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Ulrich Hiemenz et al.

Regional Integration in Europe and Its Effects on Developing Countries

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Abbreviations

ACP	African, Caribbean and Pacific countries associated with the European Community under the Lomé Convention
CAP	Common Agricultural Policy
CGE	computable general equilibrium
CIS	Commonwealth of Independent States
CMEA	Council of Mutual Economic Assistance
CSE	consumer subsidy equivalent
DC	developing country
ECB	European Central Bank
ECSC	European Coal and Steel Community
EES	European Economic Space
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
FDI	foreign direct investment
FTA	free trade agreement
GSP	Generalized System of Preferences
MFA	Multifibre Arrangement
MFN	most-favoured nation
na	not available
NIE	newly industrializing economy
NTB	non-tariff trade barrier
PSE	producer subsidy equivalent
VER	voluntary export restraint

Preface

Economic integration in Europe is proceeding on two fronts. The European Community is taking further steps towards the deepening of integration after having completed the Internal Market. At the same time, the widening of integration through an enlargement of EC membership is likely to result in a common market encompassing most of Europe. The EC's trading partners are worried about their access to European markets and about possible shifts in comparative advantages that may be induced by economic integration in Europe. Such concerns are most pronounced in developing countries that have followed outward-oriented development strategies and for which the EC is an important export market.

Against this background, this study evaluates the effects of European integration on trade and economic growth in EC member countries and on the competitive position of non-European suppliers. The Internal Market programme is shown to encourage structural adjustment within the EC, which, in turn, dominates the effects on third countries. The magnitude of these effects depends on the degree of association with the EC, the extent of mutual trade relations and the structure of production in member and non-member countries. It turns out that EFTA countries are most affected by the integration process. By contrast, marginal overall effects are revealed for the United States and Japan.

As concerns developing countries, the study argues against the likelihood of substantial trade diversion at the expense of these countries arising from the Internal Market programme. Adverse effects are shown to be largely restricted to exporters of specific agricultural products and skill-intensive manufactures. On the whole, developing countries are expected to maintain their comparative advantages in sectors in which they have successfully penetrated EC markets in the past. Taking income-induced demand effects into account, net welfare effects of European integration on developing countries will be small, but positive rather than negative.

The study is part of a joint research project entitled *Regional Integration and Its Impact on Developing Countries*, which was initiated and funded by the Institute of Developing Economies (IDE) in Tokyo and encompassed studies of regional integration schemes in North America, Asia and Europe. A preliminary version of the study was presented at a workshop held in Tokyo on 3–4 February 1993. The authors are particularly grateful to Dr. Koichi Ohno and his colleagues at IDE who bore the main burden of coordinating the project and provided intellectual and organizational support. Thanks are also due to the discussants who provided valuable comments at the Tokyo meeting.

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Kiel, February 1994

Horst Siebert

A. Introduction

The European Community (EC) has evolved considerably since the Treaty of Rome (EEC) was implemented in 1958. The deepening and widening of integration have transformed the EC from a mere customs union with six members into a fully fledged single market with twelve members and a wide range of association and preferential trading arrangements. During the remainder of this decade, this process 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. The EC is well on the way to a regional trading bloc encompassing most of Europe.

Against this background, it is hardly surprising that non-Europeans, and developing countries (DCs) in particular, worry about their access to the large European Single Market, about shifts in comparative advantages generated by economic integration and about a possible reversal of international capital flows that a Europe "without borders" may entail. The EC member countries have traditionally been important trading partners of DCs. Changes in demand, market accessibility and investment flows will have an immediate effect on the welfare of these countries, especially when they have followed an outward-oriented development strategy, such as many Asian DCs have.

The purpose of this study is to assess the effects of the Internal Market programme and of related changes currently under way in Europe on the trade and growth prospects of EC member countries and the competitive position of suppliers from third countries, especially DCs, on EC markets. Towards this end, the rationale and the scope of institutional change in the EC is evaluated in Chapters B and C. The completion of the internal market for goods, services, capital and labour 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 (EES) 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]. Chapter D highlights the degree of policy coordination achieved so far, as well as the expected effects on economic growth and the structure of production and trade in EC member countries. Chapter E deals with the economic implications of European integration for the main beneficiaries, the EFTA and Central and Eastern European countries, and for non-European industrialized countries.

Chapter D and E provide the parameters for an analysis of the external repercussions of European integration on DCs that is undertaken in the remaining

part of the study. Chapter F focuses on the trade prospects for DCs on EC markets in a more general fashion, while sensitive product categories are scrutinized in greater detail in Chapter G. The study concludes (Chapter H) that 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.

B. EC 1993

I. Background of EC Common Market

The foundation of European economic integration was internal trade liberalization. Intra-EC trade was successively liberalized 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, i.e. when the customs union became fully operative. 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 industrialized countries (mainly EFTA countries) as well as DCs around the Mediterranean Sea (Synoptical Table 1). 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 [GATT, 1991, p. 55]. In 1985, a comprehensive and ambitious approach was launched to revitalize the integration process: the completion of the Single Market by the end of 1992, which marks the third and last stage of internal trade liberalization.

The strategy toward achieving a common market in the EC was first laid out in the *White Paper on Completing the Internal Market* presented by the Commission on 15 July 1985 [EC Commission, 1985]. The legal basis for the Internal Market programme was brought about by the Single European Act, which came into effect on 1 July 1987 and established the required institutional reforms. The White Paper enumerated close to 300 proposals for adoption by the Council of EC Ministers and implementation by the member states. By the end of 1992, about 90 per cent of these proposals had been dealt with at the Community level, while implementation was lagging behind in general and in some member states (e.g. Italy) even more so than in others. The proposals concerned the following major issues (Synoptical Table 2).

After the EC member countries had accomplished a free trade area and a customs union, the Internal Market programme meant the establishment of a common market without internal borders and border controls. To achieve this, EC member countries primarily had to liberalize factor movements and trade in services within the EC. Concerning manufactures, trade had already been

Synoptical Table 1 — EC Regional Agreements

1958 Benelux, France, Germany, Italy	Membership
1961 Greece	Association Agreement
1963 Turkey ACP countries	Association Agreement Association Agreement (Yaounde)
1970 Spain Malta	Free Trade Agreement Association Agreement
1973 Denmark, Ireland, United Kingdom Portugal Austria, Finland, Iceland, Norway, Sweden, Switzerland Cyprus	Membership Free Trade Agreement Free Trade Agreement Association Agreement
1975 Israel ACP countries	Free Trade Agreement Association Agreement (Lomé)
1976 Maghreb (Algeria, Morocco, Tunisia)	Cooperation Agreement
1977 Mashreq (Egypt, Jordan, Lebanon, Syria)	Cooperation Agreement
1980 Yugoslavia	Cooperation Agreement
1981 Greece	Membership
1986 Portugal, Spain	Membership
1992 Czechoslovakia, Hungary, Poland	Europe Agreement
1993 Austria, Finland, Iceland, Norway, Sweden, Switzerland Bulgaria, Romania	European Economic Area Agreement Europe Agreement

Source: Sapir [1992, p. 1492].

Synoptical Table 2 — An Economic Classification of the Single Market Proposals

Measures	Goods	Services	Persons	Capital
Market access	Abolition of intra-EC frontier controls Approximation of: — technical regulations — VAT rates and excises — food health standards Implications for trade policy (unspecified)	Dismantling road transport quotas Access to inter-regional air travel markets Mutual recognition and "home country control" in financial services	Abolition of intra-EC frontier controls Relaxation of residence requirements Right of establishment for professionals	Abolition of exchange controls Admission of securities listed in other member states Industrial cooperation
Competitive conditions	Liberalization of public procurement Merger control Review of state aid to industry	Increased competition in air transport Approximation of fiscal and regulatory aspects in services markets	European "vocational training card"	Harmonization of take-over and holding regulations Fiscal approximation of parent-subsidiary relations
Market functioning	Research programmes in telecommunications and information technology Proposals on standards, trade marks, company law, etc.	Approximation of banking and insurance regulations EC system of permits for road transport EC standard for electronic payments	Approximation of training programs Mutual recognition of diplomas (especially for professionals)	European company statute Harmonization of intellectual property rights Common bankruptcy provisions
Sectoral policy	Agriculture: elimination of monetary compensatory amounts (MCAs) Steel: reduction in subsidies	Common air transport policy on access, capacity and prices Common rules on mass risks insurance	Deferred to European Political Union Treaty	Deferred to European Monetary Union Treaty

Source: Pohl, Sorsa [1992].

liberalized earlier except for a relatively small number of products (including those covered by the Multifibre Arrangement (MFA)) for which national quotas still existed. Such quotas had to be removed. Furthermore, market access is to be based on the country-of-origin principle, but certain technical standards, public procurement, the provision of subsidies and VAT were harmonized within the EC. For years it was not clear, though, how and when these policy changes would be fully implemented and how suppliers from third countries might fit into the new framework [for details, see Dicke, Langhammer, 1991].

As concerns restrictions of manufactured imports, the trade policies of individual member countries differed widely with respect to product and country coverage. In addition to MFA quotas, the GATT [1991, p. 12] listed some 50

bilateral restraint agreements involving the EC, individual member states or even their industries. These measures took many different forms (e.g. official quotas or "voluntary" export restraint agreements) and were implemented in a wide range of sectors, including traditional as well as technologically advanced manufactures. According to EC data on the number of eight-digit product categories subject to quantitative restrictions [Amtsblatt der Europäischen Gemeinschaften, 1991] most bilateral measures originated in France, Italy, Portugal and Spain, and were directed towards exports from Japan and Asian newly industrializing economies (NIEs) [Möbius, 1991, pp. 19 ff.].

Suppliers from these countries were also among the prime targets of anti-dumping measures. The EC ranks among the most intense users of such measures world-wide, and a total of 279 measures were implemented in 1980–1989, mostly in the form of price undertakings [GATT, 1991, pp. 17 ff.]. Messerlin [1989] has shown for 1980–1985 that the anti-dumping procedures of the EC had a strong protectionist drift: imported quantities were reduced by as much as 40 per cent, and anti-dumping duties were rather severe when they were imposed.

As concerns trade policy, most of the often redundant national import quotas were dismantled. Until recently, however, there was a core of national quotas, for example, for cars, iron and steel, textiles and clothing, and agricultural products, that were effective under the safeguard provision of Art. 115 EEC Treaty. The number of new Art. 115 restrictions authorized fell from 119 in 1989 to 8 in 1992 [GATT, 1993, Vol. A, p. 20]. Although "the Single European Act provides no scope, as from 1 January 1993, for any internal trade measures against imports from external sources" [ibid, p. vii], the legal provisions of Art. 115 remain in force as they were included in the Maastricht Treaty. The future destiny of trade in agricultural and MFA products has been decided upon in the Uruguay Round. The EC yielded to international pressure and agreed to a reduction of support granted to agriculture and the gradual liberalization of trade in textiles and clothing. Apart from the recent accord (July 1991) between the EC Commission and Japan concerning EC imports of Japanese cars (see Section E.III), no new export restraint arrangements have been concluded by the EC in the past two years. Moreover, many former arrangements have expired. Hence, the widespread fears of a "Fortress Europe" appear to have been exaggerated, even though the tightened application of anti-dumping measures and safeguard provisions, as well as the French pressure for higher import protection, will continue to create uncertainty among exporters from non-member countries.

II. Rationale of Integration

From the early 1970s, trade liberalization did not progress very much within the EC. Rather, benefits from integration were derived from the enlargement of community membership. However, these benefits could hardly offset the detrimental effects of an increasingly difficult external economic environment characterized by world-wide recession, high rates of inflation and substantial changes in relative prices as the result of successive oil price hikes. The economic slow-down experienced in the EC is well reflected by the key indicators presented in Table 1. In 1973–1980, real growth of the gross domestic product (GDP) declined to less than half of its 1960–1973 size and by another 30 per cent in the first half of the 1980s when investment and employment were even shrinking in absolute terms. Inflation rates reached unprecedented levels, there were sustained current account deficits and public debt augmented considerably. A similar picture emerges from the trade data given in Table 2. Intra-EC export shares confirm the stages of integration identified in Section B.I. These shares increased steadily following the Treaty of Rome, jumping from less than 40 per cent in 1958 to nearly 55 per cent in 1970. Thereafter, they remained roughly constant at this level until 1985, but increased again in the second half of the 1980s to reach over 60 per cent in 1990.

Table 1 — Key Indicators of Economic Performance in the Community, 1960–1992 (per cent)

	1960–1973	1973–1980	1980–1985	1986–1989	1990–1992
Annual change					
Real GDP	4.8	2.2	1.5	3.3	1.8
Employment	0.3	0.1	–0.4	1.3	0.3
Investment ^a	5.6	0.3	–0.6	6.4	1.4
Private consumption deflator	4.6	12.4	8.8	4.0	4.8
Annual average (percentage of GDP)					
Current account balance	0.5	–0.5	–0.2	0.5	–0.7
Net borrowing of general government	0.6 ^b	3.5 ^c	5.3	3.8	4.7

^aGross fixed capital formation at constant prices. — ^b1970–1973 EC 10 = EC 12 excluding Greece and Portugal. — ^cEC 10 = EC 12 excluding Greece and Portugal.

Source: European Economy [1989, p. 111; 1993, p. 5].

Table 2 — The Regional Structure of EC-12 Trade, 1958–1992 (as percentage of total EC-12 trade)

	Partners									
	Western Europe			Eastern and southern neighbours				Rest of the world		
	EC-12	EFTA	total	Eastern Europe	Mediterranean countries	ACP countries	total	Developing countries	Industrial countries	total
Exports										
1958	37.2	12.2	49.4	2.7	7.8	6.6	17.1	15.3	18.2	33.5
1965	49.6	13.0	62.6	2.9	4.8	4.4	12.1	9.4	15.9	25.3
1970	53.4	11.7	65.1	3.4	4.8	3.6	11.8	7.1	16.0	23.1
1975	52.4	10.6	63.0	4.9	6.7	3.6	15.2	9.6	12.2	21.8
1980	56.1	11.2	67.3	3.5	5.9	3.5	12.9	9.2	10.6	19.8
1985	55.2	10.0	65.2	2.8	5.2	2.3	10.3	8.7	15.8	24.5
1990	61.2	10.4	71.6	2.3	4.2	1.6	8.1	7.3	13.0	20.3
1992	61.3	9.5	70.8	2.7	4.0	1.5	8.2	9.4	11.6	21.0
Imports										
1958	35.2	9.3	44.5	2.9	4.5	6.8	14.2	19.2	22.1	41.3
1965	44.9	9.0	53.9	3.4	4.7	5.2	13.3	12.7	20.1	32.8
1970	50.3	8.7	59.0	3.2	4.7	4.4	12.3	10.3	18.4	28.7
1975	49.5	7.9	57.4	3.5	3.8	3.8	11.1	16.3	15.2	31.5
1980	49.3	8.6	57.9	3.7	4.2	3.8	11.7	15.6	14.8	30.4
1985	53.4	9.4	62.8	3.9	5.1	3.5	12.5	9.8	14.9	24.7
1990	59.0	9.6	68.6	2.7	3.8	1.8	8.3	8.2	14.9	23.1
1992	59.3	9.2	68.5	2.7	3.4	1.5	7.6	9.3	14.6	23.9

Source: Statistical Office of the European Communities [d].

Economic stagflation, structural rigidities and intensified competition from external, i.e. in particular Japanese, suppliers had nourished a strong Euro-pessimism in the early 1980s when the term "Euroclerosis" [Giersch, 1987] was coined to describe the lack of dynamism in the European economies [see also Buigues, Goybet, 1985]. This is the background against which the Commission decided to take a bold step to revitalize the integration process by completing the Single Market. It was expected that the removal of all internal barriers to trade and factor movements would trigger a supply-side shock to the EC economies and that larger markets would offer opportunities to increase production, to improve the allocation of resources and to reap economies of scale. It was also expected that the resulting productivity gains would improve the internal and external competitiveness of European firms and bring prices down, thus stimulating domestic demand. Furthermore, output growth and higher competitiveness were supposed to create new employment opportunities, to reduce inflation rates and to ease the budget constraint of government.

The expected welfare gains from the completion of the Single Market were estimated in two *ex ante* 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 ignited a heated debate both in the general public and in academic quarters within the EC as well as in third countries. Critical comments focused 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 effect 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 benefit of integration, i.e. by erecting a Fortress Europe. These aspects will be elaborated in Sections D.III and E below.

III. The GATT, the Uruguay Round and the EC

The relationship between the General Agreement on Tariffs and Trade (GATT) and the EC has always been somewhat strained for several reasons. *First*, only EC member countries are contracting parties to the GATT, not the EC as such. The Commission has nonetheless the mandate to negotiate at the GATT rounds on behalf of its members. The mandate results from consensus-building among the members. Therefore, the preparation and modification of proposals takes

time, and more often than once proposals merely represent a careful balancing of benefits and costs among member countries rather than true support of a multilateral trading system. This tendency was reinforced by the institutional shortcoming that there is no special EC council of ministers for trade policy (as is the case for, e.g. agriculture or finance). The Commission now reports to the General Affairs Council of EC Foreign Ministers and to informal trade councils [Pelkmans, Murphy, 1991, p. 17].¹ This means that the Uruguay Round vies for attention with issues such as the political relations between the EC and EFTA, Central and Eastern Europe or the former Soviet Union. Furthermore, the Agricultural Council claims responsibility for determining the direction of EC agriculture policy as concerns the GATT.

Second, multilateralism has never taken precedence over regionalism in external EC trade policies. To use the EC's words [GATT, 1991, Vol. II, p. 32]: "... the basic attitude in favour of the multilateral trade system has ..., since the inception of the GATT, existed hand-in-hand with its enthusiastic support for and active involvement in free trade arrangements of a regional character". Following this policy guideline, the EC has adopted a rather broad interpretation of GATT Article XXIV, which provides a waiver for deviations from the most-favoured-nation (MFN) treatment of regional trade agreements. The main reason for the trade policy stance of the EC is, of course, the very nature of the EC itself. While it can be argued whether the EC has actually met the provisions of Article XXIV [see the discussion in Arndt, Willet, 1991], it seems safe to state that the completion of the Single Market has brought the EC closer to the requirements for GATT-legal customs unions, which stipulate the elimination of internal barriers on the bulk of trade among member countries without raising external barriers. However, the persistent restrictions on external trade in agricultural products remain a weakness.

In pursuit of its own interpretation of Article XXIV, the EC has adopted trade policies that are extremely discriminatory among regions and countries (see also Synoptical Table 1 and Hiemenz et al. [1990]). It maintains a multi-layer system of trade preferences vis-à-vis third countries on a reciprocal or unilateral basis. Preferences are granted in the context of free trade agreements (FTAs) (EFTA countries, Israel), through a wide range of association and cooperation agreements (including the Lomé Convention) and the Community's generalized system of preferences (GSP) scheme. A major distinction between these arrangements is that the FTAs and association agreements result from ne-

¹ Responsibility for applying anti-dumping procedures and other short-term measures still rests with the Council. A group of member states have vetoed french initiatives to shift more jurisdiction from the Council to the Commission. This veto has been the main reason why the harmonization of national quotas is still pending.

gotiations and, therefore, have a contractual character whereas the GSP scheme is a unilateral trade preference in favour of DCs that can be revoked annually.

In principle, the FTAs and the association and cooperation agreements provide for unrestricted and duty-free access for industrial products. In many cases, trade in coal and steel (European Coal and Steel Community (ECSC) products) and textiles is treated in a separate context. Agricultural products are either completely excluded or subject to specific constraints as regards product coverage, quantitative ceilings, minimum price requirements, seasonal calendars, etc. This applies especially to those products that are under common market organizations.

Special benefits are granted among DCs to Mediterranean and ACP countries. More generous treatment is provided in terms of access opportunities — including rules of origin and regional cumulation possibilities — and policy regimes (e.g. for sugar and bananas). In addition, the legal status and the respective time-frames differ. While GSP preferences are not legally binding and are subject to an annual review, the recent Lomé-Convention with the ACP countries has been enacted for a ten-year period. The agreements with the Mediterranean countries are for an indeterminate time period.

Third, the differential treatment of DCs is a further reason for the GATT-EC relationship that has always been somewhat strained. A stated objective of the Community's external trade regime is to provide support to the development and industrialization efforts of DCs. Trade privileges and the active support of regional integration schemes among DCs are, thus, considered as development aid policies of the EC. For these reasons trade preferences are not only differentiated by regions or membership in an integration scheme but also by individual countries according to income levels. The intention is to interfere with the income distribution among DCs by granting substantial preferences to poor countries while NIEs often face restricted access to the EC as in the case of textiles. This mixture of aid and trade policies represented an impediment for the negotiations on the phasing out of the MFA and is an important reason why it is unlikely that the EC will abandon its discriminatory trade practices and return to a wider application of the MFN principle in the near future.

EC trade policy objectives and the weakness in decision making on trade policy matters have also overshadowed the negotiating stance of the EC in the Uruguay Round. The opening of the GATT round in 1986 coincided with beginning efforts to set up the Internal Market, and for quite some time the multi-lateral negotiations took second place behind the Internal Market programme [Page, 1991, p. 1554]. The Uruguay Round was considered as mostly technical in nature, and there is ground to assume [Pelkmans, Murphy, 1991] that the EC did not have a strategy for the negotiations but reacted defensively to US attacks on the Common Agricultural Policy (CAP). An additional impediment

for a more active participation of the EC in the Uruguay Round was the above mentioned lack of an internal arbitration mechanism that could balance agricultural and other interests. And finally, the mandate of the EC was not only restricted by diverging interests among member countries but also by the attempt to protect the privileged position of associated countries, particularly the former colonies in the ACP group. This has led the EC to clearly breach GATT rules in such cases as the Sugar and the Banana Protocol.

Given these constraints, it is hardly surprising that the EC mainly adhered to a defensive attitude in the Uruguay Round negotiations. Any change towards becoming a more constructive GATT partner seems to have been contingent on the progress made in internal liberalization for achieving the Internal Market. Internal liberalization gave the EC greater negotiating leverage and expertise in areas such as services, standards and public procurement. It facilitated a preliminary accord between the EC, the US and major DCs such as Brazil and India with respect to the much disputed rules for trade in services and helped to find a possible compromise for a gradual liberalization of trade in MFA products. Likewise, the EC had to find internal consensus in favour of a CAP reform before the Commission could attempt to break the deadlock of negotiations with the US. Hopes for progress in GATT negotiations on agriculture were frustrated, however, as France threatened to veto the so-called Blair House Agreement of November 1992, in which the US administration and the EC Commission had agreed on a substantial (21 per cent) reduction of subsidized EC exports for certain agricultural products. The finally successful conclusion of the Uruguay Round reflects changing political priorities. The Uruguay Round was no longer considered as a technical matter. Since November 1991, when President Bush put the issue on the agenda of the EC/US Summit, the importance of resolving the remaining conflicts had gained considerable political weight. Thus, it became possible to overrule the powerful farm lobby and other protectionist interest groups and reach an agreement on multilateral trade liberalization.

C. Beyond EC 1993

The economic landscape of Europe will continue to change considerably after the completion of the Single Market. The Maastricht Treaty has done the groundwork for the further integration deepening by establishing the timetable and the conditions for the European Monetary Union (EMU) to be implemented until the end of the decade. Negotiations on the formation of the EES with the EFTA countries and association agreements with formerly socialist countries in Central and Eastern Europe pave the way towards the widening of integration. 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. As concerns future integration, resentment was expressed both in member (Denmark, Great Britain) and non-member (Switzerland) countries. This may indicate that economic integration in Europe may not follow a smooth course, although intra-EC disputes on the Maastricht Treaty have been largely resolved recently.

I. The European Monetary Union

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 report, drafted by a committee of central bankers under the chairmanship of Jacques Delors, 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, which pro-

vided 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 Internal Market and the European Monetary System (EMS). In preparing for the Internal Market, all restrictions on capital flows among EC member countries were abandoned, a necessary precondition for shock absorption in a common currency area. Until recently, the EMS had 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 since the last months of 1992 have, however, clearly indicated the fragility of an exchange rate mechanism in the absence of consistent monetary and fiscal policies as a response to external shocks such as the German unification and the economic transformation of Eastern Europe. Relatively high rates of inflation and fiscal deficits in Italy and the United Kingdom, for example, caused substantial pressure on the former countries' currencies requiring a major realignment of exchange rates. Both countries suspended their participation in the EMS and had not rejoined the mechanism by mid-1993. The entire system became subject to major revisions in August 1993 when the margin for exchange rate flexibility was extended to 15 per cent in each direction of the bilateral parity and provisions for more rapid realignments were agreed upon.

The realization of EMU is supposed to follow the three-stage approach outlined in the Delors Report (Synoptical Table 3). The major decisions to be taken in Stage I are already effective since in the economic field the Internal Market programme is on track, the reform of the Structural Funds is in operation, and the mechanism governing coordination and surveillance was finalized in early 1990. In the monetary field capital market liberalization is effective in most member states, and monetary coordination is being strengthened within the framework of the Committee of Central Bank Governors. The remaining aspects mainly relate to country-specific adjustments, i.e. participation in the EMS, further convergence towards low inflation and budgetary adjustments.

In contrast to Stage I, which is basically defined in economic terms, Stage II is mainly institutional in nature. It is meant to be a transitional stage only. The Delors Report placed emphasis on the gradual transfer in Stage II of responsibility for monetary policy. After intensive discussion among member states, the emphasis has been placed more on the technical preparation of the Euro-Fed institution in Stage II, on the grounds that policy responsibility must be clear-cut. For this reason it is now widely considered that Stage II should be quite short.

Synoptical Table 3 — Major Features of the Three EMU Stages

	Economic	Monetary
Stage I	Completion of the Internal Market	Capital market liberalization
	Strengthened competition policy	Enhanced monetary and exchange rate co-ordination
	Full implementation of the reform of the Structural Fund	Realignments possible, but infrequent
	Enhanced coordination and surveillance	All EC currencies in the narrow-band ERM
Stage II	Budgetary adjustments in high debt/deficit countries	Extended use of the ECU
	Evaluation and adaptation of Stage I policies	Establishment of Euro-Fed
	Review of national macroeconomic adjustments	Possible narrowing of EMS bands
Stage III	Definitive budgetary coordination system	Euro-Fed in charge of monetary policy
	Possible strengthening of structural and regional policies	Irrevocably fixed exchange rates or ECU as single currency

Source: Emerson et al. [1992, p. 40].

