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Europe 1992 and Beyond*

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I. INTRODUCTION

Jacques Delores, President of the EC-Commission, once referred to the completion of the single European market as a "silent" revolution. Compared to the fundamental reforms in Eastern Europe this certainly holds true. But changes in Western Europe will be substantial as well, since the EC 1992-project to a large extent will turn economic structures and perceptions within the Community upside down.

II. GROWTH AND EMPLOYMENT EFFECTS

A. Higher Growth

Higher growth will result for the Community as a whole. Private consumers and the public-sector will benefit the most. Lower costs when border formalities are eliminated and the opening up of the markets will lead to more efficient production of goods and services due to stronger competitive pressure. Lower prices will increase purchasing power (Pigou-effect) and stimulate demand in real terms. This in turn will give companies the chance to sell more and to make use of economies of scale. In addition, product and process innovations will accelerate due to a broader basis. In the medium term the competitiveness of European industry will significantly improve. This dynamic aspect, which goes beyond the static effects of a one-time reduction in costs, is the ultimate economic reason for establishing the common internal market.

B. Time Profile

The time profile of these positive developments is rather vague. Many people, particularly on the labor market, fear that the transition period will be long and painful before the positive effects manifest themselves. Of course it is always much easier to identify the trouble spots than the potential benefits because it is difficult to obtain an empirical assessment of the advantages generated by closer market integration.

The Cecchini-Report estimates the costs of "non-Europe" at roughly ECU 200 bn representing five percent of the European Commu-

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nity’s (“EC”) gross national product (“GNP”). This figure has been misinterpreted. It does not necessarily mean extra growth of the EC's gross domestic product (“GDP”) rather it is the increase in the productive capacity of the Member States. The expansion of the productive capacity which is essential for any lasting upturn in growth and employment. This enhancement of capacity must be accompanied by a concerted movement in economic policies toward stimulating demand. Such a combination of supply and demand factors can increase the actual growth rate by approximately one percentage point per annum in the first half of the 1990s. In fact, the announcement of the EC 1992 program already accelerated economic growth in Europe during the final years of the eighties. In 1989, for the first time within the last ten years, the European growth rate has exceeded the American growth rate.

Higher growth will create two million or more jobs over the medium term. However, the Commission expects that in the first two years of the internal market job losses will be probable, as workers and capital after displacement face difficulties being reabsorbed in another job. This might be true especially if the single market does not improve the flexibility of the markets. But since it is aimed at improving the flexibility of markets and as investment and demand for skilled labor rises as a result of the preparations for the internal market there is a good chance of avoiding a "worsening" situation before the “final” improvement.

III. SECTORAL AND REGIONAL CONSEQUENCES

The economic consequences of completing the large internal market will be engendered by an improvement in supply-side conditions. These conditions are aimed at achieving a more favorable environment for production and investment competition, and trade. The removal of the non-tariff trade barriers means deregulation or easier market access, throughout Europe. Therefore, the Community’s plans to set up the integrated market are in accordance with the recommendations of international organizations, such as the Organization for Economic Cooperation and Development (“OECD”) or the International Monetary Fund (“IMF”), which have long urged a reduction of rigidities in the European economies, greater flexibility, and more willingness to deregulate, in short more market. EC plans are also in accordance with GATT principles of non-discrimination, even though some transitory measures, such as for car imports, are necessary.

Naturally, the integration of segmented national markets is going to entail adjustment difficulties within certain sectors of the economies. It is in this context that the question of winners and losers, referring to com-

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1 For more details on sectoral impacts see Institut für Wirtschaftsforschung München, Studien zur Industriewirtschaft Nr. 33, München 1988.
panies as well as to branches and countries, of the 1992-program is raised.

A. Companies

There is a widespread misconception that the internal market is to only benefit large firms and it is true that larger groups are already well on the way to "Europeanization." Nevertheless, the single market offers the small and medium-sized firms the possibilities which have previously been reserved for the big players. The abolition of border formalities and technical barriers will make foreign business much easier and will facilitate the transition from a purely domestic enterprise to an export-oriented company. At the same time, however, the companies will have to prepare for more intensive competition in the domestic markets.

The single market necessitates an adjustment in corporate strategies. This requires *inter alia* a review of production ranges, new distribution and logistic systems, and the willingness to participate in cooperative ventures. In association with the latter, the development of a new form of "extended firm" where entities are connected by information and technology networks bringing together a variety of partners from different nations is anticipated. Such solutions might be of greater importance for small and medium sized firms, without much previous international experience. In any case, the single market calls for more flexibility and creativity in companies of any size.

