

Tomann, Horst

Article — Digitized Version

EC internal market: An opportunity for CMEA countries?

Intereconomics

Suggested Citation: Tomann, Horst (1989) : EC internal market: An opportunity for CMEA countries?, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 24, Iss. 6, pp. 303-308, <https://doi.org/10.1007/BF02924739>

This Version is available at:

<https://hdl.handle.net/10419/140216>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Horst Tomann *

EC Internal Market: An Opportunity for CMEA Countries?

The removal of the internal frontiers within the EC will tend to have a negative effect on trade relations between EC and CMEA countries. The implications of 1992 for trade patterns between the EC and the CMEA are examined in the following article and the role which future EC trade policy could play here is outlined.

Recent developments in socialist countries are directed towards market oriented economic reforms. These developments coincide with a major institutional change within the EC, stimulating enterprise strategies and accelerating economic change. The "institutional innovation" of completing the internal market will have implications for non-EC countries, and thus may in particular influence the conditions for economic reform in socialist countries. This paper examines possible consequences for the cooperation between EC and CMEA countries resulting from completion of the EC internal market. The analysis is restricted to economic consequences and excludes pure political reasoning.

First, a review is presented of the institutional changes and the strategy chosen by the European Commission to pursue the objective of a genuine common market. The dynamic effects of economic integration which are to be expected in markets with incomplete competition according to modern trade theory are then discussed. Finally, the implications these effects may have for trade patterns between EC and CMEA countries are examined and the role of future EC trade policy is pointed out.

During the eighties, the Commission of the European Community undertook several attempts to give new momentum to the process of European integration. The programme of completing the EC internal market within a medium-term period was eventually shaped in 1985, when President Jacques Delors and his newly elected Commissioners had to respond to business leaders' complaints about the "costs of non-Europe". In particular it was argued that segmentation of markets for

high tech products within the EC impeded the process of innovation, compared with the USA and Japan. Investors had already begun to shift their foreign investments to the USA rather than to EC member states.

The programme of establishing a really integrated internal market has been called a movement "back to the future": the creation of a customs union after 1958, which stimulated growth of production and trade within the EC during the sixties, was regarded as being the model case. Similar to the first phase of integration the programme contains concrete objectives of integration, a fixed time-table and institutional reforms to overcome bureaucratic inertia. However, as Krugman¹ has pointed out, the EC of the six did not have to tackle the same structural imbalances in their economies as the EC of the twelve will be confronted with. Moreover, from an international relations point of view, the external threats to Europe pressing for political action during the fifties have greatly receded.² Therefore, expectations regarding the success of the internal market might prove to be too optimistic.

The objective of removing the common market's internal barriers was defined by the "Single European Act", a first major revision of the Treaty of Rome which came into force on July 1st, 1987. This act sets binding commitments. "The internal market shall be established by the end of 1992 and shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured ..."³ At the

* Free University, Berlin, Germany. This article is a revised version of a lecture given at the sixteenth annual EARIE conference, August 30th – September 1st, 1989, in Budapest.

¹ Paul R. Krugman: Concepts of Economic Integration in Europe, in: Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community, A report by Tommaso Padoa-Schioppa et al., Oxford 1987.

² Cf. Susan Strange: A Dissident View, in: Roland Bieber et al.: 1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy, Baden-Baden 1988, pp. 73 ff.

same time, the Single Act provides institutional changes vital for the establishment of the internal market. First, a qualified majority rule was explicitly introduced which will enable the Council to adopt measures towards completion of the internal market without much delay.⁴ Secondly, the Council is bound to take its decisions "in cooperation with the European Parliament and the Economic and Social Committee".⁵ By this procedure the Council realised its intention to take political decisions and to upgrade Parliament. In order not to disregard minority interests in the case of important issues, these institutional changes shall not apply to fiscal provisions, to those relating to the free movement of persons or to the rights and interests of employed persons.⁶ In all other cases the intention is "to overcome the bureaucratic inertia of government experts in the Council, which has been the main obstacle to internal market progress".⁷ Thirdly, the scope of harmonisation shall be reduced to minimum standards concerning health, safety and environment. Any other national standards which have not been harmonised by 1992 shall be recognised as equivalent to each other.⁸ This principle of mutual recognition may well prove to become the decisive precondition for completion of the internal market. If it is applied consistently differences in national standards must no longer be seen as trade barriers. The Commission has already announced that it intends to proceed in this way.