The main aim of Stage III is then to introduce the common currency. The timing of transition and membership in EMU will ultimately depend on the speed of convergence in inflation rates, budget deficits and public debt. The Maastricht Treaty has stipulated the following convergence criteria as a prerequisite for participation in EMU:

- a budget deficit not exceeding 3 per cent of GDP;
- a public debt stock not exceeding 60 per cent of GDP;
- a rate of consumer price inflation exceeding the inflation rate of the three most stable member countries by no more than 1.5 percentage points;
- a long-term nominal interest rate exceeding the rate in the three most stable countries by no more than 2 percentage points.

By the end of 1996, the heads of the EC governments are to decide by a (qualified) majority vote whether the majority of member countries are ready for a currency union. In the case of a positive verdict, the currency union could be introduced for these countries as of the beginning of 1997. In the case of a negative verdict, countries that are then deemed to be ready for the union will have to replace their currencies by a common one at the beginning of 1999. The criteria are non-binding, however; they merely provide the 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.

II. The European Economic Space

The completion of the Single Market was to coincide with integrating the EFTA countries pursuant to an EC-EFTA agreement on the formation of the EES. EC and EFTA markets have been connected by special economic agreements since Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, and Switzerland concluded parallel bilateral FTAs with the EC in 1972/73 (Synoptical Table 1). 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, for example, paper and steel, temporary quotas remained and tariff removal was delayed until 1984 [Abrams et al., 1990, p. 6]. To help solving problems caused by differing trade policies regarding third countries, a system of rules of origin was developed. The initial FTAs treated the EC as one country, but not the EFTA. Thus, FTAs did not allow for cumulation of processing by EFTA countries. The main features of the EC-EFTA FTAs have also been preserved 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 the ministers of the EC and EFTA agreed on a second generation of EC-EFTA initiatives in the so-called Luxembourg Declaration. The FTAs had succeeded in integrating the Western European market for industrial goods, but EFTA countries were still facing numerous technical barriers to trade in areas such as standards, rules of origin and border formalities. The desire of EFTA countries to eliminate barriers to trade and to integrate more closely with the EC increased when the White Paper envisaged the completion of the Single Market. Following the Oslo Declaration of March 1989, an EC-EFTA ministerial meeting began formal negotiations on the development of the EES in June 1990. The intentions were (i) to achieve a free movement of goods, services, capital and persons — the four freedoms —, (ii) to strengthen cooperation in other areas such as R&D (research and development), environmental protection, etc., and (iii) to reduce economic and social disparities between the regions.

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, for example, social policy, R&D, consumer as well as environmental protection, and institutional adjustments [Senti, 1992]. Appendices to the agreement concern the transfer of all EC regulations ("acquis communautaire") to EFTA countries. Furthermore, EC institutions will be sup-

plemented by respective EFTA institutions such as an EES standing committee (similar to the EC Ministerial Council) for political decisions regarding the EES, an EFTA surveillance authority guiding the implementation of the EES agreement in EFTA countries, and an EFTA court resembling the European Court in Luxembourg. Arbitration of disputes will be the responsibility of new joint EC-EFTA institutions.

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 particularly sensitive for individual EFTA countries, such as fishery (Iceland, Norway), transport (Austria, Switzerland), labour mobility and financial markets (Switzerland). These exemptions automatically apply to all EFTA countries. 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, and Norway is likely to do so soon. The EC has decided, however, to start formal negotiations about an enlargement of its membership only after the completion of the Single Market.

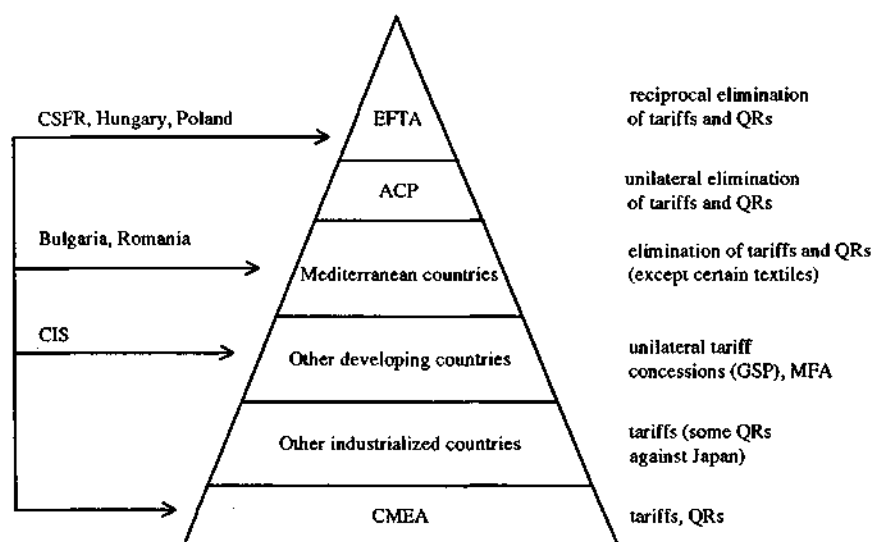
The implementation of the EES agreement depends upon ratification in all countries that are party to the agreement and the European Parliament. By the end of 1992, ratification was accomplished in (i) only two EC countries, Ireland and Portugal, (ii) the European Parliament and (iii) the EFTA members Austria, Finland, Liechtenstein, and Sweden. In Switzerland, a national referendum was held in December 1992 that rejected EES membership by a small margin. This negative vote dealt a severe blow to the timetable of the EES. It delayed the process of ratification, since the agreement had to be amended and partly even renegotiated. Switzerland will remain in the bilaterally agreed FTA with the EC, but will not become a member of the EES.

Summarizing 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 will hardly change in any significant way and, in the medium term, the EES will vanish when major EFTA countries (Austria, Finland, Sweden) become full members of the EC in 1996.

III. 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 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. Havrylyshyn and Pritchett [1991] estimate that about 75 per cent of Central and Eastern European exports would normally be directed to Western Europe. Actually, however, trade flows between the two groups of countries were much smaller and even declined in the 1980s (Table 2). 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 ranged at the bottom of the pyramid of trade preferences granted by the EC and faced tariffs and a wide range of quantitative restrictions (QRs) (Figure 1).

Figure 1 — The Pyramid of EC Preferences for Trade in Manufactures



Source: Adapted from Möbius [1991].

A liberalization of East-West trade began in mid-1988 — even prior to the ultimate demise of socialism that took place in 1990–1991 — when the EC signed trade and cooperation agreements with Hungary (September 1988), Poland (September 1989), the Soviet Union (December 1989), the Czech and Slovak Federal Republic (May 1990), Bulgaria (June 1990) and Romania (October 1990). The 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 quantitative restrictions 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 CSFR since 1991.

Economic cooperation between the EC and CMEA countries gained momentum after the collapse of central planning. Within the unprecedentedly short period of one year, the EC negotiated association agreements with the former 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: Commonwealth of Independent States (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 trade policy part of the agreements became effective prior to formal ratification by so-called “interim agreements” on 1 March 1992. They envisage a unilateral removal of EC trade barriers against most manufactured imports from the contracting parties in a five-year period. The Central European countries are granted a ten year period starting in 1995 to eliminate their trade restrictions against imports from the EC. 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 in iron, steel and coal (for details, see Section D.III below). 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. In the hierarchy of trade preferences this relatively sweeping trade liberalization puts the former CSFR, Poland and Hungary on a level roughly comparable to EFTA countries and certainly ahead of all DCs (Figure 1).

The EC offer of economic cooperation is equally far-reaching. It includes scientific and industrial cooperation, investment promotion, monetary cooperation, technical assistance, financial assistance through the PHARE programme and balance of payments support. All in all, the three countries will receive more external support than any non-member country (including the ACP countries) has ever received from the EC [Langhammer, 1992a, pp. 4-5].

As compared with the former CSFR, Hungary and Poland, the process of economic transformation is less advanced and surrounded by 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 (Table 3). The EC assumed a more cautious approach towards these countries. Initially, it offered only some of the financial and trade privileges granted in the Europe Agreements [Langhammer, 1992b, p. 11]. Concerning trade policies, the EC lifted quotas and improved the GSP coverage. To support the transformation process, the economic reconstruction programme PHARE was extended to Bulgaria and Romania. Only recently, the EC has concluded negotiations with Bulgaria and Romania on a similar type of institutionalized relations as the Europe Agreements. However, the EC denied the explicit reference to future full membership made in the preamble of the earlier Europe Agreements. It is very likely that future agreements, for example, with the Baltic states and Albania, will be rather comparable to those negotiated with Cyprus, Malta and Turkey in the 1960s and 1970s (Figure 1).

Table 3 — Basic Indicators of Economic Performance in Central and Eastern Europe, 1992

	Bulgaria	Czech Republic	Slovak Republic	Poland	Romania	Hungary	CIS	Russia
GDP ^a	-7.7	-7.1	-8.3	1.0	-15.4	-5.0	-17.4	-19.0
Industrial production ^a	-22.0	-11.0	-13.0	4.0	-22.0	-10.0	-18.0	-19.0
Inflation ^a	91.0	11.0	10.0	43.0	210.0	23.0	900.0	920.0
Unemployment (per cent of labour force; December 1992)	14.8	2.6	10.4	13.6	9.1	12.3	0.6	0.8
Per capita GNP (US\$; 1991)	1.840	2.470 ^b	—	1.790	1.390	2.720	—	3.220
^a Percentage change over the previous year. — ^b For former Czechoslovakia.								

Source: Gabrisch [1993]; KOPINT-DATORG [1993]; World Bank [1993].

Among the Eastern European countries, the 15 successor states to the former USSR represent a special case. In the cold-war period, 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 (Coordinating Committee on Export Controls (COCOM)). Since 1989 many quotas against goods originating in the USSR 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, p. 73]. 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 (Figure 1). Yet, greater trade concessions will be without much substance because the CIS states predominantly export non-dutiable items such as primary commodities.

D. Current Features of EC Integration

Chapter C has shown that 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 EMU in the first place. The Treaty of Maastricht also entails elements of policy coordination in the field of social and industrial policies. Moreover, the CAP is under review and some initial policy adjustments have already taken place.

I. Policy Coordination

1. Trade and Factor Movement

The free movement of goods, services, capital and labour provides a powerful means to foster economic integration among EC members. In designing the Internal Market programme, the policy-makers in Brussels and their external advisers were aware of the welfare costs resulting from policy-induced distortions of intra-EC flows of goods and factors of production [Emerson et al., 1988; Commission of the EC, 1988].² While tariffs and quantitative restrictions on intra-EC trade had been largely eliminated before, the remaining internal market barriers added up "to a considerable degree of non-competitive segmentation of the market" [Emerson et al., 1988, p. 17]. The following barriers were considered most important: (i) border controls for customs purposes and related administrative costs; (ii) differences in technical regulations between EC countries; (iii) restricted competition in public procurement; and (iv) restrictions on the freedom to engage in the trade of services or to establish a business in the service sector of other EC countries (e.g. financial, insurance and transport services).

What has been achieved to date in removing internal market barriers? This question must be addressed in two respects. First, it has to be assessed to which extent the EC's agenda for completing the Internal Market has been fulfilled. The expected welfare effects of the Internal Market programme, reported in Section D.II, are based on the assumption of full compliance with the earlier

² For an assessment of the welfare effects of removing internal market barriers, see Section D.II.

intentions. If major deviations in terms of policy implementation are to be observed, the estimates have to be adjusted downwards. Second, it has to be answered whether the preferred approach to policy coordination was well suited to maximize the dynamic welfare gains of market integration.

A recent progress report on the implementation of the Internal Market programme portrayed the situation in mid-August 1992 [Commission of the EC, 1992]. A number of 251 out of the 282 proposals made in the White Paper of 1985 had been adopted by the Council of Ministers. All in all, the report of the Commission provided an optimistic assessment of the progress achieved in completing the Internal Market. This judgement was mainly based on the observed acceleration of the Council's decision process, whereby the ratio of adopted to proposed measures was raised from 60 to 90 per cent within two years. For various reasons, however, this "inventory approach" provides only limited insights into the market integration effectively achieved through the removal of barriers to the free movement of goods, services and factors of production.

First, the high compliance ratio may obscure the fact that important decisions were still pending. The Commission considered remaining ambiguities with regard to intra-EC border controls to be the most delicate question. Moreover, progress had proven to be difficult to achieve as concerns the critical issue of Community-wide business activities in banking and insurance. Only recently it was agreed to apply the country-of-origin principle to the approval and supervision of banking activities, after common solvency and accounting rules had been established. The same principles were basically agreed on for the establishment and trading activities of insurance companies, including life insurance [Commission of the EC, 1992, p. 32]. However, national regulatory peculiarities remain in place for some time in the financial service sector.³ Transitory provisions characterize the liberalization of capital flows (for Greece and Portugal) and transport services as well. Finally, economic integration was still hampered by remaining restrictions with regard to the free movement and settlement of workers, as well as ambiguities concerning company laws and regulations to avoid double taxation.

Second, free trade and factor movement depends critically on the behaviour of national governments. Out of the 216 measures that had become effective by mid-1992, 174 measures had to be incorporated into national legislations. The process of national implementation was most advanced in Denmark, which

³ Moreover, the Commission has announced that additional regulatory measures will be introduced to control financial conglomerates. These measures shall ensure that the liberalization of financial markets does not infringe upon the interests of enterprises and financial institutions [Commission of the EC, 1992, p. 33], which is a somewhat confusing argument.

applied 86 per cent of the effective measures. Belgium ranked at the other extreme with a ratio of 62 per cent. The incorporation of agreed liberalization measures into national legislations was delayed in several important respects. A case in point was the resistance of France and Germany to further liberalize the freight-transport systems, by insisting on a prior harmonization of taxes [Blick durch die Wirtschaft, 4 September 1992]. Concerns about the slow national response to liberalization measures agreed at the EC level were raised by the Commission also with respect to border controls for goods and people, the mutual recognition of professional diplomas, some technical trade barriers and public procurement in sectors such as energy, transport and telecommunications, which had traditionally been highly protected [Commission of the EC, 1992]. Furthermore, scepticism is justified whether the liberalized rules in public procurement will be applied effectively by the purchasing agencies. Similar discrepancies have been observed with regard to financial services. In practice, decisions were biased in favour of national financial instruments and institutions.

Third, earlier assessments of the advances made towards completing the Internal Market have shown that the majority of the measures taken are concerned with administrative harmonization [Dicke, Langhammer, 1991]. Administrative harmonization was considered necessary for a long list of rather trivial issues, ranging from the composition of jam to the safety of toys. This indicates that the integration approach was biased in favour of ex ante coordination to overcome national peculiarities. Alternatively, harmonization could have been left to the market once transparency was established and institutional competition allowed.

The third point refers to the debate on the optimal approach to economic integration and dynamic welfare maximization [Giersch, 1988; Siebert, 1990]. From an economic viewpoint, the need for administrative ex ante harmonization is limited. In the case of non-existent property rights, harmonization may help to internalize externalities such as transborder pollution. Furthermore, basic principles defining the framework under which private initiative takes place have to be agreed upon ex ante. The fundamental rules of economic integration concern the country-of-origin principle and the mutual recognition of national standards, regulations and institutional settings. Once these principles are firmly established, ex post harmonization can be relied upon, which will develop spontaneously through the competition between national standards, qualities and policy frameworks. The preferences of consumers will then decide on the superior, i.e. welfare maximizing institutional setting, which may differ from what would be decided ex ante. Furthermore, institutional competition stimulates a permanent search for better solutions [Siebert, Koop, 1990]. Fa-

vourable growth effects are likely, whereas competition is suppressed by the cartelization that characterizes *ex ante* harmonization.

The case for institutional competition as a means for European economic integration was strengthened by the jurisdiction of the European Court of Justice [Dicke, Langhammer, 1991; Siebert, 1990]. As early as 1979, the Court established the ruling ("Cassis-de-Dijon") that a product or service legally supplied in one particular EC country can automatically be traded in other EC countries.⁴ The underlying country-of-origin principle was recommended in the Commission's White Paper of 1985 as well. The traditional concept of *ex ante* harmonization was abandoned in important respects indeed. Notable examples are: (i) the mutual recognition of inspection and test procedures (e.g. with regard to foodstuffs); (ii) the opening up of national markets for foreign insurance companies and financial intermediaries; (iii) the liberalization of capital movements; and (iv) the general recognition of professional diplomas.

Mutual recognition is not automatic, however, but must be endorsed by the Council of Ministers (Art. 100 b, para. 1, Single European Act). Moreover, the long list of measures relating to technical trade barriers clearly indicates that *ex ante* harmonization was not confined to cases of principal health and security needs [for details, see Dicke, Langhammer, 1991]. In contrast to earlier announcements, the country-of-origin principle was not applied as far as possible. Most importantly, institutional competition was not allowed between different national tax systems. The significant differences in value-added and sales tax rates were narrowed down in a protracted process of *ex ante* harmonization. Hence, it can be concluded that some welfare effects were forgone, notwithstanding the considerable progress in ensuring the free movement of goods, services and factors of production.

2. Industrial Policy

Traditionally, industrial policy measures in Europe were focused on containing sectoral adjustment crises in industries under heavy pressure due to the superior competitiveness of newly industrializing countries. This motivation is still prevalent in aging industries such as iron and steel, textiles and footwear (see also Section D.III). Recently, active industrial targeting gained momentum in sectors that policy-makers considered to be future growth industries. Strategic policy interventions were concentrated on high-tech industries to strengthen the

⁴ In the case of services such as insurance and financial services, the application of the country-of-origin principle in intra-EC trade was restricted to large customers for reasons of consumer protection.

position of European companies in international competition and to prevent technological dependence on foreign suppliers [Blentschacher, Klodt, 1991; Koopmann, Scharrer, 1989].

Strategic industrial policy has several means at its disposal to counterbalance foreign competition. Trade policy measures can be applied to protect strategically important domestic industries. State-aided cooperation and concentration within the corporate sector provide a second means. Finally, outright subsidies may be granted, e.g. to stimulate research and development activities in high-tech industries and to subsidize their exports. All these measures were applied extensively, and a multitude of different promotion schemes were implemented at the national, multilateral and Community level. Two prominent examples of industrial targeting in Europe are the aircraft industry and microelectronics.⁵

The formation of Airbus Industries in 1970 represented the major step of industrial policy in the aircraft industry [Blentschacher, Klodt, 1991, pp. 18 ff.]. Several EC governments pushed the cooperation among European producers and granted subsidies in huge amounts. Estimates suggest that the increase of the European market share in civil aircraft sales (Table 4) was achieved only at the cost of about US\$20 billion of government subsidies.⁶ When the United

Table 4 — Civil Aircraft Sales of North American and European Suppliers, 1971–1990

	1971–1975		1976–1980		1981–1985		1986–1990	
	Num- ber	Market share ^a	Num- ber	Market share ^a	Num- ber	Market share ^a	Num- ber	Market share ^a
North America	1299	88.1	1400	86.0	1372	80.5	2022	79.3
Europe	176	11.9	227	14.0	333	19.5	528	20.7
of which:								
Airbus ^b	13	0.9	108	6.6	218	12.8	325	12.7
World	1475	—	1627	—	1705	—	2550	—

^aPer cent. — ^bA-300, A-310 and A-320.

Source: Blentschacher, Klodt [1991, p. 19].

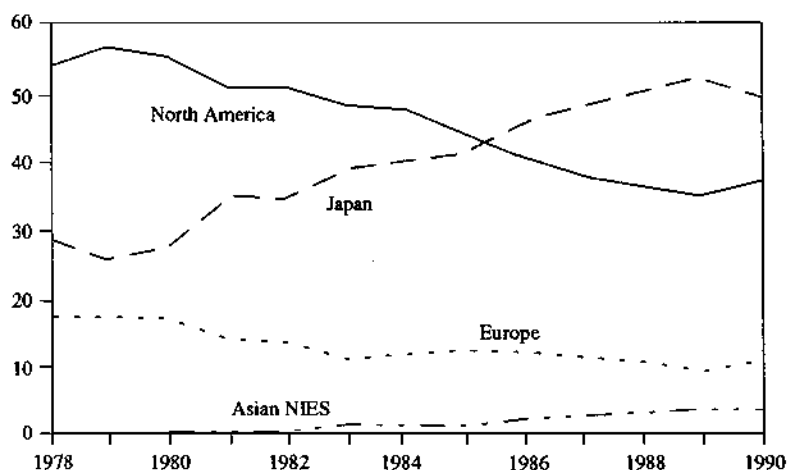
⁵ The automobile industry is another key sector at which strategic policy interventions are targeted. In this case, trade policy was used as the principal tool; for details, see Sections D.III and E.III.

⁶ Additionally, the German government subsidized exports of the Airbus. It guaranteed sales prices at a notional exchange rate of DM 2.0 to the US-dollar, and made up the difference in receipts if the market exchange rate was lower [Koopmann, Scharrer, 1989, p. 213]. According to a GATT panel decision in 1992, this measure was classified to be GATT inconsistent.

States presented this case to the GATT, European governments justified temporary state aid as a means to induce learning effects. After a transition period, the European industry was expected to cope up with the competition of US corporations. This infant industry argument has been discredited by the perpetuation of subsidies over more than two decades. Moreover, the welfare effects of permanent subsidization of the aircraft industry are reaped by its customers, rather than by the European taxpayers.

European manufacturers of microchips were protected by an import tariff of 14 per cent. Japanese competitors, facing the threat of anti-dumping procedures, agreed to a "voluntary" export restraint. Subsidies were granted by EC governments to varying degrees [Koopmann, Scharrer, 1989, p. 212]. Considerable public funds were made available to finance the research activities of European corporations. For example, DM8 billion were devoted to the JESSI project (Joint European Semiconductor Silicon) at its start in 1989 [Bletschacher, Klodt, 1991, p. 26]. These measures were intended to support the establishment of manufacturing capacity in Europe, in particular for semi-conductors. This attempt proved largely unsuccessful, although the production of semi-conductors was protected more heavily in Europe than in the United States and Japan [ibid]. After the decline of Europe's world market share in 1978–1983, its share remained stable at a low level of about 10 per cent (Figure 2).

Figure 2 — World Market Shares of Major Suppliers of Semi-Conductors, 1978–1990 (per cent)



Source: Bletschacher, Klodt [1991, p. 22].

The dismal experience with industrial policy experiments in Europe is not surprising. Strategic behaviour provokes retaliatory measures. As a consequence, all countries would suffer [Siebert, Koop, 1990]. Typically, the opportunity costs of subsidies granted to high-tech industries are not taken into account by advocates of industrial policy. The result may be a deteriorating supply of public goods, for example. Moreover, granting sector-specific aid runs the risk of a serious misallocation of resources, compared with a general improvement of R&D conditions.

Notwithstanding its inherent drawbacks, industrial and technology policy has gained momentum in Europe recently. The Treaty of Maastricht endows the EC with new and far-reaching interventionist competences [Schmieding, 1992, p. 15]. The promotion of the competitiveness of European industries shall become a major task of EC authorities [for details, see NWB, 1992; Hrbek, 1992, pp. 236 ff.]. Article 130 of the Maastricht Treaty lists various policy instruments, ranging from public assistance for structural adjustment to support for cooperation among enterprises, which aim at industrial targeting and conflict with an undistorted international competition. Pressure groups may easily refer to such provisions and ask for subsidies and protection. Similar opportunities are offered in the field of technology policy. Specifically designed promotion schemes may be adopted by the Council of Ministers at the request of the EC Commission (Art. 130i). The Community may establish "common enterprises" or make similar arrangements to carry out common research programmes and foster technological development at the EC level (Art. 130n). Comparable measures at the national level are largely exempted from EC provisions against cartelization and concentration.

The practical consequences may be exemplified by the recent request of France and Germany to support the development of a European variant of the high-definition television (HDTV). The EC was asked to provide ECU 600 million over five years for this purpose [Frankfurter Allgemeine Zeitung, 5 December 1992]. Public assistance for indigenous industrial take-off was considered necessary to cope up with the Japanese HDTV system, which was already fit for production in 1989 [Koopmann, Scharrer, 1989, p. 213]. From an economic point of view, the proposed subsidy scheme is a good example for industrial policy resulting in a waste of public resources.

3. Agricultural Policy

Strategic industrial policy has sometimes been justified on the grounds of ensuring continuity of supply, e.g. in the case of microelectronics [Koopmann, Scharrer, 1989, p. 212]. This argument was raised time and again in support of

the CAP, the disastrous results of which have become commonplace [Guth, 1992; The Economist, 1992]. According to OECD calculations, the costs of the CAP reached US\$142 billion in 1991 (Table 5). Consumers contributed nearly 60 per cent to the transfers to agriculture through higher than market clearing prices.⁷

The traditional features of the CAP may be summarized as follows.⁸ Apart from classical import protection through tariffs or quotas, numerous internal instruments are applied influencing consumption, production and storage of agricultural products. The highly interventionist system of Common Market Organizations covers the vast majority of products grown within the EC. The specific administrative arrangements differ depending on the product and the trading partner concerned. However, the increase of producer incomes above free market levels is mainly brought about by price support or production-tied aid.⁹ The ultimate results are increased internal production, reduced imports, as well as depressed and destabilized world market prices due to subsidized exports.

Table 5 — Transfers to Agriculture in Selected Industrialized Countries, 1991

	Total (US\$ billion)	Per capita (US\$)		
		total	taxpayers' contribution	consumers' contribution ^a
EC	142	409	168	241
Australia	1.2	70	41	29
Finland	5.9	1137	460	677
Japan	63.2	510	16	494
United States	81	318	200	118

^aBy paying high administered food prices.

Source: The Economist [1992] on the basis of OECD calculations.

⁷ In per-capita terms, EC transfers to agriculture ranked between Australia, paying hardly any subsidies, and some EFTA countries exhibiting extraordinarily high subsidies. Within EFTA, Finland represented the most extreme case. In most EFTA countries, the burden sharing between taxpayers and consumers was similar to that in the EC.

⁸ For a comprehensive assessment of the CAP and its effect on the exports of DCs, see Hiemenz et al. [1990, pp. 327 ff.].

⁹ Traditionally, internal market support prices combined with external protection by variable import levies covered more than 70 per cent of total agricultural production in the EC. Another 25 per cent of production benefitted from external protection exclusively.

The core instruments of the CAP are threshold border prices and intervention prices, both of which are derived from target prices fixed by annual decisions of the Council of Ministers. Intervention prices function as guaranteed minimum prices at which all quantities can be sold to market authorities. Levies on imports are fixed according to the difference between the lowest offer price and the threshold price.¹⁰ Although differentiated by country of destination, export subsidies basically compensate for the price difference between the internal EC price and the (typically lower) world market price. As a logical consequence of this support scheme, excess EC production has become a common feature for most basic food commodities. Furthermore, budgetary costs of the CAP have increased continuously.

