in transformation economies in which a new capital stock and related productivity gains lead to overproportionate rises of prices of labour both skilled and unskilled compared to goods prices. Real appreciation is at the same time a productivity whip for CEECs. For real appreciation to be sustainable, a permanent up-grading of the product supply is required. Translated into the Leamer triangle context, this would also mean that after successful transformation (as it appears to be in the aforementioned three CEECs), East Asia and the CEECs are no longer located as closely to each other in the triangle as at the beginning of transformation.

In short, there is a case for arguing that trade diversion between CEECs and East Asia is even less of a problem than the Horne/Huang results suggest in terms of small numbers.

## 2. The Investment Diversion Issue

With capital becoming increasingly mobile and with domestic market orientation being no longer the dominant motive of FDI, outsourcing within industries (“slicing up the value added chain“) has driven outward investment. Such push from globalisation is independent of integration policy measures but can lead to specific regional structures of investment flows if such measures make some hosts more attractive than others. It is probably because of the tail



wind from globalisation why the investment diversion issue has recently gained more attention than the trade diversion issue. This conclusion can be drawn from the aforementioned studies which discussed the external implications of the Single Market and unanimously rated investment diversion more important than trade diversion.

As in trade diversion, one can distinguish between the first facet, the growing attractiveness of the EU as host for FDI relative to other hosts, and the second facet, the growing attractiveness of the CEECs as hosts in the course of acceding to the EU. In both cases one can argue that risk premia on investment decline with accession thus shifting the ratios between rates of returns of investment between EU hosts and non-EU hosts on the one hand and between CEEC hosts and Asian hosts on the other hand to the benefit of the EU and CEECs, respectively.

The first facet has been narrowed down to the question whether one can observe a redirection of FDI toward the EU in the aftermath of the SMP. Such redirection can reasonably be assumed to be sector-specific because of substantial differences in driving forces behind investment decisions of industrial sectors. Hence, redirection would be reflected in (i) differences in the sectoral composition of FDI between regions and (ii) changes in the composition in specific host country regions over time. To put it differently, arguments against investment diversion would be supported if sectoral structures of FDI

across regions would be similar and if the composition would remain stable over time. This test has been performed for four EU home countries (France, Germany, Netherlands, UK) with sufficiently disaggregated FDI data for two periods, a pre-SMP period (1985-87) and a post-SMP period (1990-92) [Agarwal et al., 1994: 317-325]. The choice of the latter period was motivated by the observation that the credible announcement of the SMP induced investors to respond rapidly to the new policy environment by increasing intra-EU investment. The results of correlation analyses were rather inconsistent with pronounced investment diversion. First, the composition of FDI in non-EU industrialised countries and in developing countries was similar to that prevailing within the EU in the first period (statistically significant correlation coefficients between sectoral shares in total FDI within and outside the EU). An outlier was UK FDI in developing Asia. Its sectoral structure differed from UK intra-EU investment both in the first and the second period. The second test (changes over time) yielded that the pattern observed in the post-SMP period was largely the same as in the pre-SMP period. Again, correlation coefficients between the two patterns were significantly positive.

Hence, the SMP did not result in a pronounced reorientation of intra-EU FDI to sectors for which gains from integration deepening were expected to be particularly large, the capital-intensive sectors.

To further substantiate this finding of fairly limited investment diversion due to the SMP, changes in the share of intra-EU FDI in total FDI in the respective sector were analysed. For investment diversion to occur, one would expect an increase of this share as a necessary condition. As a matter of fact, the intra-EU share has increased for most of the manufacturing industries while FDI shares of other industrialised countries declined. Hence, developing countries' hosts escaped investment diversion. As concerns Asia, even in the case of Germany where FDI shares of developing countries declined, Asia did not suffer. Instead, German FDI stocks in Asia expanded slightly while the traditional host region for German FDI in developing countries, Latin America, incurred losses not because of the SMP but because of Latin American problems in coping with the debit crisis and subsequent structural adjustment.

A final empirical argument against this first facet of investment diversion can be drawn from a simple correlation exercise which compares the sectoral changes of intra-EU FDI with the corresponding changes of extra-EU FDI in developing Asia. The pro investment diversion hypothesis would be that growth of extra-EU FDI was relatively low or even negative in sectors for which intra-EU FDI expanded most rapidly. Hence, correlation coefficients should be negative. Such a pattern does not show up. Most of the coefficients were insignificant.

