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THE FRENCH CENTRE FOR RESEARCH
AND STUDIES ON THE WORLD ECONOMY

CONTENTS:

FOCUS

Greece: a Massive European Coordination Failure

The world financial crisis has come as a surprise to economists: they certainly were expecting real—estate bubbles to bust, but not such amplification effect through structured financial products, the freeze in the interbank market, insolvency crises and subsequent deleveraging causing a global economic crisis. Although excess leverage, especially in the US and the UK, was widely recognized, most analysts were fearing a dollar rather than a bank crisis.

In contrast, the Greek solvency crisis has not come as a surprise. Well before monetary unification, it had been understood that, with a single monetary policy, high-inflation countries would enjoy relatively low real interest rates. This feature would be destabilizing insofar as low real interest would encourage leverage and demand, hence would push consumption and asset prices further up, and real interest rates further down.

Additionally, it had been understood that insolvency from one Member state would put the monetary union at risk because sovereign bonds were to be disseminated within the European, integrated financial system: to avoid a financial crisis, there would be strong pressure on partner countries for a bail out, and on the ECB for monetization. To avoid both, bail out and monetization were proscribed in two different articles of the Treaty (Art. 123 and 125 of the TFEU). And to avoid that a Member state could be some day in a position to default, it was decided to append a Stability and growth pact (SGP) to the Treaty.

The point is that sovereign defaults are not a rare event, so denying that it could happen in the Eurozone was a risky bet. In fact, the SGP proved to be a weak protection against sovereign insolvency, which was hidden by low, often negative real interest rates. The second problem is that expectations of solvency crises are largely self-fulfilling, because higher interest rates accelerate the debt increase. Due to this feature, countries with relatively sane public finances, such as Spain, are not immune from speculative attacks.

The Eurozone was then left with four scenarios: (i) a large bailout that would cover any country in trouble; (ii) some form of partial default; (iii) monetization; (iv) a reduction in the number of euro area partners.

After weeks of uncertainty, a large bail-out and some form of monetization were decided on 9 May 2010. These infringements of the spirit of the Treaty have so far allowed the EU to avoid the two other solutions, although some kind of debt restructuring may be necessary at a later stage. Letting Greece or another country leave the Euro area would probably be the most damaging scenario, perhaps not so much for the leaving country than for those who stay. Indeed, euro membership would no longer be viewed as permanent, which could trigger a de facto disintegration of the euro area where euros from the different countries would no longer be perceived as equivalent. This would make the euro regime very much similar to the former European monetary system.

In the longer run, economic policy coordination will need reshuffling along different lines: (i) extend policy surveillance to the financial sector (leverage, bubbles) and to internal competitiveness; (ii) provide a comprehensive surveillance scheme that embodies the various policy instruments: not only fiscal balances, but also regulation and taxation; (iii) reshuffle government incentive scheme in order to rely less on sticks (that have failed), more on carrots (that have generally succeeded). This could involve access to some form of European bond issues or to cheap emergency financing for well-behaved countries.

On 12 May 2010, the European Commission issued a blueprint for a far-reaching reshuffling of policy cooperation within the Eurozone. The proposal includes an ex-ante coordination process (a "European semester"), an early-stage surveillance procedure (prior to the national vote of the budget), a broadening of surveillance to macroeconomic imbalances "and their underlying structural causes", a strengthening of sanctions and, depending on the results of the temporary stabilization mechanism decided on May 9, a permanent crisis mechanism scheme.

Later this year, the task force chaired by President von Rompuy will deliver its own proposals. Whatever the final decisions taken, one legacy of the crisis will be further intrusion of EU partners in national affairs, be it on government statistics or on policy choices. Hence, the crisis will leave EU partners with already some form of federalism. When joining the Euro, member-states thought they were just giving up their monetary sovereignty while keeping almost total control on their other policy instruments. Such construction – monetary union without fiscal federalism – was widely criticized especially in the United States. It is becoming clear today that joining a monetary union de facto involves some loss in policy independence, not just regarding monetary policy. Recognizing this fact would help building a new, more appropriate surveillance mechanism.