The Commission's Strategy

In 1985, the Commission had already designed its strategy for completion of the internal market in a white paper. The basic idea was to identify the problems and to design measures necessary to provide free trade and free movement of persons and capital within the EC. Thus, feasibility was not the strategy's criterion, and some areas – like trade relations to third countries – remained where the Commission had actually no idea what measures to adopt. Therefore, the annex to the White Paper which identifies nearly 300 measures necessary to achieve the goal of an internal market is not exhaustive.

The White Paper distinguishes three kinds of barriers to the free movement of goods, persons, services and capital:

☐ physical barriers, notably customs posts at intra EC frontiers;

☐ technical barriers which implicitly hinder the realisation of the common market's economic gains; these are barriers such as different technical regulations and standards for goods and services, but discrimination of foreign bids for public purchases is also regarded as "technical";

☐ fiscal barriers, in particular differences in indirect taxation which have to be compensated for in intra-EC trade.

The Commission was aware that a reform of the Community's budgetary system had to be part of its strategy in order to provide financial support for the programme, in particular for measures in favour of the "economic and social cohesion"⁹ of the common market. In its 1987 note to the Council "The Single Act must succeed"¹⁰ the Commission proposed a programme of complementary measures to avoid negative social consequences of enhanced structural change and to regain financial viability of the Community.

The Commission states that the process of completing the internal market has performed well in recent years: by the end of 1988, the measures identified in the White Paper were notified by the Council to about 50%. However, an open market is an indivisible good. The success of the internal market will therefore depend to a large extent on whether the principle of mutual recognition which was built in as fall-back position works. Furthermore, the performance of complementary measures will play a decisive role. After all, in contrast to the experience of the sixties, the programme of completion of the internal market imposes a real structural challenge to the Europe of the twelve.

Effects of Economic Integration

Completion of the EC internal market will teach us a lesson in supply economics. Do improvements in supply conditions by deregulation and cost reductions work as incentives which stimulate investment and economic activity? Though the Commission's economic philosophy has been widely accepted by business leaders, in particular in industry and the financial sector, this question is not yet settled.

⁶ Ibid., para. 2.

⁷ Helmut Schmitt von Sydow, in: Roland Bieber et al., op. cit., p. 102.

⁸ Art. 100B, EEC Treaty.

⁹ Single Act, Art. 23.

¹⁰ Doc COM (87) 100.

³ Art. 8A, EEC Treaty.

⁴ Art. 100A, EEC Treaty.

⁵ Ibid.

Forecasts of integration effects rely essentially on dynamic effects.¹¹ The main dynamic effects are

- scale effects, with the consequence of increased intra-industrial specialisation and product variety,
- effects from increased competition which corresponds to the enlargement of markets,
- the possibility of faster innovation.

The Cecchini report provides quantitative estimates for part of these dynamic effects. The well-known specialisation effects of trade liberalisation, in contrast, which according to neoclassical trade theory are to be expected in competitive markets, proved to be not very important in quantitative terms.

Hypotheses

An evaluation of the interrelated developments which will be induced by completion of the internal market requires a complex model. To simplify the analysis, a partial setting approach is generally adopted. With this approach it is possible to restrict the analysis to potential integration effects and to neglect repercussions and adjustment problems. The main hypotheses of the Cecchini report which are tested in a partial setting are the following:

- *Direct Cost Reductions.* Removal of physical barriers to trade has an immediate effect on the costs to exporters and importers and may indirectly result in stronger competition and increased efficiency. Moreover, removal of the technical barriers that limit market entry (including government procurement restrictions) may affect production in a wide range of industries and may have similar effects on the level of costs and prices.
- *Scale Effects.* Empirical studies suggest a correlation between market size and average plant size as well as between export expansion and average plant size. It is stated, therefore, that growth of trade may increase utilisation of potential economies of scale. The main effects are expected from exploitation of technical economies of scale. Many plants have not yet reached minimum efficient scale. Though the potential for cost reductions varies widely from industry to industry, the

level of industrial unit costs is estimated to decrease by 1.5 percent, if the single market induces expansion of plant scale of production.¹² Similarly, firms may have a potential for non-technical economies of scale concerning sales promotion, transport services, R & D and finance. In these areas, notably with R & D, realisation of economies of scale may require cooperation on a European level. In any case, scale effects require new investment to be realised and therefore are long-term effects.