In general, it must be accepted that due to the small number of observations (because of the relatively high level of sectoral aggregation), these findings must be cautiously interpreted. But one does not find a consistent pattern for the assumption that the development of extra-EU FDI in Asia and other developing countries was significantly adversely affected by the expansion of intra-EU FDI.

The second facet refers to the possible diversion of investment from Asia to CEECs. Unfortunately, this issue cannot be simply limited to the question of relocating existing investment from Asia to the CEECs due to privileged treatment. It is more important to address the issue whether investment which otherwise had been attracted by Asia has now been attracted by the CEECs and that domestic investment in the EU was foregone due to new opportunities beyond the eastern EU border. Note that growth of real gross capital formation during the first half of the nineties in the EU was zero and that this might have also been explained by the new attractiveness of CEECs. Finally, even if one identifies the attractiveness of CEEC hosts for EU FDI relative to other host regions, it is still open whether this is due to EU integration policies launched via the Europe Agreements or whether it is the transformation process itself which induced resources to flow into a well-endowed region which was isolated since World War II. The credibility of economic transformation was supported by EU policies but without comprehensive domestic reforms in institution building, stabilisation and adjustment EU policies would have been obsolete.

This is demonstrated by the cases of the Slovak Republic, Bulgaria and Romania. EU assistance was neither necessary nor sufficient for CEECs to become attractive hosts.

What is beyond any doubt is that CEECs (primarily the three leading countries Czech Republic, Hungary and Poland) have become very attractive hosts during the first half of the nineties. This is most clearly demonstrated for Germany, the by far most important EU investor in CEECs. Between 1990 and 1996, the share of CEECs in German FDI stock rose by a factor of twelve to 3.6 per cent and thus in 1996 was sizeably larger than the sum of investment in the three NIEs plus Indonesia, Thailand and the Philippines (Table 5). Neither US nor Japanese investors engaged in CEECs worth mentioning though the advantages of privileged access to EU markets were not confined to EU investors. Instead, non-EU investors in CEECs were eligible for the same treatment as EU investors.<sup>4</sup> This is a first indicator against investment diversion. A second indicator is that German investment in Asian economies (NIEs and ASEAN-3) rose as well, admittedly at much slower speed than investment in CEECs. A third indicator draws upon a detailed comparative study on motives to invest in CEECs [Agarwal, 1996]. If investment motives are splitted into

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<sup>4</sup> There could be the argument that unlike non-EU investors, EU investors benefit from rules of origin tailored in favour of supply of inputs from the EU (the so-called home country content rule). However, this argument is not convincing. Non-EU-based investors who produce in the EU and consider outlocating part of their production to the CEECs can easily take advantage of these rules in the same way as EU companies. There is non-discrimination between EU-based and non-EU-based investors.

primary commodity extraction, domestic market orientation in manufacturing and cost orientation in manufacturing, it is basically the third motive which could give rise to investment diversion. However, survey results demonstrate that the advantages of low labour costs as a motive to invest in CEECs have not been as relevant as the domestic market orientation [OECD, 1993].

Overall, Agarwal [1996: 162] concludes that „there is so far no evidence of any meaningful diversion of FDI from developing countries to the EA countries (*the Europe Agreement countries, R.J.L.*)“. He also argues that the scope for investment diversion continues to be limited for two reasons. First, a sizeable portion of FDI is in primary and tertiary activities which are not prone to investment diversion because of binding investment to the availability of an immobile factor (a natural resource, for instance). Nor is investment prone for diversion which is targeted to the domestic market. Second, in cost-oriented investment, CEECs will see some of their initial cost advantages vanishing in the course of acceding to the EU. Finally, strong economic growth in CEECs catching up will promote domestic demand for products supplied by developing countries, for instance, Asia which in turn would lead to additional flows of FDI in these countries.

Table 5 – Share of Emerging Markets in FDI Stocks of Germany, US, Japan, 1990 and 1996, on Changes in Stocks (flows)

