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## The European single market: bad news for developing countries?

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Bad News for Developing Countries?**

by  
Erich Gundlach

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**ABSTRACT**

Developing Countries have been particularly worried by the single-market-program since the EC absorbs more than a third of their total exports. At present, fears of a Fortress Europe and negative net trade effects for DCs appear to be unfounded, however. DCs have proven to be competitive in a number of labour and capital intensive industries in the past; and it is rather unplausible that European suppliers will gain a competitive edge in these industries as a result of the single market. With the exception of agricultural economies specialized on specific products, the net welfare effect of EC-1992 will, therefore, be either positive or at worst zero for most DCs.

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## 1. INTRODUCTION\*

In the mid-1980s, the announcement of the single-market-program designed to bring free movement of people, goods, capital, and services within the Community by January 1st 1993 was thought to be the appropriate answer to help overcome the then diagnosed loss of competitiveness of European suppliers on world markets. In turn, the single-market-program appears to have stimulated the Community's strong economic growth in the late 1980s. As a consequence, the economic friction resulting from the implementation process seem to have been underestimated, and the potential gains probably overestimated. With the single market in place, the present economic downturn with rising unemployment and necessary structural adjustments in several highly subsidized sectors may increase the risk that more protectionist trade policies will be taken in the future. Both aspects, the prospective improvement of the competitive position of European suppliers on world markets, and a possible Fortress Europe, worry competitors from third countries, and especially developing countries (DCs). Up to now, however, both fears by and large appear to be unfounded.

First, the single market is far from being fully completed despite the end-1992 deadline. E.g., some industries were left out of the original legislative program because they were thought to be too sensitive (e.g., telecommunications and energy), some measures such as passport checks will vanish with delay, some measures such as the value-added-tax system are in a state of transition (due for review in 1996), many of the technical standards needed to make the rules on technical harmonization work are not in place, state aid for certain industries continues to distort markets, and the huge public procurement market is still governed by national bias [The Economist, 1993]. Hence the productivity boosting effect of European integration, whatever its actual size may be, will spread out over a relatively long time span, thus giving competitors from third countries a chance to respond to changing conditions of competition: The completion of the single market is a process, not a deadline.

Second, fears of a protectionist threat of the single market have not materialized to date, apart from certain sensitive areas where EC wide arrangements with foreign suppliers or new Community restrictions are to replace previous national restrictions (cars, bananas, fish, steel). I.e., there is little evidence of any major

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*intensification* of protectionist measures on behalf of the EC in the industrial sphere, and the Commission has indicated that only for a handful of producers some form of Community measures would be needed [GATT, 1993]. Of course, this is not to deny that EC markets for, e.g., agricultural products, iron and steel, and textiles and clothing remain heavily protected.

In the years ahead, the single market is to continue with enlargements of EC membership (EFTA countries), further association agreements (Central and Eastern Europe), and the eventual establishment of an Economic and Monetary Union aimed at in the Treaty of Maastricht. The EC is well on its way of becoming a regional trading bloc encompassing most of Europe. Against this background, it is hardly surprising that non-Europeans, and in particular developing countries (DCs), are anxious about their access to the large European single market, shifts in comparative advantages generated by economic integration, and a possible reversal of international capital flows which a Europe 'without borders' may entail. Since EC member countries have traditionally been important trading partners of DCs changes of demand, market accessibility and investment flows will have an immediate impact on the growth prospects of these countries, especially when they have followed an outward-oriented development strategy such as many Asian DCs.

This paper looks at the expected trade and growth effects of the single market program (EC-1992 for short) and related changes currently under way in Europe. Towards this end, the scope of institutional change in the EC will be summarized in section 2. The completion of the single market for goods, services, capital, and labour (the so-called four freedoms) goes hand in hand with an enlarged network of policy coordination agreements with the EFTA countries and countries in Central and Eastern Europe. The emergence of the European Economic Space and the association of formerly centrally planned economies has increased trade policy discrimination among trading partners and has rendered the trade policy regime of the EC even more complex and non-transparent than it already was prior to 1993 [Hiemenz et al., 1990]. The expected growth effects of EC-1992 in EC member countries are discussed in section 3. Section 4 deals with the implications of European economic integration for developing countries. The overall conclusion is not overly pessimistic: developing countries do not need to fear an erosion of their trading opportunities in an integrating Europe if they respond in a flexible manner to the institutional changes that are being implemented in the 1990s.

## 2. THE INSTITUTIONAL FRAMEWORK OF EC-1992

The basic rationale of European economic integration was internal trade liberalisation. Intra-EC trade was successively liberalised in three major stages. The first, starting in 1958, was the elimination of customs duties and quantitative restrictions. It was completed on 1 July 1968 with the introduction of a common external tariff. The second, between 1973 and 1986, witnessed the stepwise enlargement of the EC from six to twelve member countries and the conclusion of various free trade and preferential trading agreements with neighbouring industrialised countries (mainly EFTA) as well as DCs around the Mediterranean Sea. During the 1970s and early 1980s, however, global economic setbacks, rising inflation, surging oil prices and problems of structural adjustment worked against a further deepening of economic integration among EC members. In 1985, in the so-called White Paper, a comprehensive and ambitious approach was launched to revitalise the integration process: the completion of the single market by the end of 1992 which marks the third and last stage of internal trade liberalisation.

Having accomplished a free trade area and a customs union, the 1992-project meant the establishment of a common market without internal borders and border controls. To achieve this, EC member countries primarily had to liberalise factor movements and trade in services within the EC. Concerning manufactures, trade had already been liberalised earlier except for a relatively small number of products (including those covered by the MFA) for which national quotas were still existing. Such quotas had to be removed. Furthermore, market access is to be based on the country-of-origin principle. Certain technical norms and standards, public procurement and the provision of subsidies as well as VAT treatment, however, were harmonised within the EC. It is not clear, though, how and when these policy changes will be fully implemented and how suppliers from third countries may fit into the new framework [for details, see Langhammer, Dicke, 1991].

The expected welfare gains from the completion of the single market were estimated in two studies commissioned by the EC Commission, the famous Emerson and Cecchini Reports [Emerson et al., 1988; Cecchini, 1988]. According to these studies, the removal of technical barriers to trade, the abolition of border controls, more competition in public procurement and the opening of major services markets would boost the EC's GDP by between 2.5 and 6.4 per cent over a period of roughly 5 years. These results are heavily debated. Critical comments focus on the true size of gains from integration, in particular the neglect of effects from structural adjustment, and the at most parenthetical reference to the impact on the rest of the world. The latter led to the perception shared by many DCs that the EC may try to

restrict the access of outsiders to the benefits of integration by impeding external competition, i.e. by erecting a Fortress Europe.

The economic landscape of Europe will continue to change considerably after the completion of the single market. The Maastricht Treaty has laid the groundwork for further integration deepening by establishing the timetable and the conditions for a European Monetary Union to be implemented until the end of the decade. Negotiations on the formation of a European Economic Space with the EFTA countries, and association agreements with formerly socialist countries in Central and Eastern Europe pave the way towards integration widening. The final objective of closer economic cooperation between the EC and other European countries is enlargement of EC membership although neither the countries desiring full membership nor the respective time frame for their accession have been identified.

## **2.1 The European Monetary Union (EMU)**

The EMU represents the last step of European economic integration, i.e. the transformation of the common market into an economic union. This step is considered to be a precondition for a political union, the ultimate objective of European integration. The EMU essentially means the introduction of a single European currency issued by a common, independent Central Bank. The elimination of exchange rate risks among EC member countries is expected to reduce transaction costs in intra-EC trade and - together with stability-oriented and disciplined budgetary policies - to improve the allocative efficiency of the European economy. The plan dates back to 1988, when the heads of state commissioned a report on ways and means to achieve economic and monetary union. The so-called Delors-report, proposed a three-stage plan towards monetary union, with the last stage entailing a common currency and assignment of full monetary and economic competences to EC institutions. Agreement on this proposal was reached in the Maastricht Treaty of December 1991, providing for the introduction of a common currency sometime in 1997-1999, depending on progress in economic convergence in the interim.

The EMU builds on the accomplishments of the Common Market and the European Monetary System (EMS). In preparing for the Common Market, all restrictions on capital flows among EC member countries were abandoned. The EMS has narrowed exchange rate fluctuations among the currencies of member countries to a small band. The eight core countries adhering to this mechanism were joined by Spain and the United Kingdom on 20 June 1989 and 8 October 1990.



Greece and Portugal remained outside the EMS. Events during the last months of 1992 have, however, clearly indicated the fragility of an exchange rate mechanism in the absence of coordinated monetary and fiscal policies. High rates of inflation and fiscal deficits in Italy and the United Kingdom coupled with a tight monetary policy in Germany caused substantial pressure on the former countries' currencies requiring a major realignment of exchange rates. Both countries suspended their participation in the EMS and have not rejoined the mechanism by now.

