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Bettina Hürni\*

# European Integration: West and East

*The EC internal market is to be completed by the end of 1992, the creation of a European Economic Space comprising the 18 countries of the EC and EFTA is underway, and the countries of Eastern Europe, above all the USSR, are talking more and more about a "European house" from the Urals to the Atlantic. How much progress has in fact been made so far in this direction? What are the main obstacles, and what developments are to be expected in the medium term?*

At present, European economic integration could be regarded as taking place in three concentric circles; the first being the completion of the EC's internal market as defined in the Commission's White Paper and to which the EC has given absolute priority. The second is the parallel creation of the European Economic Space, based on the Luxembourg Declaration, its follow-up work and the multilateral arrangements concluded since 1984; and the third, so to speak "outer" circle, is "Pan-European integration" of which a first positive signal can be seen in the joint EC-CMEA Declaration signed in June 1988, even though it is a rather vague, mainly political document.

The completion of the EC's internal market is in the first place an admission of failure: after 40 years of existence, the EC is far from being a "common market" and has not reached the fundamental goals set out in the Treaty of Rome, which are summarized normally in the "four freedoms", the free circulation of goods, persons, services and capital. However, the White Paper of the Commission and the first true revision of the Treaty of Rome, constituted by the "Single Act", have nonetheless accelerated economic integration in numerous fields. And the artificial deadline set for 1992 has mobilized public opinion and private economic agents within the EC and – more significantly – outside the EC. "1992" is undoubtedly a "marketing success", even though a lot remains to be done before the completion of even an internal market for goods is achieved. And the non-EC countries must be careful to distinguish between plans and programmes of the Commission, and things which have been, or are going to be, done, as there seems to be a widening gap between those favouring "centralization" with a strengthening of supranational powers and those who prefer a federal, free-trading Europe. The success of the

"Europe of regions" can be seen as a counterweight to centralized decision-making by the Brussels institutions – and not all EC members have the same strong political will to follow the Commission's proposals, which would also lead to an increase in the power of the Commission itself. The completion of the internal market remains an ambitious and long-term programme going far beyond economic integration alone and it mobilizes all intellectual energies within the supranational EC institutions, leaving no forces to deal with its external effects, so much so that until autumn 1988 those institutions gave little thought to the effects of the completion of their internal market on their non-EC trading partners.

1992 arouses fears of discrimination against the EFTA countries. And the more the EC officially insists on repeating that the creation of the single market will *not* discriminate against other trading partners, the more sceptical its neighbours become, as there are quite a few signs that the EC will *not* just open its own market to free competition for all, according to GATT rules. Hence, the simultaneous and parallel construction of the European Economic Space, comprising 18 countries, is in many ways a great "leap ahead" in integration among the EFTA countries themselves and at the same time a means of defence against discrimination. This discrimination becomes even more substantial, for instance, through anti-dumping procedures, non-national treatment of foreign banks and/or insurance companies in the EC and similar protectionist measures, which the economic agents in the EFTA countries try to eliminate by take-overs, fusions, public purchase offers etc. in order to achieve a genuine European home market for industrial goods at least.

## "Pan-European" Integration

For the more loose, outer circle, "Pan-European" integration, one can safely say that each time Western Europe took a step forward in integration, the CMEA

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reacted in order to speed up its own development, and one can equally safely say that the foundations of the "European house" are laid. Following diplomatic recognition by the CMEA, the EC Commission has concluded or is going to conclude bilateral agreements with almost all European CMEA countries, yet their contents are quite different: only the one with Hungary foresees for the time being the complete phasing out of quotas (about 2000 by the 12 EC countries) by 1995, a date after the deadline for the completion of the EC's single market. And the quotas on products considered "sensitive" by the EC will only be abolished by 1995, but represent about 20% of the total restrictions. The agreements with the seven European CMEA countries still contain – or will contain – protectionist measures, like voluntary export restraints, orderly marketing arrangements etc.