□ *Learning Effects.* In fast growing markets, in particular in markets for products with a high skilled labour content, the effects of experience and learning are of considerable importance. With cumulative production increasing, unit costs of production will fall. These cost advantages arise from the increasing experience of skilled labour and the technological improvement of production processes and organisational structures. An integrated internal market, by increasing cumulative production by the individual firm, may induce these benefits. However, as the example of the US Aerospace Industries indicates, the learning effect may turn negative due to a shortage of skilled labour, if the market expands too fast.

□ *Competition Effects.* A basic assumption of forecasts concerning the internal market is an increase in competitiveness. It is expected that the removal of non-tariff barriers within the EC will cause price variations to narrow, as x-inefficiency and monopoly rents are reduced. In particular, public procurement may become more competitive. Similarly, oligopolies which prevail in many national markets for tradeable goods and services may be confronted with new competitive momentum. Hence, along with the realisation of scale effects and learning effects which lead to larger firms and more intra-industrial specialisation, the expansion of markets induces a competitive environment. A survey of business strategies¹³ underlines that firms expect more competitive markets by 1992. They respond mainly with measures to improve productivity and increases in the number of international cooperation agreements. It should be clear, however, that these strategies could result in a restriction of competition.

□ *Innovative Effects.* It is stated that a virtuous circle between competition and innovation may evolve which essentially relies on the relationship between market growth and technological development. Actually the basic idea of the single market has been to close the technological backwardness in high technology sectors which became evident in the early eighties when Europe's market shares decreased compared to those

¹¹ John Pinder: Enhancing the Community's Economic and Political Capacity: Some Consequences of Completing the Common Market, in: Roland Bieber et al. op. cit., pp. 35 ff.; Paul R. Krugman, op. cit.; Paolo Cecchini: The Economics of 1992, in: European Economy, No. 35, March 1988.

¹² Paolo Cecchini, op. cit., p. 117.

¹³ Ibid., pp. 133 f.

of the USA or Japan.¹⁴ However, though empirical research has been done on the relationship between competition and innovation, the innovative momentum of completing the internal market seems to be a highly speculative case. No estimates on these effects are available.

Quantitative Estimates

The internal market's economic potential will correspond to that of the USA. The European Community has a population of 324 million (USA: 246 million). The domestic product of the Community amounted to 3900 billion ECU in 1988 (USA: 4000 billion ECU).

Economic gains from the completion of the internal market are estimated to amount to about 170 to 250 billion ECU in the medium term, corresponding to a relative increase of real domestic product by 4.25 percent to 6.5 percent. Thus, within a period of five years the EC's growth rate could be increased by one percentage point p.a. However, the larger part of these effects will not be felt until an adjustment period of at least five years has passed. Moreover, economic policy will have to ensure the re-employment of released resources, in particular labour.¹⁵ It should be clear, therefore, that the quantitative forecasts are only a vague approximation. Macroeconomic simulation studies result in similar growth effects from completion of the internal market (4.5 to 7.0 percent of GDP). The employment effects are estimated within these models to range from two million to five million jobs, depending on the assumptions on economic policy. In addition, a deflationary effect is forecast (the price level will decrease by 6 percent) as well as a reduction of the budget deficit. These are ideal results for supply-siders. Finally, the current account on the balance of payments will improve significantly for the EC, although an active demand management would deteriorate this result. The results of a survey on Community firms underline these estimates.¹⁶ Business opinions on the integration effects were positive. On the average, firms expected an increase in turnover by five percent.

Prospects for EC-CMEA Trade

In principle, non-EC countries may benefit from the growth potential of an enlarged common market to a similar extent as EC countries do. For example, the

establishment of a customs union within the EC during the sixties implied an increase of EC trade with the rest of the world. However, cooperation by the USA and the EC during the Kennedy Round of GATT negotiations was an essential precondition for this trade expansion.¹⁷

As far as the cooperation between EC and CMEA countries is concerned, first the impact of changed market conditions within the EC has to be analysed. Conclusions differ depending on trade patterns. Secondly the role of external EC policy has to be considered.

As shown in Table 1, trade flows between the EC and CMEA countries in eastern Europe indicate a distinct pattern of specialisation. CMEA countries have traditionally been net exporters of raw materials and energy – which amounts to nearly 60 percent of total exports – and, on the other hand, have been net importers of food and manufactured products. A regrouping of trade flows according to the factor intensity of products which has been undertaken by W. Kostrzewa¹⁸ for OECD/CMEA trade allows a more

Table 1
EC¹ – CMEA Trade by Products
January – September 1988 (in percent)

SITC section		EC exports to CMEA countries	EC imports from CMEA countries
0 + 1	Food, Drink, Tobacco	5.95	6.05
2 + 4	Raw materials	3.17	9.77
3	Fuel products	0.41	33.31
5	Chemicals	18.32	6.92
7	Machinery, transport and equipment	33.49	7.40
6 + 8	Other manufactured products	32.32	26.95

¹ Without Greece.

