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WHAT ARE THE LIMITS TO ECONOMIC INTEGRATION?

PAUL BRENTON

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Abstract

This paper discusses the continuing importance of borders, even within the EU, for the volume of international trade and global capital flows. It suggests that a range of factors, including the nature of the commercial, social and legal fabric of a country and the structure of consumers' preferences, act to constrain cross-border exchanges relative to internal transactions. Hence, whilst the process of globalisation may continue, there are likely to be distinct limits to the extent of economic integration. This entails that the traditional roles of governments in OECD countries in providing social welfare and regulating the market economy within national boundaries will not be seriously undermined. However, the situation may differ in developing countries where existing social and legal institutions may be compromised by globalisation rather than acting to dampen its impact.

* Paul Brenton is a Senior Research Fellow at CEPS and head of the Trade Policy Research Unit. He gratefully acknowledges the contribution of Thomas Walde and Wolfgang Hager for their comments. Other comments are welcome (e-mail: paul.brenton@ceps.be tel: 32.2.229.39.36).

WHAT ARE THE LIMITS TO ECONOMIC INTEGRATION?

PAUL BRENTON

1. Introduction

What is the current extent of economic integration, both at the regional level and globally? What have been the impacts of recent integration initiatives such as the Uruguay Round agreement and the creation of a Single Market in the EU? How much further integration can we expect? Are their substantial remaining productivity constraining barriers to trade and capital flows that should be receiving the attention of policy makers? To be able to address many of these questions requires a benchmark level of integration by which to compare existing economic links between countries and recent moves to enhance those links. The aim of this paper is to discuss ways of measuring and interpreting the extent of economic integration and to draw out the policy implications.

Our main focus is upon integration in Europe and the issue of how to assess the effectiveness of deep[1] integration initiatives such as the Single Market and the potential for further integration within Europe. We also look briefly at the globalisation debate and show that understanding the extent and limits of integration is important in addressing fears that the march of economic integration is inexorable and that the economic identity of the national state will continually be eroded with the undermining of the effectiveness of national economic policies. Whilst integration and globalisation on the one hand require increased intervention to counter rising inequality and social exclusion, it is argued by some that the ability of governments to implement traditional social welfare policies will be compromised. We summarise recent research that suggests that, even within the EU, borders remain a substantial impediment to international trade relative to intra-national trade. Understanding why these border effects remain and whether they can be dismantled in the future is important in assessing the scope for further trade integration in Europe and the potential gains from further expansion of the proportion of EU output that is traded internationally.

All research to date demonstrates the prevalence of the borders for OECD countries. Finally, in this paper we briefly discuss reasons to suspect that the factors underlying borders in OECD countries may not be present in developing and transition countries. Borders may not

frame the impact of globalisation in these countries in the same way that they appear to in industrialised countries.

2. The Extent of European and Global Integration and the Border Effect

Whilst there is a great deal of evidence that economic integration within Europe and globally is occurring at a rapid pace and is having a profound effect upon the economic lives and thoughts of a wide range of individuals there are also reasons to believe that the current extents of European and global integration are rather low when compared to the benchmark of completely integrated markets. In this section we discuss research that suggests that trade, for both goods and services, and financial flows, are quantitatively small relative to similar exchanges within national boundaries. In highly integrated markets we should not be able to detect any impact from national borders, the propensity to trade internationally with citizens of other countries should be the same as that to trade internally with citizens of the same country of residence. This is our benchmark of perfect integration. However, in practice it appears that borders still loom very large.

The crucial issue emanating from this empirical finding is to identify the factors that lie behind this border effect. In particular, are there impediments which can be broken down, suggesting that there is considerably more, and much more than we have already experienced, globalisation to come? Or, can we discern whether there are factors that will always constrain and limit the extent of global integration? A second issue is whether the removal of such barriers, if feasible, will lead to the sort of productivity gains that have been achieved from dismantling formal trade barriers or have the principal gains from trade already been reaped.[2]

2.1 Trade in Goods

A number of empirical studies of international trade have identified the presence of substantial border effects: international trade appears to be (very) small in comparison to the amount of internal trade. The initial stimulus to this research came from McCallum (1995) who reported results suggesting that Canadian provinces are more than twenty times more likely to trade amongst themselves than they are to trade with US States after controlling for

[1] Deep integration can be defined as policy initiatives that go beyond the reduction and removal of border trade barriers to address the range of internal regulatory policies that can act to constrain trade and capital flows.

