

# **R&D Races and Spillovers between the EU and the US: Some Causal Evidence <sup>(\*)</sup>**

Erdal Atukeren

Swiss Institute for Business Cycle Research (KOF / ETH Zürich)  
WEH - ETH Zentrum, CH-8092 Zurich, Switzerland.

atukeren@kof.gess.ethz.ch

---

## **Abstract**

This paper examines the causal relationships between the R&D sector activities of the EU and the US in a multivariate framework. As a novelty in this literature, we employ the subset transfer function methodology to account for the possibility of “dry holes” in the effects of R&D efforts on economic activity. We find that R&D activity in the EU is a direct Granger-cause of both R&D and economy-wide productivity in the US, and the effects are negative. On the other hand, the EU reacts positively to increases in R&D productivity in the US. Thus, the US can be said to respond submissively to an R&D move by the EU, while the EU’s reaction to the R&D efforts by the US firms is on the aggressive side. These findings are largely in line with the actual developments in the productivity differentials between the EU and the US and the patterns in their relative shares in the world market for high tech exports.

**JEL Codes:** C32, O30, O40

**Keywords:** R&D races, productivity spillovers, direct Granger-causality, EU’s Lisbon targets, high tech exports

---

## **I. INTRODUCTION**

In their Lisbon summit in 2000, the Ministers of the European Council declared the goal of turning the European Union (EU) into “...the most competitive and dynamic knowledge-based economy in the world by 2010”. Among various targets to achieve this aim, the ratio of spending on research and development (R&D) activity was envisaged to increase from about 1.9 percent in 2000 to 3 percent in 2010. This target was emphasised again in the Barcelona meeting of the European Council in March 2002. As of mid-2005, the progress made towards meeting the Lisbon target on R&D has been slow and partly impeded by the politics of the allocation of expenditures in the EU budget.

---

(\*) Paper presented at the annual ECOMOD (International Conference on Economic Policy Modeling) meetings on June 29, 2005 (Session: Technology and Growth), in Istanbul, Turkey. Please cite as ECOMOD 2005 Conference Proceedings.

Historically speaking, the ratio of overall spending on R&D (public and private sources) to GDP in the EU has varied between 1.6 and 2 percent since the beginning of 1980s. On the other hand, this ratio was as high as 3 percent in Japan and generally above 2.5 percent in the United States (US). Furthermore, the R&D spending to GDP ratio showed a secular increase both in the US and in Japan since 1996 while the R&D spending/GDP ratio stagnated in the EU. In this context, the ambitious R&D targets set by the European countries is a signal of showing aggressive reaction – at least at the policy making level – first of all not to lag behind and then to overtake the R&D (location) leadership. If successful, this policy should help enhance the EU’s long-term economic growth potential.<sup>1</sup> Putting the political and economic realism of the EU’s R&D targets aside, the EU’s stated willingness to make an aggressive move to match the already higher and increasing level of R&D activities in other countries has game-theoretic implications.<sup>2</sup>

While the R&D races and games among firms (e.g., whether or not to innovate, when to innovate, formation of research joint ventures, etc.) and government policies towards the protection of innovations through patent policy are well-discussed in the industrial organisation literature, the direct relationship between the R&D activities of two countries or trading blocks has received less attention. As a notable exception, Scherer (1991) examined the case of an “R&D race” between the US and Japan by means of bivariate Granger-causality tests. Scherer’s findings illustrated that the US firms reacted submissively, rather than aggressively, to the market penetration through R&D success by Japanese firms. In this context, a submissive reaction by a firm/country (say, “A”) to the R&D efforts by others (say, “B”) is said to occur when “A” does not (or, cannot) counter the innovations made by “B” and reduces its R&D budget/efforts to shift resources into non-R&D physical capital investments or just into marketing and advertising.<sup>3</sup> Scherer’s (1991) finding that the US is hurt by the Japanese R&D has been supported by a number of subsequent micro-level studies [e.g., Park (1995), Eaton and Khortum (1996), and Blonigen and Slaughter (2001), among others.] More recently, Luintel and Khan (2004) use cointegration analysis and show that international R&D spillovers could be costly for the US. At the macro level, the cost of not responding to competitors’ R&D moves aggressively could first be felt as a loss of export share in the world markets for high technology goods (i.e., exports originating from R&D intensive industries). In the longer run, lagging behind in innovation activities should also reflect itself in relatively lower economic performance and productivity growth rates.

Assessing the direction and the sign of the causality in R&D interactions between firms/countries is complicated by the fact that innovation activity leads to knowledge spillovers. These spillovers mainly stem from the imperfect appropriability of rents from innovations and diffuse through international trade, foreign direct investments, imitation, and labour mobility, among other channels.<sup>4</sup> As such, they occur not only within the home country but also across countries. Indeed, firms (domestic and/or foreign) may need to undertake catch up investments in R&D capability just to be able to make good use of the newly acquired technology from other firms since even sheer imitation requires the reverse engineering and reconstruction of the new product.<sup>5</sup> In addition, R&D is a risky business. Increased spending on R&D activities does not guarantee a successful outcome – at least immediately. Even if the results of R&D efforts become visible in the form of patents, publications, and citations, it may still take time to turn the successful basic research results into practical applications. Thus, there exists a phenomenon of “black holes” in the nature of R&D activities. Hence, the actual results of R&D games are not easy to predict/estimate due to inherent uncertainties and information asymmetries associated with innovation activities. In sum, the possibility of an aggressive or a submissive reaction, coupled with the particularities of the nature of innovation activity, makes the sign of the effects of R&D efforts by a firm/country on the R&D efforts of others indeterminate. Then, a deeper look into the nature of causality in the recent history of the R&D interactions between the EU and the US is especially important in view of the EU’s decision to set explicit R&D spending targets to counter the US’s R&D lead.

In this framework, this paper investigates the direction and the sign of causality in the international and domestic effects of R&D activity in the European Union (EU15 – i.e., the EU before the enlargement in 2004) and the United States in a multivariate framework. The analysis uses annual data on R&D productivity and labour productivity for the 1979-2002 period. In particular, we test: 1) whether changes in the R&D effort in the EU Granger-cause a response in the R&D activity by the US, and if so, whether the reaction is aggressive or submissive; 2) whether changes in the R&D effort in the US Granger-cause an R&D response in the EU, and if so, whether this reaction is aggressive or submissive.

The multivariate framework allows us to test whether the nature of the Granger-causality between the EU's and the US's R&D activities are robust to inclusion of additional variables. This is an important point. According to Hsiao (1982), for example, for a (weakly) stationary stochastic variable X to be a "direct Granger-cause" of another (weakly) stationary stochastic variable Y, X should Granger-cause Y in all setting: bi- and multi-variate. In addition to allowing for the testing of "direct causality" between the variables of interest, the multivariate framework allows for the detection of any other causal relationships among the variables in the system. In our case, this approach provides additional insights into the interaction of the R&D efforts in the EU and the US with their overall domestic economies (EU, US) as well as the overall foreign economy (US, EU). As a further methodological novelty, we address the possibility of "dry holes" in the nature of R&D activity by using a subset transfer function methodology in choosing the optimal specifications in the test equations.

The rest of the paper is organised as follows. Section II discusses the data and the methodology used in this paper. Section III presents the empirical results and puts them in perspective with respect to the observed productivity differentials between the US and the EU as well as the patterns in the relative shares of the US and EU in world high tech goods exports markets. Section IV concludes.

## II. DATA AND METHODOLOGY

### 1. *Data Issues*

The most commonly employed measure of productivity in the studies of R&D spillovers is total factor productivity (TFP). The TFP is calculated from an aggregate production function, such as  $Y = AK^\alpha L^{(1-\alpha)}$ , where Y is output, K is capital stock, L is labour input, A is a technology parameter, and  $0 < \alpha < 1$  is an elasticity parameter. In principle, one can obtain the estimates for TFP as a residual given the capital and labour input and the value of  $\alpha$ . However, there are numerous assumptions behind this approach and the estimates of technological progress hence obtained are model dependent. In addition, any adjustments made by the national statistical agencies to account for quality changes in the capital stock may reduce or eliminate the impact of embodied technical progress. Furthermore, the estimation of capital stock is problematic in itself. Also, since we take the EU as an overall entity or a trading block of 15 countries, it might be erroneous to combine the capital stock figures calculated by different national statistical offices.