Source: EUROSTAT: External Trade, Monthly Statistics, No. 2, 1989.

Table 2
OECD – CMEA Trade by Product Groups
1965, 1986 (in percent)

	Products with high content of			
	Raw materials, energy	Labour	Capital	Human capital
OECD exports to CMEA				
1965	11.6	20.9	20.4	47.1
1986	8.5	19.5	21.0	51.0
OECD imports from CMEA				
1965	55.1	16.6	18.3	10.0
1986	57.8	17.2	11.9	13.2

Source: Wojciech Kostrzewa: Verpaßt Osteuropa den Anschluß auf den Weltmärkten?, in: Kieler Diskussionsbeiträge, No. 144, Sept. 1988.

¹⁴ Ibid., p. 29.

¹⁵ Ibid., p. 19.

¹⁶ Ibid., p. 130.

¹⁷ John Pinder, op. cit., p. 50.

precise interpretation of these data (Table 2). Following Kostrzewa's analysis, CMEA countries have a comparative disadvantage in markets with a high content of capital and human capital (research-intensive products). On the other hand, there is a comparative advantage for raw materials (energy). Trade in labour-intensive products is fairly balanced. This pattern has been stable over the past twenty years. It clearly shows that inter-industrial trade prevails. Moreover, intra-industrial trade flows did not increase in the past, as one would expect for countries with similar income levels.

Changed Supply Conditions

An external supplier who wants to take advantage of the internal market has to be competitive in markets where dynamic integration effects are strong. These are markets with a large potential for economies of scale, steep learning curves, and research-intensive supply structures. In these markets the changed supply conditions of the European internal market will induce high rates of innovation and high growth rates and will stimulate external trade. Like in the sixties, intra-industrial trade will expand particularly, increasing the potential of product differentiation and hence consumer welfare. CMEA countries are disadvantaged in these dynamic sectors, as the trade patterns of the past have shown. Estimates of these countries' technological gaps show that they lag behind Western Europe and the USA by about 13-15 years.¹⁸ It is improbable that they will be able to take advantage of the changed supply conditions and participate in the expansion of intra-industrial trade. More likely, difficulties in entering these markets will increase, and the virtuous circle of innovation and competition will turn out to be a closed circle. Changed business strategies within the EC point in this direction. First, there has been a sharp rise in intra-industrial cooperation in R & D, initiated by the European technology programme SPRINT. Second, the number of mergers on a European scale has risen. This indicates strategies to take joint advantage of technological know-how and to diversify risks.

Inter-Industrial Trade

Market integration within the EC during the nineties may induce structural adjustment processes quite different from those of the sixties. Whereas the EC of

the six comprised relatively homogenous national economies – major divergencies existing only in the agricultural sector – the industrial structure of the EC of the twelve is much more divergent. The integration of these twelve economies into a single market may reveal severe economic imbalances and induce a process of structural change towards a new intra-EC specialisation. Inter-industrial trade within the EC may increase, therefore. These developments might well disturb the inter-industrial specialisation which has been settled so far between EC member states and CMEA states. In the short run backward regions within the EC might try to avoid adjustment costs and to protect their industrial base against the threat of unemployment. This strategy of protection, no longer possible within the EC, might increasingly turn against competition from third countries. Hence, non-EC countries with a traditional industrial structure (comprising labour-intensive and capital-intensive production) could be blocked in taking advantage of their competitiveness. In the long run, when structural change is working out a new pattern of comparative advantage within the EC, two interrelated effects will presumably determine trade relations between the CMEA and the EC and create a new pattern of inter-industrial specialisation. First EC-CMEA trade may benefit from the accelerated growth of EC income (income effect). An interrelated second effect is that large production units and high growth rates within the EC require a fast rate of market expansion, i.e. the opening of new markets (supply effect). Whether these developments occur depends to a large extent on the external policy of the EC.

External EC Trade Policy

As far as the external trade policy of the EC is concerned, the Commission's 1988 report on completion of the internal market strictly rejects the view that a new protectionism against third countries could evolve. The Commission ensures that any supplier may participate in the benefits of the internal market, also suppliers from third countries who offer within the EC, and that the EC will abide by the international, bilateral and multilateral commitments.