Host countries	Germany		Share in flows 1996-1997	US		Share in changes in stocks 1996 compared to 1994 <sup>b</sup>	Japan		Share in changes in stocks 1996 compared to 1994 <sup>c</sup>
	Share in stocks			Share in stocks			Share in stocks		
	1990	1996		1990	1996		1990	1996	
BIG-5	2.9	4.1	5.1	4.1	4.8	6.1	6.8	8.4	12.7
Brazil	2.4	2.8	1.1	3.3	3.3	3.9	2.1	1.8	1.1
China	0.1	0.7	2.3	0	0.4	0.6	0.9	2.8	6.6
India	0.2	0.2	0.4	0.1	0.1	0.2	0.1	0.1	1.2
Indonesia	0.1	0.1	0.2	0.7	1.0	1.4	3.7	3.7	3.8
Russia	0.1 <sup>a</sup>	0.3	0.6	0	n.a.	n.a.	0	0	0
NIEs (South Korea, Singapore, Taiwan)	0.8	1.2	1.7	1.9	3.0	3.1	4.3	4.1	3.9
Central and Eastern Europe (excl. Russia)	0.3	3.6	9.0	0	0.8	1.9	0	0.1	0
ASEAN-3 (Malaysia, Philippines, Thailand)	0.3	0.6	1.1	1.1	1.7	2.9	2.9	3.8	4.8
<b>Total</b>	<b>4.3</b>	<b>9.3</b>	<b>16.8</b>	<b>7.1</b>	<b>10.3</b>	<b>14.0</b>	<b>14.0</b>	<b>16.4</b>	<b>21.4</b>
a)1991. — b)Difference between stock data 1996 and 1994. — c)Values for fiscal years1995 und 1996.									

Source: Deutsche Bundesbank; US Department of Commerce; Japan Ministry of Finance.

Cost advantages of CEECs have already declined in the course of income convergence toward EU levels and because of a number of regulations which the countries had to accept in order to qualify for future full membership. Furthermore, exchange rate binding and strong capital inflows have already been instrumental to increase the price of non-tradables thus eroding initial cost advantages. Between 1995 and 1998, all major CEECs' currencies appreciated in real terms [Rosati et. al.: 10].

To conclude, it is more likely that it was domestic investment in EU countries (which as mentioned above showed zero growth in real terms in the first half of the nineties) which was substituted for by EU FDI in CEECs than EU FDI in Asia or other developing countries.

#### **IV. Entering the Next Millennium: What Asia Can Expect from Further EU Integration Deepening and Widening**

##### **1. The Institutional Infrastructure: Strengthening the Growth Momentum from Integration Deepening Without Centralisation**

By the end of the millennium, the EU faces a number of unprecedented institutional challenges which will profoundly shape the conditions under which partner countries maintain trade and capital transactions with the Union. Such institutional challenges have been part of deliberate political decision-taking and coincide with the economic challenges arising from shrinking economic distance and increasing tradability of goods, services, physical and human capital.



To mention but two of the institutional challenges, first the EU has irreversibly signalled integration widening toward CEECs in a stepwise approach. That will mean that the external economic relations of the CEECs and their underlying vested interests, for instance, toward Asia, will become part of EU external policies and will influence policy contents as well as the way how Europe negotiates policies. It is important to note that all acceding countries are small, economically open, relatively well-endowed with skilled labour but are poorly endowed with physical capital. Traditionally, CEEC governments have been prone to think in *étatist* terms, that is to assign redistributive functions to the public sector. However, the fact that their transformation into a market economy occurs at a time when pressure to deregulate and privatise has become a world-wide phenomenon, is likely to contain any excessive *étatisme*.

Second, in the old EU, a massive rethinking of the role of the state has begun. The negative impact of inflexible labour markets on employment, the adverse incentives of pay-as-you-go social security systems on national savings together with the unsustainability of such systems under foreseeable demographic changes, and, as a third factor, the increasing mobility of the tax base which puts a strong barrier against the continuation of subsidising weak sectors and regions, have given rise to a strong revival of market forces. They have also impaired the credibility of guarantees of state authorities toward „business as usual“ and extrapolation of salient trends. With supra-national Europe on the one hand, gaining more identity due to the Euro and other tasks

with scale economies, and with municipalities, cities and regions on the other hand gaining identities as well (for instance, as financiers of public services such as education and inner security), the in-between nation state stands to lose to both layers. Regions which neighbour to boundaries of countries begin to define common targets and instruments and thus add to borders become increasingly porous because of the SMP. Hence, integration deepening adds to redressing the role of the nation state without necessarily strengthening centralisation in Brussels.

The so-called Agenda 2000 which aims at accelerating reforms inside the core EU in order to make the accession of new member states manageable exemplifies the new trend: limiting state support to a level which is financially sustainable in an enlarged Union, replacing price support by income support and cutting the support volume, reallocating support in favour of the new periphery, reconciling support with international commitments such as the UR.