B. Sectors

Looking at the impact on sectors it is obvious that, first and foremost, those which were previously protected from competition will now have to reckon with increasing pressure from rivals in other partner countries. The Commission's Cecchini-Report enlists 40 sectors out of 120, representing 50% of the industrial value added, which will have to face severe adjustment processes. Those sectors are characterized by four factors: 1) large price differences among the countries; 2) many non-tariff barriers; 3) small cross-border trade; and 4) low international competitiveness. These descriptions especially apply to service areas that have been strongly regulated. These areas include road and air transportation, telecommunications, the insurance industry, and in some countries the banking sector. Those branches - and within the manufacturing industry it is the majority - which are already large-scale suppliers of the European market are less likely to be affected by the changes in the economic environment as far as internal EC adjustments are concerned.²

To predict the distribution of gains between the countries is even

² *Id.*
more difficult. On the one hand regions that will benefit from the single market are those which already maintain a good infrastructure and a high share of growth-orientated service industries or "light" industries with a modest burden on the environment. This argument gives the expectation of disproportional gain in the present centers. On the other hand, the chance for the periphery to gain is obvious in labor and land intensive production, thus hollowing out the industrial and agricultural base of the centers. Therefore, the preferential advantages of the periphery are in the exploitation of comparative cost advantages rather than demanding resources from the EC such as regional and structural funds. Spain is a good example of how the improvement of economic conditions may work with its high attraction of foreign investment. In summary, as the Member States start from different positions there are possible gains from a better division of labor, with labor intensive industries moving to the periphery and, on a limited scale, labor saving industries moving to the center. This reallocation will improve the welfare of all in the long-run, but will be potentially painful to some countries during the transition period. Although not all European countries will be equally affected, none will lose out in comparison with a non-integration-scenario because the single market is not going to be a "zero-sum game" in which market shares are merely redistributed.

IV. WITHIN THE TIME SCHEDULE

Doubts are mounting regarding the Communities ability to meet its time schedule for the completion of the single market. The EC-Commission has compiled 90% of the necessary measures listed in the White Paper. Almost two-thirds of these measures have already been adopted by the EC-Council of Ministers. Every time another step is taken it reinforces the target and certainty of achievement that adds to the cycle of economic pressure to move ahead in the Community.

Nevertheless, it is safe to assume that the EC will encounter some setbacks along the way. One case is in the harmonization of indirect taxes such as VAT and excise duties. The different proposals of the Commission have been refused by most of the Member States. The Commission has to find a compromise between two almost incompatible requirements: 1) to allow for the smallest budgetary effect for each of the Member States which would lead to a small degree of convergence; and 2) to achieve the smallest distortion of competition in the single market which, on the contrary, would require full harmonization. A final decision has been postponed until after 1992. But if the border controls are to disappear a compromise in time before that date is essential, otherwise there will be a massive shift in buying from high-tax to low-tax
Europe will complete its internal market, perhaps not by 1992, but certainly before the mid-90s. Market forces are driving at it and political strategies are reinforcing it. Industry is now planning and reorganizing on the basis of an integrated market. A lot of money is currently being invested in 1992. This indicates that the idea has developed so much momentum on its own that, notwithstanding political problems, the completion of the single market may be a self-fulfilling prophecy.

V. Framework of the Single Market

Aside from the measures mentioned in the White Paper there are a few that are politically essential preconditions to the realization of the potential welfare gains of the single market. The first is a liberal trade policy. As with any regional trade integration, the promotion of trade within this area leads to the displacement of trade somewhere in the rest of the world; trade diversion. In this sense, a certain negative impact on non-EC-countries is hardly avoidable. Even though the natural way to reduce such an effect is to replace trade in goods by capital mobility, which has already been done by an increasing number of non-EC-companies, as rising foreign investment in the Community shows, it is absolutely necessary to keep borders open not only within the EC but also vis-à-vis third countries. Some Member States still believe it is necessary to account for the adjustment pressure the single market imposes on them by applying restrictions on imports from third countries. The imports of Japanese cars are an appropriate example in this regard. But experience shows the protection of industry has not resulted in higher efficiency. On the contrary, the gains in efficiency and the entrepreneurial spirit in those industries have always been very remote and the welfare losses for the rest of the economy have been high. Therefore, the Community would relinquish much of the expected prosperity benefits if the single market were only realized at the cost of higher protection against imports outside the community. This is one reason why the EC-Commission has been reluctant to decide on binding directives on trade policy.