Apart from that, the report points out, however, that the Commission does not intend to pass on the advantages of internal liberalisation automatically and unilaterally to third countries in areas where no international commitments exist. The Cecchini report underlines this view and points to the principles set out within the GATT framework "which allow the Community to reserve for its members the advantages resulting from an intensification of their mutual ties as long as this

¹⁸ Wojciech Kostrzewa: Verpaßt Osteuropa den Anschluß auf den Weltmärkten?, in: Kieler Diskussionsbeiträge, No. 144, September 1988.

¹⁹ Stanislaw Gomułka: Reasons for Shifts in Competitiveness in Western und Eastern Countries, paper prepared for the Malente Symposium VIII "On the Way to stronger East-West Economic Relations: Chances and Challenges", October 1989.

does not involve a deterioration in the treatment of non-Community countries by comparison with the earlier situation".²⁰ According to the GATT rules the EC is a supranational institution. This allows to treat EC members and non-EC states differently and explains the Commission's basic philosophy which pursues negotiations leading to reciprocal agreements. In particular, the principle of reciprocity is crucial to the services sector, where GATT rules have not yet been established. The principle of reciprocity is only on face value compatible with a liberal trade policy. It invites strategic and opportunistic behaviour and hence enables the Commission, and even more so the politicians of the European parliament, to use this weapon of hidden protectionism.

This view is confirmed by recent EC policies towards cooperation with CMEA countries. In July 1988, a "Joint Declaration" was approved to normalise relations between EC and CMEA countries. This declaration provided the framework for bilateral negotiations on trade and cooperation. So far, bilateral agreements, mainly on the removal of the EC's quantitative trade restrictions, were enacted with Hungary (September 1988), Czechoslovakia (December 1988) and Poland (September 1989). Negotiations with the USSR and Bulgaria are still in process. As far as Hungary and Poland are concerned, these agreements were partly outdated by an action plan which was initiated at the Paris World Economic Summit and which comprises above all immediate financial help as well as immediate removal of quantitative trade restrictions (beginning on January 1st, 1990). Moreover, a preferential tariff treatment for a period of five years was approved.

Apart from this emergency programme, the EC Commission has made clear that a comprehensive liberalisation of relations with the CMEA countries would require fundamental economic reforms within these countries. The logic behind that position is that otherwise liberalisation would not result in mutual economic advantage. Hence, the EC Commission will not provide preferences to the CMEA countries similar to those offered to the EFTA countries until economic reforms have proceeded in the following fields: price reform, removal of state monopolies, admission of forms of private property equivalent to collective proprietorship, and convertibility of the currency.

For the same reasons a new "Marshall Plan" in favour of Poland and Hungary was rejected. At least, a range of measures have been adopted to provide assistance in

the medium term. The European Investment Bank will offer project finance to Poland and Hungary. Furthermore, cooperation is suggested in the field of environmental protection and management education. Further steps are planned.

Conclusions

What are the consequences of completing the EC internal market for socialist countries? I conclude with three theses.

First, removal of the internal frontiers within the EC will strengthen the position of the European Community as a supranational institution. Though an increase of the Community's bargaining power is to be expected, the Commission has not yet signalled the intention of initiating a new round of international trade liberalisation. Without such an intention, however, completion of the internal market will remain a sort of strategic trade policy. There seems to be little chance that the coincidence of the process of European integration with the Uruguay round of the GATT in its final phase will induce a breakthrough in trade liberalisation as was the case during the sixties.

Secondly, it will become more difficult in economic and political terms to intensify trade relations between EC and CMEA countries. The dynamic integration effects will mainly stimulate trade expansion in research-intensive industries and will induce intra-industrial trade. The CMEA countries which are disadvantaged in these sectors could however benefit from a new pattern of inter-industrial trade. This depends on whether the EC accepts the structural adjustment process necessary to establish a new pattern of industrial trade and to what extent external trade policy pursues a protectionist line in favour of the EC's own backward regions. External investors, therefore, are faced with a peculiar uncertainty as far as their investment decisions in view of the EC internal market are concerned.

In the long run, finally, liberalisation of capital flows within the EC will gain importance and attract the supply of capital. This seems to be an opportunity for socialist countries which are in urgent need of capital to implement their economic reforms and to catch up with Western countries in terms of technology. After all, a development strategy of capital import and technology transfer seems to be the essential precondition for gaining competitiveness in dynamic markets and to escape a division of labour according to comparative advantage which only would maintain economic dependence in the long run.

²⁰ Paolo Cecchini, *op. cit.*, p. 140.