The tremendous costs, the excess production induced by artificially high administered prices and the ensuing conflicts with the EC's trading partners during the GATT negotiations¹¹ rendered reforms of the CAP imperative. Throughout the 1980s, the main policy response was recourse to bureaucratic ways of rationing output. Examples for administrative interventions were: (i) quotas for milk (since 1984); (ii) the reshuffling of outlays from the EC to the national level; (iii) acreage set-aside schemes; and (iv) stabilizers in the form of price reductions for supplies of specified products exceeding the so-called guarantee threshold.¹²

The policy adjustments of the 1980s merely addressed the symptoms of the CAP, i.e. surplus production and rising public expenditures, rather than the underlying cause. Administered internal prices continued to exceed world market prices so that excess production remained profitable for farmers. Systematic policy changes were delayed until recently. Even the 1992 reform was restricted to specific agricultural markets that were plagued with the worst problems, i.e. the common markets for cereals and beef. However, a drastic reduction of prices was agreed for the first time in the history of the CAP (minus 30 per cent within three years for grain, minus 15 per cent for beef). It was decided to offset the ensuing income losses by direct transfer payments to the af-

¹⁰ For some commodities (e.g. fruit and vegetables), import levies are not based on the lowest offer price, but rather on the difference between any particular offer price and the regulated EC price. Price competition between foreign suppliers is eliminated in this way.

¹¹ These conflicts were because of the EC's attempt "to externalise their internal problems by either restricting imports of competing agricultural products from the world market or by exporting surplus production to the world market" [Guth, 1992, p. 215].

¹² For details on the 1988 agricultural reform, see Koester, Cramon-Taubadel [1992]. The following paragraphs on recent changes of the CAP also refer to Koester, Cramon-Taubadel [1992].

affected farmers. From an economic point of view, the replacement of price support by explicit income support is well suited to remove the perverse production incentives of the CAP.

The effects of the 1992 reform on agricultural production and resource allocation in the EC have been weakened in several respects, however:

- Price-related support arrangements have been maintained for products such as milk and sugar. Moreover, "there is a clear tendency to maintain the quota systems" [Guth, 1992, p. 221] in sectors where production quotas are already applicable, and "to make the necessary quantitative and price adjustments within the systems" [ibid].
- The compensatory transfer payments have not been decoupled from production. Grain producers can obtain income transfers only if they grow eligible products. In the beef market, transfers have been linked to the number of cattle. In other words, incentives persist to produce on marginal land even though the costs are not covered at the reduced support prices.
- Farmers with farms above a certain size have to set aside 15 per cent of their arable land in order to be eligible for transfer payments. This provision adds significantly to bureaucratic controls and regulations.¹³ Moreover, the compulsory uniform set-aside scheme seriously interferes with an efficient allocation of a particularly scarce factor of production. The use of land is constrained irrespective of the comparative cost advantages of farms.¹⁴ As a result, agricultural production cannot move freely to the most favourable location, which is clearly inconsistent with the Internal Market programme of the EC.

All in all, the 1992 reform of the CAP was an important step in the right direction. The chance to fundamentally overhaul the CAP was missed, however. Compensatory income transfers are not production neutral. The reform of the cereals market was identical to the acreage-based support scheme for oil-seeds,

¹³ A complex verification apparatus is also required because the acreage-based assistance scheme is differentiated according to specific products: "Each and every farm will have to be inspected" [Koester, Cramon-Taubadel, 1992, p. 155].

¹⁴ The total acreage for which applications for direct transfers are submitted may exceed the upper limit given by a region's "basic area", i.e. the area under grain in the past. In this case, sanction mechanisms will be applied which may have allocative effects not at all related to productivity and efficiency. In some regions, for example, "a small number of fairly large farms will be forced to take a considerable area of land out of production because a large number of small producers have increased their cultivation of products eligible for assistance" [Koester, Cramon-Taubadel, 1992, p. 154].

which a GATT panel judged to be non-conforming with GATT rules upon request of the United States.¹⁵ Conflicts with major trading partners thus continued in agriculture. Furthermore, the reluctant liberalization of the CAP hinders "a more constructive response to the problems arising from the future enlargement(s) of the Community and trade relations with the Central and Eastern European countries" [Guth, 1992, p. 221]. The remaining market interventions in agriculture are clearly inappropriate for meeting these challenges (see also Section D.III).

4. Macroeconomic Policy

The future of macroeconomic policy coordination remains completely open to question. This is not too surprising given that macroeconomic policy is still the national domain of EC member governments. Recently, however, attempts at coordinating fiscal, monetary and exchange-rate policies have ranked high on the policy agenda. This new focus is due to two opposing factors:

- In December 1991 the Treaty of Maastricht was agreed, which sets a detailed plan and timetable for the EMU (see Section C.I for details).
- Only shortly afterwards, the forerunner, the EMS of fixed though adjustable exchange rates was subject to significant turbulences. Several realignments proved necessary after more than five years of stable exchange rates among EMS member countries.

The recent turbulences in the EMS contradict the widespread belief that macroeconomic policy convergence among EC countries has proceeded to the point where exchange-rate adjustments are no longer needed. This belief was nourished by the declining number and the reduced size of currency realignments within the EMS [for details, see Emerson et al., 1992, pp. 41 f.]. In 1979–1983, 27 realignments took place vis-à-vis the Deutschmark with an average size of 5.3 per cent. These figures were reduced to 12 and 3.8 per cent in 1984–1987; until mid-1992 no further realignments occurred.

¹⁵ The subsequent protracted EC-US negotiations on oil-seeds resulted in a compromise in November 1992. Again, however, the agreed amendments of the oil-seed market organization require extensive bureaucratic controls, rather than strengthening market forces [Frankfurter Allgemeine Zeitung, 27 November 1992]. The oil-seed acreage in the EC was restricted to 5.1 million hectares; the set-aside of acreage has to be verified for each farm. Additional controls and regulations are necessary to enforce the EC's commitment to reduce the volume of production dumped on to the world market on a product-by-product basis (by 21 per cent within six years).

The proponents of the EMS have attributed this development to the disciplinary effects of the system. The need for realignments resulting from different inflation trends in member countries has indeed been reduced significantly (Table 6). Stabilization efforts were most pronounced in countries that had experienced double-digit inflation in the late 1970s (minus 7–9 percentage points in France, Italy and Ireland). As a result, the difference in inflation rates between the two most stable countries and the two least stable countries narrowed from more than 9 to 3.5 percentage points during the 1980s.

Declining inflation rates and smaller inflationary differences within the EMS were mainly the result of monetary policies of member countries acting in the same direction [Scheide, Trapp, 1991]. Explicit policy coordination proved unnecessary since the national central bank then least prone to inflation, the German Bundesbank, acted as a *de facto* leader.¹⁶ With fixed central parities and the fairly stable Deutschmark as an anchor currency, there was no room for an autonomous monetary policy except for the possibility of exchange-rate movements within the narrow bands of the EMS [Emerson et al., 1992, p. 41].

Notwithstanding enhanced monetary policy coherence, it proved to be an illusion that realignments were no longer necessary. Exchange-rate adjustments might still be helpful in the case of country-specific shocks and differences in productivity growth. Furthermore, the recent experience of the EMS suggests that policy coherence has remained imperfect. After several devaluations, starting with the Italian Lira in September 1992, and the subsequent withdrawal of Italy and the United Kingdom from the EMS, it was finally agreed in August 1993 to substantially extend the bands within which the remaining EMS currencies are allowed to fluctuate (from 2.25 to 15 per cent in each direction of

Table 6 — Inflation Rates in Seven EMS Countries^a, 1978/79 and 1988/89 (per cent)

	Belgium	Denmark	France	Germany	Ireland	Italy	Netherlands
1978/79	4.5	8.7	10.2	4.1	12.2	14.7	4.8
1988/89	2.5	4.7	3.3	2.0	3.3	5.8	1.6

^aCountries that participated in the EMS from its beginning in 1979.

Source: Scheide, Trapp [1991, p. 444].

¹⁶ For a critical assessment of the EMS, see Vaubel [1989] and Minford [1990]. Minford [*ibid.*, p. 333] concluded: "... the EMS does indeed act as is claimed as a deflationary discipline, an alternative to the domestic discipline of monetary targets. Its properties however are not as stabilising as floating with domestic monetary targets; nor do they act as a surrogate for cooperation".

the bilateral parity). These developments were basically the result of two factors: (i) accumulated inflationary differences over the past, and (ii) the expectation prevailing in financial markets that some EMS countries were prepared to react to deteriorating business cycle conditions by relaxing monetary and fiscal discipline.

The recent turbulences in the EMS, if continuing, may well have adverse effects on the further steps towards monetary and currency union. The smooth performance within the EMS over two years is one of the qualification criteria for full membership of EC countries in the EMU. In addition, EC countries will be judged according to a set of fiscal and monetary criteria (for the blueprint of realizing EMU in three stages, see Section C.I). Notwithstanding the formal accuracy of the convergence criteria, it is open to question whether they will lead to a more effective macroeconomic policy coordination in the Community. This can be doubted on both theoretical and politico-economic grounds. It has been argued that the adoption of the fiscal criteria would be arbitrary and economically meaningless [Buiter, 1992]. Among the long list of theoretical arguments, the following are particularly noteworthy:

- The asymmetric fiscal norms (i.e. permitting values below but not above the norm) are feared to result in a contraction during the next years.¹⁷
- It is maintained that countries with higher economic growth rates can, *ceteris paribus*, safely support a higher budget deficit than the agreed 3 per cent of GDP.
- The deficit norm should make an allowance for the distinction between nominal and real interest rates on the public debt [see also Tanzi, 1989].
- No apparent relationship exists between the fiscal norms and the criteria commonly used by economists to evaluate the solvency of the government.
- There is no need for international coordination of budgetary policies because possible external effects of government deficits and debt are by nature pecuniary rather than technological.
- Finally, it is argued that the fiscal norms are neither necessary nor sufficient for satisfying the other convergence criteria with respect to inflation, interest rates and exchange rates [see also Lehment, Scheide, 1992, pp. 53 f.].¹⁸

¹⁷ Buiter [1992, p. 7] claims that "even those approaches to positive economics and to economic policy design that are furthest removed from the Keynesian paradigm, can come up with prescriptions for the behaviour of public debt and deficits that are orthogonal to the Maastricht rules".

¹⁸ Table 7 provides some support for this argument. Countries like Belgium, Ireland and the Netherlands violated both fiscal criteria in 1991. Nevertheless, they be-

The above arguments imply that a common, stability-oriented monetary policy should be the major macroeconomic policy concern. Scepticism prevails, however, whether the envisaged EMU guarantees monetary discipline. It is feared that the relevant convergence criteria are not binding so that the economic policy of EC countries is not constrained effectively [Schmieding, 1992, p. 19]. Plenty of leeway remains in interpreting price stability in actual practice [Paqué, Soltwedel et al., 1993, pp. 32 ff.]. In 1991, the inflation target was violated by five countries and average inflation was twice the target figure (Table 7). Recent inflation rates in Germany exceeded 4 per cent. As a result, the EC country that was thought to be most inflation-adverse surpassed most of its EC partners in terms of inflation [IMF, c].¹⁹

Table 7 — Macroeconomic Criteria for Membership in the European Monetary Union, 1991^a

	General government gross debt	General government net borrowing	Consumer price inflation	Long-term nominal interest rates ^b
	per cent of GDP		per cent	
Belgium	129.4	6.4	3.2	9.3
Denmark	66.7	1.7	2.4	9.6
France	47.2	1.5	3.1	9.1
Germany	46.0	3.2	3.5 ^c	8.6
Greece	96.4	17.9	19.5	20.8
Ireland	102.8	4.1	3.2	9.2
Italy	101.2	9.9	6.4	10.1
Luxembourg	6.9	-1.9	3.1	8.2
Netherlands	78.4	4.4	3.9	8.7
Portugal	61.6	5.4	11.4	14.3
Spain	45.6	3.9	5.9	12.4
United Kingdom	43.8	1.9	5.9	9.9
Average of the three most stable EC members	—	—	2.9	8.5
EC average	68.8	4.9	6.0	10.9

^aBold figures indicate violation of the qualification criteria for full membership in the EMU. —
^bGovernment bond yields. — ^cRefers to West Germany.

Source: Buiter [1992]; IMF [b].

longed to the relatively stable EC countries in terms of inflation and interest rates. By contrast, inflation rates were beyond the target rate in Spain and the United Kingdom although the fiscal indicators were rather favourable by EC standards.

- 19 Among the EC countries for which comparable data were available for the first quarter of 1993, only Greece and Portugal reported higher inflation rates than Germany.

While the Treaty of Maastricht seems to promise more stability, there is no mechanism that will enforce this commitment. It remains an open question whether the European Central Bank (ECB) will be in a position to pursue an effectively independent policy of low inflation. Notwithstanding its formal independence, the ECB has to support EC policies, which are highly likely to aim at other goals as well. Furthermore, the ECB does not have a clear-cut competence for exchange-rate policies vis-à-vis non-EC currencies, which may seriously limit its factual independence [see also Buiter, 1992, pp. 13 ff.].

In the transition to the final stage of the EMU, the political struggle on whether the convergence criteria will be strictly applied is likely to continue. The design of macroeconomic policy of EC countries is going to face a major dilemma [Paqué, Soltwedel et al., 1993, p. 33]. If the commitment to stability is not taken seriously, the desired convergence of major macroeconomic variables will be unlikely to occur. This will add to the widespread concern that stability will be further undermined under EMU conditions in the future. If, however, the convergence criteria are taken seriously, the considerable need for fiscal and monetary correction in several EC countries will put a large burden of adjustment on labour and capital. Nominal realignments will no longer be available as a shock absorber for individual EC countries. Real adjustments to country-specific shocks will critically depend on the downward flexibility of nominal factor rewards.

It is unlikely that the greater demand for flexibility will materialize in practice. Rather, the Treaty of Maastricht obstructs adjustment incentives where they are needed most urgently [Schmieding, 1992, p. 21]. The poorer EC countries, i.e. Greece, Ireland, Portugal and Spain, have been granted access to enlarged compensation payments from a "cohesion fund". This will not only weaken the adjustment flexibility at the periphery of the Community, e.g. by inducing wage rigidities, but also add a further destabilizing burden to the Community budget.

II. Expected Effects on Member Countries

1. Overall Economic Gains

Shortly after the EC Commission had launched the White Paper in 1985, several attempts were made to quantify the economic gains from the Internal Market programme for member countries. The starting point for the intensive and ongoing debate was provided by a major EC-funded research project on the

cost of non-Europe.²⁰ The potential welfare effects were estimated in the Emerson Report on the assumption that internal market barriers would be removed by end-1992 [Emerson et al., 1988]. In this report, a first set of calculations is based on partial equilibrium estimation methods. The bottom line of this *microeconomically oriented evaluation* is given by an additional 2.2 per cent of GDP (Table 8). 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 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 liberalization-induced cost reductions on economic agents, i.e. producers, consumers and governments.

The gain in GDP, to be achieved within about five years, increases 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

Table 8 — Estimates of the Overall Economic Gains from Completing the Internal Market (per cent of GDP at 1985 prices)^a

	Variant A ^b	Variant B ^b
(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 ^c (4) + (5)	3.6	3.7
(7) Alternative measure of market integration effects ^c	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

^aAll estimates according to partial equilibrium methods; based on benchmark data for 1985. — ^bVariants A and B use alternative primary sources of information. — ^cDifferences due to alternative approaches to evaluating competition effects.

Source: Emerson et al. [1988, p. 157].

²⁰ For the summary of the basic studies conducted in this research programme, see Commission of the EC [1988].

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 Table 8).²¹ More relevant in explaining the differences are alternative methodological approaches to evaluating competition effects (variants I and II):

- A relatively modest GDP increase is achieved if a 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 such a drop in prices results in higher demand and output.
- 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 enhancing efficiency, for example, by scaling up production (economies of scale), gaining experience of how to produce most efficiently (learning curve effect), eliminating management inefficiencies (X-efficiency), and improving the capacity to innovate [Cecchini, 1988, p. 72].²²

In addition, a *macroeconomic assessment of completing the Internal Market* has been made to accompany the above mentioned microeconomically based estimates [Emerson et al, 1988, pp. 157 ff.]. This analysis refers to simulations made and scenarios worked out with the help of macroeconometric models [for details, see Catinat et al., 1988]. In modelling the feedback effects of the initial shock, i.e. the removal of internal market barriers, the focus is on GDP effects and macroeconomic constraints such as inflation, budget deficits and the external account.²³ The overall effect is differentiated according to the most rele-

²¹ For details of the microeconomic methodology and data questions, see Emerson et al. [1988, pp. 171 ff.]; the various studies on the cost of non-Europe [Commission of the EC, 1988] provided a rich body of information.

²² Theoretical models for international trade analysis were applied to some ten industrial sectors in five country groups [Smith, Venables, 1988].

²³ The simulated consequences are said to cover the medium term of five to ten years. Long-term effects resulting from structural changes in the behaviour of economic agents are ignored.

vant shocks and the supply effects resulting from the strategic reactions of firms faced with the new competitive environment (Table 9).²⁴

On average, the supply effects are clearly the most important element. They account for nearly half of the gain in GDP and employment, and for nearly two fifths of the decline in inflation. The liberalization of financial services ranks second. The macroeconomic effects of intensified competition in public procurement and abolishing border controls are considerably weaker. On the whole, EC market integration is shown to relax budgetary and external constraints, stimulate economic activity, boost employment and, simultaneously, reduce inflation. The spread in the expected GDP effects (3.2–5.7 per cent) reveals a similar, though somewhat narrower range as compared with the microeconomic estimates.²⁵

Table 9 — Macroeconomic Consequences of Completing the Internal Market^a

	GDP	Consumer prices	Employment	General government borrowing requirement ^b	External balance ^b
	per cent	percentage points	1000	per cent of GDP	
Removal of border controls	0.4	-1.0	200	0.2	0.2
Liberalization of public procurement	0.5	-1.4	350	0.3	0.1
Liberalization of financial services	1.5	-1.4	400	1.1	0.3
Supply effects ^c	2.1	-2.3	850	0.6	0.4
Total					
Average	4.5	-6.1	1800 ^d	2.2	1.0
Range ^e	3.2-5.7	-4.5 to -7.7	1300-2300	1.5-3.0	0.7-1.3

^aRefers to the medium term. — ^bPositive figures indicate an easing of budgetary and external constraints, respectively. — ^cAverage of different scenarios reflecting optimistic and pessimistic hypotheses on the strategic reactions of firms. — ^dAccounts for nearly 2 per cent of the initial employment level in the EC. — ^eDue to different scenarios concerning the supply effects.

Source: Emerson et al. [1988, p. 159].

- ²⁴ As concerns the supply effects, different scenarios were developed reflecting optimistic as well as pessimistic hypotheses on the strategic reactions of firms [for details, see Emerson et al., 1988, pp. 189 ff.].
- ²⁵ Emerson et al. [1988, pp. 162 ff.] argue that the GDP effect can be raised from an average of 4.5 per cent to about 7 per cent if the eased budgetary and external constraints lead to a more active, expansionist macroeconomic policy.

The Emerson Report stresses that the various empirical estimates are consistent, but, at the same time, "very approximate" [Emerson et al., 1988, p. 18]. The underlying assumptions and judgements have been the major subject of the ongoing debate on the growth and welfare effects of the Internal Market programme. 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 over optimistic bias of the Emerson Report.

As concerns a *first critical point*, it has been shown that the welfare effects are reduced considerably once it is taken into account that the realization of the Internal Market programme remains incomplete. Bakhoven's [1990] evaluation of the expected, rather than the potential, effects of completing the Internal Market reveals a much smaller gain in GDP (2.3 per cent, as compared with 4.5 per cent in Table 9), a minor deflationary effect on consumer prices and a slight decrease of employment.²⁶ The qualifications made with regard to the effective realization of the Internal Market programme are justified in principle. However, it is unreasonable to argue that the GDP effects will be halved because of remaining internal market barriers. Though delayed in several respects, the large majority of the White Paper proposals had been implemented by mid-1992 (see Section D.I).

A *second critical point* relates to the role of economies of scale [see Winters, 1992, p. 17, and the literature given there].²⁷ The fairly strong contribution of this factor, amounting to one third of the overall GDP effect according to Table 8, is heavily debated. It has been doubted that the average size of firms in EC countries is substantially below the cost-minimizing optimum [Geroski, 1989; Grimm et al., 1989, pp. 15 f.]. Furthermore, the extent to which potential economies of scale can be realized not only depends on the size of the enlarged internal EC market, but also on the preferences of consumers. The larger the number of varieties wanted by consumers, the smaller is the importance of economies of scale [Siebert, 1991, pp. 9 ff.].

An obvious third critical point of the Emerson Report and the related background studies is the fundamentally *partial* equilibrium nature of the models

²⁶ Bakhoven [1990] based his calculations largely on the background studies of the Emerson Report, most notably Catinat et al. [1988]. However, the interpretation of these background studies differs with respect to the composition of the initial impulses and the underlying data. Furthermore, Bakhoven added new elements such as the relocation of enterprises to the EC and policy responses of governments, and applied a different (world) model. These modifications are at least partly responsible for the different estimation results.

²⁷ The implications of economies of scale and the related modelling efforts will be discussed in greater detail in Chapter G.

applied. General equilibrium analyses have shown that partial equilibrium models tend to overstate the positive GDP effects [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 sectors with constant returns 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]. However, the computable general equilibrium (CGE) models applied so far do not fully capture gains from deregulation so that they tend to underestimate the EC 1993 effects in this respect.

Particularly the dynamic effects of EC 1993 are difficult, if not impossible to quantify. First attempts to evaluate the growth effects of the Internal Market programme suggest that "they are likely to dwarf the one-time gains" [Baldwin, 1989, p. 247] on which the Emerson Report focuses. In addition to the initial static effect, Baldwin provides evidence pointing to a substantial growth bonus in the medium run. The static efficiency gains induce higher savings and investment, and the 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.²⁸ Furthermore, arguments derived from the so-called new growth theory suggest that growth rates may be permanently increased. This effect, which is expected to be the largest of all, depends on the realization 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, p. 249]. This is a particularly large number, given that the "normal" growth rate is about 2 per cent.

All modelling exercises are subject to wide margins of error. Most importantly, the growth effects from liberalizing 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 reorganization of production and management to reduce X-inefficiencies, greater specialization because of a finer division of labour, the relocation of production facilities to exploit locational advantages, and intensified efforts at technological innovation. Such stimuli to economic

²⁸ The expectation that the Internal Market programme will have about twice as big an output effect as anticipated in the Emerson Report is based on a wide range of estimation results for five EC countries. At a minimum, output increases by an additional 0.6 per cent in the United Kingdom (under pessimistic assumptions). At a maximum, more optimistic assumptions result in an additional increase of GDP of more than 8 per cent in Germany, the Netherlands and Belgium.

growth are much more important than the static welfare gains reflected by the well-known Harberger triangles [Giersch, 1988; Waelbroeck, 1990]. 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, pp. 12 ff.].²⁹

All in all, it depends primarily on the course of economic policies at the EC level and the national level whether the higher potential welfare gains will be fully realized [see also Waelbroeck, 1990, pp. 20 f.]. Dynamic growth effects can be triggered by the liberalization of trade in services, free factor movements and fiercer competition in the first place. As argued in Section D.I, the EC's harmonization approach to economic integration has reduced competitive pressures in several respects. Presently much depends on the national implementation of and the effective compliance with principally agreed liberalization measures, which have remained critical issues. Preserving external competition may be even more important for exploiting potential welfare gains [Winters, 1992, p. 42]. External EC imports are most relevant in reducing profit margins and constraining monopoly power in the EC [see also Jacquemin, Sapir, 1991].

Finally, it is an open question whether the EMU would add significantly to the welfare gains to be achieved by the Internal Market programme. Emerson et al. [1992] have stressed as the main benefits of the EMU: (i) enhanced investment and economic growth due to the elimination of exchange rate uncertainty and transaction costs; (ii) better overall price stability by basing the EMU on the monetary stability of the EC's least inflationary member countries; (iii) more effective competition with other major currencies as international reserve and transaction currencies.

In most respects, a quantitative assessment of the effect of the EMU is not feasible. What is quantifiable reveals only small gains. Total savings of transaction costs after the introduction of a single EC currency are estimated at ECU 13–19 billion per annum (in prices of 1990), which amounts to 0.3–0.4 per cent of the EC's GDP [Emerson et al., 1992, p. 68].³⁰ More importantly, economic gains are not the automatic result of the EMU-induced institutional changes. They will only materialize if the commitment to stability is credible and economic agents behave accordingly. Section D.I has shown that serious doubts

²⁹ However, it is an open question whether a shift from lobbying to productive activities will be the consequence. Rather, interest groups may replace their lobbying at the national level by lobbying at the EC level.

³⁰ Hence, the savings in monetary transaction costs would be comparable to the savings resulting from the removal of border controls in the 1992 context.

are justified in this respect. Furthermore, any economic benefits have to be weighted against the costs of EMU. The net benefits of a common EC currency may be significantly lower, or become negative, once the consequences of discarding the nominal exchange rate as a shock absorber are taken into account [see also Buiter, 1992, pp. 21 f.].

2. Trade and Industry Structure

International trade and industrial restructuring are the principal transmission mechanisms through which the completion of the Internal Market effects on economic welfare. Table 10 reveals that close trade relations between EC members had prevailed already before the Internal Market programme became effective. At the minimum, intra-EC exports accounted for more than half of total exports in the case of Germany, Italy and the United Kingdom. For these countries, exports of food were of minor relevance. Intra-EC exports were even more important in countries that relied more strongly on food exports (such as Greece, Spain and particularly the Netherlands). The structure of intra-EC exports differed between EC members in other respects as well, most notably with regard to the share of machinery and transport equipment, because of country-specific resource endowments and different levels of industrial development. On average, machinery and transport equipment, manufactured goods classified by material (mainly iron and steel, textiles, metal products and non-metallic mineral manufactures), and chemicals accounted for two thirds of intra-EC exports in the period 1989–1992.

Intra-EC trade relations are expected to gain further momentum in the 1990s. However, the estimated effects of the Internal Market programme on trade flows are subject to qualifications similar to those discussed before.³¹ Again, the investigations concentrate on the industrial sector and largely neglect the potential of trade in services resulting from the removal of trade barriers in this highly regulated sector. In the national accounts, the service sector includes a wide range of activities (and also unallocated items; Table 11). Nevertheless, it can be maintained that the service sector is much more important than the industrial sector. This applies to all EC member countries for which recent data are available. In 1991, the share of services in overall

³¹ The following paragraphs are restricted to portraying some broad trends in production and trade in the EC. The subsequent sections of this study will provide more detailed insights into the trade effects on external regions (Chapters E and F) and the sectoral effects of industrial restructuring in the EC (Chapter G).