[2] See Helliwell (1998).

the main economic determinants of trade. Subsequently, Nitsch (2000), for example, finds evidence of substantial border effects in Europe, with internal trade being on average larger by a factor of ten than trade with EU partners, but that the magnitude of this effect declined during the 1980s. In a study of trade between US states, Wolff (1997) finds evidence of border effects within the US. These studies are all based upon applying the gravity model of international trade flows to define the benchmark of perfect, border-free, integration. The border effect is derived as the extent to which cross-border trade is lower than internal trade within a country or state (the amount of local output which is sold to local residents) after controlling for the economic factors determining the extent of exchanges; economic mass (income) and the costs of trading, as measured by distance.[3]

The concomitant of the border effect for the volume of trade in goods is that there are more substantial and longer lasting price differences between countries than between different locations within countries for similar bundles of goods that cannot be explained by distance.[4] The initial stimulus to this thread of the literature was provided by Engel and Rogers (1996) who found that the prices of goods between US and Canadian cities are systematically more variable than prices between equidistant cities within each country. Subsequent work using European data (Engel and Rogers (1999)) demonstrates that crossing national borders adds considerable volatility to relative city prices. Thus borders matter for consumer prices. Engel and Rogers (1999) find substantial differences in the magnitude of this border effect for different European countries and that local currency pricing with fluctuating nominal exchange rates explains much of the variation. Nevertheless, significant border effects remain after taking account of exchange rate variability.

As we shall discuss in more detail below it is important to clarify what is meant by the border effect and that it could capture the effects of a range of factors which constrain trade relative to domestic exchanges. Economists have tended to concentrate upon policy related factors, such as border trade barriers, differences in regulatory regimes, for example, regarding technical regulations, and different exchange rates. However, there are other factors, less visible and not so easy to quantify, which could explain the higher propensity to trade within

[3] For more details see Brenton and Vancauteren (2001). The precise magnitude of the border effect appears to be somewhat sensitive to the way that internal, within-country, distances are measured, although the statistical significance of the border does appear to be a robust result.

[4] This alternative source of evidence is useful in reinforcing the importance of border effects in the face of doubts over the specification of the gravity model and issues relating to measurement of distances and internal sales.

national boundaries, such as differences in institutional, legal and social frameworks, which raise the costs of undertaking foreign trade and analysis of which would benefit from a cross-disciplinary approach. In addition, within the economic realm, it is typical to assume that consumers are everywhere identical, whereas differences in purchasers' (consumers, firms and governments) preferences across countries could contribute to economic borders.

2.2 Capital Flows

Perhaps surprisingly the key conclusions concerning the prevalence of border effects for trade in goods also apply to capital flows: the magnitude of international capital movements are small relative to what one would expect in a situation of complete integration. The first piece of evidence in this regard is the well-known Feldstein-Horioka savings-investment puzzle: the correlation observed for OECD countries between national savings and domestic investment rates averaged over long periods (Feldstein and Horioka (1980)). In globally integrated capital markets, savings should be allocated to countries with the highest rates of return and one should not expect a strong relationship between domestic savings and investment. In initial regressions of national investment on national savings using data for the 1960s the coefficient on savings was close to unity. More recent estimates suggest that the coefficient has declined but that it is still large and highly significant (Obstfeld and Rogoff (2000)). This is compounded by studies that demonstrate that within countries there is very little correlation between regional savings and investment rates (Helliwell (1998)). The Feldstein-Horioka puzzle reflects the surprisingly small magnitude of current accounts in OECD countries in relation to domestic savings and investment.

The second major piece of evidence on the extent of effective integration of capital markets is the low correlation between country portfolio returns in international equity markets. Rouwenhorst (1998) reports that the correlation between UK and US indices of 0.5 whilst the correlation between two random portfolios obtained from splitting the US index in half was 0.99. One explanation for this is that investors exhibit home bias in their portfolios and overweigh domestic securities rather than diversify across all markets and hold a portfolio that resembles a world portfolio. This lack of international diversification raises the level of risk and reduces returns.