On the other hand, "Pan-European" integration is making progress with joint ventures, according to a study by the Economic Commission for Europe of the UN (ECE): in 1987 alone, 91 new joint ventures were created, against 75 in 1986 and only five at the end of 1981. Out of a total of 166 joint ventures (end 1987) amounting to a pledged foreign capital investment estimated at \$ 500 million, a true lion's share, i.e. 111, are with Hungarian enterprises. West German companies lead with 36 joint ventures in the CMEA, followed by Austria with 30 (for comparison: the USA has 17). This refers to the situation before the massive German investment push into the USSR. According to the Deputy Secretary of the CMEA, there are at present 190 joint ventures in the USSR alone, of which 20 are with companies from the Federal Republic of Germany, with an investment capital estimated at 500 million rubles.

The idea launched by the Soviets of creating free trading zones within their country, as many newly industrializing countries and the People's Republic of China have done successfully, is a good one – especially if adequate rates of return to capital can be guaranteed. What should not be forgotten, however, in this "joint ventures euphoria" is the fact that among all forms of foreign financial participation the joint venture model is by far the most complicated and most risky, i.e. the least predictable.

## EC-EFTA Economic Relations

According to an UNCTAD study the share in world trade of the Eastern European CMEA countries has declined since 1984 and makes up about 9%. For comparison, trade flows between EFTA and EC countries have steadily increased and amount to about

25% of world trade. The European Economic Space countries' total trade makes up about 40% of world trade.

What is, however, more essential in a "Pan-European" integration context is the fact that the EFTA countries are by far the largest clients of the EC and that numerous subcontracting relations and other integration factors like interdependent service industries etc. do not even show up in the foreign trade statistics. In addition, the EC's trade volume and trade surplus with EFTA is increasing, while there are deficits in trade and decreasing volumes with other partners. In 1987 the EC's trade with EFTA was worth \$ 51 billion more than that with the USA; it was more than twice as high as that with the newly industrializing countries and almost 3½ times as high as that with Japan. The EC ran a surplus of \$ 8.2 billion with EFTA, but a deficit of \$ 5.9 billion with the Eastern European countries. If only trade in manufactures is examined, the EC's surplus in trade with EFTA amounts to \$ 18 billion. The EFTA countries as a group have the highest per capita trade values (exports plus imports) in the world, a fact showing that they are open, foreign trade-oriented economies: in 1987 the EC exported to EFTA goods worth \$ 3,200 per capita, but only worth \$ 1,700 per capita within its own integration area (the 12 EC countries). Outside the European Economic Space, export values of the EC were much lower: \$ 340 per capita for the USA, \$ 130 for Japan, about \$ 110 for the newly industrializing countries and \$ 60 in trade with Eastern Europe.

Bearing in mind these figures, the argument sometimes heard about the CMEA market potential of over 450 million consumers does not seem so important, as long as their purchasing power is below that of the newly industrializing countries. On the other hand, it does mean that there is a large unused future potential for economic development. The EC trade deficit with the East European CMEA countries is a global figure, whereas with single countries there is a trade surplus: with Hungary since 1984, and with Czechoslovakia there was a small surplus for the first time in 1987.

Again for the sake of comparison, it is interesting to note that the EC has a much higher trade value (4% of total exports and 3.2 % of imports) with Switzerland, with its only 6 million consumers, than with the seven European CMEA countries together (2.3 % of EC's total exports and 2.9% of its imports). In 1986 and 1987 the EC earned in its trade with Switzerland over \$ 10.5 million per annum. Swiss firms have created over 600,000 jobs for EC citizens in Switzerland and over

350,000 in the EC. About 45% of total Swiss foreign direct investment goes into the EC. As a nation, Switzerland is the most important single trading partner of the EC, and EFTA as a group is a trading partner of the size of France. Of course, the EC is also by far EFTA's largest trading partner. Yet, the small, open and very export-oriented economies of the EFTA countries are vulnerable and as such dependent on having as many trading partners as possible. They cannot focus on one region alone and have therefore everything to gain from a strengthening of the GATT rules and a true liberalisation of world trade. They are actively pursuing this aim within the Uruguay Round. A "fortress Europe" concept would be a boomerang hitting not only the EC itself, which gains 10% of its total GNP from exports, but even more so the small EFTA countries.