## 2. Speculating about Consequences from Changes in EU Institutional Infrastructure for Asia

Given the still relatively weak mutual trade and capital linkages between Europe and Asia (relative to linkages to the Mediterranean countries, the ACP countries, Eastern Europe), the „naive“ scenario of consequences for Asia could be to extrapolate the current trend. Such scenario could be explained with elements of inertia in current account transactions compared to the volatility and dynamics of those capital account transactions which are not simply the flip coin of current

account transactions. But even if we disregard the capital account for a moment, the „naive“ scenario does not seem well-founded for three reasons.

First, EU integration deepening can stimulate EU growth through accelerated structural change (de-industrialisation, de-regulation) and process innovation (outsourcing inside and outside the EU). Asia can benefit from this growth momentum in four ways, first by growing EU import demand for Asian supply, second, by acting as a host for EU outlocated production chains, third by enjoying term of trade gains due to European companies becoming competitive international suppliers of service-intensive products (such as the aircraft industry or the environment technology) in which Asia is a net importer, and fourth, by participating in alliances for providing global services with increasing returns of scale (airline services, maritime transport, internet services).

Second, the 1995 new entrants (Austria, Finland, Sweden) are small open economies which strengthen the relatively free-trade oriented group within the EU as far as manufactures is concerned (for instance, Denmark, the Netherlands, the UK and Germany). Hence, this could be seen as reducing the risk of protectionist policy decisions being taken by the Council [Widgrén, 1995; Bilal, 1998]. Against this optimistic view, however, well-founded sceptical views cannot be suppressed. First, EU trade policies remain a substitute for a common foreign policy which is still lacking. As foreign policies by nature are discriminatory thus treating each partner state as special, so are trade policies

[Messerlin, 1997]. This substitute role acts against MFN rules and explains why the EU has by far the largest set of bilateral „hub and spoke“ agreements which do not reflect what the late Harry Johnson once described as a „free traders view on preferences“.<sup>5</sup> Furthermore, each enlargement makes compromising on changes of a common trade policy more difficult because of the larger number of conflicting vested interests thus favouring the status quo. If this status quo was characterised by trade restrictions, such restrictions could be maintained. Finally, the enlargement toward the CEECs could strengthen the voting position of low-income countries which may claim for infant industry protection in a transition period during which they have to lower their external protection to the EU level. In anticipation of such claims, the EU could be tempted to take infant industry protection arguments of prospective member states into consideration when starting negotiations on the new multilateral round and thus become reluctant to liberalise trade in these industries. In a number of products, basically steel, footwear, textiles and clothing, Asian suppliers could become affected.

Yet, in my view, the optimistic view prevails with respect to Asia. The EU enlargement is very likely to offer options for Asia to penetrate new markets more rapidly than would have been possible without accession to the EU. In

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<sup>5</sup> Instead, one could label the hub-and-spoke systems as protectionist (trade diversion-oriented) if they are geared to favour privileged trading partners such as the ACP countries. Recent difficulties of Thailand to find unrestricted access to the EU for deep-frozen shrimps, for instance, are rooted in the EU policy to defend privileged market access for competing ACP countries. This policy, however, has often failed because of supply-rooted constraints to become competitive.

particular, liberalisation among CEECs is driven by the accession process and thus allows Asian suppliers to benefit from all advantages of a large unrestricted market in Central and Eastern Europe and not only from the opening up of individual countries.

Third, EU deepening and widening can be expected to impact positively upon the attractiveness of Europe as a host for private risk capital. The EMU – if not challenged by severe asymmetric shocks (see below) – will deepen financial markets in Europe and encourage innovations in financial services. Profound demographic changes in ageing Europe will require such innovations to emerge rapidly in order to substitute for the no longer viable pay-as-you-go social security schemes. In addition to ageing core EU member states, the CEECs urgently need private risk capital in order to replace an obsolete capital stock from the Socialist legacy. It seems difficult, however, to assess whether enlarged Europe will become a stronger competitor for private risk capital for Asia. On the one hand, early signals of tight monetary and fiscal discipline in the EMU region (in order to dissipate any concerns about the stability of the Euro) supported by scale economies due to removing financial market segmentation in Europe could lead to downward pressure on EMU interest rates and thus stimulate investment activities. The current account balance of EMU could move toward a surplus. On the other hand, these early changes could be followed by stronger growth and import demand, rising interest rates and an appreciation of the Euro. As a result, Europe would absorb more capital inflows.

Given that the full impact of integration widening and higher attractiveness of the enlarged Union for risk capital can be expected to coincide more with the second phase, the medium term message for Asia would be that Europe becomes more competitive for risk capital. In other words, Europe is very likely to become a more attractive place for allocating its own savings. This does not mean that investment which has already been installed in Asia will be diverted back to Europe but it is possible that the relation between fresh domestic investment (in the enlarged Union) and FDI (outside the Union) will change to the benefit of the former.