By the end of 1996, the heads of the EC governments are to decide by a (qualified) majority vote whether a majority of member countries is ready for a currency union. In the case of a positive verdict, the currency union could be introduced for these countries from the beginning of 1997 onwards. In the case of a negative verdict, countries which are then deemed to be ready for the union will have to replace their currencies by a common one at the beginning of 1999. Yet, the criteria are non-binding, they merely provide a basis for a recommendation of the EC Commission to the Council of the heads of EC governments, which is free in its final decision. Hence, the criteria need not constrain the macroeconomic policy of member countries very much.

## **2.2 The European Economic Space (EES)**

The completion of the single market was to coincide with integration widening towards the EFTA countries in the framework of an EC-EFTA agreement on the formation of a European Economic Space (EES). EC and EFTA markets have been connected by special economic agreements since 1972/73, when Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, and Switzerland concluded parallel bilateral Free Trade Agreements with the EC. In these FTAs, the EC and each EFTA member individually agreed on a timetable to abolish tariffs on most industrial goods by the end of 1977. For some sensitive products, e.g. paper and steel, temporary quotas remained and tariff removal was delayed until. To help solving problems caused by differing trade policies regarding third countries, a system of rules of origin was developed. The main features of the EC-EFTA FTAs have also been maintained in the agreement on the EES: exclusion of agriculture, special provisions for some sensitive products, differential treatment of third countries, and rules of origin.

The formation of the EES dates back to April 1984 when ministers of the EC and EFTA agreed on a second generation of EC-EFTA initiatives. In May 1992, EC and EFTA countries finally concluded an agreement on the establishment of the EES on 1 January 1993, concurrently with the completion of the single market. In

compliance with the original objectives, the agreement covers the implementation of the four freedoms, the EC competition policy, special measures concerning e.g. social policy, R&D, consumer as well as environmental protection, and institutional adjustments.

Despite its far-reaching institutional and legal implications, the EES is in the final analysis no more than a free trade arrangement with extensions concerning the free mobility of capital and labour. EC and EFTA countries maintain their respective trade regimes towards third countries. Therefore, rules of origin and border controls are inevitable and will continue to impede EFTA-EC trade in contrast to intra-EC trade. The agreement also includes exemptions from the free trade/free mobility principle in sectors considered as particularly sensitive for individual EFTA countries such as in fishery (Iceland, Norway), transport (Austria, Switzerland), as well as labour mobility and financial markets (Switzerland). The special provisions and the exclusion of agriculture maintain a degree of market segmentation and reduce integration benefits. For this reason, it is hardly surprising that three EFTA countries, Austria, Finland, and Sweden, have applied for full EC membership, while Norway is likely to do so soon.

Summarising from the point of view of third countries, it seems reasonable to conclude that the formation of the EES is not really a decisive event. Conditions of market access for third countries will hardly change in any significant way and, in the medium term, the EES will vanish when all major EFTA countries (except Switzerland) become full members of the EC.

### **2.3 Integration of Central and Eastern Europe**

The former member countries of the Council of Mutual Economic Assistance (CMEA) in Central and Eastern Europe can be considered as "natural" trading partners of Western Europe. Historical trade patterns from the inter-war period as well as the simulation of "normal" trade patterns using so-called gravity models (with economic size and distance as the major determinants of the direction of trade) suggest that Central and Eastern European countries would direct the largest share of their exports to Western Europe. Some estimates say that about 75 per cent of Central and Eastern European exports would normally be directed to Western Europe [Havrylyshyn, Pritchett, 1991]. Actually, however, trade flows between the two groups of countries were much smaller and even declined in the 1980s. The two main reasons for the dismal trade relations were the limited and deteriorating supply capacity of CMEA countries and high barriers to trade in Western Europe. In terms of

market access to Western Europe, CMEA countries faced tariffs as well as a wide range of quantitative restrictions. And therefore, ranged at the bottom of the pyramid of trade preferences granted by the EC.

A liberalisation of East-West trade began in mid-1988 - even prior to the ultimate demise of socialism - when the EC signed trade and cooperation agreements with CMEA countries. These agreements focus on trade in industrial products, excluding coal and steel (ECSC products) and textiles. To facilitate the transition to a market economy the EC abolished all quantitative restrictions specifically applied against these countries (except for the Soviet Union where a stepwise procedure was adopted) and temporarily lifted all other QRs until 1992. In addition, the EC granted GSP treatment to the smaller countries of Central and Eastern Europe - to Poland and Hungary since 1990 and to Bulgaria and the former CSFR since 1991.

Economic cooperation between the EC and CMEA countries was further intensified after the collapse of central planning. Within the unprecedentedly short period of one year the EC negotiated association agreements with the CSFR, Poland and Hungary. These so-called 'Europe Agreements' were signed on 16 December 1991, effectively dividing the CMEA countries into two groups, the Central European countries (Poland, Hungary, the former CSFR) and the Eastern European countries including Albania, Bulgaria, Romania, and the former USSR republics (now CIS). The Europe Agreements were intended to actively support the transformation process, and their ultimate objective is to lead to full membership of the Central European countries [Langhammer, 1992a]. The agreements do not only include preferential trade policies but also measures of economic cooperation and institutional changes such as a partial adjustment of the legal framework in the Central European countries to accommodate EC rules and regulations.

The most remarkable feature about the agreements are the concessions the EC has granted for trade in agricultural products, textiles and clothing as well as iron, steel and coal. For the first time, the EC has facilitated access to markets of highly sensitive products in which the associated countries are likely to be or become competitive. This relatively sweeping trade liberalisation puts the former CSFR, Poland, and Hungary in the hierarchy of trade preferences on a level roughly comparable to EFTA countries and certainly ahead of all DCs.

As compared to the former CSFR, Hungary, and Poland, the process of democratisation and economic transformation is much less advanced and surrounded by many political uncertainties in the other Eastern European countries.

They are, on average, less developed, and economic fragility is reflected in high rates of inflation and rapidly declining output. The EC has assumed a much more cautious approach towards these countries and has so far offered only some of the financial and trade privileges granted in the Europe Agreements [Langhammer, 1992b]. Concerning trade policies, the EC has lifted quotas and improved the GSP coverage. In 1992, the EC has started negotiations with Bulgaria and Romania on a similar type of institutionalised relations as the Europe Agreements. However, it is very likely that in the new agreements with the Baltic states, Albania, Romania, and Bulgaria, the EC will deny the explicit reference to future full membership made in the preamble of the Europe Agreements. As a result, these agreements would be comparable to those negotiated with Cyprus, Malta, and Turkey in the 1960s and 1970s.

Among the Eastern European countries, the 15 successor states to the former USSR (CIS) represent a special case. During the cold war, bilateral trade with the EC was not only very much restricted through EC import quotas, both Community-wide and on the national level, but perhaps even more so on the EC export side for security reasons (COCOM). Since 1989 many quotas against USSR-originating goods were lifted under a ten-year trade and commercial cooperation agreement with the former USSR (December 1989). All specific EC quantitative restrictions were to be eliminated by the end of 1995 at the latest, except for a limited number of products rated as sensitive [Gatt, 1991]. After December 1991, the EC had found it difficult to formulate new policies for trade relations with the CIS. By January 1993, the GSP status has finally been granted to CIS products, thus putting the CIS on the same footing as other DCs in the pyramid of trade preferences. Yet, greater trade concessions will be without much substance because the CIS states predominantly export non-dutiable items such as primary commodities.

### **3. CURRENT FEATURES OF INTEGRATION**

The economic integration of the EC is proceeding on several fronts. Besides completing the Internal Market, this refers to macroeconomic policy coordination within the envisaged European Monetary Union (EMU) in the first place. The Treaty of Maastricht also entails elements of policy coordination in the field of social and industrial policies. Finally, the Common Agricultural Policy (CAP) is under review and some initial policy adjustments have taken place already. In the following, however, the focus is on the expected effects of economic integration on EC member countries, and the remaining trade barriers against competitors from outside the EC.

These topics provide the background for an assessment of the consequences of the 1992 program on non-members of the EC, especially DCs.

### 3.1 Expected Effects on Member Countries

Shortly after the EC Commission had launched the White Paper in 1985, several attempts were made to quantify the expected effects of the 1992 program for member countries in terms of economic gains. The starting point for the intensive and ongoing debate was provided by a major EC-funded research project on the "Cost of Non-Europe", published in two volumes by the EC Commission [1988]. The potential welfare effects were estimated on the assumption that internal market barriers would be removed by end-1992. The set of calculations presented in Table 1 is based on partial equilibrium models. The bottom line of this micro-economically oriented evaluation is given by an additional 2.2 per cent of GDP (line (3)). This figure is derived from a narrow conception of the benefits of removing internal market barriers such as customs formalities and delays (line (1)), as well as removing discrimination in public procurement, divergent national standards and regulations, and restrictions on business activities in services and manufacturing (line (2)). The figure captures only the direct welfare effects of liberalisation - induced cost reductions on producers, consumers and governments.