### EFTA's Trade with the CMEA

EFTA includes two countries with a traditionally large share of trade with Eastern Europe, Finland and Austria, in that order of importance. But total EFTA trade with Eastern Europe also declined in 1986, and it must be remembered that over 50% of EFTA's imports come from the USSR (mainly oil). EFTA's trade with Eastern Europe amounted to 5.4% of total imports and 5.9% of total exports, i.e. a larger share than the EC (3.2% of total imports and 2.5% of total exports) in 1986. Finland's trade represents about 40% of total EFTA trade with Eastern countries, Austria's about 20%. Both countries run surpluses in their trade in manufactures. In 1986 the largest export increase to Eastern Europe was run by Switzerland (+ 38.7% in dollar terms). The largest total EFTA export increase is found in the exports of machinery and transport equipment, making up for about 40% of total EFTA exports to that area. EFTA as a group runs a small surplus in its trade with Eastern Europe (\$ 400 million) whereas the EC runs a deficit. Even though Austria's total trade with Eastern countries has declined since 1985, Austria runs a surplus of Sh. 3 billion (1987). Austria has conceded preferential tariffs to Bulgaria and Romania, and since March 1988 also to Hungary, which now has the status of a "developing country" in Austrian trade. In 1987 Eastern Europe accounted for 9% of total Austrian exports and 6.8% of imports, i.e. more than double the percentage of the EC in imports and more than three times that in exports.

Recently the CMEA countries have clearly become "demandeurs" in European integration. Yet the Council meeting in Prague in July 1988 left the impression of a very heterogeneous grouping with widely differing views on their own national reforms, and hence on their coordination within the CMEA. Intra-CMEA trade was

openly criticized for not keeping delivery deadlines, exchanging low quality products etc. The CMEA countries' economies vary widely in every respect: the one dominating power has a very undiversified foreign trade structure (over 80% oil) and is not very dependent on foreign trade, which makes up only a small fraction of its GNP; the smaller CMEA countries have a much more diversified foreign trade structure, with a higher degree of industrialization, and therefore export a large share of manufactured products. There seems to be considerable uncertainty about how to go about the necessary reforms, which has led to a "stop-and-go" policy in many respects, slowing down the reforms.

Some reasons for the increase of centrifugal forces within the CMEA are obvious, even to the non-specialist. The GDR fears losing its privileged position as the "clandestine 13th member of the EC". Intra-German trade amounts to \$ 7.8 billion p.a. and represents 66% of the GDR's exports to the EC – the GDR is the EC's second partner after the USSR among the CMEA countries. In 1985 and 1986 over 160,000 t of steel were imported from East into West Germany to circulate freely within the EC from there. Other Eastern products can reach the EC through the GDR – which scares the EC countries and again stimulates protectionist attitudes, especially because their own steel industry is in a quasi-permanent crisis. The USSR seems to fear devaluation of its currency, the "complex programme of scientific and technical cooperation until 2000" does not seem too well structured, the "streamlining" of the CMEA administration appears doubtful, at least.

But the most risky business appears to be the creation of a socialist internal market by the year 2005, as any global planning for ten economically so diverse countries over such a long span as 15 years frankly appears unrealistic: integration theory and also practical experience prove that integration works best among homogeneous partners, with similar, and not complementary, foreign trade structures and with similar economies. In the EC-EFTA-CMEA triangle, *individual* firms and businessmen are the traders and investors, for whom the supranational organisations can only create a favourable framework but who are of course free to choose their business partners and who will select those with whom business is easy to do, administratively and qualitatively, and from whom there is a fair return on capital. If it is easier to produce shoes in Brazil than in Yugoslavia, they will be produced in Brazil.