Wojcik (2001) looks at the extent and nature of cross-border corporate ownership in Europe and concludes that the level of capital market integration in Europe remains low and that 'the contours of national borders on the map of the European capital markets are still very sharp'.

These border effects reflect that the conditions of foreign ownership differ between countries with particular emphasis being placed on the role of corporate governance.

3. Is there scope for further economic integration in Europe?

If one accepts that national borders remain major impediments to international trade and capital flows between European countries the obvious questions to ask are what are the causes and should policy makers seek to further enhance the level of integration? To what extent do these border effects reflect constraints that can be removed by policy intervention such that economic integration will continue or are there significant natural barriers that will always act to impede international trade even within the EU? If the latter view has some substance then national markets will always remain segmented to some extent. Following, Obstfeld and Rogoff (2000), if the costs of undertaking international trade in products remain higher than those of similar but domestic exchanges then we should not expect to see globally integrated asset markets. So what underlies these estimated border effects?

Within the EU formal border trade barriers (tariffs and quotas) have long been removed, whilst, after successive rounds of multilateral trade liberalisation, external trade barriers (with the notable exceptions of agriculture and textiles and clothing) are now quite low. The average external tariff for industrial products is in the region of 3 per cent. Quotas on external trade, with the exception of textiles and clothing, have also been broadly liberalised. Hence, border trade restrictions cannot explain the prevalence of border effects between EU countries, where there are none, or between EU and third countries, where such barriers are very low. The equivalent tariff for the typical border effects that have been estimated depend upon the degree of substitutability between domestic and foreign products. The latter is not known with confidence but plausible values suggest that the tariff equivalent of the border is at least 20 per cent and probably much higher, way in excess of current formal border trade policy restrictions.

For many commentators the principal remaining policy induced barriers to international trade are those which arise from differences in national technical regulations and the duplicity of testing procedures which assess conformity with these product rules. Indeed, this has been explicitly recognised in the EU and was a major plank in the policy of creating a Single Market in Europe. However, the economic size of these barriers and the impact of policies implemented in the EU to remove them are difficult to discern. There is very little information on the extent to which technical barriers to trade raise the costs of trading. To be

able to apply standard economic approaches to the measurement of trade barriers, researchers have typically assumed that technical barriers result in an ad hoc increase in trade costs.[5]

Brenton and Vancauteren (2001) adopt an alternative approach and assess whether border effects are more prevalent for products where technical regulations are important and if EU policy towards the harmonisation of national technical requirements has had a substantial impact on the magnitude of the border. In other words, have EU policies that have been implemented to remove technical barriers to trade in the EU, moved EU countries closer to the benchmark of perfect integration?

They find that border effects remain substantial for product groups where the EU has sought to introduce harmonised technical regulations to remove technical barriers to trade and that such policy initiatives do not appear to have reduced the magnitude of the border effect. Interestingly, they also find that there are strong border effects for products where differences in technical regulations are not deemed to be important constraints upon cross-border trade. Thus, there must be factors other than differences in domestic regulations that constrain trade.[6] There is a range of possible explanations and objective research on this issue is in its infancy. Here we suggest a number of issues that we think may be of particular importance, but the list is not exhaustive.

Firstly, tastes differ across countries. Domestically located firms will tend to have better knowledge of local tastes and more generally firms will tend to locate close to markets to avoid trade costs. This effect will be magnified if intermediate goods producers co-locate with final goods producers (Hillberry and Hummels (2000)). Further, if along the lines first suggested by Linder (1961), new products are first introduced by firms in response to domestic demand and, if as is likely, new products are (at least initially) highly income elastic in high-income countries, then such countries are likely to consume a higher proportion of domestically produced goods to foreign produced goods than would be suggested by incomes and distance. Thus, since countries specialise in producing those goods that are consumed

[5] For example, Gasiorek, Smith and Venables (1991) and Brenton and Winters (1992) in different exercises assume that the completion of the Single Market implies a 2.5 per cent reduction in trade costs for all EU members. This assumption also encapsulates the impact of the removal of internal border controls and (supposedly) the end of bias in government procurement decisions. More recently, François (1998), takes accession to the EU for CEECs to entail an across the board reduction in trade costs of 10 per cent. The standard approach involves applying a given cost increase to estimated or calibrated demand and supply curves.