### 3. The Monetary Sector: Speculating about the Impact of the Euro on Asia

#### *a. Overall scenarios*

There is nothing more speculative than the possible impact of the Euro on Asia. Given the current state of knowledge, it is only feasible to stylise the possible direction of the external dimension arising from replacing European currencies by a single currency.

First, the impact can become effective via various links which cover the three different functions of a currency (medium of exchange, unit of account, store of value). The three functions materialise in the functions of transaction (invoice) currency, reserve currency, anchor currency and as an asset currency in international financial markets. For these functions to emerge outside the EU, it is essential that the European Central Bank (ECB) can accrue the same

reputation as a resort of stability and clear monetary guidance as the German Bundesbank and that EU financial markets can benefit from greater depth and breadth, lower costs of financial transactions due to removal of market segmentation and narrowing interest spreads between national bonds.

Second, whether or not a currency is a leading international currency, can be gauged by differences between the economic size of a country in world economic transactions and the use of its currency. In this respect, the picture is clear. By major possible uses (invoice currency in world trade, international bond offerings, developing country debt, global foreign exchange reserves), the Dollar is much more widely used than indicated by the share of the US in international trade or world GDP [Tavlas, 1998]. So is the sum of European currencies if intra-EU trade is excluded. However, this degree of internationalisation is much weaker than for the US. The use of the Yen is far behind the Japanese share in world trade. This pattern emerges even more clearly if instead of European currencies only the DM is taken as a reference [Hendriksen 1998, cited in Collignon and Mundschenk: 81]. According to Hendriksen, the DM had a share as invoice currency in world exports of 15.3 per cent in 1992 (US Dollar: 47.6 per cent, Yen: 4.8 per cent) and a degree of internationalisation<sup>6</sup> of 1.4. For 1999, Hendriksen „guestimates“ a share of the

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<sup>6</sup> The degree of internationalisation is measured as the ratio between the share of exports invoiced in the currency of a country and the share of the country in world exports.

Euro as invoice currency of 23-33 per cent and a degree of internationalisation of 1.4-2.

Third, like the US, the EU is an economy with a large domestic market after intra-EU trade has become domestic trade. Thus, the share of the EU in world exports will be at the level of the US (about 15 per cent) and the extra-EU export share in EU GDP will be less than 10 per cent (the latter share being smaller than the respective US share). This could mean that the susceptibility of the monetary union against external shocks declines while the susceptibility against EU country-specific (asymmetric) shocks increases. To cope with such shocks, countries hold foreign exchange reserves. Such demand for reserves could shrink for the Union in total and could also affect demand for holding US Dollars. In general, with more world-wide transactions now labelled „domestic“ instead of „cross-border“, demand for foreign exchange reserves can be expected to decline.

Fourth, for third countries, it is important to assess both the medium trend in US-Euro exchange rates as well as the volatility in bilateral exchange rates. To begin with the former, it is argued that in order to sustain the Maastricht criteria, fiscal contraction in Euroland would continue and thus contribute to lower interest rates and to lower the value of the Euro. Public investment would be substituted for by private investment. In a second stage, an equilibrating mechanism would be expected to lead to an appreciation of the Euro [Funke,



Kennedy, 1997: 12]. Such mechanism could overlap with a medium-term confidence-building in favour of the Euro provided asymmetric shocks can be fought (see above). As far as volatility is concerned, there is no clear position. On the one hand, it is argued that with more transactions becoming domestic, the central banks of the US, EMU and Japan would care less about exchange rate volatility than did individual European central banks because the risk of importing inflation would become smaller [ibid: 13]. Hence, more than in the past, the three banks would follow their own nominal anchors without any exchange rate targeting. Exchange rate volatility would increase. This view assumes that European central banks in the past had some sort of exchange rate targeting. However, this was not true for the only EU currency for which this argument would have mattered, the DM as the anchor currency. The DM had its own nominal anchor, preannounced money supply expansion, and the other currencies either openly or implicitly pegged to the DM. There was no exchange rate targeting in recent years. On the other hand, there is the argument that in an early stage during which the ECB had not yet a clear internal nominal anchor (neither money supply expansion nor a direct inflation target), the ECB would take relative stability of exchange rates to the Dollar more into account following financial markets preference for a clear anchor. If at all, this might be a problem of transition as long as monetary policies within EMU are not as coordinated as within the past European Exchange Rate (ERM). Presumably, the ECB will soon establish and follow its own anchor especially if there are no

bad-weather conditions with asymmetric shocks and deep recession. However, an own internal ECB anchor does not imply necessarily more volatility if the US and Europe become more similar in economic size, domestic market orientation and market flexibility, the latter being a result of ongoing structural reforms in European labour markets.