One advantage simplifying the approach to the West of the CMEA countries lies precisely in the absence of

supranational structures, which could be a severe obstacle to economic progress. The programme to create a CMEA internal market by 2005 should therefore not stand in the way of giving some countries the chance to develop faster than others. But also the percentage of CMEA trade with the EC has declined over the years: it represented around 20% of exports and imports in 1980 – for the six smaller Eastern European CMEA countries (without the USSR) – and declined to 15% of exports and 14% of imports by 1986.

### Progress within the EC

The EC Commission admits that progress on the completion of its internal market is not as fast as initially foreseen: of the 300 proposals for liberalisation of trade in goods, services, persons and capital, many are delayed in the Council of Ministers, and the most far-reaching ones will remain there until 1992. In many respects, the mood of the EC countries has changed since the publication of the White Paper in 1985 to a more protectionist one. Some examples may suffice:

- a German study contradicts the White Paper and explains why internal barriers do not need to be eliminated,
- the completely arbitrary notion of “reciprocity” in trade (equivalent to “horse-trading” in some minds) for access of third countries to the single market,
- the tougher stand on anti-dumping procedures: the value of “penalized” trade has strongly increased recently, as have the number of judgements of the European Court in Luxembourg against imports from the newly industrializing countries,
- “transitional measures”, which are bilateral voluntary export restraints, e.g. Italy’s quota on Japanese cars,
- the EC’s stand against “screwdriver factories”,
- some EC legislation dealing with industrial standards and technical regulations,
- the difficulties of the banana import regime, with a range of differing external tariffs: duty-free imports into the UK, “dollar bananas” with different import quotas in different EC countries, e.g. duty-free quotas for the FRG, 20% customs duties in the Benelux countries etc.,
- the rules for foreign companies and banks already established within the EC and those foreseen for newcomers.

This list is by no means exhaustive – as the human mind knows no bounds to its ingenuity in finding non-

tariff barriers to competition – and experience shows that the “devil shows up in the details” when completing the single market. The result has been that countries like Turkey want to push their association with the EC and numerous companies in neighbouring countries want to get established in the EC.

This has made the North-South gap within the EC even worse. At present it appears to be one of the greatest dangers to European integration: firms in countries like Greece, Spain, Portugal or Ireland are often less well integrated into the EC than Swiss or other EFTA countries’ firms. They fear outside competition most. Moreover, they compete against each other on a large range of goods, as well as with the ACP countries and other third countries around the Mediterranean.

In addition, there are negative integration effects: integration theory predicts, and successful economic integration confirms, that in the integration process – to put it bluntly – the poor get poorer and the rich get richer. That is why, for instance, the Greek presidency, but also Spain or Ireland, stress the problem of cohesion, meaning efficient mechanisms for redistributing the additional wealth created by dynamic integration effects between poor and rich regions. The EFTA countries have successfully used the model of the Portugal Fund without any need for supranational institutions, yet with a considerable impact on returns to invested capital and job creation. They stand ready to finance projects in the EC countries, but one large EC country “fears EFTA interference” – or rather participation – in EC decision-making, and the poorer EC countries do not yet have too many projects ready for investment. But the completion of the internal market will enhance and accelerate their absorptive capacity. Even so, the North-South gap within the EC has definitely reinforced protectionist tendencies, so that countries with free trade traditions like the UK and the FRG have become a minority.

### European Economic Space

The “Bangemann meeting” of the European Economic Space countries in 1988 led to the decision to adopt multilateral instead of bilateral cumulation in trade within the European Economic Space as of 1.1.1988, decided in June. EFTA then agreed to making its INST procedure for the notification of technical regulations compulsory as a precondition for a framework agreement with the EC. Another Convention on mutual recognition of tests and proofs of conformity among EFTA countries should not only facilitate the introduction of new products on EFTA markets, but should extend the old EFTA idea of mutual recognition instead of complete

harmonisation throughout the European Economic Space.