[6] Similar conclusions are reached by Head and Mayer (2000) who find that crude indicators of non-tariff barriers cannot explain the cross-industry variation in the size of estimated border effects.

relatively intensely at home, internal trade will be greater than that suggested by economic size alone.

Even if consumers in different countries have identical tastes for products they may still have different preferences for the way that these products are packaged and marketed, which will add to the costs of international trade. Engel and Rogers (1999) suggest that one of the factors behind the border effects in consumer prices that they identify in Europe will be differences in national marketing and distribution systems. However, one would anticipate that such issues would be less important in explaining the strength of the US-Canada border.

It is also suggested that both consumers and producers tend to have a preference for purchasing products produced in their own country. Such bias in preferences has been recognised by legislators in Europe as a distinct possibility. The European Court of Justice has ruled that mandatory labelling of goods with their national origin is not consistent with Community law since this would have an effect equivalent to a quantitative restriction. The Court felt that marks of national origin would 'prompt the consumer to give his preference to national products', and would thus contribute to 'slowing down economic interpenetration in the Community'.[7]

Clearly, if consumers were completely rational in a strict neo-classical economic sense, and made their choices only on the basis of relative prices and their income, then such rulings would not be necessary. So, if consumers are able to ascertain the national origin of products they will be able to exert any home bias they have in their preferences. In fact, whilst there are no mandatory rules on product labelling, voluntary labelling of national origin is extremely common. Indeed, there is a large literature in the context of marketing that documents the presence and importance of home bias on the basis of consumer surveys. For example, Knight (1999) reports the results of a survey of US consumers' preferences regarding microwave ovens and dishes and concludes that US made products were preferred over products made in Japan and interestingly this was regardless of whether the company was American or Japanese owned. Thus, from this source of information it would appear that the country of location of production not the country of ownership of production matters in consumer preferences – home bias.

[7] These decisions by the Court are referred to, for example, in a speech on labelling given to the European Parliamentary Forum on Textiles and Clothing by Erik Liikanen of the European Commission which is available at http://europa.eu.int/enterprise/textile/speeches/el20010301.pdf

More generally, systematic evidence on home bias in preferences is sparse. But if home bias in preferences is a genuine phenomenon and reflects actual desires on the part of consumers then policies that seek to undermine such bias and to promote further trade are unlikely to be welfare improving. In fact we are probably observing the opposite trend. Consumers are demanding more and more information about the products that they purchase and the companies that produce them. The scope to undermine biases in preferences through lack of information is being eroded.

Governments may also play an important role in determining the overall size of the border by being significant purchasers of good and services through procurement. One of the objectives of the Single Market Programme in Europe was to undermine bias in government purchasing decisions. Policies have been introduced to improve the transparency of the procurement process although there are few serious studies and no strong evidence that this has significantly increased the import content of general government purchases. Here we have even greater problems in assessing welfare implications. A part of bias in government procurement may reflect covert protectionism to favour domestic products over more efficiently produced substitutes from abroad. On the other hand, if consumers exhibit home bias then some of the bias in government procurement may reflect similar desires.

More generally, one of the main reasons for the economic impact of the border is that movement across a national frontier, even those in the EU where, with the Single Market, there are no border formalities and only empty border posts, entails movement into a different legal, regulatory, social and cultural jurisdiction. These borders ‘proscribe, adjudicate and enforce a wide range of norms, rules, habits, networks and the like’ (Thompson (2000), p. 4), which differentiate one geographical area from another, in terms of both consumers preferences but also the legal and institutional environment for doing business. Rauch (1999) has argued that products are often produced in an environment in which complex networks of contacts interact to establish markets and set prices, which usually involves extensive search costs. These costs are likely to be lower within than between countries. Fukuyama (1995) emphasises the role of trust and that overcoming lack of trust can involve substantial transaction costs. It follows that high levels of trust will tend to be associated with higher levels of productivity. In our context, trust in general is likely to be much higher between individuals within a national community. In general, these are all issues that have received relatively little attention from economists and are likely to be more fruitfully addressed in collaboration with other disciplines.