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ON THE RESEARCH AGENDA

Foreign Sales Strategies of Multinational Firms

This research analyzes the foreign sales strategy of multinational firms. Our theoretical framework is related to the work of Helpman *et. al.* (2004), who introduce firm-level heterogeneity in a proximity-concentration model of the multinational firm. Our work differs from theirs in that we model explicitly the option of a multinational firm to export through its wholesale trade affiliate. We assume that multinational firms can produce goods abroad or set up wholesale trade affiliates to sell their goods. In contrast to the previous literature, we analyze multinational firms' choice between foreign production and foreign distribution. We assume that markets are segmented by trade costs that increase the price of goods shipped to a foreign country. Trade costs affect the sales of wholesale trade affiliates negatively, but they do not affect the sales of production affiliates. However, the fixed costs for installing production in a foreign plant are higher than the fixed costs of wholesale trade. Exporting through wholesale trade affiliates and producing abroad yield different prices and quantities and, thus, different profits. The resulting equilibrium strategy arises endogenously from the comparison of the expected profits. Thus, trade costs affect the relative profits of producing abroad positively, whereas fixed costs affect it negatively.

We use detailed data on multinational firms' foreign activities. The data provide a geographical breakdown of foreign affiliates of German multinational firms and gathers panel information from 1996 to 2003 that allows us to distinguish between wholesale trade affiliates and production affiliates. The data are supplemented with sector- and host-country-specific variables. We find that trade costs have the expected positive effect on the likelihood to produce abroad, while plant-level set-up costs reduce the likelihood to produce abroad. A larger foreign market size and lower sector -specific production costs increase the probability of setting up production affiliates. Finally, as predicted by our heterogeneous firm model, the size of the parent firm increases the probability of producing abroad.

Jörn Kleinert & Farid Toubal

China's New Growth Strategy and its Impact on International Trade

China's economy has come at a turning point because of the global crisis but also because of the domestic tensions engendered by the export-led model. To have a sustainable growth China has to rebalance its economy towards the domestic market.

China is very deeply integrated into the world economy. The research focuses on an analysis of foreign trade which is a major channel of interactions between China's economy and its international environment.

The research uses a detailed database derived from China's customs statistics, covering the past ten years (1997-2007). The database makes it possible to take full account of the great divide in China's foreign trade between assembly trade and ordinary trade; and between Chinese and foreign-capital firms (FCF).

The exposure of China's economy to external shocks concerns some crucial industries (Electronics and Textiles) and the coastal areas. Foreign-capital firms are the major channel of transmission of external shocks since they are highly specialised in electronics and dependent on western demand. Chinese firms are more oriented towards emerging markets and have diversified their exports in capital -intensive goods (machinery), but without technological upgrading.

To adjust to the new international and domestic context, FCF can upgrade their exports to western markets or/and relocate their production sites in lower-cost countries. The role of China as an export platform of cheap products would thus progressively shift to other countries. Chinese exporting firms are in a better position to take advantage of emerging countries demand as well as to redirect their exports towards the domestic market.

Turning to China's imports, Asian neighbours have been most successful in taking advantage of

China's domestic demand (ordinary imports). They have increased their lead as major suppliers of investment goods and high-technology products. In Asian integration, China is not only the hub of the regional division of labour but also a growing market for Asian final goods. China is thus likely to provide Asia with an engine of autonomous growth. Foreign-capital firms play a crucial role in China's imports and China's industrial production. Foreign firms' local production for domestic demand by far exceeds China's ordinary imports. What is thus at stake is not only the competitiveness of the partners' exports but the sharing of local production between foreign-capital firms and Chinese firms to serve the China's market.

Guillaume Gaulier, Françoise Lemoine & Deniz Ünal

Competition and Restructuring in the French Business Services

The aim of this research is to examine the effects of import competition on the survival and restructuring of firms in the French business services sector. It is a significant contribution, considering the few studies on services at a firm-level. To our knowledge this is the only analysis of the effects of liberalization on services firms. The primary focus is the effect of import competition on the probability of firm to exit or to be purchased through Merger and Acquisition (M&A).