Table 10 — Structure of Intra-EC Trade, 1989–1992^a

	EC-12	France	Germany	Greece	Italy	Netherlands	Spain	United Kingdom
Food	10.3	13.1	5.3	24.3	5.9	18.2	12.6	6.0
Beverages and tobacco	1.6	2.8	0.8	4.2	1.3	2.1	1.3	2.1
Crude materials	3.1	3.9	2.2	4.9	1.2	5.8	2.8	2.2
Fuel products	3.5	2.2	1.0	3.2	1.4	10.6	2.8	6.9
Oils, fats, etc.	0.4	0.2	0.3	5.8	0.3	0.7	1.3	0.1
Chemicals	11.2	12.3	11.3	2.5	6.6	14.3	6.9	12.1
Manufactured goods classified by material	18.5	17.1	18.2	23.1	23.0	13.9	18.3	15.7
Machinery and transport equipment	36.5	39.6	47.8	3.3	36.8	20.2	45.5	35.4
Miscellaneous manufactured articles	11.9	8.6	10.3	26.4	22.7	9.3	8.2	11.4
Goods not classified elsewhere	3.2	0.4	2.9	2.4	0.9	4.8	0.2	8.0
<i>Memo items:</i>								
Total intra-EC exports								
billion ECU	656.5	121.3	179.2	4.7	79.4	81.9	35.2	80.2
per cent of total exports	61.3	63.0	54.1	64.2	57.7	75.4	66.3	55.5

^aPer cent of total intra-EC exports of EC-12 and selected member countries; period averages. Deviations from 100 are due to rounding.

Source: Statistical Office of the European Communities [d].

production was twice to four times as high as the share of manufacturing (Table 11). Within manufacturing, the relative importance of broadly defined industries varied significantly across EC member countries. Similar to the structure of intra-EC trade, such differences can be attributed to country-specific resource endowments and income levels.

Completing the Internal Market affects EC industries to varying degrees. There is an obvious reason for such differences. The research on the cost of non-Europe reveals that the incidence of internal market barriers is industry specific [for the case of technical barriers, see Groupe MAC, 1988]. Consequently, the direct trade and production effects of removing such barriers vary across industries. For example, the liberalization of public procurement practices is most relevant in areas like telecommunication and pharmaceuticals [Cecchini, 1988, p. 50]. The evident degree of the initial distortion is such that

Table 11 — Structure of Production in Selected EC Countries, 1991 (per cent of GDP)

	Belgium	Denmark	France	Germany	Greece	Italy	Netherlands
Agriculture	2	5	3	2	17	3	4
Services ^a	68	67	68	59	56	64	64
Industry	30	28	29	39	27	33	32
Manufacturing thereof: ^b	22	19	21	23	14	21	20
Food, beverages, tobacco	17	21	13	9	22	8	16
Textiles, clothing	8	4	6	4	21	13	3
Machinery, transport equipment	23	23	31	42	12	33	25
Chemicals	11	11	9	12	8	10	18
Other	41	40	41	32	38	36	39

^aIncludes unallocated items. — ^bPer cent of manufacturing value added in 1990 at current prices.

Source: World Bank [1993, pp. 243 and 249].

significant changes in trade patterns are predicted even if the analysis is based on the traditional concept of trade creation and trade diversion, which assumes perfectly competitive markets and, implicitly, internationally segmented markets [Winters, 1992, pp. 3 ff.].

On the whole, however, the traditional tools of customs union theory reveal only modest trade effects from removing internal market barriers in the EC [for a detailed analysis of 65 industries, see Cawley, Davenport, 1988]. In the absence of barriers to intra-EC trade, trade diversion is found for every good. But the total is equivalent to only about 2.5 per cent of final goods imports; the associated intra-EC trade creation is around 4 per cent. Trade diversion at the expense of external EC imports rises to about 10 per cent if the effects of eliminating cost-increasing restrictions on all production activities in the EC are considered additionally. The latter aspect of market integration has no effect on trade creation as long as efficiency improvements are assumed to be distributed uniformly across EC suppliers.

It is frequently argued that the predictions of the traditional competitive model are likely to underestimate the increase of intra-EC trade and overestimate the reduction of external EC imports caused by the removal of intra-EC trade barriers [for a comprehensive discussion, see Winters, 1992]. This is attributed to the restrictive assumptions underlying this model. The import-expanding effect of economic growth will at least partly offset trade diversion. The above mentioned 10 per cent reduction of external EC imports is eliminated completely if the EC's estimate of a GDP gain of around 5 per cent is accepted,

and the average income elasticity of demand for external EC imports is around 2 [Winters, 1992, p. 20]. Furthermore, the estimates ignore the trade and production effects induced by increased competition and market integration in imperfectly competitive markets. Structural differences among industries in terms of competitiveness and market segmentation are said to represent a crucially important reason for an industry-specific effect of the Internal Market programme on trade and production. Smith and Venables [1988] have studied ten industries in partial equilibrium and have performed various simulations:³²

- If EC markets remain segmented after 1992, the fiercer competition induced by removing internal trade barriers will increase intra-EC output and trade as well as EC exports, and reduce external EC imports.³³ The variation across industries is considerable. The increase in production ranges from less than 1 per cent (cement, pharmaceuticals, electric motors) to 6.6 per cent for synthetic fibres and 12.5 per cent for office machinery. Intra-EC trade expands at a maximum of 180 per cent for cement and at a minimum of 13 per cent for pharmaceuticals.
- The picture changes significantly if EC markets are assumed to be integrated, which is the clear objective of the Internal Market programme. In the case of integrated EC markets, firms lose the ability to price high in their relatively captive domestic markets.³⁴ This causes demand to switch towards domestic producers, and thus it tends to reduce both intra-EC trade and external EC imports [Smith, Venables, 1988, pp. 1522 f.]. The gain in domestic production ranges from 0.03 per cent (cement) to more than 25 per cent (office machinery, motor vehicles). Intra-EC trade is reduced by more than 40 per cent in four out of ten industries, but still increases by at least 25 per cent in three industries. External EC imports fall by more than one third in half the cases.

These production and trade effects should be interpreted with great caution because of the partial equilibrium nature of the simulations. General equilib-

³² In the following, we refer to some simulation results achieved under the assumption of Cournot competition, a variable number of firms, and a constant number of varieties produced by each firm. Smith and Venables [1988, p. 1518] "regard the variation in results across different variants of the model as surprisingly small".

³³ The reduction of barriers is considered equivalent to 2.5 per cent of the gross value of trade. It is an open question to which extent external EC imports will also benefit, relative to domestic EC supplies, from reduced trade barriers, e.g. from the harmonization of standards and testing procedures [Winters, 1992, p. 4]. This would result in more trade creation.

³⁴ The view of Smith and Venables [1988] that the consequence will be a reduction of domestic prices is challenged by Haaland and Wooton [1992].

rium analysis allows for input and factor price increases, thereby mitigating the tendency in partial equilibrium analysis for all industries to expand after 1992. Recent examples of CGE models analysing the EC 1993 effects on the industrial structure and trade flows are Gasiorek et al. [1992], and Haaland and Norman [1992]. Important results may be summarized as follows:³⁵

- EC output expands in all imperfectly competitive industries, but only by modest amounts if market segmentation persists. Output expansion is enhanced if EC markets are integrated. The overall output effects are expected to be quite small, however: 1.5 per cent of GDP according to Gasiorek et al. [1992], and 0.5 per cent according to Haaland and Norman [1992].
- 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 liberalization is supposed to be greatest. Furthermore, Haaland and Norman [1992] show that the expansion is strongest in engineering and other skill-intensive industries. The evidence for capital-intensive industries is mixed, whereas output effects remain fairly small for 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 rise by 25–36 per cent for metalliferous products, non-metallic mineral products, transport equipment and food products. The external EC imports in the same sectors fall by 14–40 per cent [Gasiorek et al., 1992].

In summary, some CGE simulations predict large sectoral production and trade effects associated with imperfect competition but relatively modest overall GDP effects. Resources will be shifted into rapid-growth industries, typically R&D and skill-intensive engineering sectors. Hence, the degree of sector specific trade diversion may be substantial according to these models. The specification of the CGE models must be subjected to important qualifications, however. The classification of industries into perfectly and imperfectly compe-

³⁵ The CGE models repeat the segmented and integrated market experiments of Smith and Venables [1988]. Again, we concentrate on results achieved for the long run, i.e. with free entry and exit of firms.

titive sectors is based on arbitrary indicators such as concentration ratios.³⁶ 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 that 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 those based on CGE models (see Chapters E–G).

3. Capital Flows and Direct Investment

In contrast to the considerable work done on the production and trade effects of the Internal Market programme, the effects of the programme on capital flows have largely been ignored so far. Net capital flows are, of course, the reverse of net trade flows. Thus, the development of net capital flows to the EC will largely depend on changes of net EC exports to the rest of the world. The EC will logically absorb less foreign capital or become a net capital exporter if completing the Internal Market results in substantial trade diversion rather than external trade creation. By contrast, net capital flows will be affected only marginally if trade diversion remains negligible.

Even if a small effect of the Internal Market programme on total (net) capital flows is considered to be more likely, this result does not necessarily hold for different types of capital flows. This refers to foreign direct investment (FDI) in the first place. In fact a wide consensus exists that the EC will gain in attractiveness as an investment location. Previous studies have identified the size and the growth of host-country markets to be important determinants of FDI [Stehn, 1992; Agarwal et al., 1991]. The completion of the Internal Market and the favourable growth prospects thus can be expected to stimulate FDI in the EC [see also Young et al., 1991]. Uncertainties of foreign enterprises concerning the future trade policy of the Community are considered to be another incentive to invest in rather than to export to the EC.³⁷ Restrictive local content requirements and rules of origin are particularly relevant in this respect [Agarwal, 1992]. Foreign companies already established in the EC may encourage

³⁶ For example, Haaland and Norman [1987, p. 219] have reported that despite apparently high concentration in the steel industry, the assumption of perfect competition gave the best fit.

³⁷ For the case of Swiss FDI in the EC, see Bührenmeier [1991].

follow-up FDI by input suppliers, in order to be able to draw on their preferred input sources and benefit from unrestricted access to EC markets.³⁸

The extent to which these investment incentives will affect future FDI in the EC is impossible to quantify. However, foreign investors could easily anticipate that the Community was heading towards economic integration, even if the final shape of the Internal Market was not quite discernible when the White Paper was published in 1985. Casual empirical evidence and survey results have shown that multinational corporations did indeed take into account the Internal Market programme in their strategic planning in the 1980s already [Gittleman, 1990].³⁹ Therefore, recent data on FDI flows should be able to provide first insights as concerns the effects of the Internal Market programme.

The short discussion on FDI motivations suggests that the response of EC and non-EC investors to the completion of the Internal Market may differ. For example, the incentive to circumvent trade barriers through FDI may be important for investors from non-EC home countries, while it is irrelevant for intra-EC investment. A differentiated analysis is subject to serious data constraints, however. The reaction of major home countries outside the EC can be evaluated on the basis of Japanese and US statistics on FDI outflows. This will be done in Section E.III, which also provides evidence on the sectoral structure of investment by these countries. As concerns total FDI inflows to the EC, balance-of-payments data have to be relied upon (Table 12). This data set includes intra-EC investment so that a clear-cut breakdown into intra-EC and external FDI is not feasible. As a first indication of the reactions of investors within the EC, recent data on German FDI in other EC countries will be presented below.⁴⁰

As a host region of FDI, the EC lost importance until the mid-1980s. Its share in total FDI inflows to OECD countries dwindled from 57 per cent in 1970–1979 to about 37 per cent in 1980–1987 [Koopmann, Scharrer, 1989, p. 209]. Recently, though, a turnaround in this trend is to be observed (Table 12). Total FDI inflows increased more than fourfold between 1986 and 1990, and the EC's share in worldwide FDI flows nearly doubled. Although various other

³⁸ Investment in the United Kingdom by Japanese car manufacturers is a case in point (see Sections D.III and E.III below).

³⁹ Casual evidence refers to Japanese FDI in the EC, which aimed at circumventing export restraints. Moreover, companies from EFTA countries "have launched aggressive merger-and-acquisition offensives inside the European Community to gain a stronger foothold in the Single Market" [UN, b, p. 19].

⁴⁰ Molle and Morsink [1991] provide a comprehensive data set on the size and structure of FDI flows among EC countries. However, these data are not useful in the present context since they refer to the period 1975–1983.

Table 12 — Flows of Foreign Direct Investment to the EC, 1980–1990 (US\$ billion)^a

	1980–1985 ^b	1986	1987	1988	1989	1990
All EC countries	14.7 (29.5)	20.0 (25.5)	36.4 (27.4)	54.3 (34.3)	75.5 (38.7)	88.9 (48.4)
Benelux	2.84 (5.7)	4.25 (5.4)	5.24 (3.9)	10.17 (6.4)	15.72 (8.1)	16.62 (9.0)
Denmark	0.09 (0.2)	0.16 (0.2)	0.09 (0.1)	0.50 (0.3)	1.09 (0.6)	1.21 (0.7)
France	2.34 (4.7)	3.26 (4.2)	5.14 (3.9)	8.49 (5.4)	10.31 (5.3)	12.73 (6.9)
Germany	0.69 (1.4)	1.06 (1.4)	1.92 (1.4)	1.17 (0.7)	6.67 (3.4)	1.43 (0.8)
Greece	0.50 (1.0)	0.47 (0.6)	0.68 (0.5)	0.91 (0.6)	0.75 (0.4)	1.01 (0.5)
Ireland	0.20 (0.4)	-0.04 (-0.1)	0.09 (0.1)	0.09 (0.1)	0.09 (0.0)	0.10 (0.1)
Italy	0.97 (1.9)	-0.15 (-0.2)	4.10 (3.1)	6.75 (4.3)	2.54 (1.3)	6.41 (3.5)
Portugal	0.18 (0.4)	0.24 (0.3)	0.47 (0.4)	0.92 (0.6)	1.74 (0.9)	2.12 (1.2)
Spain	1.72 (3.5)	3.45 (4.4)	4.57 (3.4)	7.02 (4.4)	8.43 (4.3)	13.84 (7.5)
United Kingdom	5.16 (10.4)	7.31 (9.3)	14.11 (10.6)	18.26 (11.5)	28.17 (14.4)	33.39 (18.2)
<i>Memo items:</i>						
Other industrialized countries	22.5 (45.2)	44.1 (56.3)	71.5 (53.8)	74.3 (46.9)	89.9 (46.1)	63.1 (34.3)
Developing countries	12.6 (25.3)	14.2 (18.1)	25.0 (18.8)	29.7 (18.8)	29.8 (15.3)	31.8 (17.3)
Total flows	49.8 (100)	78.3 (100)	132.9 (100)	158.3 (100)	195.2 (100)	183.8 (100)

^aFigures in parentheses refer to the percentage share in total flows. — ^bAnnual average.

Source: UN [b].

factors may have played a role, it is hardly a pure coincidence that this favourable development started shortly after the White Paper had been launched, and that it gathered momentum as the completion of the Internal Market progressed.⁴¹

The aggregate figures for the EC obscure considerably different developments in individual EC countries as hosts of FDI. Two large EC countries represent the extremes, i.e. Germany and the United Kingdom. Germany, which had traditionally been a minor host of FDI, did not participate in the boom of FDI in the EC. This is probably because of its reputation as a high-cost location, which made foreign investors to look for more attractive locations in the Community. The United Kingdom ranks at the other extreme largely because of Japanese investment [Koopmann, Scharrer, 1989, p. 207]. The UK accounted for 38 per cent of FDI in the EC in 1990 and contributed nearly 40 per cent to the rise in the EC's share in total FDI flows. The remaining EC countries can be divided into two groups:

- Measured by the share in total FDI flows, foreign investors considered Denmark, Greece, Ireland, Portugal and Italy to be relatively unattractive investment locations within the Community.⁴² It may be surprising that three of the four poorer EC countries belong to this category (except Spain). Greece, Ireland and Portugal did not succeed to any significant extent to divert FDI from traditionally preferred locations with similar resource endowments, i.e. newly industrializing countries in the Third World [see also Agarwal, 1992].
- FDI flows increased fourfold in the period 1986–1990 in the Benelux countries, in France and Spain. The contrast between Spain and the other relatively poor EC members is striking. Although FDI soared only recently in Spain, it became the second-largest host country within the EC in 1990.

The data suggest that extremely high unit-labour costs, such as in Germany, discouraged foreign investors, while a favourable cost situation was no sufficient condition to participate in the boom of FDI in the EC. When the development of German FDI stocks in EC countries is considered to be a yardstick (Table 13), the latter conclusion also holds for intra-EC investment. The com-

⁴¹ As concerns external influences, the persistent difficulties of debt-ridden DCs to attract FDI and the dramatically reduced FDI flows to the United States in 1990 contributed to boosting the EC's share in total FDI flows [UN, b, pp. 311 ff.].

⁴² The shares of these countries remained constant (Greece, Ireland), increased only marginally (Denmark, Portugal) or fluctuated heavily (Italy).

Table 13 — Stocks of German Direct Investment in the EC, 1984–1991 (DM billion)^a

	1984	1986	1988	1989	1990	1991
All EC countries	47.2 (32.4)	57.8 (38.2)	73.0 (39.4)	85.4 (41.3)	111.7 (49.3)	131.7 (50.9)
Benelux	18.37 (12.6)	22.66 (15.0)	26.04 (14.0)	29.51 (14.3)	38.05 (16.8)	43.98 (17.0)
Denmark	0.81 (0.6)	0.97 (0.6)	1.05 (0.6)	1.07 (0.5)	1.40 (0.6)	1.50 (0.6)
France	10.14 (7.0)	12.26 (8.1)	14.61 (7.9)	17.34 (8.4)	21.07 (9.3)	22.83 (8.8)
Greece	0.54 (0.4)	0.61 (0.4)	0.64 (0.3)	0.81 (0.4)	0.86 (0.4)	1.05 (0.4)
Ireland	0.55 (0.4)	0.60 (0.4)	1.01 (0.5)	1.90 (0.9)	6.65 (2.9)	12.91 (5.0)
Italy	5.71 (3.9)	6.32 (4.2)	8.78 (4.7)	9.47 (4.6)	11.84 (5.2)	13.88 (5.4)
Portugal	0.46 (0.3)	0.54 (0.4)	0.77 (0.4)	0.94 (0.5)	1.31 (0.6)	1.67 (0.6)
Spain	4.83 (3.3)	6.37 (4.2)	9.34 (5.0)	10.62 (5.1)	12.94 (5.7)	14.69 (5.7)
United Kingdom	5.76 (4.0)	7.45 (4.9)	10.71 (5.8)	13.78 (6.7)	17.58 (7.8)	19.23 (7.4)
<i>Memo items:</i>						
Other industrialized countries	67.3 (46.2)	67.3 (44.4)	82.5 (44.5)	89.3 (43.2)	93.3 (41.2)	102.0 (39.4)
All countries	145.6 (100)	151.5 (100)	185.5 (100)	206.9 (100)	226.5 (100)	258.8 (100)

^aFigures in parentheses refer to the percentage share in total stocks. Pre-1989 and post-1989 data are not strictly compatible because of slightly different compilation methods.

Source: Deutsche Bundesbank [1992a; 1993].

mitment of German investors remained extremely weak in Greece and Portugal, and percentage shares were basically stagnant. The same applied to Ireland until the most recent past. Again, in sharp contrast to the rest of the EC periphery, Spain attracted a significant and rising share of German FDI.

However, Spain still ranked only fourth among EC hosts of German FDI in 1991.⁴³ Traditionally, close investment relations prevailed with regard to France. Similar to the development of total flows, Belgium, the Netherlands and, most notably, the United Kingdom attracted increasing shares of German FDI.⁴⁴ Since recently, Ireland has also received significantly higher FDI. Furthermore, the relatively unattractive position of Denmark and Italy revealed above is substantiated by more or less stagnant shares in total German FDI stocks.

All in all, the behaviour of German investors appears to be similar to the response of non-EC investors to the Internal Market programme. Not surprisingly, the changes in FDI stocks are less pronounced, as compared with FDI flows. Nevertheless, a significant shift of FDI towards the EC, mainly at the expense of other industrialized countries, is evident from both data sets. This supports the proposition that completing the Internal Market has enhanced the attractiveness of the EC for external as well as internal foreign investment.

4. Disparity between Member Countries

The second issue of economic integration largely neglected so far concerns its effects on individual EC countries. The sharing of the expected welfare gains from completing the Internal Market was not addressed in the Cecchini and Emerson Reports [Cecchini, 1988; Emerson et al., 1988].

On theoretical grounds, it is debatable whether completing the Internal Market will contribute to a balanced distribution of wealth among EC members [Paqué, Soltwedel et al., 1993]. Convergence rather than widening disparity is anticipated by those who stress the role of the four freedoms in stimulating the intra-EC movement of goods and production factors. Most importantly, it is expected that capital moves to labour-intensive sectors in low-wage regions at the EC periphery if wages and the productivity of capital are inversely correlated [Molle, 1990b, p. 177]. Furthermore, capital imports may help to narrow the technology gap and enable backward countries to catch up with leading countries by a strategy of imitation. Hence, economic growth would be faster in peripheral than in central regions.

⁴³ The 1991-share of the Benelux countries can be decomposed as follows [Deutsche Bundesbank, 1993]: Belgium: 7.4 per cent; Luxembourg: 3.3 per cent; the Netherlands: 6.3 per cent.

⁴⁴ The share of Luxembourg declined from 4.9 per cent in 1984 to 3.3 per cent in 1991.

Another school of thought claims that the existing technology gap perpetuates unbalanced development and leads to greater divergence instead of convergence. This may happen if advanced countries invariably claim "for themselves the high-value new products, leaving to peripheral regions mature productions which sustain only low incomes" [Molle, 1990b, p. 178]. Factor movements may even reinforce this tendency, e.g. by advanced countries drawing on qualified labour not finding adequate employment in peripheral regions.

The theoretical debate reveals that our understanding of the relative importance of and the interaction between factor endowments and prices, imperfect competition, economies of scale and transaction costs has remained seriously deficient [Winters, 1992, pp. 16 f.]. It can be shown that variations in the importance of these factors can lead industries variously to concentrate in either richer locations, or poorer ones, or not to concentrate at all [Krugman, Venables, 1990].

Although there is some support for the convergence hypothesis, recent empirical evidence remains inconclusive as well.⁴⁵ According to simulation exercises [Gasiorek et al., 1992], the expected output effects are relatively large for Greece, Ireland, Portugal and Spain. The highest welfare gains resulting from EC 1993 are predicted for "economies in which labour is relatively cheap and initial industrial concentration relatively high" [Winters, 1992, p. 23]. This would foster convergence. Similarly, Neven [1990] concludes from analysing labour costs across the EC that there is little unexploited comparative advantage between the northern EC members, but plenty of scope for increased labour-intensive exports from the southern members.

As concerns the critical factor of technology transfers through capital flows, however, the preceding section has revealed an ambiguous picture. A clear pattern of FDI flowing to less advanced EC countries is not to be observed so far. This piece of evidence suggests that there is no determinism with regard to the relation between economic integration and regional disparity. Rather, it indicates that two major conclusions from earlier assessments of the regional effect of EC policies are still valid: (i) such policies tend to have contradictory effects [Molle, Cappellin, 1988], and (ii) "much depends on ... the capacity of regions to adapt" [Molle, 1990a, p. 419].

Arguably, a linkage exists between regionally oriented EC policies and economic adjustment at the regional level in the sense that the former tend to undermine the latter. The incentives for backward regions of the EC to develop

⁴⁵ Historical analyses of the regional development in the EC came to the conclusion that disparity decreased considerably and consistently [for a summary, see Molle, 1990b, pp. 186 ff.]. The national GDP figures converged as manufacturing and services grew faster in the poorer member countries than in the richer ones.

their economies by efficiently using domestic and imported resources may be weakened if adjustment needs are camouflaged by an easy access to intra-EC transfers from official sources. In this respect, it is important to note that the Treaty of Maastricht has strengthened the tendency to achieve economic and social cohesion by Community decrees rather than by economic adjustment at the national level [Schmieding, 1992]:

- The treaty stresses the need for “financial solidarity” of the advanced EC members. The poorer countries at the EC periphery have been granted further payments under the label of a “cohesion fund”.
- Moreover, the Social Charter of 1989 shall be complemented by a set of common minimum standards with regard to working conditions and, possibly, also social security provisions [for details, see Paqué, Soltwedel et al., 1993].

Eventually, the set of regional and social policies envisaged by the Treaty of Maastricht may result in a vicious circle of widening economic disparity among EC countries and of mounting needs for financial compensation [see also Flassbeck, 1992]. The reduction of differences among the national social regulations is held necessary to equalize competitive conditions among member countries. However, the attempt to avoid “unfair” competition in the form of “social dumping” triggers serious boomerang effects. The mandated social benefits raise labour costs at the EC periphery, especially for less productive workers. The option of parity changes being no longer available under EMU conditions, the likely consequences are: higher unemployment, less economic growth and reduced capital inflows. The chances of poorer EC countries to catch up with the richer ones are eroded, which will make the former to ask for more official financial support from the latter. Ever increasing financial support would, in turn, further undermine wage discipline.

To summarize, policy induced wage rigidity at the EC periphery would not only pervert the stated aim of regional and social policies, i.e. to reduce disparity among EC countries. Furthermore, it “could really blow up social cohesion by ruining the willingness to pay of the taxpayers in the net-payer countries” [Paqué, Soltwedel et al., 1993, p. 39].

III. Remaining Trade Barriers

The external trade policy of the EC can still be characterized by instability, discrimination, lacking transparency and conceptual deficiencies.⁴⁶ Differences in protection levels among individual EC member countries remained sizeable until the early 1990s, since national governments handled important non-tariff trade barriers (NTBs). In many cases, the EC Commission's authorization to restrict intra-EC trade according to Art. 115 of the EEC Treaty frustrated attempts to circumvent national barriers by "indirect" imports via less restrictive EC member countries (Table 14).⁴⁷ The decline of Art. 115 authorizations 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.⁴⁸

Table 14 — Number of Authorizations to Restrict Intra-EC Trade under Article 115 of the EEC Treaty, 1980–1992

	1980	1985	1988	1989	1990	1991	1992
Total	222	176	128	119	79	48	8
of which:							
Textiles	164	119	76	78	48	32	na
Agriculture	5	12	7	5	4	na	na
Electronics	na	na	13	15	11	na	na
Vehicles, motor-cycles	na	na	10	6	6	na	na
Leather, footwear	na	na	5	6	3	na	na

Source: GATT [1991, Vol. I, p. 54; 1993, Vol. A, p. 20].