In September 1988, the Convention on a uniform jurisdiction and enforcement of judgements in civil and commercial matters ("Exequatur Convention") was signed by all European Economic Space countries. In general, it gives more legal security to traders and consumers, for instance in product liability cases. Yet the EC members have attached to this Convention an important reservation on the "development of EC law". In order to counteract the risk of this reservation becoming a new instrument of protection, all parties agreed to an obligation to renegotiate, should the reservation of EC law development hamper the application of the Exequatur Convention – which is an elegant way of avoiding implementation troubles. In addition, about 20 joint informal EC-EFTA expert groups are discussing as many other fields of cooperation – on common research, on the free circulation of university staff and students and the mutual recognition of diplomas of higher education, on EC-Eastern Europe university cooperation etc. Yet, the obstacles are significant. The EFTA countries in general suffer from the fact that they are large economic partners of the EC, but with rather limited individual political power, and that EFTA as an organisation is quite small and without supranational competences (with only 70 civil servants compared to 22,000 in Brussels). It is therefore difficult to combat the new streams of "eurocentrism". Nonetheless, the EC Commission has clearly stated that it prefers multilateral negotiations with EFTA as a group to individual, bilateral ones, even though bilateral problems can and will always be solved bilaterally: Switzerland, for example, has 113 bilateral agreements with the EC.

For "Pan-European" integration the time factor is absolutely decisive for the success of economic reforms in the East. The longer these reforms are delayed, the larger will be the economic and social costs to be paid for them. Again, the ECE/UN paints a rather gloomy picture of those reforms for the following reasons:

- the already high costs of economic reforms, waste of manpower, low labour productivity, high energy needs of obsolete industries, no incentives plus "new" phenomena of bankruptcy, unemployment, inflation,
- the relatively high indebtedness of some CMEA countries (Poland) – yet at the end of November 1988 the ECE published a study showing that the external indebtedness of the European CMEA countries would be reduced in 1988 by \$ 3 to 99 billion and that both exports and imports of these countries increased in the

first half of 1988 (exports by 6.5% in volume, imports by 5%), which shows a reversal of the negative trend of the years 1986 and 1987 into quite a positive picture,

- the reluctance of other CMEA countries to take up credits, which leads to import restrictions for needed investment goods.

We should also add:

- the lack of convertible currencies, which restricts CMEA trade to bilateral exchanges, and limits the basic imports from the West urgently needed for the reforms,
- the arbitrary valuation of the transfer ruble,
- the large differences in economic development levels and hence the centrifugal forces within the CMEA,
- administered prices, which falsify the cost structures and do not allow the international competitiveness of products for sale on the world markets to be measured,
- a large number of non-economic, administrative obstacles to efficient resource allocation,
- last, but not least, psychological factors in connection with a necessary national consensus on backing the reforms.

The time factor is so decisive, because Eastern Europe has to compete with the very efficient Asian newly industrializing countries, which mostly have open markets, decentralized production, high labour productivity etc. It is also decisive because the destabilizing effects of true reforms must be absorbed and can be absorbed more rapidly in a period of world-wide economic growth. In addition, Western Europe needs a single market to regain the competitiveness lost in comparison to the USA and Japan – and it has many obstacles to overcome before achieving this, even among countries with the same economic regime. It is then all the more risky to work for the achievement of "Pan-European" integration with trading partners having not only a lower level of development, but an entirely different economic regime, and hence also divergent views on economic matters – apart from a different political ideology.

