Book Reviews

Trading Blocs: Alternative Approaches to Analysing Preferential Trade Agreements by BHAGWATI, JAGDISH, PRAVIN KRISHNA and ARVIND PANAGARIYA (eds.) (London, Cambridge, Mass: The MIT Press, 1999), pp. 583, £38.50 hardback, ISBN 0 262 02450 0.

There has been a proliferation of regional trading arrangements in the recent past, so regionalism has become an important area of contemporary trade policy. Although trading blocs are not a new area of intellectual inquiry, thank God it is not yet surfeited. There is still room for plenty of analytical and policy-related writing. Since 1950 noted scholars, like Jacob Viner, Richard Lipsey and Harry Johnson, have made authoritative contributions. Trading blocs or regionalism have enjoyed periods of intellectual fad, when several trade economists turned their attention to it and analysed its various aspects. One such period was the Uruguay Round (1986–94) and the period immediately following it. Over 60 per cent of the papers in this volume were written in or after 1986. The reason for the rise in popularity of this issue in the profession was that many participants, observers and analysts of the Uruguay Round suspected that the Round would either not culminate at all, or would achieve little, and thereby would toll the death knell of the multilateral trading system. Had this come to pass, the global trading system would have been left with the only alternative, namely, regional trading blocs. Expanding regionalism in trade is considered a counter to multilateralism. Some think of it as a threat to multilateralism and that it is destroying what the GATT has built over the last half-century.

The volume under review has been edited by three economists, two of whom (J.N. Bhagwati and A. Panagariya) have published a good deal on regionalism and trading blocs in the past. Little wonder that they have more than a nodding acquaintance with the regionalism literature. These two have also published edited volumes in this area. This is an ambitious work, having 28 pre-published papers covering a large period (1950–98) and 574 pages. The volume gets high marks for being up-to-date; it has four papers which were published in 1997 and two which were published in 1998. These papers have been grouped into five categories. A strength of the volume is the wide temporal coverage of some of the important works in this area. The volume is devoted largely to theoretical research. The editors claim to bring together the 'disjointed, outpouring of analysis by trade theorists'. This target has made their coverage needlessly narrow. The favoured areas of this volume are the welfare effect of preferential trading areas (PTAs), welfare-improving customs unions, the dynamic time-path effect of the PTAs, and the implications of certain well-known 'institutional' features of trade institutions and treaties. Thus, despite a wide temporal coverage, the volume is narrowly focused in subject matter. Its utility is limited only to those researchers and graduate students who are focusing on the area of specialisation of this volume. The first chapter by Bhagwati and two policy papers at the end – perhaps an afterthought – are all we have in the name of policy. Along with this, there are no papers on the World Trade Organisation and the General Agreement on Trade in Services in the backdrop of expanding regionalism. This renders the volume rather an unbalanced one. Editors of volumes of this kind must be bereft of one flaw of character, namely, nepotism. This set of editors is not above it. One glaring example is paper 15, co-authored by one of the editors with Richard A. Brecher, which does not fit in the volume at all.

Instead of reproducing the papers, the volume would have been much richer if the editors had abridged and integrated them. Notwithstanding the imbalance, this would have led to enormous value-added for academics and policy makers alike. The volume would have become a little more cohesive and accessible. However, the cost to the editors would have been some more work on the volume. It would have been well worth it.

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Generational Accounting Around the World by AUERBACH, ALAN J., LAURENCE J. KOTLIKOFF and WILLI LEIBFRITZ (eds.) (Chicago, London: The University of Chicago Press, 1999), pp. 534, US$72.00, £57.50 hardback, ISBN 0 226 03213 2.

Generational accounting is now an established tool in economics for examining the long-run incidence of fiscal policies. Past and current governments in a number of countries, including the United States and the United Kingdom, have explicitly used or cited these accounts as a tool in evaluating fiscal policy. This volume brings together some of the key papers which argue for a generational accounting perspective, along with seventeen country case studies of generational accounting calculations in practice.

The basic argument of generational accounts is that conventional measures of the government budgetary balance and wealth position are misleading and subjective. In particular, they fail to give an adequate description of the generational *incidence* of fiscal policy. An example from Kotlikoff's earlier book will suffice. It is a traditional tenet of the analysis of social security (public pension) programmes that the generational incidence of pension expenditures will depend on whether the programme is Pay-as-you-go (unfunded) or prefunded. Suppose, however, that a pre-funded Social Security Trust Fund invests its accumulated contributions in government debt. The government then uses the availability of the extra supply of funds to increase its debt (i.e. run a budget deficit). As generations retire, their accumulated social security funds will be exactly matched by the increased liabilities of the government. Leaving aside questions of 'Ricardian equivalence', it is clear that such a budgetary strategy blurs the distinction between unfunded and prefunded social security. Many confusions of this type (including, for example, the UK budgetary treatment of privatisation receipts) abound.