The gain in GDP, to be achieved within about five years, is expected to increase to 4.3-6.4 per cent if enhanced competition in an integrated EC market is taken into account. Indirect GDP effects are attributed to the adjustment of economic agents to the new business environment. The range of estimation results is partly due to alternative primary sources of information on cost reductions (variants A and B in the Table). More relevant in explaining the differences are alternative methodological approaches to evaluating competitiveness effects (variants I and II):

- A relatively modest GDP increase is achieved if a so-called price convergence approach is applied to calculate the indirect market integration effects (line (7)). The underlying assumption is that the observed price dispersion between EC countries is reduced or abolished (depending on sector-specific characteristics) after the removal of non-tariff barriers. However, it is not considered that prices may fall below the lowest price observed before and that the drop in prices results in higher demand and output.

Table 1 - Estimates of the Total Economic Gains from Completing the Internal Market<sup>a</sup> (per cent of GDP at 1985 prices)

	Variant A <sup>b</sup>	Variant B <sup>b</sup>
(1) Removing barriers affecting trade only	0.2	0.3
(2) Removing barriers affecting all production	2.0	2.4
(3) Total direct effects (1) + (2)	2.2	2.7
(4) Economies of scale from restructuring and increased production	2.0	2.1
(5) Competition effects on X-inefficiency and monopoly rents	1.6	1.6
(6) Total market integration effects <sup>c</sup> (4) + (5)	3.6	3.7
(7) Alternative measure of market integration effects <sup>c</sup>	2.1	2.1
(8) Total direct and market integration effects		
- Variant I (3) + (6)	5.8	6.4
- Variant II (3) + (7)	4.3	4.8

<sup>a</sup>All estimates according to partial equilibrium methods; based on benchmark data for 1985. -  
<sup>b</sup>Variants A and B use alternative primary sources of information. - <sup>c</sup>Differences due to alternative approaches to evaluating competitiveness effects.

Source: Emerson et al. [1988].

The gain in GDP increases significantly (to 5.8-6.4 per cent) if the above omissions are taken into account, which is attempted by the so-called welfare gains approach (lines (4)-(6)). The focus is on the effects of industrial restructuring and enhanced efficiency, e.g. by the exploitation of economies of scale by gaining experience of how to produce most efficiently (so-called learning curve effects), by eliminating management inefficiencies, and by improving the capacity to innovate.

The Emerson Report [Emerson et al., 1988] stresses that the various empirical estimates are consistent, but, at the same time, "very approximate". The underlying assumptions and judgements have been the major subject of the ongoing debate on the growth and welfare effects of the 1992 program. On the one hand, it is argued that the potential welfare gain due to dynamic growth effects is underestimated. On the other hand, the discussion has also raised some critical points suggesting an overly optimistic bias of the Emerson Report.

A debatable point in these calculations refers to the role of economies of scale. The fairly strong contribution of this factor, amounting to one third of the overall GDP effect according to line (4) in Table 1, has been criticized. It has been doubted that the average size of firms in EC countries is substantially below the cost-minimising optimum [Geroski, 1989]. Furthermore, the extent to which potential economies of scale can be realised not only depends on the size of the enlarged

internal EC market, but also on the preferences of consumers. E.g., the larger the number of varieties wanted by consumers, the smaller the importance of economies of scale.

Another problem with the Emerson Report and the related background studies is the fundamentally *partial* equilibrium nature of the models applied. *General* equilibrium analyses have shown that the positive GDP effects tend to be overstated by partial equilibrium models [Gasiorek et al, 1992; Haaland, Norman, 1992]. Assuming full employment, industries with increasing returns to scale would draw on labour from sectors with constant returns. The production of the latter would drop as a result. Moreover, it seems unlikely that the rather modest increases in output revealed for industries that are considered to be most susceptible to integration gains would gross up to the above mentioned gain in GDP of about 5 per cent [Winters, 1992]. On the other hand, however, the CGE models applied so far do not fully capture gains from deregulation so that they tend to underestimate the '1992' effects.

Particularly the dynamic effects of '1992' are difficult, if not impossible to quantify. First attempts to evaluate the growth effects of the 1992 program suggest that "they are likely to dwarf the one-time gains" [Baldwin, 1989], on which the Emerson Report focuses. In addition to the initial static effect, this study provides evidence pointing to a substantial growth bonus in the medium-run. The static efficiency gains induce higher savings and investment. Extra investment causes an increase of output, which is likely to be of the same order of magnitude as the one-time effect given in the Emerson Report. Arguments derived from the so-called endogenous growth theory suggest that growth rates may even be permanently increased. This latter effect, which is expected to be the largest of all, depends on the realisation of economies of scale, however. With scale economies, "1992 might add between 0.2 and 0.9 percentage points to the EC's long-term growth rate" [Baldwin, 1989]. This is a large number, given that the "normal" growth rate is in the range of two per cent.

Of course one has to remember that all these modelling exercises are subject to wide margins of error. Most importantly, the growth effects from liberalising trade in services which was highly regulated prior to 1993 are largely ignored. In addition, the fiercer competition under internal market conditions can be expected to lead to various behavioural changes (especially with regard to investment), which largely escape quantitative analysis. Examples are: the reorganisation of production and management to reduce X-inefficiencies, greater specialisation because of a finer

division of labour, the relocation of production facilities to exploit locational advantages, and intensified efforts at technological innovation. In addition, political-economy arguments suggest favourable growth effects to result from the removal of internal market barriers. Free intra-EC trade may undermine the power base of national lobbies so that inefficiency and inflexibility can no longer be sustained [Waelbroeck, 1990]. All in all, it depends primarily on the course of economic policies at the EC and the national level whether the higher potential welfare gains will be fully realised.

In most respects, a quantitative assessment of the impact of the Common Market is hardly feasible. What is quantifiable reveals only small overall gains. E.g., recent examples of CGE model simulations analysing the '1992' effects on the industrial structure and trade flows may be summarised as follows [Gasiorek et al, 1992; Haaland, Norman, 1992]:

- EC output expands in all industries modelled as imperfectly competitive, but only by modest amounts if market segmentation persists. Output expansion is enhanced considerably if EC markets are integrated. It appears unlikely, however, that the output expansion in the industries considered would gross up to a GDP effect of around 5 per cent as foreseen by the EC Commission.
- The differences across industries depend on several structural characteristics. The industrial structure in the EC is expected to change in favour of sectors with greater economies of scale and a high proportion of output traded within the EC. Relatively large output effects are revealed in highly concentrated industries, in which the pro-competitive effect of intra-EC liberalisation is supposed to be greatest. Furthermore, the output expansion is expected to be strongest in engineering and other skill-intensive industries; in contrast, output effects are expected to remain fairly small in labour-intensive industries.
- As a corollary, the effect on external EC trade is most pronounced in industries where EC output grows the most: EC exports to the rest of the world are expected to rise by 30 per cent, e.g., for metalliferous products, non-metallic mineral products, transport equipment and food products. The external EC imports in the same sectors are expected to fall by 14 - 40 per cent.

In summary, CGE analyses predict relatively large sectoral production and trade effects associated with imperfect competition but only modest effects for the overall EC GDP (in the range of 2 per cent). Resources will be shifted into rapid-growth industries, typically R & D and skill-intensive engineering sectors. The overall



degree of trade diversion is likely to remain modest once the import-stimulating income effects of completing the Internal Market are taken into account. Despite the plausibility of the latter results, the specification of the CGE models must be subjected to important qualifications. The classification of industries into perfectly and imperfectly competitive sectors is based on arbitrary indicators such as concentration ratios. Moreover, the assumption of a uniform reduction of trade costs by 2.5 per cent is highly unrealistic as was shown already in the Cecchini Report. Both qualifications are particularly relevant for services which are generally treated as perfectly competitive in the CGE models. For these reasons, production effects in manufacturing are most likely to be overestimated, while they are definitely underrated in services. This implies that the conclusions for trade creation and trade diversion would also differ significantly from alternatively modelled CGE models.

### 3.2 Remaining Trade Barriers

The external trade policy of the EC can still be characterised by instability, discrimination, lacking transparency, and conceptual deficiencies.<sup>1</sup> Differences in protection levels among individual EC member countries remained sizeable until the early 1990s, since important non-tariff trade barriers (NTBs) were handled by national governments. In many cases, attempts to circumvent national barriers by "indirect" imports via less restrictive EC member countries were frustrated by the EC Commission's authorisation to restrict intra-EC trade according to Art. 115 of the EEC Treaty. The decline of Art. 115 authorisations until 1990 to roughly one third of the 1980-figure indicates that the process of transforming national NTBs into a common protection level was well under way. By July 1992, the number of surveillance measures authorized by the Commission under Article 115 had dropped to three; likewise, the number of intra-EC trade restrictions in force dropped from 128 in 1988 to only three in mid-1992 [EC Commission, 1993]. From a sectoral perspective, the huge majority of restrictions has been imposed on EC imports of textiles.

It is difficult to see how regional supply targets under the MFA or other voluntary restraint agreements would in future be applied effectively. To the extent that technical requirements are harmonized and EC wide approval is introduced, internal substitutes for border measures, such as national registration measures, would also vanish. All this should contribute to freer trade conditions for extra-EC imports as well as for goods produced within the EC [GATT, 1993]. Therefore, the

<sup>1</sup> For an earlier assessment with respect to EC protectionism against DCs, see Hiemenz et al. (1990).

subsequent list of remaining trade barriers concentrates on the protection against imports from non-members of the EC. A distinction is made between European and non-European trade partners. EC trade policies towards EFTA and Central and Eastern Europe underwent significant changes recently. By contrast, protectionist measures against non-European competitors are basically unchanged.