Fifth, the potential role of the Euro as reserve currency and transaction currency depends on the substitution process between individual European currencies and the Euro. First of all, for all member countries of the EMU, assets denominated in European currencies of member states change their nature from „foreign exchange assets“ into „domestic assets“. This includes assets held by European national central banks. That means that the potential of the Euro as reserve currency is smaller relative to that of the DM and other European currencies. This effect arising from inside EMU can eventually be countervailed by greater attractiveness for non-European asset holders not only to replace their assets denominated in European currencies fully by Euro but to replace their Dollar or Yen assets partly by Euro-denominated assets for various reasons. Such reasons could include portfolio diversification, growing trade links to the Euro economic space, stronger borrowing in Euro and hence stronger asset holding in Euro in order to avoid a mismatch of currency denominations. Again, fast progress in reputation building would help to enhance this attractiveness. Arguments pro increased use of the Euro in financial transactions are based on the weight of the Euro economic space in world trade (invoice currency), in

inter-central banks official transactions (reserve currency and anchor currency for Mediterranean and CEECs) and the development of deep and wide Euro financial markets. There are estimates which assume a market share of the Euro of 35 per cent in international portfolios, hence, almost at the level of the Dollar [Leany, 1994].

*b. Possible implications for Asia*

There are a number of developing countries' regions and transformation countries which traditionally maintain strong trade links with the EU, receive sizeable amounts of aid from the EU area and/or have used European currencies as anchor currencies or reserve currencies. Typical examples are the North African countries, the CEECs and the member states of the francophone currency area in West and Central Africa (the CFA-Franc area). For these countries, the likely impact of the Euro has already been discussed [Khemani and Nord, 1997; Memedovic, 1998; Mogni, 1998]. Regions with which the EU maintains relatively weak current account transactions (such as Asia) have not been subject to analyses except for the Caribbean member states of the ACP group for which income from providing consumer services (European tourists) and revenues from exporting agricultural products to Europe (for instance, bananas) have been important. Interestingly enough, Caribbean countries often peg to the Dollar while maintaining relatively strong current account transactions with Europe under the ACP agreement. Under these auspices,

changes in the Euro/\$ rate compared to the DM-area/\$ rate are expected to have large effects on the international competitiveness of these countries compared to suppliers of competing products pegging to the DM-area (followed by the peg to the Euro) [Khemani, Nord, 1997].<sup>7</sup>

To approach possible impacts of the Euro upon Asia, one may first start from the state of bilateral current account transactions and take this as a proxy for the possible importance of the Euro as an *invoice* currency. Given that the trade links (including services) have been relatively small and not overly dynamic as concerns Asian exports to Europe and given that commodity trade (oil, mineral ores, rubber) is traditionally invoiced in Dollar, there is no dramatic increase to expect from the invoice currency function. There are differences among Asian countries (the NIEs being traditionally linked more to the APEC area and the ASEAN countries traditionally more linked to Euroland in current account transactions) but these differences do not change the overall result. Unless trade relations improve substantially, it is unlikely that the Euro will gain invoice currency shares at the expense of the Dollar.

One should expect more information to be available for the currency composition of reserves of Asian Central Banks to assess the likely importance

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<sup>7</sup> It is not surprising that the impact of EMU will be transmitted through the Euro-Dollar exchange rate and interest rate differentials between the Euro area and Dollar area. To the extent that these countries (such as the member countries of the Eastern Caribbean Currency Union) maintain a fixed single currency peg vis-à-vis the Dollar a devaluation of the Euro against the Dollar would make tourist services more expensive for European tourists and thus discourage tourist exports. The same holds for agricultural exports.

of the Euro as reserve currency. Unfortunately, this is not the case. Dooley, Lizondo and Mathieson [1989] analysing the determinants of the currency composition of foreign exchange reserves used IMF data and, in order to maintain confidentiality of the data file, ran all regressions blind without any country specific parameters [ibid: 410]. The IMF itself [IMF, 1997] anonymises such information by publishing aggregate data on the currency composition for industrial and developing countries separately. For developing countries, the share of Deutschmark, French Franc and Netherlands Guilders (as the only listed Euroland members' currencies) in total identified official holdings of foreign exchange declined from 14.4 per cent to 12.6 per cent [ibid: 159] but again data unreliability is large as shown by the increasing share of unspecified currencies. It seems that this indicates a lack of information on currency composition in official holdings of newly acceded Fund members.

