European Integration: Impact on world trade and capital flows

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The EC's 1992 single market programme originated in the disillusion generated in the late 70s and early 80s by the attempts of the national governments of the EC Member States to cope individually with the effects of the first two oil shocks. This approach led, as far as the European economies are concerned, from stagflation to slow growth — the so-called Eurosclerosis as it was somewhat complacently described by the US and Japanese media during the first years of the Reagan era.

The EC’s 1992 programme is first of all an attempt to complete the Internal Market by removing all the physical, technical and fiscal barriers which at present criss-cross the Community. The purpose of removing these barriers is to create an economic zone, incorporating all twelve Member States, throughout which people, goods, services and capital can move freely. In this way factors of production will go to where their returns are highest and the free movement of goods and services will stimulate competitive forces and put downward pressure on inflation, so benefitting both consumers and producers.

The achievement of the Internal Market will therefore lead to a better allocation of resources and to a more efficient competitive and dynamic Community economy so creating benefits for all other economies as well. It is already a well-documented fact that the gains from all this in terms of increased growth for the Community economy should be substantial.

Thus the Cecchini report, published in 1988, suggested that the growth
rate of the Community, over a five year period, could be as much as 1 % per annum higher than it would otherwise be. This would lead in particular to increased imports thereby benifitting non-member countries as well.

It is planned that all the necessary legislation to remove the three types of barriers listed above will have been passed into national law by the end of 1992. So far there is every reason to believe that this ambitious programme will be met. Inevitably it is proving difficult for the Member States to reach agreement on every aspect of the programme. Difficulties have arisen, for example in reaching agreement on removing fiscal barriers. The process of fiscal harmonisation and the development of the necessary administrative arrangements to deal with this will clearly take longer than originally envisaged in the 1985 White Paper. However, it is a reasonable assumption that the political will shall be there to resolve these problems and we can expect that at the beginning of 1993 the Community of 12 will be a zone in which goods, services, people and capital circulate without restrictions of any kind.

However, a moments reflection will show that matters cannot just stop there. The removal of physical, technical and fiscal barriers has profound implcations, in particular for the conduct of economic policy. These implications mean that the integration process will not stop once the Internal Market barriers have been removed ; it is bound to go on — it cannot do otherwise. The forces at work here are relatively easy to describe. For example :

The elimination of fiscal and physical barriers not only requires the harmonisation of indirect taxation throughout the Community but makes in any case such harmonisation virtually inescapable. This in turn reduces the room for manoeuvre in fiscal policy.

Member States will not be unable to manipulate indirect tax rates in the interest of demand management, or as a means of meeting public sector budget constraints, as they have done in the past.

The freedom to move capital anywhere means that not only capital taxation but also general monetary and financial conditions must be in harmony throughout the Community — interest rates, credit controls, etc. Moreover, to
ensure orderly capital markets (essential for the creation of a climate of confidence) the currencies of the individual Member States must be convertible, each into others, in a dependable and predictable way. A way that avoids the encouragement of speculative movements and the disruption this would involve.

These two considerations alone show that for the Community, to reap the full benefits of the Internal Market integration process, monetary, fiscal and exchange rate arrangements must be in-line as between countries. This in turn requires the harmonisation of fiscal and monetary policies between Member States and the assurance of stable exchange rates. Going a step further, the ever closer coordination of economic policies must imply or require in the longer term a fixed exchange regime and a substantial move along the path to economic and monetary union.

Therefore the 1992 process has gradually given rise to a more ambitious objective: the building of an Economic and Monetary Union, whose foundations lie in the present EMS and the development of a Political Union.

In December two important conferences will start. The first one starting on December 13th, dealing with Economic and Monetary Union, the second starting on December 14th, on Political Union.

Although the conference on Political Union is important, as it deals both with external policy and institutional reform of which the latter could in turn have a bearing on the decision making process (unanimity versus qualified majority), the following discussion is limited to Economic and Monetary Union.