Similar arguments also pertain to international capital flows where as noted above investors tend to hold a much smaller number of securities from other countries than one might expect in a well diversified portfolio. Again, investors appear to exhibit home bias in their preferences and imperfect information and transaction costs remain a barrier to cross-country investment flows. Here apparent home bias may reflect that local assets are a better hedge against country-specific risks.

A number of conclusions can be derived from the above analysis of European integration. Firstly, even though the EU has attempted to achieve a deep level of economic integration it would appear that borders in Europe still act as formidable constraints upon commerce between member countries. This is so even in sectors where the EU has sought to remove regulatory barriers to trade and sectors where different national regulations are not thought to be important constraints to trade. Part of the border effect that we identify here could reflect the costs of different currencies in Europe, which will be removed by the use of the single currency. Nevertheless, there are many other factors that could also act to constrain trade across borders relative to trade within borders. Carefully identifying these and assessing whether they constitute ‘removable’ barriers to trade whose erosion would stimulate greater productivity in Europe or are constraints which are embedded in tastes and cultures is an important issue which will frame the way that Europe will look economically in 20 to 30 years time. If integration continues then it is likely that more and more competences will be transferred from the national to the EU level and the scope for independent policy initiatives at the national level will be increasingly curtailed. If, on the other hand, borders are impregnable to further policy initiatives or the additional gains in productivity from their erosion are so modest as to not justify action then the primacy of the nation state in its current form will continue. It is to this issue that we now briefly turn.

4. Implications for National Economic Policy in an Integrated World

Is economic integration a *process,* which once embarked upon inevitably leads to a borderless environment with a complete deterioration in the capacity for governments to implement national policies and where only supranational policy making is effective? In OECD countries generally, and in the EU where economic integration is furthermost, national policies concerning taxes and transfers, including unemployment benefits, play a major role in reducing the extent of poverty. In the mid-1990s the pre-tax and transfer poverty rate for the working-age population was about 23 per cent in Belgium, 25 per cent in France, 14 per

cent in Germany and 23 and 24 per cent respectively in Sweden and the UK. However, the post-tax and transfer poverty rates for the working population were around 6 per cent in Belgium, 7 per cent in France, 9 per cent in Germany and 7 per cent and 12 per cent in Sweden and the UK respectively (Forster (2000)). In general the effectiveness of tax and transfer systems in OECD countries has increased in the period of globalisation. In a number of countries (Australia, Canada, Denmark, Ireland and the US) pre-tax and transfer poverty rates increased between the mid-1980s and the mid-1990s whilst post-tax and transfer rates fell. For most other countries post-tax and transfer poverty rates increased by less than pre-tax and transfer poverty rates, the exceptions being Germany and the Netherlands. So in most countries the redistributive impact of the tax-transfer system increased in the late 1980s and 1990s.

Our analysis of the strength and causes of border effects suggests that although the processes of European integration and globalisation may continue, ultimately they are likely to be constrained. A borderless world in which national governments are completely neutered in their ability to implement independent policies, and in particular are unable to provide current levels of social protection does not appear to be a realistic possibility. Thus, whilst European integration and globalisation may exacerbate problems of social exclusion the choice of the scope and level of social protection will to all intents and purposes remain a national prerogative.

5. Borders, Developing Countries and Globalisation

Whilst a range of factors will continue to segment OECD markets and provide the continuing basis for independent economic policies to address the implications of globalisation, in developing countries the situation may well be quite different. For these countries global integration is occurring whilst governments do not have access to the array of policies available to OECD countries. As such there may not be any means to compensate those who lose from globalisation, even though net gains are achieved. In addition, globalisation is taking place at the same time as many countries seek to introduce market mechanisms and commensurate institutions. This suggests that the business and social networks, the legal frameworks and consumer preferences which characterise OECD countries and which have evolved over long periods are unlikely to be present. The existing social networks and social norms may be undermined by globalisation rather than be a mechanism by which to frame the impact of integration, as in OECD countries.