⁴⁶ For an earlier and more detailed assessment, that is focused on EC protectionism against DCs, see Hiemenz et al. [1990].

⁴⁷ In the late 1980s, about 70 per cent of Art. 115 authorizations were directed against exports of East Asian countries; for details, see Spinanger [1989].

⁴⁸ Davenport [1990, p. 191] argued, however, that the declining relevance of Art. 115 "may partly be the result of third countries realising that deflection will be frustrated, particularly since Member States may now apply to the Commission for 'surveillance'. This means that import licences must be obtained for each shipment". Furthermore, national EC governments may continue to restrict intra-EC trade even under Internal Market conditions. In the Treaty of Maastricht, Art. 115 of the EEC Treaty was not eliminated, but slightly modified only [NWB, 1992, pp. 77 and 137]. Furthermore, a GATT draft proposal for textiles trade would enable a customs union to apply restrictive measures not only for the entire area but under specific circumstances also for parts of it.

Recourse to Art. 115 has further declined recently [GATT, 1993, Vol. A, p. 20]. New authorizations were reduced to 48 and 8 in 1991 and 1992 respectively; and in spite of pressure from some member states, no authorization was given in 1993. Many long-standing "residual" national trade restrictions have been removed [ibid., p. vii]. Therefore, the subsequent review 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 (see also Sections C.II–III). By contrast, protectionist measures against non-European competitors are basically unchanged.

I. EC Trade Policies towards European Neighbours

The EC is an extremely important export market for both EFTA countries and the post-socialist countries in Europe (Table 15). While EC exports to EFTA and Central and Eastern Europe account for a relatively small and stagnant share of total EC exports, the exports of neighbouring non-members rely to a large and increasing degree on open EC markets. The importance of the EC for Central and Eastern Europe has further increased with the recent collapse of CMEA trade. This pattern of trade of the EC with EFTA countries and post-socialist countries is not surprising because economic distance (geographical distance plus language barriers) is small and therefore does not impose high transaction costs upon trade and capital flows within total Europe. Furthermore, the absorptive capacity of the Community is so large relative to the size of the domestic markets of EFTA and Central and Eastern Europe that there is no alternative to trade with the EC. Gravity models unanimously confirm economic size and distance to be the most important determinants of the direction of world trade in general and of intra-European trade in particular.

Export dependence is particularly strong for EFTA countries. Trade figures suggest that EFTA exports received a relatively liberal treatment on EC markets. Exports to the EC increased by 121 per cent in 1985–1991, which was only slightly below the growth of intra-EC trade (139 per cent) [GATT, 1992; UN, a].⁴⁹ This favourable development can be attributed to long-standing special trading arrangements (see Section C.II).

⁴⁹ In marked contrast extra-EFTA exports to non-EC partner countries rose by only 54 per cent in 1985–1991, which was below the growth of world trade.

Table 15 — Trade Relations of the EC with EFTA and Central and Eastern Europe^a, 1985 and 1991

	1985		1991	
	US\$ bn.	Per cent of total exports of exporting region	US\$ bn.	Per cent of total exports of exporting region
EC imports from:				
EFTA	58.2	53.1	128.6	59.4
Central and Eastern Europe	29.8	19.1	30.7	33.7
EC exports to:				
EFTA	64.3	9.9	132.8	9.7
Central and Eastern Europe	17.9	2.8	39.0	2.8
<i>Memo item:</i>				
Intra-EC trade	351.9	54.3	839.7	61.4

^aUSSR included.

Source: GATT [1992]; UN [a, February 1993; May 1993].

However, European markets continue to be fragmented despite the fact that EC-EFTA trade in manufactures is freed from tariffs and quantitative restrictions.⁵⁰ Various obstacles to market integration via trade persist [for details, see 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.⁵¹ The EES is not a customs union, which is also responsible for the persistent struggle on rules of origin. Only since 1989, the EC has agreed that inputs provided by *all* EFTA and EC countries can be accumulated to meet the rules-of-origin requirements. Originally, the rules had been applied on a strictly bilateral basis between the specific EFTA member and the EC.

⁵⁰ Abrams et al. [1990, pp. 21 ff.] provide evidence on the large price differences for many commodities between different markets.

⁵¹ In 1988, it was agreed to replace all customs documents used in EC-EFTA trade by the single document required for intra-EC trade. The computerization of customs procedures by 1992 was expected to minimize the relative cost disadvantage of EFTA exporters.

- 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. The EC has indicated that anti-dumping rules would be dropped with regard to EFTA only if they were replaced by uniform competition rules.
- As stressed in the White Paper, a strong competition policy requires that "discipline on state aid be rigorously enforced" [Commission of the EC, 1985, para. 158]. In practice, however, EFTA countries complain about the EC for not meeting this requirement. Proposals for an EC-EFTA reporting system on state aid and consultation procedures have been under study since 1988.
- Similarly, progress has been slow to ensure undistorted competition in public procurement. EC legislation on open tenders was bypassed and ignored by national and local purchasing bureaucracies [Cecchini, 1988, pp. 18 ff.]. The Luxembourg Declaration of 1984 listed public procurement as a primary area of EC-EFTA cooperation, but no proposals were made.
- As concerns the replacement of national technical standards by EC standards, EFTA members are in a relatively favourable position as compared with other trading partners of the EC. EFTA participates in the setting of EC standards and already uses them whenever possible.⁵² Furthermore, an EC-EFTA agreement on the mutual recognition of test results and certification was signed in 1988.

EC-EFTA disputes in the field of services may adversely affect merchandise trade in an indirect way. Negotiations on transport issues, for example, on regulating Alpine road transport, proved to be protracted. Financial integration has been impeded by the EC's reciprocity requirements with regard to lifting limitations on foreign ownership and establishment of financial institutions. All in all, however, trading conditions with regard to the EC are quite favourable for EFTA. EFTA members face lower trade barriers than other non-members of the EC due to the tradition of preferential trading arrangements.

Since recently, several post-socialist countries in East Central Europe have come close to the favourable EFTA status (see Section C.III).⁵³ However, the Europe Agreements with the former CSFR, Hungary and Poland [Commission

⁵² EFTA members discount the argument that EC standards are drafted to discriminate against non-members.

⁵³ The subsequent paragraphs draw heavily on Langhammer [1992a], who evaluates the Europe Agreements in considerable detail.

of the EC, 1991] fall short of free trade arrangements.⁵⁴ EC concessions are most generous where a significant supply response of East Central European countries is highly unlikely, for example, for “non-sensitive” manufactured goods the production of which is technology-intensive (for an overview, see Synoptical Table 4). In “sensitive” areas, the concessions boil down to a preferential market access of the post-socialist countries compared with 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 CAP. Quota restrictions are maintained for most agricultural products, though quotas will be enlarged gradually. Furthermore, quota

Synoptical Table 4 — EC Tariff and Quota Dismantling Granted in Europe Agreements

	Date of full duty elimination and mode of reduction	Quantitative restrictions
Non-sensitive industrial goods	March 1992 One step (a few items by 1993)	none
Iron and steel	January 1997 Four steps of 20 per cent, then two steps of 10 per cent	none
Textiles	January 1998 2/7th in 1993, then five steps of 1/7th	Quota increase of about 200 per cent in 1992 over original MFA quota for 1991. Additional outward processing quotas equivalent to 100 per cent of increased quotas for 1992. Full phase-out by January 1998.
Other sensitive industrial goods	January 1997 Five steps of 15 per cent, then 25 per cent; duty-free GSP quotas for about 50 per cent of imports, growing at 20 per cent	none
Agricultural products	Not specified Reductions of tariffs on some non-CAP products, typically up to 50 per cent	Preferential access for CAP products, except cereals, at 50–75 per cent reduced variable levies and tariffs with 8 per cent quota growth; levy reductions phased over three years.

Source: Pohl, Sorsa [1992, p. 95].

⁵⁴ In addition, negotiations on Europe Agreements with Romania and Bulgaria have been concluded recently.

imports are not tax free. The EC offered tax concessions, amounting to 50–75 per cent of the regular levies (except cereals). Restrictive health standards, for example, for potatoes, may further undermine the liberalization of agricultural imports from East Central Europe.

Preferential tax treatment is characteristic for “sensitive” manufactures such as textiles as well. The more relevant NTBs persist, though MFA quotas were increased considerably. The EC is prepared to shorten the transition period of reintegrating textile trade into the GATT framework for the East Central European countries after the MFA’s fate has been decided upon multilaterally in the Uruguay Round. However, the EC insists on specific safeguard provisions, thereby contributing to the uncertainty of exporters, and on quotas with regard to offshore processing to stem a surge in labour-intensive textile imports.

The restrictions on imports of coal, iron and steel are even more subtle. Tariffs on and quantitative limitations of coal imports will be abolished, though with some delay in Germany and Spain. However, the agreements contain competition rules, for example, on cartelization and state aid, which effectively bind the EC’s trading partners in East Central Europe, but do not apply to the practices of EC members. For example, the partner countries had to agree not to quarrel over subsidized supplies of national coal to the energy and steel sectors in Germany. By contrast, they face the threat of countervailing actions if state aid for their coal and steel producers causes injury to EC producers.

In summary, trade diversion will dominate in the short run. But the overall liberalization 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.

2. 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 Internal Market programme, 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, Vol. I, p. 20]. 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 (see also Section B.III and Figure 1). Apart from the aforementioned privileges 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 Generalized System of Preferences (GSP), and has established a network of special arrangements with Mediterranean countries [Sideri, 1990]. Even before the Europe Agreements, about 60 per cent of external EC imports originated from countries participating in some form of preferential trade scheme [GATT, 1991, Vol. I, p. 7]. Taking further into account that trade is closely managed with a host of discriminatory export restraints (e.g. Japan, Taiwan) or is largely agricultural and thus subject to the variable levies of the CAP (e.g. Australia, New Zealand), MFN treatment by the EC is effectively restricted to the United States and Canada [Davenport, 1990, p. 183].⁵⁵

The complex hierarchy of preferential arrangements is going to outlive the Internal Market programme, and 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.⁵⁶ 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, p. 38]. The benefits in terms of stimulating the beneficiaries' export and income growth have remained modest at best.⁵⁷ At the same time the restricted product coverage of privileges hampered the diversification of exports,⁵⁸ and strict rules of origin interfered with an efficient division of labour at an international scale.⁵⁹ Preferences were biased against the most competitive suppliers. The schemes suffered from a serious lack of transparency, and the ensuing uncertainty added to the reluctance of Third World producers to invest [Langhammer, Sapir, 1987]. The cost-benefit analysis of

⁵⁵ Sideri [1990, p. 29] estimated that only 25 per cent of the EC's total trade was conducted on a MFN basis, compared with almost 90 per cent of US trade.

⁵⁶ For an overview, see e.g. Hiemenz et al. [1990, pp. 337 ff., pp. 359 ff.]; Langhammer, Sapir [1987]; Sideri [1990].

⁵⁷ This is not surprising. Preferences are largely confined to tariff concessions, whereas the more important NTBs remain in place. Furthermore, the eligibility to the EC's GSP scheme is limited by a complex set of country-specific quotas.

⁵⁸ In evaluating the EC's GSP scheme, Brown [1988/89, p. 757] concluded: "The products of greatest immediate interest to the less developed countries have not been the object of significant reductions in tariffs or nontariff barriers".

⁵⁹ In negotiating the Lomé IV Convention, for example, the EC insisted on a maximum outside content for manufactured ACP goods of 40–50 per cent.

preference schemes will further deteriorate to the extent that multilateral negotiations result in general trade liberalization, and preference margins are narrowed in this way.

The *second constant feature* of EC trade policy relates to the traditionally large differences in protection levels across sectors and industries [Weiss et al., 1988]. For a wide range of industrial raw materials, fuels and manufactures, moderate tariffs are the main factor affecting access to the EC market.⁶⁰ In sharp contrast, a hard core of product areas has remained highly protected by an outstandingly complex trade regime [for details, see GATT, 1991, Vol. I; Hiemenz et al., 1990].⁶¹

The bulk of agricultural commodities produced and consumed in the EC continues to be insulated from the world market through a restrictive system of variable levies (for a discussion of recent developments concerning the CAP, see Section D.I). Commodities outside this system face substantial tariffs, including specific tariffs (e.g. wine and spirits) as well as seasonal and alternate tariffs (e.g. fruits and vegetables). Furthermore, countervailing charges are imposed if exporters of wine, some fruits and vegetables, and some fishery products do not comply with established reference prices.

The textile and clothing industries were protected by 19 bilateral restraint agreements under MFA IV,⁶² which covered nearly half of external EC textile imports in 1988.⁶³ The technical complexity of the EC's MFA system renders it extremely difficult for exporters to fully utilize the product and country-specific annual quotas.

Coal and steel are regulated in a separate legal framework. The ECSC Treaty allows for considerable government intervention and state aid until its expiration in 2002.⁶⁴ Apart from internal support measures, "voluntary" export restraint arrangements and autolimitations of major exporters had traditionally

⁶⁰ In 1988, the average tariff rate for all non-agricultural products amounted to 7.3 per cent [GATT, 1991, Vol. I, p. 10].

⁶¹ The following paragraphs do not take into account the distortions in competition on EC markets that are due to subsidies granted to technology-intensive sectors, state-aided cartels, etc. The motivation to support the development of new technologies and industrial independence, e.g. in microelectronics and the aircraft industry, is discussed in Section D.I.

⁶² By 1987 the EC had quantitative restrictions on more than 5000 individual MFA categories on a country-by-country basis. The subsequent reduction in the number of quotas during MFA IV exaggerates the liberalization effect since product categories were combined and redundant categories were dropped [Spinanger, 1991].

⁶³ Imports from Mediterranean countries, partly under self-restraints, accounted for an additional 22 per cent. Furthermore, EC member countries had imposed several autonomous restrictions against centrally planned economies.

⁶⁴ In 1988, production quotas were replaced by a system of surveillance.

been manifest in the iron and steel sector. The share of steel imports under restraint arrangements dropped to 19 per cent in 1989 (1980: 68 per cent) due to the gradual reduction in country and product coverage since 1985. Restraint arrangements with South Korea and Venezuela were terminated in 1990. However, with stronger import competition, a dramatic decline in domestic demand and deteriorating export markets, "the Communities' resolve to defend these achievements is under challenge" [GATT, 1993, Vol. A, p. xvi]. Import surveillance remains in force. Some imports from Central European countries and Egypt have recently been made subject to anti-dumping duties or price undertakings, as were imports from Mexico, Turkey and the former Yugoslavia before.

Until recently, nationally administered protectionist measures dominated in the automobile industry. Most of them were targeted against Japan.⁶⁵ The substantially different policy stance among national governments in the EC triggered parallel interventions in intra-EC trade of imported automobiles. Indirect imports, flowing from less restrictive (e.g. Germany) to more restrictive EC countries (e.g. Italy, Spain), were contained on the basis of Art. 115 of the EEC Treaty. Direct investment in the EC by Japanese car producers provided a possible way to circumvent the quantitative export restraints. However, high local content requirements had to be met (reportedly up to 80 per cent in the case of investments in the UK) in order to escape the national quota regimes for Japanese made cars [GATT, 1991, Vol. I, p. 219].

The recent "voluntary" export restraint (VER) arrangement on automobiles, which the EC concluded with Japan in 1991, provides an indication of the effect on the average level of protection, when national quantitative restrictions are replaced by a common trade policy under Internal Market conditions (for a detailed analysis, see Section E.III).⁶⁶ Japan agreed to restrict its automobile exports to the EC to 1.23 million units until 1999 (about 8 per cent of the estimated total market volume) [Siebert, 1992, p. 5]. This export figure, which largely resembles the annual exports in the late 1980s [GATT, 1991, Vol. I, p. 218], was further reduced after protracted negotiations of the EC with Japan in mid-1993. Furthermore, EC markets will remain segmented since some EC

⁶⁵ For example, Italy accepted only 2500 direct car imports annually from Japan in the late 1980s. The respective number for Spain was 1000. In France, the market share of Japan was limited to about 3 per cent.

⁶⁶ Winters [1992, p. 34] provides another example by referring to the replacement of French and Italian restrictions by EC-wide restraints on footwear imports from South Korea and Taiwan in 1990. The latter were not more restrictive than their predecessors, but redistributed the costs of protection at the expense of formerly more liberal EC countries. The common trade policy with regard to automobile imports will be of increasing relevance for some newly industrializing countries (for details, see Section G.III).

countries insisted on a maximum share of Japanese cars in total new registrations in the order of 5–8 per cent.⁶⁷ For formerly less restrictive EC members such as Germany, the agreement may result in a considerably reduced supply and in higher prices of imported Japanese cars.

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, EC surveillance and anti-dumping procedures [Hiemenz et al., 1990, pp. 311 ff.]. Not surprisingly, export restraints and similar measures were concentrated on "sensitive" sectors (Table 16). Some 50

Table 16 — Export Restraint Arrangements^a Affecting Imports into the EC and Individual Member States (situation as of end-1992)

Sector	Exporting country affected ^b
Agriculture	
Sheep and goat meat	All suppliers
Dessert apples	Argentina, Australia, Chile, New Zealand, South Africa
Frozen squid	South Korea
Footwear ^c	China, South Korea, Taiwan
Textiles (outside MFA) ^d	Bulgaria, Cyprus, Egypt, Estonia, Japan, Latvia, Lithuania, Malta, Morocco, Tunisia, Turkey
Steel and steel products ^c	South Korea ^e
Machinery	Japan (6)
Electrical and electronic household equipment	Japan (3), South Korea (3), Singapore
Road motor vehicles	Japan (2)
Other products	Japan (2), South Korea (2)

^aIncludes voluntary restraints, surveillance, industry-to-industry arrangements, price and export monitoring, consultation mechanisms, and similar measures. — ^bNumber of export restraint arrangements in parentheses if more than one; a number larger than one is due to specific arrangements for different segments of the industry or with several individual EC members. — ^cAll third country imports are under retrospective EC surveillance. — ^dIn addition, exchange of letters with 10 Latin American countries. — ^eExport recommendation.

Source: GATT [1993, Vol. B, pp. 6–8].

⁶⁷ Persistent market segmentation is to be expected for domestically produced cars as well. This is because of highly different sales taxes for automobiles among EC countries and the retention of the principle to tax cars according to the rules of the country of destination.

bilateral restraint arrangements were known to be in place by mid-1990, involving the EC, individual member countries or their industries. Apart from the "consensus" on motor vehicles with Japan, the EC has apparently not concluded any new bilateral restraint arrangement until 1993 [GATT, 1993, Vol. A, p. xi]. Formerly concluded arrangements have expired recently. However, in the context of association or cooperation agreements, the EC and its Mediterranean partners have continued export moderation and monitoring arrangements on certain sensitive textile and clothing products. Monitoring arrangements have also been negotiated in the Europe Agreements with East Central European countries, for instance for steel products.

Traditionally, Japan, Asian NIEs, and centrally planned economies were the principal targets of export restraints. The EC's anti-dumping actions (Table 17) were directed predominantly against the same countries.⁶⁸ Since the late 1980s, the focus has shifted from price undertakings to definitive anti-dumping duties. Important features of the regional distribution of anti-dumping cases initiated during the 1980s may be summarized as follows [Weidemann, 1990, p. 33]:⁶⁹

- Japan: 8 per cent (1.1);
- Argentina, Brazil, Mexico, Venezuela: 7 per cent (1.5);
- Hong Kong, Singapore, South Korea, Taiwan: 8 per cent (2.0);
- centrally planned economies: 41 per cent (4.5);
- Yugoslavia: 7 per cent (6.3).

Though of declining importance during the preparations for the Internal Market, a considerable number of unilateral quotas continued to be applied by some EC member countries until the early 1990s. By mid-1990, quantitative restrictions or import prohibitions were imposed on more than 120 non-textile categories (at a four digit level), mostly by France and Italy [GATT, 1991, Vol.

⁶⁸ For an earlier detailed assessment of EC anti-dumping regulations, see Messerlin [1989]. Messerlin calculated an average duty burden of 23 per cent resulting from anti-dumping tariffs, and a quantitative reduction in imports of 40 per cent. Since 1987, it has also been possible to impose anti-dumping measures on products assembled in the EC if imports of those products are already subject to such measures and the proportion of parts supplied by the country concerned is at least 60 per cent of the total component value ("screwdriver-plant legislation") [Koopmann, Scharrer, 1989, pp. 211 f.]. Until mid-1990, 32 assembly operations were subject to investigations under these provisions.

⁶⁹ The first figure refers to the number of cases in per cent of total cases. The figure in parentheses indicates the share of anti-dumping cases relative to the respective countries' share in total EC imports (ranking according to this relative share; for all other countries, the relative share is below 1.0).

Table 17 — Anti-Dumping Actions by the EC, 1980–1992 (number of cases)^a

	1980–1981	1982–1983	1984–1985	1986–1987	1988–1989	1990–1992 ^b
Initiations	72	91	85	63	67	76
Measures taken	69	89	44	45	33	60
of which:						
definitive duties	17	27	13	12	28	47
price undertakings	52	62	31	33	5	13

^aIn the period 1980–1989, nearly half of the measures related to chemicals and allied products, followed by mechanical machinery (13 per cent), textiles (9 per cent), iron and steel (9 per cent) and consumer electronics (6 per cent). — ^bUntil June 1992.

Source: GATT [1991, Vol. I, p. 114; 1993; Vol. B, p. 9].

I, p. 96].⁷⁰ Most of them affected supplies from Japan and Asian NIEs. Only recently, the picture has changed significantly. As of October 1992, the number of restrictions was reduced from 71 to 30 cases and from 48 to 19 cases for France and Italy respectively [GATT, 1993, Vol. A, p. 56].

The EC clearly preferred the above mentioned discriminatory instruments to safeguard provisions according to Art. XIX of the GATT, after the EC had failed in its attempt to agree on a selective use of the safeguard clause during earlier GATT negotiations [Koopmann, Scharrer, 1989, p. 210].⁷¹ Only two Art. XIX actions of the EC, i.e. minimum prices for fruit imports, were in force in December 1992 [GATT, 1993, Vol. A, p. 58].

To summarize, any empirical assessment of the protectionist effects of NTBs is seriously flawed as long as it has to be based on the afore mentioned frequency distributions of trade interventions. This inventory approach cannot capture the price and quantity effects of NTBs. Notwithstanding its limited informative value, 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.

⁷⁰ National quotas by Portugal and Spain, for which the Act of Accession to the EC provided the legal basis, are excluded.

⁷¹ The preference is also because Art. XIX requires an increase in import restrictions in a particular sector to be compensated with liberalization elsewhere in the economy.

E. Implications of EC Integration on Other Industrialized Countries

I. Effects of EC 1993 on EFTA Countries

The direction of trade of EFTA countries is seen as widely independent of the type of institutional affiliation with the EC and the EC integration process itself, since there is no alternative to the EC as the most important trading partner. Yet, what is influenced by institutional arrangements is the openness of the regions approximately measured by their export/GNP ratio [Pohl, Sorsa, 1992, p. 89] as well as their overall welfare. EFTA includes countries with income levels similar to the EC member countries, similar factor endowments and similar levels of trade barriers. EC exports to EFTA and EC imports from EFTA concentrate on manufactures with the exception of Norway, which basically exports fuels and fuel products to the EC (Table 18). Intra-industry specialization (in particular with EC member countries) dominates inter-industry specialization and has grown overproportionately [Balassa, Bauwens, 1988; Greenaway, Hine, 1990/91, p. 614].

Effects on EFTA countries are discussed in the institutional framework of the EES (see Section C.II). The following mechanisms can be identified: *First*, there is a pure comparative advantage effect under perfect competition and constant returns to scale. The EFTA countries are expected to incur a welfare loss because they continue to face trade costs. Even under EES conditions, border controls between the EFTA and the EC will not be abolished. EFTA terms of trade will deteriorate because the elimination of intra-EC border controls will divert some trade away from EFTA products, and EFTA countries will have to lower their export prices through cutting real wages. This trade effect will be small, because standard trade effects of the Internal Market programme are estimated to be negligible (Table 8). To the extent that intra-industry trade mostly occurs under imperfect competition the following effects are more important for the EC-EFTA economic relations.

Second, similar to EC producers, EFTA companies operating in oligopolistic markets stand to gain from economic integration in the EES. These gains will, however, be smaller than those enjoyed by EC companies because EFTA suppliers will face a number of trade barriers. Finally, EFTA companies will gain a competitive advantage alongside with EC companies in third-country markets because their marginal costs will decrease.

Table 18 — Sectoral Structure of EC Trade with EFTA Countries, 1991 (in per cent of total trade)^a

		Partner countries					
		Austria	Finland	Norway	Sweden	Switzerland	Total EFTA
Food	X	3.5	4.0	4.6	4.9	4.0	4.1
	M	0.2	0.9	6.9	1.2	2.1	3.2
Beverages, tobacco	X	0.4	1.0	0.7	0.9	1.5	1.0
	M	0.3	0	0	0	0.1	0.1
Crude materials	X	2.9	4.6	2.2	3.0	2.2	2.7
	M	5.1	13.9	4.1	11.2	1.5	6.0
Fuel products	X	1.6	3.3	2.9	4.1	5.0	3.7
	M	1.3	2.0	51.2	4.1	1.3	9.8
Oils, fats, waxes	X	0.1	0	0.1	0.2	0.1	0.1
	M	0	0	0.1	0.1	0	0.1
Chemicals	X	9.9	13.8	9.2	10.8	12.5	11.2
	M	7.9	5.3	5.0	7.8	20.3	11.0
Manufactured goods classified by material	X	20.1	15.5	22.8	17.2	17.0	18.2
	M	30.3	53.7	17.8	30.6	15.4	25.8
Machinery, transport equipment	X	40.8	39.5	31.7	38.0	31.0	35.6
	M	37.1	18.7	7.4	36.8	28.3	27.6
Miscellaneous manu- factured articles	X	18.6	14.4	17.2	16.5	21.5	18.8
	M	13.9	4.3	2.2	6.0	17.6	10.4

^aX=EC exports to EFTA countries; M=EC imports from EFTA countries. The sum of shares does not add up to 100 due to traded goods not classified elsewhere (SITC 9).

Source: Statistical Office of the European Communities [d].