The meeting of EC Heads of State and Government (European Council) at Hannover in 1988 reaffirmed EMU as a goal for the Community and asked a committee of EC Central Bank governors and some independent experts, chaired by President Delors, to examine and make recommendations on how EMU should be achieved. This Delors Committee reported in early 1989 and set out a blueprint for progress towards EMU in three stages. These stages are summarized below.
## Major features of the three EMU stages

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<td><strong>Stage I</strong></td>
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<td>Completion of the internal market</td>
<td>Capital market liberalization</td>
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<td>Strengthened competition policy</td>
<td>Enhanced monetary and exchange rate co-ordination</td>
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<tr>
<td>Full implementation of the reform of the Structural Funds</td>
<td>Realignments possible, but infrequent</td>
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<td>Enhanced co-ordination and surveillance</td>
<td>All EC currencies in the narrow-band ERM</td>
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<td>Budgetary adjustments in high debt/deficit countries</td>
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The timing of the transition through the stages was viewed largely as a matter of political choice. However, as discussed below, cost / benefit considerations argue for a fast pace of progress towards full EMU.

The Madrid meeting of the European Council discussed the recommendations in the report of the Delors Committee and decided to move ahead to Stage I from 1 July 1990.

As to its basic monetary logic, Stage I is not very different from the EMS of the late 1980s. To complete the membership of the exchange rate mechanism (ERM) is regarded as a vital element for Stage I. That means that both Spain and the UK move to the narrow band of fluctuation and that countries still outside the system (Portugal and Greece) enter. Further convergence of Member States economies is also sought under Stage I. The degree of convergence that needs to be achieved varies from country to country.

Regarding inflation, three broad groups of countries might be distinguished:
1) The original narrow band members are already characterized by a high degree of convergence towards low inflation since inside this group inflation differentials are only about 1%, not far from what is required by EMU.

2) More adjustment in terms of inflation is needed in Italy, Spain and the UK where inflation has now stabilized at a level that is about 3 to 5 percentage points above the best performance in the EC. However, for this group participation in Stage I should be feasible provided the adjustment is seen to continue.

3) In Portugal and Greece inflation is still above 10% so that even participation in Stage I clearly needs more time.

Regarding the need to establish sound public finances, it is again possible to identify three groups of countries:

1) In Denmark, Ireland and the United Kingdom the level of the public debt/GDP ratio is declining and France and Germany are very close to this situation so that in this group of countries budget policy should be under control.

2) In Belgium, Spain and Portugal, the public debt/GDP ratio has not yet been stabilized, but this objective seems to be within reach in the near future.

3) In Greece, Italy and the Netherlands present trends in budgetary policy would lead to a rapid deterioration in the public debt/GDP ratio.

Imbalances need to be addressed during Stage I so as to achieve the necessary convergence for the following stages. Convergence to sound public finances is necessary for a stable EMU in the long run.

As regards how quickly to proceed to Stages II and III, the European Council meeting in Rome last December decided (with the exception of the UK) that Stage II should begin from 1 January 1994 subject to a satisfactory achievement of the aims of Stage I. The Delors Committee report placed emphasis on the gradual transfer in Stage II of responsibility for monetary policy from the Member States to a Community monetary authority, the
EuroFed, a Community Central Bank organized on federal principles.

After discussion, however, the emphasis has since been placed more on the technical preparation of the EuroFed 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.

A committee of Central Bank governors has already completed drafting of a set of legal statutes for the EuroFed.

Detailed discussions are now under way in the inter-governmental conference about these issues and, in particular, when the EuroFed should take charge and implicitly when Stage III, the final stage of EMU, should begin.

The primary economic aim of EMU is to strengthen the integration of the Community and to improve its economic performance. However, due to the Community's weight EMU will also have far-reaching implications for the world economy. The ecu will emerge as a competitor to the dollar as an international currency.

Expansion of the ecu as a vehicle currency will yield some small microeconomic efficiency gains for the EC economy, by reducing transaction costs on the exchange market for trade with non-EC countries (up to 0.05 % of Community GDP), by reducing exchange rate risks due to the development of ecu invoicing (which might increase by about 10 % of EC trade), and also by giving to European banks enlarged opportunities to work in their own currency.

Regarding the official sector, EMU would allow a saving on the exchange reserves of Community Member States, amounting perhaps to USD 200 billion.

As the European currency becomes a vehicle for trade, an increase in the demand for ecu assets can also be expected in financial markets.