Labour productivity is an alternative measure to TFP. It is not dependent on the assumptions of a theoretical model and it does not require capital stock estimates.<sup>6</sup> Furthermore, various versions of labour productivity are used in making cross-country comparisons of economic growth and development. Falvey, Foster, and Greenaway (2002, 2004), for example, argue in favour of a productivity measure (GDP per capita), which is rather related to labour productivity than the TFP. In view of the above considerations, we also take labour productivity as a measure of domestic productivity developments in the EU and in the US.

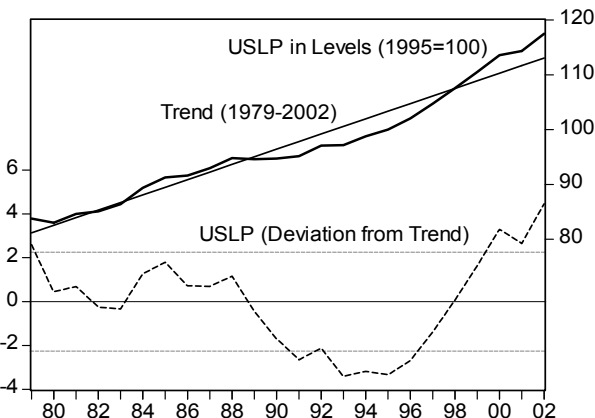
The choice of the R&D variable is made as follows. In the literature, the R&D activity is generally quantified in terms of expenditures. The EU indeed set its target in terms of R&D expenditure/GDP ratio. Nevertheless, there are a number of problems in using R&D expenditure

data. First of all, the timing and the intensity of successful outcomes from increased R&D expenditures involve uncertainties. Secondly, the definition of what is “high tech” or R&D intensive good changes overtime. The R&D expenditure figures from the OECD’s Main Science Indicators database (as of July 2005) contains many breaks, making them unsuitable for long-term time series analysis purposes. It may be possible to pool the R&D expenditure data for shorter periods of time, where they are consistent, and use panel data methods. Indeed, a large share of the studies in the literature that uses R&D expenditure data employs pooled time-series – cross-section data and conducts panel cointegration tests. The panel data techniques are useful especially when the span of data is too small to conduct meaningful bilateral cointegration and causality tests between the variables of interest. However, they are subject to more stringent assumptions about the data generating processes due to pooling. Indeed, Luintel and Khan (2004) in a study of R&D spillover across G10 countries conclude that it is not appropriate to pool their data since “...long-run spillover elasticities differ significantly among sample countries; and panel estimates, in general, do not correspond to country-specific parameters. Thus, panel tests appear to conceal important cross-country differences in knowledge spillovers.” (p. 909).

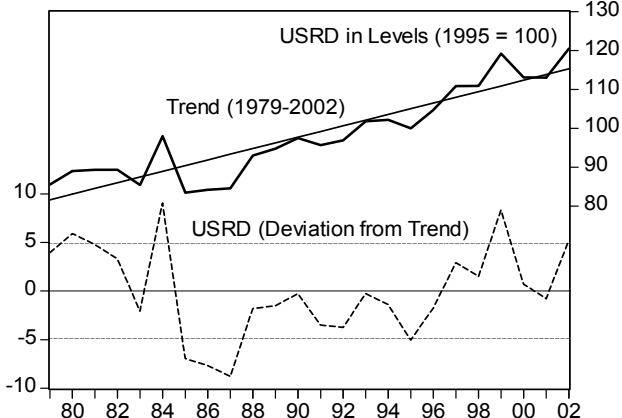
Since this paper is particularly aiming at causally investigating the foreign and domestic effects of R&D activities in the EU and in the US, we need consistently compiled time series data with a reasonably long span to run the multivariate Granger-causality tests. Therefore, we make use of the University of Groningen’s “Growth and Development Centre, 60-Industry Database (GGDC\_60), version February 2005”. The GGDC\_60 reports national-accounts-based value-added data, standardised by the ISIC (revision 3) classification system, for a large number of OECD countries for the 1979-2002 period. Under the ISIC rev. 3, “Section 73” is the “research and development” activity from all sources.<sup>7</sup> Thus, we select this entry to as a measure of the economy-wide R&D activity.

Both the value added in the R&D sector and in the total economy are measured in real terms (at 1995 constant prices). They are further adjusted for differences in employment levels and indexed as 1995=100 to make the data comparable across countries and in levels. The resulting four real variables are thus the real value added per worker (labour productivity) in the R&D sectors and in the total economies of the EU (EURD, EULP) and the US (USRD, USLP). Since labour productivity growth is also due to other factors than R&D, we also take the deviations of these series from their 1979-2002 trend growth. Figures 1-4 show the graphs of the series in question.

**Figure 1. Labour Productivity in the US (USLP)**



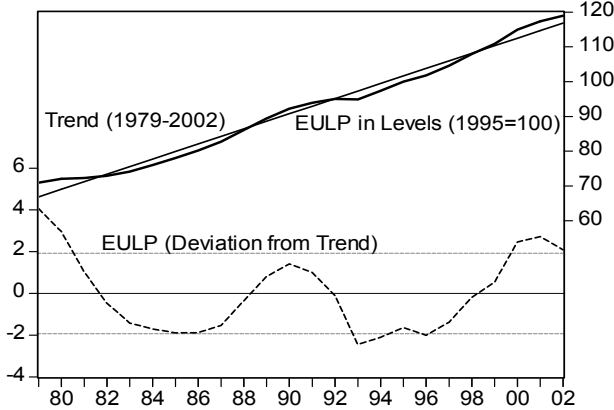
**Figure 2. R&D Productivity in the US (USRD)**



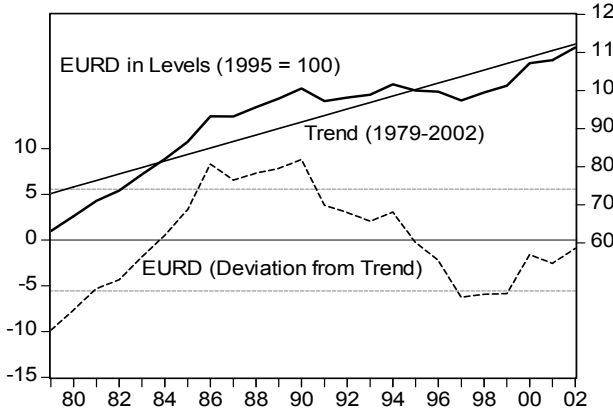
As Figures 1 and 2 show, there is a coincidence between the general productivity slump (1989 – 1998) in the US and the slump in the real value-added per worker in R&D activities (1985 – 1996). Furthermore, there appears to be a leading effect from the R&D sector. The productivity

slump in the US is well-studied. The decline in the R&D spending (and thus R&D output) has been put forth as one of the explanations. Nevertheless, it was further argued that the decline in the R&D alone would not be sufficient to produce the magnitude of this slump. In the case of EU, the situation is not clear (see Figures 3 and 4). However, a time-series analysis of the lead-lag relationships may still tell a different story than the first visual impressions.

**Figure 3. Labour Productivity in the EU15 (EULP)**

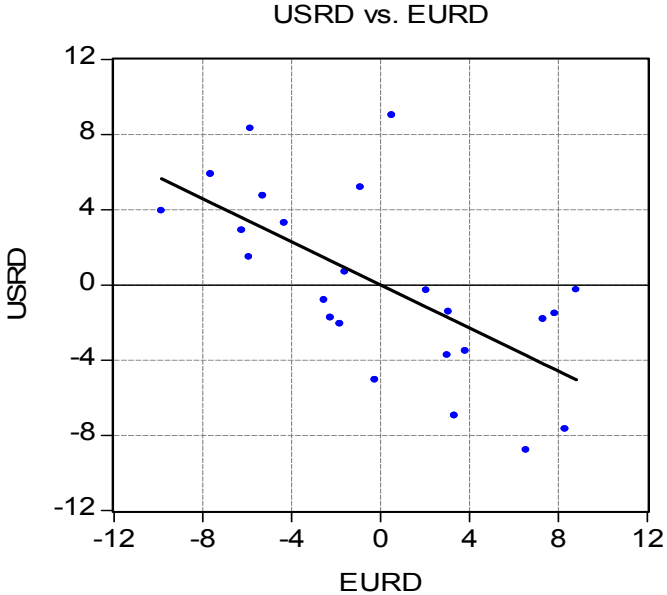


**Figure 4. R&D Productivity in the EU15 (EURD)**



When it comes to the relationship between the deviation of the value added in the R&D sector per worker from its long-run trend in the US and the EU, there indeed appears to be a negative relationship.<sup>8</sup> This is illustrated as a scatterplot with a linear regression line in Figure 5.