To my knowledge, the only disaggregated analyses for some Asian countries' currency composition of official holdings has been published by Tavlas and Ozeki [1992] and Tavlas [1997]. These analyses cover the period of the eighties and early nineties do not allow to identify individual Asian countries (Table 6). Only three Euroland currencies are displayed individually (DM, FF, HFL) apart from the Yen, Dollar and Pound Sterling. The share of Euroland currencies was shown to have steadily declined over the eighties while the Dollar enjoyed an all-time-high in 1995 when 60 per cent of official holdings were kept in this currency. The Yen's role fluctuated in the range of 12-27 per

cent. Fluctuations are partly due to valuation effects. Without knowing which countries were in the sample it seems futile to speculate about the driving forces behind the strengthened role of the Dollar but the undisputed role of the Dollar as the anchor currency for most Asian countries (either with the fixed single currency peg or a large weight in a basket) can be expected to have fostered this leading role.<sup>8</sup> Beyond that, the minor role of Euroland currencies in foreign exchange reserves is notable.

Table 6 – Share of Euroland Currencies in Selected Asian Countries' Official Holdings, 1980-1995

	1980	1984	1986	1992	1995
Deutschmark	20.6	14.6	16.7	16.3	14.6
French Franc	0.6	0.6	1.1	1.0	1.1
Netherland Guilder	2.8	1.9	2.2	1.2	1.1
<b>MEMO:</b>					
US Dollar	48.6	58.2	48.4	55.8	60.2
Yen	13.9	16.3	22.8	14.2	12.3
Pound Sterling	3.0	3.5	3.6	6.3	6.0

Source: Tavlas/Ozeki [1992: 40]; Tavlas [1997: 742].

<sup>8</sup> In a recent paper, Bénassy-Quéré [1998] supports the view of the undisputed role of the Dollar by showing that there has never been a Yen bloc in Asia although there was an increasing use of the Yen for denominating the debt (see below Table 7) and also for denominating trade transactions. She concludes that there is a mismatch between trade blocs, capital blocs and currency blocs in Asia. Trade was increasingly intensive among Asian countries other than Japan, capital flows were most intensive between Japan and the other Asian countries and exchange rate targeting was sustained to the Dollar as long as possible.

Differences between Asian countries emerge if it is asked which currencies Asian countries prefer if they borrow long-term abroad. Except for China which has increasingly borrowed in Dollar, the Yen seems to have played a much larger role than in foreign exchange reserves during the nineties (Table 7). This role may reflect Japan's strong engagement as a bilateral and multilateral donor within Asia and the active role of its banks in supporting trade and capital links of Asian countries to Japan by providing loans denominated in Yen. Even if one would assume Euroland currencies to participate in so-called multiple currency lending, the negligible role of the DM and the FF as debt currencies for Asian countries cannot be denied. This role while also declining during the nineties has always been much smaller than the role of reserve currencies. This holds in particular for the DM where the discrepancy between reserve currency function and debt

Table 7 – Share of Euroland Currencies in Asian Countries' Long-Term Debt, 1990-1996

	Indonesia			Malaysia			Philippines			Thailand			China		
	1990	1993	1996	1990	1993	1996	1990	1993	1996	1990	1993	1996	1990	1993	1996
Deutschmark	5.0	4.8	4.8	5.9	3.0	0.8	1.5	1.4	1.6	3.6	2.3	2.1	3.1	1.0	1.4
French Franc	3.4	3.3	3.7	2.8	0.8	0.5	1.5	0.8	0.8	1.0	1.2	1.1	0.4	0.3	0.3
<b>MEMO:</b>															
Yen	34.6	37.6	34.5	36.5	37.5	28.0	31.0	38.3	35.3	43.2	50.1	45.4	30.4	21.0	15.9
Pound Sterling	1.4	0.9	1.2	1.6	3.4	1.2	1.0	0.3	0.3	0.4	0.2	0.1	0.7	0.3	0.2
Swiss Franc	0.4	0.5	0.8	3.6	2.4	1.7	0.5	0.4	0.3	3.9	2.3	0.3	0.2	0.0	0.0
US Dollar	21.0	19.9	24.3	31.8	29.4	55.7	36.2	30.4	33.8	17.0	22.6	32.1	29.1	54.2	64.8
Multiple currency, SDR, other currencies	34.3	33.6	39.7	17.7	23.6	11.9	28.2	28.6	28.0	30.8	21.3	18.8	36.2	23.1	17.5

Source: World Bank [1998].



currency function has been significant (unlike the FF being equally weak in the two functions).