EMU will strengthen the Community as an economic policy pole within the world economy because adoption of a common monetary policy under the responsibility of EuroFed will enhance the Community's identity and weight in international policy cooperation. This will be felt in macroeconomic policy coordination within the G7. Monetary coordination at this level can be
expected to become easier, provided the sharing of responsibilities for exchange rate policy between EuroFed and the Council ensures an efficient handling of this policy.

As the Community becomes a policy pole, spill-over effects of domestic policies and therefore the need for coordination at the global level increase. Since the reduction in the number of policy actors would also make it easier to reap coordination gains, EMU could act as an incentive to tighter policy coordination at the global level.

EMU could finally be a decisive building block for a more stable multipolar monetary regime. Monetary cooperation among the G7 countries still falls short of an adequate monetary system.

**The EC integration process and its impact on the international economic system**

**A. Trade**

EC, largest trading power in the world plays a major role in the GATT where the EC speaks with a single voice.

Although its bargaining power is substantial, if not massive, as regards third countries it still has difficulty in dealing internally with the distributional effects of trade liberalisation among the Member States. The EC lacks the instruments — co-ordinated monetary and fiscal policies as well as structural policies — of a full State, such as the USA and Japan, and, therefore cannot exercise active and effective leadershiping the world.

But its commitment to the success of the UR cannot be questioned. Through the successful outcome of the UR, the risk of Fortress Europe and of trade blocks confronting such other will fade away. In that sense, we must see EC 1992 as a step towards multilateral trade liberalisation.

**B. Aid**

The Community is the largest aid donor in the world. A fact not very well-
known. Combined the Community and its Member States disbursed in 1988 almost 22 billion US dollars in development aid, compared to 10 billion US dollars in the case of the USA and 9 billion US dollars in the case of Japan. According to the latest OECD figures, Community aid as a percentage of GDP amounted to 0.5 %, compared to 0.32 % for Japan and 0.15 % for the USA. Moreover, we tend to concentrate our aid effort more on the poorest countries, as compared again to the USA and Japan.

These are the historical facts. We are committed to increase our aid flows. The Lomé IV convention, linking the Community with 68 developing countries in the Africa, the Caribbean and the Pacific, provides for 12 billion ECU in assistance during the 1991 to 1995 period, a real increase of 26 %. Furthermore, the Commission has recently tabled proposals to increase substantially our aid effort for Mediterranean, Asian and Latin American countries.

Quality of aid is important as well. Priorities are changing, with a greater emphasis being given to structural adjustment assistance and economic cooperation through foreign direct investment, scientific and technological cooperation schemes, etc.

Yet, our aid effort at the Community level which is growing in importance and accounts now for 15 % of total Community aid, compared to 12 % only a few years ago. It is not matched by a Community representation in the boards of the multilateral institutions like the World Bank and the regional development banks. The EBRD is an exception, and will hopefully act as a precedent. Here the integration process has not yet exercised any impact. But it will come and it should follow the enhanced role of the Community in the area of development.

C. International economic cooperation

Although there is now ample evidence that domestic policies are the key to the development of LDC's, it is also recognised that for most of them the external economic environment matters a lot.

Hence it is important that industrialised countries which, because of their
sheer, economic weight play a major role in shaping up this environment, pursue efficient domestic policies and cooperate together to improve the world growth performance, and to keep inflation under control. This is done principally in the G7 framework (USA, Canada, Japan, Germany, France, Italy and United Kingdom).

The Community as such, through the Commission and the Presidency of the Council, is represented at the Heads of States and governments Western Economic Summits where general policy orientations are set down. But the EC does not participate in the Finance Ministers G7 which is therefore dominated by the US and Japan. The four European participants play a secondary role compared to the contribution the EC should make to such a debate. The result is all too obvious: the USA and Japan have for years maintained several external imbalances which have, in the case of the USA, contributed to the high real interest rates which have proved devastating for overindebted Third-World countries.

Europe acting together would have the political and economic weight to persuade the USA to bring down their twin deficits and on Japan to open up its markets to manufactured goods exports from the surrounding LDC’s. But if the EC is not yet a full Member of the G7 Club, it is at least making its voice heard in the major international fora where cooperation issues are addressed: UNCTAD, United Nations and conferences on environment (ozone, climate change, tropical forest ...).