### *EC Trade Policies towards European Neighbours*

European markets continue to be fragmented despite the fact that EC-EFTA trade in manufactures is freed from tariffs and quantitative restrictions. Various obstacles to market integration via trade persist [Abrams et al., 1990]:

- Some form of border control between the two blocs will be maintained, although progress has been made in cutting the related administrative costs.
- Another concern of EFTA-based firms has been that they may become vulnerable to anti-dumping actions by the EC, once price cuts are necessary to remain competitive on EC markets.
- As stressed in the White Paper, a strong competition policy requires that discipline on state aid is rigorously enforced. In practice, however, EFTA countries complain about the EC for not meeting this requirement.
- Similarly, progress has been slow to ensure undistorted competition in public procurement.

Since recently, several post-socialist countries in East Central Europe come close to the favourable EFTA status [Langhammer, 1992a]. However, the Europe Agreements with Czechoslovakia, Hungary and Poland fall short of free trade arrangements. EC concessions are most generous where a significant supply response of East Central European countries is highly unlikely, e.g. for "non-sensitive" manufactured goods the production of which is technology intensive. In "sensitive" areas, the concessions boil down to a preferential market access of the post-socialist countries over third countries. Trade diversion at the expense of the latter will dominate over trade creation, since fundamental protectionist measures of the EC remain in place. The best example is the Common Agricultural Policy (CAP). Quota restrictions are maintained for most agricultural products, though quotas will be enlarged gradually. Furthermore, quota imports are not tax free. Restrictive health standards, e.g. for potatoes, may further undermine the liberalisation of agricultural imports from East Central Europe.

In summary, trade diversion will dominate in the short run. But the overall liberalisation effect may become stronger in the medium run. The Europe Agreements have set a precedent for the rest of Central and Eastern Europe. The concessions with regard to "sensitive" products, though limited, have somewhat opened the door to highly protected EC markets. On these achievements the beneficiaries may build when the EC's dilemma gains momentum, i.e. to open the door further or to be confronted with mass migration.

### *Trade Barriers Against Non-European Competitors*

While EC trade policy has changed significantly in a European context, the considerable delay in concluding the Uruguay Round prevented major changes in protectionism against non-European exports. Positively stated, "initial concerns that, in the course of the single-market-program, the EC would turn inward-looking have not been confirmed to date. There is little evidence of any recent major intensification of protective measures on the part of the EC" [GATT, 1991]. Negatively stated, high barriers against non-European exports in "sensitive" sectors remained largely unaltered, as did the main characteristics of EC trade policy, i.e. discrimination, selectivity and discretion.

The first constant feature concerns the complex structure of preferential trade arrangements. Apart from the afore mentioned trade preferences of EFTA and East Central European countries, the EC offers duty-free access for manufactured exports of the ACP countries, grants tariff preferences in the context of its Generalised System of Preferences (GSP), and has established a network of special arrangements with Mediterranean countries [Sideri, 1990].

The complex hierarchy of preferential arrangements is going to outlive the Internal Market program, and presumably the Uruguay Round as well. The effects of preferences on the EC's trade relations with the beneficiaries have been analysed time and again, and so have the inherent protectionist traps in many of the preference schemes. From the viewpoint of DCs, in particular, "serious criticism can be levelled at the discrepancy between lofty objectives and numerous impediments to free trade and security of access to the Community's market" [Pelkmans, 1987].

The second constant feature of EC trade policy relates to the traditionally large differences in protection levels across sectors and industries. For a wide range of industrial raw materials, fuels and manufactures, moderate tariffs are the main factor affecting access to the EC market. In sharp contrast, a hard core of product

areas has remained highly protected by an outstandingly complex trade regime, in, e.g. agricultural products, textiles and clothing, and coal and steel [for details, see GATT, 1991; Hiemenz et al., 1990].

The third constant feature of EC trade policy concerns the preferred protectionist instruments, which reflect the EC's bias towards bilateralism, selectivity, discrimination, and discretion. The most important NTBs continued to consist of "voluntary" export restraints (VERs), EC surveillance, and anti-dumping procedures. Not surprisingly, export restraints and similar measures were concentrated on "sensitive" sectors. Some 50 bilateral restraint arrangements were known to be in place by mid-1990, involving the EC, individual member countries, or their industries. Japan, Asian NIEs, and state trading countries were the principal targets of export restraints.

To summarise, it can be maintained that EC trade policy reveals a remarkable propensity for sector specific interventions. Furthermore, strong elements of discrimination and selectivity among trading partners have become entrenched in the trade policy regime. All this has resulted in greater uncertainty among exporters with respect to their access to EC markets.

#### **4. IMPLICATIONS FOR DEVELOPING COUNTRIES**

Since the end of the 1980s, the external dimension of EC-1992 has extensively been discussed for individual DCs, for groups of DCs as well as for DCs as a whole. DCs could be seriously affected by EC-1992 because

- for a large number of them, the EC is either the largest export market or at least an important outlet for domestic production;
- the majority of national quotas within the EC (including MFA quotas) applied to products exported by DCs;
- the 1986 accession of Spain and Portugal as two countries with a resource endowment similar to DCs may result in trade diversion.

With respect to the implications of EC-1992 for DCs, there are two major questions. First, as concerns the trade effects, is trade diversion quantitatively more relevant than additional import demand due to higher income in the EC (external trade creation)? Second, will investment diversion occur in favour of the EC periphery (Spain, Portugal, Greece, Ireland) and to the detriment of DCs? In general,

these issues cannot be satisfactorily addressed without referring to specific areas and sectors. Differences among developing countries in specialisation profiles, export potential and adjustment flexibility are large, and so are the consequences of EC-1992 on sectors like agriculture, natural resources, manufactures and services.

Notwithstanding such differences, the following consequences for DCs as a whole can be summarised:

First, no major trade diversion is expected for primary commodities simply because of lacking domestic substitutes in the EC [Page, 1992; Koekkoek et al., 1990]. Hence, the income effect will dominate the price effect, but given elasticities of import demand below unity (except for fuels), the overall trade effect is assumed to be small. The expected additional import demand following a five per cent EC GDP growth is in the range of 2.5 per cent of total DCs' non-fuel primary commodity exports in 1987 [Matthews, Mc Aleese, 1990]. Effects could be smaller for products for which EC competitive substitutes exist and higher for specific products such as coffee and cocoa for which additional policy measures (such as a harmonization of excise taxes) would fuel demand.

Second, exporters of manufactures may be more affected by trade diversion than commodity exporters because of competing supply from the Mediterranean member states, but they may also benefit more from the income effect. Which effects will dominate has been open to controversies with respect to the appropriate income elasticity of demand: Langhammer [1990] argues that the income effect will be larger than the trade diversion effect, whereas Davenport [1990] predicts a rough balance between income and price effects. Assuming rather low elasticities, the total net trade effects (the residual of income and trade diversion effects) have been summarized for various regions as follows (in per cent of their exports to the EC): ACP countries: 2.3 per cent; Mediterranean countries: 0.8 per cent; Maghreb countries: 0.9 per cent; South Asian countries and China: -0.3 per cent; Asian NIEs: -6.1 per cent; ASEAN countries: -0.3 per cent; Latin American countries: 1.3 per cent; OPEC countries: 3.8 per cent; all DCs: 1.5 per cent [Davenport, 1990; Page, 1992]. The assumptions underlying these estimates clearly favour trade diversion over trade creation. The estimates reflect the logic also inherent in the above-mentioned CGE models: European integration benefits commodity producers and negatively affects virtually all third country suppliers of manufactures. This result is of course rather implausible if one does not accept that EC producers still can realise substantial economies of scale in manufacturing industries such as textiles and

clothing or iron and steel, in which DCs have achieved a high degree of international competitiveness in the past.

Third, the effect of replacing national quotas by a Community-wide quota leaving the total volume of imports unchanged is expected to impact but marginally on DCs' exports of sensitive items [Davenport, 1990; Langhammer, 1990]. These estimates critically depend on assumptions regarding import growth in formerly constrained national markets and on the discipline in monitoring a Community-wide quota. This discipline was much lower in large non-restricted markets such as Germany under national surveillance (to the benefit of DCs), but could be stricter under rules of Brussels.

Fourth, very little is known about the overall effects on DCs' exports of non-factor services. The effects are likely to differ significantly between various segments of the service sector. Because of the large amount of restrictions in the pre-1992 period the highest productivity gains are expected for business services, and consequently this leads to higher "guestimates" for trade diversion. Such "guestimates" hold for air transport where intra-EC prices are likely to decline and where some DCs penetrated EC markets in the past. By contrast, gains for developing countries are likely to arise in consumer services such as tourism, especially when wage costs rise in the main EC tourist resorts.