**Figure 5. Scatterplot of the EU’s and the US’s R&D Productivities**



Nevertheless, Figure 5 displays the bivariate relationship between the productivity in the EU’s and the US’s R&D sectors without controlling for any third variables. In any case, the direction of causality cannot be deduced by using (partial-) correlation analysis. Then, the question is whether the negative relationship between USRD and EURD – suggesting the existence of a possibly submissive reaction by one of the players – should be seen as the US’s R&D hurting the EU’s or vice versa.

## 2. Methodology: Testing for Granger-causality in a multivariate framework

Granger's (1969) definition of causality between two weakly stationary stochastic variables X and Y is as follows. X is said to Granger-cause Y if and only if Y can be better predicted by using X in addition to the history (lags) of Y and all other relevant information. In a bivariate case, this definition takes the following form in practice:

$$y_t = \alpha_1 + \sum_{j=1}^p \beta_{1j} y_{t-j} + \sum_{j=1}^q \gamma_{1j} x_{t-j} + \varepsilon_{1t} \quad (1)$$

$$x_t = \alpha_2 + \sum_{j=1}^r \beta_{2j} y_{t-j} + \sum_{j=1}^s \gamma_{2j} x_{t-j} + \varepsilon_{2t} \quad (2)$$

where:  $\alpha$ 's are constant terms,  $\beta$ 's and  $\gamma$ 's are parameters to be estimated, p, q, r, and s are lag-lengths, and  $\varepsilon_{it}$  are well-behaved error terms. In equation (1) if  $\sum \gamma_{1j} \neq 0$ , then X Granger-causes Y. Granger-causality from Y to X can be similarly defined. The practical problem with the above equations is how to choose the optimal lag-lengths (p,q,r,s). This is an important consideration since the results from Granger-causality tests are generally sensitive to the specification of the test equation. Granger (1969) used fixed lags, i.e., p=q=r=s. In later versions of the Granger's causality test, flexible lag-lengths were used, e.g., Hsiao (1979, 1982). In this study, we use the subset autoregression and transfer function approach which includes only the significant lags in the specification of equations (1) and (2) as suggested by Penm and Terrel (1984) and Kang (1989). Using the subset transfer function methodology has a further relevance in the context of empirical modelling of the effects of R&D activity. As discussed earlier, there might exist "dry holes" in the relationship between R&D and economic activity [see, for example, Rouvinen (2002)]. That is, not every increase in R&D effort necessarily immediately reflects itself into higher productivity in the economy. At times, there might be no visible effects, or the effects are small and unclear. But, they accumulate (e.g., learning effects even from unsuccessful attempts) and may show themselves after a long lag, or perhaps after "...some promising discovery." (Rouvinen, 2002, p. 125). Then, the subset transfer function approach that suppresses the insignificant lags and allows for the possibility of including distant but significant lags into the specification is conceptually well-suited for empirically addressing the phenomenon of "dry holes".

For the selection of the optimal lag specifications in subset autoregressions and subset transfer functions, we use Schwarz's (1978) "Bayesian Information Criterion (SBIC)". SBIC is given by the formula:  $SBIC = (ESS/T) * T^{(k/T)}$ , where ESS is the error sum of squares from estimation of the model in question, T is the sample size, and k is the number of estimated parameters in the model. Conceptually, SBIC is derived from Bayesian foundations. As such, it is an attempt to find the most probable model for the data at hand.

The detection of Granger (non-) causality from X to Y even in a bi-variate framework has important implications. According to Hsiao (1982), for X to be a direct cause of Y, X should cause Y in all settings: bi- and multi-variate. Furthermore, if X causes Y only indirectly via another variable Z, X should still cause Y when Z is not in the equation. Nevertheless, if Z is a common cause of both X and Y, and if there is no other direct or indirect relationship between X and Y, one may detect Granger-causality between X and Y in the absence of Z. The detected causality in this case would be spurious. In our study, we start with the examination of Granger-causality in the bivariate case, but extend the analysis into a 4-variable framework subsequently. Still, we qualify our findings as *prima facie* since the missing cause problem is not necessarily solved in a multivariate framework.

Analysing the causal relationships among the variables of interest in a multivariate framework is a complex task due to any indirect linkages and possible spurious relationships. For example, consider the case where a variable X Granger-causes Y in a trivariate system (i.e., in the

presence of a distinct variable Z) but not in a bivariate relationship. Hsiao (1982) calls this as “Type I spurious causality”. This may be a misnomer since the Z variable indeed acts as a catalyst or as a co-requisite condition for the causal relationship between X and Y to hold. In order to conclude in favour of non-causality from X to Y in a multivariate setting, X should not cause Y in a bivariate setting and, in addition, X should not be a (direct) cause of any variable that in turn causes Y. Further definitions can be found in Hsiao (1982). See also the Appendix to this study for a parameterised extension of Hsiao’s (1982) definitions in a 4-variable framework.

Another complication that arises in testing for Granger-causality is the following possibility: even if the introduction of X (say, with lags 1 and 2) over the best univariate specification for Y leads to a lower forecast error variance of Y (i.e., X Granger-causes Y), the estimated coefficients on lag 1 and 2 may carry opposite signs and cancel out, or their sum may not be statistically significant. In this case, it would be wrong to conclude that X does not cause Y since the conditions for Granger-causality are still fulfilled. This case, discussed in Sturm and De Haan (1998) among others, is called “neutrality”.

In addition, the following case may also be encountered in a 4-variable system consisting of Y, X, W, and Z. That is, one runs the Granger-causality test between X and Y first in a bivariate relationship, secondly in a system when W is present (X,Y,W), thirdly in a system when Z is present (X,Y,Z), and finally when all four variables are in the system (X,Y,W,Z). Now, let us assume that X is found to be a direct cause of Y (that is, X causes Y in all settings), but the sign of the estimated coefficients changes from specification to specification. Then, one must conclude that the relationship between X and Y is not robust in different specifications despite the findings of direct causality in the Granger-Hsiao sense.

### III. EMPIRICAL FINDINGS

#### *1. Causal Analysis*

Following the above discussion of the data and the methodological details and problems, we now turn to the examination of the Granger-causal links between the four variables described and graphically displayed above: EURD, EULP, USRD, and USLP. We are especially interested in finding out whether there are cases of “direct causality” between these variables. In running the Granger-causality tests, we first test for the time series properties of the variables in question using the augmented Dickey-Fuller (ADF), Phillips-Perron (PP), and the KPSS unit root tests. The test results shown in the Appendix (Table A1) indicate that all series are stationary. Hence, the original (non-detrended) series can be considered as  $I(0)$  processes around a deterministic trend. Next, we examine the bivariate causal relationships using the system shown in equations (1) and (2). The generic variable names X and Y are replaced with a pair of the EURD, EULP, USRD, USLP variables in the actual test. The lag-lengths are selected through a subset autoregression and transfer function methodology as discussed before. The maximum lag-length was set to six. This is in line with Ravenscraft and Scherer (1982) who calculate that the mean lag for the R&D efforts to show their effects (on industrial profitability) is 4 to 6 years. Our choice has also been necessitated by the available number of observations (1979-2002, i.e., 23 years) and the number of variables (four) in our study. For example, if we were to estimate a vector autoregression (VAR) that is formed without a subset autoregression and transfer function methodology, we would be able to use at most 4 lags – leaving only 2 degrees of freedom in each equation, not a healthy choice for making statistical inferences. Nevertheless, the subset methodology eliminates the insignificant or redundant parameters and leads to more efficiency in estimation in addition to allowing for the inclusion of more distant but possibly significant lags in the specification. Table 1 shows the summary results from the bivariate Granger-causality tests. The “Caused Variables” and the “Causing Variables” in Table 1 can be read as the Y and X variables, respectively, in equation

(1). [See the Appendix Table A2 for the details of the specifications and the resulting SBIC values.]

