

Box 6

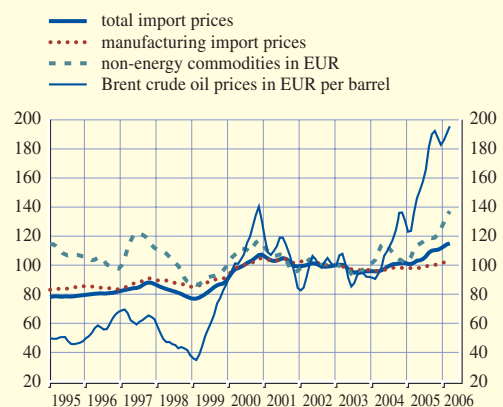
EFFECTS OF THE RISING TRADE INTEGRATION OF LOW-COST COUNTRIES ON EURO AREA IMPORT PRICES

Higher international economic interdependence through trade, production and financial market linkages – in short, globalisation – has had contrasting effects on import prices, and thereby also on consumer price inflation in the euro area. On the one hand, globalisation and the associated rise in trade integration with emerging markets and developing economies has contributed to import price moderation, notably in the manufacturing sector, due to increased imports from these low-cost countries. On the other hand, the combined effect of rising global demand and the existence of important supply bottlenecks has boosted prices of commodities, particularly energy (see chart). This box aims to quantify the former effect.

Increased international economic interdependence and the rapid integration of several emerging economies into global trade and production networks have certainly contributed to stimulate competition in domestic markets and to increase and diversify euro area trade linkages. Since the mid-1990s, the geographical distribution of euro area imports has changed substantially. In 1995, two-thirds of extra-euro area manufacturing imports came from industrialised countries (high-cost countries hereafter), whereas in 2005 their share had declined to around 50%. The decrease is distributed among the traditional major euro area trade partners (United Kingdom, Japan, United States), while the shift towards emerging, low-cost economies is mainly accounted for by increased imports from China and, to a lesser extent, the new EU Member States (see table).

Extra-euro area import prices of goods

(monthly data; indices: Jan. 2003 = 100; 3-month moving average)



To obtain an order of magnitude of the direct downward effects of a higher level of imports from low-cost countries on import prices, the change in import shares to the euro area is multiplied by the estimated price level difference of imports from low-cost countries vis-à-vis high-cost countries. In addition, the change in euro area import prices due to import price inflation differentials between high and low-cost countries is computed. The combined impacts of these two effects are estimated to generate a sizeable dampening of overall euro area import price growth of approximately 2 percentage points per annum on average over the period 1996–2005.¹

¹ The methodology used in the estimation is similar to the work by S. B. Kamin, M. Marazzi and J.W. Schindler (2004) "Is China exporting deflation?" *Board of Governors of the Federal Reserve System, International Financial Discussion Papers, No 791*.

Country shares in extra-euro area manufacturing imports ¹⁾

| | High-cost of which: | United States | Japan | United Kingdom | Low-cost of which: | China | New EU Member States |
|-------------------------|------------------------|------------------|-------------|-------------------|-----------------------|------------|-------------------------|
| 1995 | 65.7 | 16.1 | 10.7 | 20.3 | 34.3 | 5.0 | 8.0 |
| 1997 | 65.2 | 17.7 | 9.6 | 21.2 | 34.8 | 5.8 | 8.4 |
| 1999 | 64.1 | 18.4 | 9.8 | 19.6 | 35.9 | 6.3 | 9.8 |
| 2001 | 60.2 | 18.1 | 8.5 | 18.6 | 39.8 | 7.9 | 11.6 |
| 2003 | 55.1 | 15.1 | 7.8 | 16.6 | 44.9 | 11.0 | 14.0 |
| 2005 | 50.7 | 13.9 | 6.7 | 15.0 | 49.3 | 14.8 | 13.1 |
| Change 1995-2005 | -15.0 | -2.2 | -4.0 | -5.3 | 15.0 | 9.8 | 5.1 |

Sources: Eurostat Comext database and ECB staff calculations based on values in EUR.

1) The country decomposition considers 25 countries (and regions) of origin which cover the trading partners of the euro area. These were divided into two groups ("high-cost countries" and "low-cost countries") on the basis of their GDP per capita. The "high-cost countries" include Australia, Canada, Denmark, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. The "low-cost countries" comprise 15 countries and regions: ASEAN, EU candidate countries, CIS, Central America and the Caribbean, China, India, MEDA (excluding Malta, Turkey and Cyprus), the Middle East, the new EU Member States, North Africa, Rest of Africa, Rest of Asia, South America, South Korea and Taiwan.

In addition to such direct effects, second-round effects are also likely. For example, increased imports from low-cost countries may induce moderation in import prices and in mark-ups on goods imported from high-cost trade partners, given the availability of substitutes produced in low-cost locations and the possibility of increasing cost-efficiency via globalisation-induced low prices for intermediate inputs of goods and services.

Overall, differentials in both the import price level and inflation between high-cost and low-cost countries have implied a rather important and persistent moderating impact on overall import prices over the last decade. From a longer-term perspective, this dampening effect might tend to fade out unless the export prices of low-cost countries remain well below international levels and the shift in import shares continues to move away from high-cost countries and towards low-cost countries. In addition to the effects on import prices, the rising integration of emerging markets into the world economy has had other dampening effects on consumer price inflation through channels such as wage containment and increased product market competition. However, these effects are to some extent counterbalanced by the strong pressure which is associated with the increase in commodity prices arising from increased demand from emerging economies and persistent supply bottlenecks.

FINANCIAL ACCOUNT

In the three-month period to May 2006, euro area combined direct and portfolio investment showed average net inflows of €32.7 billion (see Table 8), mostly as a result of net inflows in both equity portfolio investment (€5.6 billion) and debt instruments (€24.4 billion). Moreover, euro area direct investment also recorded net inflows of €2.8 billion during the same period.

Turning to 12-month cumulated data, combined direct and portfolio investment recorded net inflows of €68.9 billion in the period to May 2006 compared with net inflows of €36.4 billion in the same period a year earlier. Combined direct and portfolio investment flows have been characterised by rather large swings since 2005: net inflows declined sharply in the second half of 2005 from the high level recorded in the first half of that year, before rising again in 2006 (see Chart 32). This primarily reflected developments in net portfolio investment flows, particularly in equity investment.