The generational accounts strategy to resolve this issue is as follows. Calculate, for each living generation at a particular date, the prospective flow of tax receipts and incidence of budgetary expenditures. For the generation only just born at the relevant date, this will provide an exact account of whether that generation is in 'surplus' or 'deficit'. (However, for generations born *before* this date, it should be noted that this method conflates life cycle and generational incidence, which makes interpretation of the 'accounts' problematic for these generations.) Now in projecting forward the prospective path of public expenditure beyond the current generation, clearly some of its incidence will fall on future generations. Making some assumption about the future time path of tax receipts (e.g. a constant rate structure) and assuming a discount rate, we obtain a present value of the net liabilities of future generations. The generational accounting method suggests that these projected liabilities provide a measure of fiscal (un)sustainability. If the present value of liabilities is zero or negative, the fiscal policy stance is sustainable; if positive, unsustainable.

There are two big issues here. The first is whether this is the appropriate measure of 'sustainability'. Clearly there must be some link between the discount rate used and a concept of a long-run 'equilibrium' or 'optimum' in the economy – whether the long-run growth rate, the 'golden rule' rate of profit on capital, an Aaron-Samuelson condition, or whatever. While the authors talk of an 'intertemporal budget constraint' underpinning the methodology, it would be useful to see an explicit discussion of optimality.

The second issue is that of measurement. Clearly the data requirements of the generational accounting methodology are considerable. Some heroic assumptions have to be made as to the future trajectory of the economy, including population and productivity growth rates, the evolution of the labour force, wage structure and so on. In particular, most of the cited studies use cross-section data on wages and participation rates, augmented in some cases by growth adjustments. But we know that adjusted cross-section data are very bad estimates of, say, future longevity, the evolution of male cohort-specific participation rates or of cohort-specific female earnings. We do not know how sensitive measured generational accounts are to these assumptions – it is hard to put confidence intervals or standard errors on these projections – but, if such measures are to be credible, an attempt must be made, just as demographers are now trying to do this for population projections.

This difficulty is reflected in some of the numbers. For example, in Table 4.2 (pp. 78–80), there are large generational imbalances in Germany, Italy and Japan, as one would expect, but the imbalance is considerably smaller in

France and actually negative in Sweden. Given relatively generous spending programmes in Sweden, this is hard to believe, notwithstanding recent reforms that purport to put the Swedish social security system back in 'actuarial balance'. Numbers tend to acquire a force of their own and there is a danger that generational accounts will provide further numbers that can be misinterpreted and misused by policy-makers.

Nevertheless, this is an impressive collection of evidence on an important issue and will be the standard reading on what promises to be an important contribution to improving public understanding of budgetary policy.

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Intra-Industry Trade and Adjustment by BRÜLHART, MARIUS and ROBERT C. HINE (Basingstoke: Macmillan, 1999), pp. 256, £45.00 hardback, ISBN 0 333 62304 5.

A casual look at trade statistics should be sufficient to demonstrate that intra-industry trade – the simultaneous export and import of the same product group – is an important empirical phenomenon. The study by Grubel and Lloyd (1975), showing that such two-way trade existed even on a very detailed level of classification, initiated a growing literature in three fields: first, the description of patterns of intra-industry trade among countries, across products or industries and over time; second, econometric studies of the determinants of these product and country patterns; and third, the development of theoretical models capable of explaining trade driven by other factors than comparative advantage.

Why is intra-industry trade interesting? One may give at least two reasons. The first is that it is an interesting empirical phenomenon in search of an explanation. The fact that intra-industry trade is so widespread was seen by some authors as the final blow to the neo-classical factor proportions model. Others argued that it is perfectly compatible with such a model provided that product groups are not homogeneous with respect to factor proportions.

The recognition of widespread intra-industry trade, together with the development of theoretical tools capable of incorporating imperfect competition, differentiated demand and economies of scale into general equilibrium models, initiated theoretical work leading up to what came to be known as the new trade theory. From these models it was possible to derive predictions of the country pattern, though very few of the product pattern, of intra-industry trade. However, most of the first-generation econometric studies were not linked to explicit models, and explanatory variables were introduced mostly ad hoc.

The other reason is that the welfare implications of intra- and inter-industry trade may be different. First, the gains from trade – in addition to the traditional effect of gains from specialisation according to comparative advantage – includes also welfare gains for consumers from increased diversity and lower prices because of increased competition and lower unit costs. Second, the costs arising from adjustment to increased trade and specialisation were somehow believed to be lower for intra- than for inter-industry trade.

This notion, which came to be known as 'the smooth adjustment hypothesis' (SAH), seems to have been generally accepted as an article of faith and subjected to very little analysis, either theoretical or empirical. As indicated by the title, the book under review focuses on the issue of adjustment to intra-industry trade. In addition to three chapters on methodology and a summary chapter, the book contains a description and analysis of intra-industry trade in eight EU countries up to the early 1990s.

As an illustration of the lack of theoretical foundations for the early econometric studies, Torstensson shows that some of the *a priori* notions commonly found in these studies, e.g. that the share of intra-industry trade should increase with increasing economies of scale and falling trade costs, cannot be derived from standard models; in fact, in the 'workhorse' model of Helpman and Krugman (1985, ch. 10.4) the opposite holds. Given this lack of theoretical underpinning, it is not surprising that Torstensson finds most of the variables commonly used to explain IIT to be fragile in the sense of extreme bounds analysis (EBA), and thus that the results from the first-generation econometric studies are not very robust.

Two recently developed concepts of IIT are central in this book: vertical intra-industry trade (VIIT) and marginal intra-industry trade (MIIT). In contrast to the dominating models of IIT, where product differentiation was assumed to be horizontal, and where prices are the same for all products, the VIIT models assumed that products differ in quality, i.e. are vertically differentiated, which is reflected in higher prices for high-quality goods. Moreover, high-quality products are assumed to be (human or physical) capital-intensive. Like the SAH, this assumption seems to have been accepted without empirical verification, mainly to reintroduce the factor proportions model through the back door.

In empirical work VIIT is identified on the basis of the difference between export and import unit values. In spite of likely measurement errors and the arbitrariness of defining VIIT, Hine, Greenaway and Milner are able to show that a major proportion of IIT in the UK appears to be vertically differentiated, which casts some doubt upon the applicability of the standard textbook IIT models. This holds for some EU countries, such as Germany, but not for all, e.g. Belgium and France. However, the central prediction of the VIIT models – that such trade should be most important among countries with different factor endowments – is strongly rejected by the data. Both IIT and VIIT are greatest among countries on the same level of per capita income.

As pointed out by the authors, the results conform better to the prediction of the Linder theory, where the country pattern of trade is determined by similarity of demand patterns linked to per capita income levels. The failure of the VIIT model could be attributed to faulty measurement of the variables or to the model itself being incorrect. An obvious candidate is here the assumption that production of quality is capital-intensive. This may change the conclusions on the adjustment effects of VIIT.

The SAH is based on two assumptions:

(1) that trade changes of the intra-industry type mainly result in intra-industry adjustment; and
(2) that intra-industry adjustment is less costly than reallocation of resources among industries.

On the second proposition, economic literature has not much to say. On the first, Brülhart shows that under certain simplifying assumptions, the proportion of intra-industry trade changes – marginal intra-industry trade, MIIT – will be directly proportional to the proportion of total job turnover that is reallocation of jobs among firms in the same industry. This is an interesting proposition to be tested empirically but no proof of the SAH since the cost dimension is not dealt with.

According to conventional wisdom, the fact that the early stages of European integration, while resulting in a strong increase in intra-European trade, did not cause large adjustment problems can be explained by the fact that most of the increase in international specialisation took place within industries. However, as shown by Torstensson, a central prediction of some of the new trade theory models is that a process of continous reduction of trade barriers at first will result in an increasing proportion of intra-industry trade, but that in later stages this proportion will again fall, so that specialisation will increasingly be of the inter-industry kind. This prediction was thought to be confirmed by the finding of some studies that the earlier positive time trend seemed to be broken and that the Grubel-Lloyd (GL) index stagnated in the 1980s. This led some analysts to believe that the adjustment consequences of the Single Market would not be so benign as those of the European customs union in the 1960s.

However, this book produces strong evidence against that conclusion. First, taking more recent trade data into account, most country GL indices increased again in 1988–92. Moreover, the earlier picture of stagnation may have been a consequence of measurement errors. Second, as argued by Brülhart and others, the relevant measure of adjustment pressure – inter- or intra-industry – is not the GL but the marginal intra-industry trade index, MIIT. Since the average level of MIIT in the EU countries has in fact increased there seems to be no sign of an increasing proportion of job reallocation between rather than within industries.

To sum up, the book presents the most comprehensive, recent and detailed set of data for intra-industry trade and its components – vertical, horizontal and marginal IIT – available to date for the EU. It also contains results from a set of country studies of the role of trade for adjustment. The book should be highly valuable for scholars interested in economic integration, intra-industry trade and the adjustment consequences of international trade.

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Restoring Japan's Economic Growth by ADAM S. POSEN (Washington DC: Institute for International Economics, 1998), pp. 186, $18.95 paperback, ISBN 0 88132 262 8.

Posen argues that the inability of the 1990s' Japanese economy to grow at a rate of which it is capable, not its *potential* rate, is attributable to a combination of fiscal austerity and financial laissez-faire by Japanese authorities which transformed a normal cyclical downturn, following the burst of the bubble economy, into a serious and protracted recession. Thus, contrary to wide claims, the culprit is not lack of return on investment or political deadlock.

Posen begins by tackling three related rationales supporting these Japanese 'mistakes' because they are prominent and consciously chosen. The first is that stagnation is due to a deterioration in Japanese economic fundamentals, not to inadequate aggregate demand, hence rendering inappropriate a macroeconomic response. This is discarded because the extent and sources of output decline cannot sensibly be explained by a shift in potential growth, hence the priority should have been to make up the shortfall between the prevailing and potential rate of growth of about 2–2.5 per cent per annum. The second is that significant fiscal stimulus has already been undertaken, but to no avail. This is debunked because a serious examination of the packages undertaken during 1992–8 reveals that they were actually far smaller than claimed, that for a number of years the budgets acted to reverse their declared effects, and that the only time fiscal stimulus was seriously attempted (in September 1995), strong growth ensued. The third is that fiscal stimulus is unlikely to have the desired short-term effects, and any immediate benefits from it will be outweighed by long-term costs due to Japan's looming social security burdens. This is rejected because most of the recognised economic determinants of the effectiveness of fiscal stimulus are actually favourable today, given people's flight from domestic investment – the combination of sharp rises in households' demand for cash and low expectations by both households and businesses regarding returns on investment preclude crowding-out offsets to Japanese fiscal policy – and in the long-term fiscal stimulus will not result in an explosive increase in public debt.

Posen then turns to what should be done to reverse these mistakes. He starts by evaluating the mounting risks that domestic financial fragility, consumer confidence and the international environment pose for Japan's future economic growth: massive capital flight abroad; financial disintermediation at home; and competitive devaluations. These risks explain why banking reform and monetary stabilisation are inseparable from fiscal stimulus, and colour his recipe for a Japanese economy growing at the rate of 2–2.5 per cent. His programme is a combination of: a sizable fiscal stimulus of 4 per cent of GDP through permanent tax cuts, funding the deficit with short-term government debt; a stabilisation of price expectations, through the announcement of an inflation target of 3 per cent for the summer of 2000 and the avoidance of deliberate yen depreciation; and financial reform through a cleanup of the Japanese banking system along the lines followed by OECD nations in the 1980s and 1990s. Since financial reform may have short-term contractionary effects, due to the exit of insolvent banks, the need for its linkage to financial stimulus is reinforced. The successful implementation of Posen's programme requires neither structural reform nor a lengthy and painful transition, indicating that the restoration of Japan's economic growth is a matter of policy choice.

However, the OECD's October 1999 recommendation for an increase in tax revenues with a broadening of the tax base and a raising of the consumption tax above its present level of 5 per cent, is in direct contradiction with Posen's recipe. Moreover, although the Japanese government has flatly rejected the OECD's call for an increase in the consumption tax, it is not contemplating reducing it, and Mr Kazuo Ueda, an influential member of the board of the Bank of Japan, has clearly indicated (on 17 October, 1999) that the Bank will not consider inflation targeting until the Japanese economy has completely recovered. It would therefore seem that neither Japan nor the OECD is heeding Posen's advice. Furthermore, Posen does not entertain the scenario that it is consensus politics under fragile ruling party coalitions, which has been responsible for the lack of full implementation of the fiscal packages. Nevertheless, I totally agree with him that there has been no change in fundamentals (see my response to Krugman). This book should be compulsory reading for all those concerned with macroeconomics, public finance and the Japanese, hence world, economy.

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