The single market will also bring advantages to companies from third countries. Europe is the world’s most important region for international trade, well ahead of the United States and Japan. The EC is also the world’s largest importer. Therefore, the expected growth stimulus from the single market will have an immediate world-wide impact. Another positive impact on nations outside the EC will be that a harmonized Europe will enlarge opportunities for third country companies.

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since they, like any firm from within the EC, can supply the EC market with uniform products, under unified rules.

The second prerequisite for the successful completion of the unified market is a firm and coherent competition policy tailored to the dimensions of a single market. Again, as in the discussion on trade policy, some countries tend to mix up industrial policy and competition policy. Opinions are divided over whether the main emphasis should be on enhancing competition or on facilitating industrial rationalization through EC-wide and national mergers. Germany clearly prefers competition over industrial policy initiatives supposedly designed to bolster the competitiveness of specific companies or sectors. The fact that the proposal of the EC-Commission on crossfrontier acquisitions and mergers has taken almost sixteen years of discussion before a compromise could be found at the end of last year is a reflection of these divergent attitudes.

The third issue is the so called "social dimension" of the single market. Several Member States feel it is necessary to harmonize the security regulations and wage policies in order to support the adjustment processes within the Community. But this institutional approach would reduce flexibility which is necessary to successfully promote structural change. Wage differentials in the Community have to be conceded in order to allow countries like Spain and Portugal to maintain and improve their economic competitiveness and close the gap between the richer and poorer EC Member States.

VI. PROGRESS IN THE FINANCIAL INTEGRATION

More than one-third of the estimated welfare gains of the single market are expected from the liberalization of the financial markets where average cost or price reductions of ten percent are believed to be possible. The Cecchini-Report concludes that the liberalization of financial services in the EC will, in the medium term, enable the GDP to rise by 1.5%.

Even though this may be somewhat optimistic the financial sector is undoubtedly a key element of the infrastructure and its quality is a crucial factor in determining the strength of the European economy. In fact, banks and insurance companies have been outgrowing the rest of the economy for quite some time; recent statistics put their share of the Community’s GDP at seven percent a share and it is likely to increase in the future.

For the German banks that are already involved in European and international business the starting position appears to be relatively favorable. One reason is the strong position of the German economy

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within the EC. Its share of the GNP of the twelve Member States is more than one quarter. Another reason is that Germany profits from the international importance of the Bundesbank. In particular, it profits from its dominating role in the European Monetary System ("EMS"). The fact that this view is shared by others is reflected by the strong influx of foreign banks. In Frankfurt alone there are almost 250 foreign banks compared with roughly 150 German institutions.

This is an indication of the traditional openness of the German banking market. Therefore, it can be expected that Europe 1992 will not confront German banks with any major competitive "shocks" since they are used to living with a high degree of competition.

Another reason the position of Germany is dynamic going into 1992 is in the strength of the German stocks and bonds market. Their turnover came third in the world-league in 1988, after Tokyo and New York. Nevertheless, the market capitalization on the German stock exchanges is low in the international arena. It goes without saying that London is, at present, the only financial center in Europe of the same importance as New York and Tokyo. Undoubtedly, however, the financial centers on the European Continent will gain in importance in case the United Kingdom keeps its reservations against European monetary integration. Frankfurt would then have a chance to become number one in the single European market.

Steps have been taken to improve the international standing of Germany's financial market. The Germans led the well-known British magazine "The Economist" to talk about a "modest revolution" in the Federal Republic. Its beginnings go back to the so-called "residual liberalization" when in the spring of 1985 new capital market instruments such as zero bonds, floating rate notes, and dual currency bonds were admitted in Germany. Further steps have been taken in the last few years. The abolition of the ten percent withholding tax in mid-1989 was a clear sign that the government of the Federal Republic saw the need to improve the German financial market position within the single European market. Another important example was the initiative to establish a German options and futures exchange. It was operating by the beginning of 1990. Investors in the Federal Republic are now able to hedge their portfolios using financial futures and options.

All this means that the prospects for the German banks to do business on their home market are improving. For German banks it is equally important, that Europe 1992 will open up additional fields of business. For banks in particular the single market is a great challenge. It is a great challenge because first, they have to support companies and consumers in the new surroundings by consulting them and financing new ventures. Second, the regulatory environment for the banks themselves will change. Despite some details still to be resolved, one can say
that the structures of the EC financial market are becoming much clearer than those of other areas of the single market.