These arguments suggest that the positive effects of the EES for EFTA companies are similar to those of EC 1993 for EC companies. Authors like Krugman [1988] concluded, therefore, that EFTA countries could not afford not to participate in an EES. EFTA countries would need the facilitated access to the much larger EC markets in order to reap the potential gains from scale economies and increased competition [Norman, 1989]. Industry-specific analyses for individual EFTA countries [ibid; for Norway and Sweden] strongly supported this view for oligopolistically structured industries like automobiles and electrical machinery. Other studies [Abrams et al., 1990; Gardener, Teppett, 1992; Pintado et al., 1988] have focused on service industries such as telecommunication, transport, energy, banking and insurance. They have assessed the implications of an adaptation of the EFTA regulatory framework to EC standards.

The findings of these studies indicate substantial gains from EES membership for EFTA service industries.⁷²

To consolidate these effects in a general equilibrium framework has proven to be difficult. Two approaches were chosen. Either was the EES regarded as a common market between the two groups of countries or it was assumed that the EES would involve integration to the same extent as the Internal Market programme, i.e. full membership. Under the second assumption, Haaland and Norman [1992] not surprisingly estimate much higher income gains for EFTA countries than for the EC, which would only marginally benefit from expanding the Internal Market programme to EFTA countries. EFTA countries are estimated to gain in terms of real income by 3.3 per cent of expenditures on traded goods compared with 1.9 per cent for the EC due to EC 1993 and to only 0.1 per cent for the EC as an additional gain if the EFTA countries were included.

The Haaland-Norman model focuses on industrial restructuring. Within the industrial sector, a shift from physical capital-intensive to more skill-intensive industries is expected for both the EC and EFTA countries, while production of labour-intensive goods will shift from EFTA to the more labour-abundant member states at the EC periphery. More generally, Haaland and Norman expect the production of perfectly competitive sectors, including services, to decline. The treatment of services as a perfectly competitive sector is debatable (D.II.2). Gardener and Teppett [1992, p. 12] estimate — albeit in a partial equilibrium setting — EFTA gains in the consumer surplus in financial sectors of 1.3 per cent of 1986 GDP for the EES scenario compared with only 0.9 per cent for the scenario of bilateral integration between individual EFTA countries and the EC, and to 1.1 per cent for the scenario of EFTA integration alone.

Both the EES and full membership scenarios describe stages of institutional affiliation of EFTA countries to the EC that have not been accomplished by mid-1993. The December 1992 referendum in Switzerland against a Swiss accession to the EES Treaty created new uncertainty regarding the implementation of the EES for the remaining EFTA countries (in particular, on the terms of burden sharing). Given past experiences with the negotiations on the second enlargement of the EC, the negotiations on full membership of Austria, Sweden and Finland, which were opened in early 1993, were expected to be time-

⁷² The agricultural sector is a case *sui generis* as there is not yet free trade between EFTA and the EC as in manufactured products. Brink [1991] concludes that the integration of EFTA countries into the CAP would require the smallest adjustment burden in Sweden and Austria and a much higher adjustment burden in Norway and Switzerland closely followed by Finland. For the EC, Switzerland and Norway as net importers would be more preferred partner countries than Austria, Finland and Sweden, which either export to the EC or compete with EC suppliers on third markets. Under given conditions of administratively fixed prices, these three countries could make the problem of excess production in the EC more serious.

consuming. In such a stage of transition and with the Internal Market programme by and large operating already, one of the immediate responses of EFTA companies to the changing institutional environment could be to intensify direct investment in the EC. This would mean to enjoy the same conditions of production as their EC competitors. To what extent an investment inflow from EFTA countries into the EC has already materialized can be shown by changes in FDI inflows in three major EC member countries, i.e. West Germany, France and the UK, during 1984 and 1991.

In fact, stock data for EFTA investment in West Germany yield more than a doubling of investment between 1984 and 1991. Yet, as total foreign investment in Germany increased by similar rates of growth, the EFTA share in foreign investment remained fairly stable except for the last year in which EFTA investment rose overproportionately (Table 19). Expectedly, flow data for France and the UK show much larger year-to-year variations, but again investment grew rapidly in absolute terms as did total foreign investment. Sweden and Switzerland were by far the largest EFTA investors. In 1991, the Swedish car industry (Volvo) strongly invested in France in a pre-stage of a merger with Renault which finally did not materialize. The rapid increase of EFTA investment may support the hypothesis that the EC became more attractive as a host relative to other hosts.

II. The Central and Eastern European Countries: Widening of Integration and Economic Transformation

During the entire post-war period the Central and Eastern European countries were isolated and delinked from their traditional trading partners in Western Europe. This happened through supply-side measures, i.e. the enforced trade and factor integration in the framework of the CMEA, as well as through demand-side measures, such as binding quantitative restrictions of Western Europe against allegedly dumped imports from Central and Eastern Europe or export restrictions such as the COCOM list. EC 1993 had no direct effect upon Central and Eastern European countries. They were fully integrated into the centrally planned division of labour and, thus, could neither benefit from an EC income-induced demand surge for their products nor lose markets in the EC due to trade diversion because their market shares were very small. As internal prices and exchange rates were widely distorted, the Central and Eastern European planners under the old system would have tried to countervail the price ef-

Table 19 — EFTA Countries' Foreign Direct Investment in Germany, France and the UK, 1984–1991

	1984	1985	1986	1987	1988	1989	1990	1991
Germany ^a	stocks at year-end in million DM							
Finland	225	265	376	517	662	592	1091	1340
Norway	188	266	276	302	281	359	502	682
Austria	1202	1139	1239	1372	1522	1985	2725	3781
Sweden	1786	1904	1929	2326	2435	2838	7863	7973
Switzerland	12159	12712	13808	15440	16241	17824	26223	26191
EFTA	15560	16286	17628	19957	21141	23598	38404	39967
In per cent of total FDI in Germany	18.4	17.9	18.4	19.5	19.3	18.6	21.5	20.4
France	net inflows in million FF							
Finland	56	138	40	na	na	na	na	na
Norway	18	59	397	488	172	431	498	270
Austria	47	13	39	69	-11	16	293	104
Sweden	664	214	542	807	1666	2165	2788	14224
Switzerland	2344	1773	1842	3032	2915	4057	2297	2759
EFTA	3129	2197	2860	4396	4742 ^b	6669 ^b	5876 ^b	17357 ^b
In per cent of total FDI in France	16.2	11.0	14.9	15.8 ^b	11.1 ^b	10.9 ^b	11.9 ^b	27.2 ^b
UK	net inflows in million £							
Finland	15	-7	-17	8	26	56	29	na
Norway	34	30	67	141	218	-53	178	na
Austria	1	4	2	1	8	—	—	na
Sweden	40	111	130	349	284	185	1718	na
Switzerland	196	409	906	-222	1802	2363	178	na
EFTA	286	547	1078	278	2340	2551 ^c	2103 ^c	na
In per cent of total FDI in the UK	— ^d	12.4	19.1	3.1	20.2	14.7	12.2	na

^aPre-1989 and post-1989 data are not strictly compatible because of slightly different compilation methods. — ^bExcluding Finland. — ^cExcluding Austria. — ^dNet disinvestment (-) for total net investment in the UK in 1984.

Source: Banque de France [various issues]; UK [1991; 1992]; Deutsche Bundesbank [1993].

fects stemming from EC 1993 by subsidizing their capital goods exports. In the medium run, however, they might have incurred somewhat larger terms of trade losses because of the resource-saving technological progress. Such progress supported by stricter environmental regulations within the Single Market would have forced them either to lower prices of commodities in order to mitigate these effects or to subsidize other exports. On the import side, they might have even gained from intensified competition on world markets for capital goods caused by the second-round effects of EC 1993.

With the beginning of economic transformation following the collapse, this picture changed fundamentally:

- Trade policy-induced price distortions for tradables were reduced rapidly when Western and Eastern Europe began to cut tariffs on the basis of bilateral trade and co-operation agreements.
- Both sides, in particular the EC, also began to dismantle quantitative restrictions. As with tariffs, this shift will bring domestic prices in Central and Eastern Europe closer to world market prices.
- Public loans and grants have increasingly been channelled from the EC into Central and Eastern Europe to support the transformation process externally.
- Technical assistance has been granted for a wide range of issues in order to help Central and Eastern European countries to build up a legal and institutional framework that could facilitate full membership in future.

The traditional links to the EC reemerged rapidly. In 1991, Hungarian exports to the EC, for instance, accounted for already 50 per cent of total Hungarian exports compared with only 20 per cent for exports to Central and Eastern Europe [KOPINT-DATORG, 1992, p. 119]. The geographical shift in Polish and CSFR exports is similar. Gravity models suggest even higher "normal" EC shares in Central and Eastern European trade of 74 per cent for Western Europe in total [Havrylyshyn, Pritchett, 1991; for some lower estimates see Wang, Winters, 1992].

The policy measures are not an integral part of EC 1993 but they are instrumental to let Central and Eastern Europe participate in its effects. Yet, before discussing such likely effects, a qualification is needed. Unlike in EFTA or other third countries, the effects of EC 1993 on Central and Eastern Europe are crucially dependent on getting supply conditions in the partner countries right, i.e. achieving a success in economic transformation. In this respect, Central and Eastern European countries are in a similar situation as the African EC associates with their structural adjustment programmes. Unless stabilization and transformation succeeds, there will be hardly any positive effect of the Single

Market on Central and Eastern Europe. Given this qualification, the following effects are likely.

First, EC 1993 will intensify the adjustment pressure on labour-intensive industries in the EC. In the short run, the Mediterranean member countries might still be able to attract such industries from EFTA countries and more advanced EC countries. In the medium run, however, EC 1993 will bring an equilibrating effect on wage costs, i.e. a continuing of the upward trend in wage costs at the EC periphery, which materialized already in attractive host countries for FDI such as Spain. Both the "social dimension" of the Single Market and the binding of exchange rates under the EMS will contribute to such a trend. Neighbouring countries in Central and Eastern Europe with much lower wage costs will benefit from the pressure to find new locations for labour-intensive production outside the EC. This has already materialized in the aftermath of the Interim Agreements with the former CSFR, Poland and Hungary in spring 1992, through which first steps were taken to dismantle quantitative restrictions against textiles and clothing goods. Off-shore assembly as a pre-stage of FDI has become very important in the three countries, and MFA quotas can now be better exhausted. As a result, it is likely that the share of the three countries in extra-EC imports of textiles and clothing, which increased from 3.7 per cent in 1988 to 5.2 per cent in 1991, will rise further [Langhammer, 1993, Table A2].

Second, Central and Eastern Europe will enjoy a terms of trade gain as prices of imports of capital goods needed for economic transformation are going to decline relative to the pre-1993 period because of intensified competition on world markets. To what extent Central and Eastern Europe will be able to collect such gains depends on whether EC economic aid to import new equipment is tied.

Third, the removal of border controls on persons within the Community will make migration from Central and Eastern Europe more attractive. This will apply to legalized guest worker contracts for which an option has been opened in the Europe Agreements for individual EC member states. But the migrants' drain will be stronger in informal (and illegal) migration for gaining jobs in activities like construction, harvesting and maid services. Given high unemployment in the process of economic transformation in the home countries, the benefits of sending remittances might outweigh the disadvantages of losing skilled and motivated labour.

Fourth, should the EC enforce stricter common environmental and social standards after 1992 and should Central and Eastern Europe be allowed to follow lower national standards, some relatively pollution-intensive industries could find it attractive to move to Central and Eastern Europe.

To conclude, Central and Eastern Europe is a latecomer in economic relations with the EC because of its isolation from its natural trading partner

Western Europe for more than 40 years. Thus, the region has much to gain from product innovations, process innovations and locational innovations encouraged by the EC Single Market. Because of the profound differences in resource endowment, the Heckscher-Ohlin type of inter-industry specialization will prevail in trade between the two regions. The effects arising from such specialization patterns are assessed to be clearly positive for Central and Eastern Europe provided that the transformation process does not fail. Given the early stage of the transformation process, it is obvious that quantitative assessments of income and trade gains resulting from the Europe Agreements and other trade preferences for Eastern Europe are not yet available.

III. Implications for OECD Countries

1. Implications for the US

Among third countries, the US were among those who have vigilantly expressed their concerns about possible "Fortress Europe" effects [Centre for European Policy Studies, 1992, pp. 358-359]. This concern was based on three aspects of EC-US economic relations: first, on the importance of the EC as the largest US export market (almost 25 per cent of US exports in 1991); second, on the disputes with the EC on multilateral trade policies (Uruguay Round); and third, on the directives of the EC to liberalize trade in the rapidly growing market of business services and service equipment (such as telecommunication and related services). In this sector, the US were internationally leading suppliers but felt discriminated against by some early EC directives on government procurement allegedly favouring EC suppliers and by the monopolies of state-owned companies in many EC member states [Hufbauer, 1990b, p. 19]. In the course of implementing EC 1993, however, the early fears cooled down somewhat, and EC integration began to be viewed as "Opportunity Europe" [ibid, p. 13].

The economic rationale of assuming losses from EC 1993 is similar to that in EC-EFTA relations, except for the fact that EFTA suppliers with their smaller domestic markets are more dependent on EC markets than US suppliers. The division of labour between the US and the EC is determined by strong intra-industry specialization and imperfect competition. Under such conditions, the EC companies are feared to gain a competitive edge over US suppliers. The US suppliers would be forced to lower their prices and, thus, to accept terms of trade losses in order not to lose in market shares. Such effects could materialize

not only on EC markets but also on US markets and on third markets. Among trade effects, the income-induced effect of increased demand for US imports is rated lower than the price-induced effects of static trade diversion and the dynamic effects of process innovations (cost reduction) and product innovations of EC suppliers [Arndt, Willett, 1991, p. 1569].

Beyond trade, there is the issue on foreign direct investment. It is feared in the US that investment diversion occurs towards the EC. US companies would then be forced to follow suit in order to defuse protectionist threats in the EC (*quid pro quo* investment) [Bhagwati, 1989, p. 35] and to be able to participate in EC-sponsored high-tech research consortia. Enhanced profit expectations may also enable EC companies to borrow more on world capital markets thus increasing costs of borrowing for US competitors or the risk of being crowded out [Arndt, Willett, 1991, p. 1569].

More specifically, the US government has raised four controversial issues with respect to EC 1993 [Hufbauer, 1990a, pp. 33–44].⁷³

- There is the question how the US would have to reciprocate in order not to see their companies discriminated against on EC markets.
- The dismantling of national quotas within the EC was expected to affect US automobile exports to the EC from Japanese transplants. Community-wide quotas against direct automobile exports from Japan could trigger a stricter monitoring of US exports in order to keep Japanese transplant cars out of the EC market.
- Ex ante harmonized EC technical standards could be instrumental to deny American companies easy access to the single market. Even the principle of mutual recognition of standards (*ex post* harmonization) within the EC would not be helpful to non-EC parties unless the US standards and norms would be included in this principle.
- Rules of origin and minimum local content requirements could emerge as impenetrable barriers to US companies operating in industries like cars and semi-conductors.

Finally, government procurement in telecommunication has been regarded as an extremely relevant issue because of the closed-market character of this sector in both the EC and the US.

Many of these technical issues were tackled either bilaterally or multilaterally in the Uruguay Round (for instance, in government procurement and standards). Others escape from quantitative assessments because such assessments

⁷³ On a very detailed discussion of these issues and their effect upon core industries like banking and securities, automobiles, telecommunication and semiconductors, see Hufbauer [1990a].

depend on how the US may reciprocate in order to protect their companies against discrimination on EC markets.

Potential trade effects can be addressed by comparing an *ex post* income elasticity of import demand of the EC towards the US between two short periods, that is 1985–1988 as the announcement period and 1988–1990 as the beginning of implementing the Internal Market programme. In the first period, the ratio between the annual average growth rate of EC imports from the US relative to the growth rate of the nominal GNP of the EC was 2.2 compared with 1.8 in the second period. Including the year 1991 in the second period, this ratio even drops to 0.4 as US exports to the EC declined heavily in 1991 while they rose to other areas and in total.⁷⁴ This suggests a decline that cannot be explained by exchange rate movements because the dollar depreciated further. It is also doubtful, however, whether the 1991 drop of US exports can be attributed to the Internal Market programme.

Haaland and Norman [1992] run simulations on the effects of trade cost reductions and market integration not only for the EC and EFTA but also for the US and Japan. As concerns the US, they report very small real income losses of about 0.04 per cent of expenditures on tradables [*ibid.*, p. 13]. Losses are estimated to be somewhat higher in the relatively skill-intensive industries, which account for almost half of US exports to the EC, for example, office machines (loss of 0.2 per cent). This holds because intra-industry specialization, imperfect competition and economies of scale are assumed to be particularly relevant in skill-intensive industries. On the other hand, the US is expected not to lose and even slightly to gain in some labour-intensive industries. No change compared with the pre-1993 situation is expected for non-tradables. Gains and losses do not exceed 0.2 per cent in each direction. This visibly contrasts to the gains that the EC could hope for (1.9 per cent). Losses for the US become marginally larger in the scenario of integrating EFTA and the EC.

With respect to FDI, there is no trend towards a growing attractiveness of the EC as a host for US investors. In 1981–1986, more than 70 per cent of US incremental manufacturing investment abroad went to the EC. This share dropped to 50 per cent during the period 1986–1991, which overall saw much higher growth of total US FDI. This is a clear indication that investment diversion in favour of the EC did not take place. Moreover, it is difficult to reconcile the sectoral pattern of changes in US investment with the Haaland–Norman results for structural change in Europe. These results suggest increasing FDI in skill-intensive industries and decreasing FDI in labour-intensive industries.

⁷⁴ These calculations are based on Statistical Office of the European Communities [d].

Table 20 — Stocks of US Foreign Direct Investment in the EC, 1986–1991^a

	1986	1989	1991
Total	37.9	40.1	41.8
Manufacturing	47.8	47.3	48.8
of which:			
Non-electrical machinery	65.3	56.9	60.0
Electric and electronic equipment	31.6	35.7	36.1
Transport equipment	33.6	40.6	42.5
Banking	38.1	29.6	27.7
Finance except banking	37.5	44.4	44.0
Services	47.1	42.5	54.3

^aPercentage of all US FDI in the respective activity.

Source: US Department of Commerce [various issues].

Table 20 shows, however, the opposite trends for (skill-intensive) non-electrical machinery and (relatively labour-intensive) electric and electronic equipment.

In general, the quantified effects of EC 1993 for the US can be summarized as small with minor losses for oligopolistically structured industries that compete against EC-based counterparts. Service industries are usually excluded from CGE models. This is highly unsatisfactory because a major part of adjustment challenges for US companies will emerge in this sector.

2. Implications for Japan

Contrary to the US, which could not substantiate their initial "Fortress Europe" concerns, Japan has actually suffered from measures specifically taken against its exports (see Section D.III). Such measures concern EC imports of Japanese cars, local content requirements for Japanese transplants and reciprocity requirements.

In July 1991, the EC reached a tacit agreement with Japan on the issue of car quotas. Japanese producers were to limit their share of the EC market to 16.1 per cent until 1999. This would mean an opening of the market from the present 11 per cent market share (including transplants) [EC, 1991]. Japan agreed to "avoid disruption" of European markets and to "monitor" direct car exports in accordance with a "forecast" of 1.23 million exported units per annum until 1999 (under the assumption of total EC demand of 15.1 million units in that year; Table 21). For the time being, Japan also monitors car exports to the five

restricted national markets to ensure that exports to these EC markets do not exceed specific maximum market shares. The agreement is subject to revision as far as annual exports of cars are concerned. In September 1993, for instance, Japan, under the pressure of the EC Commission, agreed to lower exports to a volume below one million units following a substantial decline in car sales in the Community. The EC has announced to remove all internal barriers until 1999. Japan insisted on no ceiling for cars delivered from transplants either located in the EC or elsewhere, but EC assumptions on Japanese transplant sales are included in the ceiling of a 16.1 market share in 1999. Internal inconsistencies in this agreement suggest that EC monitoring of Japanese car imports will not be terminated by the end of this decade. First, the EC projections envisage a decline of Japan's market share by 2.6 percentage points from 1998 to 1999. Reasons for this abrupt change are not given. Second, the internal projections of the EC Commission on market shares in formerly restricted and non-restricted markets in 1998 still show much lower shares of both Japanese direct export sales and transplant sales in France and Italy (the two largest "managed trade" markets) than in the other markets (Table 21). Under such conditions a free internal market after 1999 would probably lead to import surges in the former countries and to a shockwise adjustment pressure upon domestic suppliers. One may express doubts whether the French and Italian governments are prepared to accept such a rapid adjustment at the end of the transition period.

As concerns rules of origin, Japanese companies fear that the EC may introduce restrictive measures severely affecting Japanese investment in the EC. Such fears are empirically well-founded, as the EC has already set some stringent local content rules for Japanese transplants operating in the Community. Examples are Nissan UK in the car industry, which has to meet a 80 per cent local content rule to qualify as a "non-Japanese product", and the so-called screwdriver plants, which allegedly were set up in the EC to circumvent anti-dumping duties imposed on products like photocopiers, electric weighing machines and electric typewriters. For the screwdriver plants, a minimum local content of 40 per cent was fixed to avoid the extension of anti-dumping duties to products assembled in these plants. In 1990, a GATT panel found this legislation inconsistent with relevant GATT provisions [GATT, 1991, Vol. I, p. 117]. Furthermore, in 1989, the EC adopted rules of origin for semi-conductors stipulating that only those microcircuits that were etched within the EC would qualify as "EC originating products". This regulation was said to affect Japanese producers heavily because companies had established only assembly plants for semi-conductors in the EC with the exception of one factory.

Reciprocity requirements primarily relate to the EC's initial version of the Second Banking Directive. This directive includes provisions that foreign in-

Table 21 — The EC Market for Japanese Cars, 1989–1999^a

	1989 actual	1998-hypothesis ^b	1999-forecast ^c
<i>Restricted markets</i>			
France			
Overall market size	2,667,000	2,850,000	2,850,000
of which: Total Japanese sales	(3.0)	317,000 (11.1)	
Japanese imports		162,000 (5.7)	150,000 (5.3)
Japanese transplants		155,000 (5.4)	
Italy			
Overall market size	2,519,000	2,600,000	2,600,000
of which: Total Japanese sales	(2.0)	290,000 (11.1)	
Japanese imports		148,000 (5.7)	138,000 (5.3)
Japanese transplants		142,000 (5.4)	
Spain			
Overall market size	1,376,000	1,475,000	1,475,000
of which: Total Japanese sales	(3.0)	280,000 (19.0)	
Japanese imports		84,000 (5.7)	79,000 (5.4)
Japanese transplants		196,000 (13.3)	
Portugal			
Overall market size	252,000	275,000	275,000
of which: Total Japanese sales	(14.0)	58,000 (21.0)	
Japanese imports		23,000 (8.4)	23,000 (8.4)
Japanese transplants		35,000 (12.7)	
UK			
Overall market size	2,600,000	2,700,000	2,700,000
of which: Total Japanese sales	(11.0)	783,000 (29.0)	
Japanese imports		189,000 (7.0)	190,000 (7.0)
Japanese transplants		594,000 (22.0)	
<i>Total restricted markets</i>			
Overall market size	9,414,000	9,900,000	9,900,000
of which: Total Japanese sales	(5.5)	1,728,000 (17.5)	
Japanese imports		608,000 (6.1)	580,000 (5.9)
Japanese transplants		1,122,000 (11.3)	
<i>Unrestricted markets</i>			
Overall market size	4,531,000	5,200,000	5,200,000
of which: Total Japanese sales	(17.4)	1,092,000 (21.0)	
Japanese imports		714,000 (13.7)	650,000 (12.5)
Japanese transplants		378,000 (7.3)	
<i>Total EC (including eastern Germany)</i>			
Overall market size	13,946,000	15,100,000	15,100,000
of which: Total Japanese sales	(9.4)	2,820,000 (18.7)	2,430,000 (16.1)
Japanese imports	1,237,000	1,320,000 (8.7)	1,230,000 (8.1)
Japanese transplants		1,500,000 (10.0)	1,200,000 ^d

^aNumber of units including light commercial vehicles under 5 tonnes gross vehicle weight. Figures in parenthesis refer to market share in per cent. — ^bInternal European Commission projection, September 1990. —

^cEC/ Japanese forecasts as a basis for monitoring system, July 1991. — ^dEC internal assumption, July 1991. Japan insists on no ceiling.

Source: EC [1991].

vestment in the EC banking sector is only allowed if the home country of the investor provides equal access to EC banks. The response of Japanese banks to EC 1993 is likely to be three-fold [Hirota, 1990; MacKinnon, 1990]. First, branches are transformed into subsidiaries in order to be recognized as true EC banks and to receive a banking licence. Second, Japanese banks want to engage in more partnerships with European banks. Third, Japanese banks will increasingly enter into the most difficult market for non-resident banks, retail banking, in order to exploit a relatively cheap funding source. Credit cards and other consumer related products may serve as gateways for banks that lack a strong customer deposit base. Again, joint ventures with European companies in non-financial services as well as financial services will be expanded to facilitate market access.

As concerns quantitative assessments of EC 1993 for Japan, there are estimates on total exports and imports and on changes in real income derived from general equilibrium world trade models. As far as Japanese trade and the EC 1993 induced changes are concerned, Stoeckel et al. [1990] examine two scenarios. In the first scenario, the Community's macroeconomic policy is conducted in a way that improves the EC's trade balance as a result of higher international competitiveness. In the second scenario, an expansionary macroeconomic policy boosts domestic demand. Under the first scenario, the study estimates a decline of Japanese exports by 8.2 per cent of 1988 exports, a decline of Japanese imports by 4.2 per cent of total imports and of Japan's GDP by 0.6 per cent. Under the second scenario, Japan's losses would be negligible (0.4 per cent in exports, 0.2 per cent in imports, and 0.1 per cent in GDP).

As for the US, Haaland and Norman [1992] have estimated changes in real income for Japan due to the combined effect of trade cost reductions and market integration in the EC. The losses incurred by Japan are slightly larger than the losses incurred by the US. They amount to 0.06 per cent of the expenditures on tradables [ibid., p. 13]. As Shigehara [1991, p. 19] points out, what matters is the direction of industrial reorganization in the EC and the implications for third countries rather than the numerical estimates of overall losses, which are unanimously assessed to be small anyway and partly overlapped by other events.