More and more often, the Community speaks with a single voice in these international meetings. The main thrust of the European vision is the co-responsibility of industrialised and developing countries in promoting an ecologically and economically sustainable development.

D. Trade diversion or creation?

Viewed from the outside, the completion of the internal market may have negative consequences if it would be accompanied by trade diversion. In the classical theory of economic integration, trade diversion occurs if, through the
formation of a customs union, the common external tariff of the countries forming the union implies that products which were imported from the outside the union under the previous tariff are imported from inside the union afterwards. In empirical analyses of the effects of economic integration, trade diversion is usually assumed to occur if the value of imports from outside the customs union decreases after the formation of the union. The internal market programme does not deal with tariff barriers, but rather with the breakdown of non-tariff barriers (NTBs) inside the Community. Conceptually this is not very much different from the classical integration case, however, and it is therefore no surprise that the partial equilibrium calculations for the direct cost of barriers (which run along the lines of classical integration theory) show decreases in extra-Community imports of 2-2.5% for stage 1 of the direct cost calculations (barriers affecting trade) and 5.5-7.5% for stage 2 (barriers affecting production), together yielding a range of 8-10.5% (cf. Commission of the EC).

The decrease in extra-Community imports implied by the direct, static cost calculations will however diminish if regarded in the context of the economic growth brought about by indirect, market integration effects, which will also benefit producers outside the Community. In the end, even though inter-Community trade will expand much faster, the macroeconomic simulations for the Cecchini report suggest that extra-Community imports could increase as well.

The initial trade-reducing effect of the removal of trade barriers and the trade-enhancing demand increases provoked by the indirect integration effects have led to mixed reactions from the Community’s main trading partners. Positive reactions are associated with the increase in economic activity providing opportunities for extra-EC exporters on the Community-wide market. These reactions arise notably from the industrialised countries, which are well-equipped to compete inside the Community, even though it has been estimated that also the growth rate of the value of exports of developing countries as a consequence of the completion of the internal market could in-
crease permanently by 1%.

The stance of countries such as the United States and Japan with respect to the dismantling of intra-Community NTBs has initially been overshadowed by fears for an increase in barriers towards non-Community countries. These fears mainly concerned two issues. The first relates to the problem that it will not be possible in the internal market to maintain intra-Community border controls ex Art. 115 of the EEC Treaty in order to impose the remaining national import quotas. The main sectors exposed to this problem are those for automobiles and textiles (under the Multifibre Arrangement). Often the fear is expressed that the existing national quantitative restrictions would be transformed into Community-wide restrictions which would possibly be more severe than the average of existing restrictions. Quite apart from the desirability of new Community-wide restrictions (e.g. individual Commissioners have already expressed the opinion that restrictions for cars should disappear in the long run), they would be hard to defend in the context of the GATT, and it is therefore difficult to imagine how the existing restrictions would have to be converted on a Community-wide scale. The second issue concerned the liberalisation of the services sectors and notably financial services, or more generally the issues of national treatment and reciprocity. At present, Community countries have granted each other national treatment in the area of services (Art. 58-66 EEC). Progressively, the principle of national treatment will be replaced by that of mutual recognition, combined with the establishment of minimum prudential rules applicable throughout the Community. In the most widely discussed example so far, the second banking Directive, the increased opportunity for banks from third countries to exercise activities throughout the Community on the basis of establishment in one single country was initially linked to equivalent access for Community banks in the country of the bank seeking access (reciprocity). In the final version of the Directive, on which the Council reached a “common position” in July 1989, the lack of effective market access for banks from Community countries in a third country comparable to that granted by the Community to banks from
that third country is no longer an impediment for access of the latter, but could be a reason to open up negotiations with a view to obtaining comparable competitive opportunities. Only if the absence of effective market access is accompanied by the absence of national treatment this could be a reason, in addition to opening up negotiations, to temporarily limit or suspend any pending or future applications for a banking licence. Moreover, there would not be any measure with retro-active effect. This last clause and the more prudent approach towards the problem of mutual benefits have taken away a considerable amount of fear with respect to possible increases in outside NTBs alongside internal liberalisation.