#### **4.1 Sectoral Implications**

EC-1992 will induce structural change within the Community, and this structural change will have implications for DCs. A number of specific industries seem to provide cases in point. The list of industries includes textiles and clothing, electrical machinery, automobiles and parts, iron and steel, and agricultural and food products. These industries are important for DCs because these countries have already become internationally competitive exporters of these products or are expected to emerge as competitive suppliers in the near future, while EC trade policies reveal a considerable propensity for sector specific interventions, especially against non-European competitors. E.g., for most agricultural commodities the access to the EC market is limited by an almost prohibitive system of variable levies and quotas. Exports of textiles and clothing into the EC are limited by the EC's MFA system. In the iron and steel industry, the ECSC Treaty allows for state subsidies until 2002 and EC imports are limited by VERs, which, together with nationally administered protectionist measures also dominate in the automobile industry. Similarly, anti-dumping measures are used to restrict EC imports of consumer electronics. These

trade restrictions must be borne in mind when the trade relations between the EC and DCs, and the EC market shares of DCs in the EC are assessed.

Table 2 shows the trade flows between the DCs and the EC for selected products in 1991, measured by EC imports (exports) from (to) DCs in per cent of total EC imports (exports). EC import shares of DCs as a whole reveal that EC-1992 trade diversion effects can only be expected for textiles and clothing, electrical machinery, and agricultural products where DCs account for a substantial fraction of EC imports. For automobiles and iron and steel, EC imports from DCs are of minor importance. Furthermore, certain subgroups of DCs will be affected differently by sectoral effects, depending on the sectoral composition of trade with the Community. E.g., Asian DCs<sup>2</sup> account for more than 70 per cent of EC imports of textiles and clothing from DCs and for almost all EC imports of electrical machinery from DCs. ACP and Latin American countries together account for roughly 60 per cent of EC imports of agricultural products from DCs. Hence the potential sectoral impact of EC-1992 on DCs, whatever its actual size may be, will have a strong regional component (see section 4.2). To fully appreciate the expected sectoral implications of EC-1992, a closer look at selected product categories may be useful.

### *Textiles and Clothing*

Over the last two decades, a considerable restructuring process has taken place in the textile and clothing sector world-wide. E.g., from 1975 to 1985 EC employment in this industry fell by roughly 40 per cent, amounting to a loss of one million jobs [Emerson et al., 1988]. In the textile industry, traditional methods of production were readily adopted in many less developed and newly industrialising countries, and, given their low wage costs, they became highly competitive in this labour-intensive industry. One of the characteristics of textile technology is that there are few obstacles to its diffusion to DCs. Given the existence of fierce international competition in textiles for years, it is unlikely that the completion of the Internal Market will greatly alter the competitive climate in the industry within the EC [O'Donnell, 1989]. Put differently, because a considerable amount of specialisation has taken place already, the scope for further exploitation of economies of scale seems to be rather limited. The clothing industry has remained labour intensive

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<sup>2</sup> Excluding South Asian DCs; all Asian DCs together account for about 90 per cent of EC imports of textiles and clothing.

Table 2 - Developing Countries' Trade with the EC, Selected Products, 1991

	EC imports from developing countries (per cent of total EC imports)	EC exports to developing countries (per cent of total EC exports)
Textiles and clothing	22.0	8.6
ACP	0.8	0.8
Other Asia	8.8	0.3
Asian NIEs	6.8	1.8
Latin America	0.7	0.4
Electrical machinery <sup>a</sup>	10.3	12.1
ACP	0.0	1.1
Other Asia	2.2	2.0
Asian NIEs	7.9	2.8
Latin America	0.2	1.2
Automobiles and parts	0.8	7.8
ACP	0.0	1.2
Other Asia	0.1	0.6
Asian NIEs	0.3	1.0
Latin America	0.2	0.9
Iron and steel	2.8	14.4
ACP	0.3	1.5
Other Asia	0.2	1.0
Asian NIEs	0.5	2.3
Latin America	1.2	1.3
Agricultural products <sup>b</sup>	18.7	11.5
ACP	4.0	1.9
Other Asia	3.2	0.7
Asian NIEs	0.3	1.4
Latin America	7.0	0.6

Asian NIEs: Hong Kong, Singapore, South Korea, Taiwan. - Latin America: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico. - Other Asia: China, Indonesia, Malaysia, Philippines, Thailand.  
<sup>a</sup>Includes office equipment and consumer electronics. - <sup>b</sup>Includes food products.

Source: Statistical Office of the European Communities [b]; own calculations.

because of the difficulty of automating and mechanising the key stages of production. Therefore, economies of scale could not be realised to the same extent as in the textile industry and labour costs have still an important impact on competitiveness.

Taken together, all EC producers of textiles and clothing are threatened especially by producers from DCs, partly because the production technology is easily available, and partly because labour is an important cost factor [Hamilton, 1990]. As a consequence, the manufacturing of large production runs has been shifted to DCs, whereas the European producers have increasingly specialised in the manufacture



of high quality and fashionable products. Thus, the ability to react to quickly changing market conditions has become an important parameter of competitiveness, whereas strategies based on mass production and concentration have lost ground in the EC.

All EC imports of textiles and clothing have been subject to quantitative controls [Davenport, 1991]. The criterion for intervention allowed under the MFA refers to "market disruption", which has only been applied to low cost producers, and that is, to DCs. Therefore, the DCs have a keen interest in the overall approach of the Community towards the MFA. The debate on the effects of 1992 centres on one particular issue: the impact of removing national quotas. As of 1 January 1993, each member state is entitled to issue import authorizations valid for the entire EC market. Community surveillance will be ensured through a computer link between the Commission and the competent national bodies [GATT, 1993]. It is expected that EC-1992 will expose the Community's textile and clothing industry to greater import competition, mainly for two reasons. First, the integrated market will, through free circulation, permit full quota utilisation. Second, the transfer of quota management responsibilities from national governments to the Community level will make it more difficult for national industries to observe the actual level of imports from DCs, and argue in favour of a national interest case [Cable, 1990].

There have been attempts to estimate the effects of abolishing member state quotas while holding EC quotas at their 1987 level. By making use of alternative assumptions on the increase in imports following the removal of a binding quota it was concluded that overall exports of MFA goods from DCs could rise by 3-5 per cent [Davenport, 1991]. The exporting countries that were found to benefit most likely are Sri Lanka and Brazil, and possibly Peru, Thailand, and the Philippines. By contrast, the ACP countries only hold a small share in EC imports of textiles and clothing (see Table 2). Obviously, these countries have not gained from the lack of formal MFA controls and from tariff preferences. It has been found that the principle obstacles to ACP exports lie on the supply side, not in EC protection [Langhammer, Amelung, 1989]. The conclusion is that the marginal erosion of ACP preferences from eliminating member state quotas will have little impact. The only exceptions may be Mauritius and Zimbabwe, which will have to compete more aggressively where market access for lower cost producers has been restricted. Taken together, for the DCs as a supplier of textiles and clothing, EC-1992 is expected to have an overall positive, but relatively modest impact. EC quotas for many MFA products and vis-à-vis some 30 or more countries will be applied until the late 1990s [Pelkmans, 1992], even if the Uruguay Round is successfully concluded. More substantial gains

can be expected for specialised low cost producers which were restricted by the pre-1993 system of national quotas.

### *Electrical Machinery*

Broadly speaking, electrical machinery encompasses two rather different subcategories: the skill-intensive production of computers and office equipment, and the more traditional production of electrical and electronic consumer goods. While the electronics industry in general is widely regarded as one of the growth industries providing the inputs for future production technologies, the production of electrical consumer goods in the EC is held to be a rather mature industry, with increasingly declining international competitiveness relative to DCs, especially in Southeast Asia.

The reduction of trade costs as a result of EC-1992 is expected to impact on both subcategories. Based on currently existing trade patterns,<sup>3</sup> it can be argued that the implications for DCs could be more severe in the production of electrical and electronic consumer goods. However, it is important to note that the industry as a whole has already been subject to restructuring and transformation in the recent past, partly independent of the foreshadowing of EC-1992. Therefore, the apparent rapid structural change in electronics-related industries should be interpreted first of all in the context of global competition for markets and technologies. That is, the EC-1992 effects can be seen as simply supporting a restructuring of the EC electronics industry which would also occur without EC-1992.

The main world-wide trends influencing the market for electrical machinery are the rapid technological innovation and, as a result, the intensifying competitive pressures. Historically, the industry has been rather fragmented into separate branches such as electrical consumer goods, electronic components, computers and office equipment, and telecommunication [Wong Poh Kam, 1991]. Beginning with the microelectronics revolution, this has changed. The resulting increase of economies of scope for producing related electronic products has led to a speed up of integration of the separate sub-branches. Increasingly, most electronic products are based on the use of very few standardised electronic components, reducing the rest of the hardware to relatively simple products. Then, end products can be assembled almost under conditions of mass production. Furthermore, the assembly process is becoming automated by flexible manufacturing systems allowing for a wider range of products to be manufactured using the same assembly line. In effect, this development has led to a competitive edge of relatively large integrated firms.