Lessons to be drawn from this insufficient empirical bottom line with respect to the likely role of the Euro are almost impossible. If one departs from the assumption of a high short-term substitutability between functions fulfilled by the DM and the European currencies pegging to the DM on the one hand and the Euro on the other hand, the Euro could be expected to become immediately relevant for Asian countries as a reserve currency followed by the invoice currency function. The function of a transaction currency in international capital markets depends very much on the nature of such transactions. As concerns the function of a currency in which Asian countries would prefer to borrow, the Euro will have to offer scale economies and reputation first before it can surpass the former national currencies of Euroland in this role in Asia. Only to the extent that Japanese private capital exports to Asia would decline and/or the Japanese donor role in public capital would shrink, the Euro could incorporate part of the function hitherto taken by the Japanese currency. Finally, given weak and even declining functions as reserve currency and debt currency in Asia, Euroland currencies cannot be expected to be substituted for by the Euro as an anchor currency. Among all functions, the anchor role of the Euro in Asia seems to be the most unlikely one.

## **V. Concluding Remarks**

Both Europe and Asia live in interesting times (to rephrase the Chinese curse). These times have in common that seemingly well-established structures and patterns have broken in the two regions. Such breaks were deliberately taken into account in Europe through the processes of integration deepening and widening while they have been unintentionally set in motion in Asia because of the financial crisis. Only the implications of the former breaks were subject of this paper but how they will be received on the Asian side will also be influenced by the breaks caused by the crisis.

Past implications of European integration for Asia up to the Single Market effects focused strongly on current account transactions between the two regions (merchandise trade and trade in services). Projections on whether this integration stage would be beneficial or detrimental for Asia have been found to differ widely according to differences in parameter estimates or type of analysis but the common bottom line was that the effects were unlikely to be large in both directions. The Single Market effects have carried the debate beyond the current account to the capital account. It was investment diversion to the detriment of Asia which became the key issue but again unanimous empirical evidence could not be found simply because the medium-term Single Market effects overlapped with the short-term effects of the opening of former Socialist economies to the world market. European investors immediately responded to the incentives of tapping the potential of the near-by market endowed with relatively skilled

labour and low labour costs long before the institutional incentives of the Europe Agreements became effective and began to erode parts of cost competitiveness. This was not investment diversion caused by discriminatory trade policy. Such policies have become effective later but again their static „once and for all“ effects are unlikely to be large since the CEECs have simultaneously lowered their external barriers toward imports from non-EU countries in their role as participants of the Uruguay Round. This parallel event in the multilateral arena has of course also mitigated possible discrimination effects arising from the Single Market.

With the Euro project becoming a reality with a large number of first-round participants, the discussion on integration effects for Asia has reached a new quality for several reasons. First, the effects are likely to focus on the capital account transactions which – with the exception of FDI – were hitherto not in the centre of EU integration effects for non-members. Second, policy discrimination in the sense of treating EMU candidates unequally could have been deplored by a group of potential first-round members downgraded to second-round members all belonging to Europe. But Asian countries have been far from this group. Third, the foreseeable effects of EMU for Asian countries are small compared to the effects for countries pegging to European currencies. The anchor currency function is essential for the magnitude of effects and this function is not relevant for the Euro in Asia. Nor are probably other effects such

as those arising from international borrowing by Asian countries, at least in the short run.

Both integration deepening and widening will make Europe much more diverse, with different speeds of integration between core and periphery countries, sometimes called „variable geometry“. This will make the threats of a „Super-Fortress Europe“ which have often been articulated in Asia even more implausible than before. Instead, the historical challenge of Western Europe could be to accelerate the process of integrating Central and Eastern Europe more rapidly into the world market than it would have been possible without EU integration widening. In other words, the perspective of EU membership has made economic transformation irreversible, credible and has therefore anchored monetary stability, structural change, and market institution-building as indispensable principles underlying all decision-making in CEECs (unlike in the former Soviet Union). For Asia, enlarged Europe is therefore a chance to benefit more rapidly from the internal efficiency-enhancing effect of integration widening than to suffer from the external discrimination effect.

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