In this respect, two findings of the Haaland-Norman study are worth mentioning. First, Japanese losses are found to be mainly due to overproportionate losses (-0.6 per cent) in one skill-intensive industry: transport equipment (automobiles). This is just the sector in which EC companies are expected to gain most from market integration (4.5 per cent). Second, except for physical capital-intensive industries, where Japan is found to gain slightly, the only skill-intensive industry for which gains from EC market integration are reported (0.1 per cent) is the computer industry (office machines). The significantly negative

effects on transport equipment result from the assumption of substantial scale economies in European car manufacturing. While this assumption may be subject to debate (see Section D.II), Japanese car producers may indeed be negatively affected by the restrictive access to EC markets, which is not incorporated in the Haaland-Norman model.

Irrespective of the generally marginal implications of EC 1993 on Japanese producers, earlier studies [Engering, 1989; Hirata, 1991] have anticipated an expansion of Japanese FDI in the EC. Table 22 shows that there was in fact a strong response of Japanese investors to anticipated European integration. For all sectors, the EC's share in Japanese investment stocks rose from 13.7 to 19.1 per cent between 1987 and 1991 and to 18.3 per cent in the fiscal year 1992 [Japan Ministry of Finance, a, June 1993]. The increase was stronger in the manufacturing sector, where it started from a lower level than in the non-manufacturing sector. Outstanding changes in individual sectors comprise investment in real estate, in which Japan had almost no stakes prior to 1987, in banking and insurance, where a high initial share of one third could even be expanded, and in a number of manufacturing industries, in which investment shares doubled (textiles, chemicals, machinery).

In spite of the growing importance of the EC as a host of Japanese investment, no more than 21 per cent of new Japanese foreign direct investment during 1987 and 1992 was absorbed by the EC [Japan, Ministry of Finance: Monthly Finance Review]. The US and Canada, which in this period announced the Canadian-US Free Trade Area and later on also NAFTA, still remained a much more attractive host than the EC (48 per cent of Japanese incremental investment). Given this ranking, it is not surprising that for Japan it has not yet been possible to match foreign investors from other OECD countries in spite of its rising interest in the EC. In 1991, Japanese investment still accounted for only 24 per cent of the US investment stock in Germany (compared with 13 per cent in 1984) and for only 7.3 per cent of total FDI in Germany (1984: 5.1 per cent) [Deutsche Bundesbank, 1993, p. 60].

Shares in net direct investment in the most important EC host country of Japan, the UK, are not much different. In 1990, Japanese investment flows to the UK were 34 per cent of US investment figures and only 10 per cent of total net FDI in the UK [UK, 1992, p. 96]. Finally, also in the Netherlands, the second largest host of Japanese investors in the EC, they accounted for only 16 per cent of US investment in 1990 (3.8 per cent of total FDI in the Netherlands) [Nederlandsche Bank, 1992, pp. 64-65].

To conclude, starting as a latecomer in investment in the EC, Japan has positively responded to the incentives and options of the Single Market. While estimates on the effects of EC 1993 on Japan's income unanimously end up

Table 22 — Share of the EC in Notified Japanese Foreign Direct Investment, 1987 and 1991 (per cent)

	Stocks end March 1987	Stocks end March 1991
Manufacturing		
Food	7.6	12.7
Textiles	9.8	21.6
Lumber, pulp	0.2	0.7
Chemicals	5.2	12.9
Iron and non-ferrous metals	4.8	5.8
Machinery	10.7	22.6
Electric appliances	11.1	21.2
Transport equipment	11.9	17.5
Others	15.9	10.9
Total manufacturing	8.7	15.4
Non-manufacturing		
Agriculture, forestry	0.1	1.2
Fishery	0.4	2.8
Mining	7.2	9.4
Construction	5.3	4.9
Commerce	19.8	21.4
Banking, insurance	33.0	38.5
Services	5.0	9.4
Transport	0.5	1.3
Real estate	2.2	14.4
Others	16.8	14.0
Total non-manufacturing	15.3	20.0
Grand total	13.7	19.1

Source: Japan Ministry of Finance [b].

with very small losses, Japanese companies seemingly anticipated more disadvantages if they continued to focus on direct exports rather than investing in the EC. Such anticipation cannot only be derived from the Single Market but more generally from long-standing tensions between the Community and Japan on equilibrating the bilateral trade balance. Thus, Japanese companies have increasingly discovered the EC market as a host of FDI, first in the UK but later on also on the continent, in order to counter restrictive rules of origin, to defuse protectionist threats of Community-wide quotas, and to benefit from the same

standards and norms as domestic suppliers. In doing so, they will also enjoy side benefits of penetrating more easily the Central and Eastern European markets than it might be possible from their home base.

F. EC Integration and Developing Countries

I. The Overall Effect

Since the end of the 1980s, the external dimension of EC 1993 has extensively been discussed for individual DCs, for groups of DCs and for DCs as a whole. DCs could potentially be seriously affected by EC 1993 because

- for a large number of them, the EC is either the largest export market or at least an important outlet for domestic production (Table 23);
- 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 1993 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 specialization profiles, export potential and adjustment flexibility are large, and so are the implications of EC 1993 for sectors such as agriculture, natural resources, manufactures and services.

Table 23 — Share of the EC in Developing Regions' Exports and Imports, 1985 and 1991 (per cent)

	Exports	Imports	Exports	Imports
	1985		1991	
Developing Africa	53.9	45.9	57.3	49.7
Developing America	17.2	14.1	24.7	18.6
Middle East	18.4	33.3	24.2	38.8
Other Asia	11.2	12.6	15.6	12.7
All developing economies	20.1	22.6	22.0	21.6

Source: UN [a].

Notwithstanding such differences, the following implications for DCs as a whole can be summarized:

First, no major trade diversion is expected for primary commodities [Page, 1992; Koekkoek et al., 1990] because of lacking domestic substitutes in the EC. Hence, the income effect will dominate the price effect [Matthews, McAleese, 1990]; but given elasticities of import demand below unity (except for fuels), the overall trade effect is assumed to be small. Matthews and McAleese [ibid., p. 163] estimate an additional import demand of 2.5 per cent following a five per cent EC GDP growth, i.e. 1 per cent of total DCs' non-fuel primary commodity exports in 1987. 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 (e.g. domestic tax reductions in consumer countries) would fuel demand (for details see Chapter G). In the medium term, however, the Internal Market is likely to accelerate resource-saving technological progress, thus delinking commodity consumption from economic growth. This may hold in particular for mineral commodities used as inputs in heavy industries. Such an effect would be detrimental to commodity exporters.

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 concerning the appropriate income elasticity of demand. Langhammer [1990], using own estimates of income elasticities of EC import demand for manufactures from DCs, argues that the income effect will be higher than the trade diversion effect. Over a period of five years, additional import demand is expected to exceed the trade diversion effect by more than four times [ibid., p. 137]. The main argument against using high income elasticities is that they are determined by a very small number of NIEs as successful exporters of manufactures. Davenport [1990] prefers much lower import elasticities and assumes trade diversion effects to be underestimated in the Emerson Report (about 10 per cent reduction in extra-EC imports). As a result, his estimates show a rough balance between income effects and price effects so that the net trade effects will be fairly small for this group of exporters.

Davenport [1991] and Page [1992] summarize total net trade effects (the residual of income and trade diversion effects) 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. The assumptions underlying these estimates clearly favour trade diversion over trade creation. The estimates reflect the

logic inherent in the aforementioned 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 realize 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 Community-wide quotas leaving the total volume of imports unchanged is expected to affect but marginally DCs' exports of sensitive items [Langhammer, 1990; Davenport, 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. Such differences could explain welfare losses due to a Community-wide quota because of the extension of restricted markets from some member states to the entire Community. Economic rents would accrue and be captured either by exporting companies forming a coalition and raising prices or, alternatively, by the exporting state auctioning export licences. The EC could only collect the rents if it introduced a tariff.

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-1993 period the highest productivity gains are expected for business services, and consequently this leads to higher "guestimates" on 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 [Langhammer, 1990].

Fifth, according to Table 24, DCs lost about ten percentage points of their share of total FDI in 1990 compared with 1985. This decrease is mainly due to the drop in the shares of the Middle East and Latin America. In none of these cases the drop of shares can be directly related to developments in the EC. In the Middle East, the FDI flows are quite volatile. FDI flows in this region consist more of long-term intercompany loans than of equity capital. In Latin America the trend of declining shares began in the 1970s, i.e. long before the initial step for the completion of the Internal Market was made in 1985. The further decline during the 1980s was conditioned by adverse domestic factors, for example, high international indebtedness and the failure to service foreign

Table 24 — Regional Shares in Total FDI-Flows, 1981–1990 (per cent)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Industrial countries	66.69	53.60	66.84	71.60	75.03	84.29	88.36	85.37	85.39	84.05
of which:										
US	40.76	25.71	24.34	47.57	39.43	45.00	47.74	39.67	36.66	20.71
EC	25.11	25.46	30.54	15.91	29.48	26.42	29.89	36.24	39.11	49.38
Developing countries	33.31	46.40	33.16	28.40	24.97	15.71	11.64	14.63	14.61	15.95
of which:										
East Asia	5.55	6.26	6.52	5.51	5.27	4.45	4.10	5.35	5.13	6.85
China	—	0.80	1.29	2.34	3.44	2.48	1.90	2.13	1.76	1.95
South Asia	0.25	0.24	0.14	0.16	0.33	0.18	0.16	0.16	0.12	0.16
Africa	2.40	3.22	2.41	2.07	1.55	0.73	1.14	0.80	1.39	0.67
Middle East	10.18	22.50	11.98	11.33	4.62	3.03	-0.11	0.97	0.97	0.22
Latin America	12.43	11.47	7.13	6.02	8.33	4.12	3.46	4.04	3.50	4.08

Source: IMF [a].

loans, high inflation, poor prospects of economic growth, and budget deficits arousing the concern of investors on a future drain of resources through high taxes [Nunnenkamp, 1989]. The share of East Asian DCs in total FDI declined in 1986 and 1987 with a little more than one percentage point but recovered in the following years. In 1990, it was higher than in any of the preceding years. Here, too, no conspicuous negative effect of EC 1993 can be found. On the contrary, the annual growth of FDI in East Asia during 1985–1990 was higher than for the world total. DCs as a whole lost in attractiveness as hosts but this had little to do with EC 1993 [Agarwal, 1992].

II. Effects on Individual Developing Regions

1. Sub-Saharan Africa

All what has been said about the implications of EC 1993 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 1993 will accelerate the ongoing delinking of commodity consumption from economic growth in Europe. This may further lower income elasticities for goods that are primarily exported by Africa. Stricter environmental rules in

Europe may also affect Africa negatively 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 C.III).

There is little to say on investment diversion since Africa has become a marginal host of FDI long before the Internal Market programme was launched [Langhammer, 1991].

2. Latin America

To some extent, the consequences for Latin America are similar to those for Africa because of overlaps in the commodity supply [Langhammer, 1992c]. Specific policy measures for Latin American exports exist only for some agricultural products such as bananas, coffee, cocoa, sugar and rum (see Section G.II.5). The final shape of EC policies in these areas is still being negotiated. The banana "solution" indicates that the EC is determined to protect the special interests of associated ACP countries and domestic suppliers at the expense of the more competitive Latin American suppliers. 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 with 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 [Page, 1992].

With respect to investment flows, Latin America's longstanding role as a preferred host of German investment in DCs [Agarwal et al., 1991; Langhammer, 1991] may suffer for two reasons. First, 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. Second, the frequently mentioned "bridge" function of Portugal and Spain, which was supposed to link Europe and Latin America, does not materialize. It is a nice phrase without any economic substance.

Summarizing, stagnant trade flows with Europe and the relatively income-inelastic export supply of Latin America do not make the region a prime candi-

date for medium-term gains from EC 1993. 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.

3. East and Southeast Asia

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 of EC 1993 effects on East and Southeast Asia is ambivalent.

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 (see Section F.I).⁷⁵ An alternative view is that productivity gains will be small in those manufacturing industries in the EC that 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 [Verbiest, Tang, 1991; Page, 1992; Dicke, Langhammer, 1991].⁷⁶

Even some proponents of high trade diversion effects admit [Page, 1992, p. 33] 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 ship-building may react to market integration by closing down or relocating production sites outside the EC rather than by attempting to realize productivity

⁷⁵ Applying a trade overlap analysis and assuming that third countries would have to lower their export prices (in order to defend market shares), Kreinin and Plummer [1992] estimate trade diversion effects for ASEAN and South Korean exports to the EC of 8 per cent and 5 per cent of their exports, respectively.

⁷⁶ Verbiest and Tang [1991, pp. 20–21] show that the NIEs stand to gain significantly (about one third of 1 per cent of baseline GDP by the end of a period of six years) partly because of high income elasticities for their exports and partly because of their export orientation. In contrast to the NIEs, the income gains of Indonesia and the Philippines are marginal because the income elasticities for their exports are lower and because these two countries depend relatively little on the EC market.

increases within the EC. And third, export supply from East and Southeast Asia is focused 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].

Concerning FDI, East and Southeast Asian economies appear to enter well prepared into the international competition for risk capital. Multinational enterprises will hardly adopt a strategy of shifting investment away from the region because such a strategy would endanger their chances in the rapidly growing Asian markets. Especially European firms will have to strengthen their engagement in Asia-Pacific economies to get a better foothold in this growth pole of the world economy, where they have traditionally been underrepresented. Additional investment in the EC will go at the expense of the US and other industrialized countries and Latin America rather than at the expense of the Asia-Pacific region.

G. Effects on Developing Countries by Industry

I. The Pattern of Trade between the EC and DCs for Selected Industries

EC 1993 will induce structural change within the Community, and this structural change will have implications for DCs as was shown in the previous Chapter. The focus in this Chapter is on a number of specific industries that seem to provide cases in point. The list of industries includes textiles and clothing, electrical machinery, automobiles and parts, iron and steel, and agriculture and food. 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. The analysis in Section D.III has shown that EC trade policies reveal a considerable propensity for sector specific interventions, especially against non-European competitors. For example, 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 to 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, VERs are used to restrict EC imports of electrical and electronic household goods. 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 25 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 1993 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 almost non-existent. Furthermore, certain subgroups of DCs will be affected differently by sectoral effects, depending on the sectoral composition of trade with the Community. For example, the Asian DCs account for more than 70 per cent of EC imports of textiles and clothing 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. The potential sectoral effect of EC 1993 on DCs, whatever its actual size may be, will have a strong regional component (see also Section E.IV).

Table 25 — Developing Countries' Trade with the EC: Selected Products, 1991^a

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

^aLatin America: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico. Asian NIEs: Hong Kong, Singapore, South Korea, Taiwan. Other Asia: China, Indonesia, Malaysia, Philippines, Thailand. — ^bIncludes office equipment and consumer electronics.

— ^cIncludes food products.

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

Table 26 provides additional insight on potential sectoral EC 1993 effects for DCs. The import penetration ratios given in this table are defined as EC imports from DCs in EC absorption. These ratios represent market shares of DCs in the EC for selected manufactured products. First, they show that extra-EC suppliers of manufactures had achieved market shares in the range of 9–13 per cent in the four largest EC economies (1987). These shares had increased by between 10 to over 20 per cent in three out of the four EC countries in the 1980–1987 period. Among extra-EC suppliers, the DCs as a whole accounted for 2–3 per cent of the EC market of manufactures in 1987. These shares increased by similar magnitudes as the shares of extra-EC suppliers taken together. Second, turning to specific product categories the data show that the DCs are major suppliers in textiles and clothing, and increasingly also in electrical machinery. The changing market shares again reflect the growing importance of Asian suppliers in EC markets of these products.

Within the EC, the industries under consideration contributed between 1 and 3 per cent to the GDP of the Community, and employed between 1 and 5 per cent of the total workforce in 1990. Table 27 shows the pronounced relative decline of agriculture, textiles and clothing, and iron and steel in terms of production and employment between 1980 and 1990, whereas the production and employment shares of electrical goods, automobiles, and food products declined only slightly and less than for total manufacturing. The first group of industries has lost international competitiveness, because production technologies correspond more closely to the factor endowments of DCs. Therefore, such industries are heavily protected by EC policies. By distorting international trade, these policies lead to an inefficient allocation of resources, mainly at the cost of European consumers and DCs' producers.

The above evidence does not suffice to assess the overall sectoral effects that can be expected from EC 1993. This task requires taking into account the economy-wide feedbacks that will arise. Usually, this is done by the application of general equilibrium models, which can be calibrated to reflect observed production and trade patterns and "shocked" with specific policy changes to simulate EC 1993 effects. The presently available results of these exercises will be summarized in the last part of this section. To fully appreciate their implications a closer look at the consequences of EC 1993 for selected product categories is necessary.

Table 26 — Import Penetration Ratios^a in Selected EC Countries: Selected Products, 1980 and 1987 (per cent)

	France		Germany		Italy		United Kingdom	
	1980	1987	1980	1987	1980	1987	1980	1987
Manufactured goods^b								
Extra-EC	7.3	8.8	10.2	13.3	10.1	9.9	9.5	11.7
Developing Countries	1.9	2.3	1.9	2.5	2.6	2.3	2.8	2.2
Africa	0.6	0.6	0.2	0.2	0.6	0.4	0.3	0.2
Latin America	0.5	0.4	0.2	0.2	1.0	0.6	0.5	0.4
Asian NIEs ^c	0.3	0.7	1.0	1.4	0.4	0.6	0.8	1.3
Other Asia	0.5	0.6	0.6	0.8	0.7	0.7	0.5	0.8
Textiles, clothing and leather								
Extra-EC	8.3	12.9	19.4	27.7	12.5	14.2	15.8	18.6
Developing Countries	4.9	8.7	9.9	13.7	6.0	7.3	9.1	12.1
Africa	1.2	2.8	0.8	1.3	0.5	0.6	0.2	0.4
Latin America	0.5	0.5	1.1	0.8	1.3	0.8	0.5	0.5
Asian NIEs ^c	1.3	2.2	4.9	6.3	1.2	1.5	5.5	6.7
Other Asia	2.0	3.2	3.2	5.3	3.1	4.3	2.9	4.5
Electrical machinery								
Extra-EC	8.6	12.5	9.7	12.2	7.8	10.3	10.9	18.4
Developing Countries	1.4	3.4	1.8	2.6	1.5	2.6	2.1	4.8
Africa	0.1	0.2	0.0	0.1	0.0	0.0	0.1	0.0
Latin America	0.0	0.1	0.1	0.1	0.1	0.1	0.0	0.2
Asian NIEs ^c	1.0	2.2	1.4	1.9	1.3	2.2	1.6	3.3
Other Asia	0.2	1.0	0.3	0.5	0.1	0.3	0.4	1.1
Transport equipment^d								
Extra-EC	6.3	7.2	5.8	10.3	4.8	7.0	8.3	9.9
Developing Countries	0.5	0.6	0.4	0.6	0.8	1.6	0.4	0.7
Africa	0.0	0.1	0.0	0.9	0.1	0.1	0.1	0.0
Latin America	0.1	0.1	0.2	0.3	0.6	1.3	0.1	0.1
Asian NIEs ^c	0.1	0.0	0.1	0.1	0.0	0.1	0.1	0.2
Other Asia	0.0	0.0	0.0	0.2	0.0	0.0	0.2	0.2
Iron and steel								
Extra-EC	3.3	4.0	6.6	10.8	5.9	5.0	6.0	5.1
Developing Countries	1.0	0.4	0.6	1.2	0.8	0.6	0.3	0.4
Africa	0.1	0.0	0.1	0.2	0.1	0.1	0.0	0.2
Latin America	0.1	0.2	0.2	0.5	0.4	0.4	0.2	0.2
Asian NIEs ^c	0.0	0.1	0.1	0.4	0.2	0.1	0.1	0.1
Other Asia	0.8	0.2	0.2	0.2	0.1	0.1	0.0	0.0

^aExtra-EC imports in domestic absorption (GDP minus exports plus imports). — ^bExcludes food products, petro-chemical products and non-ferrous metals. — ^cHong Kong, Singapore, South Korea, Taiwan. — ^dAutomobiles.

Source: Möbius [1991, Table 7].

Table 27 — EC-7^a Value Added and Employment in Selected Industries, 1980, 1985 and 1990 (per cent)

	Gross value added in GDP			Employed persons in total employment		
	1980	1985	1990	1980	1985	1990
Agriculture, forestry and fishery products	3.7	3.1	2.6	7.1	6.3	5.2
Manufacturing	27.7	25.7	24.7	27.6	23.7	24.3
Textiles and clothing ^b	2.4	2.1	1.7	3.6	2.9	2.7
Electrical goods	2.7	2.7	2.6	2.8	2.4	2.5
Transport equipment	2.8	2.7	2.7	2.8	2.4	2.4
Iron and steel	1.3	1.1	1.0	1.3	0.9	0.8
Food, beverages, tobacco	3.7	3.7	3.2	2.8	2.6	2.5
^a Belgium, Denmark, France, Germany, Italy, Netherlands, United Kingdom.— ^b Includes footwear.						

Source: Deutsche Bundesbank [1992b]; Statistical Office of the European Communities [c]; own calculations.

II. The Consequences of EC 1993 for Selected Industries

1. Textiles and Clothing

Over the last two decades, a considerable restructuring process has taken place in the textile and clothing sector world-wide. For example, 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, p. 74]. In the *textile industry*, traditional methods of production were readily adopted in many less developed and newly industrializing countries, and, because of 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 completing the Internal Market will greatly alter the competitive climate in the industry within the EC [O'Donnell, 1989, p. 30]. Put differently, because a considerable amount of specialization has taken place al-

ready, the scope for further exploitation of economies of scale seems to be rather limited. The *clothing industry* has remained labour-intensive because of the difficulty of automating and mechanizing the key stages of production. Therefore, economies of scale could not be realized to the same extent as in the textile industry, and labour costs have still an important effect 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 in large production runs has been shifted to DCs, whereas the European producers have increasingly specialized in the manufacturing 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, p. 29]. The criterion for intervention allowed under the MFA refers to "market disruption", which has only been applied to low cost producers, 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 1993 centres on one particular issue: the effects of removing national quotas. It is expected that EC 1993 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 utilization. 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, p. 260].

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, p. 34]. 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 25). 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; they are not the result of EC protection [Langhammer, Amelung, 1989]. The conclusion is that the marginal erosion of ACP preferences from eliminating member state quotas will have little effect. The only excep-

tions 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 1993 is expected to have an overall positive, but relatively modest effect. EC quotas for many MFA products and vis-à-vis some 30 or more countries will be applied until the late 1990s [Pelkmans, 1992, p. 34], despite the successful conclusion of the Uruguay Round. More substantial gains can be expected for specialized low cost producers that were restricted by the pre-1993 system of national quotas.

2. 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 1993 is expected to affect both subcategories. Based on currently existing trade patterns,⁷⁷ 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 1993. 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 1993 effects can be seen as simply supporting a restructuring of the EC electronics industry, which would also occur without EC 1993.

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, pp. 154 f.]. Beginning with the microelectronics revolution, this has changed.

⁷⁷ For an analysis of ASEAN-EC trade in electronics see, Schmitt-Rink and Lilienbecker [1991].

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 standardized 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.

Another trend in the electronics industry is that software and system design increasingly become the crucial bottleneck skills, because of 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 by the availability of microprocessors have given rise to significant potential economies of scale. In turn, these economies of scale have altered the comparative advantage of nations and firms. The share of European firms has steadily declined in favour of suppliers from Japan and the Asian NIEs. EC 1993 is expected to change this trend, at least partly. This may come true especially in sub-branches of this industry where EC 1993 will facilitate the creation of harmonized technical standards, thereby reducing the costs of interfacing and the problems of non-interoperability [Wong Poh Kam, 1991, p. 156]. For example, in the case of telecommunications, EC 1993 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 1993 are relatively marginal in this industry. This does of course not preclude that the EC will continue to apply retrospective Community surveillance and anti-dumping actions against foreign companies in a protectionist way. For example, retrospective Community surveillance of imports has long been maintained vis-à-vis Japan and South Korea on televisions and video tape recorders, and anti-dumping measures were, at mid September 1992, in force against China and Hong Kong (colour televisions and video tape recorders) and South Korea (car radios, CD-players, colour televisions, video cassettes and recorders) [GATT, 1993, Vol. A, p. 161].

3. Automobiles⁷⁸

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. 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 that are at least not immediately expected to vanish as a result of EC 1993. Technical requirements that must be fulfilled in order to get a registration permit for a specific type of car have not been fully harmonized. 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 authorized by the Commission in 1985 for a period of ten years. This system represents a network of exclusive dealing contracts.

Since end-1992, protectionist measures against imports from third countries are directed against Japan (see Section E.III) and, to some extent, against South Korea. 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 1993 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 reorganization of production permits both mass production and the production of

⁷⁸ This section draws on Emerson et al. [1988, pp. 71–74] and Hild [1991].

differentiated products. Computer aided design (CAD) and computer integrated manufacturing (CIM), robotics, just-in-time organization and global or single sourcing are the main headings in this context.

Especially in the automobile industry, EC 1993 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, p. 73]. 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 does not mean that economies of scale will only benefit EC-originating firms. 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 effect of EC 1993 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 and Mexico possess a comparative advantage.

4. Iron and Steel

Special characteristics of the European steel industry are the organization 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, authorized by the Commission. Whereas the system of managed production quotas was 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 former 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, p. 121]. A new sectoral support régime, introduced in 1991, continues the granting of aid to the steel industry in the period 1992–1996 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, Vol. A, p. 181]. The future of this industry actually depends on the emerging Community market regime, rather than on the completion of EC 1993 *per se*.

At present, the steel market has become increasingly oversupplied because of 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 since 1980 can be best understood in terms of industrial organization and possible pricing strategies in this sector [Weiss et al., 1988, p. 127]. 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, McKern, 1987, p. 57]. 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, p. 4], 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 modernization policy and a policy for monitoring the installation of new capacity. Table 28 shows the development of production capacities for the most important steel suppliers in the EC. Notably German producers lost market shares from 1980 to 1988, not as a result 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., 1988, p. 82] with possible employment effects in the order of 50,000 [GATT, 1993, Vol. A, p. 179].

Table 28— Steel Production Capacities in the EC, 1975–1990 (million tonnes)

	EC ^a	Germany	France	Italy	United Kingdom
1975	190.8	62.9	33.6	32.8	27.1
1980	206.0	66.9	32.5	39.4	28.0
1985	171.6	49.0	28.5	36.2	23.7
1986	165.6	47.2	28.2	35.4	22.6
1987	165.3	47.1	27.1	36.5	22.9
1988	190.7	46.8	27.9	37.3	23.6
1989	188.4	47.1	25.2	39.4	23.9
1990 ^b	188.2	48.0	25.4	40.1	23.9

^aEC-10 since 1982, EC-12 since 1986. — ^bEstimates.