<sup>3</sup> For an analysis of ASEAN-EC trade in electronics see, Schmitt-Rink and Lilienbecker [1991].

Another trend in the electronics industry is that software and system design increasingly become the crucial bottle-neck skills, due to the advancing incorporation of microprocessors which serve to enhance the information processing capacity of final products. This increase in product complexity has led to a relatively high share of research and development expenditures in the cost structures of the electronics industry. The competition arising under these industry parameters has produced a considerable shortening of the product life-cycle of technology-based microelectronics products.

Taken together, process and product innovations made possible through the availability of microprocessors have given rise to significant potential temporary economies of scale. In turn, these economies of scale may have altered the comparative advantage of firms. The share of European firms has steadily declined in favour of suppliers from Japan and the Asian NIEs. EC-1992 is expected to change this trend, at least partly. This may come true especially in sub-branches of this industry where EC-1992 will facilitate the creation of harmonised technical standards, thereby reducing the costs of interfacing and problems of non-interoperability [Wong Poh Kam, 1991]. E.g., in the case of telecommunication EC-1992 makes possible the creation of EC-wide information technology infrastructures for telephones, data transmitting, broadcasting, and other value-added services.

The trade policy effects of EC-1992 are relatively marginal in this industry. All bilateral restrictions had been abolished by the end of 1992 and the only remaining Community-wide quota applies to both South Korean exports of microwave ovens and video tape recorders [GATT, 1991]. This does of course not preclude that the EC will continue to apply anti-dumping actions against companies from DCs in a protectionist way.

#### *Automobiles<sup>4</sup>*

The EC has become the largest regional automobile market in the world, accounting for about 35 per cent of total world production. The other major producers are the United States (20 per cent) and Japan (25 per cent). Within the EC, the automobile industry is one of the largest manufacturing industries. It produces roughly 6 per cent of the value added in EC manufacturing (almost 2 per cent of the Community's GDP), and it employs about 7 per cent of the manufacturing workforce. Nearly 30 per cent of production is exported, 90 per cent of which goes to other member states. Approximately half of the total value of car production is accounted for by Germany.

<sup>4</sup> This section draws on Emerson et al. [1988] and Hild [1991].

The EC automobile market is dominated by about 10 large manufacturers. By contrast, the components industry is much more fragmented. The value of components produced in the EC accounts for 60 per cent of the value of car production, and is highest in Germany and in France.

Within the EC, there exist a number of NTBs which are at least not immediately expected to vanish as a result of EC-1992. Technical requirements which must be fulfilled in order to get a registration permit for a specific type of car, have not been fully harmonised. That is, up to now every car model needs a special licensing for use on public roads, and therefore, automobile producers have to seek type-approval in each member state. Differing VAT rates are regarded as a major obstacle to intra-EC trade for consumers in Denmark, France, Italy, and the United Kingdom. Probably the instrument that mostly contributes to a segmentation of markets is the so-called "selective distribution system" agreed upon by all manufacturers in the Community and authorised by the Commission in 1985 for a period of 10 years. This system represents a network of exclusive dealing contracts.

Since end-1992, protectionist measures against imports from third countries are only directed against Japan. Imports from DCs are granted tariff preferences under the GSP if they meet the rules of origin requirements, and can therefore enter the EC duty free. Meeting the rules of origin is crucial and at least in the South Korean case, European suppliers contest that these requirements are met.

EC-1992 is expected to speed up the present process of restructuring and technical change in the EC, both in the production of automobiles and in the production of parts. Significant economies of scale are hoped to be achieved by the widespread introduction of so-called "platforms", which combine certain features of a production line and a flexible workshop. In effect, this reorganisation of production permits both mass production and the production of differentiated products. Computer aided design and integrated manufacturing (CAD, CIM), robotics, just-in-time organisation and global or single sourcing are the main headings in this context.

Especially in the automobile industry, EC-1992 could be seen as a catalyst for this restructuring process. Assuming that total production remains unchanged, it has been estimated that savings in terms of total unit costs for the EC as a whole would amount to 5 per cent, only because of the changes in the production technology [Emerson et al., 1988]. The exploitation of economies of scale will have dynamic effects: EC-competitiveness is enhanced, and more cars will be sold as lower production costs will ultimately show up in lower consumer prices for cars. In turn, the increase in production may give rise to further economies of scale, and,

therefore, to a further stimulus to demand. The intensified competition may give rise to mergers and production agreements within the EC, and possibly even outside the EC. Of course, this neither means that economies of scale will only benefit EC-originating firms, nor that economies of scale of the size expected can actually be captured by European producers. Subsidiaries of Japanese companies, especially in the UK, have proven to be even more competitive than EC-originating firms, at least in some market segments.

The overall direct impact of EC-1992 on DCs in this industry will be negligible, because to date, only single DCs (notably South Korea) are exporting cars to the EC in small amounts. Hence, no substantial trade diversion effects should emerge. Potential trade creation could result if suppliers from DCs could successfully compete on EC markets. This may be the case in the production and sale of compact small-size vehicles, in which advanced DCs such as the Asian NIEs and Brazil or Mexico possess a comparative advantage.

#### *Iron and Steel*

Special characteristics of the European steel industry are the organisation in large production units and the declining competitiveness vis-à-vis suppliers from third countries. This may partly explain why this industry is one of the highly protected industries in the EC: intra-EC steel production benefits from aid provided by national governments, authorised by the Commission. While the system of managed production quotas has been abolished in July 1988, at present the Commission monitors trends in current imports to identify any "adverse" effects on the EC steel industry. A range of primary and semi-manufactured products from non-EFTA sources is subject to prior surveillance. In August 1992 the EC imposed unilateral quotas on certain imports from the CSFR. Various national import restrictions were replaced by Community quotas. According to the Commission, in late 1992 no steel imports were subject to VERs [GATT, 1993]. A new sectoral support régime, introduced in 1991, continued the granting of aid to the steel industry in the period 1992-96 to four broad subject areas: research and development, environmental protection, partial or total cessation of production, and investments in certain EC regions. All other forms of aid were prohibited [GATT, 1993]. The future of this industry actually depends on the emerging Community market regime, rather than on the completion of EC-1992 per se.

At present, the steel market has become increasingly oversupplied, due to the world-wide recession and the simultaneous intensification of competition, especially

from Central and Eastern European sources seeking new markets. Conceptionally, the deep structural crisis in the steel industry can be best understood in terms of industrial organisation and possible pricing strategies in this sector [Weiss et al., 1988]. Technology in most steel-making operations has become relatively ubiquitous, and the economic success of so-called mini-mills suggests that optimal plant size has tended to fall. Hence, technology for steel making seems to be fairly easy to obtain, and possibilities for low-scale entry seem to exist [Brown and Mc Kern, 1987]. If there are sunk costs associated with entering steel making, they are likely to be relatively low. If this description of the steel industry holds, excess profits can not emerge as long as there are no protectionist barriers to entry. Theoretically speaking, if fixed costs in the steel industry are low enough, the contestability [Baumol et al., 1982] of the steel market would converge to perfect competition; and if fixed costs are high enough, one firm would serve the whole market, but this monopolist could earn no rent because the threat of entry would force him to charge no more than average costs for his product. Put differently, with the higher competitiveness of NIEs and other DCs in the production of steel due to lower wage costs and easy access to the production technologies [UNCTAD, 1990], the state support for the steel industry in the EC has resulted in a great deal of excess capacity.

In the words of the EC, the strategy of state support to the steel industry is an "orderly" run-down of obsolete and non profitable production capacity, which is accompanied by a modernisation policy and a policy for monitoring the installation of new capacity. Notably German producers lost market shares from 1980 to 1988, not because of a relative loss of competitiveness, but as a result of interventions of the Commission under the system of managed production quotas. The capacity problem has not yet been resolved. In the Commissions' opinion, there are still some 30 million tonnes (roughly 15 per cent) of spare capacity [Emerson et al., 1992] with possible employment effects in the order of 50,000 [GATT, 1993].

Since EC-1992 is generally expected to reduce or even eliminate production inefficiencies by achieving full market integration, it becomes clear why model simulations intended to capture these effects generally predict large production increases in iron and steel as a consequence of EC-1992 (see section 3.2). The motivation for this line of reasoning seems to come from estimates that show somewhat lower internal steel prices in the Community than in the other two large iron and steel using regions of the world economy, namely Japan and the United

States [Emerson et al., 1988].<sup>5</sup> This reasoning may be flawed, however, because of the subsidisation of the European steel industry.

Furthermore, competitive suppliers of iron and steel have emerged in DCs. The world-wide shifts in comparative advantage towards DCs can be seen from the increase in their share of world steel exports from 3.4 per cent in 1975 to 11.2 per cent in 1987 [UNCTAD, 1991]. The main DC exporters are Brazil and South Korea, both identified to be low labour cost producers [Fischer, Nunnenkamp et al., 1988]. These highly competitive producers will be denied access to the EC even after 1992, as was mentioned above. EC-1992 will not bring an abolition of "production assistances" and, therefore, will not reduce existing inefficiencies. The predicted production increase is not plausible as long as excess capacities continue to exist, which can be considered obsolete when measured at world market prices.

#### *Agricultural and Food Products*

In the Community, agricultural production is mainly determined by the CAP. As a consequence of EC-1992, a general dismantling of intra-EC border controls will eliminate the system of border taxes and subsidies called monetary compensatory amounts (MCA), which so far guaranteed the existence of different national levels of price support. In December 1987, the highest support price levels for the average of all agricultural products prevailed in Germany and the Netherlands (7 per cent above the Community's average), and the lowest prices prevailed in the United Kingdom and in Greece (12 and 38 per cent below the average) [Matthews and McAleese, 1990]. As a consequence, many EC markets for temperate-zone agricultural products are virtually impossible for third countries to penetrate.

The total impact of these policy interventions, i.e., the total economic costs of the CAP have been estimated in terms of producer subsidy equivalents (PSE) and consumer subsidy equivalents (CSE) [Emerson et al., 1988]. The former (PSE) is defined as the payment that would be necessary to compensate farmers for the loss of income resulting from the removal of support policies; and the latter (CSE) measures consumption foregone as a result of artificially high prices for agricultural products. In the EC there are large transfers from consumers and taxpayers to producers in the range of 3 per cent of GDP. The loss of economic welfare is about 1 per cent of GDP, which reflects that not all the transfers by consumers and taxpayers end up as additional income for producers. Put differently, average net percentage

<sup>5</sup> In 1988, all three suppliers together accounted for about 45 per cent of world steel production [UNCTAD, 1991].

PSEs for the sector as a whole of close to 50 per cent in 1990 and 1991 indicate that about one-half of EC farm revenue results from policy intervention, either through border restrictions or by financial assistance [GATT, 1993]. Subsidy equivalents and welfare losses will not be reduced to zero because of EC-1992. It would be politically unreasonable to assume that public price or income support will be eliminated completely. This is not intended by the EC-1992 program. Therefore, DC exports of agricultural products will hardly be facilitated in the future.

The principle barriers to trade within the EC in the food-processing industry included restrictions on the use of specific ingredients, regulations with respect to the content and description of products (e.g., purity law on pasta in Italy), packaging and labelling requirements (e.g., recyclable containers), specific taxation (e.g. on beer in the United Kingdom) and specific bureaucratic import restrictions. The net direct benefit from the elimination of such non-tariff barriers has been estimated at 2-3 per cent of this industry's total value added [Emerson et al., 1988]. Direct benefits are very heavily concentrated on 10 products, the most important ones being beer, pasta, and vegetable fats. Intra-EC trade is predicted to grow; e.g., imports are estimated to increase by about 3-5 per cent of consumption in the case of pasta in Italy and in the case of beer in Germany. Indirect effects stem from the increase in competition, that will lead to a reorganisation of production. In contrast to US companies, European food companies generally operate on a much more limited scale, mainly because they are largely oriented towards their national markets. Hence, the removal of non-tariff barriers should initiate an adjustment process which will lead to an increase in specialisation of the large European food companies, as well as a wider spread of their activities in Europe.

The abolition of intra-EC border controls for agricultural products was combined with a harmonisation of tight veterinary and phytosanitary rules. Controls of all products shall be limited to the place of departure, whereas the verification of certificates will be made at the place of destination. The DCs worry that their exports to the Community will be adversely affected by the introduction of such harmonised technical standards as part of EC-1992. Those most likely to cause problems concern DCs' exports of plants, fish, and meat [Davenport, 1991].

In the case of plant health, each shipment cleared at the EC border will be issued with a "plant passport" which will guarantee free circulation throughout the Community. There also exists the possibility of negotiating pre-export inspection. Such tightening of product standards is most likely to impact on exporters of tropical timber, planting material, and cut flowers. With respect to animal health and hygiene,



which refers to (potential) EC-imports of fresh meat, the extra-EC slaughterhouses and processing plants must be licensed by EC inspectors.

Probably those EC-1992 standards with the greatest impact on DCs, concern fish and related products. Under the new regime, the Commission will formulate specific conditions for the import of such products. These conditions may include a list of plants and factory vessels which are authorised to export to EC markets. From the point of view of DCs, these conditions seem to be very demanding and, obviously, exhibit some discretionary leeway with respect to non-authorisation. An additional effect comes from the fact that in the context of NAFTA, the United States administration could possibly copy these tighter standards. The list of countries that are likely to suffer from more demanding import standards for fishery products includes Mediterranean, African, and Southeast Asian suppliers.

The EC market for fish is also a special case because contrary to the situation for many farm products, the EC is a net importer of fish. In principle, tariffs are the sole means of external protection. For the next four years, however, imports of certain canned sardine and tuna varieties have been made subject to Community quotas. Faced with a sharp increase of cheap imports in early 1993, the EC made the release for free circulation of various fish categories subject to the importers' compliance with the reference prices. In case significant quantities enter the EC market at prices below these reference prices, the EC may revoke autonomous tariff suspensions, make importation subject to compliance with the reference price, or introduce counteracting charges (if compatible with existing GATT bindings) [GATT, 1993].

There are a number of tropical products exported by DCs where EC-1992 is expected to have a substantial impact. Bananas<sup>6</sup> are the most prominent case. EC-1992 will have an impact on the structure of the Community's banana imports, simply because the import policies operating before January 1st 1993 can no longer be maintained. World exports of bananas are dominated by Latin American suppliers, roughly accounting for 70 per cent of world exports; exports from ACP countries and from EC overseas territories account for about 15 per cent. Up to now, less than half of the EC's consumption originates from ACP countries and the Community itself, the other half being so-called dollar-bananas almost entirely from Central and South America. These EC imports of dollar-bananas are subject to specific intra-EC arrangements, designed to protect former colonies of EC member countries. Guaranteed markets for bananas from the English speaking Caribbean and from

<sup>6</sup> See, e.g., Borell and Yang [1992], Cable [1990], Davenport [1991], and Matthews [1992].

Surinam existed in the United Kingdom; the same held for imports from French overseas departments, Cameroon, and Côte d'Ivoire in France, and from Somalia in Italy. Greece, Spain, and Portugal restricted (or prohibited) imports of bananas other than from Crete, the Canaries, and Madeira.

For a number of ACP countries and overseas territories of the Community, bananas represent a significant share of total merchandise exports. The privileged position of these ACP and EC suppliers depended on the exclusion of intra-EC banana trade. Insulated intra-EC banana markets were made possible by the frequent recourse to Article 115. Hence, any opening of the intra-EC market for bananas could be expected to worsen the position of ACP and EC suppliers. This explains why the Community has implemented an EC-wide tariff and a quota for dollar-banana imports (effective since 1 July 1993), since a free German banana market as before would have meant a free EC-wide banana market as a consequence of EC-1992.<sup>7</sup> It has been estimated that even if the overall quota for dollar-bananas were set at the average level of imports over some base period, the ACP/EC banana suppliers would not be able to preserve their earlier privileged positions [Davenport, 1991]. More dramatically, model simulations predict that banana exports from favoured exporters will decline by 50 per cent under free trade, and even under the protection of a tariff of 20 per cent on dollar-banana imports, their exports will decline by almost 30 per cent [Borell and Yang, 1992]. Without substantial increases in their productivity, which is hardly to be expected in the short run, and in the absence of additional restrictions, ACP banana producers will lose as a consequence of EC-1992, and dollar-banana producers will gain. These results will, of course, not be realised if the implemented binding dollar-banana quota will not be challenged by the GATT.

A similar situation emerges in the case of sugar. Here, potential difficulties for DCs do not directly arise from EC-1992, but should be taken into account especially by producers in the Caribbean who enjoy a quota at a fixed EC supported price under the EC-ACP Sugar Protocol, notably Barbados, Belize, Guyana, Jamaica, St. Kitts, Surinam, and Trinidad [Stevens, 1991]. Part of the problem originates from the dependence of the Sugar Protocol on the maintenance of a genuine demand for *cane* sugar in the Community. To date, this demand is primarily originating from Britain, where most ACP sugar is refined. With EC-1992, and especially with the

<sup>7</sup> For a Community-wide quota of 2 million tonnes the duty was set at 100 ECU per tonne (20 per cent). Imports exceeding the quota will be subject to a (prohibitive) duty of 850 ECU/tonne (approximately 170 per cent). At present, EC imports from Latin America exceed the quota agreed upon by 300,000 tonnes. It remains to be seen, however, whether this decision will be challenged within the GATT.

completion of the Channel Tunnel, it will be much cheaper to move beet sugar from continental Europe to the United Kingdom. As a consequence, the cane sugar exporters would have to accept a cut in price, or the cane refiners would have to go out of business. While it is generally expected that low-cost ACP sugar exporters could live with a (moderate) price cut, the high-cost Caribbean producers probably could not. Hence, the reason for the sugar problem is not only to be found in EC policies, but rather in the lack of competitiveness of the Caribbean exporters.

Other tropical products for which EC-1992 was expected to have an impact on DCs exports are coffee, cocoa, tobacco, and tea. The concern for these commodities came from the anticipated EC harmonisation of indirect taxation, i.e., the harmonisation of excise taxes. In some member states these taxes are substantial, reaching almost 50 per cent on coffee and tea in Germany, and 15 per cent in Denmark, while there are zero rates in the United Kingdom, France, and the Netherlands [Cable, 1990]. Up to now, these products have been excluded from tax harmonisation in the single market context [GATT, 1993]. Tax evasion through purchase in other member states can not longer be limited through border controls, however.

Tobacco might provide a case for an overall negative impact of EC-1992. Since there seems to exist a majority preference in the Community for "levelling-up" some health standards, the Commission decided to gradually harmonise the excise duties upwards, obviously not only because of health, but also because of revenue concerns. This strategy will have severe consequences for tobacco exporters. If excise tax rates were to be harmonised on the average of the four highest rates (Germany, Denmark, Ireland, United Kingdom), the EC average rate would more than double, resulting in an expected reduction of EC imports from DCs of about 4 per cent [Davenport, 1991]. Taking into account the partial compensation by an increase of DC tobacco exports to the rest of the world due to declining world market prices, it has been estimated that Brazil, Zimbabwe, India and Malawi will have to face the overwhelming part of the losses.

#### **4.2 Regional Implications**

Most of what has been said about the implications of EC-1992 on primary commodity exporters holds for *Sub-Saharan Africa*, which is still almost exclusively concentrating on commodity exports [Langhammer, Amelung, 1989]. While some income-induced additional demand for commodities could benefit African exporters in the short run, the medium-term perspectives look gloomy. EC-1992 will probably

accelerate the ongoing delinking of commodity consumption from economic growth in Europe. This may further lower income elasticities for goods which are primarily exported by Africa. Stricter environmental rules in Europe may also impact negatively on Africa because the continent's supply consists of a large number of environment-intensive goods such as phosphates, tropical timber, bauxite etc. [Tovias, 1990]. As far as manufactured exports are concerned, African countries have to face an erosion of their trade preferences granted in the Lomé Convention because of the Europe Agreements of the EC with the three Central European countries (see section 2.4).

To some extent, the consequences for *Latin America* are similar to those for Africa because of overlaps in the commodity supply. Specific policy measures for Latin American exports only exist for some agricultural products such as bananas, coffee, cocoa, sugar and rum. The final shape of EC policies in these areas is still being negotiated. The banana case indicates that the EC appears to be determined to protect the special interests of associated ACP countries. Any preservation of ACP trade preferences will be detrimental to other Latin American suppliers.

Within manufactures which figure much less prominently in Latin American exports to the EC (20 per cent of total exports to the EC), Latin American exporters of "hypersensitive" textiles might gain after the national quotas have been scrapped, but compared to Asian suppliers they are unlikely to be among the major beneficiaries. As few items (such as shoes) dominate in their export supply, they even stand to lose if the trading patterns of Germany (being by far the major buyer of Latin American manufactures) change in favour of Central and Eastern Europe and other developing areas. With respect to investment flows, Latin America's longstanding role as a preferred host of German investment in DCs [Agarwal, Gubitz, Nunnenkamp, 1991] may suffer because export-oriented investment in manufacturing outside the EC faces a better macroeconomic background in East and Southeast Asia (including China) and - pushed by special investment incentives - increasingly in Central and Eastern Europe.

In summarising, stagnant trade flows with Europe and the relatively income-inelastic export supply of Latin America do not make the region a prime candidate for medium-term gains from EC-1992. Given the emergence of regional integration schemes in the Western Hemisphere (NAFTA, Enterprise of the Americas Initiative) and the early success of Mexico to attract foreign capital, there is much reason to assume a further deepening of trade relations within the Western Hemisphere rather than between the EC and Latin America.

EC imports from *East and Southeast Asia* primarily consist of manufactures. These products accounted for 86 per cent of their total exports to the EC in 1990. For this reason, the assessment on EC-1992 effects on East and Southeast Asia is ambivalent. Estimated trade effects depend on the assumptions made with respect to productivity gains in European manufacturing industries. If these gains were high, trade diversion effects would be sizeable in the short run. This is reflected in the estimated net trade loss of 6.1 per cent of the NIE's exports to the EC mentioned already. An alternative view is that productivity gains will be small in those manufacturing industries in the EC which had already lost their international competitiveness in the past. In this case, East and Southeast Asian countries could exploit their proven high capability for structural change and adjust their export supply, including services, to changing demand patterns in the EC. Therefore, the medium-term prospects for these countries would be positive.

Even some proponents of high trade diversion effects [Page, 1992] admit that the second scenario is more plausible, at least in the medium term. First, the estimated efficiency gains of EC suppliers appear to be on the high side in light of the unrestricted international competition in most manufacturing industries. Second, highly protected industries such as iron and steel or shipbuilding may react to market integration by closing down or relocating production sites outside the EC rather than by attempting to realise productivity increases within the EC. And third, export supply from East and Southeast Asia is focussed on sectors for which relatively low internal productivity gains were forecasted (i.e. labour-intensive manufactures). These observations support the tentative conclusion that EC integration to a single market by 1993 is likely to open up substantial new export opportunities for suppliers from the Asian region which are not eroded by trade diversion [Hiemenz, Langhammer, 1991].

## 5. CONCLUSIONS

European economic integration is a continuous process which is likely to extend well into the next millennium. The establishment of a Common Market in 1993 marks an important stage of integration since the removal of border controls, harmonised technical norms and standards, the liberalisation of trade in services and the free movement of factors of production are expected to offer opportunities to increase production, to exploit economies of scale and to improve the allocation of resources. The resulting productivity gains would strengthen the internal and external competitiveness of EC firms. Suppliers from non-member countries may be negatively affected because of the fiercer competition and the higher attractiveness

of locations in Europe for internationally mobile capital, but they may also benefit from income-induced demand growth. It is important to note that economic integration so far was not accompanied by a deteriorating access to European markets for third country suppliers, i.e. fears of an emerging Fortress Europe have not materialised.

In addition to integration deepening, the economic landscape of Europe is changed by integration widening. The EFTA countries are joining the EC in the European Economic Space (EES). Further applicants are the formerly socialist Central European countries with which the EC has negotiated a time schedule for bilateral free trade in the framework of the Europe Agreements. Somewhat less far-reaching agreements were also offered to the East European countries, including the former USSR. These new arrangements imply an erosion of trade preferences granted to DCs and could result in trade and investment diversion away from DCs since Central and Eastern European countries possess a factor endowment similar to many DCs. However, supply constraints will prevent Central and Eastern European countries from exploiting their advantages on EC markets in the short and medium term.

Concerning non-European countries, the EC is maintaining its complex hierarchy of preferential trading arrangements with important protectionist remnants in sensitive sectors such as agriculture, iron and steel, textiles and clothing, and cars. On the other hand, there are hardly any restrictions on non-sensitive manufactured imports from these countries. National quotas and VERs have been replaced by EC-wide regulations, but the trade policy stance of the EC towards non-European countries has otherwise remained unchanged.

Internal adjustments in the EC determine the impact of the 1992 program on third countries. The magnitude of the impact depends on the degree of association with the EC, the extent of mutual trade relations, and the structure of production in non-member countries. By these criteria, EFTA countries will be most affected by the integration process. They have close trade ties with the EC, a comparable production structure and preferential market access under the EES. General equilibrium computations suggest a shift from physical capital-intensive to more skill-intensive EFTA industries, while more labour-intensive industries would relocate to the southern periphery of the EC. As a result, EFTA countries can enjoy substantial income gains in an EES setting. Because of the remaining trade barriers, these gains would be even larger in the case of full membership.

DCs have been particularly worried by the 1992 program since the EC absorbs more than a third of their total exports. A number of partial and general

equilibrium estimates of trade effects for DCs show that net trade effects (the residual of trade diversion and income induced trade creation) crucially depend on the assumptions about EC substitutes and market structures. Most models assume lacking EC substitutes for primary commodities and the existence of unexploited economies of scale virtually in all manufacturing industries. The logical consequence is an estimated net trade loss of all DCs taken together amounting to 1.5 per cent of total trade, with commodity exporters such as the ACP and Latin American countries as net gainers and suppliers of manufactured exports such as the Asian NIEs as heavy losers. The latter result does not appear to be plausible, however. It is derived from trade diversion, primarily caused by economies of scale in labour and physical capital-intensive industries, in which DCs have already proven to be competitive on EC markets in the past. Analyses of individual manufacturing industries in the EC suggest that there are reasons to expect that DCs can continue to exploit their comparative advantages, in textiles and clothing, footwear, iron and steel, electrical and electronic consumer goods, and automobile parts, since the respective markets must be classified as perfectly competitive. In this scenario, income-induced demand effects tend to overcompensate trade diversion not only for commodity producers, but also for suppliers of semi-skilled and standardised manufactures such as the Asian DCs. With the exception of agricultural economies specialized on specific products, such as bananas, the net welfare effect of EC-1992 will, therefore, be either positive or at worst zero for most DCs.

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