The qualitative findings from the Granger-causality tests provide a first glimpse into the causal relationships among our set of variables. First of all, the impact of an increase in the productivity of R&D activity in the EU is found to have negative effects on the R&D and overall labour productivity in the US. On the other hand, the EU appears to be positively affected from an increase in the US's R&D productivity. Similar to the findings on the effects of Japanese R&D efforts on the US, the R&D efforts in the EU also appear to be hurting the U.S.

Table 1. Results of Bivariate Granger-causality Tests

Caused Variables ↓	← Causing Variables			
	EURDLR	EULPR	USRDLR	USLPR
EURDLR	---	None	(+)	(+)
EULPR	Neutral	---	(+)	Neutral
USRDLR	(-)	(-)	---	(-)
USLPR	(-)	None	None	---

Notes: “None” means no Granger-causality is detected; (.) indicates there is Granger-causality between the variables in question and shows the sign of the relationship. The sign is confirmed as a result of joint-significance tests (Wald) in case of multiple lags entering the specification. The indicator “Neutral” is used when there is indeed Granger-causality from the causing variable to the caused one, but the signs on the lags of the causing variable do not turn out to be jointly significant. Detailed estimation results and regression diagnostics are available upon request.

When it comes to the effects of R&D on the domestic sectors, no significant or persistent effect is found either in the EU or in the US. In addition, the impact of an increase in labour productivity (above the long-run trend) does not appear to spill into the R&D efforts in the case of EU. In the US, the impact is indeed negative. Since labour productivity may increase also due to improvements in human capital quality or substitution of physical capital for labour, the firms may be in a position to cut down their R&D budgets to shift resources into marketing and advertising and/or compete in the domestic or international markets through productivity increases brought about by other means. Finally, there is no spillover effect from the EU's labour productivity on the US. There is some indication of spillovers from the US labour productivity to the EU's , but the overall effect is neutral.

Keeping these findings in mind, we now analyse the causal relationships in 3- and 4-variable settings. The following are the trivariate systems to be investigated: 1) EULP, EURD, USRD, 2) EULP, EURD, USLP, 3) EULP, USRD, USLP, and 4) EURD, USRD, USLP. In the 4-variable system, we estimate four models, each one explaining one of the above variables (as the dependent variable) on its own lags and on the lags of the three remaining variables.

In multivariate models, the choice of the lag-lengths and thus the optimal model becomes rather complicated. We follow the following route. First, we use the bivariate specifications (say, EULP and EURD) as the basis to introduce the third variable (say, USRD). The optimal specification was found through minimising the SBIC criterion resulting from different lag-length specifications. This procedure was repeated once more by changing the order of the variables in the bivariate specification (i.e., EURD and EULP with USRD again being the third variable), and the resulting SBIC value was noted. Then, comparing the SBIC values from the two models, we pick the one with the lowest value as the basis for the 4-variable model. This is in line with the

principle that the optimal specification should be robust to variable orderings. Next, we enter the fourth variable into the systems. A similar methodology to the trivariate case is again used to select the model with the lowest SBIC value. The equations of the 4-variable case and a description of the conditions to evaluate the causal relationships among the variables are given in the Appendix. The qualitative results obtained from the trivariate and 4-variate models are presented in Table 2, while the underlying optimal specifications and the resulting SBIC values are shown in the Appendix (Tables A3 and A4).

An examination of Table 2 shows that robust results (i.e., both the existence of a causal relationship and the sign of it) are obtained for the following cases only: EURD → USRD (-), EURD → USLP (-), USRD → EURD (+), and USLP → EURD (+), where the “→” sign shows the direction of Granger-Hsiao causality and the (.) shows the sign of the causal relationship.

Table 2. Summary of the Causal Findings from Bi- and Multivariate Systems

Causal Relationship	Bivariate Model	Trivariate Model (third variable in the system)		4-Variate Model
EURD → EULP	Neutral	(-), USRD	Neutral, USLP	Neutral
EURD → USRD	(-)	(-), EULP	(-), USLP	(-)
EURD → USLP	(-)	(-), USRD	(-), EULP	(-)
EULP → EURD	None	(-), USRD	Neutral, USLP	(-)
EULP → USRD	(-)	(-), EURD	(-), USLP	(+)
EULP → USLP	Neutral	(+), EURD	Neutral, USRD	(-) 10% sig.
USRD → EURD	(+)	(+), EULP	(+), USLP	(+)
USRD → EULP	(+)	(-), EURD	(-), USLP	(-)
USRD → USLP	None	(-), EURD	(+), EULP	(+)
USLP → EURD	(+)	(+), EULP	(+), USRD	(+)
USLP → EULP	None	Neutral, EURD	(+), USRD	(+)
USLP → USRD	(-)	(-), EULP	(+), EURD	(-)

Notes: As in Table 1. The variable names indicated in the columns for the trivariate models indicate the third variable present in the model.

The neutral causal impact of EURD on EULP is close to being invariant to the inclusion or exclusion of other variables, but EURD negatively causes the EULP when the USRD is in the system. On the other hand, the USRD is found to be a direct cause of EURD with a positive sign. Are these results reconcilable? One explanation may be as follows. To start with, “neutrality” does not mean “no causality”. Thus, there is evidence of some complex causal relationship, but the overall effect is neutral over time. Secondly, an increase in USRD leads to an increase in EURD. Thus, the producers in the EU react aggressively to an R&D move from the US. This reaction

may, in turn, require a diversion of other productive resources into R&D activities given that there are budget constraints. Then, the fact that R&D takes time and that its outcome is uncertain might reflect itself as a decline in labour productivity in the short-run. Nevertheless, in the 4-variable system where USLP is also present, the negative effect is mitigated through the positive spillovers of USLP on the EULP. In a way, the non-R&D EU activity could be compensating the decline in the resources allocated to it through international linkages. This analysis illustrates the contribution of a multivariate framework to the understanding of the causal linkages among the variables of interest. The results presented in Table 2 provide a rich ground for discussion both in terms of possible linkages (or lack thereof) and also the status of the causal relationships. The analysis, however, is further complicated by the sign (reversals) of the causal relationships and the so-called “neutrality” findings.

At this point, we focus mainly on the robust findings that provide evidence for direct Granger-causality and suggest answers to the questions asked in the Introduction.<sup>9</sup>

1) R&D effort in the EU is a direct Granger-cause of R&D productivity in the US. In particular, the reaction of the R&D sector in the US to an increase in EU’s R&D productivity is found to be submissive – using Scherer’s (1991) terminology. This is a strong and robust result which extends the similar previous findings between the US and Japan’s R&D sector interactions into the context of the US and the EU.

2) An increase in the R&D productivity in the US leads to an increase in the EU’s R&D productivity. This is again a robust result, which satisfies the Granger-Hsiao definition of direct causality.

3) Furthermore, an increase in the R&D productivity in the EU is found to be a direct Granger-cause of the US total economy labour productivity, and the sign of the relationship is negative. This finding strengthens the evidence that the US economy is hurt by successful R&D activity by the EU. The reverse case, i.e., the effects of US’s R&D on total economy labour productivity in the EU, does not have a clear verdict.

4) There is no conclusive or strong evidence, either in the US. or in the EU, on the spillover effects of R&D productivity growth on domestic labour productivity. Nevertheless, the post-1997 increase in the economy-wide labour productivity in the US (USLP) can be related to the increase in the R&D productivity in the US (USRD) and the factors driving it. In Table 2, for example, the entry for USRD → USLP shows that there is no Granger-causality in a bivariate model, but the causal impact of USRD on USLP is positive in a 4-variate model.