The same is likely to be true in transition countries where the social, legal and business environment evolved under a completely different system over the 40 years or more before transition commenced. It is an interesting question whether the current social, legal and business framework in the transition countries acts to segment the domestic from international markets in the same way as it appears to do in the industrialised countries? Can the sort of institutional environment that has evolved over many years in the industrialised countries be re-introduced (or introduced for the first time in the case of the CIS countries) in less than two decades?

Hence developing and transition countries are generally less able to address the domestic distributional implications of globalisation. Thus the impact of trade integration may be quite different than in an environment in which social and business associations have developed in a specific way over many years. In turn the ability of governments to apply policies to ameliorate the impact on those who lose from globalisation will remain constrained. The consequences of trade expansion in the absence of social safety nets can be quite different from when there are guarantees that governments are able and willing 'to do their job' (Dasgupta (2001), p. C19).

In addition to the issue of redistribution within developing and transition countries is that of the increasing perception held by many that globalisation is increasing inequality between rich and poor countries, leading to the questioning of globalisation and the role of the international institutions. At the global level redistribution between countries is tiny relative to redistribution within countries. The largest border effects are probably to be found in relation to overseas aid flows relative to flows within countries. At the global level globalisation has promulgated increased economic links and has been supported by the development of a clear and effectively enforced set of rules governing international exchange but, as political scientists emphasise, has not yet provided mechanisms for the establishment of a set of shared values and norms.

The continued economic feasibility of the nation state will frame the political environment in which issues with regard to inequality between countries and the appropriate level and nature of global governance structures are determined. In this context economic and political power will remain centred upon the US and to a lesser extent the EU. Currently, debate is dominated by the 'post-Washington consensus' agenda for global governance, which is focused upon the issue of the effectiveness and efficiency of institutions and a dialogue with western civil society. Whether this will be sufficient to provide the global trading system with legitimacy

in the eyes of those who are currently sceptical of its value is an important issue to be assessed.

6. Conclusions

At the start of the 21st century the rules-based international trading system is under threat. Whilst economists have tended to become even more convinced of the benefits of trade, adding dynamic effects in terms of higher investment and growth, to the static efficiency gains identified by Smith and Ricardo, there has arisen a 'large category of actors, groups and individuals who look increasingly negatively at globalisation and who firmly believe that it leads to increases in inequality' (Higgott (2000), p.149). Economists typically gloss over the distributional consequences of global economic integration concentrating upon the overall increases in income. However, political scientists' stress that addressing inequality both within and between nations is necessary to preserve the legitimacy of, and broad support for, the current system. In this perception a system which perpetuates substantial inequality is unstable.

In this paper we have highlighted the continued empirical importance of national borders, even within the EU, which exhibits a much higher degree of economic integration than has been achieved at the global level. Perhaps even more surprising is that capital flows show distinctly similar patterns, a bias towards investment in the home market. In fact it would appear that these two phenomena are closely linked. Thus, whilst globalisation has had profound effects on economic actors there is little to suggest that the traditional role for governments in OECD countries in providing social welfare and in regulating the domestic market economy are being undermined.

If these borders to international commerce are impervious to further policy initiatives, or if their removal would reduce welfare by, for example, undermining individual preferences, then the frictionless world foreseen by some where national administrations become largely impotent in affecting domestic economic outcomes is unlikely to occur. Thus, future discussions concerning global governance will take place between sovereign states that retain substantial discretion in economic policy making in an environment of considerable differences in economic and political power.

We have noted, however, that this situation is apparent for the industrialised countries. In developing countries the situation may be very different. The range of policies that is available in OECD countries is not accessible to many developing countries. In addition the

social and business networks and the nature of consumer preferences, which have evolved over many years in OECD countries, and which are key elements in differentiating national from international markets, are not developed to the same extent or take forms which may be inconsistent with and undermined by the increasing use of the market mechanism.

Finally, we raise the issue, but provide no answers, of how to treat, at the international level, constraints upon trade and capital movements that arise from the nature of the social and legal and preference structure of a country but which are not present in other countries? This issue may well lie at the heart of future discussions concerning the ‘fairness’ of the global trading system.

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Centre for European Policy Studies
1 Place du Congrès
1000 Brussels, Belgium
Tel: 32(0)2.229.39.11 Fax: 32(0)2.219.41.51
E-mail: info@ceps.be Website: http://www.ceps.be