The free and unfettered financial EC-market will be based on three prerequisites:
- the elimination of all capital controls;
- the right to sell financial services across borders; and
- the complete freedom of establishment for the suppliers of financial services.

Thanks to the new dynamism in integration policy, a number of steps toward satisfying these requirements have already been taken or are being prepared.

Of particular significance in this context is the directive on the complete liberalization of capital movements in the Community by mid-1990 with longer transition periods for Spain, Portugal, Greece, and Ireland. Some basic changes in banking law in the EC are also under way. The EC directive on a bank's own capital has recently been adopted and the Second Banking Directive was passed by the Council of Ministers. Germany is satisfied that the Commission's original proposal, which was a rather rigid and potentially protectionist instrument, has been removed. It met heavy criticism not only from American banks, but also from the British, Dutch, and German governments. The new revised proposals are more liberal and more workable. It now appears that reciprocity will be used as a weapon of last resort only to gain equal access for European banks in third countries.

Despite some criticism the German banks can be content with the changes being brought about by EC banking law. The Second Banking Directive allowing the full scope of universal banking under one roof is very important to them. That means they can offer their broad range of services to private and corporate customers all over Europe; new opportunities are waiting to be tapped. However, care must be taken to ensure that the planned Directives on specialized securities houses will not lead to a competitive disadvantage of the universal banks' investment banking business. Generally, the EC-Commission should apply to the principle of "same business - same risk - same rules."

VII. CONCLUSION

The completion of the single market is not the end of the road. The smooth functioning of a Europe without frontiers will depend on an even greater coordination of economic and monetary policies as formally in-

cluded in the Single European Act. If the EC is to achieve a truly dynamic and integrated financial market, it will have to deal with a number of difficult issues. First is the task of broadening the membership of the EMS where invitations to join have been constantly refused (Pound Sterling) and the task of choosing new EC-members among those that are anxious to join the EMS at least by 1992. The second question is whether to create a European central bank and a European common currency.

There is no doubt that even with the single market and well-functioning EMS trade, 1992 will still be hampered by currency risks as well as transaction costs and will be distorted by divergent cost and price developments due to diverging macro-policies. The full benefits of a single European market will not be forthcoming unless there is a common European currency designed to pre-empt recurrent exchange rate fluctuations and a possible relapse into exchange rate controls.

The report of the Delors Committee proposes a number of practical steps on the way toward monetary union. The main preconditions for a monetary union with a European central bank ("ECB") have been agreed upon. The report states that:
- the ECB should be independent from political institutions;
- the system would be committed to the objective of price stability;
- it would have a federate structure since this would correspond best to the political diversity of the Community; and
- monetary financing of budget deficits should not be allowed.

The report does not give a deadline as to when the proposed series of steps should be implemented. However, at the last summit in December, 1989 the politicians decided to start with the first stage of increased institutionalized consultations for the monetary union in July, 1990. Still, the attitudes of the Member States toward the goal of a monetary union cover a wide range, from complete rejection to enthusiastic reception. That some countries have reacted with reserve, to say the least, is not surprising since the autonomy of national institutions is at stake here. By definition, there can be no independent monetary policy in a currency union. Instead, with much of the ability of conducting an independent monetary policy gone a growing role of fiscal policy is perceived. In principle, fiscal policy's independence is preserved in the new regime. In practice, however, fiscal policy is likely to be restricted especially in countries with high deficits, such as Italy. Therefore, the decisive question is whether the governments are prepared to surrender sovereignty to a supranational institution. Quite a few doubts still exist concerning this surrender of sovereign power.

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Monetary union is a long-term goal rather than something to be settled by the end of 1992. On the other hand, EC governments and central banks may soon understand that most of the national sovereignty has already become an illusion. Open borders for goods and capital are inconsistent with divergent national policies if recurring and divergent capital flows are to be avoided. Thus, steps to monetary union are less revolutionary than originally perceived.

The repercussions of the single European market go far beyond any assessment of the direct effects of the measures set forth in the White Paper. The incidental pressure of the Single European Act will have a potentially enormous effect. 1992 is a grand scale European-style supply-side program; it looks as though it could set the ball rolling for the restructuring of firms, branches, and economies on a continental scale and by doing so improve European and worldwide welfare.