We find that services import competition does significantly affect the probability for a firm to exit the market and be bought out by M&A: with a larger effect for imports from within the EU, and a larger effect for OECD compared to non-OECD countries. This effect is at odds with findings in the literature on trade liberalization in manufacturing industries, which has found that competition from low-wage countries has a larger detrimental effect on local firms. We can thus contribute to the debate on the offshoring threat by pointing out that the threat may in fact be more potent from neighboring high-income competitors than from typically-cited countries such as India or China. At the firm level, we find that firms with higher intangible assets, that are engaged in international trade, or are affiliates of large corporate groups are less likely to exit, while firms with higher levels of intangible assets are more likely to be purchased by M&A. This latter finding fits in with the "cherry-picking" hypothesis, by which buying firms choose high-performing firms as targets.

Pamela Bombarda, Fergal McCann & Farid Toubal

The Effects of the Subprime Crisis on the Latin American Financial Markets: an Empirical Assessment

After a strong resistance at the beginning of the subprime crisis, the Latin American countries (henceforth LAC) were confronted with a recession at the end of 2008. They were affected through both the temporary collapse in world trade and the financial sphere, as evidenced by the fall of their stock markets. The drying out of the international liquidity entailed difficulties in accessing the international markets and reduced the sources for loans to the private sector. After a decade of considerable capital gains in the LAC, the stock market indices had become barometers of the trust put in these economies by the international markets.

In this study, we focus on the financial linkage and examine empirically the link between the US subprime crisis and the volatility of the LAC equity and stock markets. We aim at answering the following question: can the considerable rise in the volatility of the LAC equity and stock markets in the aftermath of the 2007/2008 crisis be explained by the worsening financial environment in the US markets? To this end, we rely on time-varying transition probability Markov-switching models (TVPMS) which have the advantage of being helpful in investigating whether the impact of the financial stress indicators is asymmetric, with an influence differing between crisis and non-crisis episodes. Crisis and non-crisis regimes are identified endogenously, and the switch from one regime to the other can happen at any time. From the estimation of this model, we will be able to robustly investigate the financial decoupling hypothesis.

Gilles Dufrénot, Valérie Mignon & Anne Péguin-Feissolle

Productivity, Relationship-Specific Inputs and Sourcing Modes of Multinational Firms: Evidence from French-Firm Level Data

Globalization of the last decades is characterized by the increasing importance of multinational firms (MNEs) in investment, employment and foreign trade. One-third of world trade is intra-firm, and an other third involves the participation of multinational firms in one of the two sides of the exchange (WTO, 1996). MNEs organize their production on a global scale, importing inputs from their affiliates (intra-firm trade) and/or from independent suppliers (outsourcing). Sourcing strategies of multinational firms have triggered considerable research efforts among trade theorists. In a new body of work, modern theories of the firm have been brought into models of international trade.

In this study, we follow Antràs and Helpman (2004, 2008) and we investigate the organization choice of multinational firms that import inputs. First, we show that the implication of the model is borne by the data: namely, the intensity of non-contractible relationship specific inputs has a positive effect on the outsourcing decision. Second, we show that the sorting predictions of Antràs and Helpman's models (2004, 2008) are also borne by the data. As the authors stress, these predictions are sensitive to the ranking of fixed costs. Interestingly, the data shows the same sensitivity. Whereas previous empirical works have used industry-level data, we show that the empirical implications of the models of Antràs and Helpman hold true using finer data at firm-level.

Our paper makes two specific contributions to the literature. First, we propose a measure of the intensity in suppliers' relationship-specific inputs. We build on the work of the SESSI to classify the inputs with respect to their relationship specificity. In the French accounting, firms have to report the amount of their inputs that have been produced by suppliers following the firm requirement, and that would form part of the firm's products. This includes inputs bought from both independent suppliers and affiliates purchased nationally and internationally. To guide our empirical analysis, we use the ratio of the value of relation specific inputs to the value of total inputs. This measure has the advantage to be specific to the firm.

Second, we show that the productivity of the multinational firm impacts significantly its sourcing behavior. In particular, we show that the most productive multinational firms outsource. A survey conducted by the SESSI shows that French multinational firms perceive outsourcing to be related to higher fixed costs than vertical integration (SESSI survey, 1999). At least 70% of the survey's respondents answer that intra-firm trade has lower fixed organization costs than outsourcing.

Fabrice Defever & Farid Toubal

DATABASES

Quality and Specialization: CEPII Indicators

Recently, the United Nations Statistical Division has provided to the CEPII a privileged access to the “Tariff Lines” trade data. This is the result of a close cooperation between the two institutions that started a couple of years ago.