Source: Klodt, Stehn et al. [1992, p. 120].

Since EC 1993 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 1993 (see Section G.III). 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, p. 82].⁷⁹ This reasoning may be flawed, however, because of the subsidization 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, 1990, p. 3]. The main DC exporters are Brazil and South Korea, both identified to be low labour cost producers [Fischer, Nunnenkamp et al., 1988, p. 192]. These highly competitive producers will be denied access to the EC even after 1992, as was mentioned above. EC 1993 will not bring an abolition of state aid to the steel industry and, therefore, will not eliminate 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.

⁷⁹ In 1988, all three suppliers together accounted for about 45 per cent of world steel production [UNCTAD, 1990, Table 2].

5. Agriculture and Food

In the Community, agricultural production is mainly determined by the CAP. As a consequence of EC 1993, a general dismantling of intra-EC border controls will ultimately eliminate the system of border taxes and subsidies called monetary compensatory amounts (MCA), which traditionally 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 price levels prevailed in the United Kingdom and in Greece (12 and 38 per cent below the average) [Matthews, McAleese, 1990, p. 175]. Many EC markets for temperate-zone agricultural products are virtually impossible for third countries to penetrate.

The total effects 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, p. 81]. 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; 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 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 interventions, either by border restrictions or by financial assistance [GATT, 1993, Vol. A, p. 110]. Subsidy equivalents and welfare losses will not be reduced to zero because of EC 1993. It would be politically unreasonable to assume that public price or income support will be eliminated completely. This is not intended by the Internal Market programme. Therefore, EC 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, p. 67]. Direct benefits are very heavily concentrated on ten products, the most important ones being beer, pasta, and vegetable fats. Intra-EC trade is predicted to grow; for example, imports are estimated to in-

crease 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, which will lead to a reorganization 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 that will lead to an increase in specialization of the large European food companies, and to a wider spread of their activities in Europe.

The abolition of intra-EC border controls for agricultural products was combined with a harmonization 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 harmonized technical standards as part of EC 1993. Those standards most likely to cause problems concern DCs' exports of plants, fish and meat [Davenport, 1991, pp. 57–61].

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 affect 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 1993 standards with the greatest effects 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 that are authorized 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-authorization. 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 a special case also 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 catego-

ries 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, Vol. A, p. 140].

EC 1993 is expected to have a substantial effect on a number of tropical products exported by DCs. Bananas⁸⁰ are the most prominent case. EC 1993 has an effect on the structure of the Community's banana imports, simply because the import policies operating before 1 January 1993 could 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. Under the old regime, less than half of the EC's consumption originated from ACP countries and the Community itself, the other half being so-called dollar-bananas originated 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 Surinam existed in the United Kingdom; the same held for imports from French overseas departments, Cameroon and Côte d'Ivoire in France, and for imports 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 EEC Treaty. 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 imports⁸¹ (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 1993. It has been estimated

⁸⁰ See, e.g. Borell and Yang [1992], Cable [1990], Davenport [1991, pp. 46–55], and Matthews [1992].

⁸¹ 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 are subject to a (prohibitive) duty of 850 ECU/tonne (approximately 170 per cent). In 1992, EC imports from Latin America exceeded the quota agreed upon by about 300,000 tonnes [Financial Times, 18 December 1992; Handelsblatt, 18 and 19 December 1992]. It remains to be seen, however, whether this decision will be challenged within the GATT.

that even if the overall quota for dollar-bananas were set at the average level of imports over some base period, the ACP and EC banana suppliers would not be able to preserve their earlier privileged positions [Davenport, 1991, p. 52]. 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, Yang, 1992, p. 283]. 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 1993, and dollar-banana producers will gain. These results will, of course, not be realized 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 1993, 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, p. 277]. 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 1993, and especially with the 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 1993 was expected to have an effect on DCs' exports are coffee, cocoa, tobacco and tea. The concern for these commodities came from the anticipated EC harmonization of indirect taxation, i.e. the harmonization 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, p. 264]. Up to now, these products have been excluded from tax harmonization in the single market context [GATT, 1993, Vol. A, p. 133]. Tax evasion through purchase in other member states can no longer be limited by border controls, however.

Tobacco might provide a case for an overall negative effect of EC 1993. Since there seems to exist a majority preference in the Community for "leveling-up" some health standards, the Commission decided to gradually harmo-

nize 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 harmonized 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, p. 63]. 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.

III. Quantitative Assessments of EC 1993 by Industry

Except for agricultural products, few empirical studies exist that try to estimate detailed sectoral effects of EC 1993 on DCs. Some indirect quantitative estimates, however, can be derived from a comparison of various recent modelling exercises. These studies differ widely with respect to the underlying modelling framework and with respect to sectoral and regional disaggregation. To fully understand the variety of the estimated quantitative sectoral effects of EC 1993, a distinction has to be made between the direct and the indirect effects of market integration, and the capability of the various models to fully capture these.

The direct effects of market integration refer to cost reductions from the removal of NTBs (see Table 8). The indirect effects of market integration refer to price reductions through increased competition and to the increase in market size that may allow the exploitation of economies of scale. According to Emerson et al. [1988], the latter effects are expected to be highest in highly concentrated industries, where scope for monopoly pricing, price discrimination and X-inefficiencies seem to have existed in the pre EC 1993 period. Section G.II suggests that this reasoning could possibly apply for industries such as electrical machinery and automobiles. Productivity gains resulting from market integration seem to be less important for textiles and clothing, as well as for iron and steel.

The classification of industries into perfectly and imperfectly competitive sectors is crucial for the modelling exercises. For imperfectly competitive sectors significant indirect effects are possible because market integration may allow to exploit economies of scale even if the direct effects on a particular industry are small. Hence, the key questions are whether there are economies of scale in particular industries, and whether a high degree of concentration actu-

ally is an indication of an inefficient production structure. Depending on the competitive environment, the strategic responses will differ between industries and will be based on what firms identify as the key determinants of competitive advantage. As is almost self-evident, the indirect effects are very difficult to evaluate. Empirical results on the sectoral effects of EC 1993 will vary according to the classification of industries, and the approaches used to capture these effects. These problems are revealed when it comes to a quantification of sectoral trade diversion and trade creation effects of EC 1993.

Table 29 presents partial equilibrium estimates of selected sectoral trade diversion and trade creation effects for manufactured products. They were derived on the assumptions of a five per cent increase of EC GDP (over five years), relatively low uniform sectoral import elasticities (2 per cent), and sector specific reductions in transaction costs [Möbius, 1991, p. 14], i.e. assumptions that are consistent with the Emerson Report (see Section D.II.2). The results point to a positive EC 1993 effect for DC exports of textiles and clothing (4 per cent) and to a large negative effect for DC exports of iron and steel (-24 per cent). For electrical machinery and for automobiles, the estimated net effects are relatively small. For the DCs as a whole, there is a small positive EC 1993 effect (1 per cent). Not surprisingly, these findings are reflecting the assumptions made. DCs gain in labour-intensive industries, and the overall effects remain limited because the applied import elasticities are low. If higher import elasticities were applied, the gains for DCs would be larger because of a higher trade creation effect (see Section F.I).

The results for selected DCs mainly reflect their pattern of specialization with respect to EC trade. For example, the effects for Pakistan result from the expansionary effects in textiles and clothing; and the somewhat smaller positive effects for the Asian NIEs mainly reflect trade diversion effects in electrical machinery. For the ACP countries, the overall effect of EC 1993 on manufactured exports is negative (-3 per cent) because of expected productivity gains in European manufacturing industries and the specialization of ACP producers on income inelastic segments of the market.

The first study that, at least partly, took up the issue of explicitly modelling imperfect competition was made by Smith and Venables [1988]. In this study and in the following ones discussed below, no reference to the effects of EC 1993 on DCs was made. These studies can be used, however, to indirectly assess the sectoral implications for DCs and, by doing this, to put the previous results somehow into perspective.

The general idea of the Smith-Venables exercise is that EC 1993 can be modelled as a reduction in the costs of intra-EC trade, either by an equiproportionate reduction in intra-EC trading costs across all industries (reductions-in-

Table 29 — Trade Creation and Trade Diversion Effects of EC 1993: Selected Products and Selected Developing Countries (percentage change)

	Trade diversion	Trade creation	Net effect
Products			
Manufactured goods	-12	11	-1
Textile and clothing	-7	11	4
Electrical machinery			
Office equipment	-9	11	2
Electrical goods	-11	11	-1
Transport equipment (automobiles)	-11	11	0
Iron and steel	-35	11	-24
Countries			
Developing Countries	-10	11	1
ACP	-13	10	-2
Others			
Argentina	-11	12	1
Brazil	-13	11	-2
China	-10	11	1
Hong Kong	-9	11	2
Pakistan	-8	11	4
Singapore	-11	10	0
South Korea	-10	10	0
Taiwan	-10	11	2
Thailand	-9	11	2

Source: Möbius [1991, Table 5].

trade-barriers scenario), or by additionally requiring that price differences between markets only reflect transportation costs (integrated-markets scenario). The simulation results show that internal trade liberalization induces a decrease in extra-EC imports and a small rise in EC exports mainly for two reasons. First, the direct effect of the policy is to reduce the prices of intra-EC imports, thus switching expenditures away from extra-EC imports. Second, the expanded EC output reduces the firms' marginal costs, thus reducing EC producer prices both inside and outside the EC and encouraging exports. Full market integration will cause a reduction in the firms' domestic market prices and in the degree of market concentration. Essentially, this means that firms lose the ability to price high in their relatively captive domestic markets.

The sectoral classification used in the Smith-Venables model appears to be somewhat arbitrary. Differential degrees of market imperfections are assumed

for ten 3-digit product categories ranging from cement via motor vehicles to footwear, while all other industries are rated as perfectly competitive. With respect to the industries considered in this section, the model results predict that intra-EC production increases for automobiles and electrical machinery (Table 30). Relatively high output increases suggest a substantial degree of potential trade diversion in these two industries, which would be detrimental for DCs, particularly in Asia (see Table 26). Such effects have, however, not been computed by Smith and Venables.

Recently, disaggregated CGE analyses have been performed to assess explicitly whether income growth (trade creation) is the dominant effect of EC 1993, or whether growth does not offset the diversion of manufactured exports implied by the combination of all stages of market integration. The CGE modelling framework accounts for the fact that factor and material inputs are not available to all industries at fixed prices, which is the implicit assumption of the two previous partial equilibrium analyses. Hence, the tendency in partial equilibrium analyses is to predict an output expansion in almost all sectors as a result of EC 1993, which is likely to be mitigated by increases in factor prices [Winters, 1992]. With a fixed endowment of factors, one industry's expansion in terms of inputs will be another's contraction. This means that EC 1993 is likely to have more complex effects on international trade flows than partial equilibrium analysis would suggest. If EC 1993 favours one set of industries — say, those with imperfect competition and economies of scale — it will stimulate EC net exports in those industries and curtail them in others, and this in turn will affect patterns of specialization elsewhere in the world. The two studies considered in detail below can be used to answer how sectoral EC imports and exports will change as a consequence of EC 1993 and which region of the world will be affected by the change in the composition of trade.

Evidence for the predicted effect of EC 1993 on output growth and imports of specific industries comes from a CGE model that was used to simulate alternative changes in intra-EC trade barriers [Gasiorek et al., 1992]. The model

Table 30 — Output Effects of EC 1993 on Member Countries: Selected Products (percentage change)

	Reduction in trade barriers	Integrated markets
Electrical machinery		
Office equipment	10.4–12.5	27.3
Electrical goods	2.1	8.1–12.7
Motor vehicles (automobiles)	3.4–3.6	10.5–26.4

Source: Smith, Venables [1988, Table 6].

consists of five factors of production, namely physical capital and four types of labour differentiated by skill-intensities, and 14 imperfectly competitive sectors. These sectors include virtually all important manufacturing industries as well as financial services. The remainder of the stylized EC-economy is modelled as a large perfectly competitive sector, which accounts for roughly 2/3 of the economy (see Table 11). With respect to the industries considered in this section, agriculture is the only one belonging to the perfectly competitive sector of the model. The simulation results show that EC output rises substantially in all industries assumed to be imperfectly competitive and slightly falls in the perfectly competitive sector (Table 31), and EC imports from the rest of the world decline.

The distribution of output changes across industries depends on a number of assumptions that are difficult to disentangle quantitatively for outside model users, including: the degree of economies of scale in the industry, the degree of concentration in the industry, the elasticity of demand for the individual product varieties, and cost changes due to general equilibrium changes in input prices. Qualitatively, the simulation results simply reflect that the higher the share of trade in production, the greater will be the benefits from the reduction

Table 31 — Output and Trade Effects of EC 1993: Selected Products^a (percentage change)

	EC output		Extra-EC exports		Extra-EC imports	
Textiles and clothing	10.2	(3.1)	12.0	(2.2)	-22.1	(-16.1)
Electrical machinery						
Office equipment	10.6	(3.6)	-0.2	(0.3)	-13.9	(-6.8)
Electrical goods	15.9	(1.8)	11.5	(0.6)	-15.2	(-5.0)
Transport equipment (automobiles)	25.5	(5.5)	25.7	(2.0)	-39.4	(-19.6)
Metalliferous products (iron and steel)	28.0	(1.9)	30.5	(1.4)	-13.9	(-4.2)
Food products	17.4	(1.1)	32.7	(5.6)	-27.5	(-11.6)
Perfectly competitive sector ^b	-0.8	(-0.6)	na		na	

^aLong-run, integrated-markets scenario, with number of firms flexible (free entry); figures in parentheses refer to short-run scenario with number of firms fixed (entry restricted). — ^bIncluding agriculture.

Source: Gasiorrek et al. [1992, Tables 4.1 and 4.2].

in trade costs; the greater the economies of scale in the industry, the larger will be the cost reductions from increasing output; the more concentrated the industry, the greater will be the gains arising from trade liberalization; and the more elastic demand for specific products, the larger will be the change in output for a given change in costs.

Taken together, the largest output effects are expected to arise in the most heavily concentrated industries, in which the pro-competitive effect of intra-EC liberalization is assumed to be largest. The overall expansion of the imperfectly competitive sector partly occurs because of the release of real resources as trade costs are reduced and as firms exploit the advantages of economies of scale, but also because of the contraction of the perfectly competitive sector.

The effects of EC 1993 on extra EC-trade are predicted to be most pronounced in industries where EC output grows the most.⁸² Under the market integration scenario, EC exports are generally expected to rise, and EC imports are expected to decline (by 15–40 per cent). Especially the estimated decline in extra-EC imports in textiles and clothing, electrical machinery, and food products points to less optimistic expectations for DCs than predicted by the partial equilibrium studies. It should be borne in mind, however, that CGE-model simulation results are highly sensitive with respect to parameters and disaggregation, even if the same broad theoretical model structure is calibrated to an identical set of data. This can be seen by comparing the first columns of Table 31 and Table 32, which both predict sectoral output effects of EC 1993.

The Haaland and Norman [1992] results presented in Table 32 are based on a stylized EC economy consisting of twelve traded goods and one non-traded good, with an outside world including EFTA, the United States and Japan. The authors stress that they have used the same data and have assumed essentially the same production technologies for the same set of industries as in the study by Gasiorsek et al. Nonetheless, their predictions with respect to sectoral EC output changes are much smaller than those of the previous model (see Table 31). On the basis of published information, these differences cannot be explained. The moderate output expansion presented in Table 32 is more in line with a priori expectations. The small average reduction in trading costs of 2.5 per cent suggests only limited production responses. Furthermore, it is in line with the loss of comparative advantage for EC industries such as textiles and clothing, iron and steel, and food processing that these industries will hardly gain from market integration.

⁸² For the plausibility of the estimated production increase in iron and steel, see Section G.II.4. Note that if this industry were to be modelled as perfectly competitive (as suggested by, e.g. Haaland and Norman [1987, p. 219]) due to contestability properties, the simulation exercise would predict a production decline, as it does for the competitive sector.

Table 32 — Regional Dispersion of Output Effects of EC 1993: Selected Products^a (percentage change)

	EC	EFTA	USA	Japan
Textiles and clothing	0.05 (1.05)	0.00 (-6.60)	0.10 (0.00)	0.00 (0.00)
Electrical machinery				
Office equipment	4.70 (0.30)	-0.7 (4.80)	-0.20 (0.00)	0.10 (-0.02)
Electrical goods	2.10 (-0.40)	1.00 (10.60)	0.03 (-0.03)	-0.05 (-0.05)
Transport equipment (automobiles)	4.50 (-1.10)	-4.20 (23.00)	-0.03 (-0.02)	-0.60 (0.00)
Ores, metals, mineral products (iron and steel)	-0.54 (0.55)	2.38 (-4.18)	0.02 (0.13)	0.34 (0.11)
Food products	1.00 (0.20)	0.80 (0.60)	0.06 (0.01)	0.06 (0.01)

^aMarket integration scenario with free entry and exit of firms; figures in parentheses refer to additional effects of full EC-membership of EFTA countries.

Source: Haaland, Norman [1992, Tables 4 and 5].

Table 32 shows that the effects of EC integration on Japan and the United States are very small. This would confirm the view that the Internal Market will not create a "Fortress Europe". The effects on production and real income in the EFTA countries are quite significant, however, because of their dependence on EC trade (see Section E.I). This underlines the earlier contention that freer trade within Europe is highly important to European countries, but no serious threat to overseas production, including the production of DCs.

When the effects of a full European integration (EES) are simulated, it is estimated that the production of skill-intensive (engineering) products will rise substantially in both the EC and EFTA, to some extent at the expense of production in the United States and Japan. Within Europe, production of labour-intensive products will shift from EFTA to the EC. All these changes reflect two distinct forces. First, the reallocation of resources from initially highly competitive industries to industries assumed to be imperfectly competitive. Since the imperfectly competitive industries are highly concentrated, market integration is expected to have a higher positive effect here. Second, with imperfectly competitive markets, comparative advantage will be less than fully exploited. This may be changed by more competition; according to the simula-

tion results, particularly strong effects again may show up in engineering products.

The overall conclusion from the above review of partial and general equilibrium analyses is that their contribution to explaining the sectoral effects of EC 1993 on DCs remains fairly limited. This is not only the case because the CGE models do not explicitly account for DCs, but more so because the approaches used are questionable for various reasons. *First*, the direct effects of EC 1993, i.e. the reduction of intra-EC trading costs, must differ among sectors because of large differences in the regulatory framework (see Section G.II). The uniform 2.5 per cent reduction applied in the CGE models is an inadequate tool to capture these differences. Möbius [1991] used sectorally differentiated direct effects, but some of these appear to be completely unrealistic. A case in point is the iron and steel industry, for which a free trade scenario seems to have been used to impute the reduction of trading costs. Market segmentation in this industry, however, will not be eliminated after 1992. Therefore, the gains for EC producers and the trade diversion effects for DCs were overestimated.

Second, the importance of classifying industries into perfectly and imperfectly competitive sectors has repeatedly been stressed. The CGE models attribute economies of scale to virtually all manufacturing industries. Yet, the success of DCs in penetrating EC markets of a wide range of standardized and semi-skilled products suggests that industries such as textiles and clothing, footwear, iron and steel, electrical and electronic consumer goods, and automobile parts are operating under conditions of fierce competition and should rather be classified as perfectly competitive. If this had been done, the modelled structural change enhanced by EC 1993 would have resulted in a resource reallocation from these industries towards skill-intensive sectors. In such a scenario, there is much to gain for DCs from EC integration.

Third, almost all simulations largely neglect services although there is wide agreement that the most important EC 1993 effects will accrue to this sector. The dismantling of the substantial regulations in the service sector is expected to generate considerable productivity gains and output effects. This implies that resources will be shifted from manufacturing to services, and manufacturing output will decline on average in relative terms. Expansion of services will, therefore, strengthen the argument that manufactured exports of DCs will benefit from EC 1993.

These considerations lead to the final assessment that DCs will be able to continue to penetrate EC markets with products in which they traditionally have enjoyed comparative advantages. The expected income effect of EC 1993 may even help to accelerate their export growth. More advanced DCs such as Asian NIEs may, however, find it a bit more difficult to successfully compete in EC markets for skill-intensive products such as automobiles or sophisticated

office equipment. In these markets, EC suppliers stand to gain from market integration and may realize economies of scale.

H. Conclusions

European economic integration is a continuous process, which is likely to extend well into the next millennium. The establishment of the Internal Market in 1993 marks an important stage of integration since the removal of border controls, harmonized technical standards, the liberalization 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 materialized.

In addition to the deepening of integration, the economic landscape of Europe is changed by the widening of integration. The EFTA countries will be joining the EC in the EES. The EES is in essence a free trade agreement that also provides for the free movement of factors of production. Since differential treatment of third country imports requires rules of origin and border controls, EFTA suppliers do not enjoy the same advantages as their competitors within the EC, and hence many EFTA countries have applied for full EC membership. 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.

As concerns 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. By contrast, 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.

The effects of European integration on the welfare of third countries depend on income growth generated by integration, the respective magnitudes of trade diversion and trade creation, and regional diversion of investment funds. The size of these effects is predominantly determined by the reduction of transaction costs within the EC resulting from integration and market structures. Lower transaction costs will translate into higher output and productivity growth in imperfectly competitive markets, i.e. when industries can reap economies of scale. Resources will be shifted to these industries at the expense of all other sectors of the economy operating in perfectly competitive markets with constant returns to scale. As a result, external trade diversion could be substantial in sectors with highly segmented internal markets prior to 1993 (e.g. services) and substantial economies of scale. External trade creation could stem from additional income growth inducing higher import demand in perfectly competitive sectors. These basic relationships have to be born in mind when evaluating the estimates on the effects of the Internal Market programme.

All quantitative assessments of third country effects take — one way or another — recourse to the original Commission estimates of the costs of non-Europe [Emerson et al., 1988]. These were derived from sectoral partial equilibrium models. Assuming a uniform reduction of transaction costs across all sectors by 2.5 per cent and different degrees of economies of scale, the consensus figure suggests that static welfare gains add up to about 5 per cent of GDP over a five year period. This estimate disregards any general equilibrium repercussions in the form of declining output in perfectly competitive sectors. Yet it also ignores potential dynamic gains from integration through the liberalization of trade in services, free factor movement and the specialization effects of fiercer competition. It seems safe to conclude that the Commission has presented an upper bound estimate of static welfare gains. While dynamic gains are hardly quantifiable, a slight but permanent increase of the growth rate of GDP may dominate the static gains in the long run.

The sectoral production and trade effects on which the income estimates are based can be summarized as follows. Some CGE simulations predict large sectoral production and trade effects associated with imperfect competition. Resources will be shifted into rapid-growth industries, typically R&D-intensive and skill-intensive engineering sectors. While the degree of trade diversion may be substantial for specific sectors, it will be offset at least partially once the import-stimulating income effects of completing the Internal Market are taken into account. The specification of the CGE models must be subjected to important qualifications, however. The classification of industries into perfectly and imperfectly competitive sectors is based on arbitrary indicators such as concen-

tration ratios. Moreover, the assumption of a uniform reduction of transaction costs by 2.5 per cent is highly unrealistic. 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. However, the general trend of the model predictions appears to be valid: trade diversion will occur in sectors that can realize economies of scale.

In contrast to the considerable work done on production and trade effects of the Internal Market programme, its effect on capital flows has been largely ignored so far. As a host of FDI, the EC lost importance until the mid-1980s. Recently, though, total FDI inflows increased more than fourfold between 1986 and 1990, and the EC's share in worldwide FDI flows nearly doubled within four years. A close examination of detailed data suggests that the Internal Market programme has indeed enhanced the attractiveness of the EC for external investors, albeit by much less than the cumulated flows seem to suggest. The increase of the EC's share partly mirrors the decline of FDI flows to debt-ridden DCs, an event completely unrelated to European integration. Furthermore, higher EC shares reflect a decline of FDI in other industrialized countries, notably the US. There are no indications of investment diversion at the expense of those DCs without major debt problems.

The degree of structural adjustment in the EC determines the effects of the Internal Market programme on third countries. The magnitude of the effects depends on the degree of association with the EC, the extent of mutual trade relations, and the structure of production in member and 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 simulations 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.

By contrast, all estimates indicate only marginal overall effects of European integration for the US and Japan. The diversified structure of production and trade in these countries and the limited net trade effects of the Internal Market programme on non-European competitors will prevent a general decline of output in the manufacturing sector and associated income losses. In some oligopolistic markets, however, US and Japanese firms are likely to be affected in a more significant way. Cases in point are relatively skill-intensive industries such as office machines in the US and the car industry in Japan, which suffers from the mutually agreed ceiling of the share of Japanese exports in EC car

markets. Other areas of concern are the US access to EC telecommunication markets and the reciprocity requirements in banking, which are hard to meet for Japanese banks.

Central and Eastern Europe is a latecomer in economic relations with the EC because of its isolation from its natural trading partner Western Europe for more than 40 years. In the long run, the region has much to gain from product innovations, process innovations and locational innovations encouraged by the EC Single Market. Because of the profound differences in resource endowment, the Heckscher-Ohlin type of inter-industry specialization will prevail in trade between the two regions. The effects arising from such specialization patterns are assessed to be clearly positive for Central and Eastern Europe provided that the transformation process does not fail. Quantitative assessments of income and trade gains resulting from the Europe Agreements and other trade preferences for Eastern Europe are not yet available because of the early stage of the transformation process.

DCs have been particularly worried by the Internal Market programme since the EC absorbed more than one third of their total exports in 1991. A number of partial and general equilibrium estimates 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 consequences are net gains for commodity exporters such as the ACP and Latin American countries and heavy losses for suppliers of manufactured exports such as the Asian NIEs. For all DCs taken together gains are estimated amounting to 1.5 per cent of total trade.

The result for the Asian NIEs does not appear to be plausible since it is derived from trade diversion primarily caused by economies of scale in labour-intensive and physical capital-intensive industries in which DCs have already proven to be competitive on EC markets. Analyses of individual manufacturing industries 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 can be expected to overcompensate trade diversion not only for commodity producers but also for suppliers of semi-skilled and standardized manufactures such as the Asian DCs. The net welfare effect of EC 1993 will, therefore, be either positive or at worst zero for most DCs. Major exceptions are agricultural economies, the exports of which are heavily concentrated on specific products, such as bananas, that enjoyed privileged market access prior to 1993. Another caveat is that more advanced DCs such as

the Asian NIEs may find it a bit more difficult to compete successfully in EC markets for skill-intensive products such as automobiles or sophisticated office equipment. In these markets, EC suppliers stand to gain from market integration and may realize economies of scale.

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