## Effects of European Integration

In conclusion, we compare two hypotheses. The first is that West European integration will be successful. The main effect will be increased competition leading to stronger industrial concentration of efficient concerns, and the manoeuvring out of the market of inefficient ones. Under this assumption, more venture capital will be available, also to the small and medium-sized firms, which today in Western Europe fear the 1992 deadline

most, but are at the same time the most innovative economic agents. The EFTA countries do not have any interest in a weak, and therefore more protectionist, EC. Hence they support the creation of the single market as their main economic challenge. Also, the majority of their industries are less shielded from world-wide competition than those in many EC countries. Hence they stand to gain from increased competition in general. So far, the construction of the European Economic Space is a formidable challenge having to eliminate just as formidable obstacles. This is a long-term and difficult task, but it will be achieved among partners who have the same economic system. How much more difficult is true cooperation among countries with different economic regimes – where everything up to the vocabulary is different for the normal West European businessman – and tends to get more confused through the reforms the longer they last, and the more often those in charge and responsible for foreign trade change.

If the overall effect of successful European integration is increased competition, it will stimulate growth in general. It is, however, unscientific to calculate the gains from potential or hypothetical growth as is done in the Cecchini report or other studies. (The gains from growth are estimated at \$ 232 billion and 1.8 – 5 million jobs should be created. Nothing is said, however, on the distribution of this increased wealth – and of the 300 directives needed for the EC internal market, only about 100 have passed the Council of the EC and those are on minor subjects.) Yet, there is a lot of pressure to succeed, were it only to regain the competitiveness lost to Japan and the USA. The EFTA countries would, within the European Economic Space, most likely reinforce the free trade tendencies and hence work against a “fortress Europe” concept, even against their own protectionist lobbies. Under this optimistic hypothesis, the economic reforms planned and started in Eastern Europe will be achieved in time and the technically developed industrialized CMEA countries would gain market shares in Western Europe, were it only by reducing, for instance, transport costs for goods now imported from the newly industrializing countries. There would be a magnet effect for the other trading partners provided that the Uruguay Round succeeds, which in turn could stimulate world-wide South-South trade.

The opposite hypothesis is that European integration fails. The costs of non-Europe will be extremely high. For the EC, they have been calculated by a British member of the European Parliament to amount to \$ 140 billion (June 1988) and are increasing with time. The main reasons for these high costs are:

- the absence of a real single market for goods,
- the incomplete implementation of the European Monetary System,
- the insufficient coordination of economic policies,
- the costs of the common agricultural policy,
- the non-open public procurement. Public procurement makes up for about 15 % of the EC's GNP and a volume of over \$ 426 billion a year. At present only about 2 % of the EC's public procurement is open to bids from other EC countries, let alone to those from EFTA, CMEA or other trading partners. In addition, there are costs due to duplication of R&D programmes, to what is nicknamed the “subsidy contest” among the EC countries, to the costs of checks and surveillance measures at internal borders etc.

If the EC were to become more protectionist, it would eventually ruin the multilateral world trading system with its network of bilateral agreements containing the whole arsenal of neoprotectionist measures. That is at stake in the Uruguay Round. So far, only the economic costs have been mentioned. But there are social, political, and maybe even military, costs as well, if European integration fails.

In the immediate future, there will probably be a median situation between the two hypotheses, rather favouring the more optimistic one, where for the time being neither the gains from European integration nor the costs of non-Europe can be calculated precisely – and where a pragmatic approach is needed more than Descartes' logic. Between East and West in Europe there are obvious fields of cooperation, like transport, transborder environmental protection, common technical standards and quality controls, a common system of trade documentation, statistical data, better information on economic plans and programmes etc.

Finally, should the optimistic hypothesis come true, any changes in EC, CMEA or EFTA membership will become redundant. And, certainly, an economically integrated Europe from the Atlantic to the Urals would be appreciated as a valuable trading partner by the USA/ Canada free trade zone and by Japan. In addition it would be a positive contribution to world peace. This is sweet music for the future – but economics, as much as politics and diplomacy, is also “the art of the possible”, and things unthinkable ten years ago have been achieved today. The whole of Europe cannot afford to lose the chance described in the optimistic hypothesis – even if for its accomplishment Europe needs to mobilize every single intellectual, political and economic force available – and absolutely all of its vital energy.