The Tariff-Lines trade data report exports and imports flows between pairs of countries, with the highest degree of disaggregation (tariff lines) corresponding to reporting countries’ declarations to the United Nations. For instance, Canada and the United States report their international trade flows using the Harmonized System 6-digit product codes + 4 additional digits. For the European Union, the 8-digit “Combined Nomenclature” (CN8) corresponds to the HS6 codes + 2 European-specific codes. Japan declares trade flows at the product level using 9-digit product categories.

Disaggregated trade data with World coverage, like the UN-Comtrade data, are usually provided with the HS 6-digit disaggregation. This disaggregation level is common to all countries and is very convenient for setting up consistent matrices of trade flows. But it still neglects much information.

Recent developments in the international trade literature have demonstrated the interest of performing empirical analyses at a highly disaggregated level. These data are particularly useful to identify precisely the number of varieties imported and exported by countries, and the degree of vertical differentiation of those varieties. This, of course, requires data on bilateral trade values at the product level, but also reliable data on quantity for each individual trade flow. The combination of values and quantities enables to compute unit values for each variety, and to classify varieties on a quality ladder on each market.

Our objective is to make use of the highest degree of detail in the Tariff Lines data provided by the United Nations and refine the computation of the unit values in trade databases having World coverage. For each year, reporter country, partner country and product category, the Tariff Lines trade data report the value of exports or imports, and the quantity corresponding to each individual trade flow. The data are originally provided for the period 2000-2007, with 163 reporter countries and 254 destinations, including territories with special status as French Polynesia for instance. As discussed above, the product category of each individual trade flow is specific to each reporting country. CEPII's researchers have re-treated the original Tariff Line data in several ways:

(1) sub-totals and very small trade flows are dropped;

(2) for all countries and years all revisions in HS (1992, 1996, 2002, 2007) are converted into a single classification;

(3) all quantities are converted into tons, which enables the comparison of unit values across products and countries;

(4) finally, unit values are computed at the most available disaggregated level. FOB unit values (relying on declarations by the exporter) and CIF unit values (relying on declarations by the importer) are provided at the level of tariff-lines in two separate databases, together with the associated trade values and quantities, for the period 2000-2007.

The interest of unit values computed at the level of tariff lines is twofold:

• For cross-country comparison Tariff Lines unit values can be re-aggregated at the HS 6-digit level . This gives more accurate proxies for unit values than those based on COMTRADE HS-6 data.

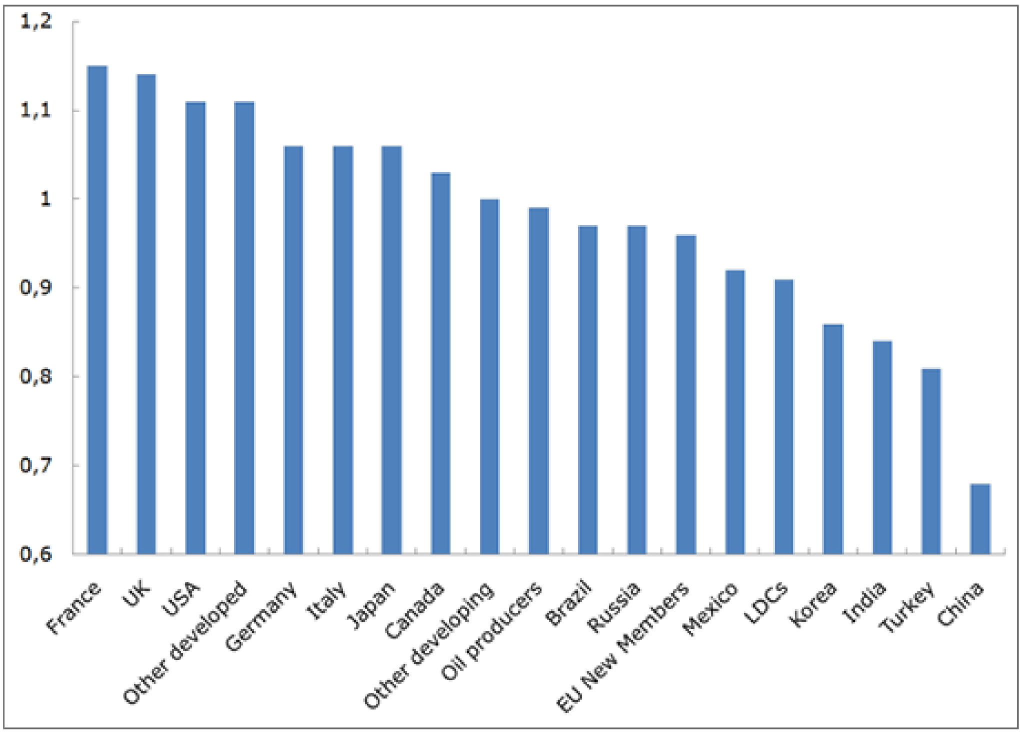
• Compared to the average price on each market for each good, these unit values provide indicators of the quality-specialization of country's exports.

Unit values computed at the HS 6-digit level from the tariff lines data will be merged with the BACI database, developed by the CEPII, and released by the end of 2010.

We provide below some descriptive statistics regarding the specialization of countries' exports according to quality. For each exporter, destination and product category, we calculate the unit price of a specific variety relative to the price of competing varieties. This information is then aggregated by exporter. We propose two different aggregate indicators that weight each relative unit value by each country's own trade structure (1), or the world trade structure (2) alternatively.

Figure 1: Price of Exports Relative to Competitors

(Exporter's own trade structure, 2007)

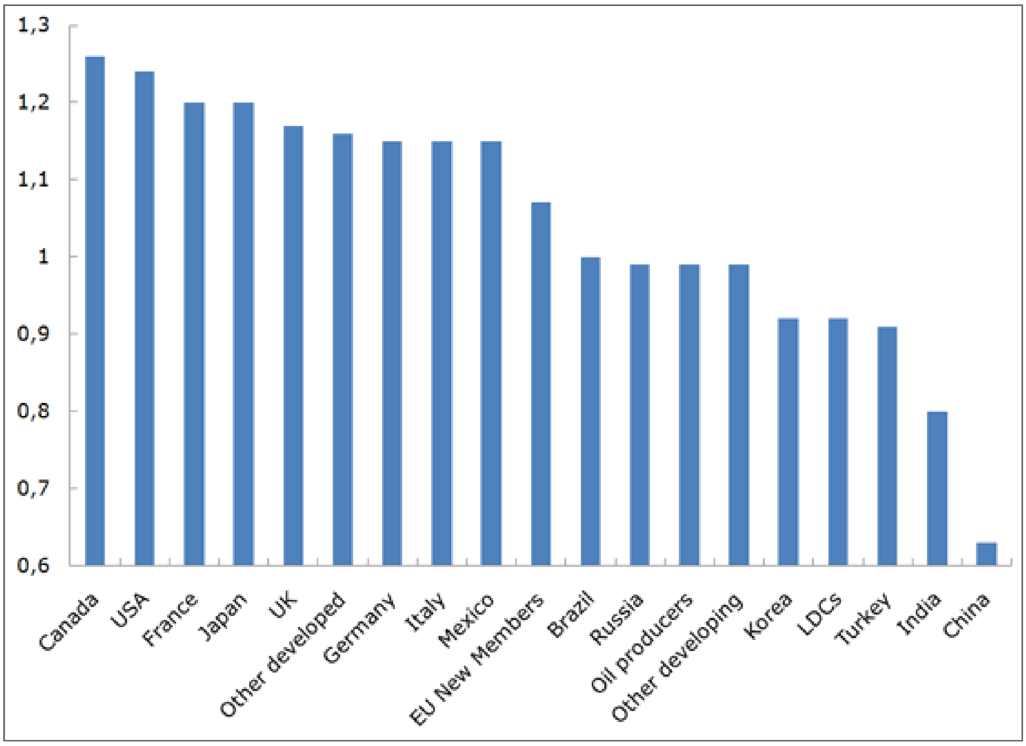


Source: Berthou & Emlinger (forthcoming).

The first indicator gives us information related to the specialization of each exporter over ranges of quality on its main markets. The second provides information related to the quality specialization of selected exporters on the market of the largest importers in the World. The descriptive evidence is detailed in Figure 1 above and Figure 2 below.

Figure 2: Price of Exports Relative to Competitors

(World Imports trade Structure, 2007)



Source: Berthou & Emlinger (forthcoming).

Not surprisingly, the numbers reported in Figures 1 and 2 show that wealthy countries are specialized on higher quality levels, whereas developing countries and large emerging economies are specialized on lower quality segments. On average, China sells at a price that is 30% to 35% below the average price observed on the global market for the same varieties. Countries specialized on high quality sell their varieties at a price that is 15% to 25% above the average price.

This pattern can be observed when both the country-specific exports structure (Figure 1), or the world trade structure (Figure 2) is used to aggregate relative price indicators. However, using the World imports structure emphasizes the difference between high quality and low quality exporters. This is particularly true for both Canadian and US exporters where the specialization over the high quality is especially visible in Figure 2. France is always ranked among the top quality exporters in Figures 1 and 2. Interestingly, EU New Members tend to concentrate on high quality when global markets are concerned (Figure 2). The reverse pattern can be observed for China and India, that tend to concentrate on low quality on the global market (Figure 2).

Antoine Berthou

WORKING PAPERS

Foreign Bank Presence and its Effect on Firm Entry and Exit in Transition Economies

N° 2010-10, June 2010

This study investigates the impact of foreign bank penetration in Central and Eastern Europe on firm entry. We demonstrate that the acquisition of domestic banks by foreign investors has led to reduced firm creation, smaller average size of entrants and increased firm exit in opaque industries compared to transparent ones. At the same time, the entry of greenfield foreign banks spurred firm creation and exit. Unlike previous studies, which use interchangeably the notions of opacity and size, we define opacity in terms of technological process and show that economic significance of foreign bank entry is larger for opaque industries than for industries with large shares of small firms. Our findings can be interpreted as evidence of increased credit constraints and are consistent with theories that argue that foreign bank presence exacerbates informational asymmetries.

Olena Havrylchyk

The Distorted Effect of Financial Development on International Trade Flows
N° 2010-09, April 2010

This paper investigates the effects of financial development on the intensive and extensive margins of countries exports, at different stages of economic development. The paper develops a partial equilibrium model with monopolistic competition. In this model, firms are heterogeneous in terms of productivity and have access to external liquidity. The effect of financial development on the intensive and extensive margins of countries exports is predicted to be positive, especially in sectors with a higher demand for external finance. In countries with poor financial institutions though, only the most productive firms benefit from an increased access to financial resources and start exporting, with little effect on aggregate exports. The effect of financial development on exports is therefore higher for a better initial development of financial institutions. The empirical analysis confirms that financial development promotes both the intensive and extensive margins of countries' exports. This is more the case in industries with a higher demand for external finance. Though, more than 60% of the effect of financial development channels through the intensive margin. In industries where the demand for external finance is high, the effect of financial development is the highest in economies characterized by an intermediate development of financial institutions, and the lowest in countries with poor or advanced financial institutions. This contradicts the traditional expectation that financial development benefits more in terms of exports to countries where financial constraints are the most binding.

Antoine Berthou

Exchange Rate Flexibility Across Financial Crises
N° 2010-08, April 2010

This paper studies the impact of global financial turmoil on the exchange rate policies in emerging countries. Many emerging countries have loosened the link of their currencies to the US dollar since the bursting of the subprime crisis in July 2007. Spillovers from advanced financial markets to currencies in emerging countries stem from the same causes documented in the literature on contagion, such as the drying–up of investors' liquidity, the rise in risk aversion, and the updating of their risk assessments. Consequently, interdependencies across currencies are likely to be exacerbated during crisis periods. To test this hypothesis, we assess the exchange rate policies by their degree of flexibility, itself proxied by the exchange rate volatility, and investigate their relationship to a global financial stress indicator, measured by the volatility on global markets. We introduce the possibility of non-linearities by running smooth transition regressions (STR) over a sample of 21 emerging countries from January 1994 to September 2009. The results confirm that exchange rate flexibility does increase more than proportionally with the global financial stress, for most countries in the sample. We also evidence regional contagion effects spreading from one emerging currency to other currencies in the neighboring area.

Virginie Coudert, Cécile Couharde & Valérie Mignon

Crises and the Collapse of World Trade: the Shift to Lower Quality
N° 2010-07, March 2010

One of the most striking features of the crisis that started during the fall of 2008 has been the sharp decrease in the world volume of trade in goods. The collapse of trade values has been even larger, leading to a decrease of import price indices. We argue that the decrease of import price indices can be explained by a decrease of the demand addressed to the most expensive varieties. Descriptive statistics for the EU15 confirm that the decrease in the import price index is mainly due to a loss in market shares by high price varieties. The estimation of import demand equations confirm that higher price varieties report a larger elasticity with respect to GDP variations, as compared to low price varieties. Countries specialized over high quality varieties are expected to lose more trade in periods of global turmoil, and experience a faster recovery.

Antoine Berthou & Charlotte Emlinger

The Heterogeneous Effect of International Outsourcing on Firm Productivity
N° 2010-06, March 2010

This paper analyses how international outsourcing affects plant productivity. The results point to a striking pattern: the status of being an outsourcer matters strongly for firms that are indigenous and not exporting, while for exporters and foreign affiliates, Total Firm Productivity (TFP) increases are lower, insignificant and sometimes negative. On the other hand, higher intensity of outsourcing matters for both exporters and foreign affiliates. Similarly, in dynamic analysis, indigenous non-exporters are found to increase TFP for two periods after entering into international outsourcing, while indigenous exporters experience one more weakly significant period of growth. The message is clear: international outsourcing's effect on TFP is most pronounced when it serves as a first exposure to international markets.

Fergal McCann

CEPII Working Papers are available free, on-line, in PDF format.

RECENT PUBLICATIONS

LA LETTRE DU CEPII, MONTHLY

Can Notional Accounts Save the French PAYG System?
N° 297, 7 April 2010

The French Pay-As-You-Go (PAYG) pensions system is faced with a major challenge: how can it absorb the demographic shock resulting from the retirement of the baby-boom generations and the increase in life expectancy? After several reforms reconfiguring the system, restructuring the current systems in favour of one based on notional accounts is now in debate. Using the CEPII's OLGAMAP model, we evaluate the effects in terms of pension financing, redistribution between generations and institutional transition. We show that, even if it makes the system easier to understand and to adapt to future demographic and economic fluctuations, the notional accounts system does not provide new solutions for the financing of pensions, being still based on the question of the choice between increasing contributions, reducing pensions and inciting the increase of the average retirement age.

Xavier Chojnicki & Riccardo Magnani

Why Regulating Hedge Funds?
N° 296, 28 January 2010

The risks of hedge funds are embedded in their strategies in the pursuit of high performance. A combination of leverage and dependence on market liquidity makes them vulnerable to financial crises. Their reactions under stress can cause the spread of systemic risk. This is why the indulgent attitude traditionally adopted by regulators is changing. Registering hedge fund managers, limiting leverage, disclosing specific information about the risks they take and making management fees less twisted against investors are legislative proposals currently being discussed.

Michel Aglietta

Dollarization in Latin America: Much Ado About Nothing
N° 295, 28 December 2009

The 2000-2001 period saw Ecuador and El Salvador adopt the dollar as their national currency. The decision was to trigger much criticism, undermining the enthusiasm of a number of developing countries prepared to relinquish a degree of independence in return for more stability and credibility. But what does the Latin American experience tell us about dollarization? Does the use of another country's currency go hand in hand with additional costs in terms of economic performance? And do these costs outweigh the benefits resulting from greater stability?

David Khoudour-Castéras

NEWS

"European Firms in a Global Economy" (EFIGE)

The CEPII is part of EFIGE project. EFIGE stands for "European Firms in a Global Economy: internal policies for external competitiveness". The aim of this project is to examine the patterns of internationalisation of European firms, and disseminate high quality research on this issue in a policy perspective. This new project has received the support of the Directorate General Research of the European Commission through its FP7 programme. It is running from September 1th 2008 to August 31th 2012.

For more information an to subscribe to EFIGE Newsletter go to: http://www.efige.org

FORTHCOMING

International Cooperation in Times of Global Crisis: Views from G20 Countries
Organized by the CEPII, ICRIER, Bruegel, ADB Institute & IMF
New Delhi, September 16-17, 2010

L'économie mondiale 2011
Organized by the CEPII for the release of its yearly publication
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8th ELSNIT Annual Conference
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