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Domino effects in Western European regional trade, 1960–1992

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Abstract

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 nonmembers and, thereby, prompted their application to EC membership. The paper finds that the deepening of integration inside the EC in the late 1980s may have created such effect on EFTA member countries. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The question of regionalism has long attracted interest among international economists and policy makers. The early debate, initiated by Viner (1950), concentrated on static issues, in particular, whether preferential trading arrangements (PTAs) are trade-creating or trade-diverting. Recently, the discussion has shifted to what Bhagwati (1993) calls the “dynamic time-path” question, which can be formulated in two ways: (a) whether PTAs, once formed, tend to expand or

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to stagnate; or (b) whether PTAs are "building blocks" or "stumbling blocks" towards multilateral trade liberalization.

Nowhere has the phenomenon of regionalism developed like in Western Europe. In 1960, the 16 trading countries of the region fell into three groups: the five trading members of the European Economic Community (EEC; Belgium–Luxembourg, France, Germany, Italy and the Netherlands); the seven members of the European Free Trade Association (EFTA; Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom); and four countries belonging to neither the EEC nor the EFTA (Finland, Greece, Ireland and Spain).[1] By 1995, the region had evolved into a large entity, the European Union (EU), comprising of fourteen trading countries. The other two countries of the region belonged to the EFTA, and were linked to the EU by means of separate PTAs (the European Economic Area (EEA) for Norway, and a more modest free-trade area (FTA) in the case of Switzerland).[2]

The static question concerning the impact of PTAs on trade flows has been analyzed 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. As noted by Leamer and Levinsohn (1995), the impact of the EEC on trade was one source of issues on which gravity models focused first. This line of investigation originated with Aitken (1973), which examines the effect of the EEC and EFTA on European trade by inserting into the basic gravity equation dummy variables for participation in these two trade blocs. Using a model estimated annually over the period 1951–1967 on a sample of intra-European trade flows,[3] Aitken finds significant preferential effects for the EEC and EFTA starting in 1961 and 1964, respectively. According to his estimate, by 1967 intra-EEC (intra-EFTA) trade was cet. par. 2.4 (1.8) times larger than "normal" European trade, i.e. trade between the two blocs.

Since Aitken's study, gravity models have been used extensively to test the effect of preferential trading arrangements on trade flows. A recent example is Bayoumi and Eichengreen (1998), which estimates for the period 1956–1992 a first-difference version of the gravity model on bilateral trade flows among 21 industrial countries (the 16 Western European trading countries listed above, plus Australia, Canada, Japan, New Zealand and the United States). The study finds that the EEC and EFTA both significantly encouraged intra-area trade, especially in the early years of membership to the respective grouping.[4] Another noteworthy

[1] Finland became a *de facto* member of EFTA in 1961.

[2] In 1995, EFTA also included Iceland and Liechtenstein, both of which are ignored here.

[3] The equations were estimated for the 132 flows between 12 trading countries (the original five EEC trading countries plus the seven EFTA members): 20 intra-EEC flows, 42 intra-EFTA flows and 70 flows between the two trading blocs.

[4] Other studies of preferential trade arrangements which use gravity-type models include Sapir (1981), Frankel and Wei (1993) and Frankel et al. (1995).