### *3. A Look at the Patterns in the High Tech Goods Exports Markets*

Since we measure the R&D effort in the US and the EU in actual terms (i.e., the value added per worker) and not as a figure with an uncertain actual outcome (e.g., expenditures on R&D or patent registrations), it may be interesting to see if the causal patterns found in our analysis reflect themselves in the actual developments of the EU’s and the US’s relative positions in the world market for high tech exports. We would, for example, expect that the EU should be improving its world share in high tech goods exports, possibly to the detriment of the US, especially when the EU’s R&D productivity increases. Table A5. presents the developments in world high tech goods exports market by industry. In choosing the periods displayed in Table A5, we made use of the patterns evident in Figure 4. For instance, the EURD is below trend but increasing between 1981 and 1984; it is above trend between 1985 and 1994; it is below trend and decreasing between 1995 and 1999; and it is below trend but increasing between 2000 and 2002. We obtained the data on trade in high tech goods from the OECD’s Main Science Indicators database (version 2004, release 02). The data is available for the 1981-2002 period, but a change in the definitions effective from 1995 onwards renders the comparison of the pre- and post-1995 figures difficult. Therefore, we focus on the pre- and post-1995 periods individually. Furthermore, since the export market penetration of other countries (e.g., Japan and the Asian countries) leads to

changes in the overall composition of trade, we also look at the shares of the EU and the US in their total world export market share [i.e.,  $US/(US+EU)$  and  $EU/(US+EU)$ ] to evaluate the changes in their relative positions with respect to each other. This is shown in Table A6.

The picture that emerges from Table A6 is that the EU expanded its relative export market share in the “aerospace” and “office equipment & computers” industries vis-à-vis the US even when the R&D productivity in the EU was below its long-run trend. In “electronics” industry, the EU gained ground in export markets only slightly between 1981-1984 and 1985-1994, but it lost to the US between the 1995-1999 and 2000-2002 periods. In the “pharmaceuticals” and “instruments” industries, the EU increased its relative export market share in the 1981-1994 period, but the pattern was reversed in the post-1995 period.<sup>10</sup> These findings are largely in line with our causal findings: when the EU’s R&D productivity increases or when it is above its long-run trend, the US’s relative share of high tech exports in all sectors (1981-1984 and 1985-1994 periods) suffers. On the other hand, when the EU’s R&D productivity is below its long-run trend, the US generally gains relative ground in the high tech exports markets. The aerospace and the office equipment and computers industries are the exceptions. Nevertheless, the main driving factor for the EU’s success, especially in the aerospace area, should be linked to the Airbus project. Overall, the post-1996 stagnation in the EU’s R&D sector is reflected in the actual high tech exports data. This is again in line with the Lisbon summit’s explicit call for taking measures in the R&D sector to remedy and reverse the situation.

#### IV. CONCLUSIONS

In this study, we examine the domestic and international linkages among R&D productivity and economy-wide labour productivity in the EU and the US using multivariate Granger-causality tests. The definition of Granger-causality in a multivariate context is more complicated than the bivariate case due to possible additional causal interactions between the variables of interest as Hsiao (1982) demonstrates. A variable X, for example, is said to be a “direct Granger-cause” of another variable Y if X causes Y in all settings: bi- and multivariate. Empirical evidence on the Granger-causal relationships between the aggregate R&D activities of two countries or trading blocks is scarce in the literature. Even so, the analysis is restricted to a bivariate framework, which does not allow for the testing of “direct causality”. This paper contributes to the literature by investigating the causal relationships between the R&D activities of the EU and the US in a multivariate framework.

In the literature on R&D, there is also a “dry holes” phenomenon that stems from the fact that R&D activity may not always have visible effects on the economy. For example, turning the results of basic research into something concrete and practical may take time and indeed it may happen at irregular time intervals. To deal with this phenomenon in the framework of Granger-causality tests, we used a subset transfer function approach, which suppresses any insignificant lags, in choosing the optimal specifications. From a statistical point of view, this approach has the added benefit of providing more efficient parameter estimates. The application of the subset transfer function methodology to testing for Granger-causality in the R&D literature is novel.

In an overall perspective, our findings identify the direction of causality in the observed negative correlation between the R&D activity in the EU and the R&D activity in the US (e.g. Figure 5). It is found that R&D in the EU is a direct Granger-Hsiao cause of R&D and labour productivity in the US, and the signs of these effects are negative. The EU, on the other hand, shows a positive reaction to the increased R&D productivity in the US and enjoys positive spillovers from increases in labour productivity in the US. In Scherer’s (1991) terms, the US is found to be responding rather submissively when R&D effort increases in the EU, while EU’s reaction to an increase in R&D efforts by the US is on the aggressive side. The aggressive reaction by the EU reflects itself in different forms, for example, by the gains made in basic research results (e.g., increased share of top 1% publications and citations) even when the R&D activity

was stagnating in the EU. Nevertheless, it should be kept in mind that the findings of this study are based on aggregate R&D data from all sources. Thus, more disaggregate studies at the industry level are needed. Furthermore, there are differences in the composition of R&D by source (public vs. private) between the US and the EU – e.g., the share of public R&D in total R&D expenditures is higher in the EU. Indeed, the EU's Lisbon targets envisage an increase in the share of private R&D in total R&D expenditures to about 66% from the current levels of about 55%. Therefore, an empirical investigation of whether there is a difference between the responses of public and private R&D in the EU (US) to public and private R&D in the US (EU) remains to be undertaken.

Notwithstanding the above caveats, our results based on aggregate R&D data suggest that the EU did make efforts not to fall behind the US by taking positive counteraction in response to the US's success as an R&D location. In this perspective, the explicit R&D targets set in the Lisbon summit in 2000 by the EU are largely a reflection on the need to increase the effort level further – given the stagnation in the share of R&D expenditures to GDP (which correlates well with the R&D productivity measure used in this paper) and the loss of some share in the high tech exports market in the post-1995 period.

The empirical findings of our study as well as the results of other macro-and micro-level studies in the literature share the view that the US's R&D reaction to the aggressive R&D efforts by competitors is generally submissive. Hence, if the EU can make progress towards achieving its ambitious R&D targets (possibly at a later date than 2010), the chances of achieving the Lisbon vision remains good. This, however, assumes that the US does not change its game strategy. Even then, both the EU and the US would benefit from the technological progress hence achieved.

## ACKNOWLEDGEMENTS

I would like to thank the participants of the session on “Technology and Growth” at the ECOMOD 2005 conference in Istanbul (June 29 – July 1, 2005) where an earlier version of this paper was presented and Spyros Arvanitis for their valuable comments. Needless to say, all errors and omissions are mine.

## FOOTNOTES

1 The link between R&D or innovation activity and economic performance has long been recognised. Schumpeter, for example, put forth the process of “creative destruction” as an engine economic growth. More recently, R&D is formally given a central role in the new theories of economic growth (e.g., endogenous growth theory and its variants) in driving technological progress and long-term economic growth whereas technological progress comes as “manna from Heaven” in the neoclassical growth theory framework. The introduction of R&D as a driver of economic growth is an important development since it connects the economic growth process further with micro foundations, bearing implications for economic and public policy. See Dosi (1988), Lucas (1988), Romer (1990), Grossman and Helpmen (1991), Grilliches (1992), Jones (1995), Aghion and Howitt (1998), and Segerstrom (1998). See also Lingens (2005) for a short discussion of the various versions (the first and second generations) of endogenous growth models and their policy implications. Joel and Rich (2005) provide a neat representation of the various aspects of the markets for R&D activity.

2 This is indeed a race for becoming an attractive R&D location since R&D activities in an economy (say, the EU, the US, or Japan) are undertaken not only by the nationals but also by the affiliates of foreign companies or as multinational research joint ventures. Kuemmerle (1999) studies the factors that determine the multinationals' decision to invest in R&D abroad. The home-base-exploiting (HBE) foreign direct investments (FDI) are found to be related to the relative

attractiveness of the target market. The home-base-augmenting (HBA) FDI, on the other hand, correlates with the "...relative commitment to R&D of private and public entities in the target country, as well as with the level of human resource pool and the level of scientific achievement in relevant sciences." (Kuemmerle, 1999, p. 18)

**3** This example illustrates the conceptual suitability of Granger's (1969) causality test and its variants as an empirical tool to investigate the nature of R&D races and spillovers. For example, the aggressive vs. submissive reaction of one country to an increase in another country's R&D efforts as well as the causal nature of the dynamic interaction between R&D and domestic economic activity. In the literature on R&D, there exist a number of studies that use Granger-causality tests to examine the interactions between physical capital accumulation and R&D activity, the relationship between total productivity growth and R&D at the aggregate or industry level, the effects of government policies and subsidies on private sector R&D, and the interactions between publicly and privately funded R&D. The following papers, among others, cover some of these topics: Verspagen (1995), Colombo and Garrone (1996), Frantzen (1998), Chiao (2001), Neelankavil and Alaganar (2003), Guellec and van Pottelsberghe de la Potterie (2003), Garcia-Quevedo (2004), Kim and Lee (2004), and Greunz (2004).

**4** E.g., Coe and Helpman (1995), Coe, Helpman and Hoffmaister (1997), and Engelbrecht (1997a, 1997b). See also Hejazi and Safarian (1999) and Lewer and van den Berg (2003) for a discussion of the impact of foreign trade and foreign direct investment on R&D spillovers and economic growth.

**5** See, for example, Griffith, Redding, and van Reenen (2004).

**6** See Sargent and Rodriguez (2000) for a further discussion and comparison of the advantages and disadvantages of using total factor productivity or labour productivity in economic analysis.

**7** The dataset is available from <http://www.ggdc.net>

**8** A negative correlation between the R&D activities of the EU and the US is also reflected by other indicators. For instance, the EU's average share in the highly cited (top 1%) publications increased from 35.42% to 37.12% between the 1993-1997 and 1997-2001 periods, while the US's share declined from 37.46% to 34.86% in the same periods. Similarly, the EU's share of citations in the top 1% cited publications increased from 36.57% to 39.3% and the US's share registered a decline from 39.3% to 32.85% between the 1993-1997 and 1997-2001 periods. See King (2004) for further details and comparisons.

**9** Since the R&D activity showed ups and downs both in the EU and in the US in our sample period, it is important to note that the findings from the causality tests are meant to be taken as results holding true on average during period under investigation.

**10** See Scherer (2004) for a discussion of the players in the pharmaceutical industry and the welfare implications of patenting policy.

## REFERENCES

- Aghion, P. and P. Howitt (1998), *Endogenous Growth Theory* (MIT Press, Cambridge: MA).
- Blonigen, B.A. and M.J. Slaughter (2001), 'Foreign Affiliate and U.S. Skill Upgrading', *The Review of Economics and Statistics*, **83**, 2, 362-376.
- Chiao, C. (2001), 'The Relationship between R&D and Physical Investment of Firms in Science-based Industries', *Applied Economics*, **33**, 23-35.
- Coe, D.T. and E. Helpman (1995), International R&D Spillovers, *European Economic Review*, **39**, 859-888.
- Coe, D. T., E. Helpman and A. W. Hoffmaister (1997), 'North-South R&D Spillovers', *Economic Journal*, **107**, 134-149.
- Colombo, M.G. and P. Garrone (1996), 'Technological Cooperative Agreements and Firm's R&D Intensity. A Note on Causality Relations', *Research Policy*, **25**, 923-932.
- Dosi, G. (1988), 'Sources, Procedures, and Microeconomic Effects of Innovation', *Journal of Economic Literature*, **26**, 3, 1120-1171.
- Eaton, J. and S. Khortum (1996), 'Trade in Ideas: Patenting and Productivity in the OECD', *Journal of International Economics*, **40**, 251-278.
- Engelbrecht, H.J. (1997a), 'International R&D Spillovers, Human Capital, and Productivity in OECD Countries', *European Economic Review*, **41**, 1479-1488.
- Engelbrecht, H.J. (1997b), 'International R&D Spillovers among OECD Economies', *Applied Economics Letters*, **4**, 315-319.
- Falvey, R., N. Foster, and D. Greenaway (2002), 'North-South Trade, Knowledge Spillovers and Growth', *Journal of Economic Integration*, **17**, 650-670.
- Falvey, R., N. Foster, and D. Greenaway (2004), 'Imports, Exports, Knowledge Spillovers and Growth', *Economics Letters*, **85**, 2, 209-212.
- Frantzen, D. (1998), 'R&D, International Technical Diffusion and Total Factor Productivity', *Kyklos*, **51**, 4, 489-508.
- Garcia-Quevedo, J. (2004), 'Do Public Subsidies Complement Business R&D? A Meta-Analysis of the Econometric Evidence', *Kyklos*, **57**, 1, 87-102.
- Granger, C.W.J. (1969), 'Investigating Causal Relationships by Econometric Models and Cross-Spectral Methods', *Econometrica*, **36**, 424-438
- Greunz, L. (2004), 'Industrial Structure and Innovation – Evidence from European Regions', *Journal of Evolutionary Economics*, **14**, 563-592.
- Griffith, R., S. Redding and J. van Reeten (2004), 'Mapping the Two Faces of R&D: Productivity Growth in a Panel of OECD Industries', *The Review of Economics and Statistics*, **86**, 4, 883-895.

- Grilliches, Z. (1992), 'The Search for R&D Spillovers', *Scandinavian Journal of Economics*, **94**, Supplement, S29-S47.
- Grossman, G.M. and E. Helpman (1991), *Innovation and Growth in the Global Economy* (MIT Press, Cambridge, MA).
- Guellec, D. and B. van Pottelsberghe de la Potterie (2003), 'The Impact of Public R&D Expenditure on Business R&D', *Economics of Innovation and New Technology*, **12**, 3, 225-243.
- Hejazi, W. and A.E. Safarian (1999), 'Trade, Foreign Direct Investment, and R&D Spillovers', *Journal of International Business Studies*, **30**, 491-511.
- Hsiao, C. (1979), 'Autoregressive Modeling of Canadian Money and Income Data', *Journal of the American Statistical Association*, **74**, 553-560.
- Hsiao, C. (1982), 'Autoregressive Modelling and Causal Ordering of Economic Variables', *Journal of Economic Dynamics and Control*, **4**, 243-259.
- Joel and Rich (2005), 'Organisation of Markets for Science and Technology', *Journal of Theoretical and Institutional Economics*, **161**, 1-17.
- Jones, C. I. (1995), 'R&D-based Models of Economic Growth', *Journal of Political Economy*, **103**, 759-784.
- Kang, H. (1989), 'The Optimal Lag Selection and Transfer Function Analysis in Granger-Causality Tests', *Journal of Economic Dynamics and Control*, **13**, 151-169.
- Kim, J.W. and H.K. Lee (2004), 'Embodied and Disembodied International Spillovers of R&D in OECD Manufacturing Industries', *Technovation*, **24**, 359-368.
- King, D.A (2004), 'The Scientific Impact of Nations', *Nature*, **430**, 15 July, 311-316.
- Kuemmerle, W. (1999), 'The Drivers of Foreign Direct Investment into Research and Development: An Empirical Investigation', *Journal of International Business Studies*, **30**, 1, 1-24.
- Lewer, J.J. and van den Berg, H. (2003), 'How Large is International Trade's Effect on Economic Growth?', *Journal of Economic Surveys*, **17**, 3, 363-396.
- Lingens, Joerg, (2005), 'Policy Implications of Endogenous Growth Models: A Note', *Economics Bulletin*, **5**, 13, 1-7.
- Lucas, R.E. (1988), 'On the Mechanics of Economic Development', *Journal of Monetary Economics*, **22**, 3-42.
- Luintel, K. B. and M. Khan (2004), 'Are International R&D Spillovers Costly for the United States?', *The Review of Economics and Statistics*, **86**, 4, 896-910.
- Neelankavil, J.P. and V.T. Alaganar (2003), 'Strategic Resource Commitment of High-technology Firms. An International Comparison', *Journal of Business Research*, **56**, 493-502.

Park, W.G. (1995), 'International R&D Spillovers and OECD Economic Growth', *Economic Inquiry*, **33**, 4, 571-591.

Penm, J.H.W. and R.D. Terrell (1984), 'Multivariate Subset Autoregressive Modelling with Zero Constraints for Detecting 'Overall Causality' ', *Journal of Econometrics*, **24**, 311-330

Ravenscraft, D. and F.M. Scherer (1982), 'The Lag Structure of Returns to Research and Development', *Applied Economics*, **14**, 603-620.

Romer, P.M. (1990), 'Endogenous Technological Change', *Journal of Political Economy*, **98**, 5, S71-S107.

Rouvinen, P. (2002), 'R&D Productivity Dynamics: Causality, Lags, and 'Dry Holes' ', *Journal of Applied Economics*, **5**, 1, 123-156.

Sargent, T.C. and Rodriguez, E.R. (2000), 'Labour or Total Factor Productivity: Do We Need to Choose?', *International Productivity Monitor*, **1**, Fall, 41-44.

Scherer, F.M. (1991), 'International R&D Races: Theory and Evidence', in L. G. Mattsson and B. Szymne (eds.), *Corporate and Industry Strategies for Europe* (Elsevier Science Publishers B.V).

Scherer, F.M. (2004), 'A Note on Global Welfare in Pharmaceutical Patenting', *The World Economy*, **27**, 7, 1127-1142.

Schwarz, G. (1978), 'Estimating the Dimension of a Model', *Annal of Statistics*, **6**, 461-464.

Segerstrom, P. (1998), 'Endogenous Growth without Scale Effects', *American Economic Review*, **88**, 1290-1310.

Sturm, J-E. and De Haan, J. (1998), 'Public Capital Spending in the Netherlands: Developments and Explanations', *Applied Economics Letters*, **5**, 1, 5-10.

Verspagen, B. (1995), 'R&D and Productivity: A Broad Cross-section Look', *Journal of Productivity Analysis*, **6**, 117-135.

## APPENDIX A: GRANGER (NON-) CAUSALITY IN A 4-VARIABLE SYSTEM

This Appendix is an application of Hsiao's (1982) definitions of different types of causal relationships in 4-variable framework.

$$Y_t = \alpha_1 + \sum_{i=1}^k \beta_{1i} Y_{t-i} + \sum_{i=1}^k \delta_{1i} X_{t-i} + \sum_{i=1}^k \varphi_{1i} M_{t-i} + \sum_{i=1}^k \lambda_{1i} Z_{t-i} + \varepsilon_{1t}$$

$$X_t = \alpha_2 + \sum_{i=1}^k \beta_{2i} Y_{t-i} + \sum_{i=1}^k \delta_{2i} X_{t-i} + \sum_{i=1}^k \varphi_{2i} M_{t-i} + \sum_{i=1}^k \lambda_{2i} Z_{t-i} + \varepsilon_{2t}$$

$$M_t = \alpha_3 + \sum_{i=1}^k \beta_{3i} Y_{t-i} + \sum_{i=1}^k \delta_{3i} X_{t-i} + \sum_{i=1}^k \varphi_{3i} M_{t-i} + \sum_{i=1}^k \lambda_{3i} Z_{t-i} + \varepsilon_{3t}$$

$$Z_t = \alpha_4 + \sum_{i=1}^k \beta_{4i} Y_{t-i} + \sum_{i=1}^k \delta_{4i} X_{t-i} + \sum_{i=1}^k \varphi_{4i} M_{t-i} + \sum_{i=1}^k \lambda_{4i} Z_{t-i} + \varepsilon_{4t}$$

For the causal relationship between X and Y:

- 1) **Direct Causality.** a)  $\sum \delta_{1i} \neq 0$ , when  $\sum \varphi_{1i} \neq 0$  and  $\sum \lambda_{1i} \neq 0$ ; (in a 4-variable system)  
b)  $\sum \delta_{1i} \neq 0$ , when  $\sum \varphi_{1i} \neq 0$  and  $\sum \lambda_{1i} = 0$ ; (in a 3-variable system)  
c)  $\sum \delta_{1i} \neq 0$ , when  $\sum \varphi_{1i} = 0$  and  $\sum \lambda_{1i} \neq 0$ ; (in a 3-variable system)  
d)  $\sum \delta_{1i} \neq 0$ , when  $\sum \varphi_{1i} = 0$  and  $\sum \lambda_{1i} = 0$ ; (in a bi-variate system)

That is, X should cause Y in a bivariate system and in all multivariate systems.  
Direct causality from X to Y is represented as  $X \Rightarrow Y$ .

- 2) **Feedback.** If  $X \Rightarrow Y$  and  $Y \Rightarrow X$ , then there is direct feedback between X and Y.  
Or,  $X \Leftrightarrow Y$

- 3) **No Causality.** a)  $\sum \delta_{1i} = 0$ , when  $\sum \varphi_{1i} = 0$  and  $\sum \lambda_{1i} = 0$ ; (*sufficient condition*)  
b) if  $\sum \delta_{1i} = 0$  but  $\sum \varphi_{1i} \neq 0$  and  $\sum \lambda_{1i} = 0$  and if  $\sum \delta_{3i} = 0$  in all bi- and multivariate settings that involve X to explain M,  
c) if  $\sum \delta_{1i} = 0$  but  $\sum \lambda_{1i} \neq 0$  and  $\sum \varphi_{1i} = 0$  and if  $\sum \delta_{4i} = 0$  in all bi- and multivariate settings that involve X to explain Z,  
d) if  $\sum \delta_{1i} = 0$  but  $\sum \varphi_{1i} \neq 0$  and  $\sum \lambda_{1i} \neq 0$  and if  $\sum \delta_{3i} = 0$  and  $\sum \delta_{4i} = 0$  in all bi- and multivariate settings that involve X to explain M and Z, then, there is no causality from X to Y (directly or indirectly).

That is, for X not to be a Granger-cause of Y in any way, X should not cause Y directly or indirectly.

- 4) **Type I Spurious Causality.** If  $\sum \delta_{1i} \neq 0$ , when  $\sum \varphi_{1i} \neq 0$  and/or  $\sum \lambda_{1i} \neq 0$  in a 4- variable system, but  $\sum \delta_{1i} = 0$  when  $\sum \varphi_{1i} = 0$  and/or  $\sum \lambda_{1i} = 0$  (i.e. in a bi-variate system), then X is said to cause Y spuriously.

This situation may arise if M and/or Y (together or individually) is/are pre- or co-requires for X to cause Y.

- 5) **Indirect Causality.** If  $\sum \delta_{1i} = 0$  when  $\sum \phi_{1i} \neq 0$  and/or  $\sum \lambda_{1i} \neq 0$ , but  $X \Rightarrow M$  and / or  $X \Rightarrow Z$ . Furthermore,  $\sum \delta_{1i} \neq 0$  when  $\sum \phi_{1i} = 0$  and  $\sum \lambda_{1i} = 0$ . Then, X is an indirect, but not spurious, cause of Y. This case is denoted by  $X \rightarrow Y$ .

In this case, X causes Y via other variables for which it is a direct cause of. Note that the X should cause in a bivariate system or in multivariate systems.

- 6) **Type II Spurious Causality.** a) the no-causality conditions in (3) hold. However,  $\sum \delta_{1i} \neq 0$  in a bivariate Granger-causality test between X and Y. b) Furthermore,  $M \Rightarrow X$  and  $M \Rightarrow Y$  and / or  $Z \Rightarrow X$  and  $Z \Rightarrow Y$ . Then, there is Type II spurious causality from X to Y. The case can be similarly derived for Z.

This case may arise if, for example, M (Z) is a direct Granger-cause of both X and Y. Then, in the absence of M (Z) (say, in a bivariate causality test between X and Y), X is found to Granger-cause Y, when this result is indeed due to a missing common cause.

## APPENDIX B: ADDITIONAL TABLES

Table A1. UNIT ROOT TEST RESULTS

	EURD	EULP	USRD	USLP
ADF (level)	-2.781663*** [N,4]	-3.514640*** [N,1]	-3.300224*** [N,0]	-1.956874** [N,4]
ADF (1 <sup>st</sup> Diff.)	-3.681901*** [N,0]	-2.435185** [N,0]	-7.207506*** [N,0]	-3.786142*** [N,0]
PP (Level)	-2.040573** [N,3]	-2.413733** [N,2]	-3.247849*** [N,1]	-1.176495 [N,2]
PP (1 <sup>st</sup> Diff.)	-3.721546*** [N,2]	-2.410303** [N,2]	-8.501124** [N,6]	-3.789211*** [N,1]
KPSS (Level)	0.160017 [C,3]	0.116081 [C,3]	0.170184 [C,2]	0.145178 [C,3]
KPSS (1 <sup>st</sup> Diff.)	0.324349* [C,2]	0.290246 [C,2]	0.270488 [C,7]	0.432268 [C,2]

ADF: Augmented Dickey Fuller test, PP: Phillips – Perron Test, KPSS: Kwiatkowski-Phillips-Schmidt-Shin test. N: no trend and no intercept in the specification, C: intercept but no trend in the specification. The numbers in the square brackets indicate the lag-length in the ADF test, and the bandwidth in the PP and KPSS tests. Note that the null hypothesis is non-stationarity in the ADF and PP tests, while the KPSS takes the null hypothesis as stationarity. (\*\*\*), (\*\*), and (\*) indicate, respectively that the null hypothesis can be rejected at 1%, 5% and 10% statistical significance levels.

TABLE A2.

## BIVARIATE GRANGER-CAUSALITY TEST SPECIFICATIONS AND RESULTS

Caused variable:	Univar. Spec.	SBIC <sub>UV</sub>	Causing variable:	TF Spec.		SBIC <sub>2V</sub>
EURD	1,4,5	4.673850	EULP	4	(+)	4.735744
	1,4,5		USRD	2	(+)**	4.512524 ‡
	1,4,5		USLP	1,6	(+)***	4.585471 ‡
EULP	1,4	2.563014	EURD	1,3,4	(-)	2.501711 ‡
	1,4		USRD	1,6	(+)***	2.401400 ‡
	1,4		USLP	2,5	(-)	2.511896 ‡
USRD	6	5.952995	EURD	1,3	(-)***	5.664985 ‡
	6		EULP	3,4,6	(-)***	5.871018 ‡
	6		USLP	1,5,6	(-)***	5.633191 ‡
USLP	1,5	2.692500	EURD	1,2,3	(-)**	2.336714 ‡
	1,5		EULP	1,2,3	(-)	2.693477
	1,5		USRD	3	(+)	2.725659

Notes : The entry for the case of EURD and USRD, for example, should be read as follows:

$EURD_t = \alpha + \beta_1 EURD_{t-1} + \beta_2 EURD_{t-4} + \beta_3 EURD_{t-5} + \beta_3 USRD_{t-2}$ , with the resulting univariate Schwarz BIC (SBIC<sub>UV</sub>) value of 4.673850 and a subset bivariate transfer function (TF) SBIC value (SBIC<sub>2V</sub>) of 4.512524. Since the  $SBIC_{2V} < SBIC_{UV}$ , the USRD can be said to Granger-cause EURD in a bivariate specification. The other entries in the table can be interpreted similarly. The signs of the coefficients are shown in parantheses. (\*\*\*) , (\*\*), and (\*) indicate, respectively that the coefficient(s) is/are (jointly) significant at 1%, 5% and 10% statistical significance levels. (‡) indicates that the  $SBIC_{2V} < SBIC_{UV}$  for the entry in question, thus there is evidence of Granger-causality in a bivariate setting. Nevertheless, if the joint sum of the coefficients are not indicated as statistically significant, the resulting case is indicated as “Neutral” in Table 1 in the text.

Table A3. TRIVARIATE SPECIFICATIONS

A) EULP, EURD, USRD						
	EULP(t-i)		EURD(t-i)		USRD(t-i)	SBIC <sub>3V</sub>
EULP(t)	1,4		1,3,4	(-)	2,3,4,6	(-) 1.821814
EURD(t)	1,5,6	(-)	1,4,5		1,2,3,6	(+) 3.973010
USRD(t)	6	(-)	1,3	(-)	6	4.871124
B) EULP, EURD, USLP						
	EULP(t-i)		EURD(t-i)		USRD(t-i)	SBIC <sub>3V</sub>
EULP(t)	1,4		1,3,4	(N)	1,2,4,6	(N) 2.437927
EURD(t)	1,4	(N)	1,4,5		1	(+) 4.292234
USLP(t)	2	(+)	1,2,6	(+)	1,5	2.200939
C) EULP, USRD, USLP						
	EULP(t-i)		EURD(t-i)		USRD(t-i)	SBIC <sub>3V</sub>
EULP(t)	1		1,2,3,4,5,6	(-)	2,5	(+) 1.540702
USRD(t)	6	(-)	6		3,6	(-) 5.253640
USLP(t)	1,2,3	(N)	1	(+)	1,5	2.764862
D) EURD, USRD, USLP						
	USLP(t-i)		EURD(t-i)		USRD(t-i)	SBIC <sub>3V</sub>
EURD(t)	1,4		4,6	(+)	1,6	(+) 4.385553
USRD(t)	1,3	(-)	6		3,4	(+) 5.064726
USLP(t)	1,2,3	(-)	2	(-)	1	1.846757

Notes: The entry for the trivariate system involving EURD, USRD, and USLP should be read as follows:  $EURD_t = \alpha + \beta_1 EURD_{t-1} + \beta_2 EURD_{t-4} + \beta_3 USRD_{t-4} + \beta_4 USRD_{t-6} + \beta_5 USLP_{t-1} + \beta_6 USLP_{t-6}$  with the resulting Schwarz BIC (SBIC<sub>3V</sub>) value of 4.385553. Note that the SBIC<sub>3V</sub> value is less than the bivariate specification between the EURD and the USRD (SBIC = 4.512524). The sum of the coefficients  $\beta_3 + \beta_4$  on the USRD are positive, as indicated in parantheses. Furthermore, they are found to be jointly significant by means of the Wald test. The same case is also established for the sign and the joint significance of the  $\beta_5 + \beta_6$  coefficients on the USLP variable. These findings indicate that EURD is Granger-caused by USRD and USLP and the sign of these causal relationships is positive. The (N) sign in the Table indicates that the sum of the estimated coefficients is not statistically different than zero. The qualitative implications of the results presented here are shown in Table 2 in the text.

Table A4. 4-VARIATE SPECIFICATIONS

	EURD(t-i)		USRD(t-i)		EULP(t-i)		USLP(t-i)	SBIC <sub>4V</sub>
EURD	1,4,5		2	(+)	1,5,6	(-)	1,4	(+) 3.693182
USRD	3,4,6	(-)	6		1,5,6	(+)	1,5,6	(-) 3.994254
EULP	4,6	(N)	1,2,3,4,5,6	(-)	1,4		2,5	(+) 0.694562
USLP	1,2,6	(-)	3	(+)	5,6	(-)	1,5	1.588105

Notes: The entries in this table can be read similar to those in Table A3, but the specifications are extended into a 4-variate framework. SBIC<sub>4V</sub> denotes the value of the Schwarz BIC in the best 4-variate transfer function specification.

Table A5. The Export Shares of the US and the EU in the High Tech World Trade (%)

	Aerospace			Electronics			Office Equipment & Computers			Pharmaceuticals			Instruments		
	Total	US	EU	Total	US	EU	Total	US	EU	Total	US	EU	Total	US	EU
1981-84	76.4	49.4	27.0	34.8	19.0	15.8	48.4	36.7	11.7	53.0	18.2	34.8	43.1	22.4	20.7
1985-94	75.4	46.3	29.0	34.4	18.6	15.8	38.3	26.9	11.4	48.1	13.7	34.4	40.3	19.6	20.7
1995-99	72.5	41.6	30.9	37.6	21.0	16.6	35.1	23.0	12.1	45.1	11.1	34.1	46.8	24.2	22.7
2000-02	69.4	36.8	32.6	38.2	22.4	15.8	35.5	22.3	13.2	44.7	12.2	32.5	49.5	26.7	22.8

Source : OECD Main Science Indicators, 2004, Release 02.

Note: The corresponding ISIC revision 2 and revision 3 classification numbers for these industries are as follows (in the square brackets respectively): Aerospace industry [3845, 353]; Electronic industry [3832, 32]; Office machinery and computer industry [3825, 30]; Pharmaceutical industry [3522, 2423]; Instruments (medical, precision and optical instruments, watches and clocks industry) [385, 33]. Please also note that the EU figure excludes trade within the EU (15 countries). The export market shares are calculated according to the ISIC rev. 2 until 1994, and the figure after 1995 are in line with the ISIC revision 3. Therefore, there is a break in the definition in 1994-1995.

Table A6. The Relative Shares of the EU and the US in their Total (US +EU) High Tech Exports, (%)

	Aerospace		Electronics		Office Equipment & Computers		Pharmaceuticals		Instruments	
	US	EU	US	EU	US	EU	US	EU	US	EU
1981-84	64.7	35.3	54.7	45.3	75.8	24.2	34.3	65.7	51.9	48.1
1985-94	61.5	38.5	54.2	45.8	70.3	29.7	28.6	71.4	48.7	51.3
1995-99	57.4	42.6	55.9	44.1	65.5	34.5	24.5	75.5	51.6	48.4
2000-02	53.0	47.0	58.7	41.3	62.8	37.2	27.3	72.7	53.9	46.1

Source: Author's own calculations using figures from Table A5. Please also see the notes to Table A5.