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ABSTRACT

Domino Effects in West European Trade, 1960–92*

This paper uses a standard gravity equation to test the hypothesis of domino effects in Western Europe. The question being addressed is whether increased integration within the EC has impacted negatively on non-members and thereby prompted their application for EC membership. The paper finds that the EC's Internal Market programme may have caused such an effect on EFTA member countries.

JEL Classification: F13, F15
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NON-TECHNICAL SUMMARY

The question of regionalism has long attracted interest among international economists and policy-makers. The early debate concentrated on static issues, in particular whether preferential trading arrangements (PTAs) are trade-creating or trade-diverting. Recently, the discussion has shifted to the ‘dynamic time-path’ question, which can be formulated in two ways: (a) whether PTAs, once formed, tend to expand or to stagnate; or (b) whether PTAs are ‘building blocks’ or ‘stumbling blocks’ towards multilateral trade liberalization.

Nowhere has the phenomenon of regionalism developed like it has in Western Europe, where the two main vehicles have been the European Community (EC) and the European Free Trade Association (EFTA).

The static question concerning the impact of PTAs on trade flows has been analysed by many empirical researchers with the help of gravity-type models, which relate trade among pairs of countries to each country’s gravity (measured by its gross domestic product) and the distance between them. This line of investigation originates with Aitken (1973), who examines the effect of the EC and EFTA on European trade by inserting into the basic gravity equation dummy variables for participation in these two trade blocs. Aitken finds significant preferential effects for the EC and EFTA.

By contrast, there has been no systematic empirical study of the dynamic time-path question, despite insightful analyses of the impact of increased integration within the EC on neighbouring EFTA members. Krugman (1988) argues that the EC’s move, in the mid-1980s, to achieve a unified internal market by 1992 threatened EFTA members unless they managed to participate in European integration. Likewise, Baldwin (1995) holds that the EC’s 1992 programme posed a special threat to EFTA countries, since, on average, 60% of their exports went to the EC market. According to Baldwin, this threat triggered a ‘domino effect’ in Europe, leading to requests for EC membership by Austria in 1989, by Sweden in 1991 and by Finland, Norway and Switzerland in 1992, and to actual membership by the first three countries in 1995.

This paper uses a standard gravity equation to test the hypothesis of domino effects in Western Europe. The question addressed is whether increased integration within the EC has impacted negatively on non-members, and thereby prompted their application for EC membership.

The situation of EFTA members offers a good illustration of such domino effects and their impact on EC membership. Throughout the period 1960–92, EFTA members shipped roughly two-thirds of their exports to Western Europe, 90% of which went to either EFTA or EC countries. During the sub-period 1960–72, exports to EFTA partners performed relatively well thanks to preferences matching those enjoyed by intra-EC trade. By contrast, EFTA exports to the EC suffered from their non-preferential status.

This handicap affected EFTA countries differently: in 1970, the effect was relatively small for Nordic members, which traded mostly within EFTA, but relatively large for Alpine members and the United Kingdom (UK), which shipped 50% or more of their West European exports to the EC. The result was the UK's application for EC membership, soon followed by Denmark and Ireland, who both depended heavily on the UK market. Austria and Switzerland, however, were unable to follow suit due to their political status.

In 1973, the United Kingdom, Denmark and Ireland joined the EC, while the enlarged EC and the remaining EFTA countries set up a free-trade area for industrial products. Over the next 12 years, EFTA members' exports to EFTA partners and to EC countries fared well in comparison to intra-EC trade. This situation lasted until the mid-1980s, when the EC widened and deepened.

The empirical estimates indicate that intra-EFTA trade holds its own *vis-à-vis* trade within EC–5 until 1985, with a coefficient of the EFTA dummy equal to 0.24 (and not significant at 5%), on average, during 1960–75, and –0.06 between 1976 and 1985. Thereafter, intra-EFTA trade becomes, *ceteris paribus*, less intensive than trade within EC–5, significantly so beginning in 1989, the coefficient of the EFTA dummy dropping to –0.48 (and significant at 5%) during 1989–92. Similarly, a break in the pattern of EC-EFTA trade occurs in the late 1980s, the coefficient of the relevant dummy falling from –0.29 (and not significant at 5%), on average, during 1973–85 to –0.35 (and significant at 5%) during 1989–92.

The main result of this study conforms with the analysis by Baldwin, Forslid and Haaland (1995), which shows that, starting in 1989, the EC's Internal Market programme probably led to investment diversion in the economies of EFTA. On the other hand, it contrasts sharply with the findings of Eichengreen and Bayoumi (1995), who find no negative impact on EFTA between 1987 and 1992. Instead, their results indicate that between 1987 and 1989 there was a slight increase in intra-EFTA trade and a more distinct rise in EC-EFTA trade.

In 1989, Austria (now liberated from the political constraint imposed by its post-war status) applied for EC membership, soon followed by Sweden, Finland, Norway and Switzerland. The story is unlikely to end in 1995, however, with the addition of Austria, Finland and Sweden to the EC. Domino effects will continue to shape the dynamics of EC integration; witness the growing number of membership